

2016 Tax Symposium

Friday, September 23, 2016



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Presenter Biographies

2016 Tax Law Symposium Presenter Biographies

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Prior to joining IRS-CI he was a police officer with the City of Baltimore from June 1999 through 2001. He started with IRS-CI in January 2002 assigned to, what was then, the Baltimore Field Office working out of Washington, DC. As a criminal investigator, and conducted a wide array of financial investigations involving tax evasion and money laundering crimes. He was also detailed to the FBI's Joint Terrorism Task Force within their Washington, D.C., Field Office for almost 3 years. In October 2009 Rick took a senior analyst position in headquarters in the Operations Policy & Support section before moving over to the Strategy section. As a senior analyst, he worked on a variety issues and responsibilities; ranging from Continuity of Operations to Equipment and Vehicles to assisting with the Commissioner's Protection Detail and providing Use of Force training. In February 2015 he started in his current position as the Supervisory Special Agent for New Mexico which is part of the Phoenix Field Office. In this current leadership role he is responsible for CI's investigative and operational activity in New Mexico and ensures collaboration with all Federal, State and local law enforcement agencies and is a liaison with public and private entities.

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Federal Tax Update

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

“Recent developments are just like ancient history, except they happened less long ago.”

By

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Note: This outline was prepared jointly with Martin J. McMahon, Jr., James J. Freeland Eminent Scholar in Taxation and Professor of Law, University of Florida College of Law, Gainesville, FL.

This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code generally are not discussed except to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected previously issued rulings and regulations otherwise covered by the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

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I. ACCOUNTING

A. Accounting Methods

1. Howard Hughes may have died nearly 40 years ago, but his successors are still trying to fly the Spruce Goose. Howard Hughes Co., LLC v. Commissioner, 142 T.C. 355 (6/2/14), *amended and superseded by* 2014 WL 10077466 (6/2/14). The taxpayer was in the residential land development business. The taxpayer generally sold land through bulk sales, pad sales, finished lot sales, and custom lot sales. In bulk sales, it developed raw land into villages and sold an entire village to a builder. In pad sales, it developed villages into parcels and sold the parcels to builders. In finished lot sales, it developed parcels into lots and sold whole parcels of finished lots to builders. In custom lot sales, it sold individual lots to individual purchasers or custom home builders, who then constructed homes. The taxpayer never constructed any residential dwelling units on the land it sold. The taxpayer reported income from purchase and sale agreements under the § 460 completed contract method of accounting—generally when it had incurred 95 percent of the estimated costs allocable to each sales agreement. The IRS took the position that the land sales contracts were not home construction contracts within the meaning of § 460(e) and that the bulk sale and custom lot contracts were not long-term construction contracts eligible for the percentage of completion method of accounting under § 460. (The IRS conceded that the other contracts were long-term construction contracts.) The Tax Court (Judge Wherry) held that the bulk sale and custom lot contracts were long-term construction contracts under § 460(f)(1), and that the taxpayer could report gain or loss from those contracts on the appropriate long-term method of accounting to the extent it had not completed the contracts within a year of entering into them. The contracts included more than just the sale of lots. The costs incurred for a custom lot contract are not really different from the costs for the finished lot sales. The contracts included development of things such as water service, traffic signals, landscaping, and construction of parks, which did not necessarily occur prior to the closing. Completion of the contracts thus occurred upon final completion and acceptance of the improvements, the cost of which was allocable to the custom lot contracts. However, none of the contracts qualified as home construction contracts eligible for the completed contract reporting method under § 460(e). In relevant part, § 460(e)(6) defines a home construction contract as follows:

(A) Home construction contract. -- The term “home construction contract” means any construction contract if 80 percent or more of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities referred to in paragraph (4) with respect to —

(i) dwelling units (as defined in section 168(e)(2)(A)(ii)) contained in buildings containing 4 or fewer dwelling units (as so defined), and

(ii) improvements to real property directly related to such dwelling units and located on the site of such dwelling units.

The taxpayer argued the costs met the “80 percent test” applied to determine whether the land sales contracts met the definition in § 460(e)(6). At the end of a long analysis of the statutory language, the regulations, and the legislative history, Judge Wherry concluded that the contracts did not qualify as home construction contracts. The taxpayer’s costs were, if anything, common improvement costs. The taxpayer did not incur any costs with respect to any home’s “structural, physical construction.” The costs were not “costs for improvements ‘located on’ or ‘located at’ the site of the homes.” Accordingly, the costs could not be included in testing whether 80 percent of their allocable contract costs are attributable to the dwelling units and real property improvements directly related to and located on the site of the yet to be constructed dwelling units.

Our Opinion today draws a bright line. A taxpayer’s contract can qualify as a home construction contract only if the taxpayer builds, constructs, reconstructs, rehabilitates, or installs integral components to dwelling units or real property improvements directly related to and located on the site of such dwelling units. It is not enough for the taxpayer to merely pave the road leading to the home, though that may be necessary to the ultimate sale and use of a home. If we allow taxpayers who have construction costs that merely benefit a home that may or may not be built, to use the completed contract method of accounting, then there is no telling how attenuated the costs may be and how long deferral of income may last.

a. And spruce doesn’t grow in the deep South; it’s piney woods down there. *Howard Hughes Co., L.L.C. v. Commissioner*, 805 F.3d 175 (5th Cir. 10/27/15). The Fifth Circuit, in an opinion by Judge King, affirmed the Tax Court’s holding. “A plain reading of [§ 460(e)(6)(A)(i)] supports the Tax Court’s holding. ... [A] taxpayer seeking to use the completed contract method must be engaged in construction, reconstruction, rehabilitation, or installation of an integral component of a home or apartment.” Because the costs taxpayer incurred were “‘not the actual homes’ structural, physical construction costs,’ or were not related to work on dwelling units,” taxpayer did not come within § 460(e)(6)(A)(i). Taxpayer’s construction activities for common improvements were not ‘located on the site of such dwelling units,’ and thus not within § 460(e)(6)(A)(ii). The statute requires more than “some causal relationship between the dwelling units and construction costs incurred.”

2. An attempt to transmute ordinary income to capital gain founders on the accounting method change rules. *Greiner v. United States*, 122 Fed. Cl. 139 (7/22/15). The taxpayer received a stream of contingent payments from an acquiring corporation in exchange for surrendering his compensatory stock options in the target. After reporting the payments as ordinary income under the open transaction doctrine for six years, he sought to change to the closed transaction method, reporting as ordinary income the estimated fair market value of the income stream in the year of the exchange, followed by a return of capital and long-term capital gains as payments were received. The Court of Federal Claims (Judge Campbell-Smith) agreed with the government that the refund was properly denied because the change of reporting method from open transaction to closed transaction was a change of accounting method for which permission had not been sought under § 446(e). Regardless of which method was used, the

amount of total income reported over the years was the same, but the amount (as well as the character) of the income reported in each year differed.

a. **Affirmed without opinion.** Greiner v. United States, ___ Fed. Appx. ___, 2016 WL 3196753 (Fed. Cir. 6/9/16). Without issuing an opinion, the Federal Circuit affirmed the decision of the Court of Federal Claims.

3. **Insurance company, insurance policy? The IRS and the Tax Court never seem to agree on what's what, but the Tax Court continues to show its love for insurance.** R.V.I. Guaranty Co., Ltd. v. Commissioner, 145 T.C. No. 9 (9/21/15). The taxpayer sold "residual value insurance" contracts (hence the name "RVI") to customers such as leasing companies, manufacturers, and financial institutions that were the lessors of property or provided financing for the leases. The insured assets insured included passenger vehicles, commercial real estate, and commercial equipment. When pricing a lease, a lessor estimates the residual value that the asset will have when it is returned at the end of the lease. The contracts sold by the taxpayer insured against the risk that the actual value of the asset upon termination of the lease would be significantly lower than the expected value. The IRS determined that the contracts were not insurance for federal income tax purposes and disallowed the use of insurance company accounting under § 832, asserting that the lessors were purchasing protection against an investment risk, not an insurance risk. The Tax Court (Judge Lauber) held that the risks insured by the policies were insurance risks and that the policies were insurance contracts for federal income tax purposes. The contracts involved both risk shifting and risk distribution. The court rejected the IRS's argument that the policies did not transfer enough risk of loss because losses were relatively unlikely to occur. "This argument is unpersuasive on both theoretical and evidentiary grounds. Both parties' experts analogized the RVI policies to 'catastrophic' insurance coverage, which insures against earthquakes, major hurricanes, and other low-frequency, high-severity risks. An insurer may go many years without paying an earthquake claim; this does not mean that the insurer is failing to provide 'insurance.'" The court also rejected the IRS's argument that the policies did "not sufficiently distribute risk because some systemic risks, like major recessions, could cause insured assets to decline in value simultaneously, reasoning that "[l]ike most insurers, [RVI] did face certain systemic risks, but many of the risks against which it insured were uncorrelated." Further, "[t]he legal requirement for 'insurance' is that there be meaningful risk distribution; perfect independence of risks is not required." The court also rejected the IRS's argument that the contracts were not insurance because the contracts did not indemnify the purchasers against a loss that was both fortuitous, such as an unexpected calamity, and the timing of which was uncertain. The court analogized the residual value policies to mortgage guaranty and municipal bond insurance. Furthermore, the states in which the taxpayer did business treated the contracts as insurance policies, not as indemnification for investment losses. Thus the § 832 insurance accounting method used by the taxpayer was upheld.

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

1. **This Eagle's wings got clipped.** Giant Eagle, Inc. v. Commissioner, T.C. Memo. 2014-146 (7/23/14). The taxpayer owned and operated supermarkets and gas stations. It offered a customer loyalty program by which customers making qualifying purchases at the supermarket could earn "fuelperks!" that were redeemable for a discount against the purchase price of gas at the gas stations. The taxpayer, which used the accrual method, claimed deductions for certain unredeemed fuelperks! for the years at issue. The Tax Court (Judge Haines) disallowed the deductions because the "all events" test of § 461 had not been satisfied. The redemption of fuelperks! was structured as a discount against the purchase price of gas, and the purchase of gas was necessarily a condition precedent to the redemption of fuelperks! The court declined to analogize the fuelperks! to trading stamps or premium coupons "redeemable in merchandise, cash, or other property" issued by a retailer which under Reg. § 1.451-4(a)(1) can offset income in the year issued, applying Rev. Rul. 78-212, 1978-1 C.B. 139, in which the IRS

ruled that a taxpayer using the accrual method of accounting and that with the sale of products issued coupons that could be redeemed for a discount on the sale prices of products purchased in the future could not apply Reg. § 1.451-4(a)(1); those coupons were not “redeemable in merchandise, cash, or other property” because the redemption of the coupons was conditioned on an additional purchase of the retailer’s product by the consumer.

a. But the Eagle soars in the Third Circuit. Giant Eagle, Inc. v. Commissioner, 822 F.3d 666 (3d Cir. 5/6/16). The Third Circuit, in an opinion (2-1) by Judge Roth, reversed the Tax Court and allowed a current deduction in the year the “fuelperks!” were issued. The Court of Appeals looked to the Pennsylvania common law of unilateral contracts and concluded that the evidence established “the existence—as of year’s end—of both an absolute liability and a near-certainty that the liability would soon be discharged by payment.” Accrued fuelperks! were not expressly permitted to be, and never had been, retracted by Giant Eagle. Relying on *Lukins Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971), the court concluded that “it is irrelevant that neither the total amount of Giant Eagle’s anticipated liability nor the identity of all the customers who eventually applied discounts toward gasoline purchases could be conclusively identified at year’s end.”

- Judge Hardiman dissented. He concluded that Giant Eagle’s liabilities accrued under its fuelperks! program were not absolute; the fuelperks! had an expiration date. Therefore, the “all events” test had not been satisfied. “[T]he question for our resolution is whether Giant Eagle’s liability to any individual shopper with accrued-but-not-yet-redeemed fuelperks! was certain to continue under the rules applicable to that liability until it was paid. Because one of those rules allowed for the expiration of each shopper’s fuelperks! (and Giant Eagle’s corresponding liability to that shopper), the answer is plainly ‘no.’ While Giant Eagle became liable to a shopper at checkout, it did not become absolutely liable to that shopper unless and until the shopper redeemed fuelperks! prior to their expiration.”

2. The duty of consistency required the taxpayer to include in income for 2009 gross receipts properly reportable in 2008. Squeri v. Commissioner, T.C. Memo. 2016-116 (6/15/16). In four consolidated cases, the taxpayers were shareholders of a cash-basis subchapter S corporation. The S corporation determined the gross receipts that it reported on Form 1120S using the deposits made into its bank accounts during the calendar year. For example, it determined its gross receipts for 2010 with reference to amounts deposited in its bank account in 2010, even though some of the checks deposited in January 2010 had been received in 2009, and even though some checks received in late 2010 were not deposited until January 2011. The IRS issued a notice of deficiency in which it determined that the S corporation had improperly computed its gross receipts. For the years 2010 and 2011, the IRS adjusted the gross receipts by excluding deposited amounts that had been received in the prior year and including amounts that had been received during the year but deposited in the following year. For example, the IRS reduced 2010 gross receipts by excluding amounts deposited in January 2010 that had been received in 2009, and increased 2010 gross receipts by including amounts that had been received in 2010 but deposited in January 2011. However, for 2009, the IRS did not make any adjustments. The taxpayers argued that 2009 gross receipts should be reduced by amounts deposited in January 2009 that had been received in 2008. The year 2008 was not before the court and the period of limitations on assessment for 2008 had expired. The Tax Court (Judge Kerrigan) held that, although the gross receipts received in 2008 and deposited in 2009 were properly reportable as gross receipts for 2008, the duty of consistency required the taxpayer to report the gross receipts in 2009. The duty of consistency is an equitable doctrine that prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the limitations period for the earlier year has expired. As applied by the U.S. Court of Appeals for the Ninth Circuit, to which this decision is appealable, the duty of consistency has three elements: (1) a representation or report by the taxpayer, (2) reliance by the IRS, and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the IRS. These elements, the court held, were satisfied by the taxpayer’s filing of Form 1120S reporting the

gross receipts for 2009, the IRS's acceptance of the 2008 return that did not reflect the gross receipts, and the expiration of the period of limitations on assessment for 2008.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. **Oops, an old revenue ruling is discovered no longer to get it right in light of subsequent legislation.** Revenue Ruling 2016-15, 2016-26 I.R.B. 1060 (6/10/16). This revenue ruling clarifies when a real estate developer may exclude COD income under the qualified real property business indebtedness (QRPBI) exclusion in § 108(a)(1)(D). Indebtedness incurred or assumed in connection with property held by a real estate developer as rental property qualifies as QRPBI because the property is depreciable. But because property held for sale to customers is not depreciable, indebtedness incurred or assumed in connection with property held for sale to customers is not QRPBI, and thus any cancellation of debt with respect to such property is not excludable under § 108. Rev. Rul. 76-86, 1976-1 C.B. 37, which relied on prior law under §§ 108 and 1017 to conclude that a taxpayer could exclude income arising from the cancellation of debt incurred to purchase merchandise for resale, is obsolete.

2. **Transparent insolvency for disregarded entities, and a push by the IRS to encourage partners to file for bankruptcy along with their partnership.** T.D. 9771, Guidance under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 81 F.R. 37504 (6/10/16). The Treasury Department and IRS have finalized Reg. § 1.108-9, proposed in REG-154159-09, Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity, 76 F.R. 20593 (4/13/11). Reg. § 1.108-9(a) provides that, for purposes of applying § 108(a)(1)(A) and (B), the bankruptcy and insolvency exclusions, to discharge of indebtedness income of a grantor trust or a disregarded entity, the term "taxpayer," as used in § 108(a)(1) and (d)(1) through (3), refers to the owner(s) of the grantor trust or disregarded entity. Reg. § 1.108-9(a)(2), which was not in the proposed regulations, but which was added in the final regulations, specifically provides that the bankruptcy and insolvency exclusions (I.R.C. § 108(a)(1)(A) and (B)) are applied at the partner and not the partnership level, and Reg. § 1.108-9(c)(4), through a cross reference to 11 U.S.C. § 101(13), provides that "The term 'debtor' means person or municipality concerning which a case under this title has been commenced." Thus, the owner of the grantor trust or disregarded entity must itself be under the jurisdiction of the court in a title 11 case as the title 11 debtor to qualify for the bankruptcy exclusion.

- The preamble emphasizes the IRS's nonacquiescence, AOD 2015-01, in the *Gracia* Cases (*Gracia v. Commissioner*, T.C. Memo. 2004-147; *Mirarchi v. Commissioner*, T.C. Memo. 2004-148; *Price v. Commissioner*, T.C. Memo. 2004-149; *Estate of Martinez v. Commissioner*, T.C. Memo. 2004-150 (collectively)) in which the Tax Court held that partners who as a result of being general partners were under the jurisdiction of a bankruptcy court as part of the proceedings regarding the partnership, but who were not debtors, could take advantage of the bankruptcy exclusion in § 108(a)(1)(A). Together Reg. § 1.108-9(a)(2) and (c)(4) prevent a partner who was not a debtor in bankruptcy in his individual capacity to claim an exclusion for his shares of the partnership COD income under § 108(a)(1)(A).

- Even though the issue is not addressed in the regulations, the preamble states that Treasury and the IRS "are of the view that indebtedness of a grantor trust or a disregarded entity is indebtedness of the owner for purposes of section 108(d)(1); assuming the owner has not guaranteed the indebtedness and is not otherwise liable for the indebtedness under applicable law, such indebtedness should generally be treated as nonrecourse indebtedness for purposes of applying the section 108(a)(1)(B) insolvency exclusion." The principles of Rev. Rul. 92-53, 1992-2 C.B. 48 apply to determine the extent to which the debt is taken into account in determining the owner's insolvency under § 108(d)(3).

B. Deductible Expenses versus Capitalization

1. **Custom homes are no different from spec houses; both are subject to the uniform cost capitalization rules.** *Frontier Custom Builders, Inc. v. Commissioner*, T.C.

Memo. 2013-231 (9/30/13). The taxpayer corporation constructed custom homes. It argued that its business model was centered around sales and marketing rather than production related services and asserted that employee salaries and other indirect expenses were not subject to capitalization under § 263A. The Tax Court (Judge Goeke) disagreed. The court stated that the taxpayer's creative design of homes "is ancillary to the physical work and is as much a part of a development project as digging a foundation or completing a structure's frame." Thus the court found that the taxpayer was a producer of property subject to § 263A's capitalization requirements. The court also held that the IRS did not abuse its discretion by treating the taxpayer's deduction of production expenses as an accounting method and requiring the taxpayer to adopt the simplified production and simplified service cost methods of accounting under Reg. §§ 1.263A-2(b)(1) and 1.263A-1(h)(1). The court required an allocation of salaries, bonuses and other expense items between indirect expenses subject to capitalization and operating expenses currently deductible.

a. The Fifth Circuit sees it uniformly. Frontier Custom Builders, Inc. v. Commissioner, 626 Fed. Appx. 89 (5th Cir. 9/16/15). In a per curiam opinion, the Fifth Circuit affirmed the Tax Court's decision. Most of the costs in question were for employee salaries and year-end bonuses, including \$1.3 million in total compensation paid to the taxpayer's founder and CEO. The Fifth Circuit rejected the taxpayer's arguments that it was exempt from the requirements of § 263A because its primary business was sales and marketing (rather than production-related services) and that, even if it was subject to § 263A, the CEO's compensation need not be capitalized because his work related to overall management, marketing, and business planning. The court concluded that his activities were sufficient to support the IRS's position that his compensation must be capitalized. These activities included "selecting developers and reviewing subcontractors; resolving issues that arose at worksites during production; selecting and installing the home design software; meeting weekly with project managers to stay apprised of production timelines; and evaluating project managers' productivity reports."

2. "Candy, Cigarettes, and . . . ?" City Line Candy & Tobacco Corp. v. Commissioner, 141 T.C. 414 (11/19/13). Section 263A(b)(2)(B) provides a small reseller exception to the § 263A uniform capitalization rules, which applies to businesses acquiring goods for resale if the firm's average annual gross receipts for the three-year period immediately preceding the taxable year do not exceed \$10 million. The Tax Court (Judge Marvel) held that, for purposes of determining eligibility for the § 263A(b)(2)(B) small reseller exception, the gross receipts of a cigarette wholesaler included the entire sale proceeds from the sale of cigarettes, including the costs of the state cigarette tax stamps the wholesaler was required to purchase. As a result, the wholesaler's gross receipts exceeded the \$10 million ceiling. The cigarette stamp tax costs were indirect costs under Reg. § 1.263A-1(e)(3)(i), properly characterized as handling costs, not selling expenses, which Reg. § 1.263A-1(e)(3)(iii)(A) exempts from the capitalization requirement.

a. The taxpayer gets smoked in the Second Circuit as well. City Line Candy & Tobacco Corp. v. Commissioner, 624 Fed. Appx. 784 (2d Cir. 9/30/15). In a summary order, the Second Circuit affirmed and concluded that the Tax Court correctly included the value of the cigarette tax stamps in the taxpayer's gross receipts for purposes of determining eligibility for the small reseller exception of § 263A(b)(2)(B). Therefore, the taxpayer was subject to the uniform capitalization rules. The court also held that, under the uniform capitalization rules, the taxpayer could not deduct the cost of the tax stamps, but instead had to capitalize the cost as an indirect cost.

3. A generous safe-harbor accounting method to encourage retailers and restaurateurs to "remodel-refresh." Whether K-Mart will make any effort to match the ambiance of Le Targét is still doubtful. Rev. Proc. 2015-56, 2015-49 I.R.B. 827 (11/19/15). This revenue procedure provides certain taxpayers operating a retail establishment or a restaurant with a formulaic "remodel-refresh" safe harbor method of accounting (which is too complex to explain here) for determining whether expenditures paid or incurred to remodel or refresh a retail or restaurant building are deductible under § 162(a), must be capitalized as improvements under § 263(a), or must be capitalized as the costs of property produced by the taxpayer for use in its

trade or business under § 263A. It also provides procedures for obtaining automatic consent to change to the permitted safe harbor method. The revenue procedure is effective for taxable years beginning on or after 1/1/14.

4. A “de minimis” capital expenditure that can be expensed now exceeds the cost of Professor McMahon’s first new car, purchased in 1974. Notice 2015-82, 2015-50 I.R.B. 859 (11/24/15). Reg. § 1.263(a)-1(f) provides a de minimis safe harbor election that permits a taxpayer to not capitalize, or treat as a material or supply, certain amounts paid for tangible property that it acquires or produces during the taxable year provided the taxpayer meets certain requirements and the property does not exceed certain dollar limitations. This Notice increases from \$500 to \$2,500 the de minimis safe harbor limit in Reg. § 1.263(a)-1(f)(1)(ii)(D) for a taxpayer without an applicable financial statement. (In contrast, the limit for a taxpayer with an applicable financial statement is \$5,000.) The notice is effective for expenditures incurred during tax years beginning on or after 1/1/16, but the notice provides audit protection by stating that the IRS will not challenge a taxpayer without an applicable financial statement who deducts an amount not in excess of \$2,500 under the de minimis safe harbor for prior years.

C. Reasonable Compensation

1. It’s not as easy as you think to legitimately zero out the income on a large professional services corporation. Brinks Gilson & Lione A Professional Corporation v. Commissioner, T.C. Memo. 2016-20 (2/10/16). The Tax Court (Judge Halpern) upheld accuracy-related penalties imposed on an incorporated law firm for mischaracterizing, as compensation for services, dividends paid to shareholder-attorneys on the ground that the taxpayer lacked substantial authority for its treatment of payments as compensation and failed to show reasonable cause and that it acted in good faith. The analysis of the substantial authority issue and reasonable cause issues is a mini-treatise on “reasonable compensation” analysis with respect to incorporated service businesses. The corporation zeroed-out its taxable income with bonuses to the shareholder employees. For at least 10 years before and including the years in issue, the taxpayer had not paid a dividend. The IRS and the taxpayer stipulated to the amount of the underpayment relating to amounts the corporation deducted as officer compensation that were recharacterized as nondeductible dividends. The firm employed about 150 attorneys, of whom only about 65 were shareholders. It also employed a non-attorney staff of about 270. The firm had invested capital, measured by the book value of its shareholders’ equity, of about \$8 million at the end of 2007 and about \$9.3 million at the end of 2008. The court noted that the taxpayer’s expert witness “admitted that a firm’s reputation and customer lists could be valuable entity-level assets, even though determining their precise worth might be difficult.” The firm’s tax returns were prepared by McGladrey, but the firm did not seek or receive advice from McGladrey regarding whether the full amount of the year-end bonuses it paid to shareholder attorneys properly was deductible as compensation for services. Perhaps because the case is appealable to the Seventh Circuit, the court applied the hypothetical independent investor test first articulated in *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999), *rev’g Heitz v. Commissioner*, T.C. Memo. 1998-220.

Regardless of the possibility that petitioner might own valuable intangible assets, it had invested capital, measured by the book value of its shareholders’ equity, of about \$8 million at the end of 2007 and about \$9.3 million at the end of 2008. Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder employees is really a distribution of earnings. We do not believe that petitioner’s shareholder attorneys, were they not also employees, would have forgone any return on invested capital that at least approached, if it did not exceed \$10 million. Thus, petitioner’s practice of paying out year-end bonuses to its shareholder attorneys that eliminated its book income fails the independent investor test.

The court rejected the taxpayer’s argument that the hypothetical independent investor test was inapposite because the shareholder-employees were required to sell their stock back to the corporation at book value upon termination of employment and book value thus did not reflect

fair market value. The court further rejected the taxpayer's argument that *Law Offices—Richard Ashare, P.C. v. Commissioner*, T.C. Memo. 1999-282, supported the proposition that an incorporated law firm with significant capital can pay out compensation that eliminates book income. The court found *Ashare* distinguishable because the taxpayer in that case did not consistently pay compensation that eliminated book income. Furthermore, in *Ashare* the firm had minimal capital—its sole shareholder had invested only \$1,000 in the corporation. Accordingly, the authorities that supported the taxpayer's deduction of the full amount of the year-end bonuses it paid to shareholder attorneys are not substantial when weighed against the contrary authorities. Finally, the firm did not rely in good faith on McGladrey's preparation of its returns for the years in issue. It had "provided McGladrey with inaccurate information." The taxpayer "consistently followed a system of computing year-end bonuses that disregarded the value of its shareholder attorneys' interests in the capital of the firm and inappropriately treated as compensation amounts that eliminated the firm's book income." There was no evidence that the firm based that practice on McGladrey's advice or the advice of any other qualified tax professional.

2. Shareholder-employees apparently can rake off economic rents as reasonable comp. *H. W. Johnson, Inc. v. Commissioner*, T.C. Memo. 2016-95 (5/11/16). In this reasonable compensation case, the IRS, among other arguments, advanced the proposition that because the corporation's return on equity, after deducting compensation paid to the two shareholder-employees, fell below the industry averages in the years in question, the two shareholder-employees were unreasonably compensated in those years. According to the IRS, an independent investor would have demanded a return more commensurate with the corporation's superior performance. The Tax Court (Judge Gale) agreed with the taxpayer's argument that its return on equity was in line with the industry average and therefore would have satisfied an independent investor. The IRS cited no authority for the proposition that the required return on equity for purposes of the independent investor test must significantly exceed the industry average when the subject company has been especially successful, and the court found none in the case law. The IRS conceded that the two shareholder-employees "were absolutely integral to petitioner's successful performance, a performance that included remarkable growth in revenues, assets, and gross profit margins during those years." The Tax Court concluded that in applying the independent investor test courts have typically found that a return on equity of at least 10 percent tends to indicate that an independent investor would be satisfied and thus payment of compensation that leaves that rate of return for the investor is reasonable. That standard was met on the facts of this case. The IRS effectively conceded the other four factors of *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983)—(1) the employee's role in the company; (2) a comparison of compensation paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) the internal consistency of compensation arrangements—which controlled because an appeal would lie to the Ninth Circuit. In analyzing the fourth factor, the Ninth Circuit emphasizes evaluating the reasonableness of compensation payments from the perspective of a hypothetical independent investor, focusing on whether the investor would receive a reasonable return on equity after payment of the compensation. Accordingly, the Tax Court allowed the deduction.

D. Miscellaneous Deductions

1. Seventy months in the slammer, a \$19 million fine, and a \$44 million forfeiture for insider trading was penalty enough. *Nacchio v. United States*, 115 Fed. Cl. 195 (3/12/14). The taxpayer was the CEO of Qwest Communications International when he realized profits of approximately \$44 million trading Qwest stock. He was convicted of insider trading, paid a fine of \$19 million, and forfeited \$44 million that was paid over to victims of his securities fraud scheme. (He also was sentenced to 70 months in prison.) On a motion for summary judgment, the Court of Claims (Judge Williams) held that the \$44 million forfeiture was deductible under § 165. Because the forfeiture served to compensate victims of the taxpayer's securities fraud, the payment was not a "fine or similar penalty" that is not deductible pursuant to § 162(f). The court rejected the government's argument that allowing a deduction under § 165 would frustrate public policy, reasoning that "[a]llowing the deduction would not

increase the odds in favor of insider trading or destroy the effectiveness of the securities laws.” Furthermore, “[d]isallowing the deduction would result in a ‘double sting’ by requiring the taxpayers to both make restitution and pay taxes on income they did not retain.” However, whether § 1341 applied required further proceedings because there was a material question of fact whether Nacchio, who did not plead guilty, believed that he had an unrestricted right to the profits in the year he realized them.

a. On appeal, no tax deduction for the \$44 million forfeiture made the penalty even tougher. *Nacchio v. United States*, ___ F.3d. ___, 117 A.F.T.R.2d 2016-2070 (Fed. Cir. 6/10/16), *rev’g* 115 Fed. Cl. 195 (3/12/14). On appeal, the Federal Circuit, in an opinion by Judge O’Malley, saw things differently and reversed. The Court of Appeals concluded that the forfeiture was a “fine or similar penalty” within the meaning of § 162(f). First, examining the language of the statute under which the amount of the forfeiture was calculated in the criminal proceeding, 18 U.S.C. § 981(a)(2)(B), rather than 18 U.S.C. § 981(a)(2)(A), the court concluded that “the plain language of the statutory provision under which the amount Nacchio forfeited was calculated supports the view that Congress intended the forfeiture to be paid with after-tax dollars.” Second, “Treasury Regulation § 1.162-21(b)(1) defines ‘fine or similar penalty’ for the purposes of § 162(f) as including, *inter alia*, ‘an amount — (i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding.’ ... Nacchio’s criminal forfeiture was imposed pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c), as part of his sentence in a criminal case.” Thus, the forfeiture was punitive, not compensatory, and “[t]he Attorney General’s post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under § 162(f). The decision to use the forfeited funds to compensate the victims was discretionary.” Finally, because establishing deductibility under a section allowing a deduction is a prerequisite to claiming § 1341 relief, Nacchio was not entitled to § 1341 relief. Judgment was entered in favor of the government.

2. Pushing the right drugs garners a magic deduction. *Precision Dose, Inc. v. United States*, 116 A.F.T.R.2d 2015-6231 (N.D. Ill. 9/24/15). A § 199 deduction was allowed to a taxpayer who sold “unit doses” of medications. The taxpayer bought certain drugs in bulk and packaged drugs in non-reusable containers intended for administration as a single dose to a patient. Relying on *Dean v. United States*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), the court (Judge Reinhard) rejected the government’s argument that the taxpayer engaged only in repackaging, which is expressly excepted from the definition of qualifying activities.

3. It looks like the Treasury and the IRS don’t like the way some courts are interpreting the § 199 Regs. The solution? Spread on a little Mayo.² REG-136459-09, Amendments to Domestic Production Activities Deduction Regulations; Allocation of W-2 Wages in a Short Taxable Year and in an Acquisition or Disposition, 80 F.R. 51978 (8/27/15). The Treasury Department and the IRS have proposed numerous amendments to the regulations under § 199 to reflect various amendments to the statute. Of particular significance are proposed amendments to Reg. § 1.199-3(f)(1). Current Reg. § 1.199-3(f)(1) provides that if one taxpayer performs a qualifying activity pursuant to a contract with another party, then only the taxpayer that has the benefits and burdens of ownership of the qualified product, qualified film, or utilities during the period in which the qualifying activity occurs is treated as engaging in the qualifying activity. The proposed amendments would replace the benefits and burdens of ownership rule with a rule providing that “if a qualifying activity is performed under a contract, then the party that performs the activity is the taxpayer for purposes of section 199(c)(4)(A)(i).” This change is intended to better implement the direction of § 199(d)(10) that the regulations prevent more than one taxpayer from being allowed a deduction under § 199 with respect to any qualifying activity. According to the preamble, “[t]he Treasury Department and the IRS have interpreted the statute

² Mayo Foundation for Medical Research v. United States, 562 U.S. 44 (2011).

to mean that only one taxpayer may claim the section 199 deduction with respect to the same activity performed with respect to the same property.”

[The proposed new] rule, which applies solely for purposes of section 199, reflects the conclusion that the party actually producing the property should be treated as engaging in the qualifying activity for purposes of section 199, and is therefore consistent with the statute’s goal of incentivizing domestic manufacturers and producers. The proposed rule would also provide a readily administrable approach that would prevent more than one taxpayer from being allowed a deduction under section 199 with respect to any qualifying activity.

This amendment could change the result in a case such as *Advo, Inc. v. Commissioner*, 141 T.C. 298 (2013), which held that gross receipts attributable to printed direct-mail advertising did not qualify as domestic production gross receipts; only a taxpayer that has the “benefits and burdens” of the ownership of qualifying production property may claim the § 199 deduction; the printers maintained title to the manufactured paper during the printing process and had possession of the manufactured material before delivery to the taxpayer; the printers bore the risk of damage before delivery of the printed material to the taxpayer, and the printers bore the economic gain or loss on the fixed-price printing contracts.

- Another important proposed amendment would negate the holding of *United States v. Dean*, 945 F. Supp. 2d 1110 (C.D. Cal. 2013), which concluded that the taxpayer’s activity of preparing gift baskets was a manufacturing activity and not solely packaging or repackaging for purposes of § 199. Reg. § 1.199-3(e)(2) provides that if a taxpayer packages, repackages, labels, or performs minor assembly of “qualified production property” (QPP) and the taxpayer engages in no other “manufactured, produced, grown, or extracted” (MPGE) activities with respect to that QPP, the taxpayer’s packaging, repackaging, labeling, or minor assembly does not qualify as MPGE with respect to that QPP. The Treasury Department and the IRS disagree with the interpretation of Reg. § 1.199-3(e)(2) in *Dean*, and the proposed regulations add Reg. § 1.199-3(e)(2), Ex. 9, that illustrates the appropriate application of this rule in a situation in which the taxpayer is engaged in no other MPGE activities with respect to the QPP other than those described in Reg. § 1.199-3(e)(2).

4. Wouldn’t it be better to increase teachers’ pay? The Protecting Americans from Tax Hikes Act of 2015 (“2015 PATH Act”), § 104, enacted as Division Q of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, was signed by the President on 12/18/15. The 2015 PATH Act retroactively extended through 2015 and made permanent the § 62(a)(2)(D) above-the-line deduction for up to \$250 of teachers’ classroom supplies expenses. For taxable years beginning after 12/31/15, the legislation also (1) expands the types of costs that are deductible by permitting deduction (subject to the \$250 limit) not only of classroom supplies, but also “professional development courses related to the curriculum in which the educator provides instruction or to the students for which the educator provides instruction,” and (2) provides that the \$250 limit shall be adjusted for inflation.

- Pursuant to Notice 2016-14, 2016-7 I.R.B. 315 (1/29/16), for taxable years beginning in 2016, the maximum deduction remains at \$250.

5. Would Ralph Lauren agree that his clothing is suitable for “general wear”? *Barnes v. Commissioner*, T.C. Memo. 2016-79 (4/27/16). The taxpayer worked as a salesman for Ralph Lauren Corp., which required all employees who worked in corporate sales positions to wear Ralph Lauren apparel while representing the company. The taxpayer purchased Ralph Lauren shirts, pants, ties, and suits, the costs of which he deducted as unreimbursed employee expenses on Schedule A. The cost of clothing is deductible as a business expense only if it meets the following three-part test: (1) the clothing is required or essential in the taxpayer’s employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not so worn. *Hynes v. Commissioner*, 74 T.C. 1266 (1980); *see also Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980). The Tax Court (Judge Paris) held that the taxpayer could not deduct the cost of his clothing because, although he was required by his employer to wear it, the clothing was suitable for general or personal wear.

6. **Is the Tax Court backing off on *Altera*?** *Santos v. Commissioner*, T.C. Memo. 2016-100 (5/17/16). The Tax Court (Judge Morrison) held pursuant to Reg. § 1.162-5(b) that an accountant could not deduct law school tuition; it qualified him for a new trade or business. The taxpayer argued that court should reconsider its decision in *Weismann v. Commissioner*, 52 T.C. 1106 (1969), *aff'd*, 443 F.2d 29 (9th Cir. 1971), upholding the validity of Reg. § 1.162-5(b), in light of *Altera Corp. & Subs. v. Commissioner*, 145 T.C. 91 (2015), which, relying on *Motor Vehicle Mfrs. Ass'n of U.S. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), held that a regulation under § 482 was invalid because, in promulgating the regulation, the Treasury did not “adequately respond to commentators.” The court declined to reexamine the validity of the regulation.

Altera is distinguishable. *Altera* held that the validity of the regulation in the particular circumstances of that case hinged on an “empirical determination” and “in no way depends on *** [Treasury's] interpretation of section 482 or any other statute.” *Altera Corp. & Subs. v. Commissioner*, 145 T.C. at __ (slip op. at 46). By contrast, the education-expenses regulation is an interpretation of sections 162 and 262. *See Taubman v. Commissioner*, 60 T.C. at 817. Second, *Santos* did not raise his theories that the regulation was invalid until after trial. As a result, neither the trial record nor the court papers in this case contain any information regarding the public’s comments to the regulation in question. Without knowing what the public comments were, it seems difficult, if not impossible, for the Court to evaluate the adequacy of the Treasury Department’s response to the public comments when it promulgated section 1.162-5, Income Tax Regs.

- Is this an invitation for FOIA requests for comments on regulations issued nearly 50 years ago? What if there are none? There was no preamble either for T.D. 6291, 1958-1 C.B. 63 (4/3/58), promulgating Reg. § 1.162-5, or for the proposed regulations, 21 F.R. 5091 (6/10/56), but the publication of the proposed regulation states, “Prior to the final adoption of such regulations, consideration will be given to any data, views, or arguments pertaining thereto which are submitted in writing”

E. Depreciation & Amortization

1. **Guidance on bonus depreciation for years prior to 2015.** Rev. Proc. 2015-48, 2015-40 I.R.B. 469 (9/15/15). This revenue procedure provides guidance for issues related to the extension by The Tax Increase Prevention Act of 2014, Pub. L. No. 113-295, to before 1/1/15 of (1) the placed-in-service date for property to qualify for the § 168(k) 50-percent additional first-year depreciation deduction, (2) the § 168(k)(4) election not to claim the 50-percent additional first-year depreciation deduction for certain property placed in service generally after 12/31/13, and before 1/1/15, and instead to increase alternative minimum tax (AMT) credit limitation under § 53(c), and (3) the extension of the application of § 179(f), allowing expensing of certain real property, to any taxable year beginning after 2009 and before 2015.

2. Certain depreciation and amortization provisions of the 2015 PATH Act:

a. **Retroactive extension and modification for the future of § 168(k) bonus first-year depreciation.** The 2015 PATH Act, § 143, retroactively extended through 12/31/15 the § 168(k) 50-percent additional first-year depreciation deduction as it had existed through 2014 and extends the deduction, with certain modifications, through 2019 (2020 for transportation property or certain property with longer production periods).

Eligible property.—The deduction generally is available for “qualified property,” which for 2015 is defined as MACRS property with a recovery period of 20 years or less, computer software (other than computer software subject to § 197), certain water utility property, and qualified leasehold improvement property, the original use of which commenced with the taxpayer. For property placed in service after 2015, the 2015 PATH Act replaces the category of qualified leasehold improvement property with a new category, “qualified improvement property,” defined (subject to certain exceptions) as “any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.” This change expands the types of improvements

that are eligible for the deduction by allowing bonus depreciation for improvements without regard to whether the property is subject to a lease and without regard to whether the improvement is placed in service more than three years after the date the building was first placed in service. The 2015 PATH Act also expands the property eligible for bonus depreciation by permitting the deduction for certain trees, vines and plants bearing fruits or nuts that are planted or grafted after 2015.

Phased reduction of bonus depreciation.—For eligible property placed in service after 2017, the percentage of the property's adjusted basis that can be deducted is reduced from 50 percent to 40 percent in 2018 and 30 percent in 2019.

Expansion of election to accelerate AMT credits in lieu of bonus depreciation.—The 2015 PATH Act retroactively extended through 12/31/15 the § 168(k)(4) election to claim additional AMT credits in lieu of claiming bonus depreciation with respect to eligible qualified property. For property placed in service after 2015, a taxpayer making this election can claim an increased amount of AMT credits.

b. Fifteen-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property made permanent. The 2015 PATH Act, § 123, retroactively extended through 12/31/15 and made permanent §§ 168(e)(3)(E)(iv), 168(e)(3)(E)(v), and 168(e)(3)(E)(ix), which treat as 15-year property qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, respectively. Qualified restaurant property also is eligible for § 168(k) bonus first-year depreciation if it meets the definition of qualified leasehold improvement property (for property placed in service in 2015) or qualified improvement property (for property placed in service after 2015). For property placed in service in 2015, § 168(e)(8)(D) provides that qualified retail improvement property is eligible for bonus first-year depreciation only if it meets the definition of qualified leasehold improvement property. The 2015 PATH Act repealed this provision for property placed in service after 2015. It appears that, for property placed in service after 2015, qualified retail improvement property is eligible for bonus first-year depreciation if it meets the definition of qualified improvement property (a new category in § 168(k)(2) that replaces the category of qualified leasehold improvement property). Congress likely repealed the cross-reference in § 168(e)(8)(D) because all qualified retail improvement property seems to constitute qualified improvement property as newly defined in § 168(k)(2). For the same reason, qualified leasehold improvement property should be eligible for bonus depreciation.

c. Special interests rule! The 2015 PATH Act, § 166, retroactively extended through 12/31/15 and extends through 2016 the § 168(e)(3)(C)(ii) 7-year straight line cost recovery period for motorsports entertainment complexes.

d. Do we see Mitch McConnell's fingerprints here? The 2015 PATH Act, § 165, retroactively extended through 12/31/15 and extends through 2016 the classification of certain race horses as 3-year MACRS property. A race horse placed in service after 2016 qualifies for the 3-year recovery period only if it is more than two years old when placed in service. The legislation also retroactively extended through 12/31/15 and extends through 2016 the election under § 179E to treat 50 percent of the cost of any qualified mine safety equipment as an expense in the tax year in which the equipment is placed in service.

e. Congress has essentially repealed capitalization of machinery and equipment for small businesses. The 2015 PATH Act, § 124, retroactively extended through 12/31/15 and made permanent the increased \$500,000 maximum amount that can be expensed under § 179 and the increased \$2 million expenditure ceiling phase-out amount. For taxable years beginning after 12/31/15, these amounts are adjusted for inflation. The legislation also retroactively extended and made permanent the eligibility for § 179 expensing of qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property (collectively, "qualified real property"), and off-the-shelf computer software. Qualified real property is subject to a \$250,000 limit on the amount that can be expensed for taxable years beginning in 2015, but the legislation removed this limitation for taxable years beginning after 12/31/15. Also for taxable years beginning after 12/31/15, the legislation repealed the rule that

qualified real property does not include air conditioning and heating units. The ability of a taxpayer to revoke any election made under § 179 (and any specification contained in such an election) without the consent of the IRS also is now permanent.

- Pursuant to Notice 2016-14, 2016-7 I.R.B. 315 (1/29/16), for taxable years beginning in 2016, the maximum amount that can be expensed under § 179 remains at \$500,000 and the expenditure ceiling phase-out amount increases to \$2,010,000.

f. Of course we need better tax treatment of luxury cars—Let's incentivize purchases of Mercedes, BMWs, and Lexuses to boost the American auto industry. What, they're not American? Surely you jest! The 2015 PATH Act, § 143, retroactively extended through 12/31/15 and extends (subject to phased reductions) through 2019 the \$8,000 increase in the first-year § 280F ceiling on depreciation deductions with respect to automobiles, light trucks, vans, and SUVs that are rated at not more than 6,000 pounds gross vehicle weight. The increase is limited to \$6,400 for property placed in service during 2018 and \$4,800 for property placed in service during 2019.

3. Section 280F 2016 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2016-23, 2016-16 I.R.B. 581 (4/1/16). The IRS has published depreciation tables with the 2016 depreciation limits for business use of small vehicles:

2016 Passenger Automobiles with § 168(k) first year recovery:

1st Tax Year	\$11,160
2nd Tax Year	\$ 5,100
3rd Tax Year	\$ 3,050
Each Succeeding Year	\$ 1,875

2016 Trucks and Vans with § 168(k) first year recovery:

1st Tax Year	\$11,560
2nd Tax Year	\$ 5,700
3rd Tax Year	\$ 3,350
Each Succeeding Year	\$ 2,075

2016 Passenger Automobiles (no § 168(k) first year recovery):

1st Tax Year	\$ 3,160
2nd Tax Year	\$ 5,100
3rd Tax Year	\$ 3,050
Each Succeeding Year	\$ 1,875

2016 Trucks and Vans (no § 168(k) first year recovery):

1st Tax Year	\$ 3,560
2nd Tax Year	\$ 5,700
3rd Tax Year	\$ 3,350
Each Succeeding Year	\$ 2,075

F. Credits

1. Certain credit provisions of the 2015 PATH Act:

a. More than thirty years after its first enactment in ERTA 1981, Congress decides that the research credit really is a good idea and makes it permanent. The 2015 Path Act, § 121, retroactively extended through 12/31/15 and made permanent the § 41 research credit. The legislation provides that, in the case of an eligible small business (as defined in § 38(c)(5)(C), after application of rules similar to the rules of § 38(c)(5)(D)), the research credit determined for taxable years beginning after 12/31/15 is a specified credit that can offset both regular tax and AMT liabilities. Also for taxable years beginning after 12/31/15, a qualified small business can elect for any taxable year to claim a certain amount (capped at \$250,000) of its research credit as a payroll tax credit against its employer OASDI liability (i.e., social security portion of the employer's FICA taxes), rather than against its income tax liability. A "qualified small business" is defined as a corporation (including an S corporation) or partnership (1) with gross receipts of less than \$5 million for the taxable year, and (2) that did not have gross receipts for any taxable year before the five taxable year period ending with the taxable year. An individual carrying on one or more trades or businesses can be a qualified small business if the

individual meets the two specified conditions, taking into account the individual's aggregate gross receipts received with respect to all trades or businesses.

b. Congress gives a “thumbs up” to energy efficiency. The 2015 PATH Act, § 188, retroactively extended through 12/31/15 and extends through 2016 the § 45L credit of \$2,000 or \$1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year.

c. A big salute to differential pay for active duty members of the armed forces. The 2015 PATH Act, § 122, retroactively extended through 12/31/15 and made permanent the § 45P differential wage credit, which permits eligible small business employers to claim a credit for so-called “differential pay,” i.e., payments to an employee called to active duty with the U.S. armed forces representing the difference between the compensation the employer would have paid to the employee during the period of military service less the amount of pay the employee receives from the military. For taxable years beginning after 12/31/15, the credit is available to employers of any size, i.e., without regard to whether the employer is a small business employer.

d. Extenders, extenders, can't get enough of those extenders. Jimmy Johnson would have been proud. Other business credits the 2015 PATH Act extended include: (1) the § 51 Work Opportunity Credit, extended through taxable years beginning before 1/1/20; (2) the § 45 credit for electricity produced from certain renewable resources, extended for facilities for which construction has commenced before 1/1/17 (except for wind facilities, for which the extension applies to facilities for which construction begins before 1/1/20); (3) the § 45G railroad track maintenance credit, extended for qualified railroad track maintenance expenditures paid or incurred in taxable years beginning before 1/1/17; (4) the § 45A Indian Employment Credit, extended for taxable years beginning before 1/1/17, and the § 45(e)(10) Indian Coal Production Credit, extended for coal produced before 1/1/17; (5) the § 45D New Markets Credit, extended through 2019; (6) the § 45N mine rescue team training credit, extended for taxable years beginning before 1/1/17; and (7) a number of others that we have missed or didn't care enough about to include.

2. Employers can claim the Work Opportunity Tax Credit for eligible individuals who begin work on or before August 31, 2016 by submitting the appropriate forms by September 28, 2016. Notice 2016-40, 2016-27 I.R.B. 4 (6/17/2016). The 2015 PATH Act extended the § 51 Work Opportunity Credit (WOTC) through taxable years beginning before 1/1/20 and, effective as of 1/1/16, expanded the “targeted groups” of individuals, the employment of whom may qualify an employer for a credit, to include qualified long-term unemployment recipients (as defined in § 51(d)(15)). An employer must obtain certification that an individual is a member of a targeted group before the employer may claim the WOTC by submitting to a designated local agency IRS Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, and also must submit Department of Labor Form 9061 (Individual Characteristics Form) or 9062 (Conditional Certification). Form 8850 generally must be submitted within 28 days after an individual begins work. The Notice provides that, for members of a targeted group other than qualified long-term unemployment recipients who begin work on or after 1/1/15 and on or before 8/31/16, and for long-term unemployment recipients who begin work on or after 1/1/16 and on or before 8/31/16, Form 8850 will be timely filed if it is submitted no later than 9/28/16. The Notice extends by three months the transition relief previously granted by Notice 2016-22, 2016-13 I.R.B. 488 (3/7/16).

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

1. The statute and regulations clearly said to the taxpayer, “you lose,” but she took it all the way to the Ninth Circuit anyway. Gragg v. United States, ___ F.3d ___, 118 A.F.T.R.2d 2016-5364 (9th Cir. 8/4/16). In an opinion by Judge Christen, the Ninth Circuit held that although a taxpayer who qualifies as a real estate professional under § 469(c)(7) is not

subject to the § 469(c)(2) per se rule that rental losses are passive, the taxpayer nevertheless must materially participate in real estate rental activities in order to deduct rental losses against nonpassive income. Because the taxpayer, who did qualify as a real estate professional, did not materially participate in the rental activity, the losses were disallowed. Based on the statutory language and Reg. § 1.469-9(e)(1), the court rejected the taxpayer's argument that, by virtue of her status as a real estate professional, the rental losses were automatically nonpassive and she did not need to prove material participation.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. **Just because you're a good guy who helps the government recover tens of millions of dollars of fraudulent Medicare claims doesn't punch your ticket to the promised land of capital gains.** Patrick v. Commissioner, 142 T.C. 124 (2/24/14). The taxpayer filed several *qui tam* complaints under the False Claims Act, alleging that his employer defrauded the government by improperly marketing medical equipment as requiring in-patient rather than out-patient treatment and that certain medical providers billed treatments under Medicare as in-patient expenses. The cases were settled for over \$75 million and the government intervened. The taxpayer received a relator's share totaling over \$6.8 million, which he reported as capital gain. The IRS treated the relators' awards as ordinary income. The Tax Court (Judge Kroupa) sustained the deficiency, rejecting the taxpayer's argument that the FCA gives rise to a contract under which the relator sells information to the government in exchange for a share of the recovery. First, there was no sale or exchange of information. "The Government does not purchase information from a relator under the FCA. Rather, it permits the person to advance a claim on behalf of the Government. The award is a reward for doing so. No contractual right exists." Second, the information provided to the government was not a capital asset. "The ordinary income doctrine excludes from the definition of a capital asset 'property representing income items or accretions to the value of a capital asset themselves properly attributable to income.'" The taxpayer "did not receive a right to the relator's share in exchange for an underlying investment of capital." The right to income was a reward, which is ordinary income. Finally, the information the taxpayer gave to the government was not a capital asset because it was not property. The information could not be property because the taxpayer did not have a legal right to exclude others from its use and enjoyment. The False Claims Act obligated him to turn over all supporting documentation to the government, and the taxpayer had no right to prevent his employer or medical providers from using or disclosing the information.

a. **The Seventh Circuit affirms: a taxpayer's recovery in a *qui tam* action is ordinary income rather than capital gain.** Patrick v. Commissioner, 799 F.3d 885 (7th Cir. 8/26/15). In an opinion by Judge Williams, the Seventh Circuit affirmed the Tax Court's decision and held that the taxpayer's recovery in the *qui tam* action was ordinary income because it was "a reward intended to compensate the [taxpayer] for his work in bringing the *qui tam* suit" rather than gain from the sale or exchange of a capital asset. Like the Tax Court, the Seventh Circuit rejected the taxpayer's arguments that the information the taxpayer provided to the government was property and that the taxpayer's right to a share of the recovery was a capital asset.

- The Seventh Circuit noted that its decision is consistent with that of the Ninth Circuit in Alderson v. United States, 686 F.3d 791 (9th Cir. 2012).

2. **You can't have your cake and eat it too!** DeBough v. Commissioner, 142 T.C. 297 (5/19/14). This case involves the interplay between § 121 and § 1038, which provides rules for computing gain when a seller repossesses real property in satisfaction of a debt secured by that real property. The taxpayer and his wife sold their primary residence in 2006 pursuant to an installment sale agreement. The buyers' debt was secured by a mortgage on the home. The price was \$1,400,000 and the taxpayers recognized a gain of \$657,796. The taxpayers properly excluded \$500,000 in gain on the sale. They calculated the gain reportable in each year by (1) excluding \$500,000 of gain pursuant to § 121, (2) calculating their gross profit percentage by dividing the \$157,796 in remaining gain ($\$657,796 - \$500,000 = \$157,796$) by the \$1,400,000

sale price exclusive of commissions and other costs of sale, and (3) multiplying the gross profit percentage by the amount of money received. In total, the taxpayer (his wife having died in 2006) received payments of \$505,000 and reported \$56,920 in gain over the course of 2006, 2007, and 2008. In 2009 the buyers defaulted and the taxpayer reacquired the property. He treated his reacquisition of the property in 2009 as a reacquisition of property in full satisfaction of indebtedness under § 1038 and recognized \$97,153 in the form of long-term capital gains related to the reacquisition of the property. The IRS asserted that the long-term capital gain the taxpayer was required to recognize on the reacquisition of the property included the \$500,000 that he had previously excluded under § 121. The Tax Court (Judge Nega) agreed with the IRS, holding that the gain recognized on the reacquisition of the property included gain previously excluded under § 121. Generally speaking, under § 1038 if the seller of real property receives the buyer's purchase money debt obligation and the seller reacquires the property in partial or full satisfaction of the buyer's debt, the seller does not recognize gain or loss upon the reacquisition, except, as provided in § 1038(b), to the extent he has received money or other property that exceeds the amount of gain reported before the reacquisition. (The special exception to the general rule in § 1038(e) was inapplicable because the taxpayer had not resold the residence within one year after its reacquisition.) Because the taxpayer had received \$505,000 in cash before the reacquisition and had both the cash and the house as a result of the reacquisition, he was "actually in a better position than he was before the sale by virtue of having ownership over both the property and \$505,000."

a. The Eighth Circuit affirms by focusing on the statutory language, not the double dipping. DeBough v. Shulman, 799 F.3d 1210 (8th Cir. 8/28/15). The Eighth Circuit, in an opinion by Judge Loken, affirmed the Tax Court's decision and required recognition of gain. Section 1038(b) allows a taxpayer "to disregard gain associated with the reacquisition of property, except to the extent that the taxpayer received money from the sale of the property prior to the reacquisition that is more than 'the amount of gain on the sale' that was 'returned as income' in any tax period prior to the reacquisition." Section 1038(e) provides that if a taxpayer reacquires property that was his principal residence, but then resells that property within one year, the taxpayer may continue to apply the principal residence exclusion when calculating taxable gain. The court reasoned that the wording of § 121, consistent with the name "principal-residence exclusion" excluded the original gain from income, and having "been excluded from income ... the \$500,000 principal-residence exclusion cannot be considered gain that was 'returned as income' on a prior tax return. The court rejected the taxpayer's argument that nothing in § 1038(e) requires recognition of the gain originally excluded under § 121 when the taxpayer does not sell the reacquired property within one year, because to accept the taxpayer's argument would render § 1038(e) "superfluous."

3. 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, which requires 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. 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.

a. Despite the effective date of the new legislation, the statements required by new § 6035(a)(1) and (a)(2) are not due before February 29, 2016. Notice 2015-57, 2015-36 I.R.B. 294 (8/21/15). 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. The new legislation applies to estate tax returns filed after 7/31/15 and therefore, absent further guidance, the statements required by § 6035(a) could be due as early as 8/31/15. This notice provides that, for statements required under § 6035(a) to be filed with the IRS or furnished to a beneficiary before 2/29/16, the due date under § 6035(a)(3) is delayed to 2/29/16. According to the notice, this delay is to allow Treasury and the IRS to issue guidance implementing the reporting requirements of § 6035. The notice directs executors and other persons required to file or furnish a statement under § 6035(a) not to do so until Treasury and the IRS issue forms or further guidance. The notice is effective on 8/21/15 and applies to executors of estates and to other persons who are required under § 6018(a) or (b) to file a return if that return is filed after 7/31/15.

b. The IRS has issued the final version of Form 8971, on which estate executors must report pursuant to § 6035(a)(1) and (a)(2) the value of property included in the decedent's gross estate. On 1/29/16, 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.

c. A further delay: the statements required by new § 6035(a)(1) and (a)(2) are not due before March 31, 2016. Notice 2016-19, 2016-9 I.R.B. 362 (2/11/16). This notice provides that, for statements required under § 6035(a) to be filed with the IRS or furnished to a beneficiary before 3/31/16, the due date under § 6035(a)(3) is delayed to 3/31/16. According to the notice, this delay is to provide executors and others with a filing obligation the opportunity to review proposed regulations to be issued shortly under §§ 1014(f) and 6035 before preparing a Form 8971 and any Schedule A. The notice recommends that executors and other persons required to file or furnish a statement under § 6035(a) not do so until the proposed regulations are issued. The notice is effective on 2/11/16 and applies to executors of estates and to other

persons who are required under § 6018(a) or (b) to file a return if that return is filed after 7/31/15.

d. The IRS issues proposed and temporary regulations. Consistent Basis Reporting Between Estate and Person Acquiring Property from Decedent, REG-127923-15, 81 F.R. 11486 (3/4/16); T.D. 9757, 81 F.R. 11431 (3/4/16). Treasury and the IRS have issued proposed and temporary 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 proposed 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. Prop. Reg. § 1.1014-10(b)(3). *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 (1) property qualifying for the estate tax charitable or marital deductions, and (2) tangible personal property 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." Prop. Reg. § 1.1014-10(b)(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, Prop. Reg. § 1.1014-10(c)(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. "[A]fter discovered or omitted property" not reported on the initial estate tax return or a supplemental return prior to the expiration of the assessment period has a zero basis, as does all property in an estate if no estate tax return has been filed by an estate that is required to file, until either a return is filed or a final value determined by the IRS. Prop. Reg. § 1.1014-10(c)(3).

Prop. 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. Prop. Reg. § 1.6035-1(a)(2). An executor must file a supplemental statement when "any 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." Prop. Reg. § 1.6035-1(e)(1) and (2). The proposed 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 marital or charitable deductions that reduce the amount of tax otherwise due to less than the allowable unified credit.

Upon publication of final regulations in the Federal Register, the proposed regulations will apply to property acquired from a decedent (or by reason of the death of the decedent) whose return required by section 6018 is filed after 7/31/15. Taxpayers can rely on the proposed regulations prior to the issuance of final regulations.

e. Another reprieve for executors: the statements required by new § 6035(a)(1) and (a)(2) are not due before June 30, 2016. Notice 2016-27, 2016-15 I.R.B. 576 (3/24/16). This notice provides that, for statements required under § 6035(a) to be filed with the IRS or furnished to a beneficiary before 6/30/16, the due date under § 6035(a)(3) is delayed to 6/30/16. According to the notice, this delay is in response to numerous comments received by Treasury and the IRS indicating "that executors and other persons have not had sufficient time to adopt the systemic changes that would enable the filing of an accurate and complete Form 8971

and Schedule A.” The notice is effective on 3/23/16 and applies to executors of estates and to other persons who are required under § 6018(a) or (b) to file a return if that return is filed after 7/31/15.

4. File the election form, stupid! Poppe v. Commissioner, T.C. Memo. 2015-205 (10/19/15). The taxpayer, whose securities trading income was four times his salary as a teacher, qualified as a trader eligible to make an election under § 475(f) to use the mark-to-market method. However, the taxpayer’s failure to file or attach to his return a Form 3115, as required by Rev. Proc. 99-17, 1999-1 C.B. 503, precluded use of the mark-to-market method. His losses were disallowed.

5. Permanent tax-free capital gains for “small” C corporation stock. The 2015 PATH Act, § 126, reinstated for 2015 and made permanent the § 1202 exclusion for gain realized on the sale of qualified small business stock. Under § 1202, gain realized on a sale or exchange of qualified small business stock, which was acquired after the date of enactment of the 2010 Small Business Act [9/27/10] and before 1/1/11 [subsequently extended to “before 1/1/12”], was subject to 100 percent exclusion from gross income. The 2012 Extenders Act extended the 100 percent exclusion to stock acquired before 1/1/14, and the 2014 Tax Increase Prevention Act extended the 100 percent exclusion to stock acquired before 1/1/15. The 2015 PATH Act makes the 100 percent exclusion permanent for stock acquired after 12/31/14. (Under the former 50 percent and 75 percent exclusions, included gain was subject to tax at the 28 percent capital gains rates.) Gain attributable to qualified small business stock acquired after 9/27/10 is not treated as an AMT preference item. The exclusion is applicable to noncorporate shareholders who acquire stock at original issue and hold the stock for a minimum of five years. The amount of excluded gain attributable to any one corporation is limited to the greater of ten times the taxpayer’s basis in a corporation’s stock sold during the taxable year or \$10 million reduced by gain attributable to the corporation’s stock excluded in prior years. Qualified small business stock is stock issued by a C corporation engaged in the active conduct of a trade or business with gross assets (cash plus adjusted basis of assets) not in excess of \$50 million.

6. Surrendering a Green Card can be very taxing. Topsnik v. Commissioner, 146 T.C. No. 1 (1/20/16). The taxpayer was a German citizen who was a permanent resident of the United States. In 2004 he sold the stock of a U.S. corporation for a down payment and monthly installments and reported the gain on the § 453 installment method. In 2010, he received equal monthly payments pursuant to the promissory note executed in connection with the sale. On 11/20/10, the taxpayer formally abandoned his lawful permanent resident status. (He completed a U.S. Citizenship and Immigration Services Form I-407, Abandonment of Lawful Permanent Resident Status, which was accepted by the USCIS; he surrendered his green card.) He filed a Form 1040NR, U.S. Nonresident Alien Income Tax Return, for 2010 claiming that the installment sale proceeds were exempt from taxation under the U.S.-Germany Tax Treaty. The IRS asserted a deficiency for 2010 attributable to the gain on his installment sale of stock. The IRS also asserted that the taxpayer was a “covered expatriate” who expatriated in 2010 and was required by § 877A to recognize gain on the deemed sale of his installment obligation on the day before his expatriation. The taxpayer claimed that he was not liable for tax on the installment sale proceeds because he was a German resident who expatriated on 12/31/09, and that he lived in Freiburg, Germany. The Tax Court (Judge Kerrigan) held that the taxpayer expatriated on 11/20/10, when he formally abandoned his status as a lawful permanent resident. Reg. § 301.7701(b)-1(b)(3) provides that when an alien initiates a determination, “resident status is considered to be abandoned when the individual’s application for abandonment (INS Form I-407) ... is filed with the INS.” (The German Competent Authority sent the U.S. Competent Authority letters stating, among other things, that (1) for tax year 2010 the taxpayer was registered in Germany as a person subject to taxation as a nonresident, (2) he did not file a German tax return for 2010, and (3) he did not have a registered residence or habitual abode in Germany in 2010.) Thus, he was liable for tax on gains attributable to the eleven monthly installment payments that he received during 2010 before his expatriation date. Furthermore, pursuant to § 877A he was liable for tax on gain from the deemed sale of his right to installment sale proceeds on the day before his expatriation date.

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

A. Fringe Benefits

1. **The IRS provides guidance on the application of the Affordable Care Act's market reforms to HRAs, EPPs, FSAs, and EAPs — it's the bee's knees!** Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13), *supplemented by* Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). The Patient Protection and Affordable Care Act amended the Public Health Service Act to implement certain market reforms for group health plans, including requirements that: (1) group health plans not establish any annual limit on the dollar amount of benefits for any individual, and (2) non-grandfathered group health plans provide certain preventive services without imposing any cost-sharing requirements for the services. The notice provides guidance, in Q&A format, on the application of these market reforms to: (1) health reimbursement arrangements (including HRAs integrated with group health plans), (2) group health plans under which employers reimburse employees for premium expenses incurred for an individual health insurance policy (referred to in the notice as "employer payment plans"), and (3) health flexible spending arrangements. The notice also provides guidance on employee assistance programs and on § 125(f)(3), which generally provides that a qualified health plan offered through a health insurance exchange established under the Affordable Care Act is not a qualified benefit that can be offered through a cafeteria plan. The notice applies for plan years beginning on and after 1/1/14, but taxpayers can apply the guidance provided in the notice for all prior periods. The Department of Labor has issued guidance in substantially identical form (Technical Release 2013-03) and the Department of Health and Human Services is issuing guidance indicating that it concurs.

a. The obvious solution has a great big catch in it. In a Q&A issued on 5/13/14, available on the IRS's web site (<https://perma.cc/FK5A-FRF2>), the IRS states:

Q1. What are the consequences to the employer if the employer does not establish a health insurance plan for its own employees, but reimburses those employees for premiums they pay for health insurance (either through a qualified health plan in the Marketplace or outside the Marketplace)?

[A1]. Under IRS Notice 2013-54, such arrangements are described as employer payment plans. An employer payment plan, as the term is used in this notice, generally does not include an arrangement under which an employee may have an after-tax amount applied toward health coverage or take that amount in cash compensation. As explained in Notice 2013-54, these employer payment plans are considered to be group health plans subject to the market reforms, including the prohibition on annual limits for essential health benefits and the requirement to provide certain preventive care without cost sharing. Notice 2013-54 clarifies that such arrangements cannot be integrated with individual policies to satisfy the market reforms. Consequently, such an arrangement fails to satisfy the market reforms and may be subject to a \$100/day excise tax per applicable employee (which is \$36,500 per year, per employee) under section 4980D of the Internal Revenue Code.

b. Good news (?) for some employers: the IRS reiterates prior guidance and clarifies issues related to employer payment plans and provides transition relief from the § 4980D excise tax. Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15). This notice reiterates the conclusion in prior guidance, including Notice 2013-54, 2013-40 I.R.B. 287, that

employer payment plans are group health plans that will fail to comply with the market reforms that apply to group health plans under the Affordable Care Act. The notice provides guidance, in Q&A format, on several issues, including the treatment of: (1) an S corporation's payment or reimbursement of premiums for individual health insurance coverage covering a 2-percent shareholder, (2) an employer's reimbursement of an employee's Medicare premiums or payment of medical expenses for employees covered by TRICARE, (3) an employer's increase of an employee's compensation to assist with payments for individual coverage, and (4) an employer's provision of premium assistance on an after-tax basis. The notice also provides a transition rule under which the IRS will not assert the excise tax imposed by § 4980D for any failure to satisfy the market reforms by employer payment plans that pay, or reimburse employees for individual health policy premiums or Medicare part B or Part D premiums: (1) for 2014 for employers that are not applicable large employers for 2014, and (2) for 1/1/15 through 6/30/15 for employers that are not applicable large employers for 2015. Generally, applicable large employers are those that employed an average of at least 50 full-time employees on business days during the preceding calendar year. Employers eligible for this transition rule are not required to file Form 8928 (Return of Certain Excise Taxes Under Chapter 43 of the Internal Revenue Code) solely as a result of having employer payment plans for the period for which the employer is eligible for the relief.

c. Final regulations provide guidance on many issues under the Affordable Care Act and incorporate prior guidance issued in forms other than regulations. T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The Treasury Department and the IRS have issued final regulations regarding grandfathered health plans, preexisting condition exclusions, lifetime and annual dollar limits on benefits, rescissions, coverage of dependent children to age 26, internal claims and appeal and external review processes, and patient protections under the Affordable Care Act. Among many other changes, the final regulations provide guidance on integration of health reimbursement arrangements with other group health plan coverage and modify Notice 2015-17 by providing a special rule for employers with fewer than 20 employees who offer group health plan coverage to employees who are not eligible for Medicare but do not offer coverage to employees who are eligible for Medicare. If such an employer is not required by the applicable Medicare secondary payer rules to offer group health plan coverage to employees who are eligible for Medicare coverage, then the employer's reimbursement of Medicare part B or D premiums may be integrated with Medicare and deemed to satisfy the annual dollar limit prohibition and the preventive services requirements if the employees who are not offered other group health plan coverage would be eligible for that group health plan but for their eligibility for Medicare. The regulations are effective on 1/19/16 and apply to group health plans and health insurance issuers beginning on the first day of the first plan year (or, in the individual market, the first day of the first policy year) beginning on or after 1/1/17.

d. Just in time for Christmas! The IRS continues to prove that the Affordable Care Act, like the jelly-of-the-month club, is, as cousin Eddie put it, "the gift that keeps on giving [guidance] the whole year." Notice 2015-87, 2015-52 I.R.B. 889 (12/16/15). This notice, in Q&A format, provides guidance on the application of various provisions of the Affordable Care Act to employer-provided health coverage. The notice supplements the guidance in Notice 2013-54, 2013-40 I.R.B. 287 (9/13/13) and T.D. 9744, Final Rules for Grandfathered Plans, Preexisting Condition Exclusions, Lifetime and Annual Limits, Rescissions, Dependent Coverage, Appeals, and Patient Protections Under the Affordable Care Act, 80 F.R. 72192 (11/18/15). The notice (1) provides guidance on the application of the Affordable Care Act's market reforms for group health plans to various types of employer health care arrangements, including health reimbursement arrangements and group health plans under which an employer reimburses an employee for some or all of the premium expenses incurred for an individual health insurance policy; (2) clarifies certain aspects of the employer shared responsibility provisions of § 4980H; (3) clarifies certain aspects of the application to

government entities of § 4980H, the information reporting provisions for applicable large employers under § 6056, and application of the rules for health savings accounts to persons eligible for benefits administered by the Department of Veterans Affairs; (4) clarifies the application of the COBRA continuation coverage rules to unused amounts in a health flexible spending arrangement carried over and available in later years, and conditions that may be put on the use of carryover amounts; and (5) addresses relief from penalties under §§ 6721 and 6722 that has been provided for employers that make a good faith effort to comply with the requirements under § 6056 to report information about offers made in calendar year 2015. The guidance provided in the notice generally applies for plan years beginning on and after 12/16/15, but taxpayers can apply the guidance provided in the notice for all prior periods.

e. Colleges and universities providing health insurance premium reductions to students who perform services might have employer payment plans that violate the Affordable Care Act's market reforms, and may need to look at alternatives. Notice 2016-17, 2016-9 I.R.B. 358 (2/5/16). Colleges and universities often provide students, especially graduate students, with health coverage at greatly reduced or no cost as part of a package that includes tuition assistance and a stipend for living expenses. Some of these students perform services for the school (such as teaching or research), which raises the issue whether these premium reduction arrangements might be viewed as employer-sponsored group health plans that are employer payment plans that violate the market reform provisions of the Affordable Care Act. The notice concludes that whether such arrangements constitute group health plans will depend on all of the facts and circumstances, and that they might or might not be viewed as employer payment plans. To give colleges and universities time to examine this issue and adopt suitable alternatives if necessary, the notice provides that Treasury (and the Department of Labor and the Department of Health and Human Services) will not assert that a premium reduction arrangement fails to satisfy the Affordable Care Act's market reforms if the arrangement is offered in connection with other student health coverage (either insured or self-insured) for a plan year or policy year beginning before 1/1/17. Thus, colleges and universities have relief for plan years or policy years that are roughly coterminous with academic years beginning in the summer or fall of 2016 and ending in 2017. This notice applies for plan years beginning before 1/1/17.

2. Final regulations provide guidance related to the § 36B premium tax credit regarding the determination whether an employer-sponsored plan provides minimum value. T.D. 9745, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the Health Insurance Premium Tax Credit, 80 F.R. 78971 (12/18/15). The Treasury and IRS have finalized proposed regulations that provide guidance on issues related to the § 36B premium tax credit, including guidance on determining whether health coverage under an eligible employer-sponsored plan provides minimum value (REG-125398-12, Minimum Value of Eligible Employer-Sponsored Plans and Other Rules Regarding the Health Insurance Premium Tax Credit, 78 F.R. 25909 (5/3/13)). Certain provisions of the proposed regulations have not yet been finalized or have been re-proposed and will be finalized separately. The final regulations are effective on 12/18/15.

3. Thousands of dollars of tax breaks for buying luxury cars, pennies for taking the bus. The 2015 PATH Act, § 105, retroactively extended through 12/31/15 and made permanent the parity provision requiring that the monthly dollar limitation for transit passes and transportation in a commuter highway vehicle under § 132(f)(2) be applied as if it were the same as the dollar limitation for that month for employer-provided parking. Thus, for 2015, it increases the monthly exclusion for employer-provided transit passes and van-pool benefits to \$250—the amount of the maximum exclusion for employer-provided parking benefits. With respect to expenses incurred by an employee for employer-provided vanpool and transit benefits for months beginning in 2015 and prior to the date of enactment, the legislation permits employers to reimburse the employee on a tax-free basis to the extent the reimbursement exceeds \$130 per month (the limit in effect for 2015 prior to enactment) and is no more than \$250 per month.

- Pursuant to Notice 2016-14, 2016-7 I.R.B. 315 (1/29/16), for

taxable years beginning in 2016, the monthly exclusion for employer-provided transit passes and van-pool benefits is \$255.

4. Providers of minimum essential health coverage and employers subject to the Affordable Care Act's shared responsibility payment get a break—information returns for 2015 have a delayed due date. Notice 2016-4, 2016-3 I.R.B. 279 (12/28/15). Sections 6055 and 6056 were added to the Code by the Patient Protection and Affordable Care Act. Section 6055 requires annual information reporting by health insurance issuers, self-insuring employers, government agencies, and other providers of health coverage and requires the provider to furnish a related statement to each individual whose information is reported. The IRS has designated Forms 1094-B and 1095-B to meet the requirements of § 6055. Section 6056 requires annual information reporting by applicable large employers relating to the health insurance that the employer offers (or does not offer) to its full-time employees and requires the employer to furnish related statements to employees that employees may use to determine whether, for each month of the calendar year, they may claim on their individual tax returns a premium tax credit under § 36B. The IRS has designated Forms 1094-C and 1095-C to meet the requirements of § 6055. The IRS and Treasury previously issued final regulations implementing these reporting requirements. T.D. 9660, Information Reporting of Minimum Essential Coverage, 79 F.R. 13220 (3/10/14); T.D. 9661, Information Reporting by Applicable Large Employers on Health Insurance Coverage Offered Under Employer-Sponsored Plans, 79 F.R. 13231 (3/10/14). Under the final regulations, the required statements generally must be furnished to individuals or employees for a calendar year on or before January 31 of the succeeding year, and the information returns for a calendar year generally must be filed on or before February 28 of the succeeding year (March 31 if filed electronically). The regulations generally apply for calendar years beginning after 12/31/14. This notice extends the due date for furnishing the 2015 Forms 1095-B and 1095-C to 3/31/16. The notice also extends the due date for filing with the IRS the 2015 Forms 1094-B and 1094-C to 5/31/16 if not filing electronically (and to 6/30/16 if filing electronically).

- Because the extended due dates may delay an individual's receipt of Forms 1095-B or 1095-C, the notice provides that, for 2015, individuals who file their income tax returns relying upon other information received from employers or coverage providers about their offers of coverage for purposes of determining either eligibility for the § 36B premium tax credit or to confirm that they had minimum essential coverage need not amend their returns once they receive their Forms 1095-B or 1095-C or any corrections. Such individuals should keep the information on which they rely with their tax records but need not send it to the IRS.

B. Qualified Deferred Compensation Plans

1. Relief for certain closed defined benefit pension plans. Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13). This notice provides temporary nondiscrimination relief for certain "closed" defined benefit pension plans (i.e., those that provide ongoing accruals but that have been amended to limit those accruals to some or all of the employees who participated in the plan on a specified date). Typically, new hires are offered only a defined contribution plan, and the closed defined benefit plan has an increased proportion of highly compensated employees.

a. The relief is extended to plan years beginning before 2017. Notice 2015-28, 2015-14 I.R.B. 848 (3/19/15). This notice extends for an additional year the temporary nondiscrimination relief originally provided in Notice 2014-5, 2014-2 I.R.B. 276 (12/13/13), by applying that relief to plan years beginning before 2017. The notice cautions that all remaining provisions of the nondiscrimination regulations under § 401(a)(4) (including the rules relating to the timing of plan amendments under Reg. § 1.401(a)(4)-5) continue to apply. Treasury and the IRS anticipate issuing proposed amendments to the § 401(a)(4) regulations that would be finalized and apply after the relief under Notice 2014-5 and this notice expires.

b. Proposed regulations provide nondiscrimination relief for certain closed plans and formulas and make other changes. REG-125761-14, Nondiscrimination Relief for Closed Defined Benefit Pension Plans and Additional Changes to the Retirement Plan

Nondiscrimination Requirements, 81 F.R. 4976 (1/29/16). The Treasury Department and the IRS have published proposed amendments to the regulations under § 401(a)(4), which provides generally that a plan is a qualified plan only if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees. The proposed regulations modify a number of provisions in the existing regulations under § 401(a)(4) to address situations and plan designs that were not contemplated in the development of the existing regulations. Many of the changes in the proposed regulations provide nondiscrimination relief for certain closed plans and formulas, but the proposed regulations also include other changes that are not limited to closed plans and formulas. The proposed amendments generally would apply to plan years beginning on or after the date of publication of final regulations and, subject to some significant exceptions, taxpayers are permitted to apply the provisions of the proposed regulations for plan years beginning on or after 1/1/14.

2. If you use an ESOP to attempt to reduce tax liability, failing to pay yourself compensation for services can be costly. DNA Proventures, Inc. Employee Stock Ownership Plan v. Commissioner, T.C. Memo. 2015-195 (10/5/15). The IRS determined that an ESOP was not qualified under § 401(a) and that its related trust therefore was not tax-exempt under § 501(a). In this declaratory judgment action, the Tax Court (Judge Dawson) held that the IRS did not abuse its discretion in making this determination. The sponsor of the ESOP, DNA Proventures, Inc., was formed by an orthopedic surgeon (Dr. Prohaska) and his wife, who were the corporation's sole stockholders, directors, and employees. In 2008, the corporation issued 1,150 shares of class B common stock to the ESOP's trust with a par value of \$10 per share. The trust then allocated those shares to Dr. Prohaska's ESOP account. The corporation paid no compensation to Dr. Prohaska or his wife in 2008. Under § 401(a)(16), a trust is not qualified if the plan provides for benefits or contributions that exceed the limitations of § 415, which for the 2008 plan year limited annual additions (the sum of employer contributions, employee contributions, and forfeitures) to the lesser of \$40,000 or 100% of the participant's compensation. The court held that, because neither Dr. Prohaska nor his wife received any compensation from the corporation for 2008, their contribution limits were zero, and the corporation's transfer of the class B common stock in 2008 was an employer contribution that exceeded the contribution limit by \$11,500. Accordingly, the court held, the ESOP failed the requirements of § 401(a)(16) and was not a qualified plan for 2008. Further, a § 415 failure is a continuing failure, and therefore the ESOP was not a § 401(a) qualified plan for all subsequent plan years. The ESOP also failed to be a § 401(a) qualified plan because it had failed to obtain annual appraisals in violation of the plan itself, which required valuation of the trust fund on each valuation date.

3. Some inflation adjusted numbers for 2016. I.R. 2015-118 (10/21/15).

- Elective deferral in §§ 401(k), 403(b), and 457 plans remains unchanged at \$18,000 with a catch up provision for employees aged 50 or older of \$6,000.
- The limit on contributions to an IRA will be unchanged at \$5,500. The AGI phase out range for contributions to a traditional IRA by employees covered by a workplace retirement plan remains unchanged at \$61,000-\$71,000 for single filers and heads of household and at \$98,000-\$118,000 for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, but the phase out range increases to \$184,000-\$194,000 for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to \$184,000-\$194,000 for married couples filing jointly, and to \$117,000-\$132,000 for singles and heads of household.
- The annual benefit from a defined benefit plan under § 415 is unchanged at \$210,000.
- The limit for defined contribution plans remains unchanged at \$53,000.
- The amount of compensation that may be taken into account for various plans remains unchanged at \$265,000, and remains unchanged at \$395,000 for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to \$61,500 for married couples filing jointly, to \$46,125 for heads of household, and to \$30,750 for singles and married individuals filing separately.

4. Guidance on application of the U.S. Supreme Court's decision in *Obergefell* to qualified retirement plans and health and welfare plans. Notice 2015-86, 2015-52 I.R.B. 887 (12/9/15). This notice, which amplifies Notice 2014-19, 2014-17 I.R.B. 979, provides guidance on the application to qualified retirement plans and health and welfare plans of the U.S. Supreme Court's decision in *Obergefell v. Hodges*, 576 U.S. ___, 135 S. Ct. 2584 (2015), which held that states must apply their civil marriage laws to same-sex couples on the same terms and conditions as they apply to opposite-sex couples and must recognize lawful same-sex marriages performed in other states. The notice states that, because same-sex marriages have already been recognized for federal tax purposes pursuant to *Windsor v. United States*, 570 U.S. ___, 133 S. Ct. 2675 (2013), and guidance issued following *Windsor*, including Rev. Rul. 2013-17, 2013-38 I.R.B. 201, "Treasury and the IRS do not anticipate any significant impact from *Obergefell* on the application of federal tax law to employee benefit plans." The notice, in Q&A format, clarifies that the *Obergefell* decision does not require changes to the terms or operation of a qualified retirement plan (because Q&A-8 of Notice 2014-19 required qualified retirement plans to be amended to reflect the *Windsor* decision no later than 12/31/14) or to the terms of a health or welfare plan. The notice provides that qualified plan sponsors might choose to make discretionary plan amendments in response to *Obergefell* and provides examples of such amendments. Pursuant to § 5.05(2) of Rev. Proc. 2007-44, 2007-28 I.R.B. 54, such discretionary amendments generally must be adopted by the end of the plan year in which the amendment is operationally effective. The notice cautions that *Obergefell* might require changes to the operation of a health or welfare plan, e.g., if the plan's terms provide that coverage is offered to the spouse of a participant as defined under applicable state law, and the plan administrator determines that applicable state law has expanded to include same-sex spouses as a result of *Obergefell*.

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

1. Reducing redundant paperwork to facilitate e-filing. T.D. 9779, 81 F.R. 48707 (7/26/16). The Treasury Department and the IRS have finalized, without change, proposed amendments to Reg. § 1.83-2(c) (REG-135524-14, Property Transferred in Connection With the Performance of Services, 80 F.R. 42439 (7/17/15)). As amended, Reg. § 1.83-2(c) requires a § 83(b) election to be made by filing one copy of a written statement with the internal revenue office with which the person who performed the services files his return. This eliminates the requirement that taxpayers submit a copy of a § 83(b) election with their tax return for the year in which the property subject to the election was transferred and thereby facilitates electronic filing. Section 83(b)(2) statutorily requires that a § 83(b) election be filed with the IRS no later than 30 days after the date that the property is transferred to the service provider. The amendment applies to property transferred on or after 1/1/16. However, taxpayers may rely on the guidance in the proposed regulations (which is identical to the guidance in the final regulations) for property transferred on or after 1/1/15.

D. Individual Retirement Accounts

1. The form of the transaction was a mystery, but Judge Gustafson peers through the fog to find that the substance was what the taxpayer said it was. McGaugh v. Commissioner, T.C. Memo. 2016-28 (2/24/16). The taxpayer had a self-directed IRA of which Merrill Lynch was the custodian. Among its other assets, the IRA held stock in First Personal Financial Corp. The taxpayer asked Merrill Lynch to purchase additional stock in First Personal Financial Corp. for the IRA. Although the investment in First Personal Financial Corp. was not a prohibited investment for the IRA, Merrill Lynch, for reasons not reflected in the record, refused to purchase the stock directly. At the taxpayer's request, Merrill Lynch issued a wire transfer directly to First Personal Financial Corp., and more than 60 days thereafter, First Personal Financial Corp. issued the stock in the name of the taxpayer's IRA. Merrill Lynch attempted to

deliver the stock certificate to the taxpayer, but at trial, the possession of the stock certificate issued in the name of the IRA was unclear. The record indicated that if the stock certificate had been received by Merrill Lynch within the 60-day period, it would have been accepted. Merrill Lynch reported the transaction on Form 1099-R as a taxable distribution because it had determined that the wire transfer was a distribution to the taxpayer that was not followed by a rollover investment within the 60-day period permitted under § 408(d)(3). The IRS determined that the wire transfer issued by Merrill Lynch constituted a “distribution” from the IRA and was includible in gross income under §§ 408(d) and 72 and that, because the taxpayer had not yet reached age 59-1/2, it was an “early distribution” subject to the § 72(t) 10 percent additional tax. The Tax Court (Judge Gustafson) held that there had not been a distribution from the IRA to the taxpayer and did not uphold the deficiency. The opinion noted that there was no evidence that the taxpayer requested an IRA distribution to himself. “No cash, check, or wire transfer ever passed through [the taxpayer’s] hands, and he was therefore not a literal “payee or distributee” of any amount.” The taxpayer “was, at most, a conduit of the IRA funds.” The court distinguished *Dabney v. Commissioner*, T.C. Memo. 2014-108, which involved a similar wire transfer of self-directed IRA funds to purchase an asset and in which the court found a taxable distribution, on the basis that the asset purchased in *Dabney* (land) was one that the IRA custodian would not permit the IRA to hold. In contrast, the asset purchased in this case, stock of First Personal Financial Corp., was a permissible investment that the IRA already held.

2. SEP IRA SNAFU. *Vandenbosch v. Commissioner*, T.C. Memo. 2016-29 (2/24/16). The taxpayer maintained a self-directed SEP IRA with Edward D. Jones & Co., L.P. as the custodian. The taxpayer agreed to lend money to a friend and/or the friend’s corporation, and to that end, the taxpayer signed a form titled “Retirement Distribution or Internal Transfer.” He requested that Edward Jones distribute \$125,000 from his SEP-IRA into his joint account with his wife. (He did not elect to have federal and state income tax withheld. He checked a box indicating “I am under the age of 59 1/2. (IRS premature distribution TAX APPLIES ***).”) Edward Jones distributed \$125,000 from the SEP-IRA into the taxpayers’ joint account at Edward Jones. The taxpayer wired \$125,000 from the joint account to his personal account at BankFirst, following which the taxpayer wired \$125,000 from the BankFirst account to his friend’s account at JPMorgan Chase Bank, N.A. The taxpayer and his friend executed a loan agreement and note in their personal capacities, with the taxpayer denominated as the lender. He did not indicate that he was signing on behalf of his SEP-IRA. The taxpayer received a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reporting a gross distribution of \$125,000; the form indicated that the withdrawal was an early distribution and that the entire \$125,000 was taxable. The taxpayer reported the transaction as a § 408(d)(3) rollover. The Tax Court (Judge Buch) had no problem in finding that the taxpayer had received a distribution includable in gross income and that the § 72(t) early distribution 10 percent additional tax applied. However, the asserted \$ 6662 accuracy related penalty was not upheld because the court found that the taxpayers acted with reasonable cause and in good faith in their reliance on the advice of a tax professional. “The Vandenbosches have been using the accounting firm for over 20 years. Dr. Vandenbosch explained to his return preparer what had happened with the distribution and provided his return preparer with the note and information regarding the transfer of funds that ended with [his friend] receiving the funds. The Vandenbosches included with their return a copy of a letter from their tax preparer stating that he did not include the \$125,000 as taxable because he believed it was directly rolled over.”

3. A multi-million dollar “Abusive Roth IRA Transaction” goes south. *Polowniak v. Commissioner*, T.C. Memo. 2016-31 (2/25/16). The taxpayer had a Roth IRA that he funded with \$2,000. The Roth IRA originally owned 98 percent of a newly formed C corporation, Bevco Investments, Inc., but ultimately came to own 100 percent. From its incorporation to its dissolution, the taxpayer was Bevco’s registered agent, and officer, director, and employee. The taxpayer’s pre-existing wholly owned S corporation, Strategies, and Bevco entered into a subcontracting agreement for the taxpayer’s consulting services. Strategies would pay Bevco 75 percent of the revenue it received from certain contracts with Delphi Automotive

Services for the taxpayer's consulting services. In exchange Bevco would provide certain specified services for Strategies that would be provided personally by the taxpayer. Over the years in issue, Strategies paid approximately \$2.0 million to Bevco. Strategies reported net losses, which were passed through to the taxpayer. The IRS issued deficiency notices based on Strategies' failure to report its consulting income and determined that the taxpayer was liable for the 6 percent § 4973 excise tax for excess contributions to his Roth IRA. Bevco's gross receipts were treated as excess contributions. The Tax Court (Judge Paris) held that the payments "from Strategies of the Delphi payments to Bevco were nothing more than a mechanism for transferring value to the Roth IRA." The subcontracting agreement did not change the services provided to Delphi, and the taxpayer continued to do all of the work as he had done previously. Accordingly, applying substance over form, the amounts transferred from Strategies to Bevco constituted excess contributions to the taxpayer's Roth IRA, and the § 4973 excise tax applied. Consistently, Strategies' gross receipts were increased by the amounts transferred to Bevco and the resulting deficiency upheld. A host of penalties—under § 6651(a)(1) for failure to file Form 5329, under § 6651(a)(2) for failure to pay the excise tax, and under § 6662A for a deficiency attributable to a listed transaction, because the taxpayer's transaction was a listed transaction under Notice 2004-8, 2004-1 C.B. 333—were sustained.

4. Another case suggesting that the answer to "Why not have a self-directed IRA?" is "Just say 'No.'" *Thiessen v. Commissioner*, 146 T.C. No. 7 (3/29/16). In 2003, the taxpayers rolled over their tax-deferred § 401(k) retirement accounts into newly formed self-directed IRAs. They then caused the IRAs to acquire the initial stock of a newly formed C corporation, and caused the corporation to acquire the assets of an existing business. The taxpayers guaranteed the repayment of a loan to the corporation from the seller of the assets that was part of the acquisition price. The taxpayers reported that the rollover of the retirement funds into the IRAs was nontaxable. The IRS determined that the loan guaranties were prohibited transactions under § 4975(c)(1)(B), resulting in deemed distributions of the IRAs' assets to the taxpayers pursuant to § 408(e)(2). The Tax Court (Judge Marvel) held that the taxpayer's guaranties of the loan were prohibited transactions under § 4975(c)(1)(B), and that consequently the IRAs' assets were deemed to have been distributed to the taxpayers. *Peek v. Commissioner*, 140 T.C. 216 (2013), was not distinguishable and was followed. Because the taxpayers were not 59½ as of the first day of the year of the deemed distributions, the 10 percent § 72(t) penalty applied. Furthermore, even if its conditions were satisfied (and they were not), § 4975(d)(23)—which provides that § 4975(c)(1)(B) does not apply to the lending of money or other extension of credit between a plan and a disqualified person "in connection with the acquisition, holding, or disposition of any security or commodity, if the transaction is corrected before the end of the correction period"—was inapplicable because the taxpayer's guaranties were not in connection with the acquisition, holding, or disposition of a security or commodity. Finally, § 6501(e) applied to extend to six years the statute of limitations for assessment. The taxpayers' reporting that the rollover was nontaxable was insufficient to advise the IRS of the nature and the amount of the unreported income flowing from the deemed distributions from the IRAs on account of the loan guaranties.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. The Treasury Department and the IRS are trying to get everyone to sing Kumbaya. T.D. 9785. Definition of Terms Relating to Marital Status, 81 F.R. 60609 (9/2/16). The Treasury Department and the IRS have finalized, with some changes, proposed regulations that reflect the holdings of *Obergefell v. Hodges*, 576 U.S. ___, 135 S. Ct. 2584 (2015), *Windsor v. United States*, 570 U.S. ___, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201, defining and describing the marital status of taxpayers (REG-148998-13, Definition of Terms Relating to Marital Status, 80 F.R. 64378 (10/23/15)). Reg. § 301.7701-18 amends the current regulations under § 7701 to provide that for federal tax purposes the terms "spouse," "husband," and "wife" mean an individual lawfully married to another individual, and the term "husband and wife" means two individuals lawfully married to each other. These definitions

apply regardless of sex. However, the terms “spouse,” “husband,” and “wife” do not include individuals who have entered into a registered domestic partnership, civil union, or other similar relationship not denominated as a marriage under the law of a state, possession, or territory of the United States; the term “husband and wife” does not include couples who have entered into such a relationship, and the term “marriage” does not include such relationships.

- *Effective date.* The regulations apply to taxable years ending on or after 9/2/16. In reality, however, as a result of the holdings in *Obergefell*, *Windsor*, and Rev. Rul. 2013-17, these rules are already in effect.

B. Miscellaneous Income

1. **Compassionate saving.** New code § 529A, enacted by the Achieving a Better Life Experience (ABLE) Act of 2014, provides yet another tax-favored savings account—the ABLE account. Like 529 accounts (used to save for college education), ABLE accounts must be established by a state. Only beneficiaries who became disabled before reaching age 26 are eligible. An eligible individual is an individual (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to benefits based on blindness or disability under the Social Security Disability Insurance program or the SSI program. A disability certification is a certification to the satisfaction of the IRS made by the eligible individual or the parent or guardian of the eligible individual, that the individual meets the requirements relating to disability or blindness that includes a copy of the individual’s diagnosis relating to the individual’s relevant impairment or impairments, signed by a licensed physician. For the most part, ABLE accounts are limited to beneficiaries who are blind or have developmental disabilities, mental illness, and severe childhood conditions such as cerebral palsy. The maximum contribution is \$14,000 per year (adjusted for inflation after 2015) in cash, but states could impose maximum limits on total contributions. A beneficiary may have only one account. Contributions are not deductible, but the income in the account is accumulated tax-free. A contribution to an ABLE account is treated as a completed gift of a present interest to the beneficiary of the account. Thus, the contribution qualifies for the per-donee annual gift tax exclusion (\$14,000 for 2014) and, to the extent of the exclusion, is exempt from the generation skipping transfer tax. Withdrawals are tax-free to the extent used for eligible services, including education; housing; transportation; employment support; health, prevention, and wellness costs; assistive technology and personal support services; and other IRS-approved expenses. Distributions used for nonqualified expenses are includable in income to the extent they represent a distribution of earnings (generally determined in the manner provided for annuities in § 72) and subject to a 10 percent penalty. (A distribution from an ABLE account generally is not subject to gift tax or GST tax.) ABLE accounts can generally be rolled over only into another ABLE account for the same individual or into an ABLE account for a sibling who is also an eligible individual. Upon the death of the beneficiary the balance in the account (after Medicaid reimbursements) is distributable to the deceased beneficiary’s estate or to a designated beneficiary; the distribution will be subject to income tax on investment earnings, but not to a penalty. Generally, account assets are not included in determining eligibility for SSI or Medicaid. However, SSI payments are suspended when an account balance exceeds \$100,000, but Medicaid benefits would continue.

a. **Gearing up for ABLE regulations.** Notice 2015-18, 2015-12 I.R.B. 765 (3/11/15). This notice provides advance notification of a provision anticipated to be included in the proposed regulations to be issued under § 529A. Although § 529A was modeled on § 529, which provides tax-exempt status to qualified tuition programs (QTPs) established and maintained by a state, the § 529A guidance, when issued, may differ in various ways from the proposed regulations that have been promulgated under § 529. In particular, the Treasury Department and the IRS anticipate that, consistent with § 529A(e)(3), the guidance will provide that the owner of an ABLE account is the designated beneficiary of the account. With regard to the ABLE account of a designated beneficiary who is not the person with signature authority over that account, the person with signature authority over the account of the designated

beneficiary may neither have nor acquire any beneficial interest in the account and must administer that account for the benefit of the designated beneficiary of that account.

b. Proposed regulations under § 529A provide guidance on ABLE accounts. REG-102837-15, Guidance Under Section 529A: Qualified ABLE Programs, 80 F.R. 35602 (6/22/15). The IRS and Treasury have issued proposed regulations under § 529A that address a wide range of issues related to ABLE accounts. The proposed regulations provide detailed guidance on the requirements a program must satisfy to be a qualified ABLE program, but the preamble explains that states enacting legislation creating ABLE accounts and individuals establishing such accounts will not fail to gain the benefits of § 529A merely because the legislation or the account documents do not fully comply with the final regulations when issued because the final regulations will contain transition relief to permit programs and account documents to be brought into compliance. Consistent with Notice 2015-18, the proposed regulations provide that the owner of an ABLE account is the designated beneficiary of the account and that a person other than the designated beneficiary with signature authority over the account may neither have nor acquire a beneficial interest in the account during the designated beneficiary's lifetime and must administer the account for the benefit of the designated beneficiary. To implement the limits on contributions to an ABLE account, the proposed regulations provide that a qualified ABLE program must return to the contributors contributions that exceed the annual gift tax exclusion or that cause the ABLE account to exceed the limit established by the state for its qualified tuition program, along with all net income attributable to the returned contributions. The proposed regulations provide that contributions to an ABLE account (other than contributions by the designated beneficiary) are treated as a completed gift of a present interest to the designated beneficiary. Although aggregate contributions to an ABLE account from all contributors cannot exceed the annual per-donee gift tax exclusion (\$14,000 in 2015), gift tax consequences could arise if a contributor makes other gifts to the designated beneficiary in addition to the gift to the ABLE account. The proposed regulations provide that, under the applicable gift tax rules (Reg. § 25.2511-1(c), (h)), a contribution to an ABLE account by a corporation, partnership, trust, estate or other entity is treated as a gift by its shareholders, partners, or other beneficial owners in proportion to their respective ownership interests in the entity. Distributions from an ABLE account are not includible in the designated beneficiary's gross income to the extent they do not exceed the beneficiary's "qualified disability expenses." The proposed regulations provide guidance on what expenses are "qualified disability expenses;" the preamble states that this term "should be broadly construed to permit the inclusion of basic living expenses and should not be limited to expenses for items for which there is a medical necessity" and could include, for example, expenses for common items such as smart phones "if they are an effective and safe communication or navigation aid for a child with autism." Although an ABLE account for a designated beneficiary may be established only under the ABLE program of the beneficiary's state of residence, the proposed regulations permit the beneficiary to continue to maintain the account even if the beneficiary ceases to be a resident of that state. The proposed regulations provide guidance on the reporting and recordkeeping requirements to which qualified ABLE programs are subject. The regulations will be effective upon publication of final regulations and generally will apply to taxable years beginning after 12/31/14. The reporting requirements will apply to information returns filed and payee statements furnished after 12/31/15. Taxpayers and qualified ABLE programs may rely on the proposed regulations until final regulations are published.

c. The IRS provides a preview of coming changes to the proposed regulations that were issued under § 529A on ABLE accounts. Notice 2015-81, 2015-49 I.R.B. 784 (11/20/15). Comments on the proposed regulations issued under § 529A suggested that three provisions of the proposed regulations would create significant barriers to the establishment of ABLE programs. This notice sets forth how the Treasury Department and the IRS intend to respond to these comments by revising the proposed regulations when those regulations are finalized. First, the final regulations will eliminate the requirement in the proposed regulations that a qualified ABLE program must establish safeguards to distinguish between distributions used for qualified disability expenses (which are tax-free) and other

distributions (which are taxable), and instead will require the designated beneficiary to categorize distributions. Second, the final regulations will eliminate the requirement in the proposed regulations that a qualified ABLE program must obtain the TIN of each contributor to the ABLE account at the time of the contribution if the program has a system in place to identify and reject excess contributions and excess aggregate contributions before they are deposited. The final regulations will require a qualified ABLE program to request the TIN of a contributor only if the contributor makes an excess contribution or excess aggregate contribution that is deposited in the ABLE account. Third, the final regulations will modify the procedure in the proposed regulations for an individual who establishes their eligibility as a designated beneficiary by filing a disability certification with the Secretary of the Treasury. The proposed regulations provide that the certification will be deemed to be filed with the Secretary when the certification, which must include a copy of the beneficiary's diagnosis signed by a licensed physician, is received by the ABLE program. The final regulations will provide that the designated beneficiary can instead submit to the ABLE program a certification under penalties of perjury that the beneficiary (or the beneficiary's agent under a power of attorney or a parent or legal guardian of the individual) has the signed physician's diagnosis and that the signed diagnosis will be retained and provided to the ABLE program or the IRS upon request. Taxpayers can rely on the guidance in this notice pending the issuance of final regulations.

2. The IRS announces that it will not kick victims of identity theft while they're down. Announcement 2015-22, 2015-35 I.R.B. 288 (8/13/15). The IRS will not assert that an individual whose personal information may have been compromised in a data breach must include in gross income the value of the identity protection services provided by the organization that experienced the data breach. Nor will the IRS assert that an employer providing identity protection services to employees whose personal information may have been compromised in a data breach of the employer's (or employer's agent or service provider's) recordkeeping system must include the value of the identity protection services in the employees' gross income and wages. This announcement does not apply to cash received in lieu of identity protection services, or to identity protection services received for reasons other than as a result of a data breach, such as identity protection services received in connection with an employee's compensation benefit package. Nor does it apply to proceeds received under an identity theft insurance policy; the treatment of insurance recoveries is governed by existing law.

a. The IRS again shows that it has a heart. Announcement 2016-2, 2016-3 I.R.B. 283 (12/30/15). Extending the principles of Announcement 2015-22, 2015-35 I.R.B. 288, the IRS has announced that it will not assert that an individual must include in gross income the value of identity protection services provided before a data breach occurs by the individual's employer or by another organization to which the individual provided personal information (for example, name, social security number, or banking or credit account numbers). Nor will the IRS assert that an employer providing identity protection services to its employees before a data breach occurs must include the value of the identity protection services in the employees' gross income and wages. Non-inclusion does not apply to cash received in lieu of identity protection services.

3. Per capita distributions to members of an Indian tribe from a tribal trust account generally are excluded from gross income. Notice 2015-67, 2015-41 I.R.B. 546 (9/18/15). This notice, which supersedes Notice 2014-17, 2014-13 I.R.B. 881 (3/10/14), explains the tax treatment of distributions to members of an Indian tribe from trust accounts maintained by the Secretary of the Interior on behalf of federally recognized Indian tribes. Such distributions generally are excluded from the recipient's gross income, but would constitute gross income if the trust account "is used to mischaracterize what would otherwise be taxable income as nontaxable per capita distributions." This exception might apply, for example, if the distributions really are mischaracterized compensation to tribal members for their services, distributions of business profits, or gaming revenues. The notice provides examples that illustrate such mischaracterization. The notice does not affect the federal income taxation of distributions from individual Indian trust accounts (from which per capita distributions cannot be made) and does

not affect the federal income taxation of and withholding from distributions made pursuant to a Revenue Allocation Plan under the Indian Gaming Regulatory Act.

4. This may be one of the few sensible extenders. The 2015 PATH Act, § 151, retroactively extended through 12/31/15 and extends through 2016 the § 108(a)(1)(E) exclusion for up to \$2 million (\$1 million for married individuals filing separately) of income from the cancellation of qualified principal residence indebtedness.

5. An exclusion from gross income for wrongfully incarcerated individuals. The 2015 PATH Act, § 304, adds to the Code § 139F, which excludes from the gross income of an individual who is convicted of a criminal offense under federal or state law and wrongfully incarcerated any civil damages, restitution, or other monetary award relating to the individual's incarceration. An individual was wrongfully incarcerated if the individual is pardoned, granted clemency, or granted amnesty for the offense because the individual was innocent, or if the conviction is reversed or vacated and the charging instrument is then dismissed or the individual is found not guilty at a new trial. The new provision applies to taxable years beginning before, on, or after 12/18/15, the date of enactment. A special rule allows individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if the claim would normally be barred by operation of any law or rule of law (including res judicata), if the claim for credit or refund is filed before the close of the one-year period beginning on 12/18/15.

a. Amounts received by a person other than the wrongfully incarcerated individual are not eligible for the § 139F exclusion. *In re Elkins*, 117 A.F.T.R.2d 2016-2124 (Bankr. N.D. Ohio 6/14/16). Clarence Elkins was convicted of rape and murder and was incarcerated for seven years. He was exonerated and filed a lawsuit based on his wrongful conviction and incarceration in which he asserted claims for loss of consortium on behalf of his wife and son, who were debtors in a Chapter 7 bankruptcy proceeding. Mr. Elkins and his family received a settlement of \$5.25 million, of which his wife and son had shares of \$611,000 and \$627,000 respectively. The bankruptcy trustee filed tax returns for the bankruptcy estates including part of their shares of the settlement in gross income. The bankruptcy proceeding was closed in 2014. Following Congress's enactment of § 139F in 2015, the wife and son sought to reopen their bankruptcy cases to file amended bankruptcy estate tax returns to exclude the settlement proceeds previously included in gross income. The Bankruptcy Court (Judge Kendig) denied their motions to reopen because doing so would be futile. The court reasoned that the exclusion of § 139F is available only to the wrongfully incarcerated individual, not to other persons, such as Mr. Elkins' wife and son. The court supported its conclusion by reference to the language of § 139F, which provides in subsection (a):

In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

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

1. "It may have been a fun business, but fun doesn't convert a business to a hobby. If it did, Facebook would be a hobby, Microsoft and Apple would be hobbies, Amazon would be a hobby, etc. ad infinitum." *Roberts v. Commissioner*, 820 F.3d 247 (7th Cir. 4/15/16). The taxpayer had been a successful owner and operator of restaurants, bars, and nightclubs. He began withdrawing from those businesses in the mid-1990s, but he remained a paid consultant to the new owners. In 1999 he bought his first horses and embarked on a career as a thoroughbred race horse owner, breeder and trainer. Over the following years, his stable of race horses increased; by 2001 he had ten race horses and a breeding stallion. In 2003 he was licensed as a trainer. In 2006 he acquired a 180-acre farm and invested between \$500,000 and \$600,000 in improvements for the training of racehorses on the property. He trained the horses himself; "he even bathed them himself." He spent 12 hours a day working with the horses on race days and about 8 hours a day on other days. In addition, he served on the boards of two professional horse-racing associations "in what the Tax Court's opinion describe[d] as

‘leadership roles.’” However, his venture was not profitable. In 2005 and 2006, the years in issue, he lost \$153,420 and \$30,604, respectively. In 2007 and 2008, which were not at issue, the losses increased to \$98,251 in 2007 and to \$291,888 in 2008. He deducted the losses on his tax returns from his other income, mainly income from consulting in the restaurant business and from renting and selling real estate, but the IRS disallowed the losses for 2005 and 2006 as hobby losses under § 183. The Tax Court (Judge Paris) sustained the IRS’s position and disallowed the losses, even though it found that only the eighth (substantial income from sources other than the activity) and ninth (elements of personal pleasure or recreation) factors in Reg. § 1.183-2 favored the IRS. The Seventh Circuit, in an opinion by Judge Posner, reversed. According to the Court of Appeals, “[t]he Tax Court’s ruling that Roberts’ horse-racing enterprise was a hobby in 2005 and 2006 but became a business in 2007 and remained so in 2008, and apparently has been one in every year since given the IRS’s failure to challenge his horse-racing deductions for any year since 2008, is untenable.” The Court of Appeals found all nine factors in Reg. § 1.183-2 to favor the taxpayer, but was dismissive of the factors, referring to the regulation as “goofy.”

Notice too that the factors in the Treasury Regulation overwhelmingly favor Roberts’ claim that even in 2005 and 2006 his horse-racing enterprise was a business. He conducted it in a businesslike way (factor 1). He prepared by extensive study (to obtain a training license) (factor 2). He largely withdrew from his previous businesses in order to devote “most of his energies” to his horse-racing enterprise (factor 3). He expected to derive an eventual profit from the enterprise, including profit in the form of appreciation of the value of the land and buildings used in the enterprise (factor 4)—it’s not as if he were a billionaire indifferent to the modest profit that probably was all he could expect from horse racing. Entering the restaurant business on a small scale in his twenties, Roberts had suffered setbacks that prevented his business from being an immediate success—indeed his first restaurant burned down and the insurance settlement was too small to enable him to rebuild it as a full-service establishment. Yet he “grew” the business to large dimensions over time, a pattern consistent with his attempting to repeat the process in his horse-racing venture in 2005 and 2006 (factor 5). “A series of losses during the initial or start-up stage of the activity may not necessarily be an indication that the activity is not engaged in for profit” (factor 6)—that’s this case, all right. A “substantial profit, though only occasional, would generally be indicative that an activity is engaged in for profit” (factor 7). The Tax Court awarded this factor to Roberts because he earned money from racing his first two horses and the growth in the prize purses (owing to the slot machines) could be expected to increase his income in the future; that one of his horses was nominated to run in the Triple Crown Races suggested that his horses might eventually achieve greater success.

“The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit” is factor 8. In 2005 and 2006 Roberts reported adjusted gross income of \$297,881 and \$1,359,339 even after deducting his horse-racing losses, but he happened to have sold a large piece of land in 2006, and the Tax Court found that he is “not an excessively wealthy individual.” The court concluded that this factor favored the IRS, but we believe the existence of other income has little weight when many other factors indicate a profit objective.

As for the last factor—“the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause

the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.” This is sensible since obviously many businessmen derive pleasure, self-esteem, and other nonmonetary “goods” from their businesses, and horse racing is just the kind of business that would generate such “goods” for participants such as the owners and trainers (Roberts is both) of the horses.

About factor 9 the court added that “there is likely no profit objective where the taxpayer combines horse racing with social and recreational activities.” That is contrary to what factor 9 says, and in addition no social or recreational activities engaged in by Roberts are listed, let alone described, by the court. The court does say that “petitioner’s involvement with the professional horse racing associations demonstrates that he engaged in some social aspect of the industry,” but that’s like saying that serving on a corporate board of directors is a “social” activity.

All in all, the Court of Appeals’ opinion is a well-written missive admonishing the Tax Court not to confuse with a hobby the start-up phase of an enjoyable but risky business, entered into as a new full-time career, in an established industry, with a high likelihood of failure with a low probability of a big payoff.

D. Deductions and Credits for Personal Expenses

1. When multiple unmarried taxpayers co-own a qualifying residence, do the debt limit provisions found in § 163(h)(3)(B)(ii) and (C)(ii) apply per taxpayer or per residence?

a. The Tax Court says the limits apply per taxpayer: two unmarried co-owners holding residences in joint ownership were restricted to mortgage interest deductions on only \$1.1 million of loans. *Sophy v. Commissioner*, 138 T.C. 204 (3/5/12). The Tax Court (Judge Cohen) decided that the \$1.1 million § 163(h)(3) limitation on indebtedness giving rise to qualified residence interest should be applied on both a per-taxpayer and a per-residence basis with respect to residence owners who are not married to each other, rather than solely on the per-taxpayer basis argued for by the unmarried taxpayers who jointly owned the two residences in question on which the purchase money mortgages exceeded \$1.1 million. Thus, each of the two taxpayers, who were registered domestic partners under California law, was limited to deducting interest on only \$500,000 of acquisition indebtedness on their two residences and \$50,000 of home equity indebtedness on their principal residence. The decision was based upon congressional intent, as shown by the statute’s repeated use of phrases “with respect to any qualified residence” and “with respect to such residence,” which would have been superfluous had Congress intended that the limitations be applied on a per-taxpayer basis.

b. But the Ninth Circuit says the debt limits apply per taxpayer, not per residence. *Voss v. Commissioner*, 796 F.3d 1051 (9th Cir. 8/7/15). In a 2-1 opinion by Judge Bybee, the Ninth Circuit reversed the Tax Court’s decision in *Sophy v. Commissioner*, 138 T.C. 204 (2012), and held that the debt limit provisions of § 163(h)(3) apply on a per-taxpayer basis to unmarried co-owners of a qualified residence and remanded the case for a determination of the proper amount of interest that each taxpayer was entitled to deduct. The opinion focused principally on the parentheticals in § 163(h)(3)(B)(ii) and (C)(ii) that halve the debt ceilings “in the case of a married individual filing a separate return.” If Congress had wanted to draft the parentheticals in per-residence terms, it could have done so. “The per-taxpayer wording of the parentheticals, considered in light of the parentheticals’ use of the phrase ‘in the case of,’ thus suggests that the wording of the main clause—in particular, the phrase ‘aggregate amount treated’—should likewise be understood in a per taxpayer manner.” Furthermore, “the very inclusion of the parentheticals suggests that the debt limits apply per taxpayer.” The Ninth Circuit majority’s reasoning was summarized as follows:

We infer this conclusion from the text of the statute: By expressly providing that married individuals filing separate returns are entitled to deduct interest on up to \$550,000 of home debt each, Congress implied that unmarried co-owners filing

separate returns are entitled to deduct interest on up to \$1.1 million of home debt each.

The majority opinion also pointed out that applying a per residence ceiling would be largely unworkable in situations where two unmarried taxpayers each had an individual primary residence that was a qualified residence but co-owned a secondary residence that was a qualified residence. Additionally, the majority noted that “[i]f Congress wants to go further and ensure that two or more unmarried taxpayers are treated as a single taxpayer for purposes of a particular deduction or credit, it can do that too,” citing the now-expired § 36 first-time homebuyer credit as an example of a provision that did exactly that. The court acknowledged that the provisions of § 163(h)(3) limiting married taxpayers filing separately to one-half of the amount of debt ceiling allowed to married taxpayers filing jointly results in a marriage penalty, but it was “not particularly troubled.”

Congress may very well have good reasons for allowing that result, and, in any event, Congress clearly singled out married couples for specific treatment when it explicitly provided lower debt limits for married couples yet, for whatever reason, did not similarly provide lower debt limits for unmarried co-owners.

Finally, the court refused to give any deference to CCA 200911007, 2009 WL 641772 (11/24/08, released 3/13/09), which concluded that unmarried co-owners are “limited to \$1,000,000 of total, ‘aggregate’ acquisition indebtedness.”

- Judge Ikuta’s dissenting opinion would have affirmed the Tax Court’s decision by giving deference to CCA 200911007, which she described as “both reasonable and persuasive.”

c. And a taxpayer friendly IRS opts to surrender to the Ninth Circuit view on a nationwide basis, thereby assuring yet another marriage penalty. AOD 2016-02, 2016-31 I.R.B. 193 (8/1/16). The IRS has acquiesced in the Ninth Circuit’s decision in *Voss*, thus negating any continuing importance for the Tax Court’s decision in *Sophy*. As a result, the § 163(h)(3) limitations apply on a per taxpayer basis, allowing each taxpayer to deduct interest on mortgage indebtedness of up to \$1.1 million, nationwide and not merely in the states comprising the Ninth Circuit.

2. Standard deduction for 2016. Rev. Proc. 2015-53, 2015-44 I.R.B. 615 (10/21/15). The standard deduction for 2016 will be \$12,600 for joint returns and surviving spouses, \$6,300 for unmarried individuals, \$6,300 for married individuals filing separately, and \$9,300 for heads of households. These figures are unchanged from 2015 except the figure for heads of households, which increased from \$9,250.

3. The IRS extends through 2017 the safe harbor method for computing deductions for payments made on a home mortgage by financially distressed homeowners. Notice 2015-77, 2015-47 I.R.B. 676 (11/6/15). The IRS previously (1) concluded that payments made with federal funds pursuant to specified programs by state housing agencies to or on behalf of a financially distressed homeowner are excluded from the homeowner’s gross income under the general welfare exclusion, (2) provided a safe harbor method for computing the amount the homeowner can deduct on the homeowner’s return, and (3) provided certain information reporting and penalty relief to mortgage servicers and state housing agencies. Notice 2011-14, 2011-14 I.R.B. 544 (2/23/11), *modified by* Notice 2011-55, 2011-47 I.R.B. 793 (10/31/11), *amplified and supplemented by* Notice 2013-7, 2013-6 I.R.B. 477 (1/16/13). This notice extends through 2017 the information reporting and penalty relief and the safe harbor method for computing the amount the homeowner can deduct on the homeowner’s return. Under the safe harbor, a homeowner can deduct the lesser of (1) the sum of all payments on the home mortgage that the homeowner actually makes during a taxable year to the mortgage servicer or the state housing agency, or (2) the sum of amounts shown on Form 1098, Mortgage Interest Statement, for mortgage interest received, real property taxes, and mortgage insurance premiums (if deductible for the taxable year under § 163(h)(3)(E)). A homeowner can use this safe harbor method if the homeowner participates in an eligible state program and the homeowner meets the

requirements of §§ 163 and 164 to deduct all of the mortgage interest on the loan and all of the real property taxes on the principal residence.

4. This one's really only for taxpayers in Texas and Florida and a few other states that don't have a state income tax. The 2015 PATH Act, § 106, retroactively extended through 12/31/15 and made permanent the § 164(b)(5)(A) election to claim an itemized deduction for state and local general sales and use taxes instead of state and local income taxes.

5. Of course there's no chance the mortgage insurance companies will increase their premiums to capture the benefit of this deduction to the involuntary purchaser. Hah! The 2015 PATH Act, § 152, retroactively extended through 12/31/15 and extends through 2016 the § 163(h)(3)(E) deduction (subject to the pre-existing limitations) for mortgage insurance premiums in connection with acquisition indebtedness with respect to the taxpayer's qualified residence.

6. Why not just increase, rather than decrease, Pell grants? The 2015 PATH Act, § 153, retroactively extended through 12/31/15 and extends through 2016 the § 222 above-the-line deduction for certain eligible individuals of a limited amount of qualified higher education tuition and related expenses of the taxpayer, his spouse, or dependents.

E. Divorce Tax Issues

1. The taxpayer and his former spouse might have been overly optimistic that they could continue to operate jointly owned businesses following their divorce. When things did not work out, § 1041 prevented the taxpayer from recognizing gain on the sale of his interest. Belot v. Commissioner, T.C. Memo. 2016-113 (6/13/16). During their marriage, the taxpayer and his former spouse operated three businesses: a dance school organized as a C corporation, a business engaged in the retail sale of dancewear and accessories organized as an LLC, and a real estate business organized as an LLC taxed as a partnership. During their divorce proceeding, the taxpayer and his spouse equalized their ownership interests in the businesses and planned to continue operating them together following the divorce. A judgment of divorce was entered in January 2007. In September 2007, the taxpayer's former spouse brought an action in which she alleged that he had mismanaged the dance school, sought to remove him as a director and employee, and asked the court to compel him to sell his shares to the corporation or to her. To resolve this litigation, the parties entered into a settlement agreement in April 2008, pursuant to which the taxpayer sold his interests in all of the businesses to his former spouse for \$1.5 million, payable over a ten-year period. The IRS asserted that the taxpayer's transfer of his interests did not qualify for nonrecognition under § 1041(a), which provides that no gain or loss is recognized on the transfer of property to a spouse or to a former spouse incident to divorce. Under § 1041(c), a transfer is incident to divorce if it occurs within one year after the date on which the marriage ceases or is related to the cessation of the marriage. The relevant regulation, Reg. § 1.1041-1T(b), Q&A-7, provides:

A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument ... and the transfer occurs not more than 6 years after the date on which the marriage ceases. ... Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

The Tax Court (Judge Colvin) held that the taxpayer's transfer of his ownership interests was "incident to divorce" within the meaning of § 1041(c). In reaching this conclusion, the court

rejected the government's argument that the taxpayer's transfer, which occurred more than one year after the date on which the marriage ceased, was not related to the cessation of the marriage because it was not made pursuant to a divorce or separation instrument. The relevant regulation, the court reasoned, contemplates that a transfer not made pursuant to a divorce or separation instrument can be related to the cessation of the marriage if it is "made to effect the division of property owned by the former spouses at the time of the cessation of the marriage." The court also rejected the government's arguments that the transfer was not related to the cessation of the marriage because (1) it took the form of a sale, and (2) the litigation that resulted in the sale concerned a business dispute, as evidenced by the fact that the litigation was brought in the superior court civil part rather than the family court, which had jurisdiction over the taxpayer's divorce.

F. Education

1. The Hope Scholarship Credit on steroids: the American Opportunity Tax Credit becomes permanent. The 2015 PATH Act, § 102, made permanent the § 25A(i) American Opportunity Tax Credit ("AOTC"), an enhanced version of the § 25A(b) Hope Scholarship Credit. The AOTC, which had been scheduled to expire after 2017, enhances several aspects of the Hope Scholarship Credit, including increasing the maximum credit to \$2,500 per student, permitting the credit for the first four years (rather than two years) of postsecondary education, expanding the definition of "qualified tuition and related expenses" to include course materials, and increasing the AGI thresholds that trigger a reduction in the credit.

G. Alternative Minimum Tax

1. What God has joined together let the tax man put asunder! Vichich v. Commissioner, 146 T.C. No. 12 (4/21/16). The issue in this case was whether § 53(e) allows a taxpayer, to use an AMT credit arising from incentive stock options exercised by a deceased spouse. The taxpayer, Nadine Vichich married William Vichich in 2002 and he died in 2004. William previously had been married to someone else. In 1998 William exercised employer-granted incentive stock options that resulted in AMT liability, which he reported on a 1998 tax return filed jointly with his then wife. (The difference between the exercise price and the fair market value of the stock on the date of exercise (the spread) is treated as an item of adjustment and is included in the taxpayer's AMTI.) Payment of the AMT liability in 1998 generated a § 53(e) AMT credit carryforward. On her 2009 tax return, Nadine reported an AMT credit derived from William's 1998 AMT credit carryforward that she used to offset her individual income tax liability. The IRS disallowed the claimed AMT credit, and the Tax Court (Judge Nega) upheld the deficiency; Nadine was not entitled to use the AMT credit to offset her individual income tax liability for 2009. The IRS conceded that William was entitled to the credit following his prior divorce, but neither the statute nor the regulations provided an answer as to whether any of the AMT credit transferred to Nadine after William's death. Prior case law established that "[i]t is axiomatic that income is taxed to the person who earns it, and credits and deductions are thus generally not transferable between taxpayers." Furthermore, "[t]he Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but 'does not create a new tax personality'." Observing that "the ability to offset one spouse's income with the other's [NOL] loss deductions is available only to spouses who elect to file joint returns," the court found that the same principle should apply to credits. "[B]ecause petitioner could not deduct for a postmarital year an NOL incurred by her husband even during their marriage, much less before it, we conclude, on the basis of the record and the arguments before us, that, she was not entitled to take into account under section 53(b)(1) her husband's premarital adjusted net minimum tax liability in computing her own minimum tax credit for tax year 2009."

VI. CORPORATIONS

A. Entity and Formation

1. **Built-in losses cannot be “imported” either from offshore or from a U.S. tax-exempt.** T.D. 9759, Limitations on the Importation of Net Built-in Losses, 81 F.R. 17066 (3/28/16). The Treasury and IRS have finalized, with minor changes, proposed regulations under §§ 334(b)(1)(B) and 362(e)(1), dealing with the importation of built-in losses in § 332 subsidiary liquidations and § 351 transfers (REG-161948-05, Limitations on the Importation of Net Built-in Losses, 78 F.R. 54971 (9/9/13)). (These regulations do not deal with § 362(e)(2); Reg. § 1.362-4 deals with § 362(e)(2).) The regulations also finalize proposed amendments to the regulations under §§ 332 and 351 to reflect statutory changes (REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 F.R. 11903 (3/10/05)). Section 362(e)(1) applies property-by-property to assign each transferred property a fair market value basis rather than the normal § 362(a) transferred basis, if (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer. If a controlled subsidiary is liquidated and (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer, § 334(b)(1)(B) provides the parent with a fair market value basis in properties received in the liquidation.

- Reg. § 1.362-3 terms the transactions to which § 362(e)(1) applies “loss importation transactions,” and the property to which it applies “loss importation property.” The regulations use a hypothetical sale analysis to identify loss importation property. The regulations clarify that § 362(e)(1) applies to transfers by U.S. tax-exempt organizations as well as transfers by foreign persons. The regulations also provide a look-through rule for transfers by grantor trusts, partnerships, and S corporations, and in certain “tax-avoidance” transactions, as well as rules dealing with tiered entities. (Although Treasury and the IRS agree that clarification of the interaction of the regulations issued under §§ 362(e)(1) and 362(e)(2) and the regulations proposed under § 704(c)(1)(C) would be appropriate, the preamble to the final regulations states that these issues will be addressed when the regulations under § 704(c)(1)(C) are finalized.) The regulations clarify that whether a transaction is a loss importation transaction is determined with respect to the aggregate amount of built-in gain and built-in loss in all importation property acquired from all transferors in the transaction, unlike the transferor-by-transferor approach of § 362(e)(2). Detailed basis calculation rules are specified. In response to comments on the proposed regulations, the final regulations expressly provide that, notwithstanding the application of the anti-loss importation or anti-duplication provisions to a transaction, the transferee’s basis is generally considered determined by reference to the transferor’s basis for federal income tax purposes. The regulations are illustrated by nine examples. The rules in Reg. § 1.362-3 apply to any transaction occurring on or after 3/28/16, unless effected pursuant to a binding agreement that was in effect prior to that date and at all times thereafter. Taxpayers may apply the proposed regulations to transactions occurring after 10/22/04 – almost 9 years retroactively.

- Amendments to Reg. § 1.334-1(b) apply similar rules to “loss importation transactions,” and “loss importation property” in § 332 liquidations. All of the examples deal with the liquidation of a foreign subsidiary by a U.S. parent.

B. Distributions and Redemptions

1. **Non-arm’s length transactions between commonly controlled corporations results in a festival of taxation.** *Key Carpets, Inc. v. Commissioner*, T.C. Memo. 2016-30 (2/25/16). Mr. and Mrs. Johnson owned all of the stock of Key Carpets, Inc., which sold carpets to businesses. Key Carpets was very successful. Mr. Johnson owned all of the stock of Clean Hands Co., Inc., which was attempting to develop a voice-activated hand washing monitoring system. Both businesses operated out of the same building. For the years in question, Clean Hands employed a computer technician who developed the voice-activated hand washing monitoring system. Mr. Johnson owned the patent on this system but testified that he thought Key Carpets owned the system. In addition to assisting with the development of the hand

washing monitoring system, the Clean Hands computer technician provided information technology (IT) services to Key Carpets. The computer technician did not maintain a time log for 2008; he testified that he estimated “with a reasonably high degree of accuracy” that 85 percent to 95 percent of his time at Clean Hands was spent working on the hand washing monitoring system. Clean Hands paid the computer technician a salary of \$100,000 in 2007 and \$90,000 in 2008. Key Carpets paid Clean Hands throughout the years at issue for purportedly developing the hand washing monitoring system and providing Key Carpets with IT services—\$130,300 in 2007 and \$128,222 in 2008—and deducted those amounts for “computer service and consulting.” The IRS asserted deficiencies against both Key Carpets and the Johnsons on the grounds that the payments by Key Carpets to Clean Hands were not ordinary and necessary business expenses, but were constructive dividends. The Tax Court (Judge Paris) upheld the deficiencies with respect to 85 percent of the amounts of the payments; only 15 percent of the amounts paid to Clean Hands by Key Carpets were actually paid for IT service provided to Key Carpets by Clean Hands’ computer technician. Because Key Carpets had no actual ownership interest in the hand washing monitoring system, Key Carpets’ transfer of funds to Clean Hands provided significant economic benefit to Mr. Johnson and his business, Clean Hands. Thus, following *Stinnett’s Pontiac Serv., Inc. v. Commissioner*, T.C. Memo. 1982-314, *aff’d*, 730 F.2d 634 (11th Cir. 1984), which held that when a shareholder was required to make capital contributions and caused a related company to pay the contributions, the payments were for the personal benefit of the common shareholder and thus a constructive dividend, Johnson received a constructive dividend. Section 6662 accuracy related penalties were upheld.

2. Clarifying the amount of deemed taxable stock dividends. We guess there was a problem. REG-133673-15, Deemed Distributions Under Section 305(c) of Stock and Rights to Acquire Stock, 81 F.R. 21795 (4/13/16). The IRS and Treasury have published proposed amendments to Regs. §§ 1.305-1, 1.305-3, and 1.305-7 that deal with distributions of warrants, subscription rights, options, convertible instruments that give the holder a right to convert the instruments into shares of stock in the issuing corporation, and similar instruments and adjustments to a convertible instrument that increase the number of shares of stock a holder would receive upon conversion that correspond to distributions of stock, cash, or other property made to actual shareholders, as well as rights to acquire stock that prevent actual shareholders’ interests from being diluted as a result of distributions of stock, cash, or other property to deemed shareholders (i.e., holders of rights to acquire stock). The proposed regulations provide that a deemed distribution of a right to acquire stock will be treated as a distribution of additional rights to acquire stock, the amount of which is the fair market value of the right. When an adjustment is or results in a deemed distribution under Prop. Reg. § 1.305-7(c)(1) or (2), the deemed distribution occurs at the time the adjustment occurs (pursuant to the terms of the relevant instruments), but in no event later than the date of the distribution of cash or property that results in the deemed distribution. For rights with respect to publicly-traded stock, if the relevant instrument does not provide when the adjustment occurs, the deemed distribution would occur immediately prior to the opening of business on the ex-dividend date for the distribution of cash or property that results in the deemed distribution. Prop. Reg. § 1.1441-2(d)(4)(i) would clarify that a withholding agent has an obligation to withhold on a deemed distribution (as defined in Reg. § 1.305-1(d)(7)).

C. Liquidations

D. S Corporations

1. The lifetime of built-in gain is now permanently shorter. The Small Business Jobs Act of 2010 shortened the holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation to five years preceding the corporation’s tax year beginning in 2011. Before the change, the holding period was ten years for sales or exchanges in tax years beginning before 2009, and seven years for tax years beginning in 2009 or 2010. The § 1374 five-year holding period reduction was extended to recognized built-in gain in 2012 and 2013 (by the 2012 Taxpayer Relief Act, § 326(a)(2)) and to recognized built-in gain in 2014 (by the 2014 Tax Increase Prevention Act). The 2015 PATH Act, § 127,

retroactively reinstated and made permanent the § 1374 five-year holding period reduction for recognized built-in gain in taxable years beginning after 12/31/14.

2. The rule concerning reductions in an S corporation shareholder's stock basis for the corporation's charitable contribution of property becomes permanent. The 2015 PATH Act, § 115, retroactively reinstated for 2015 and made permanent the rule of § 1367(a)(2) that the reduction in an S corporation shareholder's stock basis by reason of the S corporation's charitable contribution of property is the shareholder's pro rata share of the property's adjusted basis.

E. Mergers, Acquisitions and Reorganizations

1. All hail the (F) "in a bubble." Reorganizations Under Section 368(a)(1)(F); Section 367(a) and Certain Reorganizations Under Section 368(a)(1)(F), T.D. 9739, 80 F.R. 56904 (9/21/15). The Treasury Department and IRS have finalized Reg. § 1.368-2(m), proposed in Reorganizations Under Section 368(a)(1)(E) or (F), REG-106889-04, 69 F.R. 49836 (8/12/04), comprehensively defining F reorganizations. An (F) reorganization is "a mere change in identity, form, or place of organization of one corporation, however effected." An (F) reorganization does not result in the corporation being treated for federal income tax purposes as a new corporation or as transferring its assets. Nor does it cause the corporation's taxable year to close. The regulations recognize that an F reorganization may be a step in a larger transaction that effects more than a "mere change." A qualifying (F) reorganization may occur before, within, or after other transactions that effect more than a "mere change," even if the resulting corporation has only transitory existence. Related events that precede or follow the potential (F) reorganization generally will not cause that potential (F) reorganization to fail to qualify as a reorganization under § 368(a)(1)(F). The functional theme of the regulations is to identify an F reorganization "in the bubble." Under the regulations, a transaction, or a series of transactions (for example, a "liquidation-reincorporation"), that involves an actual or deemed transfer is a mere change only if six requirements are satisfied. The regulations provide that the transaction or a series of related transactions to be tested against the six requirements begins when the transferor corporation begins transferring (or is deemed to begin transferring) its assets to the resulting corporation and ends when the transferor corporation has distributed (or is deemed to have distributed) the consideration it receives from the resulting corporation to its shareholders and has completely liquidated for federal income tax purposes. The six requirements are as follows: (1) First, all the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation. (However, the resulting corporation may issue a de minimis amount of stock not in respect of stock of the transferor corporation, to facilitate the organization or maintenance of the resulting corporation.) (2) Second, subject to certain exceptions, the same person or persons own all the stock of the transferor corporation at the beginning of the potential (F) reorganization and all of the stock of the resulting corporation in identical proportions, except a change that has no effect other than that of a redemption of less than all the shares of the corporation or that has the effect of a recapitalization of stock. (3) Third, the transferring corporation must completely liquidate in the transaction (although legal dissolution is not required and it may retain a de minimis amount of assets necessary to continue its legal existence). (4) Fourth, the resulting corporation must not hold any property (except a de minimis amount necessary to establish its existence) or have any tax attributes (including those specified in § 381(c)) immediately before the transfer. (5) Fifth, no corporation other than the resulting corporation may hold property that was held by the transferor corporation immediately before the potential F reorganization if that other corporation would, as a result, succeed to and take into account the items of the transferor described in § 381(c). (This prevents a divisive transaction qualifying as an (F) reorganization.) (6) Sixth, immediately after the transaction, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would succeed to the items of the other corporation described in § 381(c). (This emphasizes existing law that acquisitive transactions involving two corporations that qualify as a type (A) or type (D) reorganization cannot qualify as a type (F) reorganization.) These requirements aid in determining which steps

in a multi-step transaction should be considered when applying the six requirements to a potential “mere change”—that is, which steps are “in the bubble.” Very significantly, the regulations allow changes of ownership that result from either (1) a holder of stock in the transferor corporation exchanging that stock for stock of equivalent value in the resulting corporation having terms different from those of the stock in the transferor corporation or (2) receiving a distribution of money or other property from either the transferor corporation or the resulting corporation, whether or not in redemption of stock of the transferor corporation or the resulting corporation. In other words, the corporation involved in an (F) reorganization may also recapitalize, redeem its stock, or make distributions to its shareholders, without causing the potential F reorganization to fail to qualify. Furthermore, any concurrent distribution is treated as a transaction separate from the (F) reorganization, and thus is a dividend (to the extent of earnings and profits) unless it qualifies as a redemption under § 302(b). Finally, continuity of the business enterprise and a continuity of interest are not required for a potential (F) reorganization to qualify as a reorganization under § 368(a)(1)(F). See Reg. § 1.368-1(b).

- The regulations are effective for transactions occurring on or after 9/21/15.

2. The basis of something acquired for nothing is nothing. Dorrance v. United States, 807 F.3d 1210 (9th Cir. 12/09/15). The taxpayers received and then sold stock derived from the demutualization of five mutual life insurance companies from which they had purchased policies. They filed an original return treating the stock as having a basis and then sought a refund on the ground that (1) the stock represented a return of previously paid policy premiums or (2) because their mutual rights were not capable of valuation, the entire cost of their insurance premiums should have been counted toward their basis in the stock. The district court held that the taxpayers had a basis in the stock, although not as much as the taxpayers claimed, and thus they were entitled to a partial refund. In an opinion by District Judge Snow, the Ninth Circuit reversed, holding that taxpayers who sold stock obtained through demutualization cannot claim a basis in that stock for tax purposes because they had a zero basis in the mutual rights that were extinguished during the demutualization. “The reality here is that the Dorrances acquired the membership rights at no cost, but rather as an incident of the structure of mutual insurance policies. The logic of this conclusion is simple—when the Dorrances purchased their mutual insurance policies in 1996, the premiums they paid related to their rights under the insurance contracts, not to collateral membership benefits such as voting.” The insurance company had advised the policyholders that their basis was zero, in accordance with Rev. Rul. 71-233, 1971-1 C.B. 113, and Rev. Rul. 74-277, 1974-1 C.B. 88.

“[B]asis ‘refers to a taxpayer’s capital stake in an asset for tax purposes.’ *Washington Mut. Inc.*, 636 F.3d at 1217 (citing *In re Lilly*, 76 F.3d 568, 572 (4th Cir. 1996)). ‘The taxpayer must prove what, if anything, he actually was required to pay ... not what he would have been willing to pay or even what the market value ... was.’”

3. Shareholders can’t fight what the merger agreement says the deal is. Tseytin v. Commissioner, T.C. Memo. 2015-247 (12/28/15). The taxpayer held two blocks of stock in a wholly owned corporation that was merged into an acquiring corporation in a transaction that qualified under § 368. He received approximately \$23 million in cash and stock with a fair market value of approximately \$31 million. He realized a gain on one block of stock and a loss on the other. The taxpayer attempted to offset the loss he realized on one of the blocks of stock against the gain he recognized on the other block of stock. The Tax Court (Judge Swift) held that the loss realized on one block of stock could not be offset against the gain recognized on the other block of stock. The merger agreement specified that each share of target stock was being exchanged for an equal portion of the total merger consideration. Applying the test of *Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967), the court held that the taxpayer could not disavow the terms of the merger agreement to treat the loss block of stock as redeemed for cash. The court also rejected the taxpayer’s alternative argument that § 356(c) should be interpreted only to prohibit recognition of a net bottom line cumulative loss on a merger

transaction and that internal netting of losses and gains should be allowed with respect to different blocks of stock involved in a merger transaction up to the total amount of the overall gain to be recognized. The court noted but did not discuss the taxpayer's argument that Reg. § 1.356-1, as amended in 2006, and Prop. Reg. § 1.356-1(b), Ex. 3, Notice of Proposed Rulemaking, 74 Fed. Reg. 3509, 3509, 3511, 3519 (Jan. 21, 2009), generally allow internal netting of a loss realized on one block of stock against a gain realized on another block of stock so long as a net overall gain is still realized.

F. Corporate Divisions

1. The IRS is taking a hard look at spin offs of investment assets to which it previously has turned a blind eye. Is this a harbinger of a substantive change requiring more than a peppercorn trade or business in order to qualify for a tax-free § 355 division? Notice 2015-59, 2015-40 I.R.B. 459 (9/14/15) This Notice identifies four circumstances in which qualification of a distribution under § 355 is under study: (1) Ownership by the distributing or controlled corporation of investment assets having substantial value in relation to (a) the value of all of such corporation's assets, and (b) the value of the assets of the trade(s) or business(es) relied upon to meet the active trade or business requirement; (2) A significant difference between the distributing corporation's ratio of investment assets to assets other than investment assets and such ratio of the controlled corporation; (3) Ownership by the distributing or controlled corporation of a small amount of active trade or business assets in relation to all of its assets; and (4) An election by the distributing or controlled corporation (but not both) to be a RIC or a REIT. These circumstances may override the non-device factors of public trading and non-pro rata distributions.

2. Back in the lamp Ali Baba (or is it alibaba.com?). Rev. Proc. 2015-43, 2015-40 I.R.B. 467 (9/14/15). The IRS ordinarily will not rule on any issue relating to the qualification under § 355 of a distribution where: (1) Property owned by any distributing corporation or controlled corporation becomes the property of a RIC or a REIT in a "conversion transaction" (i.e., conversion to RIC or REIT or transfer to RIC or REIT); (2) No deemed sale election under Reg. § 1.337(d)-7(c) is made; and (3) The conversion transaction and the distribution are parts of a plan or series of related transactions. Nor will the IRS rule if the fair market value of the gross assets of the trade(s) or business(es) on which the distributing corporation or the controlled corporation relies to satisfy the active trade or business requirement of § 355(b) is less than five percent of the total fair market value of the gross assets of such corporation. Also, the IRS will not rule (until resolved by Revenue Ruling, Revenue Procedure, Regulations or otherwise) on any issue relating to the qualification under § 355 of a distribution where, immediately after the distribution, the following conditions exist: (1) The FMV of the investment assets of the distributing or controlled corporation is two-thirds or more of the total FMV of its gross assets; (2) The FMV of the gross active trade or business assets is less than 10 percent of the FMV of its investment assets; and (3) the ratio of the FMV of the investment assets to the FMV of the assets other than investment assets of the distributing or controlled corporation is three times or more of such ratio for the other corporation. Nor will the IRS rule (until resolved) on any issue relating to the qualification under § 355 of a distribution where, as part of a plan or series of related transactions, investment assets are disposed of or non-investment assets (including active trade or business assets) are acquired with a principal purpose of avoiding No-Rule (2).

3. Congress kisses-off REIT spinoffs. The 2015 PATH Act, § 311(a), added new § 355(h), which provides that § 355 generally does not apply to any distribution if either the distributing corporation or controlled corporation is a REIT. If, however, both the distributing corporation and the controlled corporation are REITs immediately after the distribution, the distribution still may qualify under § 355. A second exception applies if (1) the distributing corporation was a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation was a taxable REIT subsidiary of the distributing corporation at all times during that period, and (3) the distributing corporation controlled (directly or indirectly) the controlled corporation at all times during that period. Section 355(h)

applies to distributions after 12/6/15 unless the transaction was described in a ruling request initially submitted to IRS on or before 12/7/15, the request was not withdrawn, and the ruling was not issued or denied as of 12/7/15.

a. TRA '86 strikes back at REIT conversions—with a vengeance.

T.D. 9770, Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]; Final and Temporary Regulations, 81 F.R. 36793 (6/8/16); REG-126452-15, Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs], 81 F.R. 36816 (6/8/16). Temp. Reg. § 1.337(d)-7T provides that a C corporation engaging in a conversion transaction (as defined in § 1.337(d)-7(a)(2)(ii)—“the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT”) involving a REIT within the ten-year period following a related § 355 distribution is treated as making an election to recognize gain and loss as if it had sold all of the converted property to an unrelated party at fair market value on the deemed sale date (as defined in Reg. § 1.337(d)-7(c)(3)). In these situations, § 1374 treatment is not available as an alternative to recognizing any gain with respect to the converted property on the deemed sale date. The temporary regulations also provide that a REIT that is a party to a § 355 distribution occurring within the ten-year period following a conversion transaction for which a deemed sale election has not been made recognizes any remaining unrecognized built-in gains and losses resulting from the conversion transaction (after taking into account the impact of § 1374 in the interim period, as described subsequently).

- There are two exceptions to the general rules. The temporary regulations do not apply if both the distributing corporation and the controlled corporation are REITs immediately after the date of the § 355 distribution and at all times during the two years thereafter. Second, the temporary regulations also do not apply to certain § 355 distributions in which the distributing corporation is a REIT and the controlled corporation is a taxable REIT subsidiary.

- The regulations generally apply to conversion transactions occurring on or after June 7, 2016 and to conversion transactions and related § 355 distributions for which the conversion transaction occurs before, and the related § 355 distribution occurs on or after, June 7, 2016.

4. Take that Alphabet! REG-134016-15, Guidance under Section 355 Concerning Device and Active Trade or Business, 81 F.R. 46004 (7/15/16). The Treasury Department and the IRS have published proposed amendments to Reg. §§ 1.355-2 and 1.355-3 that would clarify the application of the device prohibition and the active business requirement of § 355. The purpose of the proposed amendments to the regulations is to curtail tax-free distributions involving relatively small active businesses and substantial amounts of investment assets.

Device Test Factors—First, Treasury and the IRS have concluded that the presence of business assets, whether or not held for five years, generally does not raise any more device concerns than the presence of assets used in a five-year active business. Thus, a proposed change to the nature and use of assets device factor in Reg. § 1.355-2(d)(2)(iv) would focus on assets used in a business (as defined in proposed § 1.355-2(d)(2)(iv)(B)) rather than only assets used in an active business meeting the five-year history requirement of § 355(b). **Second**, conversely, Treasury and the IRS have concluded that device potential exists if either (1) Distributing or Controlled owns a large percentage of assets not used in business operations compared to total assets or (2) Distributing's and Controlled's percentages of these assets differs substantially. Accordingly, the proposed regulations would provide thresholds for determining whether the ownership of nonbusiness assets and/or differences in the nonbusiness asset percentages (the percentage of a corporation's total assets that are nonbusiness assets) for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has nonbusiness assets that are 20 percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device. Furthermore, a difference in the nonbusiness asset percentages for Distributing and Controlled ordinarily would not be evidence of device if such difference is less than 10 percentage points or, in the case of a non-pro rata distribution, if the difference is

attributable to a need to equalize the value of the Controlled stock and securities distributed and the consideration exchanged therefor by the distributees. **Third**, the nondevice factor in § 1.355-2(d)(3)(ii), which relates to corporate business purpose for a transaction as evidence of nondevice, would be revised to provide that a corporate business purpose that relates to a separation of (a) nonbusiness assets from (b) one or more businesses or from business assets would not be evidence of nondevice, unless the business purpose involves an exigency that requires an investment or other use of the nonbusiness assets in a business. Absent such an exigency, such separations are not consistent with the intent of Congress to prevent § 355 from applying to a distribution that is used principally as a device.

Per Se Device—Prop. Reg. § 1.355-2(d)(5) would provide that a transaction is a per se device (notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held) if designated percentages of Distributing's or Controlled's total assets are nonbusiness assets. The test is multi-pronged. A per se device exists if both (1) the nonbusiness asset percentage of Distributing or Controlled is 66-2/3 percent or more, and (2) the nonbusiness asset percentage of Distributing or Controlled is (a) 66-2/3 percent or more but less than 80 percent, and the nonbusiness asset percentage of the other corporation (Controlled or Distributing, as the case may be) is less than 30 percent, (b) 80 percent or more but less than 90 percent, and the nonbusiness asset percentage of the other corporation is less than 40 percent; or (c) 90 percent or more, and the nonbusiness asset percentage of the other corporation is less than 50 percent.

Active Business Test—Prop. Reg. § 1.355-9 would provide an entirely new minimum size requirement for an active business to qualify under § 355. The requirements of §§ 355(a)(1)(C) and 355(b) will be satisfied with respect to a distribution only if the five-year-active-business asset percentage (as defined in the regulations) of each of Distributing and Controlled is at least five percent.

Special Operating Rules—Various special operating rules deal comprehensively with taking into account assets held by the separate affiliated groups of both Distributing and Controlled and assets of partnerships of which either or both of Distributing and Controlled are partners for purposes of applying the above rules, as well as distributions of multiple controlled corporations. And, of course, there are anti-abuse rules: A transaction or series of transactions undertaken with a principal purpose of affecting the five-year-active-business asset percentage of any corporation will not be given effect.

Effective Date—The regulations generally will be effective upon publication of final regulations.

5. “The Treasury Department and the IRS recognize that determining whether an acquisition of control has substance for federal tax purposes can be difficult and fact-intensive.” Rev. Proc. 2016-40, 2016-32 I.R.B. 228 (7/15/16). This revenue procedure provides fact patterns (safe harbors) in which the IRS will not assert that a distributing corporation, D, lacks control of another corporation, C, within the meaning of § 355(a)(1)(A). There's no way to paraphrase it, so we quote it:

SECTION 3. TRANSACTIONS TO WHICH THIS REVENUE PROCEDURE APPLIES

This revenue procedure applies to transactions in which—

- (1) D owns C stock not constituting control of C;
- (2) C issues shares of one or more classes of stock to D and/or to other shareholders of C (the issuance), as a result of which D owns C stock possessing at least 80 percent of the total combined voting power of all classes of C stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of C;
- (3) D distributes its C stock in a transaction that otherwise qualifies under § 355 (the distribution); and
- (4) C subsequently engages in a transaction that, actually or in effect, substantially restores (a) C's shareholders to the relative interests, direct or

indirect, they would have held in C (or a successor to C) had the issuance not occurred; and/or (b) the relative voting rights and value of the C classes of stock that were present prior to the issuance (an unwind).

SECTION 4. SAFE HARBORS

The IRS will not assert that a transaction described in section 3 of this revenue procedure lacks substance, and that therefore D lacked control of C immediately before the distribution, within the meaning of § 355(a)(1)(A) of the Code, if the transaction is also described in one of the following safe harbors:

.01 No Action Taken Within 24 Months. No action is taken (including the adoption of any plan or policy), at any time prior to 24 months after the distribution, by C's board of directors, C's management, or any of C's controlling shareholders (as defined in § 1.355-7(h)(3)) that would (if implemented) actually or effectively result in an unwind.

.02 Unanticipated Third Party Transaction. C engages in a transaction with one or more persons (for example, a merger of C with another corporation) that results in an unwind, regardless of whether the transaction takes place more or less than 24 months after the distribution, provided that—

(1) There is no agreement, understanding, arrangement, or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the date of the distribution; and

(2) No more than 20 percent of the interest in the other party, in vote or value, is owned by the same persons that own more than 20 percent of the stock of C. For purposes of this section, ownership is determined by application of the constructive ownership rules of § 318(a) as modified by § 304(c)(3), except that for purposes of applying § 318(a)(3)(A) and (B), the principles of § 304(c)(3)(B)(ii) (without regard to § 304(c)(3)(B)(ii)(I)) apply.

The revenue procedure is effective with respect to distributions that occur on or after 8/1/16. However, taxpayers can apply the revenue procedure with respect to a distribution that occurs before that date.

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. Congress pretends not to love captive instance as much as the Tax Court loves it, but the “fix” is really just window dressing that does nothing to prevent tax avoidance through private captive insurance. The 2015 PATH Act, § 333, amended § 831(b) to benefit captive insurance companies in one way, but in another way to a limited extent to inhibit their use, beginning in 2017. First, the Act increases the maximum amount of annual premiums from \$1,200,000 to \$2,200,000 (adjusted for inflation after 2015), which is the ceiling on net written premiums that a nonlife insurance company may receive in order to elect to be taxed, at regular corporate rates, only on taxable investment income, instead of being taxed on both investment and underwriting income. (Note that a company that makes this election may not deduct underwriting losses.) Second, the Act adds a new diversification requirement that must be met to be eligible to make the election. To be eligible, an insurance company must not have more than 20 percent of its net premiums (or, if greater, direct premiums written) received for the taxable year be attributable to any one policyholder. For this purpose, all policyholders who are related (within the meaning of §§ 267(b) or 707(b)) or who are members of the same controlled group will be treated as one policyholder. Alternatively, the diversification requirement will be met if no “specified holder” has an interest in the insurance company that is more than a de minimis percentage higher than the percentage of interests in the “specified assets” with respect to the insurance company held (directly or indirectly) by the specified holder. A “specified holder” is any individual who holds (directly or indirectly) an interest in the

insurance company and who is a spouse or lineal descendant of an individual who holds an interest (directly or indirectly) in the specified assets with respect to the insurance company. “Specified assets” are the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of the insurance company are paid. (An indirect interest is any interest held through a trust, estate, partnership, or corporation.) Except as otherwise provided in regulations or other IRS guidance, 2 percent or less is treated as de minimis. The following example of the alternative test is provided in Staff of the Joint Comm. on Taxation Technical Explanation of Protecting Americans from Tax Hikes Act of 2015, JCX-114-15, 200 (12/18/2015):

In 2017, a captive insurance company (“Captive”) will not meet the requirement that no more than 20% of its net (or direct) written premiums is attributable to any one policyholder. Captive will have one policyholder, “Business,” certain of whose property and liability risks Captive covers (the specified assets), and Business will pay the captive \$2 million in premiums in 2017. Business will be owned 70% by a father (“Father”) and 30% by his son (“Son”). Captive will be owned 100% by Son (whether directly, or through a trust, estate, partnership, or corporation). Son is Father’s lineal descendant. Son, a specified holder, will have a non-de minimis percentage greater interest in Captive (100%) than in the specified assets with respect to Captive (30%). Therefore, Captive will be not eligible to elect to make the election. If, by contrast, all the facts were the same, except that Son will own 30% and Father will own 70% of Captive, Son would not have a non-de minimis percentage greater interest in Captive (30%) than in the specified assets with respect to Captive (30%). Therefore, Captive would meet the diversification requirement for eligibility to make the election. The same result would occur if Son will own less than 30% of the Captive (and Father more than 70%), and the other facts remained unchanged.

- Note that whenever the ownership of the business and the insurance company are perfectly congruent—even if (particularly if) there is only one owner—the captive insurance scheme satisfies the diversification requirement.

- In addition, the Act added a new reporting requirement for an insurance company that has a § 831(b) election in effect that will require it to provide the IRS information with respect to the diversification requirements.

2. ♪♪“Where have all the [factors] gone? ... Long time ago. ...Oh, When will they ever learn?” REG–108060–15, Treatment of Certain Interests in Corporations as Stock or Indebtedness, 81 F.R. 20912 (4/8/16). The IRS and Treasury have published proposed regulations under § 385 that would (1) establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes, (2) treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes, and (3) authorize the IRS to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes. The proposed regulations generally affect corporations that issue purported indebtedness to related corporations or partnerships. Section 385(a) authorizes the IRS and Treasury to “prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).” Final § 385 regulations were issued in December 1980, applicable to instruments issued after April 30, 1981. T.D. 7747, 1981–1 C.B. 141. The effective date was extended several times and the regulations were withdrawn on August 5, 1983. T.D. 7920, 1983–2 C.B. 69. No new regulations had been issued or proposed under § 385, and the debt versus equity classification issue thus continued to turn on judicial authority.

The proposed regulations would narrowly focus the regulatory debt versus equity characterization regime only on instruments issued between certain related corporations. According to the preamble,

These proposed regulations under section 385 address whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock or in part indebtedness, for purposes of the Code. While these proposed regulations are motivated in part by the enhanced incentives for related parties to engage in transactions that result in excessive indebtedness in the cross-border context, federal income tax liability can also be reduced or eliminated with excessive indebtedness between domestic related parties. Thus, the proposed rules apply to purported indebtedness issued to certain related parties, without regard to whether the parties are domestic or foreign.

The following description of these complex proposed regulations is deceptively over-simplified and superficial, and should be relied upon only at your own risk.

Parties to Whom Applicable—The proposed regulations would adopt a definition of related party that includes an expanded group of corporations identified under § 1504(a) to include corporations related through ownership of stock representing 80% of voting power and value, expanded to apply to corporations related by ownership of 80% of vote *or* value, and including exempt entities, foreign corporations and partnerships. Prop. Reg. § 1.385-1(b)(3). Furthermore, if one or more members of a modified expanded group—an expanded group, determined by substituting “50” for “80” in §§ 1504(a)(2)(A) and (B)—own, directly or indirectly, 50 percent of the interests in partnership capital or profits of a modified controlled partnership, the modified controlled partnership is treated as a member of the modified expanded group. Also, if a person is treated, under § 318, as owning at least 50 percent of the value of the stock of a modified expanded group member, that person is treated as a member of the modified expanded group. However, none of the rules in any of the proposed regulations apply to indebtedness between members of a consolidated group during the period the corporations are members of the consolidated group, Prop. Reg. § 1.385-1(e), -4(b) (2016), unless the debt instrument is transferred outside the consolidated group, Prop. Reg. § 1.385-4(c) (2016).

Documentation Rules—Prop. Reg. § 1.385-2, would provide detailed requirements for documentation and financial analysis of instruments issued as indebtedness between related parties similar to what generally would be expected on issuance of debt instruments between unrelated parties. For an instrument to be treated as debt, documentation and information must be developed at the time an instrument is issued to demonstrate (1) a binding obligation to repay, (2) that the creditor has the typical legal rights of a creditor to enforce the terms of the instrument including rights to trigger a default and accelerate payments, (3) to evidence a reasonable expectation of repayment, including cash flow projections, financial statements, business forecasts, asset appraisals, determination of debt-to-equity and other relevant financial ratios of the issuer (compared to industry averages), and (4) that show timely evidence of an on-going debtor-creditor relationship. Prop. Reg. 1.385-2(b). The documentation rules would only apply to “large taxpayer groups,” where the stock of any member of the expanded group is publicly traded, all or any portion of the expanded group’s financial results are reported on financial statements with total assets exceeding \$100 million, or the expanded group’s financial results are reported on financial statements that reflect annual total revenue that exceeds \$50 million.

General Recharacterization Rule—As a general rule, Prop. Reg. § 1.385-3 treats an expanded group debt instrument as per se stock to the extent it is issued by a corporation to a member of the corporation’s expanded group (1) in a distribution (including a redemption distribution), (2) in exchange for expanded group stock (subject to exceptions described in Prop. Reg. § 1.385-3(f)(5)), or (3) as boot in an asset reorganization described in § 368(a)(1)(A), (C), (D), (F), or (G). All or a portion of an issuance of a debt instrument may be described in more than one prong of the general rule without changing the result that follows from being described in a single prong.

Alternative “Funding Rule”—Prop. Reg. § 1.385-3(b)(3), the “funding rule,” extends the per se stock rule to treat as stock an expanded group debt instrument to the extent that it is issued, for property, including cash, when the debt instrument is issued to an affiliate with a principal purpose of funding (1) a distribution of cash or other property to a related corporate

shareholder, (2) an acquisition of affiliate stock from an affiliate, or (3) certain acquisitions of property from an affiliate pursuant to an internal asset reorganization. A per se rule automatically recharacterizes as equity any related party debt issued in the 36-month period before or after a distribution or acquisition described in the general rule. As a back-up, Prop. Reg. § 1.385-3(b)(4) would provide an anti-abuse rule providing that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations.

Cliff- Effect Threshold for Per Se Stock Rule—The per se stock rules of Prop. Reg. § 1.385-3 would apply only when the debt that would be converted to equity exceeds \$50 million. Exceeding the \$50 million threshold would have a cliff effect; if the threshold is exceeded, all of the debt, and not merely the excess over \$50 million would be treated as equity.

Hybridization Rule—Under Prop. Reg. § 1.385-1(d)(1), the IRS would be able to treat any expanded group debt instrument as part debt and part stock. The part-debt, part-equity rules would apply to all expanded group indebtedness (but not to any other indebtedness), even debt not subject to the documentation and per se stock rules. However, for a taxpayer subject to the documentation rule, the bifurcation rule would apply only if the documentation rules have been satisfied. Prop. Reg. § 1.385-1(d)(1) would eliminate the disclosure-of-contrary-treatment option in § 385(c)(2) with respect to expanded group indebtedness and require holders to treat debt consistent with the issuer's initial characterization of debt.

Effective date—The effective date rules vary by provision, but upon finalization many of the rules can apply to instruments issued after April 4, 2016.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. **A relationship formed in the oil and gas industry was a partnership, rather than a contractual agreement for services, and the income allocated to the partners was capital gain rather than ordinary income.** *United States v. Stewart*, 123 F. Supp. 3d 921 (S.D. Tex. 8/20/15). Hydrocarbon Capital LLC acquired a portfolio of oil and gas properties and entered into an agreement with Odyssey Capital Energy I, LP under which Odyssey managed the operation and exploration of the properties and operated the wells. Five individuals, including the taxpayer in this case, Mr. Stewart, were partners in Odyssey. Under the agreement between Hydrocarbon and Odyssey, Odyssey had an interest in the revenue from any sale of the properties equal to 20 percent of the amount remaining after Hydrocarbon recovered its expenses, its investment, a 10 percent return on its investment, and a \$6 million loan it had made to Odyssey. The properties eventually were sold and, pursuant to the agreement, Odyssey received \$20.1 million, which it allocated among its partners. On its partnership return and Form K-1s for 2004, Odyssey reported the \$20.1 million as ordinary income. Odyssey later amended its 2004 return and issued new K-1s to recharacterize the \$20.1 million as capital gain. Mr. Stewart filed an amended individual return for 2004 claiming a refund of more than \$1 million based on the treatment of the income as capital gain. After review, the government issued the refund (as it did to three of the other Odyssey partners), but later concluded that the income was ordinary and brought this action to recover the refund. The court (Judge Hughes) held in favor of the taxpayer. The court rejected the government's argument that the amount received by Odyssey was compensation for services. Hydrocarbon and Odyssey, the court concluded, had formed a partnership for federal tax purposes, and the \$20.1 million received by Odyssey was long-term capital gain.

This arrangement is no different than flipping a house. The gain realized through sweat equity—the appreciation in the value of the house by fixing it up—is a capital gain. The very reason it is called sweat equity instead of sweat income. In the same way, Odyssey's sweat, their management, increased the value of the capital, the portfolio of properties.

Having purchased a share of the project, the partners managed the portfolio and earned the venture significant profits when it sold. This merger of execution and financing is a partnership, and its profits are long-term capital gains.

2. A bipartisan agreement that GE and Judge Underhill got it wrong. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, signed by the President on 11/2/15, amended §§ 704(e) and 761(b) to delete § 704(e)(1), renumbered § 704(e)(2) and (e)(3) as (e)(1) and (e)(2), and added to § 761(b) the following: “In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest shall be determined without regard to whether such interest was derived by gift from any other person.” The deleted § 704(e)(1) had provided that “A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.” As amended, the operation of the rules is limited to partnership interests acquired by gift and no longer arguably applies to partnership interests acquired by purchase or through a contribution of capital. The obvious purpose of this amendment was to negate the holding of *TIFD III-E, Inc. v. United States*, 660 F. Supp. 2d 367 (D. Conn. 2009) (*Castle Harbour III*), *rev’d* 666 F.3d 836 (2d Cir. 2012), that the application of § 704(e)(1) was not limited to the context of family partnerships and that § 704(e)(1) applied to guarantee partner status to any person who advanced capital to a partnership even if the partnership did not meet the totality-of-the-circumstances test for the existence of a partnership established by *Commissioner v. Culbertson*, 337 U.S. 733 (1949)—“whether . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”

- The amendment also should negate the holding of *Evans v. Commissioner*, 447 F.2d 547 (7th Cir. 1971), *aff’d* 54 T.C. 40 (1970), which Judge Underhill relied upon extensively to reach his conclusion in *Castle Harbour III*. *Evans* held that the application of § 704(e)(1) was not limited to the context of family partnerships. *Evans* involved the question who, between two different persons—the original partner or an assignee of the original partner’s economic interest—was the partner who should be taxed on a distributive share of the partnership’s income. Although in the family context § 704(e) frequently has been applied to determine whether a partnership exists in the first place, Judge Underhill’s decision in *Castle Harbour III* was the only case ever to discover that § 704(e)(1) applies to determine whether an arrangement between two (or more) otherwise unrelated business entities or unrelated individuals constituted a partnership.

3. The taxpayers were blinded by their own planning brilliance, while the court was wearing sunglasses. *DJB Holding Corp. v. Commissioner*, 803 F.3d 1014 (9th Cir. 10/7/15), *aff’d* *WB Acquisition, Inc. v. Commissioner*, T.C. Memo. 2011-36. In an opinion by Judge Kozinski, the Ninth Circuit affirmed the Tax Court (Judge Haines), which held that a purported related-party partnership was not a bona fide partnership for tax purposes. The joint venture, which purportedly was conducting an environmental remediation project, was between a C corporation, which did conduct an environmental remediation business, and a partnership that indirectly owned (through a holding company) all of the stock of the active C corporation. The partners of the partnership were two S corporations that were wholly owned by qualified retirement plans for the benefit of the two individuals who ran the C corporation’s environmental remediation business. Under the joint venture’s terms, the partnership, together with the C corporation, the S corporations that were the partners of the partnership owning the holding company, and the two individuals provided a financial guarantee (to AIG, the bonding company) and the partnership was to be allocated 70 percent of the profits from the environmental remediation project, all of the work on which was to be performed by the C corporation. The C corporation, and not the partnership, entered into a contract to perform the environmental remediation services, and the joint venture agreement provided that the joint venture would reimburse the C corporation for all expenses plus 5 percent. The joint venture never filed a partnership return and the C corporation unilaterally reduced the partnership’s share of profits from the joint venture to 50.4 percent. On these facts the Ninth Circuit affirmed the Tax Court’s conclusion that the joint venture was not a bona fide partnership under the historic test in *Commissioner v. Culbertson*, 337 U.S. 733 (1949)—whether “the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise,” applying the factors elaborated in *Luna v. Commissioner*, 42 T.C. 1067, 1077-78 (1964):

[(1)] [t]he agreement of the parties and their conduct in executing its terms; [(2)] the contributions, if any, which each party has made to the venture; [(3)] the parties' control over income and capital and the right of each to make withdrawals; [(4)] whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; [(5)] whether business was conducted in the joint names of the parties; [(6)] whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; [(7)] whether separate books of account were maintained for the venture; and [(8)] whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.

The principal focus of the Ninth Circuit's decision was the second *Luna* factor—"the contributions, if any, which each party has made to the venture—and the Court of Appeals agreed with the Tax Court that the partnership provided nothing of value to the joint venture. Examining all of the various relationships and contracts, the court found that the C corporation, the two individuals, and the two S corporations that were the partners of the partnership owning the holding company would have been obligated to provide the financial guarantees even if the joint venture had not been formed and that the bonding company considered only the financial guarantees of the C corporation and the two individuals to have been important. Furthermore, the purported partners did not in fact respect the terms of the joint venture agreement; the actual income allocation between the partners differed substantially from the terms of the agreement and no partnership tax returns were filed. The unilateral control exercised by the C corporation belied the existence of a true partnership.

- On a second issue, the court held that no portion of the amounts received under a noncompetition agreement entered into in connection with the sale of the C corporation's business to an unrelated party, which bound the C corporation, the two individuals, and the joint venture could be allocated to the (nonexistent) joint venture (and then allocated to the holding partnership). The C corporation was the only signatory to the noncompetition agreement ever to have performed the environmental remediation services that were the subject of the agreement, and the partnership had no enforceable claim to the services of the individuals. Although some portion of the payments under the noncompetition agreement might properly have been allocable to the individuals, neither the IRS nor the taxpayer made such an argument; thus, all of the noncompetition agreement payments were taxed to the C corporation.

- Section 6662(b)(2) substantial underpayment penalties were upheld because there was no substantial authority to support the taxpayers' position. The cases on which the taxpayers relied were materially distinguishable. Finally, the court rejected the taxpayers' "reasonable cause and good faith" defense based on the argument that they reasonably relied on the advice of their accountant in deciding how to treat the proceeds from the joint venture. Nothing in the record indicated that the taxpayers asked the accountant for an opinion regarding the validity of the joint venture for tax purposes. "Instead, the record reveals only that the accountant prepared tax returns for the entities involved in the joint venture based on data supplied to him."

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

C. Distributions and Transactions Between the Partnership and Partners

1. Tax planning goes awry in Old Virginny. *SWF Real Estate LLC v. Commissioner*, T.C. Memo. 2015-63 (4/2/15). SWF Real Estate LLC owned farm land in Virginia on which it granted a conservation easement to a qualified donee. In connection with the grant of the easement, which would earn approximately \$3.5 million of State of Virginia conservation tax credits, SWF Real Estate entered into a transaction with Virginia Conservation Tax Credit Fund LLLP in which Virginia Conservation made a capital contribution to SWF Real Estate LLC (thereby converting it to a partnership from a disregarded entity) of \$1,802,000 for a 1 percent interest and an allocation of \$3,400,000 of State of Virginia conservation tax credits.

The contribution was computed as 53 cents per \$1 of Virginia tax credits allocated to Virginia Conservation. The 99 percent was allocated only \$300,000 of Virginia tax credits. The parties entered into an indemnity agreement under which SWF Real Estate and the one partner other than Virginia Conservation (the previous partners of the partnership) were jointly and severally liable to indemnify Virginia Conservation if the Virginia tax credits were disallowed. The other partner of the partnership also had the option to purchase all, but not less than all, of Virginia Conservation's membership interest in SWF on or any time after January 1, 2010 at a price to be agreed upon by the parties or, if not agreed upon, 1 percent of the net fair market value of SWF Real Estate's assets at exercise. The IRS took the position that SWF Real Estate sold Virginia tax credits to Virginia Conservation in exchange for cash, thus engaging in a disguised sale under section 707 and that the capital contributions to the partnership were ordinary income to SWF. The Tax Court (Judge Wells) upheld the IRS's position because it found that the facts were "squarely in point" with *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), *rev'g* T.C. Memo.2009-295, and that after applying the *Golsen* rule (*Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir.1971)), and that under the factors of Reg. § 1.707-3(b) the transfer of Virginia tax credits by SWF Real Estate to Virginia Conservation in exchange for money should be characterized as a disguised sale pursuant to 707(a)(2)(B). First, because the amount of Virginia Conservation's capital contribution to SWF Real Estate was based directly on the amount of Virginia tax credits to be transferred or allocated to Virginia Conservation, Virginia Conservation could precisely determine the number of Virginia tax credits it could expect to receive on the basis of the amount of money it contributed to SWF Real Estate. Reg. § 1.707-3(b)(2)(i). Second, Virginia Conservation had a legally enforceable right to the later transfer of Virginia tax credits; under the subscription agreement and operating agreement, Virginia Conservation's capital contribution would entitle it to specific dollar amount of Virginia tax credits in exchange, and if SWF Real Estate and the other partner failed to fulfill the terms of those agreements, Virginia Conservation could have pursued breach of contract claims. Reg. § 1.707-3(b)(2)(ii). Third, Virginia Conservation's right to receive the credits was secured by the indemnity agreement. Reg. § 1.707-3(b)(2)(iii). Fourth, on the facts, SWF Real Estate held Virginia tax credits, beyond the reasonable needs of its business, that were expected to be available to make the transfer to Virginia Conservation. Reg. § 1.707-3(b)(2)(iv). Fifth, SWF Real Estate's transfer of Virginia tax credits to Virginia Conservation was disproportionately large in relationship to Virginia Conservation's general and continuing interest in SWF Real Estate's profit; Virginia Conservation held a 1% interest in partnership profits and losses and net cash flow, but was ultimately allocated 92% of the Virginia tax credits available to SWF Real Estate. Reg. § 1.707-3(b)(2)(ix). Sixth (and lastly), after receiving the Virginia tax credits, Virginia Conservation was free to use or transfer the credits as it desired; it had no further obligations to SWF Real Estate with regard to the Virginia tax credits. Reg. § 1.707-3(b)(2)(x). The court went on to hold, after detailed analysis of the rights and obligations of the parties, that the sale occurred in 2005, the year that SWF Real Estate and Virginia Conservation entered into the agreement, not in 2006, the year in which the State of Virginia awarded the tax credits and in which SWF Real Estate distributed the credits to Virginia Conservation. As of December 31, 2005, Virginia Conservation "owned" the tax credits, and even though Virginia Conservation's cash contribution was held by an escrow agent until 2006, under the "economic benefit" theory, the income had been realized in 2005 because SWF Real Estate's right to the escrowed funds was vested on or before December 31, 2005.

- The opinion noted that the facts of this case were nearly identical to those in *Route 231, LLC v. Commissioner*, T.C. Memo. 2014-30 (2/24/14), which reached the same result.

a. Things continue to go poorly in Ole Virginny for taxpayers trying to pull a fast one. *Route 231, LLC v. Commissioner*, 810 F.3d 247 (4th Cir. 1/8/16). The Court of Appeals for the Fourth Circuit, in an opinion by Judge Agee, affirmed the Tax Court's decision that the § 707(a)(2)(B) disguised sale rules applied to treat as a disguised sale a transaction involving a contribution of cash to a partnership by a new partner followed by an

allocation and distribution to that partner of State of Virginia conservation tax credits earned by the partnership. The court rejected the taxpayer's argument that the Tax Court improperly relied on *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), and applied the factors of Reg. § 1.707-3 to affirm the Tax Court's conclusion that a disguised sale had occurred. "Viewing all the circumstances surrounding this transaction, and in particular the terms of the amended operating agreements, the Tax Court did not err in finding that 'Route 231 would not have transferred \$7,200,000 of Virginia tax credits to Virginia Conservation but for the fact that Virginia Conservation had transferred \$3,816,000 to it' and vice versa." In reaching its holding, the court stated as follows:

The bona fides of Virginia Conservation's status as a member of Route 231, or that entity's status as a valid limited liability company (and valid partnership for tax purposes) do not matter for this inquiry. In short, the analysis under § 707 goes to the bona fides of a particular transaction, not to the general status of the participants to that transaction. Contrary to Route 231's repeated assertions, I.R.C. § 707 applies by its plain terms to designated transactions between otherwise valid ongoing partnerships and their legitimate partners.

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. **Bye bye TEFRA!** The Bipartisan Budget Act of 2015 § 1101, Pub. L. No. 114-74, signed by the President on 11/2/15, made sweeping changes to the partnership audit rules. The TEFRA rules (in §§ 6221-6231) and Electing Large Partnership rules (in §§ 6240-6242, 6245-6248, 6251-6252, and 6255) have been repealed and replaced in new §§ 6221-6223, 6225-6227, 6231-6235, and 6241, with an entity-level audit process that allows the IRS to assess and collect the taxes against the partnership unless the partnership properly elects out. The new rules will simplify the current complex procedures on determining who is authorized to settle on behalf of the partnership and also avoid the IRS's need to send various notices to all of the partners. Under the new provisions the IRS may reduce the potential tax rate assessed against the partnership to take into account factors such as tax-exempt partners and potential favorable capital gains tax rates. The new rules should significantly simplify partnership audits. As a result, the audit rate of partnerships might increase. Although partnerships with 100 or fewer partners can elect out of the new rules, § 6221(b), such election is not available if there is another partnership as a partner. Implementation of the new rules is deferred; the new rules apply to partnership taxable years beginning after 12/31/17. Partnership agreements should be amended to take into account these changes.

a. **The early bird catches the worm (or is that eats the worm at the bottom of the tequila bottle?).** T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16). The Treasury and IRS have promulgated Temp. Reg. § 301.9100-22T dealing with the time, form, and manner for making an election to have the new partnership audit regime, §§ 6221-6223, 6225-6227, 6231-6235, and 6241, enacted in the Bipartisan Budget Act of 2015, apply to returns filed for tax years beginning after 11/2/15 and before 1/1/18. Under Temp Reg. § 301.9100-22T(b) an election to have the new partnership audit regime apply must be made within 30 days of the date of the written notice from the IRS that the partnership return has been selected for examination. The election must be in writing, signed by the tax matters partner, and must include the name, taxpayer identification number, address, and telephone number of the individual who signs the statement, as well as the partnership's name, taxpayer identification number, and tax year to which the statement applies. The statement must include representations that the partnership is not insolvent and does not reasonably anticipate becoming insolvent, the partnership is not currently and does not reasonably anticipate becoming subject to a title 11 bankruptcy petition, and the partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination. The election must designate the partnership representative (§ 6223). An election may not be revoked without the

IRS's consent. Temp. Reg. § 301.9100-22T(c) allows a partnership that has not been issued a notice of selection for examination to make an election with respect to a partnership return for the purpose of filing an administrative adjustment request under § 6227 (as amended); this election may only be made after 12/31/17. The temporary regulation is effective on 8/5/16.

2. **Al Davis led the Raiders to three Super Bowl championships and was inducted into the Pro Football Hall of Fame, but was not able to persuade the Ninth Circuit that the IRS's breach of its closing agreement rendered the assessment invalid or that the limitations period on assessment had expired.** Davis v. United States, 811 F.3d 335 (9th Cir. 1/25/16). The taxpayer had the largest interest in the Oakland Raiders, a limited partnership subject to the TEFRA audit rules, and also was the president of A.D. Football, Inc., the limited partnership's sole general partner and tax matters partner. For the years at issue, the partnership and the IRS entered into a closing agreement to settle Tax Court litigation. The closing agreement required the IRS to make computational adjustments to determine the settlement's effect on each partner's tax liability. Paragraph Q of the closing agreement provided that each partner would have at least 90 days to review and comment on the computational adjustments and at least 60 days to review and comment on revised computational adjustments before the IRS assessed the tax resulting from the adjustments. Stipulations reflecting the closing agreement and signed by the attorney for the petitioner (the partnership and its TMP) were filed in the Tax Court and the Tax Court approved and entered stipulated decisions on 6/6/06. The IRS subsequently issued computational adjustments and issued revised computational adjustments on 8/27/07. Because the limitations period on assessment was about to expire, the IRS did not give the partners 60 days to review the revised computational adjustments and instead assessed tax against the taxpayer for three taxable years on 9/4/07. The IRS collected the assessed tax by applying refunds due to the taxpayer for earlier taxable years, and the taxpayer brought this refund action. The taxpayer argued that the IRS had breached the closing agreement and that the breach rendered the assessment of tax invalid. The District Court held in favor of the taxpayer. In an opinion by Judge Hurwitz, the Ninth Circuit reversed. The government conceded on appeal that it had breached the closing agreement. Nevertheless, the court rejected the taxpayer's argument that the language of § 7121(b)(2), which provides that closing agreements are "final and conclusive," dictates that the remedy for the IRS's breach is invalidation of the assessment. The court reasoned that closing agreements are contracts, and that the remedy for the IRS's breach of contract is damages, a remedy that the taxpayer had not sought: "The IRS's failure to perform its contract with the Partnership cannot relieve Davis of his statutory obligation to pay taxes; nothing in the Closing Agreement provided that any taxes assessed on the partners pursuant to statute would be rendered invalid if the government failed to perform." The court also held that the assessment was timely. The court rejected the taxpayer's argument that the stipulated decisions entered by the Tax Court on 6/6/06 were each a "settlement agreement with the partner" within the meaning of § 6231(b)(1)(C) that triggered a one-year limitation period on assessment under § 6229(f). "[W]e conclude that the IRS does not 'enter into a settlement agreement with the partner' when it enters into a settlement agreement with the TMP and the individual partner is bound merely by operation of the tax court's decision to which the partner is a party. Here, the stipulations were not agreements with Davis individually. ... Thus, the stipulations, like the Closing Agreement, were agreements only between the IRS and the Partnership." The court concluded that, pursuant to § 6229(d), the limitations period on assessment expired one year and 90 days after the stipulated decisions were entered, and that this period expired on 9/4/07, the day on which the IRS assessed tax.

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

1. **The STARS are blacked out by the economic substance doctrine.** Bank of New York Mellon Corp. v. Commissioner, 140 T.C. 15 (2/11/13). In a case described as a case of first impression in the Tax Court, the court (Judge Kroupa) denied the taxpayer's claimed foreign tax credits and other tax benefits artificially generated through a "STARS" tax-shelter

transaction developed and marketed by KPMG. The transaction that generated the purported foreign tax credit lacked economic substance. The taxpayer's control and management over the transferred assets did not materially change as a result of the transaction and the STARS structure had no effect on the income stream generated by the assets; the assets would have generated the same income regardless of being transferred. "Thus, income from the STARS assets was not an incremental benefit of STARS." The court rejected the taxpayer's argument that the STARS structure was security for a loan from Barclays Bank, finding that the loan proceeds were not used to purchase the STARS assets and that the loan was adequately secured by other assets. Thus the loan was a separate transaction from the STARS transaction, which standing by itself lacked economic substance. Furthermore, the STARS transaction still lacked economic substance even if the STARS structure and the loan were evaluated as an integrated transaction.

The STARS transaction was a complicated scheme centered around arbitraging domestic and foreign tax law inconsistencies. The U.K. taxes at issue did not arise from any substantive foreign activity. Indeed, they were produced through pre-arranged circular flows from assets held, controlled and managed within the United States. We conclude that Congress did not intend to provide foreign tax credits for transactions such as STARS.

- Finally, the claimed transactional expenses, the zero coupon swap interest expense, and the U.K. taxes that were incurred in furtherance of the STARS transaction were not deductible. "Expenses incurred in furtherance of a transaction that is disregarded for a lack of economic substance are not deductible."

a. But on reconsideration, the taxpayer wins a skirmish after the major battle is over. Bank of New York Mellon Corp. v. Commissioner, T.C. Memo. 2013-225 (9/23/13). The Tax Court (Judge Kroupa) granted the taxpayer's motion for reconsideration of its decision, 140 T.C. 15 (2/11/13), which disallowed the taxpayer's claimed STARS tax shelter deductions, but only with respect to the disallowance in the earlier decision of interest deductions with respect to a loan incurred as part of the STARS transaction. In the earlier proceeding the taxpayer maintained that it did not deduct interest on the loan because it argued that the loan interest and the spread should be treated as though they were paid under an integrated contract. The Tax Court bifurcated the STARS transaction into the loan and the STARS structure, and found that the loan proceeds were available for the taxpayer's use throughout the STARS transaction. Based on this finding the taxpayer argued that an interest deduction should be allowed, reasoning that the loan was not necessary for the STARS structure to produce the disallowed foreign tax credits, and thus loan served a purpose beyond the creation of tax benefits. The court agreed with this argument and allowed the deduction.

b. And the STARS still can't be seen at night (or in the day) after a visit to the Thurgood Marshall Courthouse. Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104 (2d Cir. 9/9/15). In an opinion by Judge Chin, the Second Circuit affirmed the Tax Court's decision in *Bank of New York Mellon Corp. v. Commissioner*, T.C. Memo. 140 T.C. 15 (2013), *supplemented*, T.C. Memo. 2013-225, and the District Court's decision in *American International Group, Inc. v. United States*, 2013 WL 1286193 (S.D.N.Y. Mar. 29, 2013). In *Bank of New York Mellon Corp.*, the Tax Court applied the economic substance doctrine to a structured trust advantaged repackaged securities (STARS) transaction to disallow the claimed foreign tax credits. In doing so, the Tax Court held that (1) the effect of foreign taxes is to be considered in the pre-tax analysis of economic substance, (2) STARS lacked economic substance, and thus Bank of New York could not claim foreign tax credits associated with STARS, and (3) Bank of New York was allowed to deduct interest expenses associated with the STARS transaction. The Second Circuit agreed with the Tax Court's separate analysis of the trust transaction and the associated loan to Bank of New York, and that under the Second Circuit's "flexible analysis" of the two prongs of the economic substance test, both the objective and subjective prongs of the economic substance test showed that the trust transaction lacked economic substance. The "transaction's circular cash flow strongly indicated that its main

purpose was to generate tax benefits. ... STARS lacked a subjective business purpose beyond tax avoidance. ... [T]he STARS structure lacked a reasonable relationship to BNY's claimed business purposes and BNY's interest in STARS was entirely predicated on the tax benefits it involved. However, the \$1.5 billion loan to Bank of New York had independent economic substance, and the interest paid on that loan thus was deductible because "[e]ven if the motive for a transaction is to avoid taxes, interest incurred therein may still be deductible if it relates to economically substantive indebtedness." In *American International Group, Inc.*, the District Court held that: (1) the economic substance doctrine applies to the foreign tax credit regime, and (2) the pre-tax benefit that AIG gained from its "cross-border" transactions was to be calculated after taking into account foreign taxes. The District Court denied AIG's motion for partial summary judgment, and certified the matter for interlocutory appeal. In affirming both lower court decisions, the Second Circuit reasoned that foreign taxes should be taken into account, i.e., as a deduction, in calculating the pre-tax profit realized from cross-border transactions (thus, disagreeing with *Compaq Computer Corp. v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), *rev'g*, 113 T.C. 214 (1999), and *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), and agreeing with *Salem Financial, Inc. v. United States*, 786 F.3d 932, 938 (Fed. Cir. 2015)). The Second Circuit rejected the taxpayers' arguments that the economic substance doctrine cannot be applied to disallow foreign tax credits that complied with all of the statutory and regulatory requirements. The court held that "[t]he economic substance doctrine exists to provide courts a 'second look' to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit." Thus, it is proper "when assessing the objective economic substance of a transaction, to include the foreign taxes paid but to exclude the foreign tax credits claimed in calculating pre-tax profit." Because "[t]he purpose of the foreign tax credit is to facilitate global commerce by making the IRS indifferent as to whether a business transaction occurs in this country or in another, not to facilitate international tax arbitrage," and "the transactions themselves 'fictionalize[d]' the concept of international trade, it was proper to apply the economic substance doctrine. Whether AIG's transactions had economic substance was a matter for a trial; "the government offered sufficient evidence to permit a reasonable fact finder to find in its favor. Hence, the district court did not err in denying partial summary judgment."

2. A judge sees the STARS and grants partial summary judgment for the taxpayer; only the Shadow [and the First Circuit] knows what comes next. Santander Holdings USA, Inc. v. United States, 977 F. Supp. 2d 46 (D. Mass. 10/17/13). The STARS tax shelter in the form marketed to banks involved two basic components: a loan from Barclays Bank to the U.S. taxpayer, which generated interest deductions, and the U.S. taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The transaction also featured a payment from Barclays to the U.S. taxpayer equal to approximately one-half of the U.K. taxes that the U.S. taxpayer paid. A key element in whether a STARS transaction has a reasonable prospect for profit, and thus might not run afoul of the economic substance doctrine, is whether the payment from Barclays effectively reduced the taxpayer's payment of the U.K. taxes as a rebate. (We will not go into the details of the economic analysis.) Suffice it to say that the government's position was that "the Barclays payment was not 'in substance' a payment by Barclays at all, but rather it was 'effectively' a rebate of taxes originating from the U.K. tax authorities. The theory is that Barclays was only able to make the payment because of the tax credits *it* had received from the U.K." The District Court (Judge O'Toole) found the government's argument on this point "wholly unconvincing," and held that the Barclays payment was not in any way a rebate to the taxpayer of U.K. taxes, citing Reg. § 1.901-2(f)(2), which provides: "Tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer's foreign tax liability." Accordingly, he ruled that the Barclays payment to the taxpayer "should be accounted for as revenue to [the taxpayer] in assessing whether [the taxpayer] had a reasonable prospect of profit in the transaction." He also rejected the government's argument that the entire transaction was a "sham" "concocted to manufacture a bogus foreign tax credit," because he found that argument to be foreclosed by his finding that "[i]f the Barclays payment is included in the calculation of pre-tax profitability, then there was a reasonable prospect of profit

as to the trust transaction, giving it economic substance.” Finally, Judge O’Toole concluded that under First Circuit precedent, if a transaction had “objective economic substance,” the economic substance doctrine could not be applied to deny the tax benefits of the transaction on “subjective” grounds, although he acknowledged that the First Circuit might revisit the issue and “would perhaps move a bit away from a rigid ‘objective only’ test to one that is primarily objective but has room for consideration of subjective factors where necessary or appropriate.”

a. The STARS are aligned for this taxpayer. The District Court grants summary judgment and upholds both the taxpayer’s interest deductions and foreign tax credits. Santander Holdings USA, Inc. v. United States, 116 A.F.T.R.2d 2015-6795 (D. Mass. 11/13/15). The court (Judge O’Toole) granted the taxpayer’s motion for summary judgment and denied the government’s cross-motion for summary judgment and held that the taxpayer properly claimed both the interest deductions and the foreign tax credits generated by the STARS transaction. In reaching this conclusion, the court rejected what it characterized as the government’s argument that the taxpayer’s payments of U.K. tax should be ignored under two substance over form doctrines, specifically the step transaction and conduit doctrines.

- The Courts of Appeals for the Second Circuit and the Federal Circuit both have held with respect to the STARS transaction that the taxpayers properly claimed interest deductions on the loans from Barclays, but that the taxpayers were not entitled to foreign tax credits because that aspect of the transaction lacked economic substance. *Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d 104 (2d Cir. 9/9/15); *Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15). The District Court’s decision in this case that the taxpayer properly claimed foreign tax credits generated by the STARS transaction conflicts with those decisions.

3. The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. Tricarichi v. Commissioner, T.C. Memo. 2015-201 (10/14/15). The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of \$65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately \$11.2 million more than the corporation’s net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a bad debt deduction of \$42.4 million to eliminate West Side’s tax liabilities. In the notice of deficiency issued to West Side, the IRS determined a deficiency of \$15.2 million based on its disallowance of the corporation’s bad debt deduction and asserted an accuracy-related penalty of roughly \$62,000 and a gross valuation misstatement penalty of \$5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side’s federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation’s tax liability, the court stated, two requirements must be satisfied: (1) the shareholder must be liable for the corporation’s debts under some provision of state law, and (2) the shareholder must be a “transferee” within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation’s tax deficiency as well as the penalties:

In sum, we find that petitioner had constructive knowledge of Fortrend’s tax-avoidance scheme; that the multiple steps of the Midco transaction must be collapsed; and that collapsing these steps yields a partial or complete liquidation of West Side from which petitioner received in exchange for his stock a \$35.2 million liquidating distribution. Under [Ohio law], petitioner is thus a direct transferee of West Side’s assets under respondent’s “de facto liquidation” theory as well as under the “sham loan” theory discussed previously.

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer

had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

a. How about a little salt in that wound? The taxpayer also is liable for pre-notice interest of \$13.9 million. *Tricarichi v. Commissioner*, T.C. Memo. 2016-132 (7/18/16). In a supplemental opinion, the Tax Court (Judge Lauber) upheld the government's calculation of pre-notice interest, i.e., interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. The government asserted that the taxpayer's liability for pre-notice interest must be determined under federal law and computed in accordance with the rules for interest on underpayments in § 6601. According to the government, the pre-notice interest amounted to \$13.9 million. The taxpayer contended that his liability for pre-notice interest must be determined under state law, and that under state law his liability for pre-notice interest was zero. The court reviewed prior decisions addressing liability for pre-notice interest, including *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), and concluded that courts have applied state law to determine liability for pre-notice interest only when the transferee has received an amount less than the transferor's liability:

In short, the courts have consulted State law to ascertain whether the Government may recover from the transferee, in the form of pre-judgment interest, an amount larger than the value of the assets the transferee received. Petitioner has cited, and our own research has discovered, no case in which a court has invoked State law governing pre-judgment interest as a basis for reducing the Government's recovery to an amount smaller than the value of the assets the transferee received. That is what petitioner seeks to do here, and there is simply no precedent for it.

Because the taxpayer received from the corporation assets in the amount of \$35.2 million, more than the \$35.1 million total of the transferor corporation's liability for income tax, penalties, and pre-notice interest, the taxpayer's liability for pre-notice interest was properly determined under federal law. Accordingly, the court held the taxpayer liable as a transferee for \$13.9 million in pre-notice interest.

4. Another U.S. bank that was dazzled by the STARS litigates its claimed tax benefits. *Wells Fargo & Co. v. United States*, 143 F. Supp. 3d 827 (D. Minn. 11/10/15). The STARS tax shelter in the form marketed to banks involved two basic components: a loan from Barclays Bank to the U.S. taxpayer, which generated interest deductions, and the U.S. taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The transaction also featured a payment from Barclays to the U.S. taxpayer equal to approximately one-half of the U.K. taxes that the U.S. taxpayer paid. In a lengthy opinion, the court (Judge Schiltz) ruled on several motions by the taxpayer and denied most of them. The court granted the taxpayer's motion for partial summary judgment that § 269 does not apply to the transaction. Section 269 generally authorizes the IRS to disallow a deduction, credit or other tax benefit if a person acquires control of a corporation or a corporation acquires transferred-basis property from another non-controlled corporation, and the principal purpose of the acquisition was evasion or avoidance of federal income tax by securing a tax benefit that the person or corporation would not otherwise enjoy. The court agreed with the taxpayer that, even if all other requirements of § 269 were satisfied, the acquisition did not produce tax benefits (foreign tax credits) that the taxpayer would not otherwise have enjoyed because the taxpayer could have claimed the foreign tax credits even without the use of the corporate entities involved in the transaction. The court denied the taxpayer's motion for partial summary judgment that the payments received from Barclays should be considered pretax income rather than a tax benefit. The court reserved this issue for trial and noted that it is inclined to agree with the Second Circuit (*Bank of New York Mellon Corp. v. Commissioner*, 801 F.3d. 104 (2d Cir. 9/9/15)) that the Barclays payment is a tax benefit, rather than with the contrary conclusion of the Federal Circuit (*Salem Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15)). The court also denied

the taxpayer's motion for partial summary judgment that the loan from Barclays created a reasonable expectation of pretax profit from the STARS transaction, but indicated it is inclined to agree with the Second and Federal Circuits that analysis of the loan should be bifurcated from analysis of the foreign tax credits.

5. The Sixth Circuit says that a listed transaction actually does deliver the desired tax benefits. But the court admonishes the government that it possibly could have won had it argued lack of economic substance or had promulgated prophylactic regulations. *Wright v. Commissioner*, 809 F.3d 877 (6th Cir. 1/7/16), *rev'g* T.C. Memo. 2011-292 (12/22/11). The taxpayer entered into a series of mutually offsetting over-the-counter foreign currency options in euros and Danish kroner—a euro put and a krone call, and a euro call and krone put. (Because the krone is closely tied to the euro, both calls should largely offset each other, as should both puts.) The taxpayer claimed a loss by marking to market under § 1256 the euro put option upon his assignment of the option to a charity, but took the position that the transfer of the offsetting over-the-counter option in the minor currency (the Danish krone) was not a § 1256 contract (because krone positions are not traded through regulated futures contracts) and thus not subject to the mark-to-market rules. The IRS disallowed the loss because the transaction is a listed transaction. Notice 2003-81, 2003-2 C.B. 1223, *modified and supplemented*, Notice 2007-71, 2007-2 CB 472. Relying on its prior decision in *Summitt v. Commissioner*, 134 T.C. 248 (2010), the Tax Court held that the taxpayer could not recognize the loss on the assignment of the euro put option because, as argued by the IRS, the option was not a “foreign currency contract” under § 1256. That reasoning, which also was the government's argument in the Court of Appeals, was grounded on the theory that to be a § 1256 contract, a “contract must mandate at maturity either a physical delivery of a foreign currency or a cash settlement based on the value of the currency.” The Sixth Circuit, in an opinion by Judge Rogers, reversed the Tax Court's holding. Judge Rogers concluded that “[w]hile the Tax Court's disallowance of the Wrights' claimed tax loss makes sense as a matter of tax policy, the plain language of the statute clearly provides that a foreign currency option can be a ‘foreign currency contract.’ ... Section 1256 provides that a ‘foreign currency contract’ is a contract ‘the settlement of which depends’ upon the value of a foreign currency even if that contract does not mandate that any such settlement occur. I.R.C. § 1256(g)(2)(A)(i).” Judge Rogers finished his opinion with an insightful missive on statutory interpretation.

We see no conceivable tax policy that supports this interpretation of the plain language of § 1256, and none has been suggested to us by the parties. To the contrary, this interpretation of § 1256 seems to allow the Wrights to engineer a desired tax loss by paying only a minimal cash outlay and by engaging in major-minor transactions that subject the Wrights to little actual economic risk. Although these transactions involve large sums of dollars, euros, and kroner, these transactions appear to have subjected the Wrights to little actual economic risk because the four options in the major-minor transactions offset each other. Further, when the premium payments are netted against each other, the transactions subjected the Wrights to a short-term capital loss of only \$25,200. Accordingly, the Wrights were able to pay \$50,200 out of pocket—based upon the Wrights' short-term capital loss of \$25,200 and payment of \$25,000 to a tax attorney for a tax opinion—in order to reduce their taxes by at least the \$603,093 deficiency upheld by the Tax Court. Moreover, the Wrights did not plausibly explain how engaging in transactions involving transfers of offsetting foreign currency options that opened and closed over the course of three days could accomplish the Wrights' stated goals of investment diversification and realization of a significant economic return. Accordingly, the Wrights appear to have engaged in the major-minor transactions primarily to generate the desired tax loss.

Congress may have wanted to create a different result when Congress added the “settlement” prong to § 1256. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 105, 98 Stat. 494. Congress explained that prior to this amendment a

contract “require[d] delivery of a [major] foreign currency” to meet the “foreign currency definition.” H.R. Rep. No. 98-432, pt. 2, at 1646 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1269. The House report indicates that Congress amended § 1256 to allow a contract that provides for a settlement in an amount determined by the value of the foreign currency, rather than actual delivery of the currency, to meet the “delivery” requirement of the “foreign currency contract” definition. *Id.* Congress may have wanted a contract that provides for settlement in cash to fall within the “foreign currency contract” definition only if that contract mandates settlement at maturity. If Congress had wanted to expand the definition of a “foreign currency contract” to include only such contracts, Congress could have amended § 1256(g)(2)(A)(i) to provide that a “foreign currency contract” is a contract “which requires delivery of, or *which requires* a settlement which depends on the value of, a foreign currency.” But Congress did not amend § 1256 in this way.

The fact that tax policy does not appear to support allowance of the Wrights’ claimed loss is not sufficient to reform the statutory language, for two reasons. First, the court’s attempt to reform § 1256 might unintentionally permit other tax-avoidance schemes. Second, Congress provided two escape hatches to guard against the type of adverse tax policy outcome at issue here. In particular, Congress allows the Secretary of the Treasury to prescribe regulations to exclude any type of contract from the “foreign currency contract” definition if the inclusion of this type of contract would be “inconsistent” with the purposes of § 1256. I.R.C. § 1256(g)(2)(B). The Secretary therefore could prevent future taxpayers from relying on § 1256 to mark to market foreign currency options by issuing a regulation that excludes foreign currency options from the definition of a “foreign currency contract.” Further, Congress also allows the Commissioner to prevent taxpayers from claiming tax losses based upon transactions involving offsetting foreign currency options by challenging specific transactions under the economic substance doctrine, as lacking in economic substance. *See* I.R.C. § 7701(o) (providing that a transaction shall be treated as having economic substance only if “the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position” and “the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction”). These statutorily provided bases for dealing with tax shelters that may violate the underlying policy of the Internal Revenue Code make it doubly inappropriate for this court to try to achieve such a result by torturing the plain language of the statute.

B. Identified “tax avoidance transactions”

1. A brand spanking new listed transaction. Notice 2015-73, 2015-46 I.R.B. 660 (10/21/15), *revoking* Notice 2015-47, 2015-30 I.R.B. 76 (7/8/15). This Notice identifies certain “basket option contracts” and substantially similar transactions as listed transactions for purposes of §§ 6111 and 6112 and Reg. § 1.6011-4(b)(2). It applies to a type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The contract is denominated as an option contract that references a basket of actively traded personal property (i.e., securities). The contract allows the taxpayer to trade the securities referenced in the contract while the contract purportedly remains open, and the taxpayer does so. Consequently, option treatment is not warranted, and the income deferral and conversion to long-term capital gain is improper. Transactions in effect on or after 1/1/11, that are the same as, or substantially similar to, the transaction described in the notice are identified as listed transactions effective 10/21/15.

2. And another “transaction of interest” that might be on its way to being listed. Notice 2015-74, 2015-46 I.R.B. 663 (10/21/15), *revoking* Notice 2015-48, 2015-30 I.R.B. 77 (7/8/15). This notice identifies certain “basket contracts” and substantially similar transactions

as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. It applies to a type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain. The transaction may be denominated as an option, notional principal contract, or forward contract. The contract may reference assets that are not actively traded, such as interests in hedge funds, and the taxpayer has the right to change the assets in the referenced basket. The taxpayer's ability to control the assets in the basket raises the issue of whether the form of the transaction should be respected, and, thus, whether the income deferral and conversion to long-term capital gain is improper. The Treasury Department and the IRS believe this transaction (the "basket contract") has a potential for tax avoidance or evasion but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. If a transaction described in this notice is similar to a transaction described in Notice 2015-47, it is treated as a listed transaction. Transactions entered into on or after 11/2/06, that are the same as, or substantially similar to, the transactions described in the notice, and in effect on or after 1/1/11, are identified as transactions of interest effective 10/21/15.

C. Disclosure and Settlement

D. Tax Shelter Penalties

1. Tax Shelters—the gift that keeps on giving guidance. REG-103033-11, Reportable Transactions Penalties Under Section 6707A, 80 F.R. 52231 (8/28/15). Section 6707A imposes a penalty on a taxpayer who has a duty to disclose a reportable transaction and fails to do so. Section 6707A was amended in 2010 by the Small Business Jobs Act of 2010 to change the amount of the penalty from a stated dollar amount to 75 percent of the decrease in tax shown on the return as a result of the reportable transaction. There are also, however, minimum and maximum penalties. In the case of a natural person, the minimum penalty is \$5,000, and in the case of a taxpayer other than a natural person the minimum penalty is \$10,000. The maximum penalty for a natural person is \$100,000 in the case of a listed transaction, and \$10,000 in the case of any other reportable transaction. The maximum penalty for a taxpayer other than a natural person is \$200,000 in the case of a listed transaction, and \$50,000 in the case of any other reportable transaction. Proposed amendments to Reg. § 301.6707A-1(b)(3), (d) clarify the application of the amended penalty provision.

2. Final regulations on the § 6708 penalty for failing to make available lists of advisees with respect to reportable transactions. T.D. 9764, Section 6708 Failure to Maintain List of Advisees With Respect to Reportable Transactions, 81 F.R. 25328 (4/28/16). Treasury and the IRS have finalized, with some changes, proposed regulations under § 6708 (REG-160873-04, American Jobs Creation Act Modifications to Section 6708, Failure To Maintain List of Advisees With Respect to Reportable Transactions, 78 F.R. 14939 (3/8/13)). Section 6708 imposes a penalty of \$10,000 per day (absent reasonable cause) upon material advisors for failing to make available to the IRS, within twenty business days of a written request, a list required to be maintained by § 6112 with respect to any reportable transaction (as defined in § 6707A(c)). A material advisor, as defined in § 6111(b)(1), generally is any person who provides any material aid, assistance or advice with respect to carrying out any reportable transaction and who directly or indirectly derives gross income in excess of a specified threshold for doing so. The final regulations provide guidance on several issues, including the determination of the 20-business-day period, requests for extensions of the 20-business-day period for good cause, and the circumstances in which a failure to make a list available will be treated as due to reasonable cause, such as a taxpayer's reliance on advice from an independent tax professional. The final regulations contain many examples illustrating the rules. The regulations apply to all requests for lists required to be maintained under § 6112 made on or after 4/28/16.

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. **Final regulations on program-related investments.** T.D. 9762, Examples of Program-Related Investments, 81 F.R. 24014 (4/25/16). Treasury and the IRS have finalized, with minor changes, proposed amendments to regulations under § 4494 (REG-144267-11, Examples of Program-Related Investments, 77 F.R. 23429 (4/19/12)). Section 4944(a) imposes an excise tax on a private foundation that makes an investment that jeopardizes the carrying out of its exempt purposes. Section 4944(c) provides that investments that are program-related investments are not jeopardizing investments. Generally, under § 4944(c), a program-related investment is an investment: (1) the primary purpose of which is to accomplish one or more of the purposes described in § 170(c)(2)(B); and (2) no significant purpose of which is the production of income or the appreciation of property. The proposed regulations added nine new examples depicting a wider range of investments that qualify as program-related investments. The final regulations retain these nine examples with only minor modifications made in response to comments on the proposed regulations. The new examples demonstrate that a program-related investment may accomplish a variety of charitable purposes, such as advancing science, combating environmental deterioration, and promoting the arts. Several examples also show that an investment funding activities in one or more foreign countries, including investments to provide below-market loans to poor individuals in developing countries or that fund educational programs for poor individuals, may further the accomplishment of charitable purposes and qualify as a program-related investment. The amendments are effective on and after 4/25/16.

2. **From now on PACs disguised as tax-exempt social welfare organizations will have to rat themselves out within 60 days of organization. Will they really comply?** T.D. 9775, Requirement To Notify the IRS of Intent To Operate as a Section 501(c)(4) Organization; Final and Temporary Regulations, 81 F.R. 45008 (7/12/16). The Treasury and IRS have promulgated Temp. Reg. § 1.506-1T relating to the requirement, added by the Protecting Americans from Tax Hikes Act of 2015, that organizations must notify the IRS of their intent to operate under § 501(c)(4). The regulations provide that the notification must be submitted on Form 8976, "Notice of Intent to Operate Under Section 501(c)(4)," or its successor, no later than 60 days after the date the organization is organized. The notification must include: (1) the name, address, and taxpayer identification number of the organization; (2) the date on which, and the state or other jurisdiction under the laws of which, the organization was organized; and (3) a statement of the purpose of the organization. In addition, the temporary regulations provide that the notification must include such additional information as may be specified in published guidance in the Internal Revenue Bulletin or in other guidance, such as forms or instructions, issued with respect to the notification. The applicable user's fee will be published in separate guidance. Filing of the Notice and acknowledgment of receipt by the IRS does not constitute a status determination. (An organization must secure a determination of status by following procedures under § 506(f)). Section 6652(c)(4) penalties apply for failure to file the Notice. The regulations affect only § 501(c)(4) organizations that are organized after 12/18/15, and certain § 501(c)(4) organizations in existence on that date. The text of the temporary regulations serves as the text of the proposed regulations set forth in a related notice of proposed rulemaking, REG-101689-16, Requirement To Notify the IRS of Intent To Operate as a Section 501(c)(4) Organization, 81 F.R. 45088 (7/12/16).

a. **The devil is in the details.** Rev. Proc. 2016-41, 2016-30 I.R.B. 165 (7/8/16). This revenue procedure sets forth in detail the procedure for an organization to notify the IRS that it is operating as a § 504(c)(4) organization.

B. Charitable Giving

1. "[W]e do not need to decide in the instant case whether an operating golf course is inherently inconsistent with conservation purposes under section 170(h)." But we believe that the opinion comes pretty darn close to doing so. Atkinson v. Commissioner, T.C. Memo. 2015-236 (12/9/15). The principal issue in this case was whether the taxpayers were entitled to charitable contribution deductions for granting conservation easements on two

operating golf courses, one granted in 2003 and the other granted in 2005. After thorough consideration of the terms and purposes of the easements, the physical characteristics of the golf courses and the surrounding land (mostly developed home sites), and the nature of the operation of the golf courses, the Tax Court (Judge Wells) held that the conservation easements did not comply with the “conservation purpose” requirement of § 170(h), and thus never reached the valuation issue. (Judge Wells noted that the case bore some similarity to *Kiva Dunes Conservation, LLC v. Commissioner*, T.C. Memo. 2009-145, but *Kiva Dunes* did not address the issue of compliance with the conservation purpose requirement of § 170(h) because the IRS had conceded that issue on brief, after trial.) The principal 2003 easement consisted of six noncontiguous tracts, ranging in size from 4.9 acres to 23.4 acres in a vaguely figure-eight shape. It was bordered by residential lots except for the center of the figure-eight, where the property directly abutted swamps and wetlands. The easement property consisted of approximately 15 acres of fairways, greens, teeing grounds, ranges, 27 acres of rough, 12.5 acres of ponds, 4 acres of wetlands, and 21 acres described as “other.” A second conservation easement covered approximately 32.3 acres of swamps and wetlands abutting the center of the figure-eight-shaped easement. The stated purposes of the principal easement were “Preservation of the Conservation Area as a relatively natural habitat of fish, wildlife, or plants or similar ecosystem; and Preservation of the Conservation Area as open space which, if preserved, will advance a clearly delineated Federal, State or local governmental conservation policy and will yield a significant public benefit.” The taxpayers retained the right to operate a golf course, make alterations, and engage in certain construction activities. The golf course area could be altered “in such manner as Owner determines to be appropriate” as long as “the best environmental practices then prevailing in the golf industry” are used and applied. The golf course owner could cut and remove trees that are on the golf course or within 30 feet of the golf course if their removal is “appropriate for the proper maintenance of the golf course.” Additionally, the golf course owner could cut trees to build a restroom, rain shelter, rest station, or food concession stand. The golf course was permitted to, and did, apply fungicides, herbicides, insecticides, and adjuvants on the tees, fairways, and rough. Judge Wells held that the terms of the easement and the nature of the operation of the golf course did not satisfy the “protecting natural habitat” purpose requirements of § 170(h)(4)(A)(ii), which Reg. § 1.170A-14(d)(3)(i) interprets to require that the donation “protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem, normally lives.” A “habitat” is an “area or environment where an organism or ecological community normally lives or occurs” or the “place where a person or thing is most likely to be found.” *Glass v. Commissioner*, 124 T.C. 258, 281-282 (2005). After considering expert witnesses’ testimony and reports, including the fact that no consideration had been given to the effect of chemicals on the easement property by the easement holder, Judge Wells concluded that “wildlife and plants are not ‘most likely’ to be found or do not ‘normally live’ on the [golf course] easement property. The ‘use of pesticides and other chemicals could injure or destroy the ecosystem and therefore runs counter to the provisions of [Reg. § 1.170A-14(e)(2)].” Nor, considering the record, did the golf course easement “contribute” to any nearby “conservation area” by serving as a buffer or wildlife corridor: “There are no natural fruits and seeds for foraging or cover from humans or predators, and there are barriers to animal migration such as the surrounding homes, human activity, and nightly watering.” The 2005 easement, on another golf course, suffered from the same problems. Judge Wells found, based on the testimony and experts’ reports “very little wildlife” was to be found on the property, and that the fact that Venus Flytraps and Pitcher Plants grew on the parts of the property that were not mowed was not sufficient. Finally, neither easement qualified for the conservation purpose of preserving open space pursuant to § 170(h)(4)(A)(iii)(I) or (II). Under § 170(h)(4)(A)(iii)(I) the easement must be for the scenic enjoyment of the general public, and under § 170(h)(4)(A)(iii)(II) it must be pursuant to a clearly delineated Federal, State, or local government conservation policy. In either case the preservation of open space must also yield a significant public benefit. The general public was not permitted to access the golf course properties, which were open only to members, and there was no evidence that the general public had even visual access, which can be sufficient, because the golf courses were within gated

communities. And no clearly delineated Federal, State, or local government conservation policy had been identified and associated with the properties. In a partial victory, the taxpayers escaped § 6662 accuracy-related penalties.

2. Encouraging the elderly to give away their retirement savings—Does that make sense to you? The 2015 PATH Act, § 112, retroactively extended through 12/31/15 and made permanent § 408(d)(8)(F), which allows taxpayers who are age 70-1/2 or older to make tax-free distributions to a charity from an IRA of up to \$100,000 per year. These distributions are not subject to the charitable contribution percentage limits.

3. Let's go green permanently; contributions of conservation easements. The 2015 PATH Act, § 111, reinstated for 2015 and made permanent the provisions of § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher in tax years beginning after 12/31/05. Generally, under § 170(b), a corporation's charitable contribution deductions cannot exceed 10 percent of taxable income. An individual's deduction for qualified conservation easements cannot exceed 50 percent of the taxpayer's contribution base over other allowable charitable contribution deductions. The limits under § 170(b) for deduction of qualified conservation easements by a farmer or rancher are 100 percent of the taxpayer's contribution base (in the case of an individual) or taxable income (in the case of a corporation) over other allowable charitable contributions, with a fifteen year carryforward.

4. We really shouldn't have charitable organizations collect taxpayer identification numbers of donors, says the IRS. The proposed regulations are withdrawn. IRS-2015-0049-37970, Substantiation Requirement for Certain Contributions; Withdrawal, 81 F.R. 882 (1/8/16). The Treasury Department and the IRS have withdrawn proposed regulations (REG-138344-13, Substantiation Requirement for Certain Contributions, 80 F.R. 55802 (9/17/16)) under § 170(f)(8) governing the substantiation of charitable contributions of \$250 or more. Section 170(f)(8)(A) requires a taxpayer who claims a charitable contribution deduction for any contribution of \$250 or more to obtain substantiation in the form of a contemporaneous written acknowledgment (CWA) from the donee organization. An exception in § 170(f)(8)(D) provides that a CWA is not required if the donee organization files a return (on such form and in accordance with such regulations as are prescribed) that includes the information required in a CWA. When final regulations on the CWA requirements were issued in 1997, Treasury and the IRS declined to issue regulations under § 170(f)(8)(D) to effectuate donee reporting and have since taken the position that the § 170(f)(8)(D) exception is not available without final regulations prescribing the method by which donee reporting may be accomplished. Nevertheless, some taxpayers under examination for their claimed charitable contribution deductions have argued that a failure to comply with the CWA requirements can be cured if the donee organization files an amended Form 990 that includes the required information for the contribution at issue. The proposed regulations established a framework under which a donee organization could, pursuant to § 170(f)(8)(D), file an information return and furnish a copy to the donor no later than February 28 of the year following the calendar year in which the contribution was made. The information return required by the proposed regulations had to include the donor's name, address, and taxpayer identification number. In response to comments on the proposed regulations and their own misgivings about potential identity theft arising from donee organizations collecting and maintaining taxpayer identification numbers, Treasury and the IRS have withdrawn the proposed regulations. The withdrawal indicates that Treasury and the IRS have "decided against implementing the statutory exception to the CWA requirement" and continue to take the position that the § 170(f)(8)(D) "exception remains unavailable unless and until final regulations are issued prescribing the method for donee reporting."

5. Pigs get fat and hogs get slaughtered. Carroll v. Commissioner, 146 T.C. No. 13 (4/27/16). The taxpayers granted an otherwise qualifying conservation easement to a qualified donee. However, the conservation easement deed provided that if the conservation purpose was extinguished because of an unexpected change in circumstances surrounding the donated property, the donee organization would be entitled to a proportionate share of extinguishment proceeds at least equal to (1) the value of the easement at the time of the

contribution over (2) the fair market value of the property at the time of the contribution and that the value of the easement on the effective date “shall be the deduction for federal income tax purposes allowable by reason of this grant, pursuant to Section 170(b) of the Code.” The IRS disallowed the deduction on the ground that the easement was not protected in perpetuity because Reg. § 1.170A-14(g)(6)(ii), which permits a “single—and exceedingly narrow—exception to the requirement that a conservation easement impose a perpetual use restriction,” requires that the grantee’s proportionate interest upon extinguishment of a conservation easement be a percentage determined by (1) the fair market value of the conservation easement on the date of the gift (numerator), over (2) the fair market value of the property as a whole on the date of the gift. The Tax Court (Judge Ruwe) upheld the IRS’s disallowance of the deduction. Reg. § 1.170A-14(g)(6)(ii) is “designed in case of extinguishment both (1) to prevent taxpayers from reaping a windfall if the property is destroyed or condemned and they get the proceeds from insurance or condemnation and (2) to assure that the donee organization can use its proportionate share of the proceeds to advance the cause of historic preservation elsewhere.” Because the formula in the conservation easement deed employed a formula that differed from the formula in Reg. § 1.170A-14(g)(6)(ii), in the event of an extinguishment of the conservation easement, the grantee would not be guaranteed a proportionate share of extinguishment proceeds as required by Reg. § 1.170A-14(g)(6)(ii). In the event of extinguishment, if the deduction for the conservation easement was disallowed for a reason other than valuation (and the IRS had unsuccessfully raised a number of other grounds for disallowing the deduction), the taxpayers or their heirs could argue that they never received a tax deduction and, therefore, the donees would not be entitled to any extinguishment proceeds. Finally, the taxpayers could not circumvent the strict requirement of Reg. § 1.170A-14(g)(6) by showing that the probability of extinguishment is so remote as to be negligible under Reg. § 1.170A-14(g)(3). The court upheld a 20 percent accuracy-related penalty for substantial understatement of income under § 6662(a) and (b)(2) and held that the taxpayers did not qualify for the reasonable cause, good faith defense of § 6662(c)(1): they “offered no evidence which would explain why the terms of the conservation easement varied from the requirements of section 1.170A-14(g)(6), Income Tax Regs., nor do they clarify why Dr. Carroll[, who personally handled the conservation easement,] failed to seek competent advice from a tax attorney or other adviser to ensure the conservation easement’s compliance with pertinent regulations.”

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Jurisdiction is not arithmetic—you can’t divide \$24.9 million by 193. *Diversified Group, Inc. v. United States*, 123 Fed. Cl. 442 (9/29/15). The Court of Federal Claims (Judge Sweeny), in a case of first impression, held that it lacked jurisdiction in a suit seeking a refund of a partial payment of a § 6707 penalty assessed for failure to register a tax shelter as required § 6111. The plaintiff argued that the penalty was divisible, that it was not necessary to pay the full amount of the penalty prior to bringing suit but, only to pay the penalty with respect to one of the 193 individual transactions involving the tax shelter. The court rejected this argument, holding that the \$24.9 million penalty for failure to register the tax shelter related to a single act.

Although it is true that the IRS calculated the amount of the penalty based upon each client’s aggregate investment in the tax shelter, neither the number of clients that participated in the tax shelter nor the number of commercial steps necessary to accomplish that participation in the tax shelter triggers liability under § 6707. Consequently, the penalty is not divisible for any reason, including the number of clients who participated in the tax shelter.

Thus, the full payment rule for seeking a refund established by *Flora v. United States*, 357 U.S. 63 (1958), had not been met because the penalty was not divisible and “[e]xceptions to the full payment rule have been recognized by the courts only where an assessment covers divisible taxes.” *Rocovich v. United States*, 933 F.2d 991, 995 (Fed. Cir. 1991). A tax or penalty is divisible when “it represents the aggregate of taxes due on multiple transactions.”

2. ♪♪Oh! You better watch out, you better not cry; if your return is sent back you better ask why.♪♪ **A joint return that is not signed by or on behalf of one spouse is not a valid return.** Reifler v. Commissioner, T.C. Memo. 2015-199 (10/13/15). The accountant for the taxpayers, a married couple, prepared a joint return for the year 2000 and sent it to them for signature. Mr. Reifler signed it, placed it in their home in a bin where he usually placed items that required his wife's signature, but then mailed it to the IRS—several days before the extended due date—without his wife's signature. The taxpayers later received in the mail from the IRS the original return with a date-stamp and some red ink marks on it, but without any attached correspondence. Mr. Reifler testified that he was not alarmed by this because he requested copies of his tax returns from time to time for various business reasons. The taxpayers took no action until 2002, when they received a delinquency notice informing them that the IRS had not received their 2000 return. In response, the taxpayers signed and mailed to the IRS a second return, which they asserted was a copy of the original return, without any attached correspondence. The IRS treated this second return as their original return for 2000 with a filing date of 9/2/02. The Tax Court (Judge Laro) held that the return filed by the taxpayers without Mrs. Reifler's signature was not a valid return. Form 1040 itself and relevant regulations require the signatures of both spouses on a joint return. (The court noted that the exceptions under which one spouse can sign on behalf of the other pursuant to a power of attorney or because the other spouse is physically unable to sign did not apply.) In concluding that the return was not valid, the court rejected the taxpayers' reliance on the substantial compliance doctrine, which "stands for the idea that a tax return need not be perfect to be valid." The requirements for treating a document as a "return," the court reasoned, were clarified by the four-factor test established in *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). One requirement of the Beard test is that the document must be executed by the taxpayer under penalties of perjury. Because Mrs. Reifler did not sign the original 2000 return, it did not meet this requirement. The court also rejected the taxpayers' reliance on the tacit consent doctrine, which is a doctrine commonly invoked to hold a spouse jointly liable for taxes on a joint return. In most cases involving the tacit consent doctrine, the court stated, "one spouse signs a joint return for both spouses and it is later shown that the other spouse has tacitly consented to the joint return filing." The taxpayers' situation was distinguishable because only one signature appeared on the joint return. The court upheld a late-filing penalty under § 6651(a)(1) and rejected the taxpayers' argument that the late filing was due to reasonable cause and not willful neglect. To establish reasonable cause, taxpayers must demonstrate that they exercised ordinary business care and prudence and nevertheless were unable to file by the due date. "[I]t is difficult, if not impossible, to conclude that Mr. Reifler, a sophisticated businessman, acted with ordinary business care and prudence when he failed to follow up with the IRS or his accountant . . . as to why the original 2000 return was sent back to him with some red ink marks on it."

3. **Judge Holmes finds that taxpayer properly invoked the Fifth Amendment on his Form 1040.** Youssefzadeh v. Commissioner, Order (Tax Court, 11/6/15), <https://perma.cc/JW9T-PUF6>. In this collection due process case, the Tax Court (Judge Holmes) rejected the imposition of a § 7602 frivolous-return penalty that was based upon the premise that the claiming of the Fifth Amendment as a reason for omitting information is a frivolous argument. The 2011 return was timely filed and most of the lines were filled out in a normal fashion, but on Schedule B (interest and dividends) the taxpayer refused to answer some questions and fill in some values. Judge Holmes found the return to be "substantially correct" in that the total amount of interest was included, while only the source of one payer was omitted. The taxpayer also had reasonable cause to refuse to answer question 7a on Form 1040 on whether he is required to file an FBAR because it is a crime to willfully fail to file an FBAR.

- Query why the IRS did not subpoena the taxpayer's bank records, production of which is mandatory pursuant to the required records doctrine.

4. **A taxpayer who incorrectly claimed refundable credits avoids the accuracy-related penalty for substantial understatement of income because an understatement is not the same thing as a deficiency.** Gassoway v. Commissioner, T.C. Memo. 2015-203 (10/15/15). The taxpayer claimed head of household filing status, claimed a

dependency exemption deduction for four children and, with respect to three children, claimed a child tax credit, an additional child tax credit, and the earned income tax credit. The Tax Court (Judge Chiechi) determined that the taxpayer was not entitled to head of household filing status and disallowed the claimed deduction and credits. Nevertheless, the court held that the taxpayer was not liable under for the 20 percent penalty imposed by § 6662(a) on an underpayment of tax to which § 6662 applies. According to § 6662(b)(2), the penalty applies to the portion of any underpayment which is attributable to, among other things, a substantial understatement of tax. The taxpayer's return apparently showed a tax liability of zero after the application of nonrefundable credits. In addition, the taxpayer claimed two refundable credits: an additional child tax credit of \$3,691 and an earned income tax credit of \$2,658. According to the IRS, the taxpayer was not entitled to any of the credits and the taxpayer's correct tax liability was \$2,856. Thus, the IRS sought a deficiency of \$9,205 (the sum of the refundable credits and the taxpayer's unpaid tax liability). The IRS asserted that the 20 percent accuracy-related penalty for substantial understatement of income applied to the \$9,205 deficiency. (The court notes that the IRS subsequently conceded that it miscalculated the penalty and that the correct penalty was \$577.20, which is 20 percent of only the unpaid tax liability of \$2,856.) The court held that a deficiency is not the same thing as an "understatement" of tax. According to § 6662(d)(2)(A), "the term 'understatement' means the excess of—(i) the amount of the tax required to be shown on the return for the taxable year, over (ii) the amount of the tax imposed which is shown on the return" The court concluded that the amount of tax required to be shown on the taxpayer's return was \$2,856, and the amount of the tax imposed shown on the return was zero, which resulted in an understatement of \$2,856. The refundable credits claimed by the taxpayer did not reduce the amount of tax shown on the return because the statutory definition of "understatement" does not provide for this adjustment. In contrast, the amount of the deficiency was properly \$9,205 because § 6211(b)(4) directs that, in determining the amount of a deficiency, the amount by which certain credits (including those at issue here) exceed the amount of tax shown on the return must be treated as negative amounts of tax. The taxpayer's understatement was \$2,856, which was not large enough to trigger the penalty for a substantial understatement of tax, which is defined for individuals in § 6662(d)(1)(A) as the greater of 10 percent of the tax required to be shown on the return (\$2,856 in this case) or \$5,000.

- The IRS could have sought to impose the accuracy-related penalty pursuant to § 6662(b)(1) for negligence or disregard of rules or regulations, but failed to raise this argument.

- Curiously, the court's opinion does not cite *Rand v. Commissioner*, 141 T.C. 376 (2013), a reviewed decision in which the court similarly held that the earned income credit, additional child tax credit, and recovery rebate credit claimed by the taxpayer did not reduce "the amount shown as the tax by the taxpayer on his return" within the meaning of § 6664(a), which defines the term "underpayment." In reaching this conclusion, the court in *Rand* reasoned, as Judge Chiechi does in this case, that Congress provided for this result by specifically directing in the definition of "deficiency" in § 6211(b)(4) that the excess of these credits over the amount of tax shown on the return is treated as a negative amount of tax and by failing to provide this direction in the relevant statutory provision (the definition of "underpayment" considered by the court in *Rand*).

a. Congress legislatively overrules the Tax Court's interpretation of § 6664(a). The 2015 PATH Act, § 209 amends Code § 6664(a) by adding the following language: "A rule similar to the rule of section 6211(b)(4) shall apply for purposes of this subsection." The effect of this amendment is to legislatively overrule the Tax Court's decision in *Rand v. Commissioner*, 141 T.C. 376 (2013), in which the court held that refundable credits claimed by the taxpayer did not reduce "the amount shown as the tax by the taxpayer on his return" within the meaning of § 6664(a), and therefore no accuracy-related penalty or fraud penalty may be imposed to the extent refundable credits reduce the tax imposed below zero. This change is effective not only for returns filed after 12/18/15 (the date of enactment), but also for any previously filed returns for which the statute of limitations has not expired as of the date of enactment.

5. Updated instructions on how to rat yourself out. Rev. Proc. 2016-13, 2016-4 I.R.B. 290 (1/25/16). This revenue procedure updates Rev. Proc. 2015-16, 2015-7 I.R.B. 596, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return. A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position.

6. More taxpayer (or nontaxpayer?) choice of forum. *Norman v. United States*, 126 Fed. Cl. 277 (4/11/16). The Court of Federal Claims (Judge Merow) held that the court has jurisdiction to hear suits seeking a refund of FBAR penalties imposed under the Bank Secrecy Act. The court concluded that the scope of its subject matter jurisdiction under the Tucker Act, 28 U.S.C. § 1491(a)(1), extends to suits seeking the recovery of a penalty such as the one in this case. The court rejected the government's argument that exclusive jurisdiction over cases involving penalties is vested in the United States District Courts by 28 U.S.C. § 1355, which provides that "[t]he district courts shall have original jurisdiction, exclusive of the courts of the States, of any action or proceeding for the recovery or enforcement of any fine, penalty, or forfeiture ... incurred under any Act of Congress." Nevertheless, the court "acknowledge[d] ... that substantial ground for difference of opinion on this controlling question of law exists, so that an interlocutory appeal ... may materially advance the ultimate termination of the litigation."

7. Schools can report amounts billed, rather than amounts paid, on Form 1098-T for calendar year 2016, but after 2016 penalties will apply for reporting amounts billed. Announcement 2016-17, 2016-20 I.R.B. 853 (4/27/16). Prior to 2016, § 6050S(b)(2) allowed eligible educational institutions to report either the aggregate amount of payments received for qualified tuition and related expenses or the aggregate amount billed for such tuition and expenses. The 2015 PATH Act, § 212, amended § 6050S(b)(2) and eliminated the option to report aggregate qualified tuition and related expenses billed effective for amounts paid after 12/31/15 for education furnished in academic periods beginning after that date. This announcement states that the IRS will not impose penalties under section §§ 6721 or 6722 for failure to file or furnish correct or timely information returns solely because an eligible educational institution reports the aggregate amount billed for qualified tuition and related expenses for the 2016 calendar year. Educational institutions therefore continue to have the option of reporting either the amount of payments received or the amount billed for the 2016 calendar year without being subject to penalties. This penalty relief does not apply to any other failure subject to a penalty under §§ 6721 or 6722.

8. What is the meaning of "same taxpayer" when corporations merge? *Wells Fargo & Co v. United States*, 117 A.F.T.R.2d 2016-2263 (Fed. Cir. 6/29/16), *rev'g in part and aff'g in part*, 117 Fed. Cl. 30 (2014). Section 6621(d) allows "global netting" on interest rates for tax overpayments and tax underpayments by the "same taxpayer" to address the disparity between the higher interest rate imposed on tax underpayments and the lower interest rate applied when the government pays a refund on tax overpayments. On a motion for summary judgment, the Court of Federal Claims (Judge Firestone) held that the term "same taxpayer" includes both predecessors of the surviving corporation in a statutory merger. Section 6621(d) allows interest netting regardless of whether the overlapping overpayments and underpayments involve corporations that were separate prior to the merger; following a merger, the entities become one and the same as a matter of law and thus become the "same" for purposes of interest netting. The Court of Federal Claims rejected the government's argument that § 6621(d) netting applies only when the overpayment and underpayment were made by the taxpayer with the same

TIN at the time of the payments. The Court of Appeals for the Federal Circuit, in an opinion by Judge Stoll, affirmed in part and reversed in part. The Court of Appeals held that where before a merger of two corporations one had made an overpayment and the other had an underpayment, they do not meet the “same taxpayer” requirement under § 6621(d), and interest netting is not allowed—because both the underpayment and overpayment occurred prior to the merger of the underpaying and overpaying entities, the payments were made by two separate corporations. But where before a merger the corporation acquired in the merger had an overpayment and after the merger the acquiring corporation has an underpayment, the “same taxpayer” requirement of § 6621(d) has been met, and interest netting is allowed.

B. Discovery: Summonses and FOIA

1. **An incredible opinion in which a NYC Magistrate Judge refused to quash a summons issued to E&Y related to a corporate acquisition and restructuring, finding that (1) the attorney-client and tax practitioner privileges had been waived, and (2) the work product doctrine did not apply because the E&Y Tax Memo would have been *drafted in exactly the same way if litigation had not been anticipated*.** *Schaeffler v. United States*, 22 F. Supp. 3d 319 (S.D.N.Y. 5/28/14). The District Court for the Southern District of New York (Magistrate Judge Gorenstein) refused to quash a summons issued to Ernst & Young on attorney-client/tax practitioner privilege grounds because privilege was waived by sharing the document with a bank consortium that financed an acquisition, which consortium did not share a predominantly legal interest with Schaeffler but merely had a common economic interest.

- The work product claim was based on the so-called “EY Tax Memo,” which was a 321 page document that was provided to the court for *in camera* review. It “expounds on the transactional steps that [E&Y] provided” and “contains numerous appendices that provide detailed analysis of the federal tax issues implicated by each step.” Magistrate Judge Gorenstein continued:

This legal analysis makes reference to statutes, IRS regulations, IRS private letter rulings, other administrative materials, and case law. In many instances, the memorandum asserts that there is no law clearly on point and thus uses language such as “although not free from doubt,” “the better view is that,” “it may be argued,” and “it is not inconceivable that the IRS could assert.” Additionally, in explaining its recommendations for handling particular aspects of the restructuring and refinancing measures, the memorandum considers at great length the arguments and counter-arguments that could be made by Schaeffler and the IRS with regard to the appropriate tax treatment of these measures. While there is copious citation to relevant legal authority, the memorandum does not specifically refer to litigation — for example, by discussing what actions peculiar to the litigation process Schaeffler or the IRS might take or what settlement strategies might be considered. Rather, the memorandum contains detailed and thorough legal analysis as to the propriety of the planned measures and advocates what specific transactional steps should be taken.

. . . We will also accept that Schaeffler believed that litigation was highly probable in light of the significant and difficult tax issues that were raised by the planned refinancing and restructuring. Accordingly, the Court is called upon to make the factual determination required by *Adlman* [*United States v. Adlman*, 134 F.3d 1194, 1196 (2d Cir. 1998)]: whether this memorandum and the related documents “would have been created in essentially similar form” had litigation not been anticipated. 134 F.3d at 1202. While we have described this as a factual determination, in reality it is a counterfactual determination because it requires the Court to imagine what “would have” happened in a world where Schaeffler did not anticipate litigation as to the restructuring and refinancing transactions but everything else was exactly the same — in other words, Schaeffler still found himself acquiring the unexpectedly large share of Conti stock and still needed to

engage in a refinancing and restructuring arrangement that would comply with federal tax laws.

... Accordingly, given our assumption that Schaeffler is a rational businessperson who routinely makes efforts to comply with the law, we find that, even had he not anticipated an audit or litigation with the IRS, he still would have had to obtain the type of legal assistance provided by Ernst & Young to carry out the refinancing and restructuring transactions in an appropriate manner.

... As to whether Ernst & Young's advice would have been different in content or form had it known that no audit or litigation would ensue, petitioners have presented no facts suggesting that Ernst & Young would have acted any differently. To the contrary, as petitioners recognize, see Letter from M. Todd Welty, dated May 2, 2014 (Docket #52) ("Welty Letter"), **there exists legal authority demanding that tax practitioners not allow the possibility that a tax return will remain unaudited to affect the advice they give.** Treasury Department Circular 230 states:

In evaluating the significant Federal tax issues addressed in [a tax opinion], the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

[Former] Circular 230, § 10.35(c)(3)(iii). Similarly, a Treasury regulation regarding tax shelters states that in reaching conclusions regarding whether a particular tax position would more likely than not be sustained on its merits,

the possibility that the position will not be challenged by the Internal Revenue Service (IRS) (for example, because the taxpayer's return may not be audited or because the issue may not be raised on audit) is not to be taken into account.

26 C.F.R. § 1.6694-2(b). In other words, when tax practitioners give advice to clients, they must ignore the actual possibility of an audit — and, by extension, litigation — in opining on the tax implications of a transaction. Thus, when providing legal advice on the tax treatment of the restructuring and refinancing transactions, the Ernst & Young advisors had a responsibility to consider in full the relevant legal issues regardless of whether they anticipated an audit and ensuing litigation with the IRS. (Emphasis added)

• Magistrate Judge Gorenstein concluded on the work product issue:

Thus, we conclude that had Schaeffler's tax advisors been asked to opine on the legal implications of the transactions with the knowledge that an audit or litigation would not occur, they "would have" used the same methodology to render tax advice; that is, a close analysis of the relevant legal authorities to determine how various tax positions would be tested in the crucible of litigation.

For these reasons, we find that the EY Tax Memo, as well as the related responsive documents, would have been produced in the same form irrespective of any concern about litigation. Accordingly, these documents are not protected from disclosure under the work product doctrine.

a. The District Court got it all wrong, says the Second Circuit. The taxpayer did not waive the attorney-client privilege and the EY Tax Memo is protected by the work product doctrine. Schaeffler v. United States, 806 F.3d 34 (2d Cir. 11/10/15). In an opinion by Judge Winter, the Second Circuit vacated the judgment of the District Court and concluded that the taxpayer had not waived the attorney-client privilege and that the EY Tax Memo is protected by the work product doctrine. The court remanded for a determination whether any of the remaining documents at issue are protected by the attorney-client privilege or the work product doctrine.

- The court rejected the District Court's reasoning that the taxpayer had waived the attorney-client privilege by sharing documents with a consortium of banks that had financed a tender offer and that subsequently refinanced a corporate restructuring. In the Second Circuit's view, the taxpayer and the banks had a common legal interest, which parties can share "even if they are not parties in ongoing litigation." The banks had financed the taxpayer's tender offer for a German corporation. Because the tender offer period expired two days after the 2008 announcement by Lehman Brothers of its bankruptcy and the resulting plunge in stock market prices, the taxpayer acquired far more shares than anticipated, the taxpayer's solvency was threatened, and the risk of default on the loan was heightened. The taxpayer, his associated entities (which the court refers to as the "Schaeffler Group") and the banks perceived an "urgent need" to refinance the original loan and engage in a corporate restructuring. This set of circumstances, the court reasoned, created a common legal interest. "The Group and the Consortium could avoid this mutual financial disaster by cooperating in securing a particular tax treatment of a refinancing and restructuring. Securing that treatment would likely involve a legal encounter with the IRS. Both appellants and the Consortium, therefore, had a strong common interest in the outcome of that legal encounter." The court observed that the bank consortium retained control over Mr. Schaeffler's legal decisions to settle, pay, or sue. By extending credit and subordinating its debt, the court reasoned, the consortium occupied a position analogous to that of an insurer, which courts have recognized as having a common legal interest with the insured in the outcome of litigation.

- The Second Circuit also rejected the District Court's conclusion that the EY Tax Memo and related documents were not protected by the work product doctrine. Under its prior decision in *United States v. Adlman*, 134 F.3d 1194 (2d Cir. 1998), the court held that the work product doctrine does not apply to documents prepared "in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation." Nevertheless, the court reasoned in this case, even documents intended to assist in business dealings are protected if they are prepared in anticipation of litigation. In this case, the EY Tax Memo "was specifically aimed at addressing the urgent circumstances arising from the need for a refinancing and restructuring and was necessarily geared to an anticipated audit and subsequent litigation, which was on this record highly likely." The court similarly rejected the District Court's reasoning that EY would have provided the same tax advice irrespective of litigation because it was required not to consider the likelihood of audit in rendering advice. The taxpayers "would not have sought the same level of detail if merely preparing an annual routine tax return with no particular prospect of litigation." The court concluded:

Finally, we note that the district court's holding appears to imply that tax analyses and opinions created to assist in large, complex transactions with uncertain tax consequences can never have work-product protection from IRS subpoenas. This is contrary to *Adlman*, which explicitly embraces the dual-purpose doctrine that a document is eligible for work-product protection "if 'in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained because of the prospect of litigation'" (Quoting *Adlman*, 134 F.3d at 1202).

2. Turnabout is fair play. Summoned individuals might have the right to grill IRS agents regarding their motives in issuing the summons. *United States v. Clarke*, 134 S. Ct. 2361 (6/19/14). In the course of a partnership audit the IRS issued a summons to four individuals associated with the partnership whom the IRS believed had information and records relevant to the audit. The individuals refused to comply and the IRS sought enforcement of the summons. In the enforcement proceedings, the summoned individuals asserted that the IRS had issued the summons for an improper purpose, namely to punish the partnership for refusing to extend the statute of limitations, and sought enforcement for an improper purpose, specifically, that the IRS decided to enforce the summonses, subsequent to the partnership filing suit in Tax Court, to "evad[e] the Tax Court[']s limitations on discovery" and thus gain an unfair advantage in that litigation. In support of their request for an opportunity to question the IRS agents about their motives, the summoned individuals submitted an affidavit from the attorney of another

partnership associate, who had complied with a summons issued at the same time, which reported that only the IRS attorneys handling the Tax Court case, and not the original investigating agents, were present at the interview of his client. The District Court denied the request and ordered compliance, but the Eleventh Circuit reversed. 517 Fed. Appx. 689 (11th Cir. 4/18/13), finding that the District Court's refusal to allow the summonsed individuals to examine IRS agents constituted an abuse of discretion. In support of that ruling, the Court of Appeals cited Fifth Circuit precedent holding that a simple "allegation of improper purpose," even if lacking any "factual support," entitles a taxpayer to "question IRS officials concerning the Service's reasons for issuing the summons." The Supreme Court, in a unanimous opinion by Justice Kagan, vacated the Court of Appeals decision and remanded the case. After initially repeating that under *United States v. Powell*, 379 U.S. 862 (1981), and its progeny "summons enforcement proceedings are to be 'summary in nature,'" and "that courts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of 'oversee[ing] the [IRS's] determinations to investigate,'" and "absent contrary evidence, the IRS can satisfy that standard by submitting a simple affidavit from the investigating agent," the Court went on to hold as follows:

As part of the adversarial process concerning a summons's validity the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive. That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing. And the rule is little different from the one that both the respondents and the Government have recommended to us.

The Court went on to remind that (1) the appellate court review of the District Court's decision is for abuse of discretion, but that the "District Court's decision is entitled to deference only if based on the correct legal standard," and (2) the District Court's latitude does not extend to legal issues about what counts as an illicit motive. Finally, the Court specifically declined to opine on whether either of the asserted improper motives for issuance of the summons actually were improper.

- While the taxpayer got a partial victory in *Clarke*, perhaps the most important aspect of the decision is the reaffirmation of the breadth of the IRS's summons power under *Powell* and its progeny.

a. On remand, the Eleventh Circuit concluded that the alleged motives of the IRS for issuing the summonses could be improper, but the individuals involved failed to show facts giving rise to a plausible inference of improper motive. *United States v. Clarke*, 816 F.3d 1310 (11th Cir. 3/15/16). Following the U.S. Supreme Court's remand to the Eleventh Circuit, the Eleventh Circuit remanded to the District Court, which denied the request of the summonsed individuals for an evidentiary hearing and enforced the summons on the grounds that (1) none of the improper purposes alleged by the individuals was an improper motive to issue a summons as a matter of law, and (2) the individuals had failed to show facts giving rise to a plausible inference of improper motive regarding issuance of the summons. *United States v. Clarke*, 115 A.F.T.R.2d 2015-836 (S.D. Fla. 2/18/15). In an opinion by Judge Dubina, the Eleventh Circuit affirmed. The Eleventh Circuit first addressed what constitutes an improper motive for issuing a summons as a matter of law and held that the District Court had erred in its analysis. According to the Eleventh Circuit, issuing a summons for the sole purpose of retaliating against a taxpayer or for the sole purpose of circumventing the limitations on Tax

Court discovery would constitute improper motives for issuing a summons. Nevertheless, the court emphasized, “the circumstances under which a taxpayer could successfully allege improper circumvention of tax discovery are exceptionally narrow.” Next, the Eleventh Circuit concluded that the District Court’s refusal to hear additional evidence on remand was “appropriate in light of the summary nature of a summons enforcement proceeding” and did not amount to an abuse of discretion. Finally, the court held that the District Court had correctly concluded that the submissions of the summonsed individuals raised no plausible inference of improper motive.

3. In this case a not-for-profit corporation is treated the same as a for-profit corporation. Maimonides Medical Center v. United States, 809 F.3d 85 (2d Cir. 12/18/15). In an opinion by Judge Lynch, the Second Circuit held that the lower interest rate that under § 6621(a)(1) applies to a refund for an overpayment of taxes due to a corporation applies to not-for-profit corporations as well as to for-profit corporations.

4. The government can inspect a taxpayer’s books and records for a taxable year more than once as long as it does so in connection with audits of different taxable years. United States v. Titan International, Inc., 811 F.3d 950 (7th Cir. 2/1/16). The IRS audited the taxpayer’s 2009 federal income tax return and, in the course of that audit, summoned the taxpayer’s 2009 general ledger, its 2009 airplane flight logs, and other 2009 business travel documents. The taxpayer complied, the IRS reduced the taxpayer’s net operating loss for 2009 (an adjustment the taxpayer accepted), and the IRS closed the audit. The IRS subsequently audited the taxpayer’s 2010 return and, in the course of that audit, summoned the same 2009 records it had previously examined in the 2009 audit. The IRS required these documents in connection with its examination of the net operating loss carryforward the taxpayer had claimed for 2010. The taxpayer refused to comply and relied on § 7605(b), which provides that “only one inspection of a taxpayer’s books of account shall be made for each taxable year ... unless the [Treasury] Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.” The court rejected the taxpayer’s reading of the statute, under which the IRS can inspect only once the taxpayer’s books of account created for a particular taxable year. The more natural reading, the court stated, is that the statute “limits the IRS to one inspection of a taxpayer’s books per audit of a given year’s tax return” Where, as here, the IRS is auditing different taxable years, it can inspect the same books and records in connection with each audit without the finding of necessity and issuance of a written notice required by § 7605(b). In reaching this conclusion, the court discussed two cases. The first is *Reineman v. United States*, 301 F.2d 267 (7th Cir. 1962), in which the court held the IRS could not inspect 1954 records a second time in connection with an audit of 1955 because the 1954 records were wholly irrelevant to the 1955 audit. The second is *Digby v. Commissioner*, 103 T.C. 441 (1994), in which the court held that the IRS could inspect a second time records relating to the taxpayers’ basis in S corporation stock when it did so in connection with separate audits of 1987 and 1988. In *Digby*, the court upheld the IRS’s disallowance of losses passed through in both 1987 and 1988, even though the IRS previously had made no adjustment to the 1987 losses in connection with its audit of 1987. After reviewing *Reineman* and *Digby*, the Seventh Circuit concluded that “[t]his case is more like *Digby* than *Reineman*. ... [T]he net operating loss carryforward on the 2010 tax return cannot be verified unless the IRS inspects the 2009 records.” Accordingly, the court upheld the District Court’s order requiring the taxpayer to produce the records.

5. The First Circuit declines to create a split in the Circuits and holds that, pursuant to the required records exception to the Fifth Amendment privilege against self-incrimination, a taxpayer must produce records required by the Bank Secrecy Act. United States v. Chen, 815 F.3d 72 (1st Cir. 2/29/16). In the course of investigating the 2008 tax liability of Mr. Chen and his wife, the IRS served a summons that required him to appear for an interview with an IRS agent and to produce financial and banking records. Mr. Chen appeared but invoked his Fifth Amendment privilege against self-incrimination and failed to provide the requested documents. The government filed a petition in the federal district court to enforce the summons. The District Court granted the government’s petition as to documents the taxpayer was required to keep under the Bank Secrecy Act (BSA) and, after reviewing *in camera* other documents not required by the BSA, issued an order directing Mr. Chen to produce those documents as well. In

an opinion by Judge Lynch for a panel that included retired U.S. Supreme Court Justice David Souter sitting by designation, the First Circuit affirmed as to documents Mr. Chen was required to keep under the BSA but vacated and remanded for further explanation as to the other documents the District Court ordered Mr. Chen to produce. The First Circuit held that the required records doctrine, which is an exception to the Fifth Amendment privilege against self-incrimination, applies to the recordkeeping scheme of the BSA. Specifically, the court held that the three-part test established by *Shapiro v. United States*, 335 U.S. 1 (1948) and *Grosso v. United States*, 390 U.S. 62 (1968) for determining whether the required records doctrine applies was satisfied: (1) the government's inquiry must be essentially regulatory, (2) the information is to be obtained by requiring the preservation of records that are of a kind the regulated party has customarily kept, and (3) the records must have assumed public aspects that render them at least analogous to public documents. The court acknowledged that the government was not engaging in impermissible targeting of activity that is criminal or almost always criminal because "Chen's keeping an offshore bank account is not inherently criminal." However, with respect to the District Court's order, issued without explanation following its *in camera* review, that Mr. Chen produce personal and corporate domestic financial records not required to be kept by the BSA, the First Circuit vacated and remanded to the District Court for an explanation of its ruling.

- The First Circuit's holding that the required records doctrine applies to records required by the BSA is consistent with the holding of every other federal court of appeals that has considered the issue. See *United States v. Chabot*, 793 F.3d 338 (3d Cir.), *cert. denied*, 136 S. Ct. 559 (2015); *In re: Grand Jury Subpoena Dated February 2, 2012*, 741 F.3d 339 (2d Cir. 12/19/13); *United States v. Under Seal*, 737 F.3d 330 (4th Cir. 2013); *In re Grand Jury Proceedings, No. 4-10*, 707 F.3d 1262 (11th Cir.), *cert. denied*, 134 S. Ct. 129 (2013); *In re: Grand Jury Subpoena*, 696 F.3d 428 (5th Cir. 2012); *In re: Special February 2011-1 Grand Jury Subpoena Dated September 12, 2011*, 691 F.3d 903 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 2338 (2013); *M.H. v. United States*, 648 F.3d 1067 (9th Cir. 2011), *cert. denied* (2012).

6. An individual successfully invokes his Fifth Amendment privilege against self-incrimination in a summons enforcement proceeding related to captive insurance. *United States v. LaMotte*, 117 A.F.T.R.2d 2016-1725 (D. Mass. 5/10/16). In this summons enforcement proceeding, the District Court (Judge Mastroianni) adopted Magistrate Judge Robertson's report and recommendation (reported at 117 A.F.T.R.2d 2016-1718 (4/19/16)) that Timothy LaMotte had properly invoked his Fifth Amendment privilege against self-incrimination in response to 103 questions posed by an IRS Revenue Agent pursuant to a summons seeking his testimony. The IRS had issued the summons in connection with its investigation of the tax liability of a corporation for which LaMotte served as Treasurer and two captive insurance subsidiaries for which he served as director. According to the Magistrate's report and recommendation, "[t]he IRS consider[ed] [the corporation] to have been a participant in an 'abusive captive insurance program[,]'" was investigating the tax liabilities of the captive insurance subsidiaries as well as the insured corporation, and was conducting a promoter investigation of the manager of the captives under § 6700, which establishes penalties for promoting abusive tax shelters. Although the First Circuit had not expressly adopted it, the court used the two-step approach set forth in *United States v. Sharp*, 920 F.2d 1167 (4th Cir. 1990). In the first step, the court found that the information sought by the IRS—all of which related to the corporation's participation in the captive insurance transactions that the government had informed the court it considered abusive—was incriminating on its face. In the second step, the court determined that there was a sufficient possibility of criminal prosecution to trigger the need for constitutional protection. Accordingly, the court dismissed the government's petition for enforcement of the summons.

C. Litigation Costs

1. Calculating attorney's fees where there are no attorney's fees charged. Rev. Proc. 2016-17, 2016-11 I.R.B. 436 (2/29/16). This revenue procedure provides guidance regarding the recovery of administrative and litigation costs by individuals and organizations that provide pro bono representation to taxpayers. The hourly rate used to calculate an attorney fee

award for pro bono representatives who charge hourly rates in their ordinary course of business will generally be limited to the lesser of the statutory hourly rate set forth in § 7430(c)(1)(B)(iii) or their hourly billing rate, unless they can establish that a special factor, as described in § 7430(c)(1)(B)(iii), applies. The rate for individuals who provide pro bono representation but do not charge an hourly rate for representing taxpayers in the ordinary course of business is the statutory hourly rate under § 7430(c)(1)(B)(iii). The rate for students authorized to practice before the IRS pursuant to Circular No. 230 or to practice before the United States Tax Court under the supervision of a practitioner through the United States Tax Court's Clinical, Student Practice and Calendar Call Program, and by paralegals or other persons qualified to perform paralegal work who are assisting pro bono representatives is thirty-five percent of the statutory hourly rate provided for representatives under § 7430(c)(1)(B)(iii). The revenue procedure is effective for all motions for costs under § 7430 filed on or after 2/29/16, but taxpayers can elect to follow it for motions for costs filed prior to 2/29/16 and pending before the court on that date.

2. The § 7430 regulations catch up to 1997 and 1998 amendments to the Code. T.D. 9756, Regulations Under IRC Section 7430 Relating to Awards of Administrative Costs and Attorneys' Fees, 81 FR 10479 (3/1/16). The Treasury Department and IRS have promulgated amendments to the regulations under § 7430 relating to awards of administrative costs and attorneys' fees to a prevailing party in an administrative or court proceeding. The amendments to the regulations reflect the 1997 and 1998 amendments to § 7430 enacted as part of the Taxpayer Relief Act of 1997 and the IRS Restructuring and Reform Act of 1998. Notable provisions include Reg. § 301.7430-5, which provides exclusive rules for determining whether the taxpayer was the prevailing party in an administrative proceeding, and Reg. § 301-7430-5(g)(1), which provides that the net worth of married taxpayers filing jointly generally is determined jointly, but is determined separately if they "incur separate administrative or litigation costs, by retaining separate representation, and/or seeking individual administrative review or petitioning the court individually." The regulations generally apply for costs incurred and services performed in which a petition was filed on or after 3/1/16, except that the rules in Reg. § 301-7430-7 regarding qualified offers generally apply to qualified offers made in administrative court proceedings described in § 7430 after 12/4/03.

3. Which year is behind the valuation door? Alterman Trust v. Commissioner, 146 T.C. No. 14 (5/2/16). The taxpayer was a trust that had substantially prevailed on the merits in a prior proceeding (T.C. Memo. 2015-231) in which the court held that the trust was not liable as a transferee for a corporation's 2003 income tax liability. In this proceeding, the trust sought reasonable administrative and litigation costs as a prevailing party under § 7430. The Tax Court (Judge Buch) held that the trust was precluded from being considered a prevailing party by § 7430(c)(4)(A)(ii), which provides that a person can be a prevailing party only if they meet the requirements of 28 U.S.C. § 2412(d)(2)(B). Section 2412(d)(2)(B) requires that an individual have a net worth that does not exceed \$2 million at the time the civil action is filed. The trust argued that its net worth should be determined as of the date it filed the Tax Court petition or on one of two alternative dates, on all of which it met the \$2 million net worth requirement. The court rejected these arguments based on § 7430(c)(4)(D)(i)(II), which provides that, in the case of a trust, the net worth requirement "shall be determined as of the last day of the taxable year involved in the proceeding." In a transferee liability proceeding, the court concluded, the taxable year involved in the proceeding is the taxable year stated in the notice of liability as the year to which the liability relates, the year 2003, and on the last day of 2003 the trust did not meet the net worth requirement.

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. Equity, schmequity! United v. Bates, 116 A.F.T.R.2d 2015-6864 (M.D. Fla. 11/23/15). The statute of limitations for filing a refund claim is not subject to non-statutory equitable tolling. Therefore, according to the court (Judge Honeywell), the IRS could recover a refund that was erroneously paid to the taxpayer, whose refund request was untimely.

2. Don't expect a case explaining mitigation of the statute of limitations to be brief. Costello v. Commissioner, T.C. Memo. 2016-33 (3/1/16). The taxpayers, a brother and sister, were the beneficiaries of a trust that received distributions from IRAs upon the death of the trust's creator, the taxpayers' father. The sister and another brother were the trustees of the trust after their father's death. The trust reported the receipts as gross income and claimed an offsetting deduction for distributions of the amounts received on its 2001 return. The taxpayers reported the distribution from the trust as gross come on their 2001 return. Following an audit of the trust's 2001 income tax return, the IRS determined that the distributions were taxable at the trust level, disallowed the related income distribution deduction, and determined a deficiency. The trustees agreed to the deficiency and as a result of these adjustments the beneficiaries received tax abatements. In January 2005, the taxpayers received refunds with respect to their personal returns and paid the trust's deficiency out of their refunds. In November 2006, the sister, in her capacity as trustee, filed an amended Form 1041 on behalf of the trust claiming a refund, which was allowed by the IRS on August 8, 2008. The IRS sent each of the taxpayers deficiency notices, dated September 2, 2008, with respect to their 2001 tax year, adjusting their gross incomes to once again include the trust distributions. On August 11, 2009, the IRS issued a refund check to the trust. The taxpayer, as a trustee, endorsed and deposited the check on November 12, 2009. Because the IRS did not issue the 2001 notices of deficiency, dated September 2, 2008, within the period of limitations, which expired on April 15, 2005, an assessment for 2001 was barred unless the mitigation provisions of §§ 1311 through 1314 allowed the IRS's adjustments for the taxpayers' 2001 tax returns in 2008. The Tax Court (Judge Cohen) held that the mitigation provisions did apply and upheld the deficiency. The argument focused on whether certain conditions found in § 1311(b) applied to the facts.

SEC. 1311(b). Conditions Necessary for Adjustment.—

(1) Maintenance of an inconsistent position.— *** [A]n adjustment shall be made under this part only if—

(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made,

and the position *** maintained by the taxpayer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

(3) Existence of relationship.—In case the amount of the adjustment would be assessed and collected in the same manner as a deficiency *** , the adjustment shall not be made with respect to a related taxpayer unless he stands in such relationship to the taxpayer at the time the latter first maintains the inconsistent position in a *** claim for refund *** for the taxable year with respect to which the determination is made *** .

The taxpayers argued that they filed the amended 2001 trust return merely to correct an error caused by the IRS examination and that the mitigation provisions “require them, as taxpayers, to have actively asserted a position inconsistent with the determination,” and that “they did not maintain any active inconsistent position and that they have not changed their positions since they originally filed their returns.” However, the court concluded that by signing Forms 4549 in January 2005 and accepting the refunds of March 21, 2005, the taxpayers adopted a position that the tax on the distribution income should be paid at the entity (trust) level. Further, the taxpayer was still acting in her capacity as a trustee of the trust when she directed the filing of the refund claim in 2006 and when she received and deposited the refund check in 2009. In summary, the court held that (1) the IRS issued a determination regarding the trust's refund claim, which satisfied § 1313(a)(3)(A); (2) because the IRS determination accepted the trust's refund claim,

the correlating inclusion of taxable income had been erroneously excluded by the taxpayers as described in § 1312(5); (3) as of August 8, 2008 adjustments to taxpayers' 2001 returns were barred by the statute of limitations; (4) the trust maintained a position adopted by the IRS determination and that position was inconsistent with the erroneous exclusions on taxpayers' 2001 returns as modified; and (5) taxpayers, as beneficiaries, were related to the trust in 2001, the year of the error, and in 2006 when the trust first maintained its inconsistent position. Thus, the IRS satisfied all requirements and conditions of the mitigation provisions, and the period of limitations for assessment was thereby extended up to one year from August 8, 2008, the date of the final determination. Therefore, the deficiency notices sent on September 2, 2008, were timely, and petitioners' 2001 tax years were reopened for the limited purpose of correcting the § 1312(5) error.

F. Liens and Collections

1. Constructive receipt of a deficiency notice for someone who played two of the three monkeys. Onyango v. Commissioner, 142 T.C. 425 (6/24/14). Section 6330(c)(2)(B) allows a taxpayer to contest the underlying tax liability in a CDP hearing only if he did not actually receive a deficiency notice or otherwise have an opportunity to dispute the liability. In this case, on several occasions the Postal Service attempted unsuccessfully to deliver a deficiency notice that had been mailed to him at his legal residence by certified mail, return receipt requested. On at least two occasions the Postal Service left notices of attempted delivery of the certified mail which contained the notice of deficiency at the address of the taxpayer's legal residence, and informed the taxpayer that it had certified mail to deliver to him and that he had to sign a receipt for that mail before the Postal Service would deliver it to him. The taxpayer declined to check on a regular basis his mailbox at his legal residence and to retrieve on a regular basis any Postal Service mail items delivered there. After several unsuccessful attempts to deliver the certified mail, the Postal Service returned it to the IRS. The Tax Court (Judge Chiechi) held that a taxpayer who is reasonably able and had multiple opportunities to check his mail and intentionally fails to do so for the purpose of avoiding receipt of the deficiency notice cannot contend that for purposes of § 6330 he did not receive the deficiency notice. Accordingly, the taxpayer was not permitted to contest his underlying tax liability in the CDP hearing.

a. Motions to vacate and for reconsideration denied. Onyango v. Commissioner, No. 019081-12 (U.S. Tax Court 9/8/14). In a subsequent order dated 9/8/14 (available at <https://perma.cc/VM8W-V3VJ>), Judge Chiechi denied the taxpayer's motion to vacate and sealed motion for reconsideration.

b. Summarily affirmed by the D.C. Circuit. Onyango v. Commissioner, 638 Fed. Appx. 5 (D.C. Cir. 3/22/16). In a per curiam opinion, the D.C. Circuit affirmed the Tax Court. The court concluded that the taxpayer had not shown that the Tax Court clearly erred in discrediting portions of his trial testimony and finding that he received a notice of deficiency within the meaning of § 6330(c)(2)(B). The court also concluded that the Tax Court's denial of the taxpayer's motion for reconsideration was not an abuse of discretion. "Appellant has not demonstrated that his medical records could not have been obtained prior to trial, and his failure to exercise reasonable diligence in attempting to obtain them does not render them 'newly discovered evidence.'"

2. And the court says the IRS's "boilerplate" assertion of frivolity wasn't very funny. Ryskamp v. Commissioner, 797 F.3d 1142 (D.C. Cir. 8/14/15). The taxpayer owed unpaid income taxes for several years and did not respond to the IRS's demand for payment. The taxpayer requested a § 6330 CDP hearing, but the IRS denied him a CDP hearing based on its unexplained determination that all the reasons he gave for requesting a hearing were frivolous and contended that its frivolousness determination was not subject to judicial review. (Section 6330(g) provides that if any "portion of a request for a hearing" is frivolous or reflects the taxpayer's desire to delay or impede the administration of the federal tax laws, the Appeals Office may treat such portion as if it were never submitted, and it "shall not be subject to any further administrative or judicial review.") The Tax Court held that it had jurisdiction to review whether the IRS correctly treated the taxpayer's arguments as frivolous, and the D.C. Court of

Appeals, in a 2-1 opinion by Judge Pillard, affirmed the jurisdictional issue, as well as the Tax Court's holding that the IRS's "boilerplate letter" rejecting the taxpayer's arguments as frivolous, but "in which there was no statement . . . as to why [his] reasons for the request . . . were illegitimate," was inadequate.

Our reading of the statutory language respects subsection (g)'s limitation on administrative and judicial review. As we read it, subsection (g) precludes the tax court from reaching the merits of a purportedly frivolous position. . . . Instead, the tax court's review is limited to assessing whether the Service has adequately identified why it deems the taxpayer's request, or portions thereof, to be frivolous, and whether that frivolousness assessment is facially plausible. . . . That limited review provides a safeguard against the risk that the Service may have misconstrued or inadvertently overlooked a non-frivolous, *i.e.* plausible or potentially meritorious, request. . . . The letter merely included a bullet point list of all of the possible reasons the Service could find a request to be frivolous and did not correlate them with any aspects of Ryskamp's request. Such a list provides the taxpayer with little guidance as to how to proceed.

Nevertheless, after the Tax Court remanded, the Appeals Office had held a CDP hearing, and the Tax Court held that the IRS did not abuse its discretion in concluding in that CDP hearing that it could proceed with collection. That holding too was affirmed, so the taxpayer lost.

- But perhaps the IRS needs to rethink its form letters.

a. In light of *Ryskamp*, IRS Chief Counsel attorneys are advised not to contest in the Tax Court and the D.C. Circuit the Tax Court's jurisdiction to review the IRS's denial of CDP hearing requests as frivolous, but Counsel will advise the Department of Justice to continue to pursue the issue in other Circuits. Chief Counsel Notice CC-2016-008 (4/4/16) (available at <https://perma.cc/LT7T-GDZS>). This Chief Counsel Notice states that "Counsel continues to maintain the position that the Tax Court lacks jurisdiction to review a petition filed from the denial of a hearing request as frivolous under section 6330(g)." Further, the Chief Counsel disagrees with the holding of *Ryskamp* that IRS "Appeals must articulate the bases of its denial under section 6330(g) by explaining why each argument of the taxpayer is not proper." Nevertheless, because challenging in the Tax Court and the D.C. Circuit the Tax Court's jurisdiction "would be a waste of Counsel's resources," the Chief Counsel Notice modifies the current litigating guidelines. Under the revised guidelines, if a taxpayer challenges in the Tax Court the denial of a CDP hearing as frivolous under § 6330(g), and if Chief Counsel attorneys determine that the CDP hearing request should not have been denied in its entirety because the taxpayer raised at least one legitimate issue, then they should not file a motion to dismiss, but instead should file a motion to remand the case to IRS Appeals for a hearing addressing the legitimate issues and the issuance of a notice of determination. If instead Chief Counsel attorneys determine that a CDP hearing was properly denied, then they should file a motion to dismiss for lack of jurisdiction (in reliance on *Buczek v. Commissioner*, 143 T.C. 301 (2013)), a motion to dismiss for failure to state a claim, or a motion for summary judgment, each of which should explain why the taxpayer's arguments meet the criteria in § 6702(b)(2)(A) so as to justify the IRS's denial of the hearing. The Chief Counsel Notice adds that, in Tax Court cases that are appealed to Circuits other than the D.C. Circuit, Counsel will advise the Department of Justice to contest the Tax Court's jurisdiction to review IRS denials of CDP hearing requests as frivolous pursuant to § 6330(g).

3. Shame on the IRS. How could the government have litigated this case and thought its position had anything to do with justice? *Rothkamm v. Commissioner*, 802 F.3d 699 (5th Cir. 9/21/15). The plaintiff and her husband filed separate tax returns. The husband incurred an unpaid tax liability, and the IRS levied the plaintiff's bank account to satisfy her husband's tax liability. The plaintiff asserted that the bank account was her separate property, and she sought a Taxpayer Assistance Order (TAO) through the Taxpayer Advocate Service (TAS) but obtained no relief. She then filed an administrative claim under § 6343(b) and, when that was denied, filed suit for wrongful levy under § 7426(a)(1). The IRS filed a motion to

dismiss on the ground that the suit was untimely under the § 6532(c) nine-month statute of limitations (invoked by § 7426(i)) because the running of the statute had not been tolled under § 7811(d) by her TAO application. If the statute of limitations had been tolled while her application for a TAO was pending before the TAS, her administrative claim under § 6343(b) would have been timely, and the statute of limitations for filing suit would have been suspended until after the instant suit was filed. The district court concluded that the plaintiff was not a “taxpayer” for purposes of the TAO statute, § 7811, and that, even if she was, § 7811(d) would not toll the running of the statute of limitations in this case. Accordingly, the district court dismissed for lack of subject matter jurisdiction. The Fifth Circuit, in an opinion (2-1) by Judge Davis, held that “as the person who paid a tax assessed against another person,” she was a “taxpayer” (referring to the definition in § 7701(a)(14)) for purposes of § 7811 and that the nine-month statute of limitations was tolled under § 7811(d) by her TAO application. It rejected the government’s assertion that the term “taxpayer” narrowly meant only the person against whom a tax was assessed. Accordingly, it reversed and remanded.

4. The last time the IRS tried using private debt collection agencies, both the IRS and the National Taxpayer Advocate concluded that the IRS is significantly more effective in collecting tax liabilities. Congress apparently is not persuaded. The Fixing America’s Surface Transportation (FAST) Act, § 32102, Pub. L. No. 114-94, signed by the President on 12/4/15, amends Code § 6306 by adding new subsections (c) and (d) (and redesignating current subsections (d) through (g) as subsections (e)-(h)). The amendments require the IRS to enter into qualified tax collection contracts (as defined in current § 6306(b)) “for the collection of all outstanding inactive tax receivables.” Subject to certain exceptions, an inactive tax receivable is defined as a receivable (1) for an assessed tax liability that the IRS has removed from the active inventory for lack of resources or inability to locate the taxpayer, (2) that has not been assigned to an IRS employee for collection when more than 1/3 of the limitations period on collection has expired, or (3) that has been assigned for collection but with respect to which more than 365 days have passed without interaction with the taxpayer or a third party for purposes of collection. The amendment applies to tax receivables identified after the date of enactment.

5. Sometimes lack of Tax Court jurisdiction is a taxpayer victory. LG Kendrick, LLC v. Commissioner, 146 T.C. No. 2 (1/21/16). The Tax Court (Judge Marvel) rejected the IRS’s argument, and held that a supplemental notice of determination following a §§ 6320/6330 CDP hearing does not provide the basis for Tax Court jurisdiction to review the determination when the original notices of determination did not include a determination to sustain a collection activity for a particular period or liability and thus did not confer jurisdiction on the Tax Court. Because an invalid notice of determination does not provide a basis for Tax Court jurisdiction, the IRS can proceed with the collection action only if it subsequently issues a valid notice with attendant appeal rights. § 6330(c)(3); *Smith v. Commissioner*, 124 T.C. 36, 44 (2005) (describing invalid notices of determination as “void and of no effect”). With respect to other notices of determination that were valid, the court had jurisdiction and upheld the IRS’s determinations.

6. The IRS can trust the Postal Service where the Code doesn’t demand more. Bongam v. Commissioner, 146 T.C. No. 4 (2/11/16). The IRS issued a Notice of Federal Tax Lien Filing and Your Right to a Hearing, which was sent by certified mail to the taxpayer’s last known address in Bowie, Maryland. The taxpayer timely requested a CDP hearing, using an address in Washington, D.C. Following the CDP hearing, on 4/30/14 the IRS sent to the taxpayer by certified mail a Notice of Determination denying relief, which was mailed to the taxpayer at the Washington address, but which was returned to the IRS as undeliverable on 6/16/14. Without changing the date on the Notice, on 8/4/14 the IRS remailed it (including the envelope in which it had originally been posted) to the taxpayer by regular mail to the Maryland address. (The taxpayer never filed a change-of-address form with the IRS or otherwise indicated to the IRS that he wanted to have his last known address changed to the Washington address.) The taxpayer received the Notice on 8/22/14, and petitioned the Tax Court within 30 days of both the date on which he actually received the Notice and the date on which the Notice was remailed to him. The

IRS argued that the Tax Court lacked jurisdiction because the Notice originally sent to the taxpayer at the Washington, D.C. address was invalid because it had not been mailed to his “last known address.” The Tax Court (Judge Lauber) agreed that the Notice, as originally mailed to the taxpayer on 4/30/14, was invalid, because it was not sent to his “last known address” and it was not actually received by him. However, the Notice, as remailed on 8/4/14, was properly mailed and valid; thus the taxpayer’s 30-day period for petitioning the Tax Court did not start to run before that date, and he timely filed his petition. The court held that § 6330(d) does not require that the IRS send a Notice of Determination by certified mail to the taxpayer’s last known address or that the IRS deliver the Notice in any particular way—unlike §§ 6320(a) and 6330(a), which specify three permissible modes of notifying the taxpayer of liens and levies. Section 6330(d)(1) merely provides that the Tax Court will have jurisdiction if a taxpayer files a petition “within 30 days of a determination.” “This language does not limit the manner in which the IRS may notify the taxpayer that a determination has been made.” That the date appearing on the Notice did not match the date on which the Notice was successfully mailed to the taxpayer was irrelevant. Accordingly, the 30-day window prescribed by § 6330(d)(1) for filing a petition for redetermination was calculated by reference to the date of mailing of the Notice that was successfully sent to the taxpayer’s Maryland address by regular mail on 8/4/14. That the Notice was sent by regular mail was not relevant.

7. State law, rather than federal common law, governs successor liability for employment taxes. WRK Rarities, LLC v. United States, 117 A.F.T.R.2d 2016-856 (N.D. Ohio 2/29/16). William R. Kimpel was the sole owner and president of a corporation that operated a jewelry store known as Kimpel’s Jewelry and Gifts (KJG). The corporation entered chapter 11 bankruptcy proceedings, which were later dismissed when it failed to make payments pursuant to the bankruptcy plan. KJG failed to pay federal employment taxes for the years 2007 through 2010. During 2010, Kimpel formed a new business organization, WRK Rarities, LLC d/b/a Kimpel’s Fine Diamonds (WRK), which operated a jewelry store at the same address at which KJG had been located since 1957 with identical terms for its lease and the same signage, furniture, fixtures and employees as KJG. Kimpel was the sole owner, president, and manager of day-to-day operations of WRK. The IRS attempted to levy on KJG’s bank accounts for the unpaid employment taxes but was unable to recover because those accounts had minimal assets. The IRS subsequently filed a notice of federal tax lien against WRK as “nominee and/or alter ego and/or fraudulent conveyee” of KJG and, pursuant to a writ of entry, seized the assets of WRK. WRK brought this action for wrongful levy pursuant to 26 U.S.C. § 7426. The government argued that the levy was not wrongful because “the IRS has the power to levy unpaid taxes on a successor corporation for the unpaid taxes of the predecessor corporation when the successor is merely the alter ego of the predecessor.” The court rejected the government’s argument that, in determining whether WRK was KJG’s alter ego for purposes of successor liability, the court should disregard state law and instead adopt federal common law. State law, the court reasoned, determines whether an interest in property exists—including property held by a third party if it is determined that the third party holds the property as a nominee or alter ego of the taxpayer—and federal law dictates the tax consequences. Noting that applying federal common law requires a conflict between a federal policy or interest and the use of state law that justifies the adoption of federal common law, the court concluded that Ohio law on alter ego liability should apply. Under Ohio law, the court stated, the purchaser of a corporation’s assets generally is not liable for the debts and obligations of the transferor corporation, but can be liable under certain exceptions, including when the purchaser is a mere continuation of the seller corporation. The court held that WRK was a mere continuation of KJG and could be held liable for KJG’s outstanding tax liability.

8. A Notice of Determination of Worker Classification is “generally subject to deficiency procedures,” and therefore a pre-assessment conference with IRS Appeals does not preclude challenging the underlying tax liability in a CDP hearing. Hampton Software Development, LLC v. Commissioner, T.C. Memo. 2016-38 (3/5/16). Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer’s underlying tax liability in a CDP hearing only “if the person did not receive any statutory notice

of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.” In this case, the IRS determined on audit that the taxpayer should have classified a worker as an employee and issued a 30-day letter, in response to which the taxpayer filed a protest and had a conference with an IRS Appeals Officer. The taxpayer and the IRS failed to reach a settlement, and the IRS then issued a Notice of Determination of Worker Classification (NDWC) in which it determined that the taxpayer owed employment taxes. The NDWC was returned to the IRS with a U.S. Postal Service label stamped “Return to Sender” and marked as “Unclaimed.” The taxpayer did not file a petition in the Tax Court in response to the NDWC. The IRS assessed the tax and subsequently issued a notice of levy, in response to which the taxpayer requested a CDP hearing. In the CDP hearing, the IRS Settlement Officer took the position that § 6330(c)(2)(B) precluded the taxpayer from challenging the underlying tax liability because the pre-assessment conference with IRS Appeals was an opportunity to dispute the liability within the meaning of the statute. Following the CDP hearing, the IRS issued a notice of determination upholding the collection action and the taxpayer filed a petition in the Tax Court. In response to the government’s motion for summary judgment, the court (Judge Paris) held that a NDWC is “generally subject to deficiency procedures,” and therefore, under the relevant regulation (Reg. § 301.6330-1(e)(3), Q&A E2), “an opportunity for a conference with IRS Appeals prior to the assessment of the tax is not a prior ‘opportunity to dispute’ the underlying tax liability for purposes of section 6330(c)(2)(B).” For such taxes, receipt of the notice of deficiency is the prior opportunity to dispute the tax liability. In contrast, the court explained, the same regulation provides that, for taxes not subject to deficiency procedures, a prior opportunity for a pre-assessment conference with IRS Appeals is an opportunity to dispute the underlying liability that precludes a later challenge of the liability in a CDP hearing. (The court previously had upheld the validity of this regulation in *Lewis v. Commissioner*, 128 T.C. 48 (2007).) Because a NDWC is subject to deficiency procedures, the court reasoned, the taxpayer was precluded from challenging the underlying tax liability only if it had actually received the NDWC or had deliberately refused delivery of it. The court held that there was no dispute that the taxpayer had not actually received the NDWC, but that a genuine issue of material fact existed as to whether the taxpayer had deliberately refused the NDWC. Accordingly, the court denied the government’s motion for summary judgment on the question whether § 6330(c)(2)(B) precluded the taxpayer from challenging the underlying tax liability in the CDP hearing.

9. According to the Eleventh Circuit, the IRS is required to make a pre-assessment determination of a taxpayer’s liability as a responsible person under § 6672 when the taxpayer submits a protest, and its failure to do so might render the assessment invalid. *Romano-Murphy v. Commissioner*, 816 F.3d 707 (11th Cir. 3/7/16), *vacating and remanding* T.C. Memo. 2012-330 (11/29/12). The taxpayer served as the chief operating officer of a healthcare staffing business. The IRS sent to her a Letter 1153 (notice of proposed assessment) informing her that the IRS intended to hold her responsible for a penalty equal to more than \$346,000 of the business’s unpaid employment taxes pursuant to § 6672(a). The taxpayer submitted a written protest and requested a conference with IRS Appeals. Due to an unexplained error, the IRS never forwarded the protest to IRS Appeals and the taxpayer was not provided with a pre-assessment conference or a final administrative determination as to her protest. Instead, the IRS assessed the tax and issued a notice of intent to levy and notice of federal tax lien, in response to which the taxpayer requested a collection due process hearing. During the CDP hearing, the IRS Appeals Office observed that the taxpayer had not had a pre-assessment opportunity to contest her liability and therefore conducted a post-assessment review of the issues the taxpayer had raised in her protest. Following this review, the IRS issued a notice of determination sustaining the proposed collection. The taxpayer sought review in the Tax Court, which sustained the IRS’s determination. The taxpayer moved to vacate on the ground that the IRS can collect a tax only after a valid assessment, and that the assessment in her case was invalid because the IRS had failed to give her a pre-assessment hearing and determination when she filed her timely protest. The Tax Court (Judge Morrison) concluded that, notwithstanding the IRS’s failure to make a pre-assessment determination of liability under § 6672(a) in response to the taxpayer’s protest, § 6672 did not prohibit the IRS’s assessment. The

Tax Court accordingly denied the taxpayer's motion to vacate. In an opinion by Judge Jordan, the Eleventh Circuit held that the IRS erred in failing to make a pre-assessment determination of the taxpayer's liability under § 6672(a) in response to her protest. The Eleventh Circuit vacated the Tax Court's judgment and remanded for a determination whether the IRS's error was harmless or instead rendered the assessment invalid (or required some lesser form of corrective action). In reaching its conclusion that the IRS was required to make a pre-assessment determination of liability in response to the taxpayer's protest, the court relied on several sources of authority. The court first concluded that § 6672(b)(3)—which provides that, “if there is a timely protest of the proposed assessment,” the period of limitations on assessment shall not expire before “the date 30 days after the Secretary makes a final administrative determination with respect to such protest”—contemplates a pre-assessment determination of liability (and notice of such determination to the taxpayer) if a timely protest has been filed. The court therefore rejected the IRS's argument “that it may simply ignore, disregard, or discard a taxpayer's timely protest to a § 6772(b) pre-assessment notice if it so chooses.” Assuming for the sake of argument that the language of the statute is ambiguous, the court reviewed the relevant regulations and concluded that Reg. §§ 301.7430-3(d) and 301.6320-1(e)(4) “require the IRS to make a pre-assessment determination (though not necessarily through the provision of a hearing) about a taxpayer's § 6672(a) liability when timely protest is made.” These regulations, the court concluded, are entitled to *Chevron* deference and are binding on the government as well as the taxpayer. Finally, the court regarded Reg. § 601.106(a)(1)(iv) and relevant provisions of the Internal Revenue Manual as persuasive authority that supported its conclusion.

10. The fees for installment agreements are going up! REG-108792-16, User Fees for Installment Agreements, 81 F.R. 56543 (8/22/16). The Treasury Department and the IRS have issued proposed regulations that would significantly increase the user fees for entering into an installment agreement. Currently, the general user fee for an installment agreement is \$120, which is reduced to \$52 for a direct debit installment agreement that permits the IRS to withdraw the installment payments from the taxpayer's bank account. The current user fee is \$43 for a low income taxpayer, defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines. The current fee for restructuring or reinstating an installment agreement is \$50. Under the proposed regulations, the fee for low income taxpayers would remain the same, but the general fee would increase to \$225, the direct debit fee would increase to \$107, and the fee for restructuring or reinstating an installment agreement would increase to \$89. In addition, the proposed regulations establish two new user fees for online payment agreements. The proposed general user fee for a taxpayer who sets up an installment agreement online is \$149, and the proposed fee for a direct debit online payment agreement is \$31. The preamble to the proposed regulations provides a great amount of detail on how these user fees were determined, including the cost of the services provided. These regulations are proposed to be effective on 1/1/17.

G. Innocent Spouse

1. Updating the innocent spouse regulations to conform to 2006 statutory amendments. REG-134219-08, Relief From Joint and Several Liability, 80 F.R. 72649 (11/20/15). The Treasury and IRS have released proposed amendments to the regulations under §§ 66 (Prop. Reg. § 1.66-4) and 6015 (Prop. Regs. §§ 1.6015-1, -2, -3, -6, -7 and -8) that would significantly change the existing rules providing relief from joint and several liability and relief from the operation of state community property law. The proposed regulations conform the existing regulations to the 2006 amendments to § 6015(e) regarding equitable relief and incorporate the positions in Rev. Proc. 2013-34, 2013-43 I.R.B. 397. The changes include providing additional guidance on the judicial doctrine of res judicata and the § 6015(g)(2) exception to res judicata when a requesting spouse did not meaningfully participate in a prior court proceeding. The proposed regulations would add a list of acts to be considered in making the determination as to whether the requesting spouse meaningfully participated in a prior proceeding and provide examples of the operation of these rules. The proposed regulations also would (1) provide a definition of underpayment or unpaid tax for purposes of § 6015(f);

(2) provide detailed rules regarding credits and refunds in innocent spouse cases; (3) expand the rule that penalties and interest are not separate items from which relief can be obtained to cases involving underpayments; (4) incorporate an administratively developed rule that attribution of an erroneous item follows the attribution of the underlying item that caused the increase to adjusted gross income; (5) update the allocation rules under § 6015(c) and (d); and (6) revise the rules regarding prohibition on collection and suspension of the collection statute. The proposed regulations will be applicable on the date final regulations are published.

2. Venue for appellate review of Tax Court decisions in innocent spouse cases is determined by the taxpayer's legal residence. The 2015 PATH Act, § 423, amends Code § 7482(b) to clarify that Tax Court decisions rendered in cases involving petitions under sections §§ 6015, 6320, or 6330 follow the generally applicable rule for appellate review. For individual taxpayers, this rule provides that cases are appealable to the U.S. Court of Appeals for the circuit in which the petitioner's legal residence is located.

H. Miscellaneous

1. The Tax Court is an Article I court. Freytag v. Commissioner, 501 U.S. 868 (6/27/91). Justice Blackmun, speaking for the five-judge majority held that the assignment of complex tax shelter case by Tax Court chief judge to a special trial judge (a) is permitted under § 7443A(b)(4) where the actual decision is rendered by a Tax Court judge, and (b) does not violate the Appointments Clause (U.S. Const. Art. II, § 2, cl. 2) because the special trial judge is an "inferior Officer" and the Tax Court is a[n Article I] "Court of Law."

- Four concurring justices, in an opinion written by Justice Scalia, thought that the Tax Court was a "Department" and its chief judge was a "Head of Department," so the Tax Court exercised executive power. Justice Scalia wrote:

When the Tax Court was statutorily denominated an "Article I Court" in 1969, its judges did not magically acquire the judicial power. They still lack life tenure; their salaries may still be diminished; they are still removable by the President for "inefficiency, neglect of duty, or malfeasance in office." 26 U. S. C. § 7443(f). . . . How anyone with these characteristics can exercise *judicial* power "independent . . . [of] the Executive Branch" is a complete mystery. It seems to me entirely obvious that the Tax Court, like the Internal Revenue Service, the FCC, and the NLRB, exercises executive power.

a. The presidential power to remove Tax Court judges for cause does not infringe on the constitutional separation of powers with respect to adjudications of "pre-collection tax disputes." Kuretski v. Commissioner, 755 F.3d 929 (D.C. Cir. 6/20/14). In this collection due process case, the District of Columbia Circuit (Judge Srinivasan) held that the power in the U.S. President to remove Tax Court judges on grounds of "inefficiency, neglect of duty, or malfeasance in office" under § 7443(f) did not infringe on the constitutional separation of powers and result in Tax Court judges not being "free from alleged bias in favor of the Executive Branch." The taxpayers asked that § 7443(f) be struck down, the Tax Court's decision against them vacated, and the case remanded "for re-decision by a Tax Court judge free from the threat of presidential removal and hence free from alleged bias in favor of the Executive Branch." The D.C. Circuit held that it has been established that Congress can constitutionally assign to non-article III tribunals a category of cases involving "public rights" (including matters of taxation at the pre-collection stage); the Tax Court is an Article I court and, while its judges do exercise judicial power, they do not exercise the "'judicial power of the United States' under Article III." Even though Freytag v. Commissioner, 501 U.S. 868 (1991)] held that the Tax Court is a "Court of Law," Judge Srinivasan held that "the judicial power of the United States is not limited to the judicial power defined under Article III." He further held that the Tax Court, as a legislative court, is nevertheless part of the Executive Branch of government. Judge Srinivasan concluded that the "Tax Court's status as a 'Court of Law'—and its exercise of 'judicial power'—for Appointments Clause purposes under Freytag casts no doubt on the constitutionality of the President's authority to remove Tax Court judges."

- Judge Srinivasan also rejected taxpayers' challenge to the 25 percent late-payment penalties under § 6651(a)(2) on the ground that they failed to submit to the service center where their return was filed "an affirmative showing of all facts alleged as a reasonable cause for [their] failure to . . . pay such tax on time in the form of a written statement containing a declaration that it is made under penalties of perjury," as required by Reg. § 301.6651-1(c)(1).

b. Congress speaks, but its meaning is far from clear. The 2015 PATH Act, § 441, amends Code § 7441 by adding the following sentence: "The Tax Court is not an agency of, and shall be independent of, the executive branch of the Government." What Congress intended to achieve with this language is not entirely clear. The Joint Committee's explanation of the provision discusses *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 6/20/14), and states simply: "To avoid confusion about the independence of the Tax Court as an Article I court, the provision clarifies that the Tax Court is not an agency of the Executive Branch."

2. The Tenth Circuit stirs the previously muddled water on whether a late-filed return is a "return" that will permit tax debt to be discharged in bankruptcy proceedings. *In re Mallo*, 774 F.3d 1313 (10th Cir. 12/29/14), *cert denied*, 135 S. Ct. 2889 (6/29/15). In an opinion by Judge McHugh, the Tenth Circuit held, with respect to taxpayers in two consolidated appeals, that a late return filed after the IRS had assessed tax for the year in question was not a "return" within the meaning of 11 U.S.C. § 523(a) and, consequently, the taxpayers' federal tax liabilities were not dischargeable in bankruptcy. The facts in each appeal were substantially the same. The taxpayers failed to file returns for the years 2000 and 2001. The IRS issued notices of deficiency, which the taxpayers did not challenge, and assessed tax for those years. The taxpayers subsequently filed returns, based on which the IRS partially abated the tax liabilities. The taxpayers then received general discharge orders in chapter 7 bankruptcy proceedings and filed adversary proceedings against the IRS seeking a determination that their income tax liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

- (B) with respect to which a return, or equivalent report or notice, if required—
- (i) was not filed or given; or
 - (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a): the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code . . . but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code

The court examined a line of conflicting cases in which the courts had applied a four-factor test, commonly known as the *Beard* test (*Beard v. Commissioner*, 793 F.2d 139 (6th Cir. 1986)), to determine whether a late-filed return constitutes a "return" for purposes of 11 U.S.C. § 523(a) and concluded that it did not need to resolve that issue. Instead, the court concluded that, unless it is prepared by the IRS with the assistance of the taxpayer under § 6020(a), a late return is not a "return" because it does not satisfy "the requirements of applicable nonbankruptcy law (including applicable filing requirements)" within the meaning of the language added to the statute in 2005.

- In reaching its conclusion, the Tenth Circuit agreed with the analysis of the Fifth Circuit in *In re McCoy*, 666 F.3d 924 (5th Cir. 2012), in which the Fifth Circuit concluded that a late-filed Mississippi state tax return was not a "return" within the meaning of 11 U.S.C. § 523(a).

- The Tenth Circuit’s interpretation of 11 U.S.C. § 523(a) is contrary to the IRS’s interpretation, which the IRS made clear to the court during the appeal. The IRS’s interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10), is that “section 523(a) does not provide that every tax for which a return was filed late is nondischargeable.” However, according to the Chief Counsel Notice, a debt for tax assessed before the late return is filed (as in the situations before the Tenth Circuit in *In re Mallo*) “is not dischargeable because a debt assessed prior to the filing of a Form 1040 is a debt for which is return was not ‘filed’ within the meaning of section 523(a)(1)(B)(i).”

a. The First Circuit aligns itself with the Fifth and Tenth Circuits and applies the same analysis to a late-filed Massachusetts state income tax return. *In re Fahey*, 779 F.3d 1 (1st Cir. 2/18/15). In an opinion by Judge Kayatta, the First Circuit aligned itself with the Fifth and Tenth Circuits and concluded that a late-filed Massachusetts state income tax return was not a “return” within the meaning of 11 U.S.C. § 523(a). In a lengthy dissenting opinion, Judge Thompson argued that the majority’s conclusion was inconsistent with both the language of and policy underlying the statute: “The majority, ignoring blatant textual ambiguities and judicial precedent, instead opts to create a per se restriction that is contrary to the goal of our bankruptcy system to provide, as the former President put it in 2005, ‘fairness and compassion’ to ‘those who need it most.’”

b. A Bankruptcy Appellate Panel in the Ninth Circuit disagrees with the First, Fifth, and Tenth Circuits. The Ninth Circuit now might have an opportunity to weigh in. *In re Martin*, 542 B.R. 479 (B.A.P. 9th Cir. 12/17/15). In an opinion by Judge Kurtz, a Bankruptcy Appellate Panel in the Ninth Circuit disagreed with what it called the “literal construction” by the First, Fifth and Ninth Circuits of the definition of the term “return” in Bankruptcy Code § 523(a). The court emphasized that the meaning of the language in the unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which provides that “the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements),” must be determined by taking into account the context of the surrounding words and also the context of the larger statutory scheme. Taking this context into account, the court reasoned, leads to the conclusion that the statutory language does not dictate that a late-filed return automatically renders the taxpayer’s income tax liability non-dischargeable. “Why Congress would want to treat a taxpayer who files a tax return a month or a week or even a day late—possibly for reasons beyond his or her control—so much more harshly than a taxpayer who never files a tax return on his or her own behalf [and instead relies on the IRS to prepare it pursuant to § 6020(a)] is a mystery that literal construction adherents never adequately explain.” The court also rejected the IRS’s interpretation, reflected in Chief Counsel Notice CC-2010-016 (9/2/10) that, although not every tax for which a return is filed late is nondischargeable, a debt for tax assessed before the late return is filed (as in the situation before the court) is not dischargeable because the tax debt is established by the assessment and therefore arises before the return was filed. Instead, the court concluded that binding Ninth Circuit authority predating the 2005 amendments to Bankruptcy Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff’d*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a “return” for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers’ late-filed returns were “returns” within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. *In re Justice*, 817 F.3d 738 (11th Cir. 3/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the “one-day-late” rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer’s federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and

six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer's returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. "Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law." The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a "return" for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. **The Ninth Circuit holds that a taxpayer's tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable.** *In re Smith*, 118 A.F.T.R.2d 2016-5127 (9th Cir. 7/13/16). In an opinion by Judge Christen, the Ninth Circuit held that the tax liability of the taxpayer, who filed his federal income tax return seven years after it was due and three years after the IRS had assessed the tax, was not dischargeable in bankruptcy. The government did not assert the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits. Accordingly, the Ninth Circuit looked to its prior decision in *In re Hatton*, 220 F.3d 1057 (9th Cir. 2000), issued prior to the 2005 amendments to the Bankruptcy Code on which the First, Fifth and Tenth Circuits relied. In *In re Hatton*, the Ninth Circuit had adopted the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether the taxpayer had filed a "return" for purposes of Bankruptcy Code § 523(a). The fourth factor of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Ninth Circuit concluded that the taxpayer had not made such an attempt:

Here, Smith failed to make a tax filing until seven years after his return was due and three years after the IRS went to the trouble of calculating a deficiency and issuing an assessment. Under these circumstances, Smith's "belated acceptance of responsibility" was not a reasonable attempt to comply with the tax code.

The court noted that other circuits similarly had held that post-assessment filings of returns were not honest and reasonable attempts to satisfy the requirements of the tax law, but refrained from deciding whether any post-assessment filing could be treated as such an honest and reasonable attempt.

3. 🎵"Nobody knows you when you're down and out."🎵 **Victims of identity theft cannot obtain copies of the fraudulent returns filed in their names under the Crime Victims' Rights Act when the government has not brought charges for the crime.** *Stegman v. United States*, 115 A.F.T.R.2d 2015-871 (D. Kan. 2/19/15). Kathleen Stegman brought this action under the federal Crime Victims' Rights Act seeking copies of income tax returns filed in her name and certain other information, including the names of any known individuals involved in her identity theft. She asserted that an IRS Special Agent and an Assistant United States Attorney had notified her that she "was a victim of stolen identity tax refund fraud for tax years 2012 and 2013." By refusing to provide the requested information, she argued, the government had violated three rights enumerated in the Crime Victims' Rights Act: (1) "her 'right to be reasonably protected from the accused,'" (2) "the 'right to proceedings free from unreasonable delay,'" and (3) "the 'right to be treated with fairness and dignity.'" The court (Judge Lungstrum) held that she failed to state a claim with respect to the first two rights because the government still was investigating the identity theft and therefore there was no "accused" and there were no "proceedings." Even assuming the third right attaches before charges are filed, the court held, "[t]he United States Attorney ... does not have an obligation under the CVRA to

confer with Ms. Stegman or to disclose anything in its investigative file to her.” The court granted the government’s motion to dismiss.

a. The IRS does the right thing: it will establish a procedure for victims of identity theft to obtain copies of fraudulent returns filed in their names. In response to an inquiry from U.S. Senator Kelly Ayotte of New Hampshire, IRS Commissioner John Koskinen stated, in a letter to Senator Ayotte dated 5/28/15, that the IRS has decided to change its policy and will establish a procedure “that will enable victims to receive, upon request, redacted copies of fraudulent returns filed in their name and SSN.” In the letter, Commissioner Koskinen notes that § 6103 “does not pose any restrictions on us sharing a copy of the fraudulent return with the victim, so no legislative change is necessary for us to do so.” 2015 TNT 105-28 (5/28/15).

b. The IRS follows through on its plan to establish a procedure for victims of identity theft to obtain copies of fraudulent returns filed in their names. The IRS updated its web site (<http://perma.cc/Y5PA-62UG>) on 11/3/15 to provide a procedure for victims of identity theft (or a person authorized to obtain the identity theft victim’s tax information) to obtain a redacted copy of a fraudulent return that was filed and accepted by the IRS using the identity theft victim’s name and Social Security Number. To obtain a copy of the return, the victim’s name and SSN must be listed as either the primary or secondary taxpayer on the fraudulent return, i.e., a victim listed only as a dependent cannot obtain a copy of the return. There is no prescribed form for the request. Instead, the identity theft victim must submit a letter with specified information to an IRS address listed on the web site. Fraudulent returns can be requested for the current tax year and the previous six tax years.

4. The Treasury Department and IRS take a step forward in fighting stolen identity tax returns. T.D. 9730, Extension of Time To File Certain Information Returns, 80 F.R. 48433 (8/12/15). Reg. § 1.6081-8, allowing automatic extensions to file certain information returns, has been removed and replaced by Temp. Reg. § 1.6081-8T, which generally allows only one 30-day automatic extension for information returns on Forms W-2G, 1042-S, 1094-C, 1095-B, 1095-C, 1097 series, 1098 series, 1099 series, 3921, 3922, 5498 series, or 8027 if the filer or the person transmitting the information return for the filer (the transmitter) files an application in accordance with the regulations. One additional 30-day extension of time to file an information return may be allowed if the filer or transmitter submits a request for the additional extension of time to file before the expiration of the automatic 30-day extension. According to the preamble, the reason for this change is as follows:

Identity thieves often electronically file their fraudulent refund claims early in the tax filing season, using fictitious wage and other information of legitimate taxpayers. Unscrupulous preparers also electronically file early in the tax filing season, over-claiming deductions and credits and underreporting income for unwitting, as well as complicit, taxpayers. In many cases, the IRS is unable to verify the wage and other information reported on tax returns filed before April 15th, in part because the IRS does not receive the information returns reporting this information until later in the filing season. ...

Receipt of information returns earlier in the filing season will improve the IRS’s ability to identify fraudulent refund claims and stop the refunds before they are paid.

a. Congress steps in and requires information returns reporting wages and nonemployee compensation to be filed by January 31. The 2015 PATH Act, § 201, amended Code § 6071(c) to require that Forms W-2 and W-3 and any returns or written statements required to report nonemployee compensation (such as Form 1099-MISC) be filed by January 31 of the year after the calendar year to which the returns relate. The effect of this change is to require these information returns to have the same due date as employee and payee statements and to eliminate the extended filing date for electronically filed returns under § 6071(b). This change is effective for returns and statements relating to calendar years

beginning after 12/18/15, the date of enactment. Thus, the accelerated due date will apply to information returns filed in 2017 with respect to calendar year 2016.

5. Planning to travel overseas? You might need to cancel that vacation if you are seriously delinquent on your taxes. The Fixing America's Surface Transportation (FAST) Act, § 32101, Pub. L. No. 114-94, signed by the President on 12/4/15, adds new Code § 7345, which provides that having a "seriously delinquent tax debt" is grounds for denial, revocation, or limitation of a passport. A "seriously delinquent tax debt" is generally defined as an unpaid, legally enforceable federal tax liability of an individual that has been assessed and exceeds \$50,000 (to be adjusted in future years for inflation) for which a notice of lien has been filed in public records pursuant to § 6323 or a notice of levy has been filed pursuant to § 6331. Debts that are being paid on a timely basis pursuant to an installment agreement or an offer in compromise are excluded from the category of seriously delinquent tax debts, as are debts with respect to which collection is suspended because a collection due process hearing or innocent spouse relief has been requested or is pending. The IRS will certify to the Secretary of the Treasury that an individual has a seriously delinquent tax debt, and Treasury will transmit the certifications to the Secretary of State for action. The IRS must contemporaneously notify the taxpayer of the certification. The taxpayer is permitted to challenge the certification as erroneous by bringing an action in a United States District Court or the Tax Court. The new provision is effective on the date of enactment, 12/4/15.

6. The Tax Court will now apply the Federal Rules of Evidence as interpreted by the federal court of appeals to which its decision is appealable. The 2015 PATH Act, § 425, amends Code § 7453 to eliminate the requirement that the Tax Court apply the Federal Rules of Evidence applicable in trials without a jury in the United States District Court of the District of Columbia. Accordingly, pursuant to its decision in *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), the Tax Court will apply the Federal Rules of Evidence as interpreted by the federal court of appeals to which its decision is appealable. This change applies to proceedings commenced after 12/18/15, the date of enactment, "and, to the extent that it is just and practicable, to all proceedings pending on such date."

7. A lesson on the timing of a bankruptcy petition: the extended due date of the return, rather than the original due date, determines whether the late-filing penalty is dischargeable. *United States v. Wilson*, 117 A.F.T.R.2d 2016-514 (N.D. Cal. 1/21/16). The taxpayer obtained an extension of time to file his 2008 federal income tax return, pursuant to which the return was due on 10/15/09. He actually filed the return in February 2011. On 7/24/12, the taxpayer filed a chapter 7 bankruptcy petition. The taxpayer's 2008 tax liability was satisfied with funds of the bankruptcy estate, but those funds apparently were not sufficient to satisfy the taxpayer's failure-to-file or failure-to-pay penalties. The IRS subsequently collected those penalties by intercepting a California income tax refund payable to the taxpayer and levying on his Social Security benefits. The taxpayer commenced this adversary proceeding, in which he argued that the tax penalties had been discharged under 11 U.S.C. § 523(a)(7)(B), which provides that a tax penalty is discharged only if it is "imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition" in bankruptcy. In the Bankruptcy Court, the government conceded that the failure-to-pay penalty had been discharged because the event with respect to which it was imposed (non-payment) had occurred on 4/15/09, the original due date of the return, which was more than three years before the filing of the bankruptcy petition on 7/24/12. But the government argued that the failure-to-file penalty had not been discharged. The Bankruptcy Court held in favor of the taxpayer, reasoning that the tax liability with respect to which the failure-to-file penalty was imposed had accrued on 4/15/09, the original due date of the return, and therefore, like the failure-to-pay penalty, had been discharged. The District Court (Judge Chhabria) reversed. According to the District Court, the "transaction or event" with respect to which the failure-to-file penalty was imposed was the taxpayer's failure to file by the 10/15/09 extended due date. Because this event occurred within the three-year period preceding the filing of the bankruptcy petition on 7/24/12, the District Court reasoned, the failure-to-file penalty had not been discharged.

- Had the taxpayer waited three more months to file his bankruptcy petition, the failure-to-file penalty would have been discharged.

8. The IRS continues successfully to be stingy with whistleblower awards. *Whistleblower 22716-13W v. Commissioner*, 146 T.C. No. 6 (3/14/16). A whistleblower's cooperation with the Department of Justice and the IRS Criminal Investigation Division led to a taxpayer agreeing, by guilty plea, to pay an FBAR civil penalty substantially in excess of \$2,000,000 and a small amount of restitution, reflecting unpaid federal income tax on income derived from Swiss bank accounts. The petitioner sought a whistleblower award, which the IRS denied. Under § 7623(b)(5)(B), a whistleblower is entitled to a nondiscretionary award only "if the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed \$2,000,000." The issue in this case was whether the FBAR civil penalties which are imposed and collected under 31 U.S.C. § 5321, rather than under the Internal Revenue Code, constitute "additional amounts" for purposes of ascertaining whether the \$2,000,000 threshold has been met. The Tax Court (Judge Lauber) held that the term "additional amounts" as used in § 7623(b)(5)(B) means only the civil penalties set forth in chapter 68, subchapter A, of the Internal Revenue Code, captioned "Additions to the Tax and Additional Amounts." FBAR civil penalties are not "additional amounts" within the meaning of § 7623(b)(5)(B) and are not "assessed, collected, and paid in the same manner as taxes." Thus, FBAR payments must be excluded in determining whether the \$2,000,000 "amount in dispute" requirement has been satisfied. Accordingly the court upheld the IRS's denial of any award.

9. What should have been a slam dunk for the IRS turned into an embarrassing loss: an IRS revenue agent who pleaded guilty to tax evasion established that there was no tax deficiency for the year in question. *Senyszyn v. Commissioner*, 146 T.C. No. 9 (3/31/16). The taxpayer was an IRS revenue agent who became involved in the business affairs of a real estate developer. The developer brought a civil suit for fraud in which the developer asserted that the taxpayer had embezzled a total of \$1 million. In a subsequent federal criminal investigation, an IRS revenue agent determined that, during 2003, the taxpayer had taken from the developer \$252,726 more than he had returned. The taxpayer signed an agreement with the U.S. Attorney in which the taxpayer agreed to plead guilty and to stipulate at sentencing that he "knowingly and willfully did not include about \$252,726.00 in additional taxable income that he acquired in 2003." As agreed, the taxpayer pleaded guilty to the tax evasion charge. Based primarily on this omitted income, the IRS subsequently issued a notice of deficiency for 2003 asserting a deficiency in federal income tax, a fraud penalty against the taxpayer, and an accuracy-related penalty against his spouse. At trial, the taxpayer successfully established that the IRS's analysis of the funds he had received was inaccurate. The Tax Court (Judge Halpern) found that, during 2003, the taxpayer had returned to the developer more funds than he had received from the developer. Accordingly, the court held, the evidence presented by the IRS did not support the asserted deficiency. The court also held that an amended return for 2003 filed by the taxpayers, on which the taxpayers reported an additional \$252,726 of income, could not be treated as an admission that would support the deficiency because the return also reported an additional deduction of \$476,005. The court also declined to apply the doctrine of collateral estoppel to uphold the deficiency. The use of collateral estoppel to uphold the deficiency in this case, the court reasoned, should be regarded as an offensive (rather than defensive) use of collateral estoppel because the taxpayer was a defendant in the prior criminal case. Under *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979), trial courts have broad discretion in permitting the offensive use of collateral estoppel, and should not do so "when the purposes of the doctrine do not support its application." The court concluded that the purposes of the doctrine—protecting litigants from the burden of relitigating an identical issue and promoting judicial economy—"would not be served by upholding a deficiency unsupported by the evidence presented." Although the taxpayer's criminal conviction established the existence of an underpayment for 2003, the conviction did not establish its exact amount and therefore the court in this proceeding necessarily had to determine the amount of the deficiency. Because the taxpayers were not liable for a deficiency, the fraud and accuracy-related penalties based on the asserted deficiency were moot.

10. **Was Dad invited for Thanksgiving dinner even though he filed a Form SS-8 asking the IRS to determine his employment status in the family business?** B G Painting, Inc. v. Commissioner, T.C. Memo. 2016-62 (4/5/16). The IRS notified the taxpayer's president that one of the taxpayer's workers had filed a Form SS-8 asking the IRS to determine his employment status. In the taxpayer's response, the president informed the IRS that the worker was his father and provided other requested information. The IRS issued Letter 4991 to the worker and a Letter 4991-A to the taxpayer notifying them of its determination that the worker was an employee rather than an independent contractor. The taxpayer filed a petition in the Tax Court, and the IRS moved to dismiss for lack of jurisdiction. The Tax Court (Judge Dawson) granted the government's motion to dismiss. "Section 7436(a) confers jurisdiction on this Court only with regard to determinations that are made by the IRS in connection with an audit of a taxpayer. Other IRS determinations of employment status that are not made as part of a taxpayer audit, including those made in the context of private letter rulings or Forms SS-8, are not subject to review by this Court under section 7436(a)." The Letter 4991 issued by the IRS, the court explained, was not a notice of determination that would confer jurisdiction on the court. Further, under the first part of the four-part test established in *American Airlines, Inc. v. Commissioner*, 144 T.C. 24 (2015), for determining jurisdiction under § 7436(a), the IRS must make an examination in connection with an audit. The court noted that it had previously held in *Staffmore, LLC v. Commissioner*, T.C. Memo. 2013-187, "that IRS review of information provided in a Form SS-8 submission is not considered an 'audit' or 'examination.'"

11. **Taxpayers who need to pay their taxes in cash can now do so at the same time they purchase a Slurpee.** IR 2016-56 (4/6/16) (available at <https://perma.cc/R5DU-HC7J>). The IRS announced that individuals can now make tax payments at 7-Eleven stores without the need of a bank account or credit card. To do so, taxpayers must go through an online process, print out a payment code, and bring the code to the store. There is a \$1,000 payment limit per day and a \$3.99 fee per payment.

12. **Only certain private delivery services provide the benefit of the "timely mailed is timely filed" rule.** Notice 2016-30, 2016-18 I.R.B. 676 (4/11/16) This notice (1) updates the list of designated private delivery services set forth in Notice 2015-38, 2015-21 I.R.B. 984 (5/6/15), for purposes of the "timely mailing treated as timely filing/paying" rule of § 7502, (2) provides rules for determining the postmark date for these services, and (3) provides the address for submitting documents to the IRS with respect to an application for designation as a designated private delivery service. These changes are effective 4/11/16. Notice 2015-38, 2015-21 I.R.B. 984 (5/6/15), is modified and superseded.

13. **Tax is still a little bit different from general administrative law in some respects.** Ax v. Commissioner, 146 T.C. No. 10 (4/11/16). The Tax Court (Judge Gustafson) held that neither the Administrative Procedure Act (5 U.S.C. §§ 701-706 (judicial review)) nor *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80 (1943) bar the IRS from raising new grounds to support a notice of deficiency beyond those grounds originally stated in the notice.

Petitioners' proposal—that a deficiency case be confined to issues in the NOD—would be a radical innovation that not only is at odds with the statutes discussed above but that also would change longstanding practice. Under Rule 142(a)(1), "The burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Court; and except that, in respect of any new matter *** pleaded in the answer, it shall be upon the respondent." (Emphasis added.) The rules have so provided as to "new matter" since soon after deficiency litigation first began to be held in this Court's predecessor, the Board of Tax Appeals ("BTA"). This provision as to the burden of proof on "new matter" persisted when the BTA became the Tax Court of the United States in 1942—and it was therefore in effect when Congress enacted the APA. The "new matter" provision persisted in 1969 after the Court was reconstituted as an Article I court to be known as the United States Tax Court. When Congress in 1998 addressed

tax litigation procedure by enacting section 7491 (entitled “Burden of Proof”) to shift the burden of proof in some circumstances, the Tax Court rules then provided, as they had for decades and still do, that burden of proof on “new matter” was on the respondent.

Furthermore, [t]he Supreme Court did not in *Mayo Foundation Mayo for Med. & Educ. Research v. United States*, 562 U.S. 44, 55 (2011), “impose a single one-size-fits-all paradigm for standard and scope of review for all types of cases involving disputes with agencies.” Because in § 6214(a) Congress has specifically authorized the Tax Court to “redetermine” a deficiency asserted by the IRS, neither the Administrative Procedure Act nor general administrative law principles bar the Tax Court, from considering issues and arguments not stated in the IRS’s notice of deficiency.

14 . A snowy day at the Tax Court. Guralnik v. Commissioner, 146 T.C. No. 15 (6/2/16). The taxpayer filed a petition in the Tax Court challenging the IRS’s notice of determination sustaining collection action. The taxpayer sent the petition on February 13, 2015 by Federal Express using a delivery method that did not qualify for the “timely mailed is timely filed” rule of § 7502(a). Although the petition should have been delivered on February 17, 2015, which was the deadline for filing the petition, all federal offices, including the Tax Court, were closed on that day because of a snowstorm. The petition was delivered to the court on the first day the court was open following the storm, February 18, 2015. The government moved to dismiss for lack of jurisdiction because the taxpayer did not file the petition within the 30-day period prescribed by § 6330(d). In a unanimous, reviewed opinion by Judge Lauber, the Tax Court denied the motion. The court looked to Federal Rule of Civil Procedure 6(a)(3)(A), which provides that if the clerk’s office is inaccessible on the last day for filing, then the time for filing is extended to the first day that is not a Saturday, Sunday, or legal holiday on which the clerk’s office is accessible. Although the Tax Court’s rules do not address this situation, Tax Court Rule 1(b) provides:

Where in any instance there is no applicable rule of procedure, the Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand.

The court held that, in the absence of a Tax Court Rule prescribing the procedure when the clerk’s office is inaccessible, the principles of Federal Rule of Civil Procedure 6(a)(3)(A) are “suitably adaptable to govern the matter at hand.” Accordingly, the taxpayer’s petition was timely.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

1. Bankrupt employer? Little chance the promised retirement benefits will be paid? It doesn’t matter. This United Airlines pilot still owed FICA taxes on the present value of future retirement benefits he will never receive. Balestra v. United States, 119 Fed. Cl. 109 (5/31/14). In 2004, the taxpayer retired from his position as a pilot with United Airlines and, pursuant to § 3121(v)(2), the present value of his future retirement benefits (\$289,601) was included in his FICA base for the year of his retirement. Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan must be taken into account for FICA purposes as of the later of the time the services are performed or the time when there is no substantial risk of forfeiture of the right to such amounts. United Airlines entered bankruptcy proceedings in 2002 and its liability for the taxpayer’s retirement benefits was ultimately discharged. The taxpayer received only \$63,032 of the promised benefits. The taxpayer brought this action seeking a refund of the FICA taxes he paid (at the 1.45% rate for the Medicare portion of FICA) on the \$226,569 of retirement benefits that he never received. The regulations issued under § 3121(v)(2), Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), prescribe the method of determining present value and provide that the present value of future retirement benefits

cannot be discounted for the probability that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk associated with any deemed or actual investment of amounts deferred under the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies.

Among other arguments, the taxpayer asserted that, by requiring inclusion of future retirement benefits in the FICA base, Congress meant to employ an accrual accounting basis that implicitly requires an adjustment when it can be determined that the benefits will never be received, and that the failure of the regulations to incorporate such an adjustment is arbitrary and irrational. The Court of Federal Claims (Judge Wolski) rejected the taxpayer's arguments. The court concluded that the statute is silent on how the amount deferred is to be calculated. "The decision of the Treasury Department to avoid the complicated and strategic-behavior-enabling use of risk-adjusted discount rates cannot be said to be unreasonable. Under the deference due the regulations per *Chevron*, as applied to plaintiff they must stand."

a. **♪♪Eight miles high and when you touch down, you'll find that it's stranger than known.♪♪** Yes, says the Federal Circuit, the regulations are a reasonable construction of the statute. *Balestra v. United States*, 803 F.3d 1363 (Fed. Cir. 10/13/15). In an opinion by Judge Plager, the Court of Appeals for the Federal Circuit affirmed. The court held that the relevant regulation, Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), is entitled to deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). After reviewing the statutory language and legislative history of § 3121(v)(2), the court concluded in step one of the *Chevron* analysis that there was no unambiguously expressed congressional intent on the question whether the term "amounts deferred" can be defined as the compensation's present value without consideration of an employer's financial condition. In step two of the *Chevron* analysis, the court concluded that the regulation was a reasonable construction of the statute. The regulation, the court reasoned, "is rational, reasonable, and does not conflict with any law." The court also rejected the taxpayer's argument that the regulation was arbitrary and capricious under *Motor Vehicle Manufacturers Ass'n of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983). The standard in *State Farm* requires the agency issuing the regulation to "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'" *Id.* (quoting *Burlington Truck Lines v. United States*, 371 U.S. 156 (1962)). The regulation in question satisfied this standard:

Treasury explained that it sought simple, workable, and flexible rules when valuing future benefits. It devised a regulation that satisfied these goals while comporting with the governing statute. This is neither arbitrary nor capricious. It may seem unfair in a specific instance such as this, but in balancing the desire for simplicity against the ideal of ultimate comprehensiveness, the agency must be allowed a reasonable degree of discretion.

B. Self-employment Taxes

1. **Partners are self-employed, even if they are employees of a disregarded entity owned by the partnership.** Self-Employment Tax Treatment of Partners in a Partnership That Owns a Disregarded Entity, T.D. 9766, 81 F.R. 26693 (5/4/16). Treasury and the IRS have issued proposed and temporary amendments to the check-the-box regulations under § 7701 clarifying that a partner in a partnership is considered self-employed even if the partner is an employee of a disregarded entity owned by the partnership. The existing regulations provide that (1) a single-member business entity that is not classified as a corporation under Reg. § 301.7701-2(b) is disregarded as an entity separate from its owner; (2) such a disregarded entity nevertheless is treated as a corporation for employment tax purposes, which means that the disregarded entity, rather than its owner, is considered to be the employer of the entity's employees for employment taxes purposes; and (3) the rule that the disregarded entity is treated as a corporation for employment tax purposes does not apply for self-employment tax purposes.

The existing regulations state that the owner of a disregarded entity that is treated as a sole proprietorship is subject to tax on self-employment income and provide an example in which the disregarded entity is subject to employment tax with respect to employees of the disregarded entity, but the individual owner is subject to self-employment tax on the net earnings from self-employment resulting from the disregarded entity's activities. Reg. § 301.7701-2(c)(2)(iv)(C)(2), -2(c)(2)(iv)(D), Ex. The IRS's longstanding position has been that a partner is self-employed and that any remuneration the partner receives for services rendered to the partnership are not wages subject to FICA, FUTA, and income tax withholding. Rev. Rul. 69-184, 1969-1 C.B. 256. Nevertheless, some taxpayers apparently have taken the position that, because the existing regulations do not include an example illustrating how the rules apply to a disregarded entity owned by a partnership, an individual partner in a partnership that owns a disregarded entity can be treated as an employee of the disregarded entity and therefore can participate in certain tax-favored employee benefit plans. The proposed and temporary amendments to the regulations clarify that a disregarded entity is not treated as a corporation for purposes of employing either its individual owner, who is treated as a sole proprietor, or employing an individual that is a partner in a partnership that owns the disregarded entity. Instead, the entity is disregarded as an entity separate from its owner for this purpose.

- To allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, the proposed and temporary amendments apply on the later of: (1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2016, of an affected plan sponsored by a disregarded entity. An affected plan includes any qualified plan, health plan, or § 125 cafeteria plan if the plan benefits participants whose employment status is affected by these regulations.

- The proposed and temporary amendments do not address the application of Rev. Rul. 69-184 in tiered partnership situations. The IRS has requested comments on this issue, as well as the circumstances in which it may be appropriate to permit partners to be employees of the partnership and the impact on employee benefit plans and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners in certain circumstances also to be employees.

C. Excise Taxes

1. **The government prevails on the substantive issue whether an excise tax is due on S corporation shares held by an ESOP, but is barred from assessing the tax by the applicable period of limitations.** Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 110 (2/12/14), *vacated on reconsideration*, 142 T.C. 265 (10/1/14), *aff'd*, 800 F.3d 758 (6th Cir. 9/8/15). An ESOP owned all the stock of the taxpayer, a subchapter S corporation. Under the ESOP, 100 percent of the stock of the taxpayer was allocated to John H. Eggersten, the individual who formerly owned the stock. The government and the taxpayer agreed that Mr. Eggersten was a "disqualified person" within the meaning of § 409(p)(4). Because the ESOP allocated all the stock of the S corporation to Mr. Eggersten, the shares were deemed-owned shares with respect to him under § 409(p)(4)(C) and he was treated as owning them for purposes of § 409(p) and the related excise tax imposed by § 4979A. The government argued that, because disqualified persons owned 50 percent or more of the number of shares of employer securities consisting of stock of an S corporation, a non-allocation year had occurred in 2005 within the meaning of § 409(p)(3). Accordingly, the government argued, under § 4979A(a), an excise tax was imposed on the S corporation equal to 50 percent of the "amount involved." The government relied on a special rule in § 4979A(e)(2)(C), which provides that "the amount involved for the first nonallocation year of any employee stock ownership plan shall be determined by taking into account the total value of all the deemed-owned shares of all disqualified persons with respect to such plan." Thus, the government sought to impose a tax equal to 50 percent of the value of the S corporation's shares. The Tax Court (Judge Chiechi) agreed with the government that § 4979A(a) imposed the tax for tax year 2005, but concluded that the period of limitations in § 4979A(e)(2)(D) for assessing the tax had expired before the government issued its notice of deficiency. In its analysis of the imposition of the tax, the court rejected the taxpayer's argument

that § 4979A(a) does not impose an excise tax when a non-allocation year occurs. The court also rejected the taxpayer's argument that the "first nonallocation year" specified by § 4979A(e)(2)(C) was 1999, the year in which Mr. Eggerston transferred the S corporation shares to the ESOP, rather than 2005. In reaching this conclusion, the court relied on the effective date of the relevant provisions, which apply to plan years beginning after 12/31/04. Under § 4979A(e)(2)(D), the period of limitations for assessing the excise tax is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership. Section 4979A(e)(2)(D) does not define the term "notified." Relying on its approach to a similar issue in *Stovall v. Commissioner*, 101 T.C. 140 (1993), the court looked for guidance to the regulations issued under § 1033(a), which specify that a notification must contain "all of the details." The court concluded that the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. The period of limitations on assessment therefore expired in 2009. Because the IRS did not issue the notice of deficiency until 4/14/11, assessment of the tax was precluded.

a. Don't break out the champagne just yet! It turns out that the limitations period on assessment of tax had not expired when the IRS issued its notice of deficiency. Law Office of John H. Eggersten P.C. v. Commissioner, 142 T.C. 265 (10/1/14), *aff'd*, 800 F.3d 758 (6th Cir. 9/8/15). The Tax Court (Judge Chiechi) granted the government's motion for reconsideration and concluded in a supplemental opinion that the limitations period on assessment of the excise tax for 2005 had not expired when the IRS mailed its notice of deficiency. The court had concluded in its prior opinion that the limitations period on assessment of the excise tax had expired in 2009 because (1) the governing statute was § 4979A(e)(2)(D), which provides that the period of limitations is three years from the later of the allocation or ownership giving rise to the tax or the date on which the Secretary is notified of the allocation or ownership, and (2) the S corporation's 2005 return on Form 1120S and the employee benefit plan 2005 return on Form 5500, both filed in 2006, provided the requisite notification. On reconsideration, the court agreed with the government that "section 4979A(e)(2)(D) serves only to extend under the circumstances set forth therein the period of limitations prescribed by section 6501," and therefore the threshold question was whether the period of limitations on assessment prescribed by § 6501 had expired when the IRS mailed its notice of deficiency. The court concluded that the § 6501 limitations period had not expired pursuant to § 6501(c)(3), which provides that tax can be assessed at any time "[i]n the case of failure to file a return." The taxpayer had not filed for 2005 Form 5330, the designated form for reporting the § 4979A excise tax. Therefore, the court reasoned, the limitations period on assessment began to run only if the taxpayer filed for 2005 another document that constitutes a "return" under the four-factor test of *Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd per curiam*, 793 F.2d 139 (6th Cir. 1986). The court concluded that neither the S corporation's 2005 return on Form 1120S nor the employee benefit plan 2005 return on Form 5500, both filed in 2006, qualified as a return for purposes of the excise tax imposed by § 4979A(a) because neither document contained sufficient information to calculate the taxpayer's excise tax liability for 2005 as required by the *Beard* test. Accordingly, the § 4979A excise tax could be assessed at any time.

b. There will be no champagne for this taxpayer, says the Sixth Circuit. Law Office of John H. Eggersten v. Commissioner, 800 F.3d 758 (6th Cir. 9/8/15). In an opinion by Judge Sutton, the Sixth Circuit affirmed the Tax Court's decision. The Sixth Circuit agreed with the Tax Court that the taxpayer owed the excise tax imposed by § 4979A(a) and that, pursuant to § 6501(c)(3), the limitations period on assessment of the tax had not expired when the IRS mailed the notice deficiency because the taxpayer had failed to file a return with respect to the excise tax. The court noted "the taxpayer's lament that it seems strange to let the limitations period run until it files the requisite form, which in this instance merely would have reported 'no excise tax due' [.]'" and observed that the absence of a limitations period may impose an unfair burden on innocent taxpayers. But any unfairness, the court concluded, is for Congress, rather than the courts, to address. The Sixth Circuit also held that the Tax Court had not abused its discretion in entertaining the IRS's motion for reconsideration.

- Judge Clay dissented in part. He expressed concern about the IRS's change in position, as set forth in its motion for reconsideration in the Tax Court, concerning the provision that governs the limitations period on assessment of the excise tax. In his view, the court should have remanded "to the Tax Court to develop a record about the circumstances surrounding the Commissioner's reversal in position, including any communications between the parties and the court, to determine whether the Commissioner's reversal was made in good faith." The record developed on remand, he reasoned, might lead to the conclusion that the IRS's change in position is barred by the doctrine of judicial estoppel. "When the Internal Revenue Service is permitted to litigate according to its whims in the Tax Court, knowing that a do-over will be available if it does not succeed on the theory that at first seems most expedient, tax law jurisprudence suffers no less than the integrity of the rule of law and the courts."

2. The Cadillac Tax is coming and the IRS wants your input! Notice 2015-16, 2015-10 I.R.B. 732 (2/23/15). This notice describes potential approaches in future proposed regulations with respect to a number of issues under § 4980I. Generally, § 4980I, which was enacted as part of the Affordable Care Act and applies to taxable years beginning after 12/31/17, imposes a 40 percent excise tax on the amount by which the cost of group health coverage provided by an employer (referred to as "applicable coverage") exceeds an applicable dollar limit. The issues addressed in the notice primarily relate to: (1) the definition of applicable coverage, (2) the determination of the cost of applicable coverage, and (3) the application of the annual statutory dollar limit to the cost of applicable coverage. Treasury and the IRS invite comments on the issues addressed in the notice and on any other issues under § 4980I. Comments are due by 5/15/15.

- The notice indicates that Treasury and IRS intend to issue another notice, before issuing proposed regulations, inviting comments on certain additional issues not addressed in this notice.

a. The IRS addresses additional issues related to the Cadillac Tax and again invites comments. Notice 2015-52, 2015-35 I.R.B. 227 (7/30/15). This notice supplements Notice 2015-16, 2015-10 I.R.B. 732 (2/23/15) by addressing additional issues under § 4980I. These issues include: (1) identification of the taxpayers who may be liable for the excise tax, (2) application of the employer aggregation rules for purposes of § 4980I, (3) allocation of the tax among the applicable taxpayers, (4) the time and manner of payment of the applicable tax, and (5) certain issues regarding the cost of applicable coverage that were not addressed in Notice 2015-16. Treasury and the IRS invite comments (due 10/1/15) on these issues and any other issues under § 4980I. After considering the comments submitted in response to both notices, Treasury and the IRS intend to issue proposed regulations under § 4980I. The proposed regulations will provide further opportunity for comment.

b. Perhaps we spoke too soon. The Cadillac Tax has been delayed for two years. Division P, Title 1, § 101 of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, signed by the President on 12/18/15, delays the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. The legislation also amends Code § 4980I(f)(10) to make payments of the tax deductible for income tax purposes.

3. The medical device tax seems to be on life support. The 2015 PATH Act, § 174, imposes a two-year moratorium on the 2.3 percent excise tax on medical devices of § 4191. Pursuant to the moratorium, the tax will not apply to medical devices sold during calendar years 2016 or 2017.

4. In Steven Spielberg's 1971 film entitled "Duel," a large tanker truck terrorizes a car driven by Dennis Weaver. These proposed regulations address the excise tax implications. REG-103380, Excise Tax; Tractors, Trailers, Trucks, and Tires; Definition of Highway Vehicle, 81 F.R. 18544 (3/31/16). Treasury and the IRS have issued proposed amendments to regulations regarding: (1) the definition of a "highway vehicle" for purposes of various excise tax provisions (Prop. Reg. § 48.0-4); (2) the tax imposed by § 4051 on the retail sale of certain highway-type tractors and chassis and bodies for highway-type trailers and trucks (Prop. Reg. §§ 48.4051-0, -1, -2 and 48.4052-1); and (3) the tax imposed by § 4071 on the sale by a manufacturer of a taxable tire with a maximum rated load capacity greater than 3,500

pounds (among other proposed regulations, Prop. Reg. §§ 48.4071-1, -2, -3 and 48.4072-1). The proposed regulations update, restate and reorganize temporary regulations that were published in 1983 (T.D. 7882, Floor Stocks Credits or Refunds and Consumer Credits or Refunds With Respect to Certain Tax-Repealed Articles; Excise Tax on Heavy Trucks; 48 F.R. 14361 (4/4/83)) and have been periodically amended. The proposed regulations are necessary to reflect statutory changes and address relevant court decisions. The proposed regulations change the result in *Horton Homes, Inc. v. United States*, 357 F.3d 1209 (11th Cir. 2004), which held that so-called “toters,” which are tractor units designed specifically to tow manufactured homes, are not tractors subject to the excise tax imposed by § 4051. The proposed regulations will apply on and after the date final regulations are published in the Federal Register.

XII. TAX LEGISLATION

A. Enacted

1. A dramatic change is coming to the partnership audit rules. The Bipartisan Budget Act of 2015, Pub. L. No. 114-74, was signed by the President on 11/2/15. Among other changes, this legislation repeals the current TEFRA partnership audit rules and Electing Large Partnership rules and replaces them with an entity-level audit process that allows the IRS to assess and collect the taxes against the partnership unless the partnership properly elects out. This change applies to partnership taxable years beginning after 12/31/17. The legislation also amends §§ 704(e) and 761(b) to clarify the determination of whether a person is a partner in a partnership in which capital is a material income-producing factor.

2. Congress tosses an odd mix of tax provisions into year-end legislation. The Fixing America’s Surface Transportation (FAST) Act, Pub. L. No. 114-94, was signed by the President on 12/4/15. Among other changes, this legislation (1) added § 7345, which provides that having a “seriously delinquent tax debt” (generally, an unpaid tax liability that has been assessed and exceeds \$50,000) is grounds for denial, revocation, or limitation of a passport, (2) amends § 6306 to require the IRS to use private debt collection agencies for outstanding inactive tax receivables, and (3) leaves the filing extension at 2-1/2 months for employee benefit plans filing Form 5500 by repealing the 3-1/2 month extension enacted only months earlier in the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, Pub. L. No. 114-41, signed by the President on 7/31/15.

3. Congress enacts a cascade of extenders and makes many provisions permanent at the end of 2015. The Protecting Americans from Tax Hikes Act of 2015, enacted as Division Q of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, was signed by the President on 12/18/15. Among other changes, the legislation retroactively extended through 12/31/15 a myriad of deductions, credits, and special benefit provisions that had expired at the end of 2014, and made permanent (in some cases with modifications) several provisions that previously had been regular extenders, including: (1) fifteen-year straight-line cost recovery for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property; (2) the increased \$500,000 maximum amount that can be expensed under § 179 and the increased \$2 million expenditure ceiling phase-out amount; (3) the § 41 research credit; (4) the exclusion under § 1202 of 100 percent of the gain realized on the sale of qualified small business stock; (5) the § 164(b)(5)(I) election to claim an itemized deduction for state and local general sales and use taxes instead of state and local income taxes; (6) the five-year holding period under § 1374 for recognizing unrealized built-in gain on conversion from a C corporation to an S corporation; and (7) the provisions of § 170 allowing a deduction for a qualified conservation contribution made by an individual or corporate farmer or rancher.

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State Tax Update

TAXATION & REVENUE
NEW MEXICO

State and Local Tax Update

Presented at the New Mexico State Bar: 2016 Tax Symposium
September 23, 2016
Frank Crociata, Tax Policy Director, NMTRD

On the National Stage

- » Sales taxes – *Quill* Challenges
 - Remote vendor informational reporting requirements (CO);
 - Economic nexus laws and regulations (AL, SD).
- » Income taxes –
 - Market-based sourcing and uniformity;
 - Federal partnership audit changes.

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NEW MEXICO
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The Colorado Route Notice and Informational Reporting

- » 2010 statute, codified at Colo. Rev. Stat. § 39-21-112(3.5)(c):
- » Remote vendors that cannot be constitutionally required to collect must:
 - Provide transactional notice to Colorado purchasers that use tax may be due;
 - Provide an annual statement to each Colorado purchaser by Jan. 31st of each year; and
 - Provide an informational report to CDOR by March 1st of each year.
- » Penalties apply to each failure.

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The Colorado Route The Litigation Road

- » Colorado federal district court permanently enjoined enforcement on commerce clause grounds;
- » Tenth Circuit held that the District Court could not enjoin because of the federal Tax Injunction Act;
- » SCOTUS held: (1) Tax Injunction Act was not applicable because the law involved only notice and information requirements, not tax collection; and (2) Justice Kennedy invited a *Quill* challenge;
- » Tenth Circuit Remand – the law does not violate the commerce clause because Colorado is not imposing a tax and it does not place discriminatory burdens on interstate commerce.

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The Colorado Route

- » Louisiana H 1121 (2016) enacted similar notice and reporting requirements, effective July 1, 2017.

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Alabama Economic Nexus

- » Alabama Regulation 810-6-2-.90.03 (effective January 1, 2016).
- » Remote vendors with no physical presence in Alabama must remit use tax on sales to Alabama purchasers if:
 - Sales into Alabama in the previous calendar year exceeded \$250,000; AND
 - The remote vendor satisfies one of the following (among others):
 - Maintains or operates an office or facility (physical presence);
 - Registers to do business in Alabama (physical presence not necessary);
 - Employs or retains a sales solicitor (physical presence);
 - Solicits orders by mail if the solicitations are substantial and recurring (economic nexus) and the vendor benefits from any banking, financing, debt collection, telecommunication, or marketing activities in the state (minimum contacts).
- » Newegg, Inc. filed suit to challenge on June 8, 2016.

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South Dakota Economic Nexus

- » South Dakota Senate Bill 106 (2016) – pure economic nexus.
- » A remote vendor (with no physical presence in South Dakota), who sells tangible personal property, electronically transferred products, or services for delivery into the state must remit sales tax if either:
 - Its gross revenues from sales into South Dakota in the previous calendar year exceeded \$100,000; or
 - It conducted more than 200 separate transactions with South Dakota purchasers during the previous calendar year.

South Dakota Economic Nexus Expedited *Quill* Challenge

- » SB 106 was enacted to get a *Quill* challenge before the US Supreme Court as soon as possible.
- » The bill authorized the state to bring a declaratory judgment action against any taxpayer it believed met the bill's requirements;
- » It enjoined the state from collecting tax while the suit is pending (exception for voluntary compliance or previous nexus decisions);
- » It prohibits retroactive application of the bill and the state can only enforce after the injunction is lifted;
- » Provided for expedited review to SD Supreme Court.
- » Two suits filed on April 28 and 29.
 - State filed DJA against Wayfair, Inc., Systemax, Inc., Overstock.com, and Newegg, Inc.
 - American Catalog Mailers Ass'n and NetChoice filed DJA against the state.

COP, Market-Based Sourcing, and Uniformity

- » About ½ and ½;
- » Income-Producing Activity/Cost of Performance test:
 - All or nothing (original UDITPA);
 - Proportional approach;
- » Market-Based Sourcing Newcomers (2014–2016):
 - DC, MA, NE, NY, PA, RI, TN.
- » Hybrid Regimes.

New Mexico

- ▶ Traditional UDITPA:
 - Income-Producing Activity/COP test;
 - All or nothing;
 - Except for special industry regulations that adopt market-like principles:
 - Publishing, broadcast/print advertising revenues ("circulation factor");
 - Transportation;
 - Financial institutions.

Market-Based Sourcing

- ▶ Intangibles:
 - Commercial domicile;
 - Utilization location.
- ▶ Services:
 - Benefit received;
 - Service delivered;
 - Customer location.

MTC and UDITPA Reform

- ▶ 2014 MTC adopted Market-based sourcing to replace COP:
 - Services – delivered to a location in the state;
 - Intangibles – to the extent the property is used in the state;
 - Marketing
 - Production.
- ▶ Market-based sourcing proposals in NM have generally followed the MTC model.
 - SB 22 (2016);
 - SB 281 (2015);

MTC Section 17 Workgroup

- Model regulations nearing completion and adoption.

Federal Changes to Partnership Audits

- In default situation, IRS will assess the partnership directly.
- State tax consequences for federal partnership audits.
Arizona law.

On the Homefront

- Notable 2015 Legislation:
 - Independent Administrative Hearing Office (§§ 7-18-1 *et seq.*);
 - PIT Angel Investment Tax Credit (§ 7-2-18.17);
 - PIT Out-of-Pocket Medical Expense Deduction (§ 7-2-37);
 - CIT and PTE Return Deadline Extended for e-filers (§§ 7-2A-9, 7-3A-7);
 - CIT Single Sales Factor Election for Corporate Headquarters (§ 7-4-10);
 - Apportionment Throwback Rule for Sales of TPP (§ 7-4-17).

On the Homefront

▶ Notable 2016 Legislation:

- SB 47 – contributions in aid of construction not valued for centrally assessed electric generation utilities. SB 47.
- SB 19 – Out-of-state businesses that conduct limited activities in NM and only in response to declared disasters not engaged in business in New Mexico for licensure and tax purposes.
- SB 211 – technical correction to film credit “assignment.”
- HB 249 – conform NM to federal income tax filing deadlines.



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Continuing Compliance Initiatives

- ▶ Data Mismatch Limited Scope Audits
 - Schedule C/GRT comparison for sole proprietors and FEINs.
- ▶ PIT Above-the-Line Audits.



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Managed Audits (§ 7-1-11.1)

- ▶ Several of the compliance initiatives will identify non-filers.
- ▶ NM managed audit program allows taxpayers to avoid interest and penalties, if the resulting assessment is paid within 180 days.
- ▶ TRD generally allows managed audits for PIT, CIT, GRT/Comp, and Withholding.
- ▶ Agreement with TRD required considering the following factors:
 - Taxpayer's tax compliance history;
 - Taxpayer's resource availability for the audit;
 - Availability of records;
 - Taxpayer's ability to pay.



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Managed Audits

- » Managed audits are akin to VDAs.
- » TRD generally does not enter agreements if:
 - Taxpayer is under audit or has protested an assessment;
 - Taxpayer is not the subject of a collections action;
 - Taxpayer is not under criminal tax investigation;
 - Taxpayer has not previously entered a managed audit agreement for the same tax program(s).

Managed Audit Tracks

- » Option A – is like a true VDA; taxpayer prepares its own liability with minimal input from TRD and TRD reserves the right to verify.
- » Option B – is like a field audit, but conducted by the taxpayer pursuant to an audit plan prepared in conjunction with TRD.

Managed Audits

- » Taxpayers can approach TRD anonymously to determine if their situation meets the general parameters for managed audit eligibility.
- » Agreements must contain declarations of veracity and specify the tax programs, audit issues, timing of audit completion, and, if applicable, a waiver of the statute of limitations to assess.
- » Taxpayers generally have an opportunity to cure audit results not done in conformity with the agreement.

Legislative Discussion Items

- › *Healthsouth* D&O and the GRT taxation of Health Care Industry;
- › NTTCs;
- › Tax Administration Act Clean-up and Corrections;



Thank you!

Our Mission is to administer and enforce New Mexico's tax and revenue laws, vehicle and driver licensing, and transportation programs in a manner warranting the highest degree of public confidence.

<http://www.tax.newmexico.gov/>



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Low-Income Taxpayer Issues

State Bar of New Mexico
Taxation Section

2016 Tax Symposium
September 23, 2016

*Representing Low Income Taxpayers before the IRS:
A Guide for New Mexico Practitioners*

Grace Allison, Adjunct Clinical Professor of Law, UNM LITC, Allison@law.unm.edu
Mary Leto Pareja, Assistant Professor of Law, MPareja@law.unm.edu

- I. How Can Low Income Taxpayers Have Income Tax Problems?
 - A. The Obvious.
 1. Failure to file.
 - a. IRS substitute for return. I.R.C. § 6020(b).
 2. Failure to pay.
 - a. Self-employment tax. I.R.C. §§ 1401-1403.
 - (1) Independent contractor vs. employee?
 - (2) \$400 filing threshold, unchanged since 1989. I.R.C. § 6017.
 - B. The Not-So-Obvious.
 1. Audits/Audit Reconsideration.
 - a. 0.93% audit rate for those with AGI from \$1 to \$25,000.¹
 2. Audit Appeals/Appeals of Audit Reconsideration.
 3. U.S. Tax Court.
 - a. 70 percent of litigants nationwide are pro se.²
 4. Collection Due Process Hearings.
 - a. Liens. I.R.C. § 6320.
 - b. Levies. I.R.C. § 6330.

¹ Inspector General for Tax Administration, Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers, December, 2015.

² T. Keith Fogg, *An Access to Justice Milestone*, ABA Section of Tax'n NewsQuarterly, 10 (Jan. 2013), http://works.bepress.com/cgi/viewcontent.cgi?article=1032&context=t_keith_fogg.

5. Collection Alternatives.

- a. **Currently Not Collectible:** freezes collection activity, but interest and penalties continue to accrue.
 - 1. Considerations: assets, income, hardship. I.R.M. 1.2.14.1.14 and 5.16.1.
- b. **Installment Agreement:** complete payoff over time. I.R.C. § 6159.
- c. **Offer in Compromise:** partial/token payment based on (i) excess of income over expenses and (ii) assets, with consideration of special circumstances. I.R.C. § 7122 and the regulations thereunder.

6. Innocent Spouse: remedy for victims of domestic abuse.

- a. If filed joint return, not liable for spouse's understatements or underpayments. I.R.C. §6015.
- b. If filed separate return, allocation of liability based on income. I.R.C. § 66(c).

C. New Mexico Taxes

- 1. Substantive federal income tax issues often carry over into a New Mexico income tax return. E.g., if federal AGI is off, then the New Mexico return will also be off.
- 2. Failure to file and pay gross receipts taxes.
 - a. Tax on services as well as goods surprising to many new residents.
 - b. Income tax return preparers do not ask about gross receipts taxes.
 - c. "Gig economy" work common.

II. The UNM Low Income Taxpayer Clinic

A. How Are We Funded? University funds + matching grant (\$100,000 maximum) from the IRS Taxpayer Advocate Service.

B. Who Are Our Clients?

- 1. Income limits. Generally, income cannot exceed 250% of federal poverty level, e.g. \$29,700 for a single individual, \$60,750 for a couple with two children. Usually, income of our clients is much lower. I.R.C. § 7526(b)(1)(B)(i).
- 2. Amount in controversy limits. Amount of tax and penalties for any tax year cannot exceed \$50,000. I.R.C. § 7526(b)(1)(B)(ii).
- 3. Demographics. In 2015, we handled 54 client cases and 28 brief consultations in at least 12 counties throughout New Mexico. Ten percent of our clients are Native American.

C. Who Works Our Cases?

1. Clinical Law Students, supervised by UNM faculty. 10-12 per semester.

III. The UNM Pro Bono Panel

A. Inception: Summer 2015. Among the first volunteers, former Dean Robert Desiderio; attorneys Pat Tucker, Erin Ferreira and Vince Haslam; former Clinical Law Students.

B. Practitioners and Cases: Currently, we have ten practitioners on our Panel handling 11 cases, including audits, appeals, offers in compromise, and one innocent spouse claim. Overflow from UNM LITC and brand-new NMLA LITC.

C. Joining the Panel: Just fill out the attached Practitioner Information Form and e-mail to Grace Allison, Allison@law.unm.edu. We will call you!

D. Process:

1. We send you client intake memo and client contact information.
2. You interview client, decide whether to take the case.
3. Grace and Pro Bono Panel Coordinator Peter Marks are available to answer questions, share samples and provide supplementary training materials.
4. You send us a brief status report monthly + executed representation agreement (we provide template).
5. We include your case activity in our semi-annual reports to the Taxpayer Advocate Service. (All identifying information is redacted.)

IV. Where to Begin? The Basics

A. Interview

1. All IRS correspondence.
2. Tax returns for relevant years.

B. Documentation:

1. Representation letter. (We supply pro bono template.)
2. IRS Form 2848.
3. New Mexico Taxpayer Information Authorization, if needed (attorneys or accountants licensed in New Mexico do not need this form).

C. Tax Transcripts

1. IRS wage and income transcripts (e-services or Practitioner Priority Hotline).
2. IRS account transcripts (e-services or Practitioner Priority Hotline).
3. New Mexico transcripts (Taxpayer Access Point or 505-827-0951).

D. Resources

1. Practitioner Priority Hotline: 1-866-860-4259.

2. www.irs.gov
 - a. Forms.
 - b. Publications.
 - c. Fact sheets.
 - d. Internal Revenue Manual.
3. Effectively Representing Your Client Before the IRS, 6th ed. Order from www.americanbar.org.

Practical Pointer: Assess, Assess, Assess

1. What tax years are at issue? (Get transcripts!)
2. Who is the taxing authority? (IRS, NMTRD, both, other state?)
3. Which tax? (Income tax, self-employment tax, gross receipts tax?)
4. Who are the taxpayers? (Joint filers? Married filing separately?)
5. Where is the controversy procedurally? (audit, IRS appeals, U.S. Tax Court, collections?)
6. Is there a deadline?
7. Are there defenses to the liability (even if already in collections)?
8. Can I ask for a penalty abatement?
9. Are there collection alternatives?

V. Child-Based Tax Benefits

A. The Common Code Sections

1. Dependency Exemption, I.R.C. §§ 151, 152.
2. Earned Income Tax Credit. I.R.C. § 32.
3. Child Tax Credit. I.R.C. § 24.
4. Premium Tax Credit. I.R.C. § 36B.
5. Filing Status and Standard Deduction. I.R.C. § 1 (tax rates for each filing status) and § 63(c) (standard deduction for each filing status).
 - a. Definition of surviving spouse. I.R.C. § 2(a).
 - b. Definition of head of household. I.R.C. § 2(b).
 - c. Joint and Separate Returns for married couples. I.R.C. § 6013.
 - d. Definition of married. I.R.C. § 7703.

Practical Pointer:

Most low-income taxpayers use paid preparers³ who are often unqualified to analyze complex issues surrounding child-related tax benefits. In addition, these preparers may charge fees which exceed the average amount (\$275) spent by most Americans.⁴ For free tax-season preparation locations throughout New Mexico, using trained volunteers, go to <https://www.cnm.edu/depts/taxhelp/site>.

B. The Critical Concepts.

1. Deduction vs. credit
 - a. Deduction reduces income dollar for dollar.
 - b. Credit reduces tax dollar for dollar.
 - c. Deductions are more valuable for higher income (and higher rate) taxpayers.
2. Refundable credit vs. non-refundable credit
 - a. Non-refundable credit is useful only if taxpayer owes tax.
 - b. Refundable credits generate a refund, even for a taxpayer who owes no tax.
3. Interrelationship between filing status and ordinary income tax rates.

Married Filing Jointly		Head of Household		Single	
<i>Taxable Income</i>	<i>Rate</i>	<i>Taxable Income</i>	<i>Rate</i>	<i>Taxable Income</i>	<i>Rate</i>
Not over \$18,550	10%	Not over \$13,250	10%	Not over \$9,275	10%
\$18,551- \$75,300	15%	\$13,251-\$50,400	15%	\$9,276-\$37,650	15%
\$75,301- 151,900	25%	\$50,401-\$130,150	25%	\$37,651-\$91,150	25%
\$151,901-231,450	28%	\$130,151-\$210,800	28%	\$91,151-\$190,150	28%
\$231,451-413,350	33%	\$210,801-\$413,350	33%	\$190,151-\$413,350	33%
\$413,351-466,950	35%	\$413,351-\$441,000	35%	\$413,351-\$415,050	35%
Over \$466,950	39.6%	Over \$441,000	39.6%	Over \$415,050	39.6%

Example. Little Miss Muffet has \$20,000 of taxable income in 2016. She has one child. How much of her income will be taxed at 15% if she files as Head of Household? As Single?

4. Interrelationship between filing status and standard deduction amount.
 - a. Taxpayers can either itemize deductions (e.g. for real estate tax or mortgage interest) or take the “standard deduction,” an approximation of total itemized deductions for an average taxpayer. I.R.C. § 63(c).
 - b. Most low-income taxpayers take the standard deduction.

³ <http://www.taxpolicycenter.org/briefing-book/key-elements/poor/paid-preparers.cfm>.

⁴ Gillian B. White, *How the Tax-Prep Industry Takes Advantage of Low-Income Filers*, THE ATLANTIC (April 14, 2016).

- c. In 2016, the standard deduction is:
 - (1) \$6,300 for Single;
 - (2) \$9,300 for Head of Household; and
 - (3) \$12,600 for Married Filing Jointly.

Example. Jill earns \$12,000 in 2016. The standard deduction reduces her taxable income to \$2,700. Using the head of household tax brackets, at a 10% tax rate, the \$9,300 standard deduction would save her \$930 in tax.

C. The Crucial Definitions

- 1. Qualifying Child: I.R.C. § 152(c)(1). Qualifying Child status is especially valuable because it is required for the EITC, CTC, PTC. Four key requirements:
 - a. Age: Under 19; under age 24 if full time student, any age if “permanently and totally disabled.” The qualifying child also must be younger than the taxpayer.
 - b. Relationship.
 - (1) child (defined at C.3. below) or descendant of child.
 - (2) brother, sister, half-brother, half-sister, stepbrother, stepsister, or descendant of any of them
 - c. Residency: Dependent lives with taxpayer for more than one half of the calendar year.
 - d. Support: Dependent does not provide more than one half of his or her own support (see V.C.4. below)

If the potential dependent is married or files his or her own tax return, special rules may apply.

- 2. Qualifying Relative: I.R.C. § 152(d)(1). Three key requirements:
 - a. Relationship to taxpayer. I.R.C. § 152(d)(2).
 - (1) child (defined at C.3. below) or descendant of child.
 - (2) brother, sister (including half-blood), stepbrother or stepsister.
 - (3) father or mother, or ancestor of either.
 - (4) stepfather or stepmother.
 - (5) son or daughter of a brother or sister (including half-blood).
 - (6) brother or sister (including half-blood) of a father or mother.
 - (7) son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
 - (8) Any individual (even if not related by blood, marriage, or government action) if, for the ENTIRE TAXABLE YEAR, the

dependent has the “same principal place of abode” as the taxpayer and is a “member of the taxpayer’s household.”

- b. Low Income. The Qualifying Relative must have gross income under the personal exemption amount (\$4,050 for 2016).
- c. Support. The taxpayer must provide more than one-half of the qualifying relative’s support.

If the potential dependent is married or files his or her own tax return, special rules may apply.

- 3. “Child”: Blood, marriage, or government action is critical. Self-help family arrangements do not count for tax purposes. I.R.C. § 152(f)(1). Child includes only:

- a. Son, daughter, stepson, stepdaughter of the taxpayer.
- b. Eligible foster child, defined as “an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.” There are no Treasury regulations defining “authorized placement agency” for this purpose.⁵
- c. “[L]egally adopted individual” or “an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer.”

- 4. “Support”:

- a. Support is not defined in the Code. Look to Treasury regulations, case law and IRS guidance for help as to what counts as support and who is considered to be the source of support. Proof issues loom large.
- b. Be sure to distinguish between the dependent providing their own support, the taxpayer providing support and public agencies or third persons providing support.

⁵ Interestingly, there is a definition of “authorized placement agency” for adopted children: “any agency which is authorized by a State, the District of Columbia, a possession of the United States, a foreign country, or a political subdivision of any of the foregoing to place children for adoption.” Treas. Reg. Sec. 1.152-2(c)(2). At least one commentator has speculated that this definition “should apply for purposes of foster child placement,” presumably by substituting “foster care” for “adoption.” James Edward Maule, Family and Household Transactions, Tax Management Portfolio 513, Bureau of National Affairs, A-52 (2015). There is also a proposed Treasury regulation, issued in 2000 but never made final, which would expand the definition of “authorized placement agency” to include “biological parents and other persons authorized by state law to place children for legal adoption.”

- c. Some common sources of support:
 - i. Earned income and investment income received by a potential dependent count as the dependent providing their own support, but only if the money is actually spent on support items. *See* Dick v. United States, 218 F. Supp. 839 (E.D. Wis. 1963); *see also* IRS, Publication 17: Your Federal Income Tax for Individuals 34 (2016).
 - ii. Non-needs-based Social Security benefits paid on behalf of the potential dependent (such as survivor's benefits) count as the dependent providing their own support if the money is actually spent on support items. *See id.*; *see also* Rev. Rul. 57-344, 1957-2 C.B. 112.
 - iii. Needs-based support payments provided by a state, such as SNAP (food stamps), TANF (welfare), or housing subsidies are considered support provided by the state, not the potential dependent, unless the payments are not used for support. *See supra* IRS, Publication 17; *see also* Lutter v. Comm'r, 514 F.2d 1095 (7th Cir. 1975), Rev. Rul. 71-468, 1971-2 C.B. 115.
 - iv. Foster care payments by a placement agency are support provided by the agency, not the potential dependent. *Id.*

D. Tie Breaker Rules. What happens if someone qualifies as the dependent of more than one taxpayer? Tie breaker rules apply in most situations.

- 1. Parent v. Parent:
 - a. Parents of a qualifying child may allocate certain child-related tax benefits between themselves.
 - i. Note that this tie-breaker rule applies only if each parent has a qualifying child relationship to the child. A different rule (discussed in V.N. below) allows a parent with a qualifying child relationship to formally allocate certain child-based tax benefits to a parent without a qualifying child relationship.
 - b. If the parents don't allocate the child-based tax benefits, and if more than one parent *actually claims* the child as a qualifying child, then the parent with whom the child lived longer during the year is granted the dependency exemption. I.R.C. § 152(c)(4)(B). If the child lived with the parents an equal amount of time, then the parent with the higher AGI is allowed to claim the child. *Id.*
 - c. **For example**, if a child lives with his unmarried mother, and in April both move into the father's home, the mother may claim the child because the child lived with her longer. However, if the mother does

not actually claim the child, despite being allowed to do so, then the father may claim the child.

2. Qualifying Child v. Qualifying Relative:

- a. If the dependent is the qualifying relative of one taxpayer and the qualifying child of another taxpayer, only the taxpayer with the qualifying child relationship may claim the dependent. I.R.C. § 152(d)(1)(D).
- b. **For example**, if a child lives with her mother (and is a qualifying child to her) and the mother's boyfriend (and is a qualifying relative to him), the child may be claimed by the mother, but not the boyfriend.

3. Parent v. Non-Parent:

- a. If the dependent is the qualifying child of two or more taxpayers, one of whom is the parent, the child's parent is allowed to claim the child. I.R.C. § 152(c)(4)(A).
- b. Effectively, an eligible parent has a right-of-first refusal against any non-parent to claim his or her child
- c. However, if an eligible parent does not claim the child, another taxpayer may do so—as long as that other taxpayer has an AGI greater than the otherwise-eligible parent. I.R.C. § 152(c)(4)(C).
- d. **For example**, if a child lives with the child's mother and grandmother, the mother is entitled to claim the child. If the mother does not do so, the grandmother may claim the child, but only if the grandmother's AGI is higher than the mother's AGI.

4. Non-Parent v. Non-Parent:

- a. If more than one non-parent can claim the dependent as a qualifying child, the one with the highest AGI is allowed to claim the dependent. This is true provided that either (1) the parents are not eligible to claim the child or (2) the parents do not actually claim the child and any otherwise-eligible parent has a lower AGI than the non-parent allowed to claim the child. I.R.C. § 152(c)(4)(C).
- b. **For example**, if a child lives with his grandmother and aunt (and is a qualifying child to both of them), the person with the higher AGI is the one who may claim the child.

5. **Notice that only parents may change the result of the tie-breaker rules by not claiming the child or agreeing to allow another person to claim the child.**

Practical pointer:

In the initial interview, it is important to carefully explore the relationships between the people in the family and the household. Draw a family tree and confirm relationships are by blood, marriage, or government action.

It is also important to understand where the household's income comes from.

E. The Most Common Situations

1. Taxpayer has legitimate claim to child-related tax benefits, but cannot substantiate that he/she is head of household and/or that child is a qualifying child.
 - a. Unbanked clients who pay in cash.
 - b. Lack of documentation to prove a period of residence.
2. Taxpayer is a non-custodial parent
3. Taxpayer shares custody with other parent and other parent claims the child.
4. Taxpayer is not a parent
 - a. Grandparents
 - b. Significant others
 - c. Aunties and Uncles

Practical pointer:

Nontraditional families (in particular, households headed by single fathers, grandparents, or relatives other than the mother) and multi-generational households face a disproportionate audit rate for EITC and other child-related tax benefits.

F. The Dependency Deduction, aka Additional Exemption for Dependents. I.R.C. §§ 151, 152.

1. Permitted only for a qualifying child or a qualifying relative.
2. \$4,050 federal income tax deduction for each qualifying child or qualifying relative in 2016.

G. Child Tax Credit. I.R.C. § 24.

1. \$1,000 potential credit against tax for each qualifying child; credit in excess of tax liability is refundable. I.R.C. §§ 24(a) and (d).
2. The qualifying child must be under age 17. I.R.C. § 24(c).

H. Head of Household Filing Status. I.R.C. § 2(b).

1. The taxpayer must be properly treated as unmarried under I.R.C. §§ 2(b)(2) or 7703(b) as of the last day of the tax year.

- a. To be considered unmarried under I.R.C. § 2(b)(2), the taxpayer must be legally separated by court order, have a spouse that is a nonresident alien, or have a spouse who died during the year.
 - b. To be considered unmarried under I.R.C. § 7703(b), the taxpayer must not have lived with his or her spouse the last 6 months of the year and the taxpayer must not file a joint return with the spouse.
- 2. If the taxpayer is properly treated as unmarried, the taxpayer may qualify as head of household if either
 - a. The taxpayer shares (as a principal place of abode) the home for more than one-half of the year with (1) a qualifying child, or (2) a qualifying relative who is actually related to the taxpayer as described in I.R.C. § 152(d)(1)(A)-(G); or
 - i. If the taxpayer is qualifying as unmarried under I.R.C. § 7703(b) due to not having lived with his or her spouse during the last six months of the tax year, the person who lives with the taxpayer must be the taxpayer's child, stepchild, or foster child. I.R.C. § 7703(b) by cross-reference to I.R.C. § 152(f)(1).
 - b. The home is being maintained by the taxpayer for the taxpayer's mother or father, even if the taxpayer doesn't live there. I.R.C. § 2(b)(1)(B).
- 3. The taxpayer must pay more than one-half of the cost of maintaining a home.
 - a. Distinguish this from paying more than one-half of the dependent's support. Home cost includes things like rent and utilities. Dependent support also includes things like food, clothes, medical care, and education.
 - b. If the taxpayer is actually married, but properly treated as unmarried for income tax purposes, community property may affect the income and expenses the taxpayer may claim are used to maintain a household.

I. The Prime Mover: Earned Income Tax Credit, I.R.C. § 32

- 1. What is it?
 - a. Refundable tax credit, claimed on Form 1040 annually and administered by the I.R.S.
 - b. Largest U.S. social welfare program providing income support for the working poor. In 2015,
 - (1) 27.5 million U.S. households received roughly \$66.7 billion in EITC.
 - (2) 214,000 New Mexico households received roughly \$515 million in EITC.⁶

⁶ Internal Revenue Service, Statistics for Tax Returns with EITC, July 2016.

Practical pointer:

One in five households entitled to the EITC fails to claim it.⁷ Translation: New Mexico families are losing millions annually.

Needed: outreach by NM legal community to educate low-income families about the EITC.

- c. Maximum EITC benefits per household in 2016 (I.R.C. § 32(b)(2); Rev. Proc. 2015-53, I.R.B. 2015-44):

\$506 for those who work but have no children.

\$3,373 for workers with one qualifying child.

\$5,572 for workers with two qualifying children.

\$6,269 for workers with three or more qualifying children.

2. Who qualifies for it? I.R.C. § 32(c)

- a. Generally, individuals without children if they
- Are between 25 and 65;
 - Have a principal place of abode within the U.S. for more than half the year; and
 - Are not a dependent of another taxpayer for the same tax year.
- b. Generally, individuals with a qualifying child.

3. Earned income and AGI limits for the EITC.

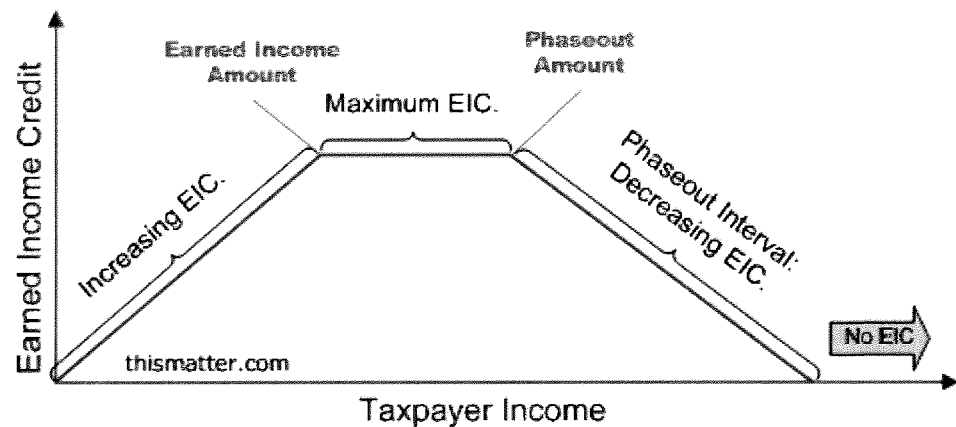
- a. The EITC is a percentage of earned income, up to certain limits, and with a cap on the maximum credit available.
- b. The EITC is targeted to low-income families. To be EITC-eligible in 2016, household earned income and adjusted gross income (AGI) must each be less than:

If filing...	Qualifying Children Claimed			
	Zero	One	Two	Three or more
Single, Head of Household or Widowed	\$14,880	\$39,296	\$44,648	\$47,955
Married Filing Jointly	\$20,430	\$44,846	\$50,198	\$53,267

Example: In 2015, Jack and Jill filed jointly, claiming an enhanced EITC based on their three children. The couple's combined earned income is \$25,000; they have no other income. Their earned income tax credit is \$4,785.⁸

⁷ IRS, EITC Fast Facts, www.irs.gov.

- c. There is a phase-in range within which, as income rises, so does the EITC.
- d. There is a plateau: At the plateau, even if income rises or falls, the EITC is steady (at the maximum credit amount).
- e. There is a phase-out range within which, as income rises, the EITC is reduced.



- f. Receiving the EITC has a demonstrated positive impact on children.
 - (1) In 2013, the benefits of (i) the earned income tax credit and (ii) the child tax credit equaled an estimated 8.1 percent of after-tax income for households with income in the lowest 20%.⁹
 - (2) Benefits for children:
 - (a) Health, e.g. each \$1,000 of EITC reduces incidence of low birth rate by two to three percent.¹⁰
 - (b) Educational achievement.¹¹
 - (c) Food security¹²

⁸ Instructions, 2015 Form 1040.

⁹ Congressional Budget Office, The Distribution of Major Tax Expenditures in the Individual Income Tax System, May, 2013.

¹⁰ Hilary W. Hoynes, Douglas L. Miller, and David Simon, Income, the Earned Income Tax Credit, and Infant Health, American Economic Journal: Economic Policy 7(1): 172-211, February 2015.

¹¹ Chuck Marr, Chye-Ching Huang, and Arloc Sherman, Earned Income Tax Credit Promotes Work, Encourages Children's Success at School, Research Finds, Center on Budget and Policy Priorities, April 15, 2014; Gordon B. Dahl and Lance Lochner, The Impact of Family Income on Child Achievement: Evidence from the Earned Income Tax Credit, American Economic Review 2012, 102(5): 1927-2956.

¹² David H. Rehkopf, Kate W. Strully and William H. Dow, The short-term impacts of Earned Income Tax Credit disbursement on health, International Journal of Epidemiology, 1884, 1886, August 2014.

- J. Dependent Care Credit. I.R.C. § 21. Up to \$1,050 for care expenses incurred for each “qualifying individual”; up to \$2,100 for two or more children.
 - 1. Nonrefundable.
 - 2. Available only if expenses are employment-related.
- K. American Opportunity Tax Credit. I.R.C. § 25A. Up to \$2,500 for “qualified tuition expenses” paid (i) by the student or (ii) on behalf of a student for whom the taxpayer can claim a dependency deduction
 - 1. Credit is up to 40 percent refundable.
 - 2. “Qualifying tuition expenses” means tuition and fees required for education of the taxpayer, his spouse, or any dependent.
- L. Adoption credit. I.R.C. § 23. Generally, up to \$13,640 of actual non-reimbursed adoption expenses for an “eligible child.”
 - 1. \$13,640 credit for special needs child, regardless of actual expenses.
- M. Premium Tax Credit. I.R.C. § 36B.
 - 1. A refundable tax credit for taxpayers with modified household AGI between 100% and 400% of the federal poverty level who purchase qualifying health coverage on an ACA Marketplace.
 - a. For 2016, the modified household AGI range is between \$11,770 and \$46,800 for a single person; each additional family member adds \$4,160. All figures are slightly higher in Alaska and Hawaii.
 - 2. Credit amount is the premium amount for a “benchmark plan” less the expected taxpayer contribution toward the premium. The taxpayer’s contribution varies depending on the taxpayer’s modified household AGI and ranges from two percent of income to 9.5 percent of income.
 - 3. Household income generally includes income from all people listed on the tax return, including the taxpayer, spouse, and all dependents.
 - 4. Credit is payable in advance, but credit amount is based on credit-year income. Advance payments must be reconciled on Form 8962, attached to the credit-year Form 1040.
- N. Allocating child-related tax benefits.
 - 1. A child could “reside” with, e.g.
 - a. Married parents.
 - b. Two divorced parents, joint physical custody; both parents work.
 - c. Single working mother/father. The other parent is absent.
 - d. Two unmarried parents, at least one of whom works.
 - e. Two unmarried parents, not living together, joint physical custody.
 - f. Grandparent who works.
 - g. Several different relatives throughout the year.
 - h. Several relatives in a multi-generational household, with or without a parent present.

- i. Non-relatives.
- j. A combination of relatives (possibly including parents) and non-relatives.
- k. Foster parents. Assume at least one foster parent works.

Look to the tie-breaker rules (V.D. above) where a child is a tax dependent of more than one taxpayer.

Practical pointer:

The less income the family has, the more likely that residency will be fluid.¹³ This makes the residency test particularly ill-suited to non-traditional low-income families, where the child may move between households throughout the year.

2. I.R.C. §§ 152(e), 24(a) and 25A(f)(1)(A)(iii) allow allocation of three child-based tax benefits—the dependency deduction, the child tax credit, and the American Opportunity tax credit—from a custodial parent to a non-custodial parent, *but only if the parents are divorced, formally separated or have lived apart for the last six months of the year.*

The screenshot shows the IRS Form 8332, "Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent". The form is for the current year (Part I) and future years (Part II). It includes fields for the noncustodial parent's name and SSN, the child's name, and the custodial parent's signature and SSN. The form is dated January 2010 and has an OMB No. 1545-0074. The form is titled "8332 Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent". The form is for the current year (Part I) and future years (Part II). It includes fields for the noncustodial parent's name and SSN, the child's name, and the custodial parent's signature and SSN. The form is dated January 2010 and has an OMB No. 1545-0074.

¹³ Elaine Maag, H. Elizabeth Peters, and Sara Edelstein, Increasing Family Complexity and Volatility: The Difficulty in Determining Child Tax Benefits, Tax Policy Center, March 3, 2016.

- a. For purposes of Form 8332, the “custodial parent” is the parent who has physical custody of the child for the greater portion of the taxable year.
- b. In order to claim a dependency exemption, child tax credit or American Opportunity tax credit with respect to children of the dissolved relationship, the “non-custodial parent” must file a separate Form 8332 with his or her federal income tax return for each year that he or she claims those tax benefits with respect to each of those children.
- c. Filing the Form 8332 does not entitle a non-custodial parent to claim an earned income tax credit with respect to the children of the dissolved relationship, to claim head of household status with respect to those children or to claim the child and dependent care credit with respect to them. The federal income tax law allocates those tax benefits only to the parent with whom the child resides for more than half the year.

Practical pointer:

Form 8332 should be, at a minimum, referenced whenever the parties agree to shift income tax benefits:

“The parties agree that B shall claim children Y and Z as dependents for federal income tax purposes in alternate years. A has signed, and delivered to B, Forms 8332 releasing the dependency exemption for Y and Z for alternate years, beginning in 2016 and ending in 2024.”

Consider adjusting support obligations to account for the value of the shifted tax benefits.

O. Applying the child-based tax benefit rules.

1. **Hansel and Gretel, ages six and nine, live with their parents, who are married to each other and who both work. The parents support the children.**

On these facts, Hansel and Gretel are “qualifying children” for purposes of the dependency deduction, the child tax credit and the earned income tax credit. The parents can claim all three tax benefits on their Form 1040 if they file married, filing jointly. (The earned income tax credit is not available to those who file married, filing separately.)

2. **The parents of Hansel and Gretel are divorced; under the custody order, the children are to live with their father, with each parent “permitted to claim one child” on his or her Form 1040. There are no Forms 8332.**

There is a major problem here. Federal income tax law does not look to the custody order or parenting agreement to determine which child-related federal

income tax benefits divorced parents can claim on their Forms 1040. In the absence of a Form 8332, each child is “treated as the qualifying child of the parent with whom [they] resided for the longest period of time during the taxable year.” I.R.C. § 152(c)(4)(B)(i).

Accordingly, the father and only the father is entitled to all the applicable child-related tax benefits. *See also* Cappel v. Comm., T.C. Memo, 2016-150 (Aug. 10, 2016).

3. **Same facts as above, but Hansel and Gretel reside with both parents for the same amount of time.**

They will be “treated as the qualifying child of . . . the parent with the highest adjusted gross income.” I.R.C. § 152 (c)(4)(B)(ii).

4. **Little Red Riding Hood lives with her Grandmother, who works at a minimum-wage job in the local wildlife sanctuary. Assume neither of the child’s parents could claim her as a qualifying child, because neither lives with her.**

Grandmother can claim Hood as a qualifying child for purposes of the dependency exemption, child tax credit and earned income tax credit.

VI. Special Problems for Immigrants Who Are Not Yet Citizens.

A. Filing Requirements. Undocumented immigrants living in the U.S. must file income tax returns to report their income under the same rules that apply to U.S. citizens. I.R.C. § 6112. BUT . . . if they do not have a social security card, THEY MUST OBTAIN AN ITIN (“Individual Tax Identification Number”) in order to file, not an easy task. I.R.C. § 6109.

1. Immigrants without a social security number obtain an ITIN by filing Form W-7. The Form W-7 is generally submitted with the current year income tax return—and must be accompanied by original or certified supporting documents.
2. In order to file a joint return—or to claim dependents—the spouse and dependents must also have an ITIN or social security number. I.R.C. § 6109.
3. Under the PATH Act,¹⁴ if not used on a Federal income tax return for a period of three consecutive years, the ITIN expires.
4. Also under the PATH Act, ITINS issued before 2013 expire according to a statutory schedule, based on the date of issuance.

¹⁴ Section 203 of the Protecting Americans from Tax Hikes Act, enacted December 8, 2015.

- a. Notice 2016-48, I.R.B. 2016-33 purports to modify the statutory schedule by providing for the renewal of ITINs issued prior to January 1, 2013 and currently in use.
- b. Under the Notice, in August of 2016, the I.R.S. must begin notifying individuals having ITINS with the middle digits of “78” or “79” that their ITINS will no longer be in effect beginning January 1, 2017.
- c. Renewals may be submitted either starting October 1, 2016 or submitted with the 2016 Form 1040.

B. Child-related tax benefits. The rules governing child-related tax benefits, which we have seen are complex, are even more so for undocumented immigrants.

1. *Head of household filing status* may be claimed if the immigrant’s household is the principal place of abode for a qualifying child as defined in I.R.C. § 2(b)(1)(A)(i). *Note: child may be a qualifying child even if not a citizen so long as he/she is a resident of the U.S. and has an ITIN or social security number.* I.R.C. § 152(b)(3)(A).
2. For purposes of the *dependency deduction*, dependents can be either qualifying children or qualifying relatives. If a child meets the qualifying relative tests, he/she may be claimed as a dependent even if not a citizen so long as he/she is a resident of the U.S., Canada or Mexico and has an ITIN or social security number. I.R.C. § 152(b)(3)(A).

Example. Although Elsa lives and works in New Mexico, one of her three daughters still lives in Mexico with Elsa’s mother.

Elsa’s daughter is not Elsa’s qualifying child because she does not live with Elsa for more than half the year. Nevertheless, Elsa can claim her daughter as a dependent under the “qualifying relative” tests because she provides over one half of her support and because the daughter has an ITIN.

3. Child tax credit may not be claimed unless the child is a dependent who is a qualifying child and a citizen or resident of the U.S. *The child must have a social security number or ITIN.* I.R.C. § 24(c)(2).
4. Earned income tax credit may only be claimed by those immigrants who have a social security card that authorizes them to work. I.R.C. § 32(m). The enhanced earned income tax credit for those with children may only be claimed if:
 - (1) *the child has an ITIN or social security number; and*
 - (2) *the child’s “principal place of abode” is the U.S.*
5. American Opportunity tax credit may be claimed only if the student has an ITIN or social security number. I.R.C. § 25(A)(g)(1).

C. Tax preparation for this population is problematic.

1. Translation capability at free VITA sites (Tax Help New Mexico) is haphazard.
2. Notario fraud.
3. Other unscrupulous tax preparers mislead clients about the law.

VII. Collections Alternatives: The Nitty Gritty.

A. Currently Not Collectible Status.

1. “Collection of the liability would create a hardship for taxpayers by leaving them unable to meet necessary living expenses.” I.R.M. 5.16.1.
2. Does not toll the statute of limitations on collections.
3. Interest and penalties continue to accrue.
4. To Apply: Call Practitioner Priority Hotline.
 - a. Agent will likely ask for information on Form 433-F.
 - b. May have to submit completed form 433-F.
 - c. Can use Financial Standard amounts for many expenses: IRS Collection Financial Standards, <https://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards>.
5. New Mexico has a limited version of this called Hardship Status.

B. Installment Agreements.

1. Guaranteed installment agreement (financial analysis not required).
<https://www.irs.gov/individuals/online-payment-agreement-application>.
 - a. Liability less than \$10,000.
 - b. Must pay within three years.
 - c. Must remain compliant with all filing and payment requirements.
2. Streamlined installment agreement (financial analysis not required).
<https://www.irs.gov/individuals/online-payment-agreement-application>.
 - a. Aggregate liability (tax, interest, penalties) is \$50,000 or less.
 - b. Must pay within six years.
 - c. Must remain compliant with all filing and payment requirements.
 - d. If balance due is greater than \$25,000, must enroll in direct debit.
3. Regular installment agreement (Forms 9465 and 433 required).
4. New Mexico also will enter into installment agreements to pay off tax liability over time (generally up to a 5 year period).

C. Offer-in-Compromise. I.R.C. § 7122 and the regulations thereunder. Form 656 Booklet (Form 656 + Form 433-A(OIC))

1. Section 7122 (a) allows the IRS to “compromise” a taxpayer’s liability, i.e. to accept partial payment for the amount due

Practical pointer

If a loan will be used to finance an offer in compromise, attach the commitment letter to the offer in compromise package.

2. The Form 656 Booklet, “Offer in Compromise” contains the forms required to submit an offer in compromise, as well as instructions. ***Warning: the Form 656 Booklet does not include the IRS Collection Financial Standards, which are critical, as explained below.***
3. The “minimum offer amount” is calculated based on both personal asset information and net income (household income – household expenses). Before completing the household expense items, be sure to consult the IRS Collection Financial Standards, found at www.irs.gov/Individuals/Collection-Financial-Standards. In some cases, taxpayers can calculate household expenses based on the greater of actual expense or the national standard. See I.R.C. § 7122(d).
4. Prior to filing, must have filed all required income tax returns. Get transcripts!
5. If there are “special circumstances,” the IRS may, in its discretion, accept an offer amount which is less than the “minimum offer amount.” Taxpayers must document “special circumstances,” so be prepared with photos, medical records, turn-down letters for a mortgage—or whatever else is pertinent.
6. While the offer is pending—and through the end of the calendar year in which the offer is paid—the IRS will apply any refund to which the client would otherwise be entitled to offset the outstanding tax. See Treas. Reg. § 301.7122-1(g)(5) and Treas. Reg. § 301.6402-1.
7. The taxpayer generally must agree to extend the statute of limitations on assessment while the offer is pending with the IRS.
8. The offer in compromise will be rescinded if the taxpayer fails to timely file all required returns and pay all required taxes for five years after the date the offer is accepted. Our practice is to remind taxpayers of this requirement both before and after their offers are accepted.
9. New Mexico does not allow an offer in compromise to settle tax debt.

VIII. Innocent Spouse. I.R.C. §§ 61(c) and 6015. IRS Form 8557.

A. Innocent spouse who files a joint return. Relief in certain circumstances from joint and several liability for filers of joint returns. I.R.C. § 6015.

1. Election under I.R.C. § 6015(b): relief from liability for understatement of tax resulting from items attributable to the non-requesting spouse.
2. Election under I.R.C. § 6015(c): allocation of income tax deficiency between the two spouses. Note: refunds are not available under this section.
3. Equitable relief under I.R.C. § 6015(f): relief from liability for unpaid tax or deficiency. See Rev. Proc. 2013-34.

B. Innocent spouse who does not file a joint return but lives in a community property state: relief from liability for certain community property income. Equitable relief under I.R.C. § 66(c). See Rev. Proc. 2013-34.

IX. Everything We Didn't Cover: Statute of Limitations, Refunds, Penalty Abatement, Et Cetera, Et Cetera, Et Cetera.

NOTE: This outline is intended as an informal guide and is not, and is not intended to be, a complete statement of the law. Readers, including practitioners, should under no circumstances rely on the information herein as a substitute for their own research or for obtaining specific tax advice from their own counsel.

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(Revised September 6, 2016)

University of New Mexico School of Law Clinical Law Programs
Low Income Taxpayer Clinic
Pro Bono Panel Practitioner Information Form

Name: _____

Contact Information:

Preferred phone _____

Firm: _____

Email _____

Work Address: _____

If you are an **attorney**, are you licensed to practice law in NM? Yes/No

If so, year of admission: _____; bar #: _____.

If not licensed in NM, are you licensed in another state?

If so, year of admission: _____; bar #: _____.

If you are a **CPA**, are you licensed to practice as an accountant in NM? Yes/No

If so, year of license: _____; license #: _____.

If not licensed in NM, are you licensed in another state?

If so, year of admission: _____; license #: _____.

If you are an **enrolled agent**, please give us your enrolled agent number: _____

Briefly describe some of the income tax issues you have worked on in recent years.

What percentage of your work is income tax matters? _____

What kinds of income tax matters are you willing to consider for referral? (Check as many as apply)

____ Collections alternatives/lien release or withdrawal

____ Examinations and administrative appeals

____ Family tax benefits (e.g. denial of earned income/child tax credit)

____ Divorce and domestic relations tax issues (e.g. innocent spouse relief)

____ U.S. Tax Court Date admitted: _____

Are you willing to provide advice and counsel by phone?

Are there any pending disciplinary actions against you?

How did you hear about the UNM Low Income Taxpayer Clinic?

I hereby certify that the information provided above is true and complete as of the date hereof.

Signature

Date: _____

[illegible]

[illegible]

Nonprofit Financing

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LEMONS AND TROJAN HORSES

Charities are always looking for contributions, but contributions can be tricky.

Donor: Sometimes even when cash money is involved, complications persist. Often the perception of the general public of what is going on is just as important as what is actually going on. Be clear on the organization's purpose.

Example: Tobacco Company gives to a Health Organization

Condition/Restriction: Consider carefully the reasons for any restricted gifts. Is the restriction on tangible personal for three years, or is it on stocks or real estate to be held indefinitely? In one instance the donor has a legitimate tax reason. In the next the purpose is obscure and may not be in the best interests of the charity, or worse, fraudulent. Further, certain donors cannot let go. Take care to ensure they seek independent tax advice and it is disclosed that the charity is not offering any advice. Conditions often mean contracts to clarify. Better that the conditions are clear than confusion causes an unfortunate public mishap. Suing donors is bad for image, even when the charity is right.

Examples: Donor says the organization must keep the principal and only spend income.

Donor says the money must be used to build a building.

Donor wants to have control over who benefits from the scholarship and what staff work on the fund.

Donor says she wants naming rights forever.

Donor leaves the money by Will

- a) to be used to buy musical instruments
- b) without any restriction in the Will

This presentation and these materials are designed as a general overview, for educational purposes only, and should not be relied upon for legal or tax advice. Please consult an attorney or tax advisor for your specific scenario. Unless you have a signed Engagement Letter with Steffy Law Firm PC, then neither Jeanine R. Steffy, nor Steffy Law Firm PC represents you in any matter.

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Liability: Commonly a donation brings too much risk to be good for an organization, and depending on the size of the entity, its tolerance for this risk may mean investing in a donation or flat turning it down.

Examples: Real estate fees to own and sell a rental.

Historic site that has been a gas station for several years.

Use of the disregarded LLC. (Who set it up, when?)

How many steps in the donation transaction? Does it seem overly complicated for the type of asset involved? (Step transactions are no good for charities either.)

Beware of “forever” where it stated and where it might be inferred.

Things change, purposes change, buildings crumble and need renovations again, penguins need a new exhibit but endowment policies will not go away. When a donor asks for a donation to be ‘kept’ or ‘maintained’ offer to do it for 3 years. If that does not work, tie it to some event which makes sense, but ALWAYS write in an OUT for the board. (As U of MO could have said to Kenneth Lay: “For good cause the board may remove your name from the wall, so long as 3 years has passed.”) Charities should be among the best to understand that names are tied to reputations, so be careful in your policy for accepting names (can anyone join?) and in keeping them.

Too Much/Too Many

Public support charities must keep the balance of public versus substantial donor in mind. While a one-time donation can generally be classified as an ‘unusual grant’ with the help of a good CPA, the death of a mega millionaire which creates a trust to pay a small public charity indefinitely may or may not be a good thing. Too much money is not the end of the charitable purpose, but the board will need to re-weight the benefits of being a public charity versus a private foundation (if the donor trust will allow this). Creative ‘matching’ programs can spur donations by the general public: For every \$1 donated, an anonymous donor will give \$2 more!!

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Gift Acceptance Policies Reasons to set up a policy are numerous but generally focus on a few major ideas as follows (in order of priority):

- 1) Avoid Problem Gifts
- 2) Efficient Evaluation and Acceptance of the Gift
- 3) 'Excuse' for Staff to Follow the Rules
- 4) Marketing and Education

What, How, Who? The Policy is responsible for answering these questions only, not for pre-evaluating unforeseeable gifts. You cannot draft the recipe when you do not yet know the ingredients to be provided.

What refers to the type of gift (real estate, cash, stock...),

How is how the charity will evaluate the What for possible acceptance (call an appraiser, do an environmental study, call a lawyer, visit the site, review the contract, do cost benefit with the CFO...) and

Who is three-fold:

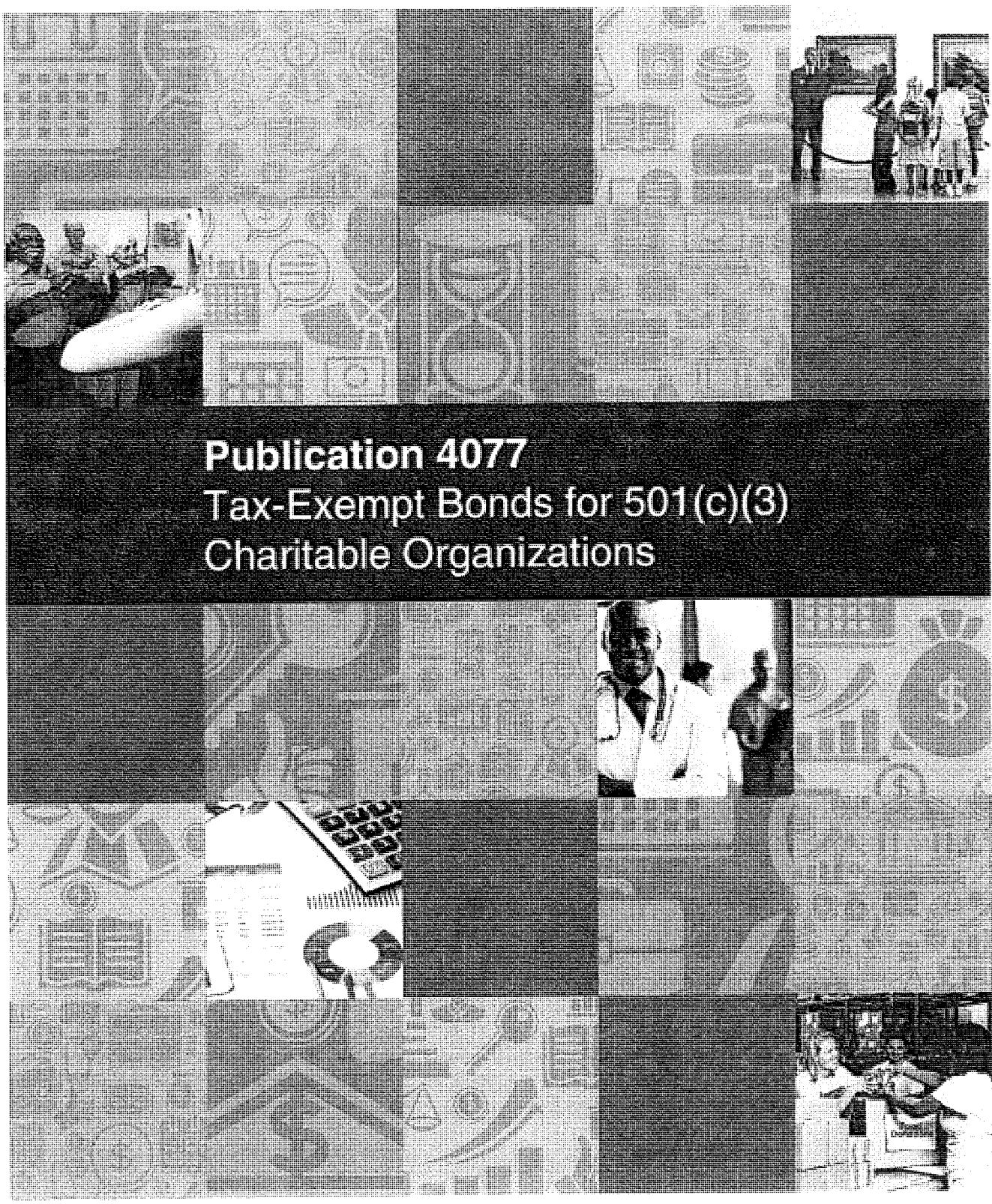
- a) Who in the charity is responsible for evaluating the gift?
- b) Who in the charity is responsible for accepting/declining the gift?
- c) Who may make an exception to the general policy rule in advantageous scenarios?

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Tax Exempt & Government Entities

OFFICE OF
TAX EXEMPT BONDS

A complex collage background featuring various images: a group of people, a large white object (possibly a sculpture or airplane), a family standing in front of a house, a man in a white lab coat, a calculator and CD-ROM, and a group of people at a table. The collage is composed of many small, overlapping rectangular images in various shades of gray.

Publication 4077 Tax-Exempt Bonds for 501(c)(3) Charitable Organizations

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INTRODUCTION

The Office of Tax Exempt Bonds ("TEB"), of the Internal Revenue Service ("IRS"), Tax Exempt and Government Entities Division, offers specialized information and services to the municipal finance community.

This IRS Publication 4077, *Tax Exempt Bonds for 501(c)(3) Charitable Organizations* (the "Publication"), provides state and local governments that issue tax-exempt bonds and 501(c)(3) tax-exempt charitable organizations that use bond proceeds (funds derived from the sale of bonds) an overview of the special federal tax law rules that apply to municipal financing arrangements commonly known as "qualified 501(c)(3) bonds" under Section 145 of the Internal Revenue Code (the "Code"). Certain exceptions or additional requirements to these rules, which are beyond the scope of this Publication, may apply to particular financing arrangements. This Publication is intended to help issuers and 501(c)(3) organizations meet applicable federal tax law requirements to ensure that interest earned by bondholders is exempt from taxation under Section 103 of the Code.

This Publication is an overview of the rules; it is not official guidance that taxpayers may rely upon for planning purposes. This Publication refers to various Code sections, income tax regulations (the "Regulations"), revenue procedures and other official guidance relating to the topics discussed. Please refer to the official guidance for the rules that apply to qualified 501(c)(3) bonds.

This Publication is only one of TEB's many outreach efforts. For publications regarding the general rules applicable to governmental bonds and private activity bonds, see IRS [Publication 4079, *Tax-Exempt Governmental Bonds*](#), and IRS [Publication 4078, *Tax-Exempt Private Activity Bonds*](#), respectively. For an overview of the responsibilities of an issuer of tax-exempt bonds in a conduit financing arrangement, see IRS [Publication 5005, *Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds*](#). TEB also provides detailed information on specific provisions of the tax law through other IRS publications and through outreach efforts as noted on the TEB website at www.irs.gov/Tax-Exempt-Bonds. See also [TEB INFORMATION AND SERVICES](#), at the end of this Publication.

BACKGROUND

State and local governments receive direct and indirect tax benefits under the Code that lower borrowing costs on their valid debt obligations. Because interest paid to bondholders on these obligations is not includable in their gross income for federal income tax purposes, bondholders are willing to accept a lower interest rate than they would accept if the interest was taxable. These benefits apply to many different types of municipal debt financing arrangements including bonds, notes, loans, lease purchase contracts, lines of credit and commercial paper (collectively referred to as “bonds” in this Publication).

To receive these benefits, issuers must ensure that the requirements under the Code are met, generally for as long as the bonds remain outstanding. These requirements include, but are not limited to, information filing and other requirements related to issuance, the proper and timely use of bond proceeds and bond-financed property, and limitations on how bond proceeds may be invested. Special additional rules apply to bonds that are private activity bonds for those bonds to be tax-exempt qualified private activity bonds. This Publication describes rules that apply to a particular type of qualified private activity bonds: qualified 501(c)(3) bonds. Information on the requirements applicable to other types of qualified private activity bonds are beyond the scope of this Publication. For information about these unique requirements, visit TEB's website. For information regarding the general rules applicable to all types of qualified private activity bonds, see IRS Publication 4078, *Tax-Exempt Private Activity Bonds*.

This Publication also addresses practices and steps an issuer or 501(c)(3) organization can take to protect the tax-exempt status of qualified 501(c)(3) bonds. For example, because requirements and limitations generally apply at the time the bonds are issued and throughout the term of the bonds, this Publication encourages issuers and beneficiaries of tax-exempt bonds to create procedures for monitoring compliance throughout the life of the bonds. For more information, see the discussion below in the section titled POST-ISSUANCE COMPLIANCE MONITORING.

TAX-EXEMPT BONDS FOR 501(C)(3) CHARITABLE ORGANIZATIONS

Generally interest on a private activity bond is not tax-exempt; however, the interest may be excludable from tax if the issuer meets additional requirements that apply to private activity bonds, making the bonds qualified private activity bonds. A qualified 501(c)(3) bond is a type of qualified private activity bond. In this section, we briefly discuss the tests for determining whether a bond is a private activity bond. This section also describes the rules an issuer must meet for a bond to be a qualified 501(c)(3) bond.

When applicable, these discussions include any special remedial action provision that applies to the particular requirement. If a deliberate action that results in a violation of any of the federal tax requirements cannot be corrected under these special remedial action provisions, issuers may be able to enter into a closing agreement under the TEB Voluntary Closing Agreement Program (“TEB VCAP”) described in Notice 2008-31, 2008-11 I.R.B. 592 (see WHAT TO DO UPON DISCOVERING A VIOLATION – TEB VOLUNTARY CLOSING AGREEMENT PROGRAM at the end of this Publication).

Testing for Private Activity Bonds

A state or local bond will be a private activity bond if as of the issue date of the bonds or at any time while the bonds are outstanding, the bond issue exceeds the limits set forth in either of the private activity bond tests:

- the private business tests of Section 141(b) of the Code, which consists of the private use test and the private security and payment test, or
- the private loan financing test of Section 141(c) of the Code.

For a description of the private business test under Section 141(b) and the private loan test under Section 141(c), see IRS [Publication 4079, *Tax-Exempt Governmental Bonds*](#).

Qualified 501(c)(3) Bonds are Private Activity Bonds

Private activity bonds are subject to general rules applicable to all tax-exempt bonds, such as the arbitrage rules, rules against hedge bonds or abusive tax transactions and record retention rules, and to special rules that apply to all private activity bonds, such as rules that limit maturities on the bonds and public approval requirements. For a description of these rules, see IRS [Publication 4078, *Tax-Exempt Private Activity Bonds*](#). This Publication addresses only additional special rules that apply to qualified 501(c)(3) bonds under Section 145 of the Code.

Qualified Use Tests—Ownership and Modified Private Business Tests

To be qualified 501(c)(3) bonds, the bonds must meet the requirements of Section 145 of the Code. Section 145(a) contains two tests for determining whether a bond is a qualified 501(c)(3) bond:

- the ownership test; and
- the modified private business tests

Both tests are applied to determine if the bond is a qualified 501(c)(3) bond, but the requirements work differently. For the bond to be a qualified 501(c)(3) bond, the bond-financed property must meet the ownership test **and** the bond must not exceed the limits set forth in the modified private business tests. Bonds issued for a 501(c)(3) organization that exceed the modified private business tests limits or fail to meet the ownership test are private activity bonds that are not tax-exempt.

Ownership Test. Section 145(a)(1) of the Code provides that all property financed by the net proceeds of a qualified 501(c)(3) bond issue must be owned by either an organization described in Section 501(c)(3) (a “501(c)(3) organization”) or a state or local governmental unit. Even if the financed property is owned by a 501(c)(3) organization or a state or local government, the modified private business tests must still be applied to determine if the bond is qualified under section 145(a).

Modified Private Business Tests. Bonds are not qualified 501(c)(3) bonds if they exceed the limits set forth in the modified private business tests. A bond exceeds these limits if both the private business use test limits and the private security or payment test limits of Section 141(b) of the Code, as modified under Section 145, are exceeded. In other words, the tests that were used to determine if the bond is a private activity bond are modified and reapplied to determine whether a private activity bond is a qualified 501(c)(3) bond. For a description of the private business tests under Section 141(b), see IRS [Publication 4079, *Tax-Exempt Governmental Bonds*](#).

Under the modified private business tests, the portion of the financed property used by a 501(c)(3) organization in an activity related to its charitable purposes is treated as though it were used

by a governmental unit. This portion must be tested to determine how much, if any, is used for a private business use for which there are private payments or security. Any amount of private business use for which there is a private payment or security must be added to the amount of continued private use of the financed facility arising from any unrelated trade or business use of the financed property. Stated differently, under the modified tests, private business use by someone other than a 501(c)(3) organization of that portion of the bond-financed facility that otherwise would be treated as governmental use with respect to the 501(c)(3) organization that owns the facility must be aggregated with unrelated trade or business use of the financed facility by the 501(c)(3) organization to see if the modified private business use limit is exceeded. Generally, issuance costs financed with bond proceeds are treated as private business use when applying the modified private business test.

Pursuant to Section 145(a)(2) of the Code, the private business tests are modified (1) to apply to the **net** proceeds of the bonds (the proceeds of a bond issue reduced by amounts allocated to a reasonably required reserve or replacement fund) and (2) so that no more than 5 percent of private business use and no more than 5 percent of private security or payments are permitted (in contrast, Section 141(b) of the Code generally utilizes 10 percent limits). For example, if the aggregate of private business use exceeds 5 percent of the net proceeds and the aggregate of private payments exceeds the 5 percent of the net proceeds, the bonds meet the modified private business tests and therefore are not qualified 501(c)(3) bonds. Also, section 1.145-2 of the Regulations limits certain of the general private activity exceptions available under Section 141 so they do not apply to qualified 501(c)(3) bonds.

Unrelated Trade or Business. Under Section 145(a)(2) of the Code, a 501(c)(3) organization is not treated as a governmental unit with respect to its activities that constitute unrelated trade or business activities. Thus, such activities continue to be treated as private business activities. Under Section 513(a) of the Code, the term “unrelated trade or business” means any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under Section 501 of the Code. See Section 513(a) for three narrow situations where certain activities are not treated as unrelated trade or business.

Qualified 501(c)(3) Organization

Generally a 501(c)(3) organization must be organized and operated exclusively for educational, religious, or charitable purposes, and no part of the organization’s net earnings may inure to or for the benefit of any private shareholders or individuals. To qualify as a 501(c)(3) organization, the organization must have received a determination letter from the IRS stating that it is an exempt organization described in Section 501(c)(3) of the Code. For information about filing an application for exemption under Section 501(c)(3), see IRS [Publication 4220, Applying for 501\(c\)\(3\) Tax-Exempt Status](#), and IRS [Publication 557, Tax-Exempt Status for Your Organization](#).

In addition, the 501(c)(3) organization must maintain its 501(c)(3) tax-exempt status throughout the entire term that the bonds are outstanding. Organizations described in Section 501(c)(3) of the Code must meet certain requirements to maintain their exempt status. These requirements are generally beyond the scope of this Publication, however, the requirement to file a Schedule K to the Form 990 is a special filing requirement related to tax-exempt financing for 501(c)(3) organizations that is discussed below.

Special Filing Requirements To Retain 501(c)(3) Status; Schedule K (Form 990). Most exempt organizations must file various returns and reports at some time during (or following the close of) their accounting period. If an organization fails to meet its annual reporting requirement for three consecutive years, it will automatically lose its tax-exempt status. To regain its exempt status, an organization will have to reapply for recognition as a tax-exempt organization or seek relief under special procedures. If the exempt status is not reinstated retroactive to the date of automatic revocation, there will exist a time during which the organization will not be a 501(c)(3) organization. This could cause bonds benefiting the organization to fail the requirements for tax exemption under Section 145(a) of the Code.

Section 501(c)(3) organizations benefiting from tax-exempt bond obligations that are required to file IRS Form 990, Return of Organization Exempt From Income Tax, or choose to do so, must also complete and attach Schedule K (Form 990), Supplemental Information on Tax-Exempt Bonds. On Schedule K (Form 990), the 501(c)(3) organization will provide required information for each outstanding tax-exempt bond issue (including refunding bonds) that (1) had an outstanding principal amount of more than \$100,000 as of the last day of the tax year and (2) was issued after December 31, 2002. The required information includes information concerning the use of bond proceeds; any private business use of bond-financed property; arbitrage requirements; and post-issuance compliance. For additional information, see IRS Publication 557, Tax-Exempt Status for Your Organization.

Application of the Ownership Test and the Modified Private Business Tests

The ownership test and the modified private business tests are applied at issuance to determine whether any arrangement with respect to the bond financed facility will cause the bonds to fail to meet the requirements of Section 145(a) of the Code. Even if the requirements of Section 145(a) are met at issuance, however, a deliberate action taken after issuance may cause the bonds to fail to meet the requirements of Section 145(a). A qualified 501(c)(3) bond issue can lose its tax-exempt status if the issuer or another user of the financed facilities takes a "deliberate action" subsequent to the issue date that causes the issue to fail the ownership test of Section 145(a)(1) or satisfy the modified private business tests of Section 145(a)(2). A deliberate action is any action taken by the issuer or 501(c)(3) organization that is within its control. Intent to violate the ownership test, the private business use test or the private security or payment tests is not necessary for an action to be deliberate. A deliberate action occurs on the date the issuer or 501(c)(3) organization enters into a binding contract (that is not subject to any material contingencies) with a nonqualified person for use of the bond-financed property.

Many types of arrangements can result in the modified private business tests under Section 145 of the Code being met at issuance or later, including management and service contracts and research agreements.

Management and Service Contracts. 11 Contracts for a private entity to manage a bond-financed facility may cause the modified private business tests to be met. For example, a management contract between a 501(c)(3) organization and a for-profit entity under which the for-profit entity receives compensation for services provided with respect to bond-financed property may result in the bonds meeting the modified private business tests. The IRS has provided safe harbors protecting against private use for management and service contracts when such service is provided in connection with bond-financed property. Those safe harbors apply to the modified private business tests. For more information, see Revenue Procedure 97-13, 1997-5 I.R.B. 18, as modified by Revenue Procedure 2001-39, 2001-28 I.R.B. 38, and

as amplified by Notice 2014-67, 2014-46 I.R.B. 822. Contracts that fail the safe harbor do not automatically meet the modified private business tests; all facts and circumstances are considered to determine whether the contract meets the tests.

Research Agreements. Research agreements may also cause the modified private business tests under Section 145 of the Code to be met. For example, when for-profit entities or the federal government sponsor research at a facility owned by a 501(c)(3) organization that financed the facility with tax-exempt bonds, such research agreements may result in a violation of the modified private business tests. However, the IRS has provided safe harbors applicable to such research agreements. For more information, see Revenue Procedure 2007-47, 2007-29 I.R.B. 108. As with the management contracts, failure to meet the safe harbors does not automatically cause the modified private business tests to be met.

Remedial Actions for Nonqualified Use. The Regulations provide that an issuer or borrower that engages in a deliberate action causing the ownership requirement to be failed, or the modified private activity bond tests to be met, may, in certain cases, cure that deliberate action using one of the prescribed remedial actions. Section 1.145-2(a) of the Regulations provides that an issuer may take remedial actions prescribed in section 1.141-12 of the Regulations to cure a deliberate action that would otherwise cause the 501(c)(3) bonds to lose their tax-exempt status. Such remedial actions can include redemption or defeasance of nonqualified bonds, alternative use of disposition proceeds and alternative use of bond-financed property.

Example: A 501(c)(3) organization sells a building financed with tax-exempt qualified 501(c)(3) bond proceeds to a for-profit corporation for the fair market value of the building. This change in ownership, and the change in the use of the property from a qualified use to a private business use, is a deliberate action that causes the issue to fail the ownership test and causes the bonds to exceed the limits under the modified private business tests. However, the issuer of the bonds may remediate the deliberate action by redeeming the nonqualified bonds within 90 days of the action.

Other Requirements under Section 145 for Qualified 501(c)(3) Bonds

Section 145 of the Code imposes other requirements on certain qualified 501(c)(3) bonds. These are a volume limit on non-hospital bonds and limits on proceeds used for residential rental housing.

Volume Limitation on Non-Hospital Bonds. Section 145(b) of the Code limits the amount of qualified 501(c)(3) bonds that may be issued to benefit a 501(c)(3) organization. This rule does not apply to qualified hospital bonds, which is any bond issue for which at least 95 percent of the proceeds are used for a hospital. This rule also does not apply to bonds issued after August 5, 1997, except those from which less than 95 percent of the net proceeds will be used to finance capital expenditures.

Generally, if Section 145(b) applies, the aggregate authorized face amount of a qualified 501(c)(3) bond issue allocated to a 501(c)(3) organization, when increased by the amount of outstanding tax-exempt non-hospital bonds allocated to such organization, may not exceed \$150 million. Certain outstanding qualified 501(c)(3) bonds are not counted in the allocation. The aggregation rules exclude qualified hospital bonds in their entirety, and exclude the portion of other outstanding bonds that financed a hospital. They also exclude any issue not subject to the Tax Reform Act of 1986, if at least 90 percent of the net proceeds of the issue were used with respect to a hospital. Finally, the rules exclude outstanding bonds that are to be currently refunded by the new issue.

Bonds are allocable to a 501(c)(3) organization under a set of “test period beneficiary” rules that bring in bond issues benefitting certain related entities, and another rule that treats organizations under common management or control as one entity. These rules may result in the Section 145(b) limit being exceeded well after the issue date for a bond issue in the event of a merger or other transaction that brings additional bond issues into the analysis.

Example: A 501(c)(3) organization occupied all of the educational facilities financed with a prior \$145 million issue of qualified 501(c)(3) bonds during the three-year test period. On the date of issuance of new qualified 501(c)(3) bonds to finance an educational facility for the organization, \$95 million of the prior bonds are still outstanding. If less than 95 percent of the net proceeds of the new bond issue will be used to finance capital expenditures, the authorized face amount of the new issue would be limited to \$55 million.

Proceeds Used for Residential Rental Housing for Family Units. Under Section 145(d) of the Code, if a 501(c)(3) organization uses proceeds of qualified 501(c)(3) bonds to finance housing units, additional restrictions apply. Generally, pursuant to Section 145(d)(2) of the Code, if any portion of the net proceeds of a qualified 501(c)(3) bond issue are used to finance residential rental housing for family units, that portion must be used to provide one of the following:

- residential rental property for family housing where the first use of such property is pursuant to the bond issue
- qualified residential rental projects satisfying the requirements under Section 142(d) of the Code, including the minimum occupancy thresholds for low-income tenants
- property which is to be substantially rehabilitated in a rehabilitation beginning within a two-year period ending one year after the date of the acquisition of such property

For determining whether use is the first use, Section 145(d)(3) of the Code provides special rules. First, if the first use of property is pursuant to taxable financing, and there was a reasonable expectation when the taxable financing was provided that it would be replaced with tax-exempt financing, and the taxable financing is replaced with a reasonable period with tax-exempt financing, the first use shall be treated as being pursuant to the tax-exempt financing. Second, if at the time of the first use there was no operating State or local program for tax-exempt financing of the property, the first use shall be treated as pursuant to the first tax-exempt financing of the property.

For determining whether a rehabilitation is substantial, Section 145(d)(4) looks to the rules for rehabilitation credits in Section 47 of the Code with certain adjustments to that section’s definition of “substantially rehabilitated.”

Election To Apply Other Qualified Private Activity Bond Rules

Section 145(e) of the Code permits an issuer to elect out of applying Section 145 if the bond issue would otherwise qualify as an exempt facility bond or a qualified redevelopment bond to which the volume cap limitations of Section 146 of the Code apply.

Special Maturity Limitation Rule

Generally, private activity bonds are subject to limits on the maturity of the bonds. Those rules are described in IRS Publication 4078, *Tax-Exempt Private Activity Bonds*. A special rule exists for certain qualified 501(c)(3) bonds. Section 147(b)(4) of the Code provides that the issuer may elect a special exception to the general maturity limitation rule with respect to pooled financings of 501(c)(3) organizations.

Refunding of Qualified 501(c)(3) Bonds

Qualified 501(c)(3) bonds may be currently refunded and advance refunded. However, qualified 501(c)(3) bonds issued after 1985 can only be advance refunded one time. For rules describing what is a refunding bond issue, a current refunding, and an advance refunding, see IRS Publication 4078, *Tax-Exempt Private Activity Bonds*.

POST-ISSUANCE COMPLIANCE MONITORING

As with other types of tax-exempt bonds, TEB notes the importance of post-issuance compliance monitoring for issuers of qualified 501(c)(3) bonds and 501(c)(3) organizations that benefit from those financings. This section supplements the information about compliance monitoring procedures for private activity bonds, in general, contained in IRS Publication 4078, *Tax-Exempt Private Activity Bonds*. For information on procedures and other options to assist issuers in their tax compliance responsibilities, see IRS Publication 5005, *Your Responsibilities as a Conduit Issuer of Tax-Exempt Bonds*.

Steps to Better Monitoring of Qualified 501(c)(3) Bonds. In formulating procedures, issuers and 501(c)(3) organizations may consider:

- Designating one or more officials to assist in post-issuance compliance, including completion of Schedule K (Form 990);
- Providing training or other technical support to designated official(s);
- Designating time intervals within which compliance monitoring activities will be completed; and
- Timely completing remedial actions (including requests under TEB's Voluntary Closing Agreement Program) to correct or otherwise resolve identified noncompliance.

The chart below identifies particular areas for compliance monitoring procedures that are relevant to qualified 501(c)(3) bonds. IRS Publication 4078, *Tax-Exempt Private Activity Bonds*, contains additional information on other compliance monitoring areas applicable to all private activity bonds, including some of the items in this chart.

Compliance Procedures		
Type of Procedures	Description of Procedures for Post-Closing Matters	Where Responsibility is Discussed in this Publication
501(c)(3) status	Procedures to ensure exemption	TAX-EXEMPT BONDS FOR 501(c)(3) CHARITABLE ORGANIZATIONS – Qualified 501(c)(3) Organization
Proprietary Use of Proceeds or Bond-Financed Property	Procedures to timely identify and remediate deliberate actions	TAX-EXEMPT BONDS FOR 501(c)(3) CHARITABLE ORGANIZATIONS – Application of the Ownership Test and the Modified Private Business Tests
\$150 million limit	Procedures during mergers and acquisitions to ensure limit is not exceeded	TAX-EXEMPT BONDS FOR 501(c)(3) CHARITABLE ORGANIZATIONS – Other Requirements under Section 145 for Qualified 501(c)(3) Bonds – Volume limitations on non-hospital bonds
Schedule K (Form 990)	Procedures for the timely completion and filing of Form 990, including Schedule K	TAX-EXEMPT BONDS FOR 501(c)(3) CHARITABLE ORGANIZATIONS – Qualified 501(c)(3) Organization – Special Filing Requirements To Retain 501(c)(3) Status; Schedule K (Form 990)
Reissuance	Procedures to satisfy applicable tax requirements when a modification in terms results in a reissuance for federal income tax purposes	IRS Publication 4078, <i>Tax-Exempt Private Activity Bonds</i> : TAX-EXEMPT PRIVATE ACTIVITY BONDS – What Happens When the Terms of a Private Activity Bond Are Modified?
Arbitrage Compliance	Procedures for the timely computation and payment of arbitrage rebate and yield reduction payments	IRS Publication 4078, <i>Tax-Exempt Private Activity Bonds</i> : TAX-EXEMPT PRIVATE ACTIVITY BONDS – Rules That Apply at Issuance and Throughout the Life of the Bonds – Proceeds Are Subject to Investment Restrictions—the Arbitrage Yield Restriction and Arbitrage Rebate Requirements
Record Retention	Procedures for the maintenance of records	IRS Publication 4078, <i>Tax-Exempt Private Activity Bonds</i> : TAX-EXEMPT PRIVATE ACTIVITY BONDS – Issuers Must Retain Records To Show That Requirements Are Satisfied
IRS Contacts	Procedures concerning contacts from the IRS	IRS Publication 4078, <i>Tax-Exempt Private Activity Bonds</i> : POST-ISSUANCE COMPLIANCE MONITORING – Steps to Better Monitoring

Additional information on [Post-Issuance Compliance](#) is available on the TEB website on irs.gov.

WHAT TO DO UPON DISCOVERING A VIOLATION – TEB VOLUNTARY CLOSING AGREEMENT PROGRAM

TEB is committed to resolving federal tax violations with the issuer. To that end, TEB created the TEB Voluntary Closing Agreement Program. The Compliance and Program Management function of TEB administers this program, which provides remedies for issuers of tax-exempt bonds, tax credit bonds, and direct pay bonds that voluntarily come forward to resolve a violation of the Code that cannot be corrected under self-correction programs described in the Regulations or other published guidance. IRS Publication 4078, *Tax-Exempt Private Activity Bonds* describes TEB VCAP in more detail.

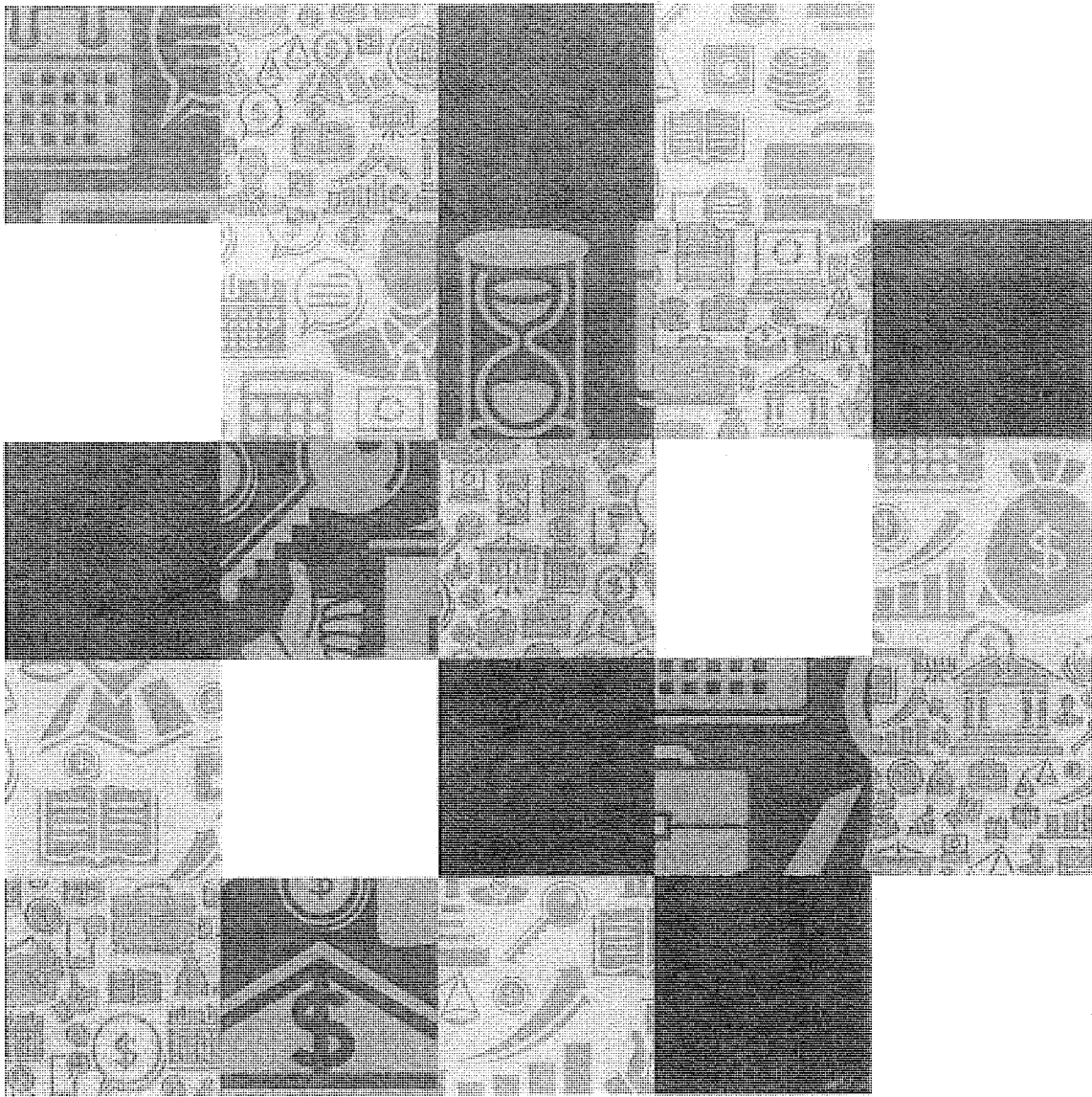
TEB INFORMATION AND SERVICES

TEB offers information and services through its education and outreach programs. You can learn about these programs through the TEB website.

TEB has reading materials about the tax laws applicable to municipal financing arrangements, including revenue rulings, revenue procedures, notices and announcements, available on the TEB website under Published Guidance.

Tax forms, instructions and publications are also available at the TEB website under Tax Exempt Bonds Forms and Publications.

For personal assistance, you can call our Customer Account Services toll-free at (877) 829-5500, Monday through Friday, 8:00 a.m. – 5:00 p.m. your local time.



United States Code Annotated
Title 26. Internal Revenue Code (Refs & Annos)
Subtitle A. Income Taxes (Refs & Annos)
Chapter 1. Normal Taxes and Surtaxes (Refs & Annos)
Subchapter B. Computation of Taxable Income
Part IV. Tax Exemption Requirements for State and Local Bonds
Subpart A. Private Activity Bonds (Refs & Annos)

26 U.S.C.A. § 145

§ 145. Qualified 501(c)(3) bond

Effective: August 5, 1997

Currentness

(a) In general.--For purposes of this part, except as otherwise provided in this section, the term "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if--

(1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and

(2) such bond would not be a private activity bond if--

(A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and

(B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and by substituting "net proceeds" for "proceeds" each place it appears.

(b) \$150,000,000 limitation on bonds other than hospital bonds.--

(1) In general.--A bond (other than a qualified hospital bond) shall not be treated as a qualified 501(c)(3) bond if the aggregate authorized face amount of the issue (of which such bond is a part) allocated to any 501(c)(3) organization which is a test-period beneficiary (when increased by the outstanding tax-exempt nonhospital bonds of such organization) exceeds \$150,000,000.

(2) Outstanding tax-exempt nonhospital bonds.--

(A) In general.--For purposes of applying paragraph (1) with respect to any issue, the outstanding tax-exempt nonhospital bonds of any organization which is a test-period beneficiary with respect to such issue is the aggregate amount of tax-exempt bonds referred to in subparagraph (B)--

(i) which are allocated to such organization, and

(ii) which are outstanding at the time of such later issue (not including as outstanding any bond which is to be redeemed (other than in an advance refunding) from the net proceeds of the later issue).

(B) Bonds taken into account.--For purposes of subparagraph (A), the bonds referred to in this subparagraph are--

(i) any qualified 501(c)(3) bond other than a qualified hospital bond, and

(ii) any bond to which section 141(a) does not apply if--

(I) such bond would have been an industrial development bond (as defined in section 103(b)(2), as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) if 501(c)(3) organizations were not exempt persons, and

(II) such bond was not described in paragraph (4), (5), or (6) of such section 103(b) (as in effect on the date such bond was issued).

(C) Only nonhospital portion of bonds taken into account.--

(i) In general.--A bond shall be taken into account under subparagraph (B) only to the extent that the proceeds of the issue of which such bond is a part are not used with respect to a hospital.

(ii) Special rule.--If 90 percent or more of the net proceeds of an issue are used with respect to a hospital, no bond which is part of such issue shall be taken into account under subparagraph (B)(ii).

(3) Aggregation rule.--For purposes of this subsection, 2 or more organizations under common management or control shall be treated as 1 organization.

(4) Allocation of face amount of issue; test-period beneficiary.--Rules similar to the rules of subparagraphs (C), (D) and (E) of section 144(a)(10) shall apply for purposes of this subsection.

(5) Termination of limitation.--This subsection shall not apply with respect to bonds issued after the date of the enactment of this paragraph as part of an issue 95 percent or more of the net proceeds of which are to be used to finance capital expenditures incurred after such date.

(c) Qualified hospital bond.--For purposes of this section, the term "qualified hospital bond" means any bond issued as part of an issue 95 percent or more of the net proceeds of which are to be used with respect to a hospital.

(d) Restrictions on bonds used to provide residential rental housing for family units.--

(1) In general.--Except as otherwise provided in this subsection, a bond which is part of an issue shall not be a qualified 501(c)(3) bond if any portion of the net proceeds of the issue are to be used directly or indirectly to provide residential rental property for family units.

(2) Exception for bonds used to provide qualified residential rental projects.--Paragraph (1) shall not apply to any bond issued as part of an issue if the portion of such issue which is to be used as described in paragraph (1) is to be used to provide--

(A) a residential rental property for family units if the first use of such property is pursuant to such issue,

(B) qualified residential rental projects (as defined in section 142(d)), or

(C) property which is to be substantially rehabilitated in a rehabilitation beginning within the 2-year period ending 1 year after the date of the acquisition of such property.

(3) Certain property treated as new property.--Solely for purposes of determining under paragraph (2)(A) whether the first use of property is pursuant to tax-exempt financing--

(A) In general.--If--

(i) the 1st use of property is pursuant to taxable financing,

(ii) there was a reasonable expectation (at the time such taxable financing was provided) that such financing would be replaced by tax-exempt financing, and

(iii) the taxable financing is in fact so replaced within a reasonable period after the taxable financing was provided,

then the 1st use of such property shall be treated as being pursuant to the tax-exempt financing.

(B) Special rule where no operating state or local program for tax-exempt financing.--If, at the time of the 1st use of property, there was no operating State or local program for tax-exempt financing of the property, the 1st use of the property shall be treated as pursuant to the 1st tax-exempt financing of the property.

(C) Definitions.--For purposes of this paragraph--

(i) **Tax-exempt financing.**--The term "tax-exempt financing" means financing provided by tax-exempt bonds.

(ii) **Taxable financing.**--The term "taxable financing" means financing which is not tax-exempt financing.

(4) Substantial rehabilitation.--

(A) In general.--Except as provided in subparagraph (B), rules similar to the rules of section 47(c)(1)(C) shall apply in determining for purposes of paragraph (2)(C) whether property is substantially rehabilitated.

(B) Exception.--For purposes of subparagraph (A), clause (ii) of section 47(c)(1)(C)(i) shall not apply, but the Secretary may extend the 24-month period in section 47(c)(1)(C)(i) where appropriate due to circumstances not within the control of the owner.

(e) Election out.--This section shall not apply to an issue if--

§ 145. Qualified 501(c)(3) bond, 26 USCA § 145

(1) the issuer elects not to have this section apply to such issue, and

(2) such issue is an issue of exempt facility bonds, or qualified redevelopment bonds, to which section 146 applies.

CREDIT(S)

(Added Pub.L. 99-514, Title XIII, § 1301(b), Oct. 22, 1986, 100 Stat. 2629; amended Pub.L. 100-647, Title I, § 1013(a)(6)-(8), Title V, § 5053(a), Nov. 10, 1988, 102 Stat. 3538, 3677; Pub.L. 101-239, Title VII, § 7815(f), Dec. 19, 1989, 103 Stat. 2419; Pub.L. 101-508, Title XI, § 11813(b)(7), Nov. 5, 1990, 104 Stat. 1388-551; Pub.L. 105-34, Title II, § 222, Aug. 5, 1997, 111 Stat. 818.)

26 U.S.C.A. § 145, 26 USCA § 145
Current through P.L. 114-219.

End of Document

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KeyCite Yellow Flag - Negative Treatment
Proposed Regulation

Code of Federal Regulations
Title 26. Internal Revenue
Chapter I. Internal Revenue Service, Department of the Treasury
Subchapter A. Income Tax
Part 1. Income Taxes (Refs & Annos)
Normal Taxes and Surtaxes
Computation of Taxable Income
Tax Exemption Requirements for State and Local Bonds

26 C.F.R. § 1.145-2, Treas. Reg. § 1.145-2

§ 1.145-2 Application of private activity bond regulations.

Effective: October 27, 2015

Currentness

(a) In general. Except as provided in this section, §§ 1.141-0 through 1.141-15 apply to section 145(a). For example, under this section, § 1.141-1, and § 1.141-2, an issue ceases to be an issue of qualified 501(c)(3) bonds if the issuer or a conduit borrower 501(c)(3) organization takes a deliberate action, subsequent to the issue date, that causes the issue to fail to comply with the requirements of sections 141(e) and 145 (such as an action that results in revocation of exempt status of the 501(c)(3) organization).

(b) Modification of private business tests. In applying §§ 1.141-0 through 1.141-15 to section 145(a)—

(1) References to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under section 513(a);

(2) References to “10 percent” and “proceeds” in the context of the private business use test and the private security or payment test mean “5 percent” and “net proceeds”; and

(3) References to the private business use test in §§ 1.141-2 and 1.141-12 include the ownership test of section 145(a)(1).

(4) References to governmental bonds in § 1.141-6 mean qualified 501(c)(3) bonds.

(5) References to ownership by governmental persons in § 1.141-6 mean ownership by governmental persons or 501(c)(3) organizations.

(c) Exceptions—(1) Certain provisions relating to governmental programs. The following provisions do not apply to section 145: § 1.141-2(d)(4) (relating to the special rule for dispositions of personal property in the ordinary course of an established governmental program) and § 1.141-2(d)(5) (relating to the special rule for general obligation bond programs that finance a large number of separate purposes).

(2) Costs of issuance. Costs of issuance. Sections 1.141-3(g)(6) and 1.141-6(d) do not apply to the extent costs of issuance are allocated among the other purposes for which the proceeds are used or to portions of a project. For purposes of section 145(a)(2), costs of issuance are treated as private business use.

(d) Issuance costs financed by prior issue. Solely for purposes of applying the private business use test to a refunding issue under § 1.141-13, the use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

Credits

[T.D. 8712, 62 FR 2303, Jan. 16, 1997; T.D. 9234, 70 FR 75035, Dec. 19, 2005; T.D. 9741, 80 FR 65646, Oct. 27, 2015]

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

Current through September 1, 2016; 81 FR 60458.

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Code of Federal Regulations
Title 26. Internal Revenue
Chapter I. Internal Revenue Service, Department of the Treasury
Subchapter A. Income Tax
Part 1. Income Taxes (Refs & Annos)
Normal Taxes and Surtaxes
Computation of Taxable Income
Tax Exemption Requirements for State and Local Bonds

26 C.F.R. § 1.150-1, Treas. Reg. § 1.150-1

§ 1.150-1 Definitions.

Effective: July 18, 2016

Currentness

(a) Scope and effective date—(1) In general. Except as otherwise provided, the definitions in this section apply for all purposes of sections 103 and 141 through 150.

(2) Effective/applicability date —(i) In general. Except as otherwise provided in this paragraph (a)(2), this section applies to issues issued after June 30, 1993 to which §§ 1.148-1 through 1.148-11 apply. In addition, this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in § 1.148-11(b)(1) is made.

(ii) Special effective date for paragraphs (c)(1), (c)(4)(iii), and (c)(6). Paragraphs (c)(1), (c)(4)(iii), and (c)(6) of this section apply to bonds sold on or after July 8, 1997 and to any issue to which the election described in § 1.148-11(b)(1) is made. See § 1.148-11A(i) for rules relating to certain bonds sold before July 8, 1997.

(iii) Special effective date for definitions of tax-advantaged bond, issue, and grant. The definition of tax-advantaged bond in paragraph (b) of this section, the revisions to the definition of issue in paragraph (c)(2) of this section, and the definition and rules regarding the treatment of grants in paragraph (f) of this section apply to bonds that are sold on or after October 17, 2016.

(3) Exceptions to general effective date. See § 1.141-15 for the applicability date of the definition of bond documents contained in paragraph (b) of this section and the effective date of paragraph (c)(3)(ii) of this section.

(4) Additional exception to the general applicability date. Section 1.150-1(b), Issuance costs, applies on and after July 6, 2011.

(b) **Certain general definitions.** The following definitions apply:

Bond means any obligation of a State or political subdivision thereof under section 103(c)(1).

Bond documents means the bond indenture or resolution, transcript of proceedings, and any related documents.

Capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under § 1.150-2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

Conduit borrower means the obligor on a purpose investment (as defined in § 1.148-1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower.

Conduit financing issue means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Conduit loan means a purpose investment (as defined in § 1.148-1).

Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; fees paid to an organization to evaluate the credit quality of an issue; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in § 1.148-4(f)); and similar costs.

Issue date means, in reference to an issue, the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. Issue date means, in reference to a bond, the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

Obligation means any valid evidence of indebtedness under general Federal income tax principles.

Pooled financing issue means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project.

Private activity bond means a private activity bond (as defined in section 141).

Qualified mortgage loan means a mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in section 143(a)(1) or 143(b) (or applicable prior law).

Qualified student loan means a student loan acquired with the proceeds of an obligation described in section 144(b)(1).

Related party means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group, and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person (as defined in section 144(a)(3)).

Taxable bond means any obligation the interest on which is not excludable from gross income under section 103.

Tax-advantaged bond means a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor with respect to the issuer's borrowing costs, a taxable bond that provides a refundable federal tax credit payable directly to the issuer of the bond for its borrowing costs under section 6431, or any future similar bond that provides a federal tax benefit that reduces an issuer's borrowing costs. Examples of tax-advantaged bonds include qualified tax credit bonds under section 54A(d)(1) and build America bonds under section 54AA.

Tax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and

(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Working capital expenditure means any cost that is not a capital expenditure. Generally, current operating expenses are working capital expenditures.

(c) Definition of issue—(1) In general. Except as otherwise provided in this paragraph (c), the term issue means two or more bonds that meet all of the following requirements:

(i) **Sold at substantially the same time.** The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.

(ii) **Sold pursuant to the same plan of financing.** The bonds are sold pursuant to the same plan of financing. Factors

material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally—

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) **Payable from same source of funds.** The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

(2) Exceptions for different types of tax-advantaged bonds and taxable bonds. Each type of tax-advantaged bond that has a different structure for delivery of the tax benefit that reduces the issuer's borrowing costs or different program eligibility requirements is treated as part of a different issue under this paragraph (c). Further, tax-advantaged bonds and bonds that are not tax-advantaged bonds are treated as part of different issues under this paragraph (c). The issuance of tax-advantaged bonds in a transaction with other bonds that are not tax-advantaged bonds must be tested under the arbitrage anti-abuse rules under § 1.148-10(a) and other applicable anti-abuse rules (for example, limitations against window maturity structures or unreasonable allocations of bonds).

(3) Exception for certain bonds financing separate purposes—(i) In general. Bonds may be treated as part of separate issues if the requirements of this paragraph (c)(3) are satisfied. Each of these separate issues must finance a separate purpose (e.g., refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose). Each of these separate issues independently must be a tax-exempt bond (e.g., a governmental bond or a qualified mortgage bond). The aggregate proceeds, investments, and bonds in such a transaction must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. If any separate issue consists of refunding bonds, the allocation rules in § 1.148-9(h) must be satisfied. An allocation is not reasonable if it achieves more favorable results under sections 103 and 141 to 150 than could be achieved with actual separate issues. All allocations under this paragraph (c)(3) must be made in writing on or before the issue date.

(ii) Exceptions. This paragraph (c)(3) does not apply for purposes of sections 141, 144(a), 148, 149(d) and 149(g).

(4) Special rules for certain financings—(i) Draw-down loans. Bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of \$50,000 or 5 percent of the issue price.

(ii) **Commercial paper**—(A) In general. Short-term bonds having a maturity of 270 days or less (commercial paper) issued pursuant to the same commercial paper program may be treated as part of a single issue, the issue date of which is the first date the aggregate amount of commercial paper issued under the program exceeds the lesser of \$50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. A commercial paper program is a program to issue commercial paper to finance or refinance the same governmental purpose pursuant to a single master legal document. Commercial paper is not part of the same commercial paper program unless issued during an 18-month period, beginning on the deemed issue date. In addition, commercial paper issued after the end of this 18-month period may be treated as part of the program to the extent issued to refund commercial paper that is part of the program, but only to the extent that—

(1) There is no increase in the principal amount outstanding; and

(2) The program does not have a term in excess of—

(i) 30 years; or

(ii) The period reasonably necessary for the governmental purposes of the program.

(B) **Safe harbor.** The requirement of paragraph (c)(4)(ii)(A)(2) of this section is treated as satisfied if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(iii) **Certain general obligation bonds.** Except as otherwise provided in paragraph (c)(2) of this section, bonds that are secured by a pledge of the issuer's full faith and credit (or a substantially similar pledge) and sold and issued on the same dates pursuant to a single offering document may be treated as part of the same issue if the issuer so elects on or before the issue date.

(5) **Anti-abuse rule.** In order to prevent the avoidance of sections 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

(6) **Sale date.** The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(d) **Definition of refunding issue and related definitions—(1) General definition of refunding issue.** Refunding issue means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a prior issue, as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

(2) **Exceptions and special rules.** For purposes of paragraph (d)(1) of this section, the following exceptions and special rules apply—

(i) **Payment of certain interest.** An issue is not a refunding issue if the only principal and interest that is paid with proceeds of the issue (determined without regard to the multipurpose issue rules of § 1.148-9(h)) is interest on another issue that—

(A) Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;

(B) Is a capital expenditure; or

(C) Is a working capital expenditure to which the de minimis rule of § 1.148-6(d)(3)(ii)(A) applies.

(ii) **Certain issues with different obligors—(A)** In general. An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue.

(B) **Definition of obligor.** The obligor of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in § 1.148-1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student).

(iii) **Certain special rules for purpose investments.** For purposes of this paragraph (d), the following special rules apply:

(A) **Refunding of a conduit financing issue by a conduit loan refunding issue.** Except as provided in paragraph (d)(2)(iii)(B) of this section, the use of the proceeds of an issue that is used to refund an obligation that is a purpose investment (a conduit refunding issue) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation

that is the purpose investment).

(B) Recycling of certain payments under purpose investments. A conduit refunding issue is not a refunding of a conduit financing issue to the extent that the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of the proceeds of the conduit refunding issue to use those amounts within 6 months (or, if greater, during the applicable temporary period for those amounts under section 148(c) or under applicable prior law) to acquire a new purpose investment. Any new purpose investment is treated as made from the proceeds of the conduit financing issue.

(C) Application to tax-exempt loans. For purposes of this paragraph (d), obligations that would be purpose investments (absent section 148(b)(3)(A)) are treated as purpose investments.

(iv) **Substance of transaction controls.** In the absence of other applicable controlling rules under this paragraph (d), the determination of whether an issue is a refunding issue is based on the substance of the transaction in light of all the facts and circumstances.

(v) **Certain integrated transactions in connection with asset acquisition not treated as refunding issues.** If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(3) **Current refunding issue.** Current refunding issue means:

(i) Except as provided in paragraph (d)(3)(ii) of this section, a refunding issue that is issued not more than 90 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; and

(ii) In the case of a refunding issue issued before 1986—

(A) A refunding issue that is issued not more than 180 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; or

(B) A refunding issue if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(4) **Advance refunding issue.** Advance refunding issue means a refunding issue that is not a current refunding issue.

(5) **Prior issue.** Prior issue means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under § 1.148-9(i), for the purposes for which that section applies, except to the extent that the context clearly requires otherwise, references to a prior issue refer only to the refunded portion of that prior issue.

(e) **Controlled group** means a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of this paragraph (e).

(1) **Direct control.** The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the controlling entity) generally controls another entity or group of entities (the controlled entity) for purposes of this paragraph if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial—

(i) The right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or

(ii) The right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

(2) **Indirect control.** If a controlling entity controls a controlled entity under the test in paragraph (e)(1) of this section, then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

(3) **Exception for general purpose governmental entities.** An entity is not a controlled entity under this paragraph (e) if the entity possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state.

(f) **Definition and treatment of grants—(1) Definition.** Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(2) **Treatment.** Except as otherwise provided (for example, § 1.148-6(d)(4), which treats proceeds used for grants as spent for arbitrage purposes when the grant is made), the character and nature of a grantee's use of proceeds are taken

into account in determining which rules are applicable to the bond issue and whether the applicable requirements for the bond issue are met. For example, a grantee's use of proceeds generally determines whether the proceeds are used for capital projects or working capital expenditures under section 148 and whether the qualified purposes for the specific type of bond issue are met.

Credits

[T.D. 8394, 57 FR 3534, Jan. 30, 1992; T.D. 8394, 57 FR 13028, April 15, 1992; T.D. 8418, 57 FR 21031, May 18, 1992; T.D. 8476, 58 FR 33549, June 18, 1993; 58 FR 44453, Aug. 23, 1993; T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8712, 62 FR 2304, Jan. 16, 1997; T.D. 8718, 62 FR 25513, May 9, 1997; T.D. 9234, 70 FR 75036, Dec. 19, 2005; T.D. 9533, 76 FR 39280, July 6, 2011; T.D. 9637, 78 FR 54759, Sept. 6, 2013; T.D. 9777, 81 FR 46598, July 18, 2016]

SOURCE: T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, unless otherwise noted.

Current through September 1, 2016; 81 FR 60458.

End of Document

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SCHEDULE K
(Form 990)

Department of the Treasury
Internal Revenue Service

Supplemental Information on Tax-Exempt Bonds

▶ Complete if the organization answered "Yes" on Form 990, Part IV, line 24a. Provide descriptions, explanations, and any additional information in Part VI.

▶ Information about Schedule K (Form 990) and its instructions is at www.irs.gov/form990.

OMB No. 1545-0047

2015

Open to Public
Inspection

Name of the organization

Employer identification number

Part I Bond Issues

(a) Issuer name	(b) Issuer EIN	(c) CUSIP #	(d) Date issued	(e) Issue price	(f) Description of purpose	(g) Defeased		(h) On behalf of issuer		(i) Pooled financing	
						Yes	No	Yes	No	Yes	No
A											
B											
C											
D											

Part II Proceeds

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
1 Amount of bonds retired								
2 Amount of bonds legally defeased								
3 Total proceeds of issue								
4 Gross proceeds in reserve funds								
5 Capitalized interest from proceeds								
6 Proceeds in refunding escrows								
7 Issuance costs from proceeds								
8 Credit enhancement from proceeds								
9 Working capital expenditures from proceeds								
10 Capital expenditures from proceeds								
11 Other spent proceeds								
12 Other unspent proceeds								
13 Year of substantial completion								
14 Were the bonds issued as part of a current refunding issue?								
15 Were the bonds issued as part of an advance refunding issue?								
16 Has the final allocation of proceeds been made?								
17 Does the organization maintain adequate books and records to support the final allocation of proceeds?								

Part III Private Business Use

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
1 Was the organization a partner in a partnership, or a member of an LLC, which owned property financed by tax-exempt bonds?								
2 Are there any lease arrangements that may result in private business use of bond-financed property?								

For Paperwork Reduction Act Notice, see the Instructions for Form 990.

Cat. No. 50193E

Schedule K (Form 990) 2015

Part III Private Business Use (Continued)

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
3a Are there any management or service contracts that may result in private business use of bond-financed property?								
b If "Yes" to line 3a, does the organization routinely engage bond counsel or other outside counsel to review any management or service contracts relating to the financed property?								
c Are there any research agreements that may result in private business use of bond-financed property?								
d If "Yes" to line 3c, does the organization routinely engage bond counsel or other outside counsel to review any research agreements relating to the financed property?								
4 Enter the percentage of financed property used in a private business use by entities other than a section 501(c)(3) organization or a state or local government		%		%		%		%
5 Enter the percentage of financed property used in a private business use as a result of unrelated trade or business activity carried on by your organization, another section 501(c)(3) organization, or a state or local government		%		%		%		%
6 Total of lines 4 and 5		%		%		%		%
7 Does the bond issue meet the private security or payment test?								
8a Has there been a sale or disposition of any of the bond-financed property to a nongovernmental person other than a 501(c)(3) organization since the bonds were issued?								
b If "Yes" to line 8a, enter the percentage of bond-financed property sold or disposed of		%		%		%		%
c If "Yes" to line 8a, was any remedial action taken pursuant to Regulations sections 1.141-12 and 1.145-2?								
9 Has the organization established written procedures to ensure that all nonqualified bonds of the issue are remediated in accordance with the requirements under Regulations sections 1.141-12 and 1.145-2?								

Part IV Arbitrage

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
1 Has the issuer filed Form 8038-T, Arbitrage Rebate, Yield Reduction and Penalty in Lieu of Arbitrage Rebate?								
2 If "No" to line 1, did the following apply?								
a Rebate not due yet?								
b Exception to rebate?								
c No rebate due?								
If "Yes" to line 2c, provide in Part VI the date the rebate computation was performed								
3 Is the bond issue a variable rate issue?								
4a Has the organization or the governmental issuer entered into a qualified hedge with respect to the bond issue?								
b Name of provider								
c Term of hedge								
d Was the hedge superintegrated?								
e Was the hedge terminated?								

Part IV Arbitrage (Continued)

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
5a Were gross proceeds invested in a guaranteed investment contract (GIC)?								
b Name of provider								
c Term of GIC								
d Was the regulatory safe harbor for establishing the fair market value of the GIC satisfied?								
6 Were any gross proceeds invested beyond an available temporary period?								
7 Has the organization established written procedures to monitor the requirements of section 148?								

Part V Procedures To Undertake Corrective Action

	A		B		C		D	
	Yes	No	Yes	No	Yes	No	Yes	No
Has the organization established written procedures to ensure that violations of federal tax requirements are timely identified and corrected through the voluntary closing agreement program if self-remediation is not available under applicable regulations?								

Part VI Supplemental Information. Provide additional information for responses to questions on Schedule K (see instructions).

Part VI Supplemental Information. Provide additional information for responses to questions on Schedule K (see instructions) (Continued)

**New Mexico State Bar Taxation Section Tax Symposium
Nonprofit Financing**

Robert J. Desiderio, Professor of Law (Emeritus)
University of New Mexico School of Law

CHARITABLE ORGANIZATION COMMERCIAL ACTIVITY

1. Tax Ramifications of Commercial Activity

A. Unrelated Business Income Tax (UBIT)

(i) IRC § 511(a) imposes corporate income tax on unrelated business taxable income.

(ii) IRC § 512(a)(1) defines unrelated business taxable income as gross income from unrelated trade or business, regularly carried on, less related business deductions and plus or minus § 512(b) modifications.

(iii) UBIT turns on the meaning of an unrelated trade or business. Section 513(a) defines an unrelated trade or business as (a) a trade or business and (b) the conduct of which is not substantially related to the organization's exempt purpose. The fact that unrelated income is used to finance exempt activities does not make the business activity related. Section 512(a) adds a third element, the trade or business must be regularly carried. Therefore, the elements of an unrelated trade or business are:

- (a) a trade or business;
- (b) regularly carried on; and
- (c) the performance of which is not substantially related to the organization's exempt purpose.

[The following discussion of UBIT comprises excerpts from Chapter 15 of Robert J. Desiderio, Planning Tax Exempt Organizations (LexisNexus 2015)]

(iv) Trade or Business

(a) Profit Motive

IRC Section 513(c) defines a trade or business as "any activity ... carried on for the production of income from the sale of goods or performance of services." The regulations make clear that the meaning of "trade or business" is the same under IRC Section 513(c) as the term means under IRC Section 162. Under the § 162 standard, the inquiry is whether a quest for profits exists. In *Professional Insurance Agents v. Commissioner*, the Tax Court stated: "Where a corporate taxpayer is involved, we think the determinative factor is resolving the trade or business issue [for purpose of

IRC Section 513] is whether the activity was engaged in with the intent to earn a profit.” 78 T.C. 246, 262 (1982), *aff’d*, 726 F.2d 1097 (6th Cir. 1984).

(b) Continuity and Regularity

The trade or business element of IRC Section 513 includes two other requirements, in addition to a profit motive. First, the activity must involve the sale of goods or performance of services. This requirement should not cause any problem for unrelated trade or business. Except for passive income, exempt organizations usually do not engage in income-producing activity that does not involve goods or services.

The second requirement, which comes from *Groetzinger*, is that the taxpayer must conduct the business activity with “continuity and regularity.” In equating a trade or business with a profit motive, the Court added that “the taxpayer must be involved in the activity with continuity and regularity.” The “regularity” requirement is not the same as the “regularly carried on” requirement of the unrelated business income tax. The *Groetzinger* regularity requirement looks to the taxpayer’s involvement in the activity in question; while the “regularly carried on” requirement assumes a trade or business and looks at the frequency the exempt organization conducts the trade or business. *Commissioner v. Groetzinger*, 480 U.S. 23, 34-35 (1987).

(c) Unfair Competition

Reflecting underlying policy behind the enactment of the unrelated business income tax, the regulations state that Congress’s primary objective in adopting the unrelated business income tax was to eliminate unfair competition by placing the unrelated business activities of exempt organizations on the same tax footing as the business activities. The regulations add that an exempt organization that engages in an activity for the production of income and that satisfies the trade or business definition under IRC Section 162 “presents sufficient likelihood of unfair competition.” When, however, the production of income activity does not meet the characteristics of IRC Section 162, the organization does not engage in unfair competition.

(v) Regularly Carried On

Even if an exempt organization is operating a trade or business, it can avoid the unrelated business income tax by showing that it does not regularly carry on the activity. The regulations indicate that the key factors of the “regularly carried on” requirement are the frequency and continuity of the activity and the manner in which an organization pursues the activity. If the manner is generally similar to comparable commercial activities of

competing taxable organizations, the exempt organization's trade or business is regular.

The principles dealing with the regularly carried on requirement fall into six categories: short-term activities, year-round activities, seasonal activities, intermittent activities, casual sales to outsiders, and infrequent or sporadic activities.

An exempt organization engaged in an income-producing activity for only a few weeks is not regularly carrying on a trade or business if a nonexempt organization normally would conduct a comparable activity on a year-round basis. Thus, a hospital auxiliary operating a sandwich stand for only two weeks at a state fair would not be engaged in the regular conduct of a trade or business. A year-round activity of an exempt organization, however, satisfies the regularly carried on requirement even if the organization conducts the activity only one day a week. Therefore, a church operating a commercial parking lot on Saturday of each week would be regularly conducting a trade or business.

If a nonexempt commercial organization normally engages in an income-producing activity only on a seasonal basis, an exempt organization carrying on a comparable activity during a significant portion of the season is regularly carrying on a trade or business. For example, a tax-exempt organization operating a horseracing track for several weeks a year is engaged in the regular conduct of a trade or business because horseracing is a seasonal activity. In Revenue Ruling 80-298, 1980-2 C.B. 197, an exempt university allowed a professional football team to use the university's facilities several months of the year for a fixed fee. The Service evidently found this time period to be a significant portion of the season because it concluded that the university was engaged in an unrelated trade or business. Under its agreement with the professional football team, the university leased its football stadium, provided ground maintenance, furnished utilities, and provided dressing room, linen, and stadium security services for the team. Because the university furnished services that went beyond those usually provided to a lessee, the IRS ruled that the university's income from the lease was not excluded from unrelated business taxable income as rent from real property.

A tax-exempt organization conducting intermittent income-producing activities is not regularly carrying on a trade or business so long as the organization does not use the promotional efforts typical of commercial endeavors. The regulations provide that "the publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the regular carrying on of business." However, in Revenue Ruling 75-200, 1975-1 C.B. 163, the IRS ruled that an exempt organization's sale of advertising in a concert program distributed free at

weekly symphony performances over an eight-month period was a business regularly carried on. Paid employees of the exempt organization, who raised funds for an exempt symphony orchestra, solicited the advertising during a four-month period.

If an exempt organization conducts a commercial activity primarily for beneficiaries of the organization's exempt purposes (e.g., a college bookstore's sale of books to students or a hospital pharmacy's sale of pharmaceutical supplies to patients of the hospital), then casual sales to outsiders do not constitute a regularly carried on business.¹²¹ The Service has provided illustrations for determining whether a hospital pharmacy's sale of pharmaceutical supplies to the general public constitutes a casual sale within the meaning of Regulations Section 1.513-1(c)(2)(ii). An exempt hospital operating a pharmacy for the convenience of its patients and selling pharmaceutical supplies to its patients is not carrying on an unrelated trade or business.

Similarly, an exempt hospital that operates a pharmacy primarily for the convenience of its patients is not making casual sales to outsiders if the pharmacy is open to the general public and if the pharmacy frequently and continuously sells to persons, not patients of the hospital, who merely walk in off the street to purchase pharmaceutical supplies.

Finally, a tax-exempt organization conducting infrequent or sporadic income-producing activities is not regularly carrying on a trade or business so long as the activities last only a short period of time. Furthermore, such activities do not meet the regularly carried on requirement merely because the organization conducts them on an annually recurrent basis.¹²⁸ Thus, in Revenue Ruling 75-201, 1975-1 C.B. 164, an organization that raised funds for a tax-exempt symphony orchestra was not regularly carrying on a trade or business when volunteers of the organization solicited and sold advertising in an annual concert book distributed at the symphony's annual charity ball.

National Collegiate Athletics Association is probably the most controversial case concerning the "regularly carried on" requirement. The case dealt with the profits earned by the NCAA from the sale of program advertising at the "final four" college basketball tournament. The Tax Court agreed with the Commissioner that when considered in the context of the annual college basketball season and all of NCAA's championships, the advertising in question was more than intermittent. The 10th Circuit reversed, concluding that programs distributed over less than a three-week period was intermittent. 914 F.2d 1417, 1421-1424 (10th Cir. 1990).

(vi) Not Substantially Related

Even though an exempt organization derives income from a regularly carried on trade or business, the income is subject to the unrelated business income tax only if the trade or business is “not substantially related (other than through the production of income) to the purposes for which exemption is granted.” The “not substantially related” requirement is the most important element of the definition of an unrelated trade or business. It looks to the content of an organization’s exempt purposes and the relationship of the business activity in question to those exempt purposes.

A trade or business is “related” to an organization’s exempt purposes only if its conduct has a “causal relationship to the achievement of exempt purposes.” The causal relationship must be “substantial.” For the causal relationship to be substantial, the activity “must contribute importantly to the accomplishment of those [exempt] purposes.” Thus, the test for an unrelated trade or business is whether the trade or business in question contributes importantly to the fulfillment of the organization’s exempt purpose. The regulations specify that a facts and circumstances test is to be employed in determining whether commercial activities contribute importantly to an organization’s exempt purpose.

(a) Meaning of “Contributes Importantly”

Generally speaking, the activity in question can be classified into three categories:

- (1) commercial activity that is an integral part of the organization’s exempt purpose;
- (2) at the other extreme, commercial activity that is related to the exempt purpose only by supporting it financially; or
- (3) commercial activity that has some relationship to its exempt purpose.

The activity in the first category contributes importantly to the organization’s exempt purpose; the activity in the second instance does not. The third category raises the issue as to what facts and circumstances are relevant in determining whether the business activity is contributing importantly to the organization’s exempt purpose.

The regulations help in answering this question. They provide that the size and extent of the commercial activities are to be compared with the size and extent of the exempt function commercial activities serve. If an organization conducts a business activity on a scale larger than reasonably necessary to carry out an exempt purpose, the gross income resulting from that portion of the activity going beyond the “reasonably necessary” level constitutes gross income from the conduct of an unrelated trade or business. The regulations state that “such income is not derived from the production or

distribution of goods or the performance of services which contributes importantly to the accomplishment of any exempt purpose of the organization.” Thus, the size and extent of a business activity must be proportional to its putative contribution to an organization’s exempt purposes.

The leading case applying the facts and circumstances test is *United States v. American College of Physicians*. In that case, the Court considered whether advertising revenues earned by the American College of Physicians constituted unrelated business income. The court also ruled that in deciding whether the advertisements were substantially related to the College’s educational purposes, the focus was to be “upon the conduct of the College, rather than upon the education quality of the advertisement.” The manner in which the College operated its advertising activities was most important. 475 U.S. 834, 848 (1986).

The American College of Physicians published a monthly periodical entitled the Annals of Internal Medicine. The purpose of the periodical was to further the College’s exempt purposes, which included supporting medical education and research. During the tax year in question, the periodical produced advertising revenues of almost \$1.4 million. The government contended that the court should apply a strict rule making all advertising revenues unrelated business income. The court refused to adopt a “per se” rule and, instead, looked at the available facts and circumstances. The court concluded that the advertising in question did not contribute importantly to the College’s educational purposes and, therefore, produced unrelated business income.

(b) Fragmentation Rule

(i) In General

IRC Section 513 (c) explicitly provides that an activity qualifies as a trade or business even if the activity is operated within a larger context of exempt activities. This separation of trade or business activities is known as “fragmentation.”

For example, in Revenue Ruling 82-139, 1982-2 C.B. 108, a bar association exempt under IRC Section 501(c)(6) published a legal journal that contained opinions of the county court, articles of professional interest to lawyers, advertisements for products and services the legal profession uses, and legal notices. The bar association charged fees for publication of the advertisements and legal notices. Although the journal contained editorial material related to the bar association’s exempt purposes, the Service segregated the advertisements and the legal notices from the overall endeavor. It concluded that publication of the commercial advertisements,

albeit directed specifically to members of the legal profession, constituted an unrelated trade or business. On the other hand, the Service ruled that publication of the legal notices was not an unrelated trade or business because the legal notices served “to inform the general public of significant legal events rather than to stimulate demand for the products or services of an advertiser.”

Similarly, in Revenue Ruling 78-145, 1978-1 C.B. 169, a blood bank exempt under IRC Section 501(c)(3) collected and maintained inventories of blood for use by hospitals. Because the hospitals needed only the red blood cells, the blood bank sold the by-product plasma to commercial laboratories. In addition, the blood bank sold to commercial laboratories the plasma salvaged from whole blood nearing the end of its shelf life. The blood bank also sold plasma derived from donors through plasmapheresis, a process of drawing whole blood, separating and replacing the red cells in the donor, and collecting the plasma. Finally, the blood bank obtained plasma from other blood banks and sold it to commercial laboratories.

In determining whether to apply the unrelated business income tax, the Service did not look to the operation of the blood bank as a whole. Instead, the Service broke down the operation into a number of components. It concluded that the blood bank’s sale of by-product plasma remaining after removal of the red blood cells for hospital use was not an unrelated trade or business. The Service noted that the blood bank was merely disposing of products that resulted from its exempt functions. Likewise, the blood bank’s sale of plasma derived from whole blood nearing the end of its shelf life was not an unrelated trade or business. However, its sale of plasma derived from donors through plasmapheresis was an unrelated trade or business. Similarly, the blood bank was engaged in an unrelated trade or business when it resold the plasma from other blood banks.

(ii) Dual Use

Another aspect of the related-unrelated mixture that might be present in an activity is the dual use of facilities, such as a theater auditorium in a museum. If the exempt museum organization uses the theater during the hours the museum is open for the showing of educational films in connection with its program of public education in the arts and sciences, the income from these presentations is from a related trade or business. If, however, the museum organization uses the theater during the evening hours for the showing of ordinary motion pictures as public entertainment, the income from the evening use is from an unrelated trade or business.

(viii) Statutory Exceptions to Unrelated Business Income Tax

The Internal Revenue Code specifically excludes a number of activities from the term “unrelated trade or business.” These exclusions are:

- (1) any trade or business in which substantially all the work is performed by individuals on a volunteer (no compensation) basis;
- (2) any trade or business of an IRC Section 501(c)(3) organization or a state college or university carried on primarily for the convenience of members, students, patients, officers, or employees;
- (3) sales of merchandise substantially all of which an exempt organization receives as gifts or contributions;
- (4) the conduct of qualified public entertainment activities at fairs and expositions;
- (5) qualifying convention and trade show activities;
- (6) certain hospital services;
- (7) certain bingo games;
- (8) low-cost articles;
- (9) rental of mailing lists; and
- (10) sponsorship payments.

(ix) Modifications

IRC Section 512(a) ends its definition of unrelated business income with the requirement that the gross income earned from an unrelated trade or business be reduced by allowable deductions and adjusted for modifications included in IRC Section 512(b). IRC Section 512(b) then includes an interesting hodgepodge of sixteen modifications,²⁹⁸ of which seven deal with passive income issues; four exclude certain items of income;³⁰⁰ four concern deductions; and one requires the designation of certain income as unrelated business income.

1. Passive Income

The most important modifications make certain that passive investment income is not taxed as unrelated business income.

(a) Dividends and Interest

The regulations incorporate within the statutory exclusion for dividends and interest all income from “routine investments.” Obviously, the typical interest and dividend payment is included.

(b) Royalties

IRC Section 512 (b)(2) specifically excludes royalties from unrelated business income. However, neither the Code nor the regulations define a royalty. The Service, however, has defined a royalty as a payment “for the use of a valuable intangible property right.” Most courts have accepted this definition.

Royalties are payments for the right to use trademarks, trade names, copyrights, facsimile signatures, other likenesses, or lists. It is irrelevant whether the payment is ascertained by the amount of use to which the intangible property right is put or is just a flat payment. A royalty also includes a payment for the use of mineral rights whether the payment is measured on production or on income. On the other hand, royalties do not encompass payments for services performed by the exempt organization

(c) Rents

IRC Section 512 (b)(3) excludes from unrelated business income certain rental income. The general rule is that rents from real property are excluded from unrelated business taxable income. Rents from personal property not leased with real property are not excluded. However, rents from personal property leased with real property (i.e., a mixed lease) are excludable only if the rents attributable to the personal property do not exceed 10 percent of the total rents from all the property leased. If the amount attributable to the personal property is more than 10 percent, but not more than 50 percent, of the total rents from all the property leased, the personal property rent is not excludable from unrelated business taxable income, but the real property rent is excludable. Finally, if the personal property rent accounts for more than 50 percent of the total, none of the rent is excludable. The terms of a mixed lease are not necessarily conclusive in making allocation determinations if the amounts allocated are unrealistic, nor does the exclusion apply if the amount payable depends in whole or in part on the income or profits any person derives from the leased property.

Amounts paid for the occupancy of space do not qualify as excludable rents if the owner of the property renders any services to the occupant that are primarily for the occupant's convenience and not customarily provided in connection with the rental of rooms or space for occupancy only. The regulations provide that "the furnishing of heat and light, the cleaning of public entrances, exits, stairways, and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant." Thus, an exempt university that leases for a fixed fee its football stadium as a practice facility to a professional football team and that provides, under the lease agreement, ground maintenance, dressing room, linen, and stadium security services for the professional team is deriving income that does not qualify as excludable rent from real property. Unrelated business income, however, does not include payments for services related to the organization's exempt purpose.

(d) Gains and Losses

Also excluded from the computation of unrelated business taxable income are gains and losses from the disposition of property other than stock in

trade, inventory property, property held primarily for sale to customers in the ordinary course of a trade or business (the so-called dealer UBIT rule), or cut timber that the organization has elected to consider, upon the application of IRC Section 631(a), as a sale or exchange of such timber.

B. Tax-exempt status

(i) Treas. Reg. 1.501(c)(3)-1(e):

Organizations carrying on trade or business

(1) In general.

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose of purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the side and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3) even though it has certain religious purposes, its property is held in common, and its profits do not inure to the benefit of individual members of the organization. See, however, section 501(d) and section 1.501(d)-1, relating to religious and apostolic organizations.

(2) Taxation of unrelated business income.

For provisions relating to the taxation of unrelated business income of certain organizations described in section 501(c)(3), see sections 511 to 515, inclusive, and the regulations thereunder.

(ii) Related versus unrelated activities

	INSUBSTANTIAL	SUBSTANTIAL
RELATED ACTIVITIES	Does not jeopardize tax-exempt status and is not subject to unrelated business income tax	Does not jeopardize tax-exempt status and is not subject to unrelated business income tax
UNRELATED ACTIVITIES	Does not jeopardize tax-exempt status but is subject to un-related business income tax	Jeopardizes tax-exempt status. Is organization operated for the primary purpose of carrying on an unrelated trade or business?

- (iii) If unrelated, how much is too much?
- In *Living Faith, Inc. v. Comm'r*, 950 F.2d 365 (7th Cir. 1992) *aff'g*, TC Memo 1990 – 484, the stated Memo stated the considered following indicia:
 - (a) the particular manner in which the organization conducts its activities;
 - (b) the commercial hue of the activities;
 - (c) completion with commercial forms;
 - (d) below – cost pricing; and
 - (e) the amount of accumulate profits.
 - Commensurate in scope doctrine.

(iv) If a charitable organization plans to engage in substantial commercial activities that further its exempt purposes only through the production of income for such purposes, the organization should house such unrelated business activities in a separately taxable feeder under IRC Section 502. By using the separate feeder, the otherwise exempt organization avoids the risk of jeopardizing its exempt status. Theoretically, creating the separate subsidiary should not result in additional federal income tax liability.

Whether the otherwise tax-exempt organization chooses to carry on such commercial activities through a separate entity or within its own structure, the net income from the business activities will be subject to the unrelated business income tax.

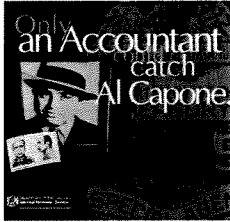
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Tax Fraud Investigations



Tax Fraud Investigations





IRS – Criminal Investigation

- The “Criminal Law Enforcement” Arm of the IRS
 - Criminal Investigations
 - Not “Audits” or “Examinations”
 - Prosecution Recommendations
 - Not Penalties upon conviction: Incarceration, Supervised Release & Probation, Fines
 - Defendants still must pay back taxes, penalties & interest
 - May be Court-ordered Restitution to IRS



Criminal Investigation’s Mission

CI Services the American public by investigating criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters **CONFIDENCE** in the tax system and **COMPLIANCE** with the law.



Criminal Investigation

Compliance Strategy – Tax Crimes

Legal Source Tax Crimes

Agency's Primary resource commitment and focus is on Title 26 violations such as:

- Tax evasion.
- Employment tax fraud.
- Aiding in filing of a false tax return

Illegal Source Tax Crimes

Income stemming from illegal sources, such as:

- Fraud schemes.
- Embezzlement.
- Public corruption.
- Id theft.
- Cyber-crimes, and
- Telemarketing scams.





Criminal Investigation

Special Agent Law Enforcement Training

25 Weeks of Training

- 1) Federal criminal law, including:
 - Criminal tax fraud
 - Money laundering
- 2) Evidence
- 3) Trial preparation and testifying
- 4) Surveillance
- 5) Interviewing
- 6) Firearms training
- 7) Arrests
- 8) Financial Investigations






Criminal Investigation

What is Tax Fraud?

- **FRAUD** is the deception by misrepresentation of material facts, or silence when good faith requires expression, resulting in material damage to one who relies on it and has the right to rely on it. Simply stated, it is obtaining something of value from someone else through deceit.
- **TAX FRAUD** is often defined as an intentional wrongdoing on the part of a taxpayer, with the specific purpose of evading a tax known or believed to be owing.



Criminal Investigation

Civil Fraud vs. Criminal Fraud



Criminal Investigation

Civil Fraud

- Civil fraud results in remedial action taken by the government such as assessing the correct tax and imposing civil penalties as an addition to tax, as well as retrieving transferred assets. Civil penalties are assessed and collected administratively as a part of the tax.



Criminal Investigation

Criminal Fraud

- Criminal fraud results in a punitive action with penalties and consisting of fines and/or imprisonment. Criminal penalties:
 - Are enforced only by prosecution
 - Are provided to punish the taxpayer for wrongdoings
 - Serve as a deterrent to other taxpayers

Criminal Investigation

Criminal Statutes

- 26 – 7201 – Tax Evasion – Evasion of Payment or Assessment of Tax
- 26 – 7202 – Failure to Collect or Pay Over Tax – Employment Tax
- 26 – 7203 – Failure to File
- 26 – 7206(1) – False Return
- 26 – 7206(2) – Assisting in the preparation of false returns
- 26 – 7212 – Attempt to impede investigation

Criminal Investigation

Willfulness/Intent

- Voluntary intentional violation of a known legal duty. The definition comes from years of judicial reviews and legal precedents



Criminal Investigation

3 Elements of Willfulness

- Knowledge
- Specific Intent
- Bad Purpose



Criminal Investigation

Ways to Prove Willfulness

- Direct Evidence
- Circumstantial Evidence
- Prior Acts
- Subsequent Acts



Criminal Investigation

Recognizing Items of Intent

- Two Sets of Books
- False entries/forgeries
- False invoices and documents
- Intentional destruction of books and records
- Concealment of amount or source of money
- Use of nominees...



Criminal Investigation

COMMON DEFENSES

- No tax due
- Intention to pay later
- Ignorance of law
- Advice of accountant or lawyer
- Mental or physical problems
- Good character



Criminal Investigation Service
Criminal Investigation

Investigative Process

- Sources of Criminal Investigations
- Preliminary Analysis and Investigative Approvals
- Conducting a Criminal Investigation
- Prosecution Recommendations
- Prosecution
- Conviction



Criminal Investigation Service
Criminal Investigation

Financial Investigative Approach



Criminal Investigation Service
Criminal Investigation

Financial Investigative Techniques

- Source and Application of Funds Analysis
 - Sources of Funds
 - Applications of Funds
- Methods of Proving Income
 - Direct Methods of Proof
 - Indirect Methods of Proof

Criminal Investigation

Primary Sources of Financial Information

- Tax Return & Tax Return Information
- Financial Institution Records
- Public Records
- Bank Secrecy Act (BSA) Reports
- Passport & Immigration Files
- Others

Criminal Investigation

Questions?



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Partnership Tax Update

**The Partnership Tax Provisions of Bipartisan Budget Act of 2015 as
Amended by the Consolidated Appropriations Act**

Edward Hymson¹
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Introduction, Definitions and Special Rules

In November, 2015, Congress repealed the Tax Equity and Fiscal Responsibility Act of 1982² (TEFRA) rules and provided new partnership audit rules effective for the tax year beginning after December 31, 2017.³ The Bipartisan Budget Act of 2015 (BBA)⁴ and technical amendments to the BBA (collectively BBA) included in the 2016 Consolidated Appropriations Act⁵ (CAA), together the BBACAA) rewrote the Internal Revenue Code (I.R.C.) partnership audit provisions⁶ (and conforming amendments elsewhere in the code).

The structure of the new partnership audit rules primarily focus on audits the information returns of the partnership itself and only secondarily on the individual partner returns. The results of the partnership audit is imposed on the partnership itself. Even if pushed out to the partners for payment, the partnership remains the guarantor of that payment. The partners' interests in the audit of the partnership are limited to representation through the partner or non-partner they select to interact with the Internal Revenue Service (IRS) and the provisions of their partnership agreement addressing how the results of an audit will be handled by the partnership. The BBACAA defines some of the new language in the implementing provisions in a definitions section late in the BBACAA. The following definitions provided in I.R.C. §6241 (2018), the date used to indicate provisions from the BBACAA) will facilitate understanding of the subsequent discussion.

1. Partnership means any partnership required to file a return under I.R.C. § 6031(a) (2016).⁷
2. Partnership adjustment means any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof.⁸ The partnership is treated as a point of collection of underpayments or

¹ Edward Hymson is a research fellow at the State Bar of New Mexico. The views expressed in the paper are those of the author and do not necessarily reflect the views of the State Bar of New Mexico. While every effort has been made to make sure that facts and references are correct, readers should independently confirm all legal conclusions and citations found in the paper. The paper does not constitute legal advice. Any errors that remain in the paper are the fault of poltergeists.

² P.L. 97-248 (1982).

³ I.R.C. § 6241(g) (2018).

⁴ Pub. L. No 114-74, §§1101(a), (b), (c).

⁵ Pub. L. No. 114-113, Div. Q § 411.

⁶ I.R.C. §§ 6221-6241(2014) and I.R.C. §§ 6221-6241 (2018).

⁷ I.R.C. § 6241(1) (2018).

⁸ I.R.C. § 6241 (2) (2018).

guarantor of partner payments that previously were the responsibility of partners. The return filed by the partnership, though it is an information return, is treated as if it were a tax return where necessary to implement examination, assessment, and collection of the tax due and any penalties, additions to tax, and interest.)⁹

3. Return due date⁹ means the date prescribed for filing the partnership return for such taxable year determined without regard to extensions.¹⁰

4. Payments nondeductible means no deduction is allowed under subtitle A for any payment required to be made by a partnership or by its partners.¹¹ (A basis adjustment (usually a reduction) to a partner's basis in its partnership interest is made to reflect the nondeductible payment by the partnership of the tax. Present-law I.R.C. § 705(a)(2)(B) (2016) applies, providing that the adjusted basis of a partner's interest in a partnership is the basis of the interest determined under applicable rules relating to contributions and transfers, and decreased (but not below zero) by expenditures of the partnership that are not deductible in computing its taxable income and not properly chargeable to capital account. Concomitantly, the partnership's total adjusted basis in its assets is reduced by the cash payment of the tax. Thus, parallel basis reductions are made to outside and inside basis to reflect the partnership's payment of the tax.

5. Suspension of the period of limitations on making an adjustment, assessment, or collection: The running of any period of limitations in I.R.C. §§ 6501 or 6502 (2016) or for making a partnership adjustment assessment or collection is suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection), for adjustment or assessment, 60 days thereafter, and for collection, 6 months thereafter.¹² The running of the period specified in I.R.C. § 6234 (2018) is also suspended for the period during which the partnership is prohibited by reason of such case from filing a petition under I.R.C. § 6234 (2018) and for 60 days thereafter.¹³

6. If a partnership ceases to exist before a partnership adjustment takes effect, such adjustment must be taken into account by the former partners of such partnership under regulations to be prescribed by the Secretary.¹⁴

7. Non-partnerships filing a partnership return: When a partnership return is filed by an entity determined not to be a partnership, to the extent provided in regulations, the provisions of this subchapter are extended for the year to the entity, its items, and to persons holding an interest in such entity.¹⁵

8. Restriction on authority to amend partner information statements. I.R.C. § 6031(b) (2016) provides: “Except as provided in the procedures under section 6225(c), with respect to statements under section 6226, or as otherwise provided by the Secretary, information required to be furnished by the partnership under this subsection may not be amended after the due date of the return under subsection (a) to which such information relates.”¹⁶

⁹⁹ See I.R.C. § 6232, 6233 (2018).

¹⁰ I.R.C. § 6241(3) (2018).

¹¹ I.R.C. § 6241(4) (2018).

¹² I.R.C. § 6241(6)(A) (2018).

¹³ I.R.C. § 624(6)(B) (2018).

¹⁴ I.R.C. § 6241(7) (2018).

¹⁵ I.R.C. § 6241(8)(A) (2018).

¹⁶ I.R.C. §§ 6241(2), 6330(c)(4) (2018).

Partnership Reporting Requirements

For Federal income tax purposes, a partnership was, and remains under the BBACAA, a conduit that files an annual information return setting forth items of partnership information on Form 1065¹⁷ reflecting items of partnership income, deduction, gain, loss, and credit (collectively partnership items) taken into account on the partners' income tax returns. A partnership furnishes to each partner a Schedule K-1 that reflects information on each partner's partnership items for income tax purposes.¹⁸

The TEFRA Partnership Audit and Adjustment Rules

Under the TEFRA partnership audit and adjustment rules; 1) partnerships with more than 100 partners may elect to use "electing large partnership" rules,¹⁹ 2) partnerships with more than 10 partners, those with pass through entities as partners, and partnerships that do not elect large partnership status are subject to TEFRA rules (under 1 and 2 partnership items are determined at the partnership level, though individual partner participation in the IRS audit and appeal proceedings as well as at court is permitted),²⁰ and 3) partnerships with 10 or fewer partners not electing TEFRA audit rules tax liability is determined under pre TEFRA, audit and adjustment rules applicable to individual taxpayers in separate deficiency proceedings.²¹ Note that prior to 1982, all partnership items were audited in individual deficiency proceedings.²²

TEFRA established unified rules that require the tax treatment of all "partnership items" it covers to be determined at the partnership, rather than the partner, level.²³ The argument leading to passage of TEFRA was, "[d]etermination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult."²⁴ Notwithstanding the purpose of the legislation, while the result of audits under TEFRA bound all

¹⁷ I.R.C. § 6031(a) (2014).

¹⁸ I.R.C. § 6031(b) (2014). Partner returns and statements are due by the third month after the partnerships taxable year; however, an automatic six-month extension of time to file is available on request.

¹⁹ I.R.C. §§ 6231 and 6201 *et seq.* (2014).

²⁰ I.R.C. § 6221–6234; I.R.C. §§ 6201 *et seq.* (2014).

²¹ I.R.C. §§ 6231 and 6201 *et seq.* (2014).

²² Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015, at 52, March 2016.

²³ Each item on a partner's return affected by a partnership item must be determined at the partnership level as an "affected item." I.R.C. § 6231(a)(3), (5) (2014).

²⁴ Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS–38–82) at 268, December 31, 1982.

partners absent an election of a partner out,²⁵ the law still required collection of deficiencies at the partner level.²⁶

TEFRA provides that a partner selected by the partnership as the “Tax Matters Partner” (TMP) would be the primary negotiator with the IRS;²⁷ however, the IRS is required to give notice of the partnership-level audit and any administrative adjustments to all partners.²⁸ The TMP is required to keep all partners informed.²⁹ Individual partners have the right to participate in the partnership audit.³⁰ Each partner retains the right to individually enter into a settlement agreement,³¹ and to decline to be bound by the TPP by providing advanced notice to the IRS.³² Otherwise, the TMP settlement is binding on all parties.³³

Partners Must Report Partnership Items In a Manner Consistent with Partnership Reporting

Each partner must report partnership items consistently with the partnership’s reporting unless a partner notifies the IRS of his or her inconsistent treatment of the item. Absent such notification, the IRS can assess that partner under its math error authority, making a computational adjustment and immediately assessing any additional tax.³⁴ Additional tax attributable to a partnership item is assessed against each partner who was a partner in the reviewed year (the year the understatement arose). Partners may participate in administrative proceedings at the partnership level, and can request an administrative adjustment or a refund for that partner’s own separate tax liability.³⁵ In addition, any partner may bind the partnership.³⁶ To the extent that a settlement is reached with respect to partnership items, all partners are entitled to consistent treatment.³⁷

Statutes of Limitations

Absent an agreement to extend the statute of limitations, the IRS generally cannot adjust a partner’s partnership item for a partnership taxable year more than 1) three years from the later of the filing the partnership return, or the last day for filing the partnership return (without extensions),³⁸ 2) six years from the later of filing the partnership return or the last day for filing (without extension) if the understatement was more than 25% of income,³⁹ or 3) without

²⁵ I.R.C. § 6221 (2014).

²⁶ I.R.C. § 6224(c) (2014). *See also* Part F of Chief Counsel Notice 2009–27, Frequently Asked Questions Regarding The Unified Partnership Audit And Litigation Procedures Set Forth In I.R.C. § 6221–6234, Part F, August 21, 2009.

²⁷ I.R.C. § 6231(a)(7) (2014).

²⁸ I.R.C. § 6223 (2014).

²⁹ I.R.C. § 6223(g) (2014).

³⁰ I.R.C. § 6224(a) (2014).

³¹ I.R.C. § 6224(c)(2) (2014).

³² I.R.C. § 6224(c)(4) (2014).

³³ I.R.C. § 6224(c)(1) (2014).

³⁴ I.R.C. §§ 6222 and 6230(b) (2014).

³⁵ I.R.C. § 6224(a) (2014).

³⁶ I.R.C. § 6224(c)(1) (2014).

³⁷ I.R.C. § 6224 (2014).

³⁸ I.R.C. § 6229(a) (2014).

³⁹ I.R.C. § 6229(c)(2) (2014).

limitation in the case of fraud or failure to file a return.⁴⁰ The period in which the tax must be assessed against the partners does not expire before one year following the date on which the final partnership administrative adjustment may no longer be petitioned to the U.S. Tax Court or, if a petition was filed, a decision of the court with respect to such petition is final.⁴¹

Electing Large Partnership Rules

In the Taxpayer Relief Act of 1997,⁴² Congress enacted what were supposed to be simplified reporting rules for electing large partnerships.⁴³

A TMP is appointed who need not be a partner.⁴⁴ Partnership items are determined at the partnership level. The IRS is required to designate a partner or other person to act on its behalf if the partnership does not. The IRS is not required to give notice to individual partners of the commencement of an administrative proceeding or of a final adjustment. Instead, the IRS sends notice of a partnership adjustment to the partnership itself by certified or registered mail.

Partners are all required to report partnership items consistently with what is shown on the partnership return and the K-1.⁴⁵ Unlike the TEFRA partnership audit rules, for electing large partnerships, partnership adjustments, other than adjustments to distributive shares, generally flow through to the partners for the year in which the adjustment takes effect.⁴⁶

Payment of Imputed Underpayments: Partnership Is Liable for Penalties and Interest

The partnership may either pass through an adjustment to its partners or pay an underpayment imputed at the partnership level, calculated by netting the adjustments to partnership items and multiplying that amount by the highest Federal income tax rate (whether individual or corporate).⁴⁷ Adjustments to credits are taken into account as increases or decreases in the amount of tax. A partner may not file a claim for credit or refund of his allocable share of the payment.

Under the electing large partnership rules the partnership itself is liable for interest and penalties.⁴⁸ Interest is computed from due date for the initial return for the adjusted year. The interest is determined on the imputed underpayment with respect to such adjustment, for the period beginning on the day after the return due date for the adjusted year and ending on the return due date for the partnership taxable year in which such adjustment takes effect or, if earlier, the date on which the payment is made.⁴⁹

⁴⁰ I.R.C. § 6229 (c)(1) (2014).

⁴¹ I.R.C. § 6229(d) (2014).

⁴² Pub. L. No. 105-34 (2014).

⁴³ I.R.C. §§ 771-777 (2014).

⁴⁴ I.R.C. § 6255(b)(1) (2014).

⁴⁵ I.R.C. § 6241(b) (2014).

⁴⁶ I.R.C. § 6242(a)(1) (2014).

⁴⁷ I.R.C. § 6242(a)(2) (2014).

⁴⁸ I.R.C. § 6242(b)(1) (2014).

⁴⁹ I.R.C. § 6242(b)(2) (2014).

Penalties are determined on a year-by-year basis (without offsets) based on the imputed underpayment. Accuracy waiver criteria (such as reasonable cause or substantial authority) as well as fraud penalties are determined as if the partnership were a taxable individual.⁵⁰ The imputed underpayment with respect to any partnership adjustment is the underpayment (if any) which would result by netting all adjustments to items of income, gain, loss, or deduction and by treating any net increase in income as an underpayment equal to the amount of such net increase multiplied by the highest rate of tax in effect under section 1 or 11 (personal or corporate) for the adjusted year, and by taking adjustments to credits into account as increases or decreases in the amount of tax.⁵¹ For purposes of the preceding sentence, any net decrease in a loss is treated as an increase in income and the inverse rule applies to a net increase in a loss.⁵² Payment of Federal income taxes, interest, and penalties are nondeductible.⁵³

If a partnership ceases to exist before a partnership adjustment takes effect, the former partners are required to pay the adjustment in the manner provided by regulations to be drafted.⁵⁴ The IRS challenges the reporting position of an electing large partnership by conducting a single administrative proceeding; partners have no right individually to participate in settlement conferences or to request a refund.⁵⁵ An electing large partnership must furnish copies of information returns (Schedule K-1, Partner's Share of Income, Deductions, Credits, etc.) to partners by March 15 of the year following the close of the partnership's taxable year.⁵⁶ As with other partnerships, the statute of limitations is 3 years after the later of date on which the return for the taxable year was filed or the due date for the return (without extensions) unless extended by agreement.⁵⁷ There is no limitation on adjustments made for fraud, filing a false return, or failure to file a return,⁵⁸ and a 6 year statute of limitations applies when there is a gross understatement in excess of 25% of gross income.⁵⁹

The partnership may petition Tax Court, District Court, or The Court of Federal Claims to resolve imputed underpayment disputes or any other readjustment of partnership items.⁶⁰

The BBACAA Regime of Partnership Taxation

BBACAA repeals the elective large partnership and general TEFRA partnership audit and adjustment rules for taxable years beginning for tax years commencing after December 31, 2017.⁶¹ The BBACAA imposes a centralized system for audit, adjustment, assessment, and collection of tax in subchapter C of chapter 63 of the Code.⁶² The structure is subject to partner

⁵⁰ I.R.C. § 6242(b)(3) (2014).

⁵¹ I.R.C. § 6242(b)(4) (2014).

⁵² I.R.C. § 6242(b)(4) (2014).

⁵³ I.R.C. § 6242(e) (2014).

⁵⁴ I.R.C. § 6255(d) (2014).

⁵⁵ I.R.C. § 6255(b) (2014).

⁵⁶ I.R.C. § 6031(b) (2014).

⁵⁷ I.R.C. § 6248(a),(b) (2014).

⁵⁸ I.R.C. § 6248(c)(1),(3) (2014).

⁵⁹ I.R.C. § 6248(c)(2) (2014).

⁶⁰ I.R.C. § 6234(a)(b) (2014).

⁶¹ I.R.C. § 6221(a) (2014).

⁶² I.R.C. §§ 6221(a), 6223 (2018).

rights to elect out of the BBACCA rules if the partnership has 100 or fewer partners,⁶³ and the right of partners to push through payment of deficiencies to individual partners.⁶⁴ Absent an election out of the BBA regime or election to pass through payments to partners, additional tax and any penalty attributable to partnership items are both assessed and collected from the partnership.⁶⁵ No distinction is made between partnership items and affected items.⁶⁶ Underpayment of tax is imputed to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership in that year.⁶⁷

The partnership may seek modification of the assessment either by submitting information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns, partnership negotiations during audit or on appeal to IRS Appeals, or to court in accordance with not yet drafted regulations and other guidance.⁶⁸

Instead of the partnership paying an imputed underpayment, the partnership may choose that each reviewed-year partner pay his or her share of the imputed underpayment. If the obligation to pay is pushed out to the partners, each partner from the reviewed-year must be furnished a statement of the partner's share of the adjustments. Each partner must then increase its tax for the year the statement is furnished.⁶⁹ A partnership may also file an administrative adjustment request.⁷⁰

Opportunity to Elect Out of the BBACAA Rules

If a partnership has 100 or fewer partners in a tax year it may elect out of the BBA provisions and be subject to the pre-TEFRA partner by partner audit of the partnership.⁷¹ To elect out, each of its partners must be an individual, a deceased partner's estate, a C corporation, or an S corporation.⁷² Each shareholder of an S corporation is counted as a partner (except a husband and wife, who are counted as one partner).⁷³ If a foreign entity is a partner, that would be taxable as a C corporation if it were domestic or elects to be treated as a per se corporation under the LLC check-the-box rules, a partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of I.R.C. § 7701, that is, the foreign entity has elected to be, or is, treated as a per se corporation under the check-the-box regulatory rules.⁷⁴ The election must be

⁶³ I.R.C. § 6221(b) (2018).

⁶⁴ I.R.C. § 6226(a),(b) (2018).

⁶⁵ I.R.C. § 6221(a) (2018).

⁶⁶ I.R.C. § 6225(a),(b),(c) (2018) Amended returns of partners take account of all changes in partnership items as well as adjustments caused by those changes.

⁶⁷ I.R.C. §§ 6221(a), 6225(a) (2018).

⁶⁸ I.R.C. §§ 6223,6234 (2018)

⁶⁹ I.R.C. § 6226 (2018).

⁷⁰ I.R.C. § 6227 (2018).

⁷¹ I.R.C. § 6221(b); I.R.C. § 6031 (2018) (describing the requirement that a partnership issue each partner a K-1 providing the partner's share of partnership items).

⁷² I.R.C. § 6221(b)(1) (2018).

⁷³ I.R.C. § 6221(b)(2)(A) (2018). K-1 Statements must be provided to each shareholder pursuant to rules similar to I.R.C. 6037(b) (2018).

⁷⁴ I.R.C. §§ 6221(b)(1)(B) (2018), I.R.C. § 7701(a)(5) (2014); Treas. Reg. §§ 301.7701-2 and -3. .

made annually with the return for that year and include the name and TIN of each partner. The partnership must notify each of its partners of the election out.⁷⁵

Partner Returns Must be Consistent with Partnership Returns

Similar to longstanding rules with respect to S corporations,⁷⁶ each partner must treat each partnership item consistently with the treatment of that partnership item on the partnership return.⁷⁷ Failure of a partner to report consistently with the partnership return is treated as a math error on the partner's return.⁷⁸ The partner can file inconsistently with the partnership if he or she files a statement of inconsistent position, in which case neither the math error nor the non-abatement provisions apply. Similarly, the math error and non-abatement provisions do not apply if the partner's return is consistent with the treatment shown on the K-1 statement, even if inconsistent with the actual partnership return.⁷⁹ Once all appeals have been exhausted, the resulting final decision as to a partnership's tax liability that has been negotiated with the Partnership Representative (PR) is binding on all partners;⁸⁰ however a final determination on a partner's identified inconsistent position is not binding on the partnership unless the partnership is party to the proceeding.⁸¹

Under BBACAA Rules, Partners are Bound by the Actions of the Partnership

Unless the partnership elects out, the partnership is required to act through its PR.⁸² A partnership and all partners of such partnership are bound by actions taken by the partnership, and by any final decision in a proceeding brought with respect to the partnership.⁸³ The PR can be either a partner or a non-partner designated by the partnership as long as he or she has a substantial presence in the United States.⁸⁴ If the partnership does not designate a PR, the Secretary will designate someone to be the PR.⁸⁵

Partnership Adjustments Made for the Reviewed Year are Paid in the Adjustment Year

The reviewed year is the year for which the partnership filed a tax return, paid tax, and is being audited by the IRS.⁸⁶ The adjustment year is the partnership taxable year in which an IRS final adjustment is mailed if there is no court appeal, matters appealed to a court are finally resolved, or the partnership makes an administrative adjustment request.⁸⁷

Partnership Payment of the Imputed Underpayment

⁷⁵ I.R.C. §§ 6221(b)(1)(D),(E) (2018).

⁷⁶ See I.R.C. § 6037(c) (2018).

⁷⁷ I.R.C. § 6222(a) (2018).

⁷⁸ I.R.C. § 6222(b) (2018). The correction of the math error cannot be abated under I.R.C. § 6213(b)(2) (2018).

⁷⁹ I.R.C. § 6222(c) (2018).

⁸⁰ I.R.C. § 6223(b) (2018).

⁸¹ I.R.C. § 6223(b) (2018).

⁸² I.R.C. §§ 6223(a) (2018).

⁸³ I.R.C. § 6223(b) (2018).

⁸⁴ I.R.C. § 6223(a) (2018).

⁸⁵ I.R.C. § 6223(a) (2018).

⁸⁶ I.R.C. § 6225(d)(1) (2018).

⁸⁷ I.R.C. § 6225(d)(2) (2018).

Any adjustment to partnership items for a partnership taxable year and any partner's distributive share thereof are determined at the partnership level. Absent an election out, any imputed underpayment for the adjustment year must be paid by the partnership.⁸⁸ Interest due is determined at the partnership level and accrues at the rate applicable to underpayments.⁸⁹ Adjustments in partnership items or any partner's distributive share that do not result in an imputed underpayment are taken into account by the partnership in the adjustment year as a reduction in non-separately stated income or an increase in non-separately stated loss.⁹⁰

Determination of the Amount of an Imputed Underpayment

A partnership adjustment for an imputed underpayment of tax for a reviewed year is determined by netting all adjustments to items of income, gain, loss, or deduction and multiplying result by the highest rate of Federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year.⁹¹ Any adjustments to tax credits are reflected as an increase or decrease in the figure resulting from this multiplication of the adjustment by the tax rate. The resulting net increase or decrease in loss is reflected in a decrease or increase in income, reflecting the limitations, restrictions, and special rules of the IRC.

For example, assume for 2018 a partnership reports:

1. ordinary income, \$300,000,
2. long term capital gain from asset sales , \$125,000,
3. long term capital loss from asset sales, \$75,000,
4. producing net long-term capital gain of \$50, 000,
5. depreciation deduction , \$100,000,
6. tax credit, \$5,000.

When the Secretary examines the partnership's taxable year in 2019, the Secretary finds:

1. ordinary income, \$500,000, a \$200,000 increase,
2. long-term capital gain, \$200,000, a \$75,000 increase,
3. long-term capital loss, \$25,000, a \$50,000 decrease,
4. producing long-term capital gain, \$175,000, a \$125,000 adjustment,
5. depreciation deduction, \$70,000, a \$30,000 decrease,
6. tax credit of \$3,000, a \$2,000 decrease.

These are netted under the provision as follows:

1. Adjustments to ordinary income and to the ordinary depreciation deduction are netted:

⁸⁸ I.R.C. § 6225(a)(1) (2018).

⁸⁹ I.R.C. § 6621(a)(2) (2018).

⁹⁰ I.R.C. § 6225(a)(2) (2018).

⁹¹ I.R.C. § 6225(b)(1) (2018). Note that I.R.C. § 6225(c) (2018) provides that the Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with requirements of the section.

- \$200,000 increase in income plus a \$30,000 decrease in depreciation equals \$230,000.
2. The adjustments to long term capital gain and loss are netted: \$75,000 increase in gain plus a \$50,000 decrease in long term capital loss equals \$125,000.

The adjustments total \$355,000.

If the highest rate of Federal income tax applicable to individuals or corporations in 2019 is 39.6%. The product of \$355,000 and 39.6% is \$140,580 in additional tax. The credit adjustment is a reduction of \$2,000, which increases that figure, yielding an imputed underpayment of \$142,580 (not taking into account possible modifications further described below). The partnership pays the imputed underpayment in taxes in the adjustment year. The payment is then allocated to partners distributive shares.

Revisions to Individual Partners' Distributive Shares

An adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any decrease in any item of income or gain and disregarding any increase in any item of deduction, loss, or credit⁹² because they are already addressed under the imputed adjustments for the partnership.⁹³

Thus, for example, consider a partnership has two partners, L and M and under the partnership agreement, \$100,000 of rental income is allocated to L and \$70,000 of depreciation and interest deductions are allocated to M for the taxable year. The Secretary notifies the partnership and the partnership representative of an administrative proceeding initiated at the partnership level with respect to the partnership's return for 2024.

If the Secretary determines that the \$70,000 distributive share of depreciation and interest deductions should be reallocated from M to L, the imputed underpayment of the partnership is determined without decreasing the \$100,000 of rental income by the \$70,000 of depreciation and interest deductions. The adjustment is a \$70,000 increase in income. If the highest rate of Federal income tax applicable to individuals or corporations in 2024 is 39.6%, \$70,000 multiplied by 39.6 percent is \$27,720, the amount of the imputed underpayment.⁹⁴ Regulations to be drafted could alter this result. As is shown infra, if the payment is pushed out to the partners, the applicable rates can, in some instances be reduced.

The Treatment and Revision of Imputed Underpayments

In general, any imputed underpayment with respect to any partnership adjustment for any reviewed year is determined as follows: 1) Net all adjustments of items of income, gain, loss, or deduction, 2) multiply such net amount by the highest rate of tax in effect for the reviewed year under section 1 or 11, 3) treat any net increase or decrease in loss under subparagraph (A) as a decrease or increase, respectively, in income, and 4) take into account any adjustments to items

⁹² I.R.C. § 6225(b)(2) (2018).

⁹³ Under I.R.C. § 6225(b)(1) (2018).

⁹⁴ Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 at 65, March, 2016.

of credit as an increase or decrease, as the case may be, in the netted adjustments.⁹⁵ Any adjustment which reallocates the distributive share of any item from one partner to another is taken into account by the provisions of I.R.C. § 6225(b)(1) by disregarding any decrease in any item of income or gain, and any increase in any item of deduction, loss, or credit.⁹⁶ This harsh result is ameliorated to some extent if payment is pushed out to individual partners.

The partnership may implement procedures for modifying the imputed underpayment as so determined. When a partnership audit commences, the Secretary must notify the partnership and PR of the administrative proceeding initiated at the partnership level and of any proposed partnership adjustment developed during the proceeding.⁹⁷ The Secretary must establish procedures for partnership modification of the amount of an imputed underpayment after initiation of the proceeding.⁹⁸ The procedures include the filing of amended returns by reviewed year partners, determination of the imputed underpayment without regard to the portion of it allocable to a tax-exempt partner, and modification of the applicable highest tax rates, including determining the portion of an imputed underpayment to which a lower rate applies as well as additional procedures developed in regulations.⁹⁹ The modifications are intended to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid.

Information and documentation submitted with respect to modification of the amount of an imputed underpayment must be submitted within a 270-day period beginning on the date the notice of a proposed partnership adjustment is mailed.¹⁰⁰

Payments Made on Amended Returns of Reviewed Year Partners

Payments made by reviewed year partners on amended returns may reduce the amount of an imputed underpayment,¹⁰¹ because the imputed underpayment amount may be modified to reflect

⁹⁵ I.R.C. § 6225(b)(1) (2018).

⁹⁶ I.R.C. § 6225(b)(2) (2018).

⁹⁷ I.R.C. § 6231(a)(1) and (2) (2018).

⁹⁸ I.R.C. § 6225(c) (2018).

⁹⁹ Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 at 65, March, 2016 explains, “See I.R.C. § 411 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113). Under the provision, certain I.R.C. § 469(k) (2016) passive activity losses can reduce the imputed underpayment of a publicly traded partnership under the centralized system. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to (*i.e.*, would be offset by) specified passive activity losses attributable to a specified partner. The amount of the specified passive activity loss is concomitantly decreased, and the partnership takes the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. A specified passive activity loss for any specified partner of a publicly traded partnership means the lesser of the I.R.C. § 469(k) (2016) passive activity loss of that partner which is separately determined with respect to the partnership (1) for the partner’s taxable year in which or with which the reviewed year of the partnership ends, or (2) for the partner’s taxable year in which or with which the adjustment year of the partnership ends. A specified partner is a person who continuously meets each of three requirements for the period starting with the partner’s taxable year in which or with which the partnership reviewed year ends through the partner’s taxable year in which or with which the partnership adjustment year ends. These three requirements are that the person 1) is a partner of the publicly traded partnership; 2) an individual, estate, trust, closely held C corporation, or personal service corporation; and 3) has a specified passive activity loss with respect to the publicly traded partnership.”

¹⁰⁰ I.R.C. § 6235(a)(2) (2018).

amended returns of partners.¹⁰² If one or more partners file returns (notwithstanding I.R.C. § 6511) for the taxable year of the partners which includes the end of the reviewed year of the partnership, the returns take into account all adjustments properly allocable to such partners. Thus, payment of any tax due is included with such return; the imputed underpayment amount is determined without regard to the portion of the adjustments so taken into account.¹⁰³ Adjustments for filing of amended returns which reallocate the distributive share of any item from one partner to another apply only if returns are filed by all partners affected by such adjustment.¹⁰⁴

Modifications that Reflect Actual Tax Obligations of Individual Partners Including Tax Exempt Partners

Imputed underpayments are first determined without regard to the portion thereof that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in section 168(h)(2)).¹⁰⁵ The IRC then provides that taxpayers may take into account a tax rate applicable to each individual partner that is lower than the highest applicable tax rate in effect. The adjustment reflects C corporation tax rates, capital gain and qualified dividend tax rates, or tax rates applicable to distributive share of each individual taxpayer, including, presumably, the tax rate of a tax exempt partner.¹⁰⁶

For example, if a portion of an imputed underpayment relates to an item of long-term capital gain or qualified dividend income that is allocable to a partner who is an individual, the highest rate of tax with respect to that item for the reviewed year is 20 percent, lower than the highest rate of ordinary income tax applicable to individuals of 39.6 percent. The highest rate for the type of income and type of taxpayer applies under the modification.

The portion of the imputed underpayment to which the lower rate applies is determined for each partner's distributive share of partnership items to which the imputed underpayment relates. It is applied by reference to the amount of the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year.

For example, adjustments are made to a partnership's rental income with respect to property A and its depreciation deductions with respect to property B. A corporate partner has a 20% distributive share of rental income from property A, a 15% distributive share of depreciation deductions from property B, and a 20% distributive share of any gain in the reviewed year. However, if the partnership had sold its assets at fair market value as of the close of the reviewed year, the gain would have been \$100,000 and based on its capital account, the corporate partner's distributive share would have been \$20,000. Thus, the portion of the imputed underpayment to which the lower rate applies with respect to the corporate partner is 20%.¹⁰⁷

¹⁰¹ I.R.C. § 6225(c)(2) (2018).

¹⁰² I.R.C. § 6225(c)(1) (2018).

¹⁰³ I.R.C. § 6225(c)(2)(A) (2018).

¹⁰⁴ I.R.C. § 6225(c)(2)(B) (2018). The provision applies notwithstanding 168(h)(2)(A) (2016).

¹⁰⁵ I.R.C. § 6225(b)(3) (2018).

¹⁰⁶ I.R.C. § 6225(b)(3) (2018).

¹⁰⁷ Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 at 67, March, 2016.

Payment of Imputed Underpayments by Individual Partners Rather than by the Partnership

Instead of partnership payment of an imputed underpayment in the adjustment year a partnership may push out the payment to the individual partners. It does so by furnishing to the Secretary and to each partner for the reviewed year a statement of the partner's share of any adjustments to partnership items determined in the notice of final partnership adjustment.¹⁰⁸ Each partner pays his or her share of the partnership tax in the tax year that includes the date of the imputed adjustment statement.¹⁰⁹

The reviewed year partner's tax is increased by the amount by which the partner's tax would increase if the partner's distributive share of the adjustment amounts were included for the partner's taxable year that includes the end of the reviewed year, plus the amount by which the tax would increase by reason of adjustment to tax attributes in years after that year of the partner and before the year of the date of the statement. Tax attributes in any subsequent taxable year are required to be appropriately adjusted.

"Push Out" of Additional Tax Payments to Individual Partners

Whether or not the partnership decides to contest the final partnership adjustment,¹¹⁰ it may within 45 days of a notice of final partnership adjustment of an imputed underpayment elect to push out payment of additional tax to the individual partners.¹¹¹ The partnership must furnish each partner for the reviewed year and the Secretary a statement of each partner's share of any adjustment to income gain, loss, deduction, or credit so the partner may the adjustment the partner's adjustment year taxes.¹¹² If push out is elected the rate of interest imposed for the time from timely filing to payment is increased. Interest is due from the due date of the return for the taxable year to which the increase is attributable under I.R.C. § 6621(a)(2), determined by substituting '5 percentage points' for '3 percentage points' in subparagraph (B) thereof.¹¹³ The partners of the partnership for the reviewed year are liable for any such penalty, addition to tax, or additional amount.¹¹⁴

Treatment of Tiered Entities

A tiered partnership that receives a statement from the audited partnership pursuant to a push out pays the tax attributable to adjustments, calculated as if it were an individual, consistently with I.R.C. § 703 (2016), for the taxable year that includes the date of the statement.¹¹⁵ A recipient partner RIC or REIT may then make a deficiency dividend for the reviewed year.¹¹⁶

¹⁰⁸ I.R.C. § 6226(a) (2018).

¹⁰⁹ I.R.C. § 6226(b) (2018).

¹¹⁰ I.R.C. § 6226(d) (2018).

¹¹¹ I.R.C. § 6226(a) (2018).

¹¹² I.R.C. §§ 6226(a)(1),(2) (2018). The taxes are paid in the partner's tax year in which the final notice of adjustment is dated, I.R.C. §6226(b)(1) (2018).

¹¹³ I.R.C. §§6226(c)(2)(A),(B) (2018).

¹¹⁴ I.R.C. §6226(c)(1) (2018).

¹¹⁵ I.R.C. § 703 (2016), (taxable income of a partnership is computed in the same manner as for an individual').

¹¹⁶ I.R.C. § 860 (2016) (Regulations to implement the provision will have to be written).

Partnership Administrative Adjustment Requests

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year.¹¹⁷ The administrative adjustment is both determined and taken into account for the partnership taxable year in which the administrative adjustment request is made either by the partnership (under rules similar to the rules of I.R.C. § 6225 (2018)), or by the partnership and partners (under rules similar to the rules of I.R.C. § 6226 (2018)).¹¹⁸ If the adjustment does not result from an imputed underpayment the rules under I.R.C. 6226 (2018) apply.¹¹⁹ The request must be filed not more than 3 years after the later of the date on which the partnership return is filed or the last day for filing the partnership return for such year without regard to extensions and the request must be made before issue of a notice of an administrative proceeding under I.R.C. § 6231 (2018).¹²⁰

Assessment, Collection, and Payment

Any imputed underpayment is assessed and collected in the same manner as if it were a tax imposed for the adjustment year.¹²¹ When an administrative adjustment request is made by a partnership, the underpayment is paid when the request is filed.¹²² Subject to exceptions provided elsewhere in the chapter, no assessment of a deficiency or levy may be made for collection of any amount resulting from an adjustment before the close of the 90th day after the later of the day on which a notice of a final partnership adjustment was mailed, or if a court appeal was filed, after the decision of the court has become final.¹²³ The IRS premature effort to collect a tax action can be enjoined by any court²³⁸ notwithstanding the general rule prohibiting suits to restrain assessment or collection of tax.¹²⁴

If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to an item is required, rules similar to the rules of paragraphs (1) and (2) of I.R.C. § 6213(b) apply to such an adjustment.¹²⁵ If a partnership is a partner in another partnership, any adjustment on account of such partnership's failure to comply with the requirements of I.R.C. § 6222(a) with respect to its interest in such other partnership is treated as a mathematical adjustment.¹²⁶ Rules similar to the math error authority under I.R.C. § 6213(b) are applies for math and clerical errors or tiered partnership undisclosed inconsistent returns.¹²⁷

¹¹⁷ I.R.C. § 6227(a) (2018).

¹¹⁸ I.R.C. § 6227(b) (2018).

¹¹⁹ I.R.C. § 6227(b) (2018).

¹²⁰ I.R.C. § 6227(c) (2018).

¹²¹ I.R.C. § 6232(a) (2018).

¹²² I.R.C. § 6232(a) (2018).

¹²³ I.R.C. § 6232(b) (2018). A partnership may waive such restrictions on making a partnership adjustment, I.R.C. § 6232(d)(2) (2018).

¹²⁴ I.R.C. § 6232(c) (2018).

¹²⁵ I.R.C. § 6232(d)(A) (2018).

¹²⁶ I.R.C. § 6232(d)(B) (2018).

¹²⁷ I.R.C. § 6232(d) (2018).

A notice of proposed adjustments informs the partnership of adjustments tentatively determined by the Secretary and the amount of any imputed underpayment resulting from such adjustments. Thereafter, the partnership has 270 days in which to supply all information required by the Secretary in support of a request for modification and during which the Secretary may not issue a notice of final partnership adjustment.¹²⁸ When the issuance of a notice of final partnership adjustment is issued to the partnership, it has 90 days to seek judicial review of the partnership adjustment and 45 days to elect the alternative payment procedures.¹²⁹

The interest is computed to any partnership adjustment determined under chapter 67, beginning on the day after the return due date for the reviewed year and ending on the return due date for the adjustment year, or, if earlier, the date payment of the imputed underpayment is made.¹³⁰ Interest is also computed on any adjustments required for taxable years after the reviewed year and before the adjustment year.¹³¹ Any penalty or addition to tax is determined at the partnership level as though the partnership were an individual and the imputed underpayment were an actual underpayment for the year.¹³² Failure to pay an imputed underpayment on the date prescribed makes the partnership liable for additional interest and for any penalty computed by applying I.R.C. § 6651(a)(2) (2018) to such failure to pay the imputed underpayment as an underpayment of tax for purposes of part II of subchapter A of chapter 68.¹³³

Computation and Payment of Interest and Penalties

The interest is added to any partnership adjustment determined under chapter 67, beginning on the day after the return due date for the reviewed year and ending on the return due date for the adjustment year, or, if earlier, the date payment of the imputed underpayment is made.¹³⁴ Interest is also computed on any adjustments required for taxable years after the reviewed year and before the adjustment year.¹³⁵ Any penalty or addition to tax is determined at the partnership level as though the partnership were an individual and the imputed underpayment were an actual underpayment for the year.¹³⁶ Failure to pay an imputed underpayment on the date prescribed makes the partnership liable for additional interest and for any penalty computed by applying I.R.C. § 6651(a)(2) (2018) to such failure to pay the imputed underpayment as an underpayment of tax for purposes of part II of subchapter A of chapter 68.¹³⁷

§ 411 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114–113), eliminates the unintended conflict between I.R.C. § 6231 (2018) (barring the Secretary from issuing the notice of final partnership adjustment earlier than the expiration of the 270 days after the notice of a proposed adjustment) and I.R.C. § 6235 (2018) (requiring that a notice of final partnership adjustment be filed no later than 270 days after the notice of proposed

¹²⁸ I.R.C. § 6231(a) (2018). The Secretary is required to promulgate regulations, I.R.C. § 6225(c)(7) (2018).

¹²⁹ I.R.C. §§ 6226, 6231(b) (2018).

¹³⁰ I.R.C. § 6233(a)(2) (2018).

¹³¹ I.R.C. § 6233(a)(2) (2018).

¹³² I.R.C. § 6233(a)(3) (2018).

¹³³ I.R.C. § 6233(b)(1) (2018).

¹³⁴ I.R.C. § 6233(a)(2) (2018).

¹³⁵ I.R.C. § 6233(a)(2) (2018).

¹³⁶ I.R.C. § 6233(a)(3) (2018).

¹³⁷ I.R.C. § 6233(b)(1) (2018).

adjustment in the case of a partnership that does not seek modification of the imputed underpayment). As amended, I.R.C. § 6235 (2018) provides that a notice of final partnership adjustment to a partnership that does not seek modification of an underpayment in response to a notice of proposed adjustment may be issued up to 330 days after the notice of proposed adjustment.

If a fraudulent return is filed, or there is a failure to file a return, a partnership adjustment may be made at any time. If a partnership files a return contains a substantial omission of income (more than 25% of reported income),¹³⁸ the Secretary may make adjustments to the return within six years of the date the return was filed. If a notice of final partnership adjustment described in I.R.C. § 6231 (2018) is mailed, the limitations period is suspended for the period during which appeal is permitted plus one year.¹³⁹ The partner who is responsible for paying an underpayment arising from the partnership reviewed year must compute tax with respect to his taxable year in which or with which the partnership reviewed year ends, and pay the additional tax with the return for the year in which the partnership mails the statements to partners¹⁴⁰ The partner may neither contest the merits of the partnership adjustment, nor may the partner claim the Secretary is time-barred with respect to such adjustment.

The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by I.R.C. §§ 6501 or 6502 (2016) on the assessment or collection of any imputed underpayment determined under this subchapter) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and for adjustment or assessment, 60 days thereafter, and for collection, 6 months thereafter.¹⁴¹

Partnership Adjustment Proceedings are Binding on Individual Partners

The provision clarifies that the merits of an issue that is the subject of a final determination in a proceeding brought under the centralized system¹⁴² is among the issues that are precluded from being raised at a collection due process hearing (in connection with the right to, and opportunity for, such a hearing prior to a levy on any property or right to any property under present law).¹⁴³ The provision does not restrict the authority of the Secretary to permit an opportunity for administrative review, similar to the Collection Appeals Program, nor does it limit a partner's

¹³⁸ I.R.C. § 6501(e)(1)(A) (2016).

¹³⁹ I.R.C. § 6234 (2018).

¹⁴⁰ I.R.C. § 6226 (2018).

¹⁴¹ I.R.C. § 6241(6)(A) (2018).

¹⁴² A proceeding brought under subchapter C of chapter 63 of the Code.

¹⁴³ I.R.C. § 6330 (2016) establishes the requirement that the IRS provide notice of potential collection action and offer an opportunity for a hearing before an impartial officer, and identifies which issues may be raised at such hearing and which are precluded. Under TEFRA, the IRS permits partners to raise computational issues, interest abatement questions and other collection due process rights in administrative appeals in order to assure consistency in the handling of the cases, even though the partners are precluded from questioning the substance of the partnership adjustment. See Internal Revenue Manual, paragraph 8.22.8.19, TEFRA Partnerships. Under the BBA, I.R.C. § 6330 (2016), issues permitted to be raised include the underlying liability only if the taxpayer did not receive a notice of deficiency or otherwise have an opportunity to contest the liability. Prior to amendment, the issues that were precluded listed those that were the subject of any previous administrative or judicial proceeding, Treas. Reg. 301-6330. The Secretary's power to levy is set forth in present-law I.R.C. § 6331 (2016).

right to seek review of the conduct of collection measures, such as whether notices of Federal tax lien or notice of intent to levy were timely issued. For example, assume that a partnership is audited with respect to taxable year 2018. One of the adjustments reflects the partnership's omission of income of \$1,000 in calculating partnership taxable income. Following receipt of the notice of final partnership adjustment, the partnership decides not to litigate. The partnership elects to issue statements to reviewed year partners, whose tax is increased for the partner's taxable year that includes the date of the statement, 2021. Reviewed year partner A's adjustment is \$100, resulting in an increase in tax of \$35, but partner A does not pay the increased amount of tax. The time for the partnership to litigate the adjustments has elapsed and the notice of final partnership adjustment is a final determination. Prior to any levy on any property or right to any property of partner A in connection with collection of the \$35 tax, partner A has the right to and is afforded the opportunity for a hearing (the collection due process hearing). At the hearing, partner A may not raise the issue of whether the \$1,000 (or A's \$100 share of it) was properly includable in determining partnership taxable income, because a final determination with respect to the issue was made in a proceeding brought under the centralized system. The result is the same if the partnership had decided to seek judicial review and the final determination of the court is that the \$1,000 is includable in determining partnership taxable income.

Amendment of Partner Information Statements

Partner information returns (currently Schedules K-1) must be furnished by the partnership¹⁴⁴ may not be amended after the due date of the partnership return to which the partner information returns relate.¹⁴⁵ The due date takes into account the permitted extension period. For example, the Schedules K-1 furnished by a partnership with respect to its taxable year 2020 may not be amended after the due date for the partnership 2020 return. If the partnership has a calendar taxable year, the due date for its partnership 2020 return is September 15, 2021 (taking into account the permitted 6-month extension following the due date of March 15, 2021), after which date the Schedules K-1 for 2020 may no longer be amended. The rule does not, however, preclude the filing of amended returns of reviewed-year partners pursuant to the procedure for modification of an imputed underpayment in I.R.C. § 6225(c)(2) (2018). The partnership may, however, file an administrative adjustment request pursuant to new I.R.C. § 6227 (2018), and the partnership may pay any resulting imputed underpayment at the partnership level.

For example, assume that a partnership files its Form 1065 for taxable year 2020 on March 15, 2021. On November 3, 2021, the partnership discovers an omission from income for 2020. The partnership may not issue amended Schedules K-1 to its partners for 2020. However, the partnership may file an administrative adjustment request and pay the underpayment consistently with new section 6227(b)(1) for the partnership taxable year in which the administrative adjustment request is made. In this situation, the partnership does not furnish amended Schedules K-1 to the partners and the partners do not file amended Federal and State income tax returns with respect to the omitted income. In addition, a partnership that files the administrative adjustment request is not precluded from furnishing under I.R.C. § 6227(b)(2) an

¹⁴⁴ I.R.C. § 6031(b) (2016) requires partnership to issue partner information returns.

¹⁴⁵ I.R.C. § 6031(b) (2016) (requirement to furnish partner information returns) The requirement in § 411 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Pub. L. No. 114-113 which corrects a conforming amendment to strike the last sentence of I.R.C. § 6031(b) (2016) under prior law.

adjusted statement (similar to a Schedule K-1) to each reviewed-year partner, who is then required to pay tax attributable to the partnership adjustment (as provided under guidance to be provided by the Secretary).

Partnership Interests Created by Gift, I.R.C. §§ 704(e), 761(b) (2016)

Under present law, a partnership includes an unincorporated organization that carries on any business, financial operation, or venture which is not otherwise treated as a trust, estate, or corporation under the IRC.¹⁴⁶ The test of a partnership is “whether considering all the facts . . . the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.”¹⁴⁷ A partner means a member of a partnership.¹⁴⁸ The manner in which a person acquires a capital interest is not determinative of whether that person is recognized as a partner for income tax purposes. If he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not the interest was derived by purchase or gift from any person, the owner is treated as a partner.¹⁴⁹ According to the legislative history, “[y]our committee’s amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxed to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefitted from the entrance of the new partner.”¹⁵⁰ The focus of the legislation was on which party (transferor or transferee) actually owns a partnership interest, not on whether a particular interest qualifies as a partnership interest. The provision states the general principle that income derived from capital is taxed to the owner of the capital.¹⁵¹

The BBA clarifies that for a capital interest in a partnership in which capital is a material income-producing factor, the determination of whether a person is a partner with respect to the interest is made without regard to whether the interest was derived by gift from any other person. The provision strikes I.R.C. § 704(e)(1) (2016) and modifies the definition of partner in I.R.C. § 761 (2016) to eliminate any argument that the provision provides an alternative test as to whether the holder of a capital interest is a partner with respect to that interest, or whether the interest constitutes a capital interest in a partnership. This is designed to make sure that the real owner of a capital interest is to be taxed on the income from the interest, regardless of the motivation behind or the means of the transfer of the interest.¹⁵² The provision places the new provision in I.R.C. § 761 (2016), relating to definitions, rather than I.R.C. § 704 (2016), relating to a partner’s distributive share.

Partnership Agreement Provisions that Should Be Considered in Light of the BBACAA.

¹⁴⁶ I.R.C. § 761(a). See also I.R.C. § 7701(a)(2) (2016).

¹⁴⁷ *Commissioner v. Culbertson*, 337 U.S. 733, 742 (1949).

¹⁴⁸ I.R.C. § 761(b) (2016).

¹⁴⁹ I.R.C. § 761(b) (2016).

¹⁵⁰ S. Rep. No. 781, 82d Cong., 1st Sess., 38, 39 (1951); H.R. Rep. No. 586, 82d Cong., 1st Sess. 32 (1951).

¹⁵¹ See 4 Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 86.3.1, at 86–29 (3rd ed. 2003).

¹⁵² Joint Committee on Taxation, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015 at 84, March, 2016.

In light of the new audit rules of the BBACAA, it is advisable for partnerships to rewrite their partnership agreements to address issues raised by the legislation and the regulations that will be developed to implement it. The most essential provisions relate to the elections to opt out of the BBACAA, to establish and manage the PR, and to determine the obligations of partners and former partners to financial obligations associated with the audit and to payment of imputed underpayments, penalties and interest. While a list of provisions that must be considered will be partially dependent on the regulations the IRS promulgates, it is already possible to begin to consider the nature of the provisions that should be considered. The following outline provides some suggestions.

Partnership Provisions that Address the New BBACAA Rules

1. Should the partners elect out of the BBACAA rules available for partnerships with fewer than 100 partners?
 - a. Should there be limitations on sale of partnership interests aimed at assuring that there continue to be 100 or fewer partners?
 - b. Should the election be made on an annual basis or on a one time basis?
2. Election to push out payment of imputed underpayment and final assessments to individual partners.
 - a. Is the push out of final assessments to individual partners to take advantage of more precise tax treatments desirable?
 - b. Is the higher interest rate applicable to push out worth the benefits?
 - c. How does the push out election relate to the election out of the BBACAA?
3. Requirement that partners provide any information necessary for the audit and any payment needed in the event of an imputed underpayment and final assessment.
 - a. Obligations of cooperation and prompt submission of information to the Partnership Representative should be included in partnership agreements where the partnership is subject to the BBACAA rules.
 - b. Provisions requiring partner payment of partner's share of any imputed underpayment and final assessment are needed.
4. In the event of an audit, provisions are needed to:
 - a. Rules covering the finance partnership level audit, either with partnership funds or by contribution, if necessary, from partners..
 - b. Rules covering the finance appeals of audit results both at the IRS and to a court.
 - c. Rules imposing an obligation on all partners to meet the consistency in filing provisions of I.R.C. § 6222.
5. Provisions guaranteeing the right of every partner to inspect the books.
6. Obligations should be imposed on partners:
 - a. Leaving the partnership to participate in paying any imputed underpayment including penalties and interest imposed for years in which they were partners.
 - b. To indemnify other partners in the event that the imputed underpayment is allocated to partners different from those who would be liable in the event of IRS allocation that is different from the correct return position of the pre BBACAA era.
7. Provisions relating to the Partnership Representative (PR) who represents the partnership in an audit:

- a. What rights should partners have to direct the PR on the conduct of the audit?
How are the rights to be enforced?
 - b. Who may be the PR?
 - i. A partner.
 - ii. An accountant employed by the partnership.
 - iii. How is the PR selected.
 - iv. How is the PR removed and for what reasons?
 - v. What happens if the PR resigns or becomes incapacitated?
 - vi. What are the fiduciary duties of the PR toward the partners and the partnership?
 - vii. Who may the PR employ (Counsel, Accountants, Bookkeepers)?
 - c. Should the duties of the PR include:
 - i. To keep the partners informed on all matters related to the audit.
 - ii. To solicit advice and comment from the partners or partnership management team.
 - iii. To develop an audit strategy in consultation with the partners or partnership management team and the partnership's tax accountants.
 1. To what extent should the PR have the final say?
 2. To what extent can the PR be overruled?
 - iv. To secure partnership approval of waivers of statutes of limitations.
 - v. To seek partnership approval of closing agreements, proposed settlements, and proposed appeals.
 - vi. To seek partnership approval of:
 1. Going to appeals,
 2. Going to court?
 - vii. To seek prior approval of filings:
 1. With the examination auditors,
 2. At appeals,
 3. At court?
 - viii. To seek approval of refund suits?
 - d. What obligations do current partners have to fund the PR?
 - e. What obligations do former partners have to fund the PR in the event of an ongoing partnership?
8. What are the indemnification provisions applicable to partners, to the PR, to the management committee?
- a. What are the rights of the former partners of an ongoing partnership in the event of a tax audit?
 - b. What are the rights of the former partners of a no longer existing partnership in the event of the tax audit?
 - c. Under what terms does one partner or former partner have the right to indemnification by other partners or former partners or the obligation to indemnify other partners or former partners?
9. After the partnership ceases to exist:
- a. Who becomes or remains the PR?
 - i. What rights do the former partners have over the PR?
 - ii. How are the rights to instruct or control the PR enforced?

- iii. How is the PR compensated and audit expenses covered after the partnership ceases to exist?
 - b. What are the rights of the former partners in the event of a tax audit where the partnership does not continue to exist?
 - c. What are the responsibilities of former partners in the event of a tax audit?
 - i. Funding, audit and judicial procedures.
 - ii. Funding final adjustments, penalties and interest.
 - iii. What are the indemnification obligations of former partners?
- 10. Indemnification of the PR.
 - a. Compensation of the PR.
 - b. What is the PR indemnified against?
 - c. How are criminal investigations and claims treated under the indemnification?
 - d. What standard of care must the PR satisfy to be indemnified?
 - e. Is the partnership required to maintain insurance in favor of the PR to implement indemnification?
- 11. Obligations of the partners and former partners with respect to payment of an imputed underpayment.
 - a. How are payments by partners to be made.
 - b. What indemnification do partners owe to other partners for overpayment or underpayment?
 - i. How are partner overpayments or underpayments determined?
 - ii. How are disputes resolved, arbitration, litigation, other means?
- 12. Who is the client entity?
 - a. The partnership entity?
 - b. The individual partners?

Appendix 1

26 U.S. Code Subchapter C **Tax Treatment of Partnership Items (PRE- BBACAA changes)** **Current through Pub. L. 114-38. (See Public Laws for the current Congress.)** (Identified in citations with 2014 date)

26 U.S. Code § 6221 - Tax treatment determined at partnership level

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

Except as otherwise provided in this subchapter, the tax treatment of any partnership item (and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item) shall be determined at the partnership level.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 648; amended Pub. L. 105-34, title XII, § 1238(a), Aug. 5, 1997, 111 Stat. 1026.)

26 U.S. Code § 6222 - Partner's return must be consistent with partnership return or Secretary notified of inconsistency

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) IN GENERAL

A partner shall, on the partner's return, treat a partnership item in a manner which is consistent with the treatment of such partnership item on the partnership return.

(b) NOTIFICATION OF INCONSISTENT TREATMENT

(1) IN GENERAL In the case of any partnership item, if—

(A)

(i) the partnership has filed a return but the partner's treatment on his return is (or may be) inconsistent with the treatment of the item on the partnership return, or

(ii) the partnership has not filed a return, and

(B) the partner files with the Secretary a statement identifying the inconsistency, subsection (a) shall not apply to such item.

(2) PARTNER RECEIVING INCORRECT INFORMATION A partner shall be treated as having complied with subparagraph (B) of paragraph (1) with respect to a partnership item if the partner—

(A) demonstrates to the satisfaction of the Secretary that the treatment of the partnership item on the partner's return is consistent with the treatment of the item on the schedule furnished to the partner by the partnership, and

(B) elects to have this paragraph apply with respect to that item.

(c) EFFECT OF FAILURE TO NOTIFY In any case—

(1) described in paragraph (1)(A)(i) of subsection (b), and

(2) in which the partner does not comply with paragraph (1)(B) of subsection (b),

section 6225 shall not apply to any part of a deficiency attributable to any computational adjustment required to make the treatment of the items by such partner consistent with the treatment of the items on the partnership return.

(d) ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION

For addition to tax in the case of a partner's disregard of requirements of this section, see part II of subchapter A of chapter 68.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 648; amended Pub. L. 99-514, title XV, § 1503(c)(1), Oct. 22, 1986, 100 Stat. 2743; Pub. L. 101-239, title VII, § 7721(c)(7), Dec. 19, 1989, 103 Stat. 2400.)

26 U.S. Code § 6223 - Notice to partners of proceedings

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) SECRETARY MUST GIVE PARTNERS NOTICE OF BEGINNING AND COMPLETION OF ADMINISTRATIVE PROCEEDINGS The Secretary shall mail to each partner whose name and address is furnished to the Secretary notice of—

(1) the beginning of an administrative proceeding at the partnership level with respect to a partnership item, and

(2) the final partnership administrative adjustment resulting from any such proceeding. A partner shall not be entitled to any notice under this subsection unless the Secretary has received (at least 30 days before it is mailed to the tax matters partner) sufficient information to enable the Secretary to determine that such partner is entitled to such notice and to provide such notice to such partner.

(b) SPECIAL RULES FOR PARTNERSHIP WITH MORE THAN 100 PARTNERS

(1) PARTNER WITH LESS THAN 1 PERCENT INTEREST Except as provided in paragraph (2), subsection (a) shall not apply to a partner if—

(A) the partnership has more than 100 partners, and

(B) the partner has a less than 1 percent interest in the profits of the partnership.

(2) SECRETARY MUST GIVE NOTICE TO NOTICE GROUP

If a group of partners in the aggregate having a 5 percent or more interest in the profits of a partnership so request and designate one of their members to receive the notice, the member so designated shall be treated as a partner to whom subsection (a) applies.

(c) INFORMATION BASE FOR SECRETARY'S NOTICES, ETC. For purposes of this subchapter—

(1) INFORMATION ON PARTNERSHIP RETURN

Except as provided in paragraphs (2) and (3), the Secretary shall use the names, addresses, and profits interests shown on the partnership return.

(2) USE OF ADDITIONAL INFORMATION

The Secretary shall use additional information furnished to him by the tax matters partner or any other person in accordance with regulations prescribed by the Secretary.

(3) SPECIAL RULE WITH RESPECT TO INDIRECT PARTNERS If any information furnished to the Secretary under paragraph (1) or (2)—

(A) shows that a person has a profits interest in the partnership by reason of ownership of an interest through 1 or more pass-thru partners, and

(B) contains the name, address, and profits interest of such person.
then the Secretary shall use the name, address, and profits interest of such person with respect to such partnership interest (in lieu of the names, addresses, and profits interests of the pass-thru partners).

(d) PERIOD FOR MAILING NOTICE

(1) NOTICE OF BEGINNING OF PROCEEDINGS

The Secretary shall mail the notice specified in paragraph (1) of subsection (a) to each partner entitled to such notice not later than the 120th day before the day on which the notice specified in paragraph (2) of subsection (a) is mailed to the tax matters partner.

(2) NOTICE OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT

The Secretary shall mail the notice specified in paragraph (2) of subsection (a) to each partner entitled to such notice not later than the 60th day after the day on which the notice specified in such paragraph (2) was mailed to the tax matters partner.

(e) EFFECT OF SECRETARY'S FAILURE TO PROVIDE NOTICE

(1) APPLICATION OF SUBSECTION

(A) In general

This subsection applies where the Secretary has failed to mail any notice specified in subsection (a) to a partner entitled to such notice within the period specified in subsection (d).

(B) Special rules for partnerships with more than 100 partners For purposes of subparagraph (A), any partner described in paragraph (1) of subsection (b) shall be treated as entitled to notice specified in subsection (a). The Secretary may provide such notice—

(i) except as provided in clause (ii), by mailing notice to the tax matters partner,
or

(ii) in the case of a member of a notice group which qualified under paragraph (2) of subsection (b), by mailing notice to the partner designated for such purpose by the group.

(2) PROCEEDINGS FINISHED In any case to which this subsection applies, if at the time the Secretary mails the partner notice of the proceeding—

(A) the period within which a petition for review of a final partnership administrative adjustment under section 6226 may be filed has expired and no such petition has been filed, or

(B) the decision of a court in an action begun by such a petition has become final, the partner may elect to have such adjustment, such decision, or a settlement agreement described in paragraph (2) of section 6224(c) with respect to the partnership taxable year to which the adjustment relates apply to such partner. If the partner does not make an election under the preceding sentence, the partnership items of the partner for the partnership taxable year to which the proceeding relates shall be treated as nonpartnership items.

(3) PROCEEDINGS STILL GOING ON In any case to which this subsection applies, if paragraph (2) does not apply, the partner shall be a party to the proceeding unless such partner elects—

(A) to have a settlement agreement described in paragraph (2) of section 6224(c) with respect to the partnership taxable year to which the proceeding relates apply to the partner, or

(B) to have the partnership items of the partner for the partnership taxable year to which the proceeding relates treated as nonpartnership items.

(f) ONLY ONE NOTICE OF FINAL PARTNERSHIP ADMINISTRATIVE ADJUSTMENT

If the Secretary mails a notice of final partnership administrative adjustment for a partnership taxable year with respect to a partner, the Secretary may not mail another such notice to such partner with respect to the same taxable year of the same partnership in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.

(g) TAX MATTERS PARTNER MUST KEEP PARTNERS INFORMED OF PROCEEDINGS

To the extent and in the manner provided by regulations, the tax matters partner of a partnership shall keep each partner informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items.

(h) PASS-THRU PARTNER REQUIRED TO FORWARD NOTICE

(1) IN GENERAL

If a pass-thru partner receives a notice with respect to a partnership proceeding from the Secretary, the tax matters partner, or another pass-thru partner, the pass-thru partner shall, within 30 days of receiving that notice, forward a copy of that notice to the person or persons holding an interest (through the pass-thru partner) in the profits or losses of the partnership for the partnership taxable year to which the notice relates.

(2) PARTNERSHIP AS PASS-THRU PARTNER

In the case of a pass-thru partner which is a partnership, the tax matters partner of such partnership shall be responsible for forwarding copies of the notice to the partners of such partnership.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 649.)

26 U.S. Code § 6224 - Participation in administrative proceedings; waivers; agreements

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) PARTICIPATION IN ADMINISTRATIVE PROCEEDINGS

Any partner has the right to participate in any administrative proceeding relating to the determination of partnership items at the partnership level.

(b) PARTNER MAY WAIVE RIGHTS

(1) IN GENERAL A partner may at any time waive—

(A) any right such partner has under this subchapter, and

(B) any restriction under this subchapter on action by the Secretary.

(2) FORM

Any waiver under paragraph (1) shall be made by a signed notice in writing filed with the Secretary.

(c) SETTLEMENT AGREEMENT In the absence of a showing of fraud, malfeasance, or misrepresentation of fact—

(1) BINDS ALL PARTIES

A settlement agreement between the Secretary or the Attorney General (or his delegate) and 1 or more partners in a partnership with respect to the determination of partnership items for any partnership taxable year shall (except as otherwise provided in such agreement) be binding on all

parties to such agreement with respect to the determination of partnership items for such partnership taxable year. An indirect partner is bound by any such agreement entered into by the pass-thru partner unless the indirect partner has been identified as provided in section 6223(c)(3).

(2) OTHER PARTNERS HAVE RIGHT TO ENTER INTO CONSISTENT AGREEMENTS

If the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with any partner with respect to partnership items for any partnership taxable year, the Secretary or the Attorney General (or his delegate) shall offer to any other partner who so requests settlement terms for the partnership taxable year which are consistent with those contained in such settlement agreement. Except in the case of an election under paragraph (2) or (3) of section 6223(e) to have a settlement agreement described in this paragraph apply, this paragraph shall apply with respect to a settlement agreement entered into with a partner before notice of a final partnership administrative adjustment is mailed to the tax matters partner only if such other partner makes the request before the expiration of 150 days after the day on which such notice is mailed to the tax matters partner.

(3) TAX MATTERS PARTNER MAY BIND CERTAIN OTHER PARTNERS

(A) In general A partner who is not a notice partner (and not a member of a notice group described in subsection (b)(2) of section 6223) shall be bound by any settlement agreement—

- (i) which is entered into by the tax matters partner, and
- (ii) in which the tax matters partner expressly states that such agreement shall bind the other partners.

(B) Exception

Subparagraph (A) shall not apply to any partner who (within the time prescribed by the Secretary) files a statement with the Secretary providing that the tax matters partner shall not have the authority to enter into a settlement agreement on behalf of such partner.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 651; amended Pub. L. 107-147, title IV, § 416(d)(1)(A), Mar. 9, 2002, 116 Stat. 55.)

26 U.S. Code § 6225 - Assessments made only after partnership level proceedings are completed

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) RESTRICTION ON ASSESSMENT AND COLLECTION Except as otherwise provided in this subchapter, no assessment of a deficiency attributable to any partnership item may be made (and no levy or proceeding in any court for the collection of any such deficiency may be made, begun, or prosecuted) before—

(1) the close of the 150th day after the day on which a notice of a final partnership administrative adjustment was mailed to the tax matters partner, and

(2) if a proceeding is begun in the Tax Court under section 6226 during such 150-day period, the decision of the court in such proceeding has become final.

(b) PREMATURE ACTION MAY BE ENJOINED

Notwithstanding section 7421(a), any action which violates subsection (a) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action or proceeding under this subsection unless a timely petition for a readjustment of the partnership items for the taxable year has been filed and then only in respect of the adjustments that are the subject of such petition.

(c) LIMIT WHERE NO PROCEEDING BEGUN

If no proceeding under section 6226 is begun with respect to any final partnership administrative adjustment during the 150-day period described in subsection (a), the deficiency assessed against any partner with respect to the partnership items to which such adjustment relates shall not exceed the amount determined in accordance with such adjustment.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 652; amended Pub. L. 105-34, title XII, § 1239(a), Aug. 5, 1997, 111 Stat. 1027.)

26 U.S. Code § 6226 - Judicial review of final partnership administrative adjustments

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) PETITION BY TAX MATTERS PARTNER Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for a readjustment of the partnership items for such taxable year with—

- (1) the Tax Court,
- (2) the district court of the United States for the district in which the partnership's principal place of business is located, or
- (3) the Court of Federal Claims.

(b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER

(1) IN GENERAL

If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a), file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

(2) PRIORITY OF THE TAX COURT ACTION

If more than 1 action is brought under paragraph (1) with respect to any partnership for any partnership taxable year, the first such action brought in the Tax Court shall go forward.

(3) PRIORITY OUTSIDE THE TAX COURT

If more than 1 action is brought under paragraph (1) with respect to any partnership for any taxable year but no such action is brought in the Tax Court, the first such action brought shall go forward.

(4) DISMISSAL OF OTHER ACTIONS

If an action is brought under paragraph (1) in addition to the action which goes forward under paragraph (2) or (3), such action shall be dismissed.

(5) TREATMENT OF PREMATURE PETITIONS If—

(A) a petition for a readjustment of partnership items for the taxable year involved is filed by a notice partner (or a 5-percent group) during the 90-day period described in subsection (a), and

(B) no action is brought under paragraph (1) during the 60-day period described therein with respect to such taxable year which is not dismissed, such petition shall be treated for purposes of paragraph (1) as filed on the last day of such 60-day period.

(6) TAX MATTERS PARTNER MAY INTERVENE

The tax matters partner may intervene in any action brought under this subsection.

(c) PARTNERS TREATED AS PARTIES If an action is brought under subsection (a) or (b) with respect to a partnership for any partnership taxable year—

(1) each person who was a partner in such partnership at any time during such year shall be treated as a party to such action, and

(2) the court having jurisdiction of such action shall allow each such person to participate in the action.

(d) PARTNER MUST HAVE INTEREST IN OUTCOME

(1) IN ORDER TO BE PARTY TO ACTION Subsection (c) shall not apply to a partner after the day on which—

(A) the partnership items of such partner for the partnership taxable year became nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231, or

(B) the period within which any tax attributable to such partnership items may be assessed against that partner expired.

Notwithstanding subparagraph (B), any person treated under subsection (c) as a party to an action shall be permitted to participate in such action (or file a readjustment petition under subsection (b) or paragraph (2) of this subsection) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to partnership items has expired with respect to such person, and the court having jurisdiction of such action shall have jurisdiction to consider such assertion.

(2) TO FILE PETITION

No partner may file a readjustment petition under subsection (b) unless such partner would (after the application of paragraph (1) of this subsection) be treated as a party to the proceeding.

(e) JURISDICTIONAL REQUIREMENT FOR BRINGING ACTION IN DISTRICT COURT OR COURT OF FEDERAL CLAIMS

(1) IN GENERAL

A readjustment petition under this section may be filed in a district court of the United States or the Court of Federal Claims only if the partner filing the petition deposits with the Secretary, on or before the day the petition is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner's return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. In the case of a petition filed by a 5-percent group, the requirement of the preceding sentence shall apply to each member of the group. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there

has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected.

(2) REFUND ON REQUEST

If an action brought in a district court of the United States or in the Court of Federal Claims is dismissed by reason of the priority of a Tax Court action under paragraph (2) of subsection (b), the Secretary shall, at the request of the partner who made the deposit, refund the amount deposited under paragraph (1).

(3) INTEREST PAYABLE

Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

(f) SCOPE OF JUDICIAL REVIEW

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of final partnership administrative adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(g) DETERMINATION OF COURT REVIEWABLE

Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Federal Claims, as the case may be, and shall be reviewable as such. With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this section.

(h) EFFECT OF DECISION DISMISSING ACTION

If an action brought under this section is dismissed (other than under paragraph (4) of subsection (b)), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership administrative adjustment is correct, and an appropriate order shall be entered in the records of the court.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 653; amended Pub. L. 97-448, title III, § 306(c)(1)(A), Jan. 12, 1983, 96 Stat. 2406; Pub. L. 102-572, title IX, § 902(b)(2), Oct. 29, 1992, 106 Stat. 4516; Pub. L. 105-34, title XII, §§ 1238(b)(1), 1239(b), 1240(a), Aug. 5, 1997, 111 Stat. 1026-1028.)

26 U.S. Code § 6227 - Administrative adjustment requests

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE A partner may file a request for an administrative adjustment of partnership items for any partnership taxable year at any time which is—

(1) within 3 years after the later of—

(A) the date on which the partnership return for such year is filed, or

(B) the last day for filing the partnership return for such year (determined without regard to extensions), and

(2) before the mailing to the tax matters partner of a notice of final partnership administrative adjustment with respect to such taxable year.

(b) SPECIAL RULE IN CASE OF EXTENSION OF PERIOD OF LIMITATIONS UNDER SECTION 6229 The period prescribed by subsection (a)(1) for filing of a request for an administrative adjustment shall be extended—

(1) for the period within which an assessment may be made pursuant to an agreement (or any extension thereof) under section 6229(b), and

(2) for 6 months thereafter.

(c) REQUESTS BY TAX MATTERS PARTNER ON BEHALF OF PARTNERSHIP

(1) SUBSTITUTED RETURN If the tax matters partner—

(A) files a request for an administrative adjustment, and

(B) asks that the treatment shown on the request be substituted for the treatment of partnership items on the partnership return to which the request relates, the Secretary may treat the changes shown on such request as corrections of mathematical or clerical errors appearing on the partnership return.

(2) REQUESTS NOT TREATED AS SUBSTITUTED RETURNS

(A) In general If the tax matters partner files an administrative adjustment request on behalf of the partnership which is not treated as a substituted return under paragraph (1), the Secretary may, with respect to all or any part of the requested adjustments—

(i) without conducting any proceeding, allow or make to all partners the credits or refunds arising from the requested adjustments,

(ii) conduct a partnership proceeding under this subchapter, or

(iii) take no action on the request.

(B) Exceptions

Clause (i) of subparagraph (A) shall not apply with respect to a partner after the day on which the partnership items become nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231.

(3) REQUEST MUST SHOW EFFECT ON DISTRIBUTIVE SHARES

The tax matters partner shall furnish with any administrative adjustment request on behalf of the partnership revised schedules showing the effect of such request on the distributive shares of the partners and such other information as may be required under regulations.

(d) OTHER REQUESTS If any partner files a request for an administrative adjustment (other than a request described in subsection (c)), the Secretary may—

(1) process the request in the same manner as a claim for credit or refund with respect to items which are not partnership items,

(2) assess any additional tax that would result from the requested adjustments,

(3) mail to the partner, under subparagraph (A) of section 6231(b)(1) (relating to items becoming nonpartnership items), a notice that all partnership items of the partner for the partnership taxable year to which such request relates shall be treated as nonpartnership items, or

(4) conduct a partnership proceeding.

(e) REQUESTS WITH RESPECT TO BAD DEBTS OR WORTHLESS SECURITIES

In the case of that portion of any request for an administrative adjustment which relates to the deductibility by the partnership under section 166 of a debt as a debt which became worthless, or under section 165(g) of a loss from worthlessness of a security, the period prescribed in

subsection (a)(1) shall be 7 years from the last day for filing the partnership return for the year with respect to which such request is made (determined without regard to extensions).

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 655; amended Pub. L. 105-34, title XII, §§ 1236(a), 1243(a), Aug. 5, 1997, 111 Stat. 1025, 1029; Pub. L. 107-147, title IV, § 417(19)(A), Mar. 9, 2002, 116 Stat. 56.)

26 U.S. Code § 6228 - Judicial review where administrative adjustment request is not allowed in full

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) REQUEST ON BEHALF OF PARTNERSHIP

(1) IN GENERAL If any part of an administrative adjustment request filed by the tax matters partner under subsection (c) of section 6227 is not allowed by the Secretary, the tax matters partner may file a petition for an adjustment with respect to the partnership items to which such part of the request relates with—

(A) the Tax Court,

(B) the district court of the United States for the district in which the principal place of business of the partnership is located, or

(C) the Court of Federal Claims.

(2) PERIOD FOR FILING PETITION

(A) In general A petition may be filed under paragraph (1) with respect to partnership items for a partnership taxable year only—

(i) after the expiration of 6 months from the date of filing of the request under section 6227, and

(ii) before the date which is 2 years after the date of such request.

(B) No petition after notice of beginning of administrative proceeding

No petition may be filed under paragraph (1) after the day the Secretary mails to the partnership a notice of the beginning of an administrative proceeding with respect to the partnership taxable year to which such request relates.

(C) Failure by Secretary to issue timely notice of adjustment If the Secretary—

(i) mails the notice referred to in subparagraph (B) before the expiration of the 2-year period referred to in clause (ii) of subparagraph (A), and

(ii) fails to mail a notice of final partnership administrative adjustment with respect to the partnership taxable year to which the request relates before the expiration of the period described in section 6229(a) (including any extension by agreement), subparagraph (B) shall cease to apply with respect to such request, and the 2-year period referred to in clause (ii) of subparagraph (A) shall not expire before the date 6 months after the expiration of the period described in section 6229(a) (including any extension by agreement).

(D) Extension of time

The 2-year period described in subparagraph (A)(ii) shall be extended for such period as may be agreed upon in writing between the tax matters partner and the Secretary.

(3) COORDINATION WITH ADMINISTRATIVE ADJUSTMENT

(A) Administrative adjustment before filing of petition

No petition may be filed under this subsection after the Secretary mails to the tax matters partner a notice of final partnership administrative adjustment for the partnership taxable year to which the request under section 6227 relates.

(B) Administrative adjustment after filing but before hearing of petition

If the Secretary mails to the tax matters partner a notice of final partnership administrative adjustment for the partnership taxable year to which the request under section 6227 relates after the filing of a petition under this subsection but before the hearing of such petition, such petition shall be treated as an action brought under section 6226 with respect to that administrative adjustment, except that subsection (e) of section 6226 shall not apply.

(C) Notice must be before expiration of statute of limitations

A notice of final partnership administrative adjustment for the partnership taxable year shall be taken into account under subparagraphs (A) and (B) only if such notice is mailed before the expiration of the period prescribed by section 6229 for making assessments of tax attributable to partnership items for such taxable year.

(4) PARTNERS TREATED AS PARTY TO ACTION

(A) In general If an action is brought by the tax matters partner under paragraph (1) with respect to any request for an adjustment of a partnership item for any taxable year—

(i) each person who was a partner in such partnership at any time during the partnership taxable year involved shall be treated as a party to such action, and

(ii) the court having jurisdiction of such action shall allow each such person to participate in the action.

(B) Partners must have interest in outcome

For purposes of subparagraph (A), rules similar to the rules of paragraph (1) of section 6226(d) shall apply.

(5) SCOPE OF JUDICIAL REVIEW

Except in the case described in subparagraph (B) of paragraph (3), a court with which a petition is filed in accordance with this subsection shall have jurisdiction to determine only those partnership items to which the part of the request under section 6227 not allowed by the Secretary relates and those items with respect to which the Secretary asserts adjustments as offsets to the adjustments requested by the tax matters partner.

(6) DETERMINATION OF COURT REVIEWABLE

Any determination by a court under this subsection shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Court of Federal Claims, as the case may be, and shall be reviewable as such. With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this subsection.

(b) OTHER REQUESTS

(1) NOTICE PROVIDING THAT ITEMS BECOME NONPARTNERSHIP ITEMS If the Secretary mails to a partner, under subparagraph (A) of section 6231(b)(1) (relating to items ceasing to be partnership items), a notice that all partnership items of the partner for the partnership taxable year to which a timely request for administrative adjustment under subsection (d) of section 6227 relates shall be treated as nonpartnership items—

(A) such request shall be treated as a claim for credit or refund of an overpayment attributable to nonpartnership items, and

(B) the partner may bring an action under section 7422 with respect to such claim at any time within 2 years of the mailing of such notice.

(2) OTHER CASES

(A) **In general** If the Secretary fails to allow any part of an administrative adjustment request filed under subsection (d) of section 6227 by a partner and paragraph (1) does not apply—

(i) such partner may, pursuant to section 7422, begin a civil action for refund of any amount due by reason of the adjustments described in such part of the request, and

(ii) on the beginning of such civil action, the partnership items of such partner for the partnership taxable year to which such part of such request relates shall be treated as nonpartnership items for purposes of this subchapter.

(B) Period for filing petition

(i) **In general** An action may be begun under subparagraph (A) with respect to an administrative adjustment request for a partnership taxable year only—

(I) after the expiration of 6 months from the date of filing of the request under section 6227, and

(II) before the date which is 2 years after the date of filing of such request.

(ii) Extension of time

The 2-year period described in subclause (II) of clause (i) shall be extended for such period as may be agreed upon in writing between the partner and the Secretary.

26 U.S. Code § 6229 - Period of limitations for making assessments

Current through Pub. L. 114-38. (See [Public Laws for the current Congress](#).)

(a) **GENERAL RULE** Except as otherwise provided in this section, the period for assessing any tax imposed by subtitle A with respect to any person which is attributable to any partnership item (or affected item) for a partnership taxable year shall not expire before the date which is 3 years after the later of—

(1) the date on which the partnership return for such taxable year was filed, or

(2) the last day for filing such return for such year (determined without regard to extensions).

(b) EXTENSION BY AGREEMENT

(1) **IN GENERAL** The period described in subsection (a) (including an extension period under this subsection) may be extended—

(A) with respect to any partner, by an agreement entered into by the Secretary and such partner, and

(B) with respect to all partners, by an agreement entered into by the Secretary and the tax matters partner (or any other person authorized by the partnership in writing to enter into such an agreement), before the expiration of such period.

(2) SPECIAL RULE WITH RESPECT TO DEBTORS IN TITLE 11 CASES

Notwithstanding any other law or rule of law, if an agreement is entered into under paragraph (1)(B) and the agreement is signed by a person who would be the tax matters partner but for the fact that, at the time that the agreement is executed, the person is a debtor in a bankruptcy

proceeding under title 11 of the United States Code, such agreement shall be binding on all partners in the partnership unless the Secretary has been notified of the bankruptcy proceeding in accordance with regulations prescribed by the Secretary.

(3) COORDINATION WITH SECTION 6501(C)(4)

Any agreement under section 6501(c)(4) shall apply with respect to the period described in subsection (a) only if the agreement expressly provides that such agreement applies to tax attributable to partnership items.

(c) SPECIAL RULE IN CASE OF FRAUD, ETC.

(1) FALSE RETURN If any partner has, with the intent to evade tax, signed or participated directly or indirectly in the preparation of a partnership return which includes a false or fraudulent item—

(A) in the case of partners so signing or participating in the preparation of the return, any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for the partnership taxable year to which the return relates may be assessed at any time, and

(B) in the case of all other partners, subsection (a) shall be applied with respect to such return by substituting “6 years” for “3 years”.

(2) SUBSTANTIAL OMISSION OF INCOME

If any partnership omits from gross income an amount properly includible therein and such amount is described in clause (i) or (ii) of section 6501(e)(1)(A), subsection (a) shall be applied by substituting “6 years” for “3 years”.

(3) NO RETURN

In the case of a failure by a partnership to file a return for any taxable year, any tax attributable to a partnership item (or affected item) arising in such year may be assessed at any time.

(4) RETURN FILED BY SECRETARY

For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

(d) SUSPENSION WHEN SECRETARY MAKES ADMINISTRATIVE ADJUSTMENT If notice of a final partnership administrative adjustment with respect to any taxable year is mailed to the tax matters partner, the running of the period specified in subsection (a) (as modified by other provisions of this section) shall be suspended—

(1) for the period during which an action may be brought under section 6226 (and, if a petition is filed under section 6226 with respect to such administrative adjustment, until the decision of the court becomes final), and

(2) for 1 year thereafter.

(e) UNIDENTIFIED PARTNER If—

(1) the name, address, and taxpayer identification number of a partner are not furnished on the partnership return for a partnership taxable year, and

(2)

(A) the Secretary, before the expiration of the period otherwise provided under this section with respect to such partner, mails to the tax matters partner the notice specified in paragraph (2) of section 6223(a) with respect to such taxable year, or

(B) the partner has failed to comply with subsection (b) of section 6222 (relating to notification of inconsistent treatment) with respect to any partnership item for such taxable year,

the period for assessing any tax imposed by subtitle A which is attributable to any partnership item (or affected item) for such taxable year shall not expire with respect to such partner before the date which is 1 year after the date on which the name, address, and taxpayer identification number of such partner are furnished to the Secretary.

(f) SPECIAL RULES

(1) ITEMS BECOMING NONPARTNERSHIP ITEMS

If before the expiration of the period otherwise provided in this section for assessing any tax imposed by subtitle A with respect to the partnership items of a partner for the partnership taxable year, such items become nonpartnership items by reason of 1 or more of the events described in subsection (b) of section 6231, the period for assessing any tax imposed by subtitle A which is attributable to such items (or any item affected by such items) shall not expire before the date which is 1 year after the date on which the items become nonpartnership items. The period described in the preceding sentence (including any extension period under this sentence) may be extended with respect to any partner by agreement entered into by the Secretary and such partner.

(2) SPECIAL RULE FOR PARTIAL SETTLEMENT AGREEMENTS

If a partner enters into a settlement agreement with the Secretary or the Attorney General (or his delegate) with respect to the treatment of some of the partnership items in dispute for a partnership taxable year but other partnership items for such year remain in dispute, the period of limitations for assessing any tax attributable to the settled items shall be determined as if such agreement had not been entered into.

(g) PERIOD OF LIMITATIONS FOR PENALTIES

The provisions of this section shall apply also in the case of any addition to tax or an additional amount imposed under subchapter A of chapter 68 which arises with respect to any tax imposed under subtitle A in the same manner as if such addition or additional amount were a tax imposed by subtitle A.

(h) SUSPENSION DURING PENDENCY OF BANKRUPTCY PROCEEDING If a petition is filed naming a partner as a debtor in a bankruptcy proceeding under title 11 of the United States Code, the running of the period of limitations provided in this section with respect to such partner shall be suspended—

(1) for the period during which the Secretary is prohibited by reason of such bankruptcy proceeding from making an assessment, and

(2) for 60 days thereafter.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 659; amended Pub. L. 99-514, title XVIII, § 1875(d)(1), Oct. 22, 1986, 100 Stat. 2896; Pub. L. 100-647, title I, § 1018(o)(3), Nov. 10, 1988, 102 Stat. 3585; Pub. L. 105-34, title XII, §§ 1233(a)-(c), 1235(a), Aug. 5, 1997, 111 Stat. 1023, 1024; Pub. L. 107-147, title IV, § 416(d)(1)(B), Mar. 9, 2002, 116 Stat. 55; Pub. L. 111-147, title V, § 513(a)(2)(B), Mar. 18, 2010, 124 Stat. 112.)

***(C) Action barred after partnership proceeding has begun**

No petition may be filed under subparagraph (A) with respect to an administrative adjustment request for a partnership taxable year after the Secretary mails to the

- (D) Failure by Secretary to issue timely notice of adjustment** If the Secretary—
- (i) mails the notice referred to in subparagraph (C) before the expiration of the 2-year period referred to in clause (i)(II) of subparagraph (B), and
 - (ii) fails to mail a notice of final partnership administrative adjustment with respect to the partnership taxable year to which the request relates before the expiration of the period described in section 6229(a) (including any extension by agreement), subparagraph (C) shall cease to apply with respect to such request, and the 2-year period referred to in clause (i)(II) of subparagraph (B) shall not expire before the date 6 months after the expiration of the period described in section 6229(a) (including any extension by agreement).

(Added Pub. L. 97–248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 656; amended Pub. L. 97–448, title III, § 306(c)(1)(B), Jan. 12, 1983, 96 Stat. 2406; Pub. L. 102–572, title IX, § 902(b)(2), Oct. 29, 1992, 106 Stat. 4516; Pub. L. 107–147, title IV, § 417(19)(B), Mar. 9, 2002, 116 Stat. 56.)

26 U.S. Code § 6230 - Additional administrative provisions

Current through Pub. L. 114–38. (See Public Laws for the current Congress.)

(a) COORDINATION WITH DEFICIENCY PROCEEDINGS

(1) IN GENERAL

Except as provided in paragraph (2) or (3), subchapter B of this chapter shall not apply to the assessment or collection of any computational adjustment.

(2) DEFICIENCY PROCEEDINGS TO APPLY IN CERTAIN CASES

(A) Subchapter B shall apply to any deficiency attributable to—

(i) affected items which require partner level determinations (other than penalties, additions to tax, and additional amounts that relate to adjustments to partnership items), or

(ii) items which have become nonpartnership items (other than by reason of section 6231(b)(1)(C)) and are described in section 6231(e)(1)(B).

(B) Subchapter B shall be applied separately with respect to each deficiency described in subparagraph (A) attributable to each partnership.

(C) Notwithstanding any other law or rule of law, any notice or proceeding under subchapter B with respect to a deficiency described in this paragraph shall not preclude or be precluded by any other notice, proceeding, or determination with respect to a partner's tax liability for a taxable year.

(3) SPECIAL RULE IN CASE OF ASSERTION BY PARTNER'S SPOUSE OF INNOCENT SPOUSE RELIEF

(A) Notwithstanding section 6404(b), if the spouse of a partner asserts that section 6015 applies with respect to a liability that is attributable to any adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment), then such spouse may file with the Secretary within 60 days after the notice of computational adjustment is mailed to the spouse a request for abatement of the assessment specified in such notice. Upon receipt of such request, the Secretary shall abate the assessment. Any reassessment of the tax with respect to which an abatement is made under this subparagraph shall be subject to the deficiency procedures prescribed by subchapter B. The period for making

any such reassessment shall not expire before the expiration of 60 days after the date of such abatement.

(B) If the spouse files a petition with the Tax Court pursuant to section 6213 with respect to the request for abatement described in subparagraph (A), the Tax Court shall only have jurisdiction pursuant to this section to determine whether the requirements of section 6015 have been satisfied. For purposes of such determination, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(C) Rules similar to the rules contained in subparagraphs (B) and (C) of paragraph (2) shall apply for purposes of this paragraph.

(b) MATHEMATICAL AND CLERICAL ERRORS APPEARING ON PARTNERSHIP RETURN

(1) IN GENERAL

Section 6225 shall not apply to any adjustment necessary to correct a mathematical or clerical error (as defined in section 6213(g)(2)) appearing on the partnership return.

(2) EXCEPTION

Paragraph (1) shall not apply to a partner if, within 60 days after the day on which notice of the correction of the error is mailed to the partner, such partner files with the Secretary a request that the correction not be made.

(c) CLAIMS ARISING OUT OF ERRONEOUS COMPUTATIONS, ETC.

(1) IN GENERAL A partner may file a claim for refund on the grounds that—

(A) the Secretary erroneously computed any computational adjustment necessary—

(i) to make the partnership items on the partner's return consistent with the treatment of the partnership items on the partnership return, or

(ii) to apply to the partner a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a),

(B) the Secretary failed to allow a credit or to make a refund to the partner in the amount of the overpayment attributable to the application to the partner of a settlement, a final partnership administrative adjustment, or the decision of a court in an action brought under section 6226 or section 6228(a), or

(C) the Secretary erroneously imposed any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item.

(2) TIME FOR FILING CLAIM

(A) Under paragraph (1)(A) or (C)

Any claim under subparagraph (A) or (C) of paragraph (1) shall be filed within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner.

(B) Under paragraph (1)(B) Any claim under paragraph (1)(B) shall be filed within 2 years after whichever of the following days is appropriate:

(i) the day on which the settlement is entered into,

(ii) the day on which the period during which an action may be brought under section 6226 with respect to the final partnership administrative adjustment expires, or

(iii) the day on which the decision of the court becomes final.

(3) SUIT IF CLAIM NOT ALLOWED

If any portion of a claim under paragraph (1) is not allowed, the partner may bring suit with respect to such portion within the period specified in subsection (a) of section 6532 (relating to periods of limitations on refund suits).

(4) NO REVIEW OF SUBSTANTIVE ISSUES

For purposes of any claim or suit under this subsection, the treatment of partnership items on the partnership return, under the settlement, under the final partnership administrative adjustment, or under the decision of the court (whichever is appropriate) shall be conclusive. In addition, the determination under the final partnership administrative adjustment or under the decision of the court (whichever is appropriate) concerning the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to a partnership item shall also be conclusive. Notwithstanding the preceding sentence, the partner shall be allowed to assert any partner level defenses that may apply or to challenge the amount of the computational adjustment.

(5) RULES FOR SEEKING INNOCENT SPOUSE RELIEF

(A) In general

The spouse of a partner may file a claim for refund on the ground that the Secretary failed to relieve the spouse under section 6015 from a liability that is attributable to an adjustment to a partnership item (including any liability for any penalties, additions to tax, or additional amounts relating to such adjustment).

(B) Time for filing claim

Any claim under subparagraph (A) shall be filed within 6 months after the day on which the Secretary mails to the spouse the notice of computational adjustment referred to in subsection (a)(3)(A).

(C) Suit if claim not allowed

If the claim under subparagraph (B) is not allowed, the spouse may bring suit with respect to the claim within the period specified in paragraph (3).

(D) Prior determinations are binding

For purposes of any claim or suit under this paragraph, the treatment of partnership items (and the applicability of any penalties, additions to tax, or additional amounts) under the settlement, the final partnership administrative adjustment, or the decision of the court (whichever is appropriate) that gave rise to the liability in question shall be conclusive.

(d) SPECIAL RULES WITH RESPECT TO CREDITS OR REFUNDS ATTRIBUTABLE TO PARTNERSHIP ITEMS

(1) IN GENERAL

Except as otherwise provided in this subsection, no credit or refund of an overpayment attributable to a partnership item (or an affected item) for a partnership taxable year shall be allowed or made to any partner after the expiration of the period of limitation prescribed in section 6229 with respect to such partner for assessment of any tax attributable to such item.

(2) ADMINISTRATIVE ADJUSTMENT REQUEST

If a request for an administrative adjustment under section 6227 with respect to a partnership item is timely filed, credit or refund of any overpayment attributable to such partnership item (or an affected item) may be allowed or made at any time before the expiration of the period prescribed in section 6228 for bringing suit with respect to such request.

(3) CLAIM UNDER SUBSECTION (C)

If a timely claim is filed under subsection (c) for a credit or refund of an overpayment attributable to a partnership item (or affected item), credit or refund of such overpayment may be allowed or made at any time before the expiration of the period specified in section 6532 (relating to periods of limitations on suits) for bringing suit with respect to such claim.

(4) TIMELY SUIT

Paragraph (1) shall not apply to any credit or refund of any overpayment attributable to a partnership item (or an item affected by such partnership item) if a partner brings a timely suit with respect to a timely administrative adjustment request under section 6228 or a timely claim under subsection (c) relating to such overpayment.

(5) OVERPAYMENTS REFUNDED WITHOUT REQUIREMENT THAT PARTNER FILE CLAIM

In the case of any overpayment by a partner which is attributable to a partnership item (or an affected item) and which may be refunded under this subchapter, to the extent practicable credit or refund of such overpayment shall be allowed or made without any requirement that the partner file a claim therefor.

(6) SUBCHAPTER B OF CHAPTER 66 NOT APPLICABLE

Subchapter B of chapter 66 (relating to limitations on credit or refund) shall not apply to any credit or refund of an overpayment attributable to a partnership item.

(e) TAX MATTERS PARTNER REQUIRED TO FURNISH NAMES OF PARTNERS TO SECRETARY

If the Secretary mails to any partnership the notice specified in paragraph (1) of section 6223(a) with respect to any partnership taxable year, the tax matters partner shall furnish to the Secretary the name, address, profits interest, and taxpayer identification number of each person who was a partner in such partnership at any time during such taxable year. If the tax matters partner later discovers that the information furnished to the Secretary was incorrect or incomplete, the tax matters partner shall furnish such revised or additional information as may be necessary.

(f) FAILURE OF TAX MATTERS PARTNER, ETC., TO FULFILL RESPONSIBILITY DOES NOT AFFECT APPLICABILITY OF PROCEEDING

The failure of the tax matters partner, a pass-thru partner, the representative of a notice group, or any other representative of a partner to provide any notice or perform any act required under this subchapter or under regulations prescribed under this subchapter on behalf of such partner does not affect the applicability of any proceeding or adjustment under this subchapter to such partner.

(g) DATE DECISION OF COURT BECOMES FINAL

For purposes of section 6229(d)(1) and section 6230(c)(2)(B), the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the Court of Federal Claims becomes final.

(h) EXAMINATION AUTHORITY NOT LIMITED

Nothing in this subchapter shall be construed as limiting the authority granted to the Secretary under section 7602.

(i) TIME AND MANNER OF FILING STATEMENTS, MAKING ELECTIONS, ETC. Except as otherwise provided in this subchapter, each—

(1) statement,

- (2) election,
- (3) request, and
- (4) furnishing of information,

shall be filed or made at such time, in such manner, and at such place as may be prescribed in regulations.

(j) PARTNERSHIPS HAVING PRINCIPAL PLACE OF BUSINESS OUTSIDE THE UNITED STATES

For purposes of sections 6226 and 6228, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

(k) REGULATIONS

The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subchapter. Any reference in this subchapter to regulations is a reference to regulations prescribed by the Secretary.

(l) COURT RULES

Any action brought under any provision of this subchapter shall be conducted in accordance with such rules of practice and procedure as may be prescribed by the Court in which the action is brought.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 660; amended Pub. L. 98-369, div. A, title VII, § 714(p)(2)(A), July 18, 1984, 98 Stat. 964; Pub. L. 99-514, title XVIII, § 1875(d)(2)(A), Oct. 22, 1986, 100 Stat. 2896; Pub. L. 100-647, title I, § 1018(o)(1), Nov. 10, 1988, 102 Stat. 3584; Pub. L. 102-572, title IX, § 902(b)(2), Oct. 29, 1992, 106 Stat. 4516; Pub. L. 105-34, title XII, §§ 1237(a)-(c)(1), 1238(b)(2)-(6), 1239(c)(1), Aug. 5, 1997, 111 Stat. 1025-1028; Pub. L. 105-206, title III, § 3201(e)(2), July 22, 1998, 112 Stat. 740; Pub. L. 110-172, § 11(a)(36), Dec. 29, 2007, 121 Stat. 2487.)

26 U.S. Code § 6231 - Definitions and special rules

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) DEFINITIONS For purposes of this subchapter—

(1) PARTNERSHIP

(A) In general

Except as provided in subparagraph (B), the term “partnership” means any partnership required to file a return under section 6031(a).

(B) Exception for small partnerships

(i) In general

The term “partnership” shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.

(ii) Election to have subchapter apply

A partnership (within the meaning of subparagraph (A)) may for any taxable year elect to have clause (i) not apply. Such election shall apply for such taxable year and all subsequent taxable years unless revoked with the consent of the Secretary.

(2) PARTNER The term “partner” means—

(A) a partner in the partnership, and

(B) any other person whose income tax liability under subtitle A is determined in whole or in part by taking into account directly or indirectly partnership items of the partnership.

(3) PARTNERSHIP ITEM

The term “partnership item” means, with respect to a partnership, any item required to be taken into account for the partnership’s taxable year under any provision of subtitle A to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the partnership level than at the partner level.

(4) NONPARTNERSHIP ITEM

The term “nonpartnership item” means an item which is (or is treated as) not a partnership item.

(5) AFFECTED ITEM

The term “affected item” means any item to the extent such item is affected by a partnership item.

(6) COMPUTATIONAL ADJUSTMENT

The term “computational adjustment” means the change in the tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item. All adjustments required to apply the results of a proceeding with respect to a partnership under this subchapter to an indirect partner shall be treated as computational adjustments.

(7) TAX MATTERS PARTNER The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence, notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.

(8) NOTICE PARTNER

The term “notice partner” means a partner who, at the time in question, would be entitled to notice under subsection (a) of section 6223 (determined without regard to subsections (b)(2) and (e)(1)(B) thereof).

(9) PASS-THRU PARTNER

The term “pass-thru partner” means a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which proceedings under this subchapter are conducted.

(10) INDIRECT PARTNER

The term “indirect partner” means a person holding an interest in a partnership through 1 or more pass-thru partners.

(11) 5-PERCENT GROUP

A 5-percent group is a group of partners who for the partnership taxable year involved had profits interests which aggregated 5 percent or more.

(12) HUSBAND AND WIFE

Except to the extent otherwise provided in regulations, a husband and wife who have a joint interest in a partnership shall be treated as 1 person.

(b) ITEMS CEASE TO BE PARTNERSHIP ITEMS IN CERTAIN CASES

(1) IN GENERAL For purposes of this subchapter, the partnership items of a partner for a partnership taxable year shall become nonpartnership items as of the date—

(A) the Secretary mails to such partner a notice that such items shall be treated as nonpartnership items,

(B) the partner files suit under section 6228(b) after the Secretary fails to allow an administrative adjustment request with respect to any of such items,

(C) the Secretary or the Attorney General (or his delegate) enters into a settlement agreement with the partner with respect to such items, or

(D) such change occurs under subsection (e) of section 6223 (relating to effect of Secretary’s failure to provide notice) or under subsection (c) of this section.

(2) CIRCUMSTANCES IN WHICH NOTICE IS PERMITTED The Secretary may mail the notice referred to in subparagraph (A) of paragraph (1) to a partner with respect to partnership items for a partnership taxable year only if—

(A) such partner—

(i) has complied with subparagraph (B) of section 6222(b)(1) (relating to notification of inconsistent treatment) with respect to one or more of such items, and

(ii) has not, as of the date on which the Secretary mails the notice, filed a request for administrative adjustments which would make the partner’s treatment of the item or items with respect to which the partner complied with subparagraph (B) of section 6222(b)(1) consistent with the treatment of such item or items on the partnership return, or

(B)

(i) such partner has filed a request under section 6227(d) for administrative adjustment of one or more of such items, and

(ii) the adjustments requested would not make such partner’s treatment of such items consistent with the treatment of such items on the partnership return.

(3) NOTICE MUST BE MAILED BEFORE BEGINNING OF PARTNERSHIP PROCEEDING

Any notice to a partner under subparagraph (A) of paragraph (1) with respect to partnership items for a partnership taxable year shall be mailed before the day on which the Secretary mails to the tax matters partner a notice of the beginning of an administrative proceeding at the partnership level with respect to such items.

(c) REGULATIONS WITH RESPECT TO CERTAIN SPECIAL ENFORCEMENT AREAS

(1) APPLICABILITY OF SUBSECTION This subsection applies in the case of—

(A) assessments under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income, estate, gift, and certain excise taxes),

(B) criminal investigations.

(C) indirect methods of proof of income.

(D) foreign partnerships, and

(E) other areas that the Secretary determines by regulation to present special enforcement considerations.

(2) ITEMS MAY BE TREATED AS NONPARTNERSHIP ITEMS

To the extent that the Secretary determines and provides by regulations that to treat items as partnership items will interfere with the effective and efficient enforcement of this title in any case described in paragraph (1), such items shall be treated as nonpartnership items for purposes of this subchapter.

(3) SPECIAL RULES

The Secretary may prescribe by regulation such special rules as the Secretary determines to be necessary to achieve the purposes of this subchapter in any case described in paragraph (1).

(d) TIME FOR DETERMINING PARTNER'S PROFITS INTEREST IN PARTNERSHIP

(1) IN GENERAL For purposes of section 6223(b) (relating to special rules for partnerships with more than 100 partners) and paragraph (11) of subsection (a) (relating to 5-percent group), the interest of a partner in the profits of a partnership for a partnership taxable year shall be determined—

(A) in the case of a partner whose entire interest in the partnership is disposed of during such partnership taxable year, as of the moment immediately before such disposition, or

(B) in the case of any other partner, as of the close of the partnership taxable year.

(2) INDIRECT PARTNERS

The Secretary shall prescribe regulations consistent with the principles of paragraph (1) to be applied in the case of indirect partners.

(e) EFFECT OF JUDICIAL DECISIONS IN CERTAIN PROCEEDINGS

(1) DETERMINATIONS AT PARTNER LEVEL No judicial determination with respect to the income tax liability of any partner not conducted under this subchapter shall be a bar to any adjustment in such partner's income tax liability resulting from—

(A) a proceeding with respect to partnership items under this subchapter, or

(B) a proceeding with respect to items which become nonpartnership items—

(i) by reason of 1 or more of the events described in subsection (b), and

(ii) after the appropriate time for including such items in any other proceeding with respect to nonpartnership items.

(2) PROCEEDINGS UNDER SECTION 6228(A)

No judicial determination in any proceeding under subsection (a) of section 6228 with respect to any partnership item shall be a bar to any adjustment in any other partnership item.

(f) SPECIAL RULE FOR DEDUCTIONS, LOSSES, AND CREDITS OF FOREIGN PARTNERSHIPS

Except to the extent otherwise provided in regulations, in the case of any partnership the tax matters partner of which resides outside the United States or the books of which are maintained outside the United States, no deduction, loss, or credit shall be allowable to any partner unless

section 6031 is complied with for the partnership's taxable year in which such deduction, loss, or credit arose at such time as the Secretary prescribes by regulations.

(g) PARTNERSHIP RETURN TO BE DETERMINATIVE OF WHETHER SUBCHAPTER APPLIES

(1) DETERMINATION THAT SUBCHAPTER APPLIES

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter applies to such partnership for such year but such determination is erroneous, then the provisions of this subchapter are hereby extended to such partnership (and its items) for such taxable year and to partners of such partnership.

(2) DETERMINATION THAT SUBCHAPTER DOES NOT APPLY

If, on the basis of a partnership return for a taxable year, the Secretary reasonably determines that this subchapter does not apply to such partnership for such year but such determination is erroneous, then the provisions of this subchapter shall not apply to such partnership (and its items) for such taxable year or to partners of such partnership.

(Added Pub. L. 97-248, title IV, § 402(a), Sept. 3, 1982, 96 Stat. 663; amended Pub. L. 98-369, div. A, title VII, § 714(p)(2)(B)-(D), (I), July 18, 1984, 98 Stat. 964, 965; Pub. L. 105-34, title XI, § 1141(b), title XII, §§ 1232(a), 1234(a), Aug. 5, 1997, 111 Stat. 981, 1023, 1024; Pub. L. 105-206, title III, § 3507(a), July 22, 1998, 112 Stat. 772; Pub. L. 107-147, title IV, §§ 416(d)(1)(C), 417(19)(C), Mar. 9, 2002, 116 Stat. 55, 57.)

26 U.S. Code § 6232 - Assessment, collection, and payment

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) IN GENERAL

Any imputed underpayment shall be assessed and collected in the same manner as if it were a tax imposed for the adjustment year by subtitle A, except that in the case of an administrative adjustment request to which section 6227(b)(1) applies, the underpayment shall be paid when the request is filed.

(b) LIMITATION ON ASSESSMENT Except as otherwise provided in this chapter, no assessment of a deficiency may be made (and no levy or proceeding in any court for the collection of any amount resulting from such adjustment may be made, begun or prosecuted) before—

(1) the close of the 90th day after the day on which a notice of a final partnership adjustment was mailed, and

(2) if a petition is filed under section 6234 with respect to such notice, the decision of the court has become final.

(c) PREMATURE ACTION MAY BE ENJOINED

Notwithstanding section 7421(a), any action which violates subsection (b) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action under this subsection unless a timely petition has been filed under section 6234 and then only in respect of the adjustments that are the subject of such petition.

(d) EXCEPTIONS TO RESTRICTIONS ON ADJUSTMENTS

(1) ADJUSTMENTS ARISING OUT OF MATH OR CLERICAL ERRORS

(A) In general

If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to a [1] item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.

(B) Special rule

If a partnership is a partner in another partnership, any adjustment on account of such partnership's failure to comply with the requirements of section 6222(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph (A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment.

(2) PARTNERSHIP MAY WAIVE RESTRICTIONS

The partnership may at any time (whether or not any notice of partnership adjustment has been issued), by a signed notice in writing filed with the Secretary, waive the restrictions provided in subsection (b) on the making of any partnership adjustment.

(c) LIMIT WHERE NO PROCEEDING BEGUN

If no proceeding under section 6234 is begun with respect to any notice of a final partnership adjustment during the 90-day period described in subsection (b) thereof, the amount for which the partnership is liable under section 6225 shall not exceed the amount determined in accordance with such notice.

(Added Pub. L. 114-74, title XI, § 1101(c)(1), Nov. 2, 2015, 129 Stat. 632.)

[1] So in original. Probably should be "an".

26 U.S. Code § 6233 - Extension to entities filing partnership returns, etc.

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE

If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.

(b) SIMILAR RULES IN CERTAIN CASES

If a partnership return is filed for any taxable year but it is determined that there is no entity for such taxable year, to the extent provided in regulations, rules similar to the rules of subsection (a) shall apply.

(Added Pub. L. 98-369, div. A, title VII, § 714(p)(1), July 18, 1984, 98 Stat. 964; amended Pub. L. 104-188, title I, § 1307(c)(3)(B), Aug. 20, 1996, 110 Stat. 1782.)

26 U.S. Code § 6234 - Declaratory judgment relating to treatment of items other than partnership items with respect to an oversheltered return

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE If—

- (1) a taxpayer files an oversheltered return for a taxable year,
- (2) the Secretary makes a determination with respect to the treatment of items (other than partnership items) of such taxpayer for such taxable year, and
- (3) the adjustments resulting from such determination do not give rise to a deficiency (as defined in section 6211) but would give rise to a deficiency if there were no net loss from partnership items, the Secretary is authorized to send a notice of adjustment reflecting such determination to the taxpayer by certified or registered mail.

(b) OVERSHELTERED RETURN For purposes of this section, the term “oversheltered return” means an income tax return which—

- (1) shows no taxable income for the taxable year, and
- (2) shows a net loss from partnership items.

(c) JUDICIAL REVIEW IN THE TAX COURT

Within 90 days, or 150 days if the notice is addressed to a person outside the United States, after the day on which the notice of adjustment authorized in subsection (a) is mailed to the taxpayer, the taxpayer may file a petition with the Tax Court for redetermination of the adjustments. Upon the filing of such a petition, the Tax Court shall have jurisdiction to make a declaration with respect to all items (other than partnership items and affected items which require partner level determinations as described in section 6230(a)(2)(A)(i)) for the taxable year to which the notice of adjustment relates, in accordance with the principles of section 6214(a). Any such declaration shall have the force and effect of a decision of the Tax Court and shall be reviewable as such.

(d) FAILURE TO FILE PETITION

(1) IN GENERAL

Except as provided in paragraph (2), if the taxpayer does not file a petition with the Tax Court within the time prescribed in subsection (c), the determination of the Secretary set forth in the notice of adjustment that was mailed to the taxpayer shall be deemed to be correct.

(2) EXCEPTION Paragraph (1) shall not apply after the date that the taxpayer—

- (A) files a petition with the Tax Court within the time prescribed in subsection (c) with respect to a subsequent notice of adjustment relating to the same taxable year, or
- (B) files a claim for refund of an overpayment of tax under section 6511 for the taxable year involved.

If a claim for refund is filed by the taxpayer, then solely for purposes of determining (for the taxable year involved) the amount of any computational adjustment in connection with a partnership proceeding under this subchapter (other than under this section) or the amount of any deficiency attributable to affected items in a proceeding under section 6230(a)(2), the items that are the subject of the notice of adjustment shall be presumed to have been correctly reported on the taxpayer’s return during the pendency of the refund claim (and, if within the time prescribed

by section 6532 the taxpayer commences a civil action for refund under section 7422, until the decision in the refund action becomes final).

(e) LIMITATIONS PERIOD

(1) IN GENERAL

Any notice to a taxpayer under subsection (a) shall be mailed before the expiration of the period prescribed by section 6501 (relating to the period of limitations on assessment).

(2) SUSPENSION WHEN SECRETARY MAILES NOTICE OF ADJUSTMENT

If the Secretary mails a notice of adjustment to the taxpayer for a taxable year, the period of limitations on the making of assessments shall be suspended for the period during which the Secretary is prohibited from making the assessment (and, in any event, if a proceeding in respect of the notice of adjustment is placed on the docket of the Tax Court, until the decision of the Tax Court becomes final), and for 60 days thereafter.

(3) RESTRICTIONS ON ASSESSMENT Except as otherwise provided in section 6851, 6852, or 6861, no assessment of a deficiency with respect to any tax imposed by subtitle A attributable to any item (other than a partnership item or any item affected by a partnership item) shall be made—

(A) until the expiration of the applicable 90-day or 150-day period set forth in subsection (c) for filing a petition with the Tax Court, or

(B) if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final.

(f) FURTHER NOTICES OF ADJUSTMENT RESTRICTED

If the Secretary mails a notice of adjustment to the taxpayer for a taxable year and the taxpayer files a petition with the Tax Court within the time prescribed in subsection (c), the Secretary may not mail another such notice to the taxpayer with respect to the same taxable year in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact.

(g) COORDINATION WITH OTHER PROCEEDINGS UNDER THIS SUBCHAPTER

(1) IN GENERAL

The treatment of any item that has been determined pursuant to subsection (c) or (d) shall be taken into account in determining the amount of any computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section), or the amount of any deficiency attributable to affected items in a proceeding under section 6230(a)(2), for the taxable year involved. Notwithstanding any other law or rule of law pertaining to the period of limitations on the making of assessments, for purposes of the preceding sentence, any adjustment made in accordance with this section shall be taken into account regardless of whether any assessment has been made with respect to such adjustment.

(2) SPECIAL RULE IN CASE OF COMPUTATIONAL ADJUSTMENT

In the case of a computational adjustment that is made in connection with a partnership proceeding under this subchapter (other than under this section), the provisions of paragraph (1) shall apply only if the computational adjustment is made within the period prescribed by section 6229 for assessing any tax under subtitle A which is attributable to any partnership item or affected item for the taxable year involved.

(3) CONVERSION TO DEFICIENCY PROCEEDING If—

(A) after the notice referred to in subsection (a) is mailed to a taxpayer for a taxable year but before the expiration of the period for filing a petition with the Tax Court under subsection

(c) (or, if a petition is filed with the Tax Court, before the Tax Court makes a declaration for that taxable year), the treatment of any partnership item for the taxable year is finally determined, or any such item ceases to be a partnership item pursuant to section 6231(b), and

(B) as a result of that final determination or cessation, a deficiency can be determined with respect to the items that are the subject of the notice of adjustment,

the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition filed in respect of the notice shall be treated as an action brought under section 6213.

(4) FINALLY DETERMINED For purposes of this subsection, the treatment of partnership items shall be treated as finally determined if—

(A) the Secretary or the Attorney General (or his delegate) enters into a settlement agreement (within the meaning of section 6224) with the taxpayer regarding such items,

(B) a notice of final partnership administrative adjustment has been issued and—

(i) no petition has been filed under section 6226 and the time for doing so has expired, or

(ii) a petition has been filed under section 6226 and the decision of the court has become final, or

(C) the period within which any tax attributable to such items may be assessed against the taxpayer has expired.

(h) SPECIAL RULES IF SECRETARY INCORRECTLY DETERMINES APPLICABLE PROCEDURE

(1) SPECIAL RULE IF SECRETARY ERRONEOUSLY MAILES NOTICE OF ADJUSTMENT

If the Secretary erroneously determines that subchapter B does not apply to a taxable year of a taxpayer and consistent with that determination timely mails a notice of adjustment to the taxpayer pursuant to subsection (a) of this section, the notice of adjustment shall be treated as a notice of deficiency under section 6212 and any petition that is filed in respect of the notice shall be treated as an action brought under section 6213.

(2) SPECIAL RULE IF SECRETARY ERRONEOUSLY MAILES NOTICE OF DEFICIENCY

If the Secretary erroneously determines that subchapter B applies to a taxable year of a taxpayer and consistent with that determination timely mails a notice of deficiency to the taxpayer pursuant to section 6212, the notice of deficiency shall be treated as a notice of adjustment under subsection (a) and any petition that is filed in respect of the notice shall be treated as an action brought under subsection (c).

(Added Pub. L. 105–34, title XII, § 1231(a), Aug. 5, 1997, 111 Stat. 1020; amended Pub. L. 107–147, title IV, § 416(d)(1)(D), Mar. 9, 2002, 116 Stat. 55.)

26 U.S. Code § 6235 - Period of limitations on making adjustments

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) IN GENERAL Except as otherwise provided in this section, no adjustment under this subpart [1] for any partnership taxable year may be made after the later of—

(1) the date which is 3 years after the latest of—

(A) the date on which the partnership return for such taxable year was filed,

(B) the return due date for the taxable year, or

(C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227, or

(2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under paragraph (4) thereof) after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted, or

(3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is 270 days after the date of such notice.

(b) EXTENSION BY AGREEMENT

The period described in subsection (a) (including an extension period under this subsection) may be extended by an agreement entered into by the Secretary and the partnership before the expiration of such period.

(c) SPECIAL RULE IN CASE OF FRAUD, ETC.

(1) FALSE RETURN

In the case of a false or fraudulent partnership return with intent to evade tax, the adjustment may be made at any time.

(2) SUBSTANTIAL OMISSION OF INCOME

If any partnership omits from gross income an amount properly includible therein and such amount is described in section 6501(e)(1)(A), subsection (a) shall be applied by substituting “6 years” for “3 years”.

(3) NO RETURN

In the case of a failure by a partnership to file a return for any taxable year, the adjustment may be made at any time.

(4) RETURN FILED BY SECRETARY

For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

(d) SUSPENSION WHEN SECRETARY MAILS NOTICE OF ADJUSTMENT If notice of a final partnership adjustment with respect to any taxable year is mailed under section 6231, the running of the period specified in subsection (a) (as modified by the other provisions of this section) shall be suspended—

(1) for the period during which an action may be brought under section 6234 (and, if a petition is filed under such section with respect to such notice, until the decision of the court becomes final), and

(2) for 1 year thereafter.

(Added Pub. L. 114–74, title XI, § 1101(c)(1), Nov. 2, 2015, 129 Stat. 635.)

[1] So in original. As enacted by

[1], Part 1, which contains this section, does not contain subparts.

26 U.S. Code § 6240 - Application of subchapter

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE

This subchapter shall only apply to electing large partnerships and partners in such partnerships.

(b) COORDINATION WITH OTHER PARTNERSHIP AUDIT PROCEDURES

(1) IN GENERAL

Subchapter C of this chapter shall not apply to any electing large partnership other than in its capacity as a partner in another partnership which is not an electing large partnership.

(2) TREATMENT WHERE PARTNER IN OTHER PARTNERSHIP If an electing large partnership is a partner in another partnership which is not an electing large partnership—

(A) subchapter C of this chapter shall apply to items of such electing large partnership which are partnership items with respect to such other partnership, but

(B) any adjustment under such subchapter C shall be taken into account in the manner provided by section 6242.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1009.)

26 U.S. Code § 6241 - Partner's return must be consistent with partnership return

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE

A partner of any electing large partnership shall, on the partner's return, treat each partnership item attributable to such partnership in a manner which is consistent with the treatment of such partnership item on the partnership return.

(b) UNDERPAYMENT DUE TO INCONSISTENT TREATMENT ASSESSED AS MATH ERROR

Any underpayment of tax by a partner by reason of failing to comply with the requirements of subsection (a) shall be assessed and collected in the same manner as if such underpayment were on account of a mathematical or clerical error appearing on the partner's return. Paragraph (2) of section 6213(b) shall not apply to any assessment of an underpayment referred to in the preceding sentence.

(c) ADJUSTMENTS NOT TO AFFECT PRIOR YEAR OF PARTNERS

(1) IN GENERAL

Except as provided in paragraph (2), subsections (a) and (b) shall apply without regard to any adjustment to the partnership item under part II.

(2) CERTAIN CHANGES IN DISTRIBUTIVE SHARE TAKEN INTO ACCOUNT BY PARTNER

(A) In general

To the extent that any adjustment under part II involves a change under section 704 in a partner's distributive share of the amount of any partnership item shown on the partnership return, such adjustment shall be taken into account in applying this title to such partner for the partner's taxable year for which such item was required to be taken into account.

(B) Coordination with deficiency procedures

(i) In general Subchapter B shall not apply to the assessment or collection of any underpayment of tax attributable to an adjustment referred to in subparagraph (A).

(ii) Adjustment not precluded Notwithstanding any other law or rule of law, nothing in subchapter B (or in any proceeding under subchapter B) shall preclude the assessment or collection of any underpayment of tax (or the allowance of any credit or refund of any overpayment of tax) attributable to an adjustment referred to in subparagraph (A) and such assessment or collection or allowance (or any notice thereof) shall not preclude any notice, proceeding, or determination under subchapter B.

(C) Period of limitations The period for—

(i) assessing any underpayment of tax, or

(ii) filing a claim for credit or refund of any overpayment of tax, attributable to an adjustment referred to in subparagraph (A) shall not expire before the close of the period prescribed by section 6248 for making adjustments with respect to the partnership taxable year involved.

(D) Tiered structures

If the partner referred to in subparagraph (A) is another partnership or an S corporation, the rules of this paragraph shall also apply to persons holding interests in such partnership or S corporation (as the case may be); except that, if such partner is an electing large partnership, the adjustment referred to in subparagraph (A) shall be taken into account in the manner provided by section 6242.

(c) ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION

For addition to tax in case of partner's disregard of requirements of this section, see part II of subchapter A of chapter 68.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1009.)

26 U.S. Code § 6242 - Procedures for taking partnership adjustments into account

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) ADJUSTMENTS FLOW THROUGH TO PARTNERS FOR YEAR IN WHICH ADJUSTMENT TAKES EFFECT

(1) IN GENERAL

If any partnership adjustment with respect to any partnership item takes effect (within the meaning of subsection (d)(2)) during any partnership taxable year and if an election under paragraph (2) does not apply to such adjustment, such adjustment shall be taken into account in determining the amount of such item for the partnership taxable year in which such adjustment takes effect. In applying this title to any person who is (directly or indirectly) a partner in such partnership during such partnership taxable year, such adjustment shall be treated as an item actually arising during such taxable year.

(2) PARTNERSHIP LIABLE IN CERTAIN CASES If—

(A) a partnership elects under this paragraph to not take an adjustment into account under paragraph (1),

(B) a partnership does not make such an election but in filing its return for any partnership taxable year fails to take fully into account any partnership adjustment as required under paragraph (1), or

(C) any partnership adjustment involves a reduction in a credit which exceeds the amount of such credit determined for the partnership taxable year in which the adjustment takes effect, the partnership shall pay to the Secretary an amount determined by applying the rules of subsection (b)(4) to the adjustments not so taken into account and any excess referred to in subparagraph (C).

(3) OFFSETTING ADJUSTMENTS TAKEN INTO ACCOUNT

If a partnership adjustment requires another adjustment in a taxable year after the adjusted year and before the partnership taxable year in which such partnership adjustment takes effect, such other adjustment shall be taken into account under this subsection for the partnership taxable year in which such partnership adjustment takes effect.

(4) COORDINATION WITH PART II

Amounts taken into account under this subsection for any partnership taxable year shall continue to be treated as adjustments for the adjusted year for purposes of determining whether such amounts may be readjusted under part II.

(b) PARTNERSHIP LIABLE FOR INTEREST AND PENALTIES

(1) IN GENERAL If a partnership adjustment takes effect during any partnership taxable year and such adjustment results in an imputed underpayment for the adjusted year, the partnership—

(A) shall pay to the Secretary interest computed under paragraph (2), and

(B) shall be liable for any penalty, addition to tax, or additional amount as provided in paragraph (3).

(2) DETERMINATION OF AMOUNT OF INTEREST The interest computed under this paragraph with respect to any partnership adjustment is the interest which would be determined under chapter 67—

(A) on the imputed underpayment determined under paragraph (4) with respect to such adjustment,

(B) for the period beginning on the day after the return due date for the adjusted year and ending on the return due date for the partnership taxable year in which such adjustment takes effect (or, if earlier, in the case of any adjustment to which subsection (a)(2) applies, the date on which the payment under subsection (a)(2) is made).

Proper adjustments in the amount determined under the preceding sentence shall be made for adjustments required for partnership taxable years after the adjusted year and before the year in which the partnership adjustment takes effect by reason of such partnership adjustment.

(3) PENALTIES

A partnership shall be liable for any penalty, addition to tax, or additional amount for which it would have been liable if such partnership had been an individual subject to tax under chapter 1 for the adjusted year and the imputed underpayment determined under paragraph (4) were an actual underpayment (or understatement) for such year.

(4) IMPUTED UNDERPAYMENT For purposes of this subsection, the imputed underpayment determined under this paragraph with respect to any partnership adjustment is the underpayment (if any) which would result—

(A) by netting all adjustments to items of income, gain, loss, or deduction and by treating any net increase in income as an underpayment equal to the amount of such net increase multiplied by the highest rate of tax in effect under section 1 or 11 for the adjusted year, and

(B) by taking adjustments to credits into account as increases or decreases (whichever is appropriate) in the amount of tax.

For purposes of the preceding sentence, any net decrease in a loss shall be treated as an increase in income and a similar rule shall apply to a net increase in a loss.

(c) ADMINISTRATIVE PROVISIONS

(1) IN GENERAL Any payment required by subsection (a)(2) or (b)(1)(A)—

(A) shall be assessed and collected in the same manner as if it were a tax imposed by subtitle C, and

(B) shall be paid on or before the return due date for the partnership taxable year in which the partnership adjustment takes effect.

(2) INTEREST

For purposes of determining interest, any payment required by subsection (a)(2) or (b)(1)(A) shall be treated as an underpayment of tax.

(3) PENALTIES

(A) In general

In the case of any failure by any partnership to pay on the date prescribed therefor any amount required by subsection (a)(2) or (b)(1)(A), there is hereby imposed on such partnership a penalty of 10 percent of the underpayment. For purposes of the preceding sentence, the term “underpayment” means the excess of any payment required under this section over the amount (if any) paid on or before the date prescribed therefor.

(B) Accuracy-related and fraud penalties made applicable

For purposes of part II of subchapter A of chapter 68, any payment required by subsection (a)(2) shall be treated as an underpayment of tax.

(d) DEFINITIONS AND SPECIAL RULES For purposes of this section—

(1) PARTNERSHIP ADJUSTMENT

The term “partnership adjustment” means any adjustment in the amount of any partnership item of an electing large partnership.

(2) WHEN ADJUSTMENT TAKES EFFECT A partnership adjustment takes effect—

(A) in the case of an adjustment pursuant to the decision of a court in a proceeding brought under part II, when such decision becomes final,

(B) in the case of an adjustment pursuant to any administrative adjustment request under section 6251, when such adjustment is allowed by the Secretary, or

(C) in any other case, when such adjustment is made.

(3) ADJUSTED YEAR

The term “adjusted year” means the partnership taxable year to which the item being adjusted relates.

(4) RETURN DUE DATE

The term “return due date” means, with respect to any taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

(5) ADJUSTMENTS INVOLVING CHANGES IN CHARACTER

Under regulations, appropriate adjustments in the application of this section shall be made for purposes of taking into account partnership adjustments which involve a change in the character of any item of income, gain, loss, or deduction.

(e) PAYMENTS NONDEDUCTIBLE

No deduction shall be allowed under subtitle A for any payment required to be made by an electing large partnership under this section.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1010.)

26 U.S. Code § 6245 - Secretarial authority

Current through Pub. L. 114-38. (See [Public Laws for the current Congress](#).)

(a) GENERAL RULE

The Secretary is authorized and directed to make adjustments at the partnership level in any partnership item to the extent necessary to have such item be treated in the manner required.

(b) NOTICE OF PARTNERSHIP ADJUSTMENT

(1) IN GENERAL

If the Secretary determines that a partnership adjustment is required, the Secretary is authorized to send notice of such adjustment to the partnership by certified mail or registered mail. Such notice shall be sufficient if mailed to the partnership at its last known address even if the partnership has terminated its existence.

(2) FURTHER NOTICES RESTRICTED

If the Secretary mails a notice of a partnership adjustment to any partnership for any partnership taxable year and the partnership files a petition under section 6247 with respect to such notice, in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact, the Secretary shall not mail another such notice to such partnership with respect to such taxable year.

(3) AUTHORITY TO RESCIND NOTICE WITH PARTNERSHIP CONSENT

The Secretary may, with the consent of the partnership, rescind any notice of a partnership adjustment mailed to such partnership. Any notice so rescinded shall not be treated as a notice of a partnership adjustment, for purposes of this section, section 6246, and section 6247, and the taxpayer shall have no right to bring a proceeding under section 6247 with respect to such notice. Nothing in this subsection shall affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1013.)

26 U.S. Code § 6246 - Restrictions on partnership adjustments

Current through Pub. L. 114-38. (See [Public Laws for the current Congress](#).)

(a) GENERAL RULE Except as otherwise provided in this chapter, no adjustment to any partnership item may be made (and no levy or proceeding in any court for the collection of any amount resulting from such adjustment may be made, begun or prosecuted) before—

(1) the close of the 90th day after the day on which a notice of a partnership adjustment was mailed to the partnership, and

(2) if a petition is filed under section 6247 with respect to such notice, the decision of the court has become final.

(b) PREMATURE ACTION MAY BE ENJOINED

Notwithstanding section 7421(a), any action which violates subsection (a) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action under this subsection unless a timely petition has been filed under section 6247 and then only in respect of the adjustments that are the subject of such petition.

(c) EXCEPTIONS TO RESTRICTIONS ON ADJUSTMENTS

(1) ADJUSTMENTS ARISING OUT OF MATH OR CLERICAL ERRORS

(A) In general

If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to a partnership item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.

(B) Special rule

If an electing large partnership is a partner in another electing large partnership, any adjustment on account of such partnership's failure to comply with the requirements of section 6241(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph (A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment.

(2) PARTNERSHIP MAY WAIVE RESTRICTIONS

The partnership shall at any time (whether or not a notice of partnership adjustment has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the making of any partnership adjustment.

(d) LIMIT WHERE NO PROCEEDING BEGUN

If no proceeding under section 6247 is begun with respect to any notice of a partnership adjustment during the 90-day period described in subsection (a), the amount for which the partnership is liable under section 6242 (and any increase in any partner's liability for tax under chapter 1 by reason of any adjustment under section 6242(a)) shall not exceed the amount determined in accordance with such notice.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1013.)

26 U.S. Code § 6247 - Judicial review of partnership adjustment

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE Within 90 days after the date on which a notice of a partnership adjustment is mailed to the partnership with respect to any partnership taxable year, the partnership may file a petition for a readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Claims Court.

(b) JURISDICTIONAL REQUIREMENT FOR BRINGING ACTION IN DISTRICT COURT OR CLAIMS COURT

(1) IN GENERAL

A readjustment petition under this section may be filed in a district court of the United States or the Claims Court only if the partnership filing the petition deposits with the Secretary, on or before the date the petition is filed, the amount for which the partnership would be liable under section 6242(b) (as of the date of the filing of the petition) if the partnership items were adjusted as provided by the notice of partnership adjustment. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirement and any shortfall of the amount required to be deposited is timely corrected.

(2) INTEREST PAYABLE

Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

(c) SCOPE OF JUDICIAL REVIEW

A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all partnership items of the partnership for the partnership taxable year to which the notice of partnership adjustment relates and the proper allocation of such items among the partners (and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under section 6242(b)).

(d) DETERMINATION OF COURT REVIEWABLE

Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

(d) EFFECT OF DECISION DISMISSING ACTION

If an action brought under this section is dismissed other than by reason of a rescission under section 6245(b)(3), the decision of the court dismissing the action shall be considered as its decision that the notice of partnership adjustment is correct, and an appropriate order shall be entered in the records of the court.

(Added Pub. L. 105–34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1014.)

26 U.S. Code § 6248 - Period of limitations for making adjustments

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE Except as otherwise provided in this section, no adjustment under this subpart to any partnership item for any partnership taxable year may be made after the date which is 3 years after the later of—

- (1) the date on which the partnership return for such taxable year was filed, or
- (2) the last day for filing such return for such year (determined without regard to extensions).

(b) EXTENSION BY AGREEMENT

The period described in subsection (a) (including an extension period under this subsection) may be extended by an agreement entered into by the Secretary and the partnership before the expiration of such period.

(c) SPECIAL RULE IN CASE OF FRAUD, ETC.

(1) FALSE RETURN

In the case of a false or fraudulent partnership return with intent to evade tax, the adjustment may be made at any time.

(2) SUBSTANTIAL OMISSION OF INCOME

If any partnership omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in its return, subsection (a) shall be applied by substituting “6 years” for “3 years”.

(3) NO RETURN

In the case of a failure by a partnership to file a return for any taxable year, the adjustment may be made at any time.

(4) RETURN FILED BY SECRETARY

For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

(d) SUSPENSION WHEN SECRETARY MAILS NOTICE OF ADJUSTMENT If notice of a partnership adjustment with respect to any taxable year is mailed to the partnership, the running of the period specified in subsection (a) (as modified by the other provisions of this section) shall be suspended—

(1) for the period during which an action may be brought under section 6247 (and, if a petition is filed under section 6247 with respect to such notice, until the decision of the court becomes final), and

(2) for 1 year thereafter.

(Added Pub. L. 105–34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1015.)

26 U.S. Code § 6251 - Administrative adjustment requests

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) GENERAL RULE A partnership may file a request for an administrative adjustment of partnership items for any partnership taxable year at any time which is—

(1) within 3 years after the later of—

(A) the date on which the partnership return for such year is filed, or

(B) the last day for filing the partnership return for such year (determined without regard to extensions), and

(2) before the mailing to the partnership of a notice of a partnership adjustment with respect to such taxable year.

(b) SECRETARIAL ACTION

If a partnership files an administrative adjustment request under subsection (a), the Secretary may allow any part of the requested adjustments.

(b) SPECIAL RULE IN CASE OF EXTENSION UNDER SECTION 6248

If the period described in section 6248(a) is extended pursuant to an agreement under section 6248(b), the period prescribed by subsection (a)(1) shall not expire before the date 6 months after the expiration of the extension under section 6248(b).

(Added Pub. L. 105–34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1016.)

26 U.S. Code § 6252 - Judicial review where administrative adjustment request is not allowed in full

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) IN GENERAL If any part of an administrative adjustment request filed under section 6251 is not allowed by the Secretary, the partnership may file a petition for an adjustment with respect to the partnership items to which such part of the request relates with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the principal place of business of the partnership is located, or

(3) the Claims Court.

(b) PERIOD FOR FILING PETITION A petition may be filed under subsection (a) with respect to partnership items for a partnership taxable year only—

(1) after the expiration of 6 months from the date of filing of the request under section 6251, and

(2) before the date which is 2 years after the date of such request.

The 2-year period set forth in paragraph (2) shall be extended for such period as may be agreed upon in writing by the partnership and the Secretary.

(c) COORDINATION WITH SUBPART A

(1) NOTICE OF PARTNERSHIP ADJUSTMENT BEFORE FILING OF PETITION

No petition may be filed under this section after the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year to which the request under section 6251 relates.

(2) NOTICE OF PARTNERSHIP ADJUSTMENT AFTER FILING BUT BEFORE HEARING OF PETITION

If the Secretary mails to the partnership a notice of a partnership adjustment for the partnership taxable year to which the request under section 6251 relates after the filing of a petition under this subsection but before the hearing of such petition, such petition shall be treated as an action brought under section 6247 with respect to such notice, except that subsection (b) of section 6247 shall not apply.

(3) NOTICE MUST BE BEFORE EXPIRATION OF STATUTE OF LIMITATIONS

A notice of a partnership adjustment for the partnership taxable year shall be taken into account under paragraphs (1) and (2) only if such notice is mailed before the expiration of the period prescribed by section 6248 for making adjustments to partnership items for such taxable year.

(d) SCOPE OF JUDICIAL REVIEW

Except in the case described in paragraph (2) of subsection (c), a court with which a petition is filed in accordance with this section shall have jurisdiction to determine only those partnership items to which the part of the request under section 6251 not allowed by the Secretary relates and those items with respect to which the Secretary asserts adjustments as offsets to the adjustments requested by the partnership.

(e) DETERMINATION OF COURT REVIEWABLE

Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the Claims Court, as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

(Added Pub. L. 105-34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1016.)

26 U.S. Code § 6255 - Definitions and special rules

Current through Pub. L. 114-38. (See Public Laws for the current Congress.)

(a) DEFINITIONS For purposes of this subchapter—

(1) ELECTING LARGE PARTNERSHIP

The term “electing large partnership” has the meaning given to such term by section 775.

(2) PARTNERSHIP ITEM

The term “partnership item” has the meaning given to such term by section 6231(a)(3).

(b) PARTNERS BOUND BY ACTIONS OF PARTNERSHIP, ETC.

(1) DESIGNATION OF PARTNER

Each electing large partnership shall designate (in the manner prescribed by the Secretary) a partner (or other person) who shall have the sole authority to act on behalf of such partnership under this subchapter. In any case in which such a designation is not in effect, the Secretary may select any partner as the partner with such authority.

(2) BINDING EFFECT An electing large partnership and all partners of such partnership shall be bound—

(A) by actions taken under this subchapter by the partnership, and

(B) by any decision in a proceeding brought under this subchapter.

(c) PARTNERSHIPS HAVING PRINCIPAL PLACE OF BUSINESS OUTSIDE THE UNITED STATES

For purposes of sections 6247 and 6252, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

(d) TREATMENT WHERE PARTNERSHIP CEASES TO EXIST

If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.

(e) DATE DECISION BECOMES FINAL

For purposes of this subchapter, the principles of section 7481(a) shall be applied in determining the date on which a decision of a district court or the Claims Court becomes final.

(f) PARTNERSHIPS IN CASES UNDER TITLE 11 OF THE UNITED STATES CODE

(1) SUSPENSION OF PERIOD OF LIMITATIONS ON MAKING ADJUSTMENT, ASSESSMENT, OR COLLECTION The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any amount required to be paid under section 6242) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and—

(A) for adjustment or assessment, 60 days thereafter, and

(B) for collection, 6 months thereafter.

A rule similar to the rule of section 6213(f)(2) shall apply for purposes of section 6246.

(2) SUSPENSION OF PERIOD OF LIMITATION FOR FILING FOR JUDICIAL REVIEW

The running of the period specified in section 6247(a) or 6252(b) shall, in a case under title 11 of the United States Code, be suspended during the period during which the partnership is prohibited by reason of such case from filing a petition under section 6247 or 6252 and for 60 days thereafter.

(g) REGULATIONS The Secretary shall prescribe such regulations as may be necessary to carry out the provisions of this subchapter, including regulations—

(1) to prevent abuse through manipulation of the provisions of this subchapter, and

(2) providing that this subchapter shall not apply to any case described in section 6231(c)(1) (or the regulations prescribed thereunder) where the application of this subchapter to such a case would interfere with the effective and efficient enforcement of this title.

In any case to which this subchapter does not apply by reason of paragraph (2), rules similar to the rules of sections 6229(f) and 6255(f) shall apply.

(Added Pub. L. 105–34, title XII, § 1222(a), Aug. 5, 1997, 111 Stat. 1017.)

Appendix II

Bipartisan Budget Act of 2015 (BBA)¹⁵³ as amended by The Consolidated Appropriations Act¹⁵⁴ (CAA) (Identified in citations with 2018 date)

I.R.C. § 6031(b) was amended by CAA §(d) and is therefore included here in addition to the BBA as amended.

26 U.S. Code § 6031 - Return of partnership income

(a) General rule

Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information, for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

(b) Copies to partners

Each partnership required to file a return under subsection (a) for any partnership taxable year shall (on or before the day on which the return for such taxable year was required to be filed) furnish to each person who is a partner or who holds an interest in such partnership as a nominee for another person at any time during such taxable year a copy of such information required to be shown on such return as may be required by regulations. ~~In the case of an electing large partnership (as defined in section 775), such information shall be furnished on or before the first March 15 following the close of such taxable year.~~ Except as provided in the procedures under section 6225(c), with respect to statements under section 6226, or as otherwise provided by the Secretary, information required to be furnished by the partnership under this subsection may not be amended after the due date of the return under subsection (a) to which such information relates (amended by CAA §d).

(c) Nominee reporting Any person who holds an interest in a partnership as a nominee for another person—

(1) shall furnish to the partnership, in the manner prescribed by the Secretary, the name and address of such other person, and any other information for such taxable year as the Secretary may by form and regulation prescribe, and

(2) shall furnish in the manner prescribed by the Secretary such other person the information provided by such partnership under subsection (b).

(d) Separate statement of items of unrelated business taxable income

¹⁵³ Pub. L. No 114-74, §§1101(a), (b), (c).

¹⁵⁴ Pub. L. No. 114-113, Div. Q § 411.

In the case of any partnership regularly carrying on a trade or business (within the meaning of section 512(c)(1)), the information required under subsection (b) to be furnished to its partners shall include such information as is necessary to enable each partner to compute its distributive share of partnership income or loss from such trade or business in accordance with section 512(a)(1), but without regard to the modifications described in paragraphs (8) through (15) of section 512(b).

(e) Foreign partnerships

(1) Exception for foreign partnership

Except as provided in paragraph (2), the preceding provisions of this section shall not apply to a foreign partnership.

(2) Certain foreign partnerships required to file return Except as provided in regulations prescribed by the Secretary, this section shall apply to a foreign partnership for any taxable year if for such year, such partnership has—

(A) gross income derived from sources within the United States, or

(B) gross income which is effectively connected with the conduct of a trade or business within the United States.

The Secretary may provide simplified filing procedures for foreign partnerships to which this section applies.

(f) Electing investment partnerships

In the case of any electing investment partnership (as defined in section 743(e)(6)), the information required under subsection (b) to be furnished to any partner to whom section 743(e)(2) applies shall include such information as is necessary to enable the partner to compute the amount of losses disallowed under section 743(e).

(Aug. 16, 1954, ch. 736, 68A Stat. 741; Pub. L. 94–455, title XIX, § 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1834; Pub. L. 97–248, title IV, § 403, Sept. 3, 1982, 96 Stat. 669; Pub. L. 99–514, title XV, § 1501(c)(16), title XVIII, § 1811(b)(1)(A), Oct. 22, 1986, 100 Stat. 2740, 2832; Pub. L. 100–647, title V, § 5074(a), Nov. 10, 1988, 102 Stat. 3682; Pub. L. 105–34, title XI, § 1141(a), title XII, § 1223(a), Aug. 5, 1997, 111 Stat. 980, 1019; Pub. L. 108–357, title VIII, § 833(b)(4)(B), Oct. 22, 2004, 118 Stat. 1590; Pub. L. 114–74, title XI, § 1101(e), (f)(1), Nov. 2, 2015, 129 Stat. 637; Pub. L. 114–113, div. Q, title IV, § 411(d), Dec. 18, 2015, 129 Stat. 3122.)

Partnership Provisions of the BBA as amended

129 STAT. 626 PUBLIC LAW 114–74—NOV. 2, 2015

“Subchapter C—Treatment of Partnerships

“PART I—IN GENERAL

“PART II—PARTNERSHIP ADJUSTMENTS

“PART III—PROCEDURE

“PART IV—DEFINITIONS AND SPECIAL RULES

“PART I—IN GENERAL

“Sec. 6221. Determination at partnership level.

“Sec. 6222. Partner’s return must be consistent with partnership return.

“Sec. 6223. Designation of partnership representative.

“SEC. 6221. DETERMINATION AT PARTNERSHIP LEVEL.

“(a) IN GENERAL.— Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year (and any partner’s distributive share thereof) shall be determined, any tax attributable thereto shall be assessed and collected, and the applicability of any penalty, addition to tax, or additional amount which relates to an adjustment to any such item or share shall be determined, at the partnership level pursuant to this subchapter.

“(b) ELECTION OUT FOR CERTAIN PARTNERSHIPS WITH 100 OR FEWER PARTNERS, ETC.—

“(1) IN GENERAL.—T his subchapter shall not apply with respect to any partnership for any taxable year if—

“(A) the partnership elects the application of this subsection for such taxable year,

“(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

“(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner,

“(D) the election—

“(i) is made with a timely filed return for such taxable year, and

“(ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and

“(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

“(2) SPECIAL RULES RELATING TO CERTAIN PARTNERS.—

“(A) S CORPORATION PARTNERS.— In the case of a partner that is an S corporation—

“(i) the partnership shall only be treated as meeting the requirements of paragraph (1)(C) with respect to such partner if such partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each person with respect to whom such S corporation is required to furnish a statement under section 6037(b) for the taxable year of the S corporation ending with or within the partnership taxable year for which the application of this subsection is elected, and

“(ii) the statements such S corporation is required to so furnish shall be treated as statements furnished by the partnership for purposes of paragraph (1)(B).

“(B) FOREIGN PARTNERS.—For purposes of paragraph (1)(D)(ii), the Secretary may provide for alternative identification of any foreign partners.

“(C) OTHER PARTNERS.—The Secretary may by regulation or other guidance prescribe rules similar to the rules of subparagraph (A) with respect to any partners not described in such subparagraph or paragraph (1)(C).

“SEC. 6222. PARTNER’S RETURN MUST BE CONSISTENT WITH PARTNERSHIP RETURN.

“(a) IN GENERAL.— A partner shall, on the partner’s return, treat each item of income, gain, loss, deduction, or credit attributable to a partnership in a manner which is consistent with the treatment of such income, gain, loss, deduction, or credit on the partnership return.

“(b) UNDERPAYMENT DUE TO INCONSISTENT TREATMENT ASSESSED AS MATH ERROR.— Any underpayment of tax by a partner by reason of failing to comply with the requirements of subsection (a) shall be assessed and collected in the same manner as if such underpayment were on account of a mathematical or clerical error appearing on the partner’s return. Paragraph (2) of section 6213(b) shall not apply to any assessment of an underpayment referred to in the preceding sentence.

“(c) EXCEPTION FOR NOTIFICATION OF INCONSISTENT TREATMENT.—

“(1) IN GENERAL.— In the case of any item referred to in subsection (a), if—

“(A) (i) the partnership has filed a return but the partner’s treatment on the partner’s return is (or may be) inconsistent with the treatment of the item on the partnership return, or

“(ii) the partnership has not filed a return, and

“(B) the partner files with the Secretary a statement identifying the inconsistency, subsections (a) and (b) shall not apply to such item.

“(2) PARTNER RECEIVING INCORRECT INFORMATION.— A partner shall be treated as having complied with subparagraph (B) of paragraph (1) with respect to an item if the partner—

“(A) demonstrates to the satisfaction of the Secretary that the treatment of the item on the partner’s return is consistent with the treatment of the item on the statement furnished to the partner by the partnership, and

“(B) elects to have this paragraph apply with respect to that item.

“(d) FINAL DECISION ON CERTAIN POSITIONS NOT BINDING ON PARTNERSHIP.— Any final decision with respect to an inconsistent position identified under subsection (c) in a proceeding to which the partnership is not a party shall not be binding on the partnership.

“(e) ADDITION TO TAX FOR FAILURE TO COMPLY WITH SECTION.—For addition to tax in the case of a partner’s disregard of the requirements of this section, see part II of subchapter A of chapter 68.

“SEC. 6223. PARTNERS BOUND BY ACTIONS OF PARTNERSHIP.

“(a) DESIGNATION OF PARTNERSHIP REPRESENTATIVE.— Each partnership shall designate (in the manner prescribed by the Secretary) a partner (or other person) with a

substantial presence in the United States as the partnership representative who shall have the sole authority to act on behalf of the partnership under this subchapter. In any case in which such a designation is not in effect, the Secretary may select any person as the partnership representative.

“(b) BINDING EFFECT.— A partnership and all partners of such partnership shall be bound—
“(1) by actions taken under this subchapter by the partnership, and
“(2) by any final decision in a proceeding brought under this subchapter with respect to the partnership.

“PART II—PARTNERSHIP ADJUSTMENTS

“Sec. 6225. Partnership adjustment by Secretary.

“Sec. 6226. Alternative to payment of imputed underpayment by partnership.

“Sec. 6227. Administrative adjustment request by partnership.

“SEC. 6225. PARTNERSHIP ADJUSTMENT BY SECRETARY.

“(a) IN GENERAL.— In the case of any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner’s distributive share thereof—

“(1) the partnership shall pay any imputed underpayment with respect to such adjustment in the adjustment year as provided in section 6232, and

“(2) any adjustment that does not result in an imputed underpayment shall be taken into account by the partnership in the adjustment year—

“(A) except as provided in subparagraph (B), as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate) under section 702(a)(8), or

“(B) in the case of an item of credit, as a separately stated item.

“(b) DETERMINATION OF IMPUTED UNDERPAYMENTS.—For purposes of this subchapter—

“(1) IN GENERAL.— Except as provided in subsection (c), any imputed underpayment with respect to any partnership adjustment for any reviewed year shall be determined—

“(A) by netting all adjustments of items of income, gain, loss, or deduction and multiplying such net amount by the highest rate of tax in effect for the reviewed year under section 1 or 11,

“(B) by treating any net increase or decrease in loss under subparagraph (A) as a decrease or increase, respectively, in income, and

“(C) by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount determined under subparagraph (A).

“(2) ADJUSTMENTS TO DISTRIBUTIVE SHARES OF PARTNERS NOT NETTED.— In the case of any adjustment which reallocates the distributive share of any item from one partner to another, such adjustment shall be taken into account under paragraph (1) by disregarding—

“(A) any decrease in any item of income or gain, and

“(B) any increase in any item of deduction, loss, or credit.

“(c) MODIFICATION OF IMPUTED UNDERPAYMENTS.—

“(1) IN GENERAL.— The Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with the requirements of this subsection.

“(2) AMENDED RETURNS OF PARTNERS.—

“(A) IN GENERAL.— Such procedures shall provide that if—

“(i) one or more partners file returns (notwithstanding section 6511) for the taxable year of the partners which includes the end of the reviewed year of the partnership.

“(ii) such returns take into account all adjustments under subsection (a) properly allocable to such partners (and for any other taxable year with respect to which any tax attribute is affected by reason of such adjustments), and

“(iii) payment of any tax due is included with such return, then the imputed underpayment amount shall be determined without regard to the portion of the adjustments so taken into account.

“(B) REALLOCATION OF DISTRIBUTIVE SHARE.— In the case of any adjustment which reallocates the distributive share of any item from one partner to another, paragraph (2) shall apply only if returns are filed by all partners affected by such adjustment.

“(3) TAX-EXEMPT PARTNERS.— Such procedures shall provide for determining the imputed underpayment without regard to the portion thereof that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity (as defined in section 168(h)(2)).

“(4) MODIFICATION OF APPLICABLE HIGHEST TAX RATES.—

“(A) IN GENERAL.— Such procedures shall provide for taking into account a rate of tax lower than the rate of tax described in subsection (b)(1)(A) with respect to any portion of the imputed underpayment that the partnership demonstrates is allocable to a partner which—

“(i) ~~in the case of ordinary income~~, is a C corporation, (struck by CAA § a) or

“(ii) in the case of a capital gain or qualified dividend, is an individual.

In no event shall the lower rate determined under the preceding sentence be less than the highest rate in effect with respect to the income and taxpayer described in clause (i) or clause (ii), as the case may be. For purposes of clause (ii), an S corporation shall be treated as an individual.

“(B) PORTION OF IMPUTED UNDERPAYMENT TO WHICH LOWER RATE APPLIES.—

“(i) IN GENERAL.— Except as provided in clause (ii), the portion of the imputed underpayment to which the lower rate applies with respect to a partner under subparagraph (A) shall be determined by reference to the partners’ distributive share of items to which the imputed underpayment relates.

“(ii) RULE IN CASE OF VARIED TREATMENT OF ITEMS AMONG PARTNERS.— If the imputed underpayment is attributable to the adjustment of more than 1 item, and any partner’s distributive share of such items is

not the same with respect to all such items, then the portion of the imputed underpayment to which the lower rate applies with respect to a partner under subparagraph (A) shall be determined by reference to the amount which would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year of the partnership.

“(5) CERTAIN PASSIVE LOSSES OF Publicly Traded PARTNERSHIPS

(A) IN GENERAL

In the case of a publicly traded partnership (as defined in section 469(k)(2)), such procedures shall provide—

- (i) for determining the imputed underpayment without regard to the portion thereof that the partnership demonstrates is attributable to a net decrease in a specified passive activity loss which is allocable to a specified partner, and
- (ii) for the partnership to take such net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which such net decrease relates.

(B) SPECIFIED PASSIVE ACTIVITY LOSS

For purposes of this paragraph, the term *specified passive activity loss* means, with respect to any specified partner of such publicly traded partnership, the lesser of—

- (i) The passive activity loss of such partnership under section 469(k) with respect to such partner's taxable year in which or with which the reviewed year of such partnership ends, or
- (ii) such passive activity loss so determined with respect to such partner's taxable year in which or with which the adjustment year of such partnership ends.

(C) SPECIFIED PARTNER

For purposes of this paragraph, the term *specified partner means any person if such person—*

- (i) is a partner of the publicly traded partnership referred to in subparagraph (A),
- (ii) is described in section 469(a)(2), and
- (iii) has a specified passive activity loss with respect to such publicly traded partnership, with respect to each taxable year of such person which is during the period beginning with the taxable year of such person in which or with which the reviewed year of such publicly traded partnership ends and ending with the taxable year of such person in which or with which

the adjustment year of such publicly traded partnership ends. (Subsection 5 added by CAA § (a)(5)(A),(B)).

“(56) OTHER PROCEDURES FOR MODIFICATION OF IMPUTED UNDERPAYMENT.— The Secretary may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of such other factors as the Secretary determines are necessary or appropriate to carry out the purposes of this subsection.

“(67) YEAR AND DAY FOR SUBMISSION TO SECRETARY.— Anything required to be submitted pursuant to paragraph (1) shall be submitted to the Secretary not later than the close of the 270-day period beginning on the date on which the notice of a proposed partnership adjustment is mailed under section 6231 unless such period is extended with the consent of the Secretary.

“(78) DECISION OF SECRETARY.— Any modification of the imputed underpayment amount under this subsection shall be made only upon approval of such modification by the Secretary.

“(d) DEFINITIONS.—For purposes of this subchapter—

“(1) REVIEWED YEAR.— The term ‘reviewed year’ means the partnership taxable year to which the item being adjusted relates.

“(2) ADJUSTMENT YEAR.— The term ‘adjustment year’ means the partnership taxable year in which—

“(A) in the case of an adjustment pursuant to the decision of a court in a proceeding brought under section 6234, such decision becomes final,

“(B) in the case of an administrative adjustment request under section 6227, such administrative adjustment request is made, or

“(C) in any other case, notice of the final partnership adjustment is mailed under section 6231.

“SEC. 6226. ALTERNATIVE TO PAYMENT OF IMPUTED UNDERPAYMENT BY PARTNERSHIP.

“(a) IN GENERAL.—If the partnership—

“(1) not later than 45 days after the date of the notice of final partnership adjustment, elects the application of this section with respect to an imputed underpayment, and

“(2) at such time and in such manner as the Secretary may provide, furnishes to each partner of the partnership for the reviewed year and to the Secretary a statement of the partner’s share of any adjustment to income, gain, loss, deduction, or credit (as determined in the notice of final partnership adjustment), section 6225 shall not apply with respect to such underpayment and each such partner shall take such adjustment into account as provided in subsection (b). The election under paragraph (1) shall be made in such manner as the Secretary may provide and, once made, shall be revocable only with the consent of the Secretary.

“(b) ADJUSTMENTS TAKEN INTO ACCOUNT BY PARTNER.—

“(1) TAX IMPOSED IN YEAR OF STATEMENT.— Each partner’s tax imposed by chapter 1 for the taxable year which includes the date the statement was furnished under subsection (a) shall be increased by the aggregate of the adjustment amounts determined under paragraph (2) for the taxable years referred to therein.

“(2) ADJUSTMENT AMOUNTS.— The adjustment amounts determined under this paragraph are—

“(A) in the case of the taxable year of the partner which includes the end of the reviewed year, the amount by which the tax imposed under chapter 1 would increase if the partner’s share of the adjustments described in subsection (a) were taken into account for such taxable year,

“(B) in the case of any taxable year after the taxable year referred to in subparagraph (A) and before the taxable year referred to in paragraph (1), the amount by which the tax imposed under chapter 1 would increase by reason of the adjustment to tax attributes under paragraph (3).

“(3) ADJUSTMENT OF TAX ATTRIBUTES.— Any tax attribute which would have been affected if the adjustments described in subsection (a) were taken into account for the taxable year referred to in paragraph (2)(A) shall—

“(A) in the case of any taxable year referred to in paragraph (2)(B), be appropriately adjusted for purposes of applying such paragraph, and

“(B) in the case of any subsequent taxable year, be appropriately adjusted.

“(c) PENALTIES AND INTEREST.—

“(1) PENALTIES.—Notwithstanding subsections (a) and (b), any penalties, additions to tax, or additional amount shall be determined as provided under section 6221 and the partners of the partnership for the reviewed year shall be liable for any such penalty, addition to tax, or additional amount.

“(2) INTEREST.—In the case of an imputed underpayment with respect to which the application of this section is elected, interest shall be determined—

“(A) at the partner level,

“(B) from the due date of the return for the taxable year to which the increase is attributable (determined by taking into account any increases attributable to a change in tax attributes for a taxable year under subsection (b)(2)), and

“(C) at the underpayment rate under section 6621(a)(2), determined by substituting ‘5 percentage points’ for ‘3 percentage points’ in subparagraph (B) thereof.

“SEC. 6227. ADMINISTRATIVE ADJUSTMENT REQUEST BY PARTNERSHIP.

“(a) IN GENERAL.— A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for any partnership taxable year.

“(b) ADJUSTMENT.— Any such adjustment under subsection (a) shall be determined and taken into account for the partnership taxable year in which the administrative adjustment request is made—

“(1) by the partnership under rules similar to the rules of section 6225 (other than paragraphs (2), (6) and (7) of subsection (c) thereof) for the partnership taxable year in which the administrative adjustment request is made, or “(2) by the partnership and partners under rules similar to the rules of section 6226 (determined without regard to the substitution described in subsection (c)(2)(C) thereof). In the case of an adjustment that would not result in an imputed underpayment, paragraph (1) shall not apply and paragraph (2) shall apply with appropriate adjustments.

“(c) PERIOD OF LIMITATIONS.— A partnership may not file such a request more than 3 years after the later of—

“(1) the date on which the partnership return for such year is filed, or

“(2) the last day for filing the partnership return for such year (determined without regard to extensions).

In no event may a partnership file such a request after a notice of an administrative proceeding with respect to the taxable year is mailed under section 6231.

“PART 1—PROCEDURE

“Sec. 6231. Notice of proceedings and adjustment.

“Sec. 6232. Assessment, collection, and payment.

“Sec. 6233. Interest and penalties.

“Sec. 6234. Judicial review of partnership adjustment.

“Sec. 6235. Period of limitations on making adjustments.

“SEC. 6231. NOTICE OF PROCEEDINGS AND ADJUSTMENT.

“(a) IN GENERAL.—The Secretary shall mail to the partnership and the partnership representative—

“(1) notice of any administrative proceeding initiated at the partnership level with respect to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, or any partner’s distributive share thereof,

“(2) notice of any proposed partnership adjustment resulting from such proceeding, and

“(3) notice of any final partnership adjustment resulting from such proceeding.

Any notice of a final partnership adjustment shall not be mailed earlier than 270 days after the date on which the notice of the proposed partnership adjustment is mailed. Such notices shall be sufficient if mailed to the last known address of the partnership representative or the partnership (even if the partnership has terminated its existence). The first sentence shall apply to any proceeding with respect to an administrative adjustment request filed by a partnership under section 6227.

“(b) FURTHER NOTICES RESTRICTED.— If the Secretary mails a notice of a final partnership adjustment to any partnership for any partnership taxable year and the partnership files a petition under section 6234 with respect to such notice, in the absence of a showing of fraud, malfeasance, or misrepresentation of a material fact, the Secretary shall not mail another such notice to such partnership with respect to such taxable year.

“(c) AUTHORITY TO RESCIND NOTICE WITH PARTNERSHIP CONSENT.—

The Secretary may, with the consent of the partnership, rescind any notice of a partnership adjustment mailed to such partnership. Any notice so rescinded shall not be treated as a notice of a partnership adjustment for purposes of this subchapter, and the taxpayer shall have no right to bring a proceeding under section 6234 with respect to such notice.

“SEC. 6232. ASSESSMENT, COLLECTION, AND PAYMENT.

“(a) IN GENERAL.— Any imputed underpayment shall be assessed and collected in the same manner as if it were a tax imposed for the adjustment year by subtitle A, except that in the case of an administrative adjustment request to which section 6227(b)(1) applies, the underpayment shall be paid when the request is filed.

“(b) LIMITATION ON ASSESSMENT.— Except as otherwise provided in this chapter, no assessment of a deficiency may be made (and no levy or proceeding in any court for the collection of any amount resulting from such adjustment may be made, begun or prosecuted) before—

“(1) the close of the 90th day after the day on which a notice of a final partnership adjustment was mailed, and

“(2) if a petition is filed under section 6234 with respect to such notice, the decision of the court has become final.

“(c) PREMATURE ACTION MAY BE ENJOINED.— Notwithstanding section 7421(a), any action which violates subsection (b) may be enjoined in the proper court, including the Tax Court. The Tax Court shall have no jurisdiction to enjoin any action under this subsection unless a timely petition has been filed under section 6234 and then only in respect of the adjustments that are the subject of such petition.

“(d) EXCEPTIONS TO RESTRICTIONS ON ADJUSTMENTS.—

“(1) ADJUSTMENTS ARISING OUT OF MATH OR CLERICAL ERRORS.—

“(A) IN GENERAL.— If the partnership is notified that, on account of a mathematical or clerical error appearing on the partnership return, an adjustment to a item is required, rules similar to the rules of paragraphs (1) and (2) of section 6213(b) shall apply to such adjustment.

“(B) SPECIAL RULE.— If a partnership is a partner in another partnership, any adjustment on account of such partnership’s failure to comply with the requirements of section 6222(a) with respect to its interest in such other partnership shall be treated as an adjustment referred to in subparagraph (A), except that paragraph (2) of section 6213(b) shall not apply to such adjustment.

“(2) PARTNERSHIP MAY WAIVE RESTRICTIONS.— The partnership may at any time (whether or not any notice of partnership adjustment has been issued), by a signed notice in writing filed with the Secretary, waive the restrictions provided in subsection (b) on the making of any partnership adjustment.

“(e) LIMIT WHERE NO PROCEEDING BEGUN.— If no proceeding under section 6234 is begun with respect to any notice of a final partnership adjustment during the 90-day period described in subsection (b) thereof, the amount for which the partnership is liable under section 6225 shall not exceed the amount determined in accordance with such notice.

“SEC. 6233. INTEREST AND PENALTIES.

“(a) INTEREST AND PENALTIES DETERMINED FROM REVIEWED YEAR.—

“(1) IN GENERAL.— Except to the extent provided in section 6226(c), in the case of a partnership adjustment for a reviewed year—

“(A) interest shall be computed under paragraph (2), and

“(B) the partnership shall be liable for any penalty, addition to tax, or additional amount as provided in paragraph (3).

“(2) DETERMINATION OF AMOUNT OF INTEREST.— The interest computed under this paragraph with respect to any partnership adjustment is the interest which would be determined under chapter 67 for the period beginning on the day after the return due date for the reviewed year and ending on the return due date for the adjustment year (or, if earlier, the date payment of the imputed underpayment is made). Proper adjustments in the amount determined under the preceding sentence shall be made for adjustments required for partnership taxable years after the reviewed year and before the adjustment year by reason of such partnership adjustment.

“(3) PENALTIES.— Any penalty, addition to tax, or additional amount shall be determined at the partnership level as if such partnership had been an individual subject to tax under chapter 1 for the reviewed year and the imputed underpayment were an actual underpayment (or understatement) for such year.

“(b) INTEREST AND PENALTIES WITH RESPECT TO ADJUSTMENT YEAR RETURN.—

“(1) IN GENERAL.— In the case of any failure to pay an imputed underpayment on the date prescribed therefor, the partnership shall be liable—

“(A) for interest as determined under paragraph (2), and

“(B) for any penalty, addition to tax, or additional amount as determined under paragraph (3).

“(2) INTEREST.— Interest determined under this paragraph is the interest that would be determined by treating the imputed underpayment as an underpayment of tax imposed in the adjustment year.

“(3) PENALTIES.— Penalties, additions to tax, or additional amounts determined under this paragraph are the penalties, additions to tax, or additional amounts that would be determined—

“(A) by applying section 6651(a)(2) to such failure to pay, and

“(B) by treating the imputed underpayment as an underpayment of tax for purposes of part II of subchapter A of chapter 68.

“SEC. 6234. JUDICIAL REVIEW OF PARTNERSHIP ADJUSTMENT.

“(a) IN GENERAL.— Within 90 days after the date on which a notice of a final partnership adjustment is mailed under section 6231 with respect to any partnership taxable year, the partnership may file a petition for a readjustment for such taxable year with—

“(1) the Tax Court,

“(2) the district court of the United States for the district

in which the partnership's principal place of business is located, or
“(3) the ~~Claims Court~~ Court of Federal Claims (amended by CAA (b)).

“(b) JURISDICTIONAL REQUIREMENT FOR BRINGING ACTION IN DISTRICT COURT OR ~~CLAIMS COURT~~ COURT OF FEDERAL CLAIMS (amended by CAA (b)).

—
“(1) IN GENERAL.— A readjustment petition under this section may be filed in a district court of the United States or the ~~Claims Court~~ Court of Federal Claims (amended by CAA (b)) only if the partnership filing the petition deposits with the Secretary, on or before the date the petition is filed, the amount of the imputed underpayment (as of the date of the filing of the petition) if the partnership adjustment was made as provided by the notice of final partnership adjustment. The court may by order provide that the jurisdictional requirements of this paragraph are satisfied where there has been a good faith attempt to satisfy such requirement and any shortfall of the amount required to be deposited is timely corrected.

“(2) INTEREST PAYABLE.— Any amount deposited under paragraph (1), while deposited, shall not be treated as a payment of tax for purposes of this title (other than chapter 67).

“(c) SCOPE OF JUDICIAL REVIEW.— A court with which a petition is filed in accordance with this section shall have jurisdiction to determine all items of income, gain, loss, deduction, or credit of the partnership for the partnership taxable year to which the notice of final partnership adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under this subchapter.

“(d) DETERMINATION OF COURT REVIEWABLE.— Any determination by a court under this section shall have the force and effect of a decision of the Tax Court or a final judgment or decree of the district court or the ~~Claims Court~~ Court of Federal Claims (amended by CAA (b)), as the case may be, and shall be reviewable as such. The date of any such determination shall be treated as being the date of the court's order entering the decision.

“(e) EFFECT OF DECISION DISMISSING ACTION.— If an action brought under this section is dismissed other than by reason of a rescission under section 6231(c), the decision of the court dismissing the action shall be considered as its decision that the notice of final partnership adjustment is correct, and an appropriate order shall be entered in the records of the court.

“SEC. 6235. PERIOD OF LIMITATIONS ON MAKING ADJUSTMENTS.

“(a) IN GENERAL.— Except as otherwise provided in this section, no adjustment under this subpart for any partnership taxable year may be made after the later of—

“(1) the date which is 3 years after the latest of—

“(A) the date on which the partnership return for such taxable year was filed,

- “(B) the return due date for the taxable year, or
- “(C) the date on which the partnership filed an administrative adjustment request with respect to such year under section 6227, or
- “(2) in the case of any modification of an imputed underpayment under section 6225(c), the date that is 270 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7)) ~~paragraph (47) thereof~~ after the date on which everything required to be submitted to the Secretary pursuant to such section is so submitted (amended by CAA § (c)), or
- “(3) in the case of any notice of a proposed partnership adjustment under section 6231(a)(2), the date that is ~~270~~ 370 days after the date of such notice (amended by CAA § (c)).

“(b) EXTENSION BY AGREEMENT.— The period described in subsection (a) (including an extension period under this subsection) may be extended by an agreement entered into by the Secretary and the partnership before the expiration of such period.

“(c) SPECIAL RULE IN CASE OF FRAUD, ETC.—

- “(1) FALSE RETURN.— In the case of a false or fraudulent partnership return with intent to evade tax, the adjustment may be made at any time.
- “(2) SUBSTANTIAL OMISSION OF INCOME.— If any partnership omits from gross income an amount properly includible therein and such amount is described in section 6501(e)(1)(A), subsection (a) shall be applied by substituting ‘6 years’ for ‘3 years’.
- “(3) NO RETURN.— In the case of a failure by a partnership to file a return for any taxable year, the adjustment may be made at any time.
- “(4) RETURN FILED BY SECRETARY.— For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

“(d) SUSPENSION WHEN SECRETARY MAILS NOTICE OF ADJUSTMENT.—

If notice of a final partnership adjustment with respect to any taxable year is mailed under section 6231, the running of the period specified in subsection (a) (as modified by the other provisions of this section) shall be suspended—

- “(1) for the period during which an action may be brought under section 6234 (and, if a petition is filed under such section with respect to such notice, until the decision of the court becomes final), and
- “(2) for 1 year thereafter.

“PART 2—DEFINITIONS AND SPECIAL RULES

“SEC. 6241. DEFINITIONS AND SPECIAL RULES.

“For purposes of this subchapter—

- “(1) PARTNERSHIP.— The term ‘partnership’ means any partnership required to file a return under section 6031(a).

“(2) PARTNERSHIP ADJUSTMENT.— The term ‘partnership adjustment’ means any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner’s distributive share thereof.

“(3) RETURN DUE DATE.— The term ‘return due date’ means, with respect to the taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

“(4) PAYMENTS NONDEDUCTIBLE.— No deduction shall be allowed under subtitle A for any payment required to be made by a partnership under this subchapter.

“(5) PARTNERSHIPS HAVING PRINCIPAL PLACE OF BUSINESS OUTSIDE UNITED STATES.— For purposes of sections 6234, a principal place of business located outside the United States shall be treated as located in the District of Columbia.

“(6) PARTNERSHIPS IN CASES UNDER TITLE 11 OF UNITED STATES CODE.—

“(A) SUSPENSION OF PERIOD OF LIMITATIONS ON MAKING ADJUSTMENT, ASSESSMENT, OR COLLECTION.— The running of any period of limitations provided in this subchapter on making a partnership adjustment (or provided by section 6501 or 6502 on the assessment or collection of any imputed underpayment determined under this subchapter) shall, in a case under title 11 of the United States Code, be suspended during the period during which the Secretary is prohibited by reason of such case from making the adjustment (or assessment or collection) and—

“(i) for adjustment or assessment, 60 days thereafter, and

“(ii) for collection, 6 months thereafter.

A rule similar to the rule of section 6213(f)(2) shall apply for purposes of section 6232(b).

“(B) SUSPENSION OF PERIOD OF LIMITATION FOR FILING FOR JUDICIAL REVIEW.— The running of the period specified in section 6234 shall, in a case under title 11 of the United States Code, be suspended during the period during which the partnership is prohibited by reason of such case from filing a petition under section 6234 and for 60 days thereafter.

“(7) TREATMENT WHERE PARTNERSHIP CEASES TO EXIST.—

If a partnership ceases to exist before a partnership adjustment under this subchapter takes effect, such adjustment shall be taken into account by the former partners of such partnership under regulations prescribed by the Secretary.

“(8) EXTENSION TO ENTITIES FILING PARTNERSHIP RETURN.—

If a partnership return is filed by an entity for a taxable year but it is determined that the entity is not a partnership (or that there is no entity) for such year, then, to the extent provided in regulations, the provisions of this subchapter are hereby extended in respect of such year to such entity and its items and to persons holding an interest in such entity.”.

(2) CLERICAL AMENDMENT.— The table of subchapters for chapter 63 of the Internal Revenue Code of 1986, as amended by the preceding provisions of this section, is amended by inserting after the item relating to subchapter B the following new item:

(d) BINDING NATURE OF PARTNERSHIP ADJUSTMENT PROCEEDINGS.—

Section 6330(c)(4) of such Code is amended by striking “or” at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting “; or”, and by inserting after

subparagraph (B) the following new subparagraph: “(C) a final determination has been made with respect to such issue in a proceeding brought under subchapter C of chapter 63.”.

(e) **RESTRICTION ON AUTHORITY TO AMEND PARTNER INFORMATION STATEMENTS.**— Section 6031(b) of such Code is amended by adding at the end the following: “Except as provided in the procedures under section 6225(c), with respect to statements under section 6226, or as otherwise provided by the Secretary, information required to be furnished by the partnership under this subsection may not be amended after the due date of the return under subsection (a) to which such information relates.”.

(f) **CONFORMING AMENDMENTS.**—

(1) Section 6031(b) of such Code is amended by striking the last sentence.

(2) Section 6422 of such Code is amended by striking paragraph (12).

(3) Section 6501(n) of such Code is amended by striking paragraphs (2) and (3) and by striking “CROSS REFERENCES” and all that follows through “For period of limitations” and inserting “CROSS REFERENCE.— For period of limitations”. and such amount is described in section 6501(e)(1)(A), subsection (a) shall be applied by substituting ‘6 years’ for ‘3 years’.

“(3) NO RETURN.— In the case of a failure by a partnership to file a return for any taxable year, the adjustment may be made at any time.

“(4) RETURN FILED BY SECRETARY.— For purposes of this section, a return executed by the Secretary under subsection (b) of section 6020 on behalf of the partnership shall not be treated as a return of the partnership.

(g) **EFFECTIVE DATE.**—

(1) **IN GENERAL.**— Except as otherwise provided in this subsection, the amendments made by this section shall apply to returns filed for partnership taxable years beginning after December 31, 2017.

(2) **ADMINISTRATIVE ADJUSTMENT REQUESTS.**— In the case of administrative adjustment request under section 6227 of such Code, the amendments made by this section shall apply to requests with respect to returns filed for partnership taxable years beginning after December 31, 2017.

(3) **ADJUSTED PARTNERS STATEMENTS.**— In the case of a partnership electing the application of section 6226 of such Code, the amendments made by this section shall apply to elections with respect to returns filed for partnership taxable years beginning after December 31, 2017.

(4) **ELECTION.**— A partnership may elect (at such time and in such form and manner as the Secretary of the Treasury may prescribe) for the amendments made by this section (other than the election under section 6221(b) of such Code (as added by this Act)) to apply to any return of the partnership filed for partnership taxable years beginning after the date of the enactment of this Act and before January 1, 2018.

SEC. 1102. PARTNERSHIP INTERESTS CREATED BY GIFT.

(a) **IN GENERAL.**— Section 761(b) of the Internal Revenue Code of 1986 is amended by adding at the end the following: “In the case of a capital interest in a partnership in which capital is a material income-producing factor, whether a person is a partner with respect to such interest

shall be determined without regard to whether such interest was derived by gift from any other person.”.

- (b) CONFORMING AMENDMENTS.— Section 704(e) of such Code is amended—
- (1) by striking paragraph (1) and by redesignating paragraphs (2) and (3) as paragraphs (1) and (2), respectively,
 - (2) by striking “this section” in paragraph (2) (as so redesignated) and inserting “this subsection”, and
 - (3) by striking “FAMILY PARTNERSHIPS” in the heading and inserting “PARTNERSHIP INTERESTS CREATED BY GIFT”.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to partnership taxable years beginning after December 31, 2015.

2016 Consolidated Appropriations Act, Pub L. No. 114-113
Div Q § 411.
Partnership Audit Rules

(a) Correction and clarification to modifications to imputed underpayments

(1) Section 6225(c)(4)(A)(i) is amended by striking in the case of ordinary income..

(2) Section 6225(c) is amended by redesignating paragraphs (5) through (7) as paragraphs (6) through (8), respectively, and by inserting after paragraph (4) the following new paragraph:

(5) Certain passive losses of publicly traded partnerships

(A) In general

In the case of a publicly traded partnership (as defined in section 469(k)(2)), such procedures shall provide—

(i) for determining the imputed underpayment without regard to the portion thereof that the partnership demonstrates is attributable to a net decrease in a specified passive activity loss which is allocable to a specified partner, and

(ii) for the partnership to take such net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which such net decrease relates.

(B) Specified passive activity loss

For purposes of this paragraph, the term *specified passive activity loss* means, with respect to any specified partner of such publicly traded partnership, the lesser of—

(i) the passive activity loss of such partner which is separately determined with respect to such partnership under section 469(k) with respect to such partner's taxable year in which or with which the reviewed year of such partnership ends, or

(ii) such passive activity loss so determined with respect to such partner's taxable year in which or with which the adjustment year of such partnership ends.

(C) Specified partner

For purposes of this paragraph, the term *specified partner* means any person if such person—

(i) is a partner of the publicly traded partnership referred to in subparagraph (A),

(ii) is described in section 469(a)(2), and

(iii) has a specified passive activity loss with respect to such publicly traded partnership,

with respect to each taxable year of such person which is during the period beginning with the taxable year of such person in which or with which the reviewed year of such publicly traded partnership ends and ending with the taxable year of such person in which or with which the adjustment year of such publicly traded partnership ends.

(b) Correction and clarification to judicial review of partnership adjustment

(1) Section 6226 is amended by adding at the end the following new subsection:

(d) Judicial review

For the time period within which a partnership may file a petition for a readjustment, see section 6234(a).

(2) Subsections (a)(3), (b)(1), and (d) of section 6234 are each amended by striking the Claims Court and inserting the Court of Federal Claims.

(3) The heading for section 6234(b) is amended by striking Claims Court and inserting Court of Federal Claims.

(c) Correction and clarification to period of limitations on making adjustments

(1) Section 6235(a)(2) is amended by striking paragraph (4) and inserting paragraph (7).

(2) Section 6235(a)(3) is amended by striking 270 days and inserting 330 days (plus the number of days of any extension consented to by the Secretary under section 6225(c)(7)).

(d) Technical amendment

Section 6031(b) is amended by striking the last sentence and inserting the following: Except as provided in the procedures under section 6225(c), with respect to statements under section 6226, or as otherwise provided by the Secretary, information required to be furnished by the partnership under this subsection may not be amended after the due date of the return under subsection (a) to which such information relates..

(e) Effective date

The amendments made by this section shall take effect as if included in section 1101 of the Bipartisan Budget Act of 2015.

Appendix 3

The material presented here is intended to identify some of the major issues that will confront the IRS in their rulemaking proceedings concerning imposition of the taxes partners would have paid had they originally computed taxes in the manner found to be correct. Whether the New York Bar Tax Section recommendations are correct or the IRS finds some alternative approach to be preferable remains to be seen.

From:

New York State Bar Association Tax Section, REPORT ON THE PARTNERSHIP AUDIT RULES OF THE BIPARTISAN BUDGET ACT OF 2015, Report No. 1247, at 32-53, May 25, 2016

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A. Example [to illustrate some issues associated with BBACAA statutory requirements]

These [BBACAA] issues are complex but we think they can be illustrated through a simple example: Partnership P is a Delaware limited liability company classified as a partnership for U.S. Federal income tax purposes. All partners (A, B and C) are Delaware C corporations with no items of income, gain, loss, deduction or credit, other than those from P, all items recognized by P are stated below, and the highest rate of tax under Sections 1 and 11 in each year is 35%. There are no special allocations and no section 754 election; liquidations are in accordance with capital account balances. Each of P and A, B and C is a calendar year taxpayer. P does not elect out under section 6221(b) in any year.

Each of A and B starts out with \$1,070 of cash and C starts out with \$1,200 of cash.

2018

- In 2018, P is formed; A and B each contribute \$1,000 of cash; all profits and losses are split 50/50.

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During 2018, P provides services to a third party and as compensation receives Asset, which P values at \$200. Accordingly, P recognizes \$200 of income, A and B each take into account \$100 of income, and therefore A and B each pay tax of \$35.

At this stage, there is no inside/outside basis discrepancy.

2019

- On January 1, 2019, A sells its partnership interest to C. C values Asset at \$400 and thus buys A's interest for \$1,200 (50% of \$2,400).
- A recognizes \$100 of section 741 gain (\$1,200 - \$1,100 basis) and pays \$35 of tax.

At this stage, there is no inside/outside basis discrepancy.

2019

- On January 1, 2019, A sells its partnership interest to C. C values Asset at \$400 and thus buys A's interest for \$1,200 (50% of \$2,400).
- A recognizes \$100 of section 741 gain (\$1,200 - \$1,100 basis) and pays \$35 of tax.

A has thus paid \$70 of taxes (which is all the taxes due on the \$200 of value that A economically realized from its investment in P). A has thus paid \$70 of taxes (which is all the taxes due on the \$200 of value that A economically realized from its investment in P).

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2020

- In 2020, the IRS audits P's 2018 return and determines that Asset was already worth \$400 when received by P in 2018 (which increases P's 2018 income by \$200). An FPA [final partnership adjustment] is issued showing \$200 of additional income for 2018.

Under the BBA, there are three possible ways to satisfy the resulting underpayment: (i) section 6225(c)(2),¹⁵⁵ (ii) section 6226, and (iii) section 6225(a). It is helpful to compare the results of the three methods with the amount of taxes that would have been paid if P's 2018 return had reflected the Correct Return Position so we start with that.

Correct Return Position

- If P had correctly valued the Asset at \$400, then in 2018 each of A and B would have been allocated \$200 (instead of \$100) of income and paid \$70 of taxes.
- At the end of 2018, P would have a \$400 basis in Asset and each of A and B would have had an outside basis in P of \$1,200 (*i.e.*, there would be no inside/outside basis discrepancy).¹⁵⁶ P also would have reflected the \$200 in each of A's and B's capital accounts, resulting in each having a capital account of \$1,200.
- In 2019, when A sold its interest to C for \$1,200, A would have had no taxable gain and thus no tax would have been due. C would have inherited A's \$1,200 capital account.

¹⁵⁵ 100 The amended return method pursuant to § 6225(c)(2) can be combined with the partnership paying the imputed underpayment (§ 6225(a)) because not all partners are required to file an amended return. (It cannot be combined with the push-out election of § 6226.) For purposes of the illustrations and discussion in this section, we analyze the results of the amended-return method as if all the partners filed amended returns.

¹⁵⁶ 101 We note that under TEFRA, the results would be identical to this in that P, A and B would all have adjusted their respective bases to reflect the adjustments made by the audit even though there is no specific statutory provision in TEFRA or other parts of the Code that specifies, authorizes or requires this. *See* Parts III.A.3 and IV.D.

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To summarize, under the Correct Return Position at the end of 2019:

- A has \$1,200 of cash (\$1,200 received from C plus \$70 of cash on hand less \$70 of taxes paid).
- B's net assets are \$1,200 (a partnership interest worth \$1,200 plus \$70 of cash on hand less \$70 of taxes paid).
- C has a partnership interest worth \$1,200.
- The IRS has collected \$140 of tax payments.

Section 6225(c)(2): Amended Reviewed Year Returns 2.

A and B, as reviewed year partners, file amended returns to reflect the adjustment from the FPA and pay the taxes due in accordance therewith. C is not implicated.

Treatment of B (a)

- **Income:** B files an amended tax return for 2018 and includes an additional \$100 of income resulting in an additional tax liability of \$35 (plus interest).¹⁵⁷
- **Basis Adjustments:** Since B has amended its tax return to recognize the additional income, and B still holds the P interest, presumably, B should increase its basis in its P interest by \$100, resulting in an outside basis of \$1,200.¹⁵⁸

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§ 6225(c)(2)(A)(ii) requires A to file an amended 2018 return that “*take[s] into account all adjustments [from the FPA] properly allocable to [A] (and for any other taxable year in respect to which any tax attribute is affected by reason of such adjustments).*” There are two issues, however:

- *Subsequent Years:* It is not entirely clear from § 6225(c)(2)(A)(ii) whether these conforming adjustments are reflected in the amended 2018 return or handled otherwise. It would seem appropriate to either allow A to include the consequences of the 2019 adjustment in its 2018 tax return (similar in a way to what is done under § 6226 in the adjustment year return), or to allow A to file an amended return with respect to 2019 (regardless of whether the time to do so has run). We note that the special rule in § 6225(c)(2)(A)(i) that authorizes A to file the amended

¹⁵⁷ At the federal short term rate plus 3%.

¹⁵⁸ This is an important point that needs to be confirmed in the guidance because the statute does not specify that this occurs, although it implies it by referring in § 6225(c)(2)(A)(ii) to “any tax attribute [which] is affected by reason of such adjustments.”

2018 return even if the time to do so has already run applies, by its terms, only to the return for the reviewed year.

- *Interest Payments:* Similarly it is not entirely clear if A receives overpayment interest to offset the underpayment interest. We note that § 6225(c)(2)(A)(iii) requires A to pay “any tax due” with the amended return.

Ignoring the time value of money (and the interest charge), B’s position (and the amount the IRS has collected with respect to B) matches the Correct Return Position.

Treatment of A (b)

- **Income:** A files an amended return for 2018. Like B, A includes an additional \$100 of income, which results in a payment of \$35 of tax (plus interest).

- **Implication for the 2019 Sale of A’s Interest to C:** If P had filed a correct return for 2018, A would have had a \$1,200 basis in its P interest when that interest was sold in 2019 to C for \$1,200. However, when the sale occurred, A reported a basis of \$1,100 in its P interest and thus paid the tax on the \$100 of section 741 gain.

We believe that the statutory language should allow A to take into account the impact of the adjustment to its outside basis, such that A should be able to claim a refund for the \$35 of taxes A paid for 2019 regardless of whether the statute of limitations for that year has otherwise expired.¹⁵⁹

Assuming this is correct, then again, setting aside the interest charge and time value of money, A’s position (and the IRS’s collections with respect to A) also matches the Correct Return Position.

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(c) Treatment of P

Presumably, P is obligated to adjust the inside basis of Asset to \$400 and to adjust the capital accounts of B and C to bring them up to \$1,200. ... [T]he TEFRA statute never

¹⁵⁹ § 6225(c)(2)(A)(ii) requires A to file an amended 2018 return that “take[s] into account all adjustments [from the FPA] properly allocable to [A] (and for any other taxable year in respect to which any tax attribute is affected by reason of such adjustments).” There are two issues, however:

- *Subsequent Years:* It is not entirely clear from § 6225(c)(2)(A)(ii) whether these conforming adjustments are reflected in the amended 2018 return or handled otherwise. It would seem appropriate to either allow A to include the consequences of the 2019 adjustment in its 2018 tax return (similar in a way to what is done under § 6226 in the adjustment year return), or to allow A to file an amended return with respect to 2019 (regardless of whether the time to do so has run). We note that the special rule in § 6225(c)(2)(A)(i) that authorizes A to file the amended 2018 return even if the time to do so has already run applies, by its terms, only to the return for the reviewed year.

- *Interest Payments:* Similarly it is not entirely clear if A receives overpayment interest to offset the underpayment interest. We note that § 6225(c)(2)(A)(iii) requires A to pay “any tax due” with the amended return.

articulated that this was required, but it was always understood to be one of the consequences of accepting the audit adjustment. We believe that BBA should be interpreted as making no changes in this regard, at least when the partners all file amended returns under section 6225(c)(2). (We discuss below how these conforming adjustments should operate under the other two payment methods.)

Section 6226 Election 3.

In 2020, P timely provides Section 6226 Statements to A and B, the reviewed-year partners. Under section 6226, each partner computes and then pays, together with its tax liability for 2020, an amount equal to the following:

- for 2018, the amount by which the tax imposed under chapter 1 would increase if the partner's share of the adjustment provided in the Section 6226 Statements were taken into account in 2018,
- for 2019, the amount by which the tax imposed under chapter 1 would increase¹⁶⁰ by reason of the adjustment made in the 2018 return,¹⁶¹ and
- interest on those two amounts from the date they would have been due (computed at an increased rate (short-term rate plus 5%, instead of plus 3%)).

Each partner prepares its 2020 (and subsequent year returns) reflecting all conforming adjustment to its tax attributes. While the statute is silent as to whether P also conforms its tax attributes (such as inside basis and capital accounts), we presume that this would also occur.

(a) Treatment of B

For B, this mechanism results in the same additional tax payment as occurred under the section 6225(c)(2) payment method, *except that* B does not file an amended 2018 return and

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interest is paid at federal short term rate plus 5% (instead of plus 3%). Presumably, B's outside basis in P is increased to \$1,200.¹⁶²

In other words, ignoring the interest charge, B is (and the IRS is) again put in a position that matches the Correct Return Position.

¹⁶⁰ This is not a typo but rather precisely what the statute provides. § 6226(b)(2)(B).

¹⁶¹ The partners also take into account the effect of the adjustment for the current year (2020), but this is part of their ordinary tax liability, not the tax due under § 6226 (and as such no interest is due in respect of any additional tax due for 2020).

¹⁶² § 6226(b)(3) provides that “*any tax attribute which would have been affected if the adjustments...were taken into account for the [reviewed year] shall...be appropriately adjusted,*” but it is not entirely clear whether these are the partnership tax attributes (e.g., inside basis), the partners' attributes or both. We believe that the latter (i.e., all tax attributes of the partnership and the partners) is the correct answer, but this will need to be addressed in the guidance.

(b) Treatment of A

For A, the answer is unclear. As a result of the sale to C in 2019, A has already paid the additional \$35 of taxes due with respect to its allocable share of Asset's correct value. Nonetheless, based on the formula set out above (which comes directly from the statute), it would seem that A's 2020 tax return should include an additional \$100 of income (and thus \$35 of tax liability) to reflect the 2018 adjustment, *but* that A's income should *not* be decreased to reflect the fact that, if the adjustment had been reflected in 2018, A would not have recognized \$100 of capital gain in 2019.

The statute thus seems to result 109 § 6226(b)(3) provides that “*any tax attribute which would have been affected if the adjustments...were taken into account for the [reviewed year] shall...be appropriately adjusted,*” but it is not entirely clear whether these are the partnership tax attributes (*e.g.*, inside basis), the partners' attributes or both. We believe that the latter (*i.e.*, all tax attributes of the partnership and the partners) is the correct answer, but this will need to be addressed in the guidance.

The Statute seems to result in A paying \$105 of taxes (plus interest) in the aggregate (\$35 in 2018, \$35 in 2019 and \$35 as part of the section 6226 election) and A never being compensated for the \$35 overpayment (solely because A had already sold its P interest).¹⁶³ In other words, A would be permanently taxed twice on the \$100 that was missing from the 2018 K-1 provided to A. We discuss this issue further below.

(c) Treatment of P

Presumably, P is required to adjust its basis in Asset (to \$400) and to adjust capital accounts. For B's capital account, this seems relatively straightforward: P should adjust it to \$1,200. Presumably, the same is true for C.¹⁶⁴

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Section 6225(a) Payment by the Partnership

Under section 6225(a), P pays the \$70 imputed underpayment (plus interest)¹⁶⁵ with its 2020 Form 1065.

Under section 6241(4), this results in a nondeductible partnership expense in 2020. That expense (presumably allocated 50/50 as between B and C) then results in a decrease of \$35 in each

¹⁶³ Since A has sold its interest to C, A cannot increase its basis in its P interest in 2020 (as B can do).

¹⁶⁴ Under the section 704 rules, A's capital account carries over to C. Presumably the adjustment of attributes would include adjusting the capital accounts of the *reviewed year partners* to match what they would have been if the FPA adjustment had been reflected in the partnership's capital accounts.

¹⁶⁵ For simplicity, the remainder of this Part V ignores the payment of interest since it does not affect the issues that are discussed here.

partner's outside basis.¹⁶⁶ As a result of this payment, the fair market value of each of B and C's interests in P has also decreased from \$1,200 to \$1,165.

Section 6225(a) is silent on how the FPA items are allocated and whether there are collateral adjustments to outside bases and capital accounts.¹⁶⁷ If the \$200 additional income from the FPA is not allocated for section 705 outside basis purposes, then the tax on the \$200 (that is, A's \$100 and B's \$100) will be collected twice:

- *A's \$100.* Each of A and P have *both* already paid the taxes due on the incremental \$100 of income allocated to A (A paid in connection with the 2019 sale and P paid in connection with receipt of the FPA in 2020). Intuitively, one would think that the double taxation of this \$100 would be fixed if A indemnified C (or P) for the portion of the imputed underpayment attributable to A's \$100, but this is not the case. The indemnity does not reduce the amount of income subject to double taxation (but only reallocates the incidence of this double taxation between A and C).¹⁶⁸

¹⁶⁶ § 705(a)(2)(B).

¹⁶⁷ TEFRA was also silent in this regard.

¹⁶⁸ If A indemnified C for the tax, then, in 2020, A would make a payment of \$35 (plus interest, which as noted in note 113 we ignore for purposes of this illustration) to C. The BBA Bluebook provides that this indemnity payment would not be a deductible expense to A, although presumably it could generate a loss. BBA Bluebook, at 70 ("Because the payment of the tax by the partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible.") and 79 (language repeated). So, what would happen to each of A, C and P for tax purposes?

We believe there are *two alternative approaches*, both of which result from applying the "relation back" doctrine of *Arrowsmith v. Comm'r*, 344 U.S. 6 (1952) to characterize the results to each party. The *first* approach applies *Arrowsmith* by looking back to the sale by A to C. This was a taxable sale giving rise to section 741 gain for A and a purchase price basis to C. Applying *Arrowsmith* with respect to that sale, the \$35 indemnity would be an adjustment to the sale price and the resulting tax and economic consequences would be as follows:

- *A:* the \$35 of indemnity payment would provide A with a \$35 capital loss (as an adjustment to the § 741 capital gain A recognized in the 2019 sale). A's tax savings from a \$35 capital loss (assuming it is usable at all) would equal \$12.25 ($\$35 \times 35\%$) so that A would have paid cumulative taxes of \$57.75 (\$70 less \$12.25) plus a tax indemnity payment of \$35, so A's total costs resulting from the transactions (*i.e.*, P's receipt of Asset, P's incorrect valuation of Asset, and A's sale of its P interest) is \$92.75. Compare this to the total costs A would have had of \$70 under the Correct Return Position (*i.e.*, the same set of transactions but without the incorrect valuation). So, A has paid \$22.75 over what A would have paid under Correct Return Position. The IRS has collected an additional \$35 from P and refunded only \$12.25 of that amount at that stage.

- *C:* the \$35 of indemnity payment would provide C with (i) \$35 in cash (which simply reimburses C for the \$35 that P used to pay the imputed underpayment on A's \$100) and (ii) a purchase price adjustment on the 2019 purchase from A and thus a reduced basis in C's P interest. Thus, C would have two downward adjustments to its initial purchase price basis in P: (a) a \$35 downward adjustment pursuant to § 705 to reflect P's payment of \$35 of imputed underpayment and (b) a \$35 downward adjustment to reflect receipt of the indemnity payment, leaving C with a basis of \$1,130. Since that P interest is worth \$1,165, C would as a result have a taxable built-in gain of \$35, which would eventually result in additional taxes. Assuming for simplicity that the additional \$35 of gain is eventually taxed at the same 35% rate, the additional tax to C would be \$12.25 ($\$35 \times 35\%$). So, the IRS would re-collect the \$12.25 and A's \$100 is indeed taxed at 35% twice, with A bearing \$22.75 of it and C bearing \$12.25 of it.

Under this approach, the indemnity payment does nothing to fix the problem that the IRS has collected tax on the \$100 twice; its only effect is to reallocate a portion of the \$35 tax from C to A, although C is not made whole.

• *B's \$100.* Similarly, if B cannot reflect the \$100 of FPA income in its outside basis in P, B will be taxed twice on this \$100. To illustrate this, assume that after the audit, B sells its interest to D (or has it redeemed by P) for \$1,165 (its fair market value). B would recognize \$100 of taxable gain and pay \$35 of tax (even though there has been no additional increase in value).

Thus, if nothing further happens to the FPA adjustments and no outside basis adjustments are made, the entire \$200 shown in the FPA is taxed twice. This cannot be the correct result.

B. Options for Section 6225 Payment

In this Part V.B, we discuss five options to account for the FPA adjustments and the section 6225 payment.¹⁶⁹

The *second* approach applies principles of Arrowsmith by looking back to the expenditure that is being indemnified for (although we are not aware of authorities which have applied this approach). That expenditure is P's payment of the \$35 imputed underpayment, which the statute tells us is a nondeductible expense. Under this approach, the payment to compensate C for that expenditure must also be nondeductible to A, and the result for the payee (C) must also be characterized by relation back to the imputed underpayment which is being compensated for. Accordingly, because the expense is not deductible, the receipt of the indemnity should not create includible income, nor should it be capitalized into the sales price as an adjustment because doing so would be the equivalent of creating includible income (as is demonstrated by what happens to C under the first approach). Applying this approach, the resulting tax and economic consequences would be as follows:

- A: the \$35 of indemnity payment would have no tax impact on A. A's total tax plus tax indemnity costs would be \$105 (\$70 of taxes paid to date plus \$35 of indemnity), which is \$35 more for A than Correct Return Position and \$35 more for the IRS than Correct Return Position.
- C: the \$35 indemnity payment would have no tax impact on C. C's total tax plus tax indemnity costs would be zero (\$35 of imputed underpayment compensated for fully by \$35 of cash; outside basis in P matches value of P interest).

How does this compare to the first approach? Under both approaches, the IRS collects tax on the \$100 of income twice. Under the first approach, the indemnity shifts some, but not all, of that tax from C to A, but C still ends up bearing some of the tax. (A and C could negotiate a "gross up" on the indemnity payment so A bears the full \$35 and C's after-tax indemnity cost is zero although this would result in additional taxes.) Under the second approach, the cost is shifted entirely from A to C with less difficulty, less room for slippage (because of differences in the tax rates applicable to A, C and P (with respect to the computation of the imputed underpayment and because of timing differences) and less wear-and-tear on the system because A does not need to claim the offset and C does not need to adjust C's basis.

We recommend that the guidance clarify which approach the IRS is adopting: we recommend that the second approach be chosen unless the Withholding Tax Approach discussed in Part V.B.5 (page 46) is adopted. Below we address the correction of the double tax result.

¹⁶⁹ Regardless of the option chosen to implement section 6225(a), at least two additional adjustments will be needed. First, the capital accounts of P will need to be adjusted to reflect the nondeductible imputed underpayment expense (which matches the decline in the value of P's assets and the section 705 allocation to the partners).

Second, the inside basis of the Asset needs to be adjusted to reflect the \$200 adjustment. Section 6225 does not explicitly provide for this (whereas § 6226(b)(3) specifically provides for conforming

1. Option 1.A: Double Taxation

A possible reading of section 6225(a) is that (i) section 6225(a) is a final payment by the partnership, and (ii) no basis adjustments should be made. In other words, when section 6225(a) applies, the FPA items are taxed twice.

We do not think that this reading is correct. We do not read section 6225(a) as providing for, or implying, such a complete departure from the principles of good tax administration and the basic substantive rules and principles of partnership taxation. First, as a matter of fairness, the fact that the partnership's returns were incorrect does not mean that the income not reported should be subject to tax twice. There is no reason or need to interpret section 6225 in a way that makes the results punitive when a non-punitive interpretation is possible. Second, the cornerstone of partnership taxation is that a partnership's income is taxed once, and only once, and this reading of section 6225(a) would create two taxes by imposing one at the partner level and a second at the partnership level. Such a drastic departure from key principles of our tax system should be done by the statute explicitly not implicitly. Nothing in the BBA indicates that subchapter K ceases to apply when adjustments are made as a result of an audit.¹⁷⁰ Finally, reading section 6225(a) in this way would essentially ensure that partnerships never use the section 6225 payment mechanism and instead always use section 6226 (or potentially section 6225(c)(2)). An interpretation of the section 6225 imputed underpayment mechanism that creates such a significant disincentive cannot be the right interpretation.

2. Option 1.B: Reviewed-Year Partners

In order to avoid the double taxation result, the partners need to obtain outside basis for the income resulting from the FPA. Under this Option 1.B, because A and B were partners in P when

the income was earned, each of A and B would get the additional \$100 of outside basis. This adjustment would be retroactive and effective as of the end of the reviewed year (2018).

adjustments to tax attributes (although it is itself unclear as to whether it applies only to partner-level attributes) and § 6225(c)(2)(A)(ii) directly addresses conforming adjustments). However, if the basis is not adjusted, then the \$200 is potentially taxed twice (temporarily, with the offsetting loss not allowed until A and C exit P). We believe that the implementing regulations should confirm this.

¹⁷⁰ The BBA Bluebook helpfully notes in this respect that: "Under the centralized system, the flow-through nature of the partnership under Subchapter K of the Code is unchanged, but the partnership is treated as a *point of collection* of underpayments that would otherwise be the responsibility of the partners." BBA Bluebook, at 79.

For A, since A has sold its partnership interest, this would mean that A would have to amend its tax return for 2019 (assuming the statute of limitations has not expired for that year either by virtue of the normal rules or a special rule that is put into place as part of the adoption of this Option 1.B)¹⁷¹ to claim a refund for the \$35 of taxes paid in connection with the sale of its partnership interest to C.

Each of B and C, as adjustment-year partners, would also take an outside basis reduction to reflect the nondeductible payment of the imputed underpayment by P in the adjustment year. Therefore, each of B and C would have a \$1,165 basis in its partnership interest (such that there would be no built-in gain or loss).

Looking now at the net assets of A, B and C under this Option 1.B:

- A's net assets are \$1,235 (\$1,200 received from C plus \$70 of cash on hand less \$35 of taxes paid in 2018), as compared to \$1,200 in the Correct Return Position;¹⁷²
- B's net assets are \$1,200 (a partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid in 2018), as was the case in the Correct Return Position.
- C's net assets are \$1,165 (*i.e.*, the value of its partnership interest) as opposed to \$1,200 in the Correct Return Position.¹⁷³

As a result, the system would collect only once the tax on the \$200 of additional income resulting from FPA *but* the tax burden has shifted from A to C: (i) A would be richer by \$35 (because the \$35 of imputed underpayment with respect to the \$100 of additional income was paid

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by P), and (ii) C would be poorer by that same amount (for the same reason). It is not entirely clear whether an indemnity would fix this imbalance.¹⁷⁴

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3. Option 1.C: Adjustment-Year Partners

¹⁷¹ Though we recognize that the mitigation provisions in §§ 1311–1314 may mitigate concerns under certain circumstances, we believe that it would be unwise to rely on these provisions as the exclusive means for rectifying this issue (or any of the adjustment issues discussed in this report). Specifically, the mitigation provisions have been interpreted to apply only to a very narrow set of circumstances. *See O'Brien v. United States*, 766 F.2d 1038, 1042 (7th Cir. 1985) (noting that the mitigation rules should be narrowly construed and apply only to some situations). For instance, in the context of the BBA, it is unclear whether an FPA will satisfy the “determination” requirement of § 1311(a) or whether basis adjustments will be permitted under § 1312(7) where the FPA and subsequent challenges do not specifically determine the basis of a partner’s partnership interest. For a detailed discussion of the mitigation provisions, *see* SALTZMAN & BOOK, *supra* note 13, at ¶ 5.05.

¹⁷² 120 A has \$35 more than Correct Return Position because P paid the \$35 tax instead of A paying it.

¹⁷³ 121 C has \$35 less than Correct Return Position because C bore \$35 of the imputed underpayment paid by P.

¹⁷⁴ Under the second approach described in that footnote, a \$35 indemnity payment by A to C would cure the imbalance (because A would pay over \$35 to C and there would be no loss or adjustment to purchase price).

Option 1.C allocates the basis to the adjustment year partners under the theory that they bear the cost of the section 6225(a) tax.¹⁷⁵

- At the end of the adjustment year, B and C each get an additional \$100 of basis (resulting in \$1,165 of total outside basis for B and \$1,265 of total outside basis for C).
- C's adjusted tax basis in P exceeds the fair market value of its interest (\$1,165) by \$100, so, while at this stage too much tax has been collected (\$175 of taxes instead of \$140), C will be able to get a refund of the \$35 if and when it disposes of its partnership interest (or otherwise uses the basis to obtain a tax-free distribution under section 731).

Looking at the partners' net assets after the payment:

A would have \$1,200 (*i.e.*, \$1,200 of cash received from C plus \$70 of cash on hand less the \$70 of taxes it paid in 2018 and 2019), which is consistent with the Correct Return Position;

- B would have \$1,200 of assets (a partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid), which is consistent with the Correct Return Position; and
- C would have \$1,165 of assets as compared to \$1,200 in the Correct Return Position but will be able to eventually realize a \$35 tax savings or refund, giving C a result which is consistent with the Correct Return Position.

Under this option, if A and C wanted an indemnity to make C whole, this could be very complicated to negotiate and execute (even under our simple fact pattern where everyone is subject to the same tax rate on all income and gain) because C's tax cost is a temporary one and precisely when C will recoup its \$35 depends upon many factors.

Furthermore, this result is somewhat deceptive: the basis increase granted to C allows C to obtain a tax benefit for the \$100 of income reassessed by the FPA as opposed to correcting the amount of taxes that should have been paid by A. All parties end up in Correct Return Position in this example because we have assumed, for simplicity sake, that (i) A, B and C all have the same tax profile and (ii) that there are no character mismatch issues. If these assumptions are not correct, the aggregate amount of tax collected under Option 1.C (and the aggregate net assets of the partners) may vary significantly from the Correct Return Position.

- **Tax Profile of the Partners:** The section 6225(a) imputed underpayment amount is calculated based on the tax attributes of the reviewed year partners but Option 1.C allocates the corresponding basis increase to the adjustment year partners. If C has a different effective tax rate than A (or C is tax-exempt), then the basis adjustment may result in permanent under-collection or over-collection of taxes. Thus, if C is a tax-exempt entity, for instance (and the income from the partnership is not "unrelated business taxable income" to C), then C will not receive any tax benefit from its additional

¹⁷⁵ This is consistent with the ELP regime, although in that case the statute is explicit. Pre-BBA § 6242.

\$100 of basis and the system will have collected \$105 of taxes (instead of \$70) on the \$200 of income resulting from the FPA.¹⁷⁶

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- **Character Mismatch Issues:** The correct amount of aggregate tax has also been preserved in the example because A, P and C are indifferent as to the character of the income. To illustrate, if A is an individual, she may have paid less than \$35 in taxes in 2019 when she sold her interest in P to C; assume the \$100 was capital gain subject to a 20% tax rate. Thus, in Option 1.C, A would be better off than in the Correct Return Position: in the Correct Return Position, A would have paid \$70 of taxes, whereas under Option 1.C, A would pay \$35 of taxes in 2018 and \$20 in 2019 (assuming no section 751 assets) thereby resulting in an aggregate tax of \$55 instead of \$70. In addition, if C is a corporation, it would be able to monetize or obtain a refund of \$35 from the \$100 of basis it received (see above), such that ignoring the time value of money, the IRS would have collected only \$55 instead of \$70 on the \$200 of income resulting from the FPA.

4. Option 1.D: Optional Allocation of The Adjustment to a Notional Partnership Interest

Part V.B.3, immediately above, identifies two downsides to Option 1.C: the timing differs from Correct Return Position and the aggregate tax may differ from Correct Return Position (in favor of the government in some cases and the taxpayers in others). At the same time, Option 1.B depends on the ability of A to amend its past returns to reflect the basis adjustment.¹⁷⁷

A possible alternative would be to allocate the basis to A, as if A still held an interest in P in the adjustment year. Since A is not a partner anymore, this mechanism (which could either be elective or mandatory) would allocate basis to a notional interest in P in the year of the adjustment, and that interest would be deemed disposed of immediately thereafter for no consideration, thereby resulting in A recognizing a \$100 loss.¹⁷⁸ Importantly, A would not be a partner for any other purposes (*e.g.*, allocation of income, attribution of activities under section 875, etc.).

¹⁷⁶ To illustrate this point further, if A was a corporation and C is an individual subject to the highest marginal tax rate as well as to the § 1411 tax with respect to its income from P, under § 6225(c)(4), P would be able to pay the § 6225(a) payment based on the highest corporate income tax rate (*i.e.*, 35%). C however, would be subject to a tax rate of 43.4% in respect of distributions from the partnership or sale of the partnership. Thus, C will have economically paid \$35 instead of \$43.40 for \$100 of basis and thus \$100 of value received from, or from the sale of, P.

¹⁷⁷ A statutory change could eliminate the need for A to file an amended return to get the benefit of the increased basis by using a section 6226-like mechanism.

¹⁷⁸ In a more complicated scenario, for instance, where the partnership has § 751 assets, this may not result in a completely neutral result as there could be differences in the character of the gain and the loss recognized by A in 2019 and 2020 if P's assets or the built-in gain in these assets has changed. Similarly, if A is an individual it may be limited in its ability to carryback the loss. However, conceptually, at least, A has received a loss which offsets the gain it recognized when it disposed of its interest in 2019. Similarly, we considered whether the allocation of basis to A should depend on whether A had agreed to indemnify P or C (and thus had agreed to economically bear the tax), but we believe that a system which would require the IRS to determine whether an indemnity existed (in light of possible baskets, caps and floors) would not be administrable.

5. Option 1E: Withholding Tax Approach

As we discussed above, none of Options 1.A, 1.B, 1.C or 1.D truly place the government and the partners in the Correct Return Position (and the extent of the difference will depend upon the facts of each case).¹⁷⁹ An approach that would achieve this result would be to interpret the section 6225(a) payment as a collection mechanism only: *i.e.*, while the partnership pays the tax, it is essentially acting as an agent for the partners with respect to the tax they owe as a result of the FPA. The system is therefore equivalent to current law in terms of all the impacts of an IRS audit adjustment at the partnership level other than (i) how the *initial* payment due is computed and (ii) who is obligated to pay it. It is very similar to the existing section 1446 withholding tax regime for effectively connected taxable income allocated to partners who are non-U.S. residents.¹⁸⁰

Under this approach, the reviewed year partners take into account the FPA adjustments and receive a credit for the imputed underpayment paid by the partnership. Applied to our example, \$100 of additional income resulting from the FPA is allocated to each of A and B, as the reviewed year partners, and they each get a \$35 credit for the imputed underpayment paid on that income by P. Thus,

- B recognizes the additional \$100 of taxable income allocated to it but gets a credit for its allocable share of the taxes paid by P (\$35). Because B would owe \$35 (plus interest) on the additional \$100 of taxable income, this credit mechanism means that B owes no additional tax. B's outside basis in P is then increased to \$1,200 to reflect this additional income, and decreased by \$35 to reflect the payment by the partnership of B's share of the imputed underpayment.¹⁸¹ B's basis in its partnership interest would thus be \$1,165, which is equal to its value. B's net assets would be \$1,200 (*i.e.*, partnership interest worth \$1,165 plus \$70 of cash on hand less \$35 of taxes paid) which is consistent with the Correct Return Position.

- A also recognizes the \$100 of taxable income resulting in pre-credit tax liability of \$35.
 - **Credit:** As between A and C, A should be the one allocated the \$35 credit. While C economically bears the burden of the \$35 of imputed underpayment paid by P, this was paid with respect to income allocable for U.S. federal income tax purposes to A, and A should therefore get the credit. This follows the section 1446 rules (and the foreign tax credit rules, which treat the recipient of interest income as if it paid the foreign taxes economically borne by the interest payor (under a gross-up) because those taxes are

¹⁷⁹ Moreover, the extent of difference will not be a result of how aggressive or weak the partnership's return position was.

¹⁸⁰ Under § 1446, a domestic partnership that derives effectively connected taxable income (or "ECTI") is required to withhold the U.S. federal income taxes due by its foreign partners with respect to that ECTI based on several conservative assumptions (*e.g.*, assuming that the highest tax rate applies, etc.), and the foreign partners can adjust the tax due or obtain a refund through their tax returns.

¹⁸¹ § 705(a)(2)(B).

imposed by law on the interest income recognized for tax purposes as income by the interest recipient).¹⁸²

- **A's Adjusted Basis:** A gets a basis increase of \$100 to reflect the allocation of income. However, because the tax was paid by P with respect to income allocable to A, then following the section 1446 model, there is an allocation of the tax expenditure to A (under either section 6241(4) or principles similar to section 731) which results in a reduction in outside basis, such that A is treated as if it had a \$1,165 basis in its partnership interest (either at the end of 2018 or at the time of the sale to C).¹⁸³
- **Impact on 2019 Return:** A would be able to recognize the effect of this basis adjustment with respect to the sale of its partnership interest in 2019 (through an amended return for 2019 or in A's adjustment year return, whichever approach the regulations adopt). Thus, A would have a \$35 gain in 2019 with respect to the sale of its partnership interest to C (as opposed to the \$100 it reported), thereby resulting in a refund of \$22.75 of the taxes it paid in 2019 (plus interest).
- **Net Assets:** A's net assets would be \$1,222.75 (*i.e.*, \$1,200 plus \$70 of cash on hand less \$35 of taxes paid in 2018, and less \$35 paid in 2019 plus a \$22.75 refund). This is more than the \$1,200 in the Correct Return Position, but this reflects the fact that the section 6225(a) underpayment mechanism inherently creates a benefit for A since P pays the tax. *If A indemnified C for the tax, then A (and C) would be put into Correct Return Position.*¹³³

It is possible to take a different approach and allocate the basis reduction to C instead of A, in which case A would get a full \$100 of basis increase (resulting in a full refund of the tax paid in 2019) and C would get a basis reduction of \$35 (for a basis of \$1,165). This is the same result as in Option 1.B.

Note that in any case, C's capital account would be decreased by the tax (either because C succeeded to A's capital account or because C was allocated the tax).

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¹⁸² § 1446(d); Treas. Reg. §§ 1.1446-3(d)(2)(v) and 1.901-2(f). § 1446(d); Treas. Reg. §§ 1.1446-3(d)(2)(v) and 1.901-2(f).

¹⁸³ § 1446(d); Treas. Reg. § 1.1446-3(d)(2)(v) ("... a partnership's payment of 1446 tax on behalf of a foreign partner is treated under section 1446(d) and this section as a deemed distribution of money to the partner on the earliest of the day on which the partnership paid the tax, the last day of the partnership's taxable year for which the amount was paid, or the last day on which the partner owned an interest in the partnership during the taxable year for which the tax was paid.").

section 6225(a) underpayment mechanism inherently creates a benefit for A since P pays the tax. *If A indemnifies C for the tax, then A (and C) could be put into Correct Return Position.*¹⁸⁴

• **Partner C:** Because A's basis was affected by the section 6225 payment, C's basis should not be decreased by the amount of the tax paid by P. In other words, C would have an adjusted basis of \$1,200 in its partnership interest reflecting a built-in loss of \$35 (for the tax paid by P). Its net assets are worth \$1,165 (plus the ability to receive a refund of \$12.25 in taxes, *i.e.*, \$1,177.25), as opposed to \$1,200 in the Correct Return Position. This reflects the economic loss C incurred because P paid the tax. Again, C could be put in the Correct Return Position if A indemnifies C by paying C \$35.¹⁸⁵

C. Recommendation

As this simple fact pattern illustrates, there is no perfect solution to account for the impact of the section 6225(a) underpayment.

1. Withholding Tax Approach

(a) A Better Approach

We strongly believe that Option 1.E. (the “**Withholding Tax Approach**”) is by far the best approach to implementing section 6225. This approach will both protect the fisc and be more fair to taxpayers. We recognize that it has some complexity, but not more than the BBA's two other payment methods, and with the significant benefit for the government of an upfront payment of tax by a single person (the partnership) that is before the IRS in the audit. The section 1446 withholding rules could be used as a precedent to implement this approach.

The Withholding Tax Approach's other important benefits include:

First, it will allow the aggregate tax collection results to be as close as possible to the Correct Return Position. There is some discrepancy with respect to which taxpayers have borne some of the tax collected because the initial payment is by P and thus the cost is economically

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borne by B and C (instead of B and A), but this can be solved as between B and C with an indemnity.

Second, if the taxes resulting from the adjustments of the items described in section 6221(a) are paid at the partnership level without any second step connecting those adjustments to the tax

¹⁸⁴ Here, the way to get to Correct Return Position is to allow the \$35 indemnity payment to offset the \$35 nondeductible expense that reduces A's basis in the P interest, so that A's basis in the P interest is equal to \$1,200 at the time of the sale. In other words, the way to arrive at Correct Return Position under Option 1.E is to adopt the first approach set out in note 116 for the tax treatment of indemnity payments.

¹⁸⁵ Again, this assumes that the first approach of note 116 is used (where the \$35 is a purchase price adjustment to C and therefore nontaxable but reflected as a decrease in C's outside basis in P).

attributes of the partners and allowing those adjustments to effect the taxes due from the partners, this will create results (we believe in many cases) that are deeply unfair and prone to manipulation. The example above has illustrated the double tax result. *Under-taxation* is also a very significant risk. The section 6225(a) payment will often fail to capture the full amount of tax that a partnership adjustment generates (under Correct Return Position) and well-advised taxpayers will use the section 6225(a) payment mechanism when section 6226 or 6225(c)(2) would increase their liabilities. A few possible examples of why section 6225 could result in under-collection include the absence of the section 1401 and 1411 tax from the section 6225 formula, the spillover effects of having effectively connected income (and thus a U.S. trade or business), the adverse effects of income resourcing for foreign tax credit purposes or the recapture of a dual consolidated loss, overall domestic loss or overall foreign loss. We explore these issues and provide additional examples in the following parts of this report.¹⁸⁶

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Third, even setting aside the interaction of the section 6221(a) adjustments with partner-level attributes, the computation of the imputed underpayment under the rules in section 6225 will often not accurately arrive at the amount of tax the partners would pay if they were taking those adjustments into account directly. The Withholding Tax Approach has the benefit of reducing the pressure on getting the amount accurately, as over-collecting or under-collecting at the partnership level can be corrected at the partner level. A reasonable amount of over-collecting under section 6225 will be more tolerable if it can be recouped by the partners.

Fourth, as discussed in Parts VI and VII, below, if the section 6225(a) payment is the final payment, then there are a whole host of complex issues that are very difficult to resolve in a way that ensures that the correct amount of tax is collected. Indeed, most of the thorny issues we address in this report would be mitigated and perhaps even fully resolved if the Withholding Tax Approach is followed.

Fifth, and perhaps most importantly, we believe that this approach is consistent with what Congress intended when it enacted BBA and is consistent with the actual changes that BBA made to the Code. The BBA was intended to change how the IRS audits partnership returns and collects the additional taxes due; it was not intended to create new substantive tax rules or new substantive taxes. The BBA Bluebook articulated this very point: “Under the centralized system, the flow-through nature of the partnership under Subchapter K of the Code is unchanged, but the partnership is treated as a point of collection of underpayments that would otherwise be the responsibility of the partners.”¹⁸⁷

(b) Statutory Authority

¹⁸⁶ In order to collect these additional taxes, the Withholding Tax Approach relies upon voluntary compliance by the partners or collection efforts by the IRS. We are mindful of not wanting to reintroduce the collection difficulties the IRS faced under TEFRA, and we think the imputed underpayment mechanism was intended to prevent that. What the Withholding Tax Approach does is prevent that mechanism from resulting in significant distortion. It should operate like a withholding tax and thereby minimize the collection risks for the IRS. Relying upon voluntary compliance and collection for any additional taxes due is preferable to having a collection regime that has the inadvertent impact of making those additional taxes not due at all.

¹⁸⁷ BBA Bluebook, at 79.

There is a question as to whether the statute, as currently drafted, allows for this approach. For the reasons outlined below, we believe that the better view is that it does, but we also believe that implementing regulations that are criticized, and challenged in court, as being beyond the Secretary's authority would create undesirable uncertainty which could last for years while the challenges work their way through the courts. Thus, we would strongly support any technical correction that would clarify this.

The reasons why we think the better view is that the statute does allow for this interpretation of section 6225 are as follows.

Section 6225 (and the remainder of the BBA) is silent in this respect. It does not indicate that the imputed underpayment is the final payment or what happens to partners in a partnership that makes a section 6225 payment. But TEFRA was also silent as to these matters. There was no statutory provision under TEFRA saying that the FPAA adjustments flowed up to the partners, that the partners owed more tax or got refunds based upon those adjustments, outlining whether the partnership was required to provide the adjustment information to the partners or the IRS would instead issue assessments to the partners, or saying that conforming adjustments to attributes occurred at the partnership and partner level.¹⁸⁸ Notwithstanding this statutory silence, there was no question that the FPAA adjustments were supposed to flow up to the reviewed year returns and to be reflected in the partners' and the partnership's tax attributes and future tax returns. The BBA's silence therefore may reflect the same approach, which is to leave it to administrative guidance and procedures to fill in the gaps.

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The authority under TEFRA for all the results not specified in the TEFRA provisions was in fact section 702, which requires each partner to take into account its distributive share of the partnership's items. Section 702 was not modified by the BBA, and there is no reason to think it does not have the same reach it had before the BBA was enacted.

If the Withholding Tax Approach is not authorized under the BBA, then the BBA created an enormous set of complex changes to the substantive tax rules, including shutting off all kinds of rules that normally apply to taxpayers (as discussed in detail elsewhere in this report). For example, an adjustment to the source of a partnership's income would otherwise potentially trigger the re-application of the foreign tax credit computations (including the income-recapture rules and potentially the interest allocation rules), but under the BBA without the Withholding Tax Approach, if the partnership pays under section 6225 those rules simply are made irrelevant—the adjustment escapes the application of those rules entirely.

The BBA would also usher in a whole new world of manipulation and incentives for taxpayers who are interested in exploiting the possibilities. Congress could not have intended the statute to be implemented in a way that facilitated this.

¹⁸⁸ We recognize that TEFRA did keep the statute of limitations at the partner level open for an additional year after the partnership level adjustment was final, but that was all that it did.

We believe that if the section 6225 rules are not interpreted in this way, the BBA is very likely to be so troubled in implementation that it will need to be revised by Congress and only after years of difficulties for all involved.

We recognize that provisions that establish a withholding tax regime are generally much clearer in that respect, and provide for a clear crediting mechanism (*cf.* section 1446(d)). In addition, we recognize that viewing the section 6225 payment as a withholding tax with subsequent adjustments at the reviewed partner level may not be fully consistent with section 6225(a)(2), which provides that adjustments that do not result in an imputed underpayment (*e.g.*, additional losses) are taken into account by the partnership in the adjustment year. However, we do not think that either of these counter-points comes close to outweighing the overwhelming problems that would arise if section 6225 is interpreted as not being a withholding tax. We think that when a statute has gaps, as the BBA does, it cannot be a reasonable interpretation to fill those gaps with an approach that makes the results of the statute so contrary to principles of good tax administration and existing substantive law. By contrast, we believe that an interpretation that fills the gaps in a way that makes the statute fully consistent with existing substantive law is, under the existing judicial authorities, a reasonable interpretation of the statute and therefore within the Secretary's power to implement. Unfortunately, we do not think that this precludes the possibility of litigation over whether it is indeed within the Secretary's power.

2. Other Options

If you believe that Option 1.E is not advisable or achievable, the “second best” alternative would be Option 1.C (“**Adjustment Year Partners**”), as it puts the partners more closely in line with the Correct Return Position. For the reasons discussed above, however, this option still creates significant risk of under-collection and over-collection.

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Ethical Practice Before the IRS

ETHICAL PRACTICE BEFORE THE IRS

Outline of Selected Ethical Rules Applicable to Tax Practitioners

September 2016

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ETHICAL PRACTICE BEFORE THE IRS

I. KEY ASPECTS OF CIRCULAR 230

A. Subpart A — Rules Governing Authority to Practice

1. Fitness to practice
 - a. Good character;
 - b. Good reputation;
 - c. Necessary qualifications to enable practitioner to provide valuable services; and
 - d. Competency to advise and assist people in presenting their cases.
2. Practice before the IRS - Section 10.2(a)(4)
 - a. All matters connected with a presentation to the IRS or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS.
 - b. Includes:
 - i. Preparing documents;
 - ii. Filing documents;
 - iii. Corresponding and communicating with the IRS;
 - iv. Rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and
 - v. Representing a client at conferences, hearings, and meetings.
3. Preparing all or substantially all of a tax return – Section 10.8(a)
 - a. Anyone who is paid to prepare or assist with the preparation of all or substantially all of a return or claim for a refund must have a PTIN.
 - b. To get a PTIN, an individual must be one of the following:
 - i. Attorney;
 - ii. CPA;
 - iii. Enrolled agent; or
 - iv. Registered tax return preparer.

B. Subpart B - Duties and Restrictions Relating to Practice Before the IRS

1. Knowledge of client's omission – Section 10.21

- a. If a practitioner knows that a client has not complied with tax laws or has made an error in or omission from any return or document submitted by the client to the IRS, the practitioner must advise the client promptly of the noncompliance, error or omission.
 - b. The practitioner must advise the client of the consequences of noncompliance.
- 2. Diligence as to accuracy – Section 10.22
 - a. A practitioner must exercise due diligence:
 - i. In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relation to IRS matters;
 - ii. In determining the correctness of representations the practitioner makes to the IRS; and
 - iii. In determining the correctness of representation made to clients.
 - b. Practitioners will be presumed to have exercised due diligence if they relied on work done by another and the practitioner used reasonable care in engaging, supervising, and training the other person.
- 3. Prompt disposition of pending matters – Section 10.23
 - a. Practitioners may not unreasonable delay matters before the IRS.
- 4. Notaries – Section 10.26
 - a. Practitioners may not take acknowledgements, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter that practitioner has been employed as counsel or agent.
- 5. Conflict of interest – Section 10.29
 - a. Practitioners may not represent a client before the IRS if a conflict of interest exists:
 - i. Representing one client would be directly adverse to another client;
 - ii. A significant risk that the representation of one client would be materially limited by the practitioner's responsibilities to another client or former client.
 - b. A conflict can be waived if a practitioner reasonably believes that she will be able to provide competent and diligent representation despite the conflict, representation isn't prohibited by law, and the client waives and gives informed consent, confirmed in writing by each affected client.

6. Best practices for tax advisors – Section 10.33

- a. Tax advisors should provide clients with the highest quality representation regarding federal tax issues by adhering to the following best practices:
 - i. Communicate clearly with client regarding the terms of engagement;
 - ii. Establish facts, determine which facts are relevant, evaluate the reasonableness of any assumptions or representations, apply applicable law to relevant facts, and arrive at a conclusion;
 - iii. Advise clients on the import of the conclusions, including whether taxpayer can avoid accuracy related penalties for relying on the advice; and
 - iv. Acting fairly and with integrity before the IRS.
- b. Tax advisors who are responsible for overseeing a firm's practice regarding federal tax matters should ensure policies are in place to make sure that all members, associates, and employees are following these best practices.

7. Standards with respect to tax returns and documents, affidavits and other papers – Section 10.34

- a. Tax returns.
 - i. A practitioner may not willfully, recklessly, or through gross incompetence:
 - 1. Sign a tax return that the practitioner knows or reasonably should know contains a position that (A) lacks a reasonable basis, (B) is an unreasonable position under Section 6694(a)(2), or (C) is a willful attempt to understate tax liability or with reckless disregard of rules and regulations; or
 - 2. Advise a client to take a position on a return or prepare a portion of a return that contains a position that (i) lacks a reasonable basis, (ii) is an unreasonable position under Section 6694(a)(2), or (iii) is a willful attempt to understate tax liability or with reckless disregard of rules and regulations.
 - ii. Under Section 6694(a)(2), a position is unreasonable if there isn't substantial authority to support the position, doesn't have a reasonable basis if it is disclosed, or would more likely than not be sustained if it relates to a tax shelter or a reportable transaction.

- b. Other documents.
 - i. A practitioner may not advise a client to take a position in a document, affidavit or other document submitted to the IRS unless the position is not frivolous.
 - ii. A practitioner may not advise a client to submit a paper to the IRS that (A) is for the purpose of delaying or impeding the administration of federal tax law, (B) is frivolous, or (C) contains or omits information that demonstrates an intentional disregard for the rules and regulations unless the practitioner advises the client to submit a document that evidences a good faith challenge to the rule.
 - c. Advising on potential penalties – a practitioner must advise the client on any penalties that are reasonably likely to apply to the client with respect to a position on a tax return if the practitioner advised the client on the position or signed or prepared the return. A practitioner must advise the client on any opportunities to avoid such penalties by disclosure.
 - d. Practitioners in general may rely in good faith without verification information provided by clients. But a practitioner may not ignore the implications of information furnished to or actually known by the practitioner, and must make reasonable inquiries if the information appears to be incorrect, inconsistent with an important fact or factual assumption, or incomplete.
- 8. Competence – Section 10.35
 - a. Appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.
 - b. A practitioner may become competent by consulting with an expert or studying the law.
- 9. Procedures to ensure compliance – Section 10.36
 - a. The person with the responsibility for overseeing a firm's practice before the IRS must take reasonable steps to ensure that all members, associates, and employees comply with Circular 230.
 - b. If the firm hasn't identified such a person, the IRS will.
 - c. The person responsible will be subject to disciplinary action if he or she fails to comply with this requirement through willfulness, recklessness, or gross incompetence, or fails to ensure people comply with such procedures, and a member or employee of the firm have engaged in a pattern of practice that fails to comply with Circular 230.

- d. The personal responsible will also be subject to disciplinary action if he or she willfully, recklessly, or with gross incompetence, fails to take prompt action to correct a pattern of noncompliance that they knew or should have known about.

10. Requirements for written advice – Section 10.37

- a. Practitioners have to follow the requirements in 10.37 when giving written advice. Written advice does not include government submission on matters of general policy or CLE presentations that are purely educational and not marketing or promoting transactions.
- b. Requirements. Written advice:
 - i. Must be based on reasonable factual and legal assumptions;
 - ii. Must consider all relevant facts and circumstances a practitioner knows or should have known;
 - iii. Must use reasonable efforts to identify and ascertain relevant facts;
 - iv. Cannot rely on representations, statements, findings, or agreements if reliance would be unreasonable—practitioner knows or should have known that such information are incorrect, incomplete, or inconsistent;
 - v. Must relate applicable law and authority to facts; and
 - vi. Cannot take into account the possibility that the return won't be audited or that the issue won't be raised on audit.
- c. Practitioners can rely on advice from another person if such advice was reasonable and reliance is in good faith under the facts and circumstances. Reliance is unreasonable if the practitioner knows or should have known that the advice should not be relied on, the other person is not competent or not qualified to give such advice, or the person has a conflict of interest.
- d. Standard of review.
 - i. Reasonable practitioner considering the facts and circumstances (scope of engagement, type and specificity of advice sought).
 - ii. If the practitioner knows that the advice will be used to promote a tax plan to avoid or evade taxes, emphasis will be put on the fact that the practitioner lacked the knowledge of a particular taxpayer's circumstances.
- e. Federal tax matter – this section applies to any matter concerning the application or interpretation of a provision in the IRC, any provision of law that impacts a taxpayer obligations under the IRC and regulations (including a taxpayer's obligation to pay tax or file returns), or any other law or regulation administered by the IRS.

C. Subpart C – Sanctions for Violations

1. Sanctions – Section 10.50

- a. Censure, suspend, or disbar any practitioner from practice before the IRS if a practitioner is shown to be incompetent or disreputable, fail to comply with Circular 230, or with the intent to defraud, willfully and knowingly misleads or threatens a client.
- b. Impose a monetary penalty on a practitioner who engages in conduct subject to sanction, and/or on a firm or employer, if the entity knew or reasonably should have known of such conduct.
 - i. The penalty can't exceed the gross income derived from the conduct leading to sanctions.

2. Incompetence and disreputable conduct – Section 10.51

- a. Incompetence and disreputable conduct includes among other things:
 - i. Conviction of a criminal offense under federal tax laws.
 - ii. Conviction of any criminal offense involving dishonesty or breach of trust.
 - iii. Conviction of a felony under federal or state law that makes practitioner unfit to practice before the IRS.
 - iv. Giving false or misleading information, or participating in giving false information, to the IRS or a tribunal, knowing that the information was false or misleading.
 - v. Willfully failing to make a federal return in violation of federal tax law or willfully evading or attempting to evade assessment or payment of federal tax.
 - vi. Willfully assisting or encouraging or suggesting a client violate federal tax law or a plan to illegally evade federal tax.
 - vii. Misappropriation or failure to properly remit client funds given to pay taxes.
 - viii. Directly or indirectly attempting to influence or offering to attempt to influence an IRS employee with a threat or bribe.
 - ix. Disbarment or suspension from the practice as a lawyer or CPA.
 - x. Willfully preparing all or substantially all of a return without a valid and current PTIN.

II. SELECTED PROFESSIONAL STANDARDS APPLICABLE TO TAX PRACTITIONERS

A. New Mexico Rules of Professional Conduct

1. Competence – Rule 16-101

- a. A lawyer must have the legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation of a client.

2. Scope of representation and allocation of authority between client and lawyer – Rule 16-102

- a. Client's decisions. Clients make decisions about the objectives of representation, and lawyers must consult with their clients about the means to pursue those objectives.
- b. Limitation of representation. Lawyers may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.
- c. Course of conduct. Lawyers shall not advise clients to engage in conduct that is criminal or fraudulent or misleads the tribunal. Lawyers may discuss the legal consequences of any proposed course of conduct with clients and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

3. Communication – Rule 16-104

- a. Status of matters. A lawyer shall keep the client reasonably informed about the status of a matter, promptly provided reasonably requested information, promptly inform the client with any decisions to which the client's informed consent is required, and reasonably consult the client about the means by which the client's objectives are to be accomplished.
- b. Client's informed decision-making. A lawyer shall explain a matter to the extent reasonably necessary let the client to make informed decisions.

4. Confidentiality of information – Rule 16-106

- a. Disclosure of information generally. A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent.
- b. Disclosure of information; specific circumstances. A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
 - i. To prevent reasonably certain death or substantial bodily harm;

- ii. To prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
 - iii. To prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
 - iv. To secure legal advice about the lawyer's compliance with these rules;
 - v. To establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved or to respond to allegations in any proceeding concerning the lawyer's representation of the client;
 - vi. To comply with other law or a court order; or
 - vii. To detect and resolve conflicts of interest arising from the lawyer's change of employment or from changes in the composition or ownership of a firm, but only if the revealed information would not compromise the attorney-client privilege or otherwise prejudice the client.
 - c. Inadvertent or unauthorized disclosure of information. A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information relating to the representation of a client.
5. Conflict of interest; current clients – Rule 16-107
- a. Representation involving concurrent conflict of interest. A lawyer shall not represent a client if the representation of one client will be directly adverse to another client, or if there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.
 - b. Permissible representation when concurrent conflict exists. Notwithstanding the existence of a concurrent conflict of interest, a lawyer may represent a client if:
 - i. The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
 - ii. The representation is not prohibited by law;

- iii. The representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
 - iv. Each affected client gives informed consent, confirmed in writing.
- 6. Imputation of conflicts of interest: general rule – Rule 16-110
 - a. Firm association. While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so.
 - b. Terminated associations. Generally, when a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer and not currently represented by the firm.
 - c. Subsequent firm associations; screening. When a lawyer becomes associated with a firm, the firm may not knowingly represent a person in a matter in which that lawyer is disqualified unless:
 - i. The newly associated lawyer has no information protected by Rule 16-106 or 16-109 NMRA of the Rules of Professional Conduct that is material to the matter; or
 - ii. The newly associated lawyer did not have a substantial role in the matter, is timely screened from any participation in the matter and is apportioned no part of the fee therefrom, and written notice is promptly given to any affected former client to enable it to ascertain compliance with the provisions of this rule.
 - d. Waiver of disqualification. A disqualification prescribed by this rule may be waived by the affected client.
- 7. Special conflicts of interest for former and current government officers and employees – Rule 16-111
 - a. Subsequent representation. A lawyer who has formerly served as a public officer or employee of the government shall not otherwise represent a client in connection with a matter in which the lawyer participated personally and substantially as a public officer or employee, unless the appropriate government agency gives its informed consent, confirmed in writing, to the representation.
 - b. Imputation of conflict to firm; screening. When a lawyer is disqualified from representation, no lawyer in a firm with which that lawyer is associated may knowingly undertake or continue representation in such a matter unless the

disqualified lawyer is screened and written notice is given to the government agency.

- c. Confidential government information. A lawyer having confidential government information about a person acquired when the lawyer was a public officer or employee may not represent a private client whose interests are adverse to that person in a matter in which the information could be used to the material disadvantage of that person.
- d. Subsequent government employment. A lawyer currently serving as a public officer or employee shall not participate in a matter in which the lawyer participated personally and substantially while in private practice or nongovernmental employment, unless the appropriate government agency gives its informed consent, confirmed in writing, and shall not negotiate for private employment with any person who is involved as a party or as lawyer for a party in a matter in which the lawyer is participating personally and substantially.

8. Organization as client – Rule 16-113

- a. Generally. A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.
- b. Acting in best interest of organization. If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to a higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.
- c. Authority to reveal information. If, despite the lawyer's efforts, the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

- d. Exception to authority to reveal information. A lawyer may not reveal information relating to the lawyer's representation of an organization to investigate an alleged violation of law or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.
- e. Notice of discharge or withdrawal. A lawyer who reasonably believes that he or she has been discharged because of following these rules, or who withdraws, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.
- f. Identity of client. A lawyer shall explain the identity of the client when the organization's interests are adverse to those of an organization's directors, officers, employees, members, shareholders or other constituents with whom the lawyer is dealing.
- g. Personal representation of officer or employee. A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents. An organization's consent may be required. See Rule 16-107.

9. Advisor – Rule 16-201

- a. A lawyer shall exercise independent professional judgment and render candid advice.

10. Meritorious claims and contentions – Rule 16-301

- a. A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law.

11. Candor toward the tribunal – Rule 16-303

- a. Duties. A lawyer shall not knowingly:
 - i. Make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law;
 - ii. Fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or
 - iii. Offer evidence that the lawyer knows to be false; if a lawyer, the lawyer's client, or a witness called by the lawyer has offered material

evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures.

- b. Criminal conduct of client. A lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging, or has engaged in criminal or fraudulent conduct related to the proceeding shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal.
- c. Ex parte proceedings; lawyer's duty. In an ex parte proceeding, a lawyer shall inform the tribunal of all material facts known to the lawyer that will enable the tribunal to make an informed decision, whether or not the facts are adverse.

12. Fairness to opposing party and counsel – Rule 16-304

- a. A lawyer shall not:
 - i. Unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document or other material having potential evidentiary value. A lawyer shall not counsel or assist another person to do any such act;
 - ii. Falsify evidence, counsel or assist a witness to testify falsely or offer an inducement to a witness that is prohibited by law;
 - iii. Knowingly disobey an obligation under the rules of a tribunal except for an open refusal based on an assertion that no valid obligation exists;
 - iv. In pretrial procedure, make a frivolous discovery request or fail to make reasonably diligent effort to comply with a legally proper discovery request by an opposing party;
 - v. In trial, allude to any matter that the lawyer does not reasonably believe is relevant or that will not be supported by admissible evidence, assert personal knowledge of facts in issue except when testifying as a witness or state a personal opinion as to the justness of a cause, the credibility of a witness, the culpability of a civil litigant or the guilt or innocence of an accused; or
 - vi. Request a person other than a client to refrain from voluntarily giving relevant information to another party unless:
 - 1. The person is a relative or an employee or other agent of a client; and

2. The lawyer reasonably believes that the person's interests will not be adversely affected by refraining from giving such information.

13. Advocate in non-adjudicative proceedings – Rule 16-309

- a. A lawyer representing a client before a legislative body or administrative agency in a non-adjudicative proceeding shall disclose that the appearance is in a representative capacity.

14. Truthfulness in statements to others – Rule 16-401

- a. In the course of representing a client, a lawyer shall not knowingly make a false statement of material fact or law to a third person; or fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited.

15. Responsibilities of partners, managers and supervisory lawyers – Rule 16-501

- a. Necessary measures. A partner in a law firm and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.
- b. Compliance with rules. A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.
- c. Responsibility for other lawyer's violations. A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

16. Responsibilities of a subordinate lawyer – Rule 16-502

- a. Responsibility for own actions. A lawyer is bound by the Rules of Professional Conduct notwithstanding that the lawyer acted at the direction of another person.
- b. Arguable question of duty. A subordinate lawyer does not violate the Rules of Professional Conduct if that lawyer acts in accordance with a supervisory lawyer's reasonable resolution of an arguable question of professional duty.

B. Selected Provisions from the AICPA Code of Professional Conduct

1. Integrity and Objectivity Rule – Section 1.100.001

- a. In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.
- b. Knowing Misrepresentations in the Preparation of Financial Statements or Records – Section 1.130.010.01
 - i. The member would be considered to have knowingly misrepresented facts in violation of the “Integrity and Objectivity Rule,” if the member:
 1. Makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records;
 2. Fails to correct an entity’s financial statements or records that are materially false and misleading when the member has the authority to record the entries; or
 3. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

2. Conflict of Interest – Section 1.110

- a. A member or his or her firm may be faced with a conflict of interest when performing a professional service. In determining whether a professional service, relationship or matter would result in a conflict of interest, a member should use professional judgment, taking into account whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists.
- b. A conflict of interest creates adverse interest and self-interest threats to the member’s compliance with the “Integrity and Objectivity Rule” [1.100.001]. For example, threats may be created when:
 - i. The member or the member’s firm provides a professional service related to a particular matter involving two or more clients whose interests with respect to that matter are in conflict, or
 - ii. The interests of the member or the member’s firm with respect to a particular matter and the interests of the client for whom the member or the member’s firm provides a professional service related to that matter are in conflict.
- c. Certain professional engagements, such as audits, reviews and other attest services require independence. Independence impairments under the

“Independence Rule” [1.200.001], its interpretations, and rulings cannot be eliminated by the safeguards provided in this interpretation or by disclosure and consent.

d. Examples of situations in which conflicts of interest may arise:

- i. Providing corporate finance services to a client seeking to acquire an audit client of the firm, when the firm has obtained confidential information during the course of the audit that may be relevant to the transaction.
- ii. Advising two clients at the same time who are competing to acquire the same company when the advice might be relevant to the parties’ competitive positions.
- iii. Providing services to both a vendor and a purchaser who are clients of the firm in relation to the same transaction.
- iv. Preparing valuations of assets for two clients who are in an adversarial position with respect to the same assets.
- v. Representing two clients at the same time regarding the same matter who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership.
- vi. Providing a report for a licensor on royalties due under a license agreement while at the same time advising the licensee of the correctness of the amounts payable under the same license agreement.
- vii. Advising a client to invest in a business in which, for example, the immediate family member of the member has a financial interest in the business.
- viii. Providing strategic advice to a client on its competitive position while having a joint venture or similar interest with a competitor of the client.
- ix. Advising a client on the acquisition of a business which the firm is also interested in acquiring.
- x. Advising a client on the purchase of a product or service while having a royalty or commission agreement with one of the potential vendors of that product or service.
- xi. Providing forensic investigation services to a client for the purpose of evaluating or supporting contemplated litigation against another client of the firm.
- xii. Providing tax or personal financial planning services for several members of a family whom the member knows to have opposing interests.

- xiii. Referring a personal financial planning or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement.

3. Client Advocacy – Section 1.140.010

- a. An advocacy threat to compliance with the “Integrity and Objectivity Rule” [1.100.001] may exist when a member or the member’s firm is engaged to perform nonattest services, such as tax and consulting services, that involve acting as an advocate for the client or to support a client’s position on accounting or financial reporting issues either within the firm or outside the firm with standard setters, regulators, or others.
- b. The code governs these types of professional services, and the member shall perform such services in compliance with the “General Standards Rule” [1.300.001], the “Compliance With Standards Rule” [1.310.001], the “Accounting Principles Rule” [1.320.001], and any interpretations thereof. The member shall also comply with the “Integrity and Objectivity Rule” [1.100.001] that requires maintaining objectivity and integrity and prohibits subordinating one’s judgment to others.
- c. Some professional services involving client advocacy may stretch the bounds of performance standards, go beyond sound and reasonable professional practice, or compromise credibility, thereby creating threats to the member’s compliance with the rules and damaging the reputation of the member and the member’s firm. If such circumstances exist, the member and member’s firm should determine whether it is appropriate to perform the professional services.
- d. When performing professional services requiring independence, a member shall also comply with the “Independence Rule” [1.200.001].

4. Confidential Client Information Rule – Section 1.700.001

- a. A member in public practice shall not disclose any confidential client information without the specific consent of the client.
- b. This rule shall not be construed (1) to relieve a member of his or her professional obligations of the “Compliance With Standards Rule” [1.310.001] or the “Accounting Principles Rule” [1.320.001], (2) to affect in any way the member’s obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member’s compliance with applicable laws and government regulations, (3) to prohibit review of a member’s professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a

complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy. Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

5. Contingent Fees Rule – Section 1.510.001

- a. A member in public practice shall not:
 - i. Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs an audit or review of a financial statement; or a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or an examination of prospective financial information; or
 - ii. Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.
- b. The prohibition in a. above applies during the period in which the member or member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.
- c. Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.
- d. A member's fees may vary depending, for example, on the complexity of services rendered.

IN THE COURT OF APPEALS OF THE STATE OF NEW MEXICO

Opinion Number: 2016-NMCA-063

Filing Date: April 20, 2016

Docket No. 33,781

**AMERICAN CIVIL LIBERTIES UNION
OF NEW MEXICO,**

Plaintiff-Appellee,

v.

DIANNA J. DURAN,

Defendant-Appellant,

and

CHRISTIANA SANCHEZ,

Defendant.

**APPEAL FROM THE DISTRICT COURT OF BERNALILLO COUNTY
Clay Campbell, District Judge**

ACLU of NM Foundation
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for Appellant

OPINION

WECHSLER, Judge.

{1} This case presents yet another opportunity to interpret provisions of our Inspection of Public Records Act—this time with respect to the district court’s award of attorney fees.

{2} Appellant, former Secretary of State Dianna Duran, appeals the district court’s order granting attorney fees.¹ Appellant’s primary argument is premised upon her assertion that the final responsive records to Appellee American Civil Liberties Union of New Mexico’s public records request were produced on May 25, 2012. Taking this assertion as true, Appellant argues that her production of any records after May 25, 2012 could not form the basis of “successful” litigation under the statute either because (1) the subsequently produced records were non-responsive or (2) Appellee already possessed the records at the time of production. In a related claim, Appellant argues that the district court’s award of attorney fees accrued after May 25, 2012 was not “reasonable” as that word is used in the statute because Appellee’s sole purpose in continuing the litigation beyond that date was to investigate the validity of Defendants’ claim that they possessed no additional responsive records.

{3} We conclude that Appellant violated the Inspection of Public Records Act by withholding responsive records until the last of those records were produced on June 5, 2013. Because additional responsive records that were previously withheld were produced during the pendency of the litigation, Appellee’s litigation was “successful” as that word is used in the statute. For the same reason, and for additional reasons related to Defendants’ conduct as discussed below, the district court’s grant of attorney fees was also “reasonable.”

{4} Appellant’s secondary argument is that the nature of Appellee’s settlement offer rendered the accrual of any post-settlement-offer attorney fees unreasonable under the statute. Because this argument is also unsupported by New Mexico law, we affirm.

BACKGROUND

{5} On March 15, 2011, the New Mexico Secretary of State’s Office announced that an internal investigation had revealed one hundred seventeen instances in which foreign nationals registered to vote in New Mexico and that, in thirty-seven of those instances, the illegal registrants had actually voted in New Mexico elections. In response to this statement, Appellee filed a request with the Secretary of State’s Office, pursuant to the Inspection of Public Records Act (IPRA), NMSA 1978, §§ 14-2-1 to -12 (1947, as amended through 2013), requesting production of all public records that supported the allegations. The same day, Appellee filed a similar IPRA request with the Governor’s Office.

¹In the district court, this case was captioned American Civil Liberties Union of New Mexico v. Dianna J. Duran and Christiana Sanchez. Sanchez is not a party to this appeal. When appropriate, we refer to Duran and Sanchez collectively as Defendants.

{6} The Governor's Office produced various public records relevant to this litigation in response to Appellee's IPRA request. Among these records was an email thread (the Colorado emails) dated March 8, 2011 to March 9, 2011. The Colorado emails began with an email from the Colorado Department of State that was forwarded to the Secretary of State's Office Bureau of Elections Director, Bobbi Shearer, and continued as a discussion between Shearer and the Director of Policy and Planning for the Governor's Office, Matt Kennicott. The emails between Shearer and Kennicott discussed a proposed database cross-check between the Secretary of State's Office and the Motor Vehicle Division of the Department of Taxation and Revenue (MVD) for the purpose of determining whether non-citizens were registered to vote in New Mexico.

{7} On March 31, 2011, Defendants formally responded to Appellee's IPRA request. Defendants did not produce the Colorado emails but did produce twelve redacted emails and one letter addressed to a New Mexico assistant attorney general. Additionally, Defendants described certain responsive records that were being withheld under IPRA disclosure exceptions. Defendants did not disclose the existence, or justify the withholding, of the Colorado emails but instead specifically stated "[t]he Secretary of State's Office does not possess any [responsive] documents that reflect communications between the Office of the Secretary of State and the Governor's Office[.]"

{8} On April 11, 2011, Appellee sent a second IPRA request to the Secretary of State's Office. This letter supplemented Appellee's original IPRA request with requests for the production of additional records. Defendants produced no additional records in response to Appellee's supplemental request.

{9} On July 20, 2011, Appellee filed this lawsuit to force the production of public records allegedly withheld in violation of IPRA. In its complaint, Appellee alleged that the Colorado emails provided the impetus for the Secretary of State's Office investigation into whether non-citizens were illegally registered to vote in New Mexico. The complaint disputes Defendants' denial of the existence of responsive communications between the Secretary of State's Office and the Governor's Office by reference to the Colorado emails.

{10} In their answer, Defendants acknowledged the existence of, and confirmed certain content within, the Colorado emails. During the discovery process, Defendants produced additional records, including spreadsheets used by the Secretary of State's Office in its review of New Mexico's voter registration file and voter registration cards for one hundred fifteen of the one hundred seventeen individuals that the investigation identified as registered voters despite not being New Mexico residents.

{11} On October 20, 2011, Defendants provided a privilege log that outlined certain documents withheld from production, including: (1) a list of one hundred seventeen names that appeared in both the Secretary of State's voter file and the MVD foreign national database (list of 117), and (2) a list of thirty-seven names of registered voters who may not be New Mexico citizens but appear to have voted in a New Mexico election (list of 37).

{12} On January 12, 2012, Appellee filed a motion for summary judgment, requesting that the district court order production of the two lists, as well as all other records responsive to its IPRA requests. The lists then became the subject of an email exchange between the parties. On February 6, 2012, Appellee sent a letter to Defendants outlining its understanding as to the existence of the two lists. On February 13, 2012, Defendants responded with a letter intended to clarify “confusion about the state of the documents at issue.” As clarification, the letter stated, “[w]hen I say that the Secretary of State’s Office did not create such lists, what I mean is that such lists do not physically exist. . . . In identifying those voters, the Secretary of State did not generate any document separately listing them.”

{13} The next day, Appellee responded with a letter stating, “[g]iven the confusion surrounding the public records, [Appellee] feel[s] that it is necessary to depose [Appellant] in order to obtain her responses under oath.” Appellee then filed notice to conduct an in-person deposition of Appellant.

{14} On March 2, 2012, Defendants filed their response to Appellee’s motion for summary judgment. The response stated that (1) the list of 37 does not exist, (2) the list of 117 would be produced upon issuance of a district court order clarifying non-liability under state law, and (3) “[t]he Secretary either has already produced or will immediately produce” all other responsive documents. Attached to Defendants’ response was an affidavit of the Secretary of State’s Office Chief of Staff, Kenneth Ortiz. The affidavit outlined the investigative procedure leading to the March 15, 2011 announcement and described the generation of the list of 117. The affidavit additionally stated that a physical copy of the list of 37 was never generated.

{15} On March 6, 2012, Defendants filed a motion for protective order to prevent Appellee from conducting an in-person deposition of Appellant. In support of the motion, Defendants argued that Appellant had no personal knowledge of the investigative process or documents at issue. Appellee filed a response outlining Defendants’ confusion as to the existence of the list of 117 and the list of 37, as well as motions to depose Ortiz and Shearer. Appellee specifically noted,

Given the wildly conflicting accounts of the documents which may or may not exist . . . [Appellee] must depose [Appellant] to ascertain whether there is, in fact, a list of thirty seven people who allegedly voted illegally, and whether there are additional documents that are responsive to [Appellee’s] IPRA requests that have not been produced. Given the multiple inconsistent and contradictory claims as to whether these documents exist at all, it is unreasonable to expect [Appellee] to rely on representations made by counsel instead of obtaining sworn statements.

Shearer’s deposition was conducted on May 4, 2012. During this deposition, Shearer was presented with the Colorado emails, which she authenticated.²

²The pages of deposition testimony in which Shearer authenticates the Colorado emails are not included in the record proper. However, the parties agree that the authentication occurred.

{16} The district court entered a stipulated order of partial summary judgment as to the list of 117. In doing so, the court noted that the “remaining issues and requests for relief . . . are not affected by this [s]tipulation and remain pending.” The list of 117 was produced on May 25, 2012.

{17} In June 2012, reports circulated indicating that executive branch employees were using private or personal email accounts to conduct state business. *See* Dan Boyd, *Private Email Flap Grows*, *Albuquerque Journal*, June 16, 2012, <http://www.abqjournal.com/113169/news/private-email-flap-grows.html>. Following these reports, Appellee requested production of all emails sent to or from private email accounts that were responsive to its IPRA requests. No responsive emails were produced in response to Appellee’s request. On June 25, 2012, Appellee filed a motion to compel production of all responsive public records, including any emails sent to or from private email accounts. Defendants responded, arguing that Appellee lacked good faith to allege such emails existed and denying that any responsive emails exist. The district court granted Appellee’s motion, ordering:

1. Defendants are *ordered to produce all [e]mails pertaining to the matters described in the two IPRA requests in this case*, including all [e]mails sent to and/or copied to and/or received by [Appellant] on private and personal email accounts.
2. Within 15 days after the entry of this [o]rder, [Appellant] *shall submit a sworn [a]ffidavit to [Appellee] verifying that all [e]mails pertaining to the matters described in the two IPRA requests in this case*, including emails sent and received on private and personal email accounts *have been produced*. If there are no [e]mails pertaining to the matters described in the two IPRA requests in this case that were sent to and/or copied to and/or received by [Appellant] on private and personal email accounts, she shall so state.

(Emphasis added.) On the same day, the district court granted Defendants’ motion for protective order, prohibiting Appellee from conducting an in-person deposition of Appellant. In lieu of an in-person deposition, Appellee was granted permission to conduct a deposition on written questions. Appellee submitted one hundred eighty-eight deposition questions to be answered by Appellant.

{18} In response to the district court’s order, on August 24, 2012, Appellant submitted an affidavit stating, in pertinent part,

3. I did not use any personal or private email account to communicate to anyone any information related to the March 2011 investigation conducted by my [o]ffice with respect to the two IPRA requests in this case.
4. *There are no emails sent to and/or received or copied to and/or received by me on private or personal email accounts pertaining to the matters described in the two IPRA requests in this case.*

(Emphasis added.) Defendants then filed a second motion for a protective order seeking protection from one hundred fifty-seven of the one hundred eighty-eight deposition questions submitted by Appellee. By way of background in their motion, Defendants outlined the various public records produced to date and stated “the Secretary of State’s Office has produced all of the documents in its possession, custody, or control responsive to [Appellee’s] requests.” Appellee submitted a response in opposition that detailed Defendants’ “[h]istory of [n]on-[d]isclosure in the [l]itigation[.]” The Colorado emails featured prominently in this argument.

{19} On October 18, 2012, Appellee filed a motion for finding of contempt, claiming that Appellant’s August 24, 2012 affidavit was non-responsive to the court’s order in that it failed to “verify” that all responsive emails had been produced. The motion specifically noted that “[t]he failure of the [Secretary of State] to produce [the Colorado emails] . . . casts doubt over Defendants’ repeated representation that all records responsive to [Appellee’s] IPRA requests have been produced.” Appellee filed a second motion to conduct an in-person deposition of Appellant, stating that Appellant “has shown through her refusal to answer [one hundred fifty-seven out of one hundred eighty-eight] deposition questions that she holds an unnecessarily narrow interpretation of what documents are responsive to [Appellee’s] IPRA requests[.]”

{20} On November 5, 2012, Defendants filed a response to Appellee’s motion for contempt. As a basis for their opposition, Defendants argued that (1) IPRA did not require production of the Colorado emails because Appellee already possessed the Colorado emails, and, in the alternative, (2) IPRA did not require production of the Colorado emails because they were non-responsive. Defendants did not produce the Colorado emails at this time.

{21} Following the filing of additional responses and replies, the district court held a hearing on Appellee’s motion to compel on January 7, 2013. During the hearing, Appellee highlighted the confusion surrounding the existence and production of the list of 117 and the list of 37. Appellee then argued that Defendants’ failure to provide all responsive documents or to comply with the court’s order compelling production justified the continuing litigation. Defendants argued at length that the Colorado emails are non-responsive to Appellee’s IPRA requests, and, therefore, were not subject to the court’s order. The district court denied Appellee’s motion, but made the following comments:

[W]hat I definitely remember saying to [counsel for Defendants] was [that] your client is begging to be deposed. So I assumed that that statement is why I have a couple of pending motions to depose your client, in addition to everything else. Because your client is being asked very direct questions, and your client appears to be answering the questions that she wants to answer or having people answer questions that she wants to have them answer[] and not fully answering the questions. So I mean, I can appreciate where the [Appellee’s] anxiety comes from.

The court entered a second order requiring that Appellant “shall submit a sworn affidavit to [Appellee] verifying that all emails pertaining to the matters described in the two IPRA requests . . . have been produced.” The court also issued orders denying Appellee’s motion to conduct an

in-person deposition of Appellant and granting in part Defendants' second motion for a protective order. Appellant was required to answer one hundred forty-five of the proposed one hundred eighty-eight deposition questions.

{22} Appellant's deposition on written questions was conducted on April 30, 2013. Following the deposition, Defendants contacted Appellee by email to determine whether unresolved issues remained. Appellee responded that materials responsive to its IPRA requests, specifically the Colorado emails, remained unproduced. Defendants ultimately produced the Colorado emails on May 23, 2013 and attachments thereto on June 5, 2013. The district court granted a stipulated dismissal, except as to attorney fees, costs, and expenses, on September 3, 2013.

{23} The district court heard arguments related to Appellee's fee motion on March 12, 2014. At this hearing, and in its subsequent order, the district court found that "counsel's hours spent in this case for which [Appellee] seeks compensation were all reasonable and necessary to [Appellee's] successful prosecution of this IPRA lawsuit." Attorney fees were granted for the work of merits counsel in the amount of \$71,239.50. Attorney fees were granted for the work of fee counsel in the amount of \$15,729.00. This appeal resulted.

STANDARD OF REVIEW

{24} Appellate courts review an award of attorney fees for abuse of discretion. *Lebeck v. Lebeck*, 1994-NMCA-103, ¶ 27, 118 N.M. 367, 881 P.2d 727. A district court abuses its discretion when "a ruling is clearly contrary to the logical conclusions demanded by the facts and circumstances of the case." *Sims v. Sims*, 1996-NMSC-078, ¶ 65, 122 N.M. 618, 930 P.2d 153. To the extent that Appellant's arguments require statutory interpretation, we apply de novo review. *State v. DeAngelo M.*, 2015-NMSC-033, ¶ 7, 360 P.3d 1151.

RESPONSIVENESS OF PUBLIC RECORDS IN IPRA LITIGATION

{25} Section 14-2-1(A) of IPRA provides that "[e]very person has a right to inspect public records" unless a specified exception precludes disclosure. IPRA's purpose—to promote the existence of (1) an informed electorate and (2) transparency in governmental affairs—is documented in the legislation itself and in our appellate case law. *See* § 14-2-5 ("Recognizing that a representative government is dependent upon an informed electorate, the intent of the [L]egislature in enacting [IPRA] is to ensure, and it is declared to be the public policy of this state, that all persons are entitled to the greatest possible information regarding the affairs of government and the official acts of public officers and employees."); *San Juan Agric. Water Users Ass'n v. KNME-TV*, 2011-NMSC-011, ¶ 16, 150 N.M. 64, 257 P.3d 884 ("IPRA is intended to ensure that the public servants of New Mexico remain accountable to the people they serve."); *State ex rel. Newsome v. Alarid*, 1977-NMSC-076, ¶ 34, 90 N.M. 790, 568 P.2d 1236 ("The citizen's right to know is the rule and secrecy is the exception."), *superseded on other grounds by statute as stated in Republican Party of N.M. v. N.M. Taxation & Revenue Dep't.*, 2012-NMSC-026, ¶¶ 14-16, 283 P.3d 853.

{26} To initiate a public records request, any person may contact the records custodian at the desired governmental entity and "identify the records sought with reasonable particularity."

Section 14-2-8(C). Email correspondence by state employees constitutes a public record as defined in the statute. *See* § 14-2-6(G).

{27} Appellant's argument in this case hinges, in substantial part, on whether the Colorado emails are responsive to Appellee's IPRA request. While the term "responsive" is appropriately used by litigants to describe the nature of public records, it does not appear in the statute. *See* §§ 14-2-1 to -12. To determine whether a public record is "responsive," courts must evaluate whether the IPRA request identified the record "with reasonable particularity." Section 14-2-8(C).

{28} The Colorado emails began with an email from Judd Choate, Director of the Colorado Division of Elections. Choate's email was addressed to the National Association of State Election Directors (NASED). The email stated, in pertinent part,

At 1pm this afternoon . . . Colorado Secretary of State Scott Gessler will hold a news conference to discuss legislation under consideration in the Colorado House that would allow the Colorado Department of State to spot check and investigate voter registrations for the possibility that non-citizens are 1) currently registered to vote, 2) are being accidentally registered to vote, or 3) are willfully seeking to register in violation of both state and potentially federal law.

Simultaneous with this press conference, the Department of State will issue a report outlining the research we have undertaken to determine the number of persons currently registered who may not be U.S. citizens. In short, that research has found that there are certainly hundreds, and likely thousands, of non-citizens who are registered to vote in the state of Colorado.

I wanted to warn you that this report will be issued in case it becomes a national story requiring that you address the issue relative to your state.

Choate's email was forwarded by NASED personnel to Shearer. Shearer forwarded Choate's email to Kennicott with comments stating, "Colorado is going to announce this today. We do already have an agreement in place [between the Secretary of State's Office], [MVD], and [S]ocial [S]ecurity to cross-check. If MVD would do it, we could run a cross-check this week. What do you think? Tell MVD to coordinate with us?" Shearer and Kennicott then exchanged emails discussing implementation of a cross-check of the Secretary of State's Office and MVD databases.

{29} Following the March 15, 2011 announcement, Appellee submitted two separate IPRA requests: one on March 16, 2011 and another on April 11, 2011. In these requests, Appellee requested nine types of documents related to the Secretary of State's Office investigation into potential voter fraud in New Mexico. One of the requests included "[a]ny documents that reflect communications between the Office of the Secretary of State and any one at the Governor's Office related to alleged and/or proven voter fraud involving foreign nationals and/or any irregularities noted in the master list of registered voters in New Mexico."

{30} While Appellee's request is somewhat unwieldy as written, it can be deconstructed using basic grammar. The use of "and/or" within the request indicates that the request contemplates both conjunctive and disjunctive readings. Because the request uses "and/or" twice, numerous possible readings are included within the request, including, "Any documents that reflect communications between the Office of the Secretary of State and any one at the Governor's Office related to alleged *or* proven voter fraud involving foreign nationals *or* any irregularities in the master list of registered voters in New Mexico." Since a disjunctive reading anticipates removal of the content following the word "or," another grammatically correct reading is, "Any documents that reflect communications between the Office of the Secretary of State and any one at the Governor's Office related to alleged voter fraud involving foreign nationals."

{31} The subject matter of Choate's email to NASED was alleged voter fraud involving foreign nationals. Choate's email was forwarded between personnel in the Secretary of State's Office and the Governor's Office. Appellant argues on appeal that the Colorado emails are not responsive because they do not contain allegations of voter fraud in New Mexico. This argument is misplaced given the construction of the request. Appellee's IPRA request was crafted "with reasonable particularity" to make the Colorado emails responsive to the request. Section 14-2-8(C).

SUCCESS IN IPRA LITIGATION

{32} IPRA's enforcement provision provides that "[t]he court shall award damages, costs and reasonable attorney[] fees to any person whose written request has been denied and is *successful* in a court action to enforce the provisions of [IPRA]." Section 14-2-12(D) (emphasis added). Appellant argues that Appellee is not entitled to an award of attorney fees accrued after May 25, 2012 because Appellee's IPRA litigation after May 25, 2012 was not "successful" as that word is used in IPRA. As a basis for this argument, Appellant claims that no responsive documents were produced after May 25, 2012. As discussed immediately above, this argument fails because the Colorado emails, produced by Defendants on May 23, 2013 and June 5, 2013, were responsive to Appellee's IPRA request.

{33} Alternatively, Appellant argues that production of the Colorado emails cannot constitute success under IPRA because Appellee already had possession of the Colorado emails at the time litigation was filed, and, as a result, Defendants did not withhold or deny Appellee access to the records. To determine whether IPRA litigation that results in the production of responsive records already in a litigant's possession is "successful" as that word is used in IPRA, we apply principles of statutory construction.

{34} Because the word "successful" is not defined, we must determine its meaning in the context of the statute. An appellate court's "primary purpose in interpreting a statute is to ascertain and give effect to legislative intent." *Maes v. Audubon Indem. Ins. Grp.*, 2007-NMSC-046, ¶ 11, 142 N.M. 235, 164 P.3d 934 (internal quotation marks and citation omitted). To ascertain legislative intent, we look first to the plain meaning of the words of the statute. *See State v. Tsosie*, 2011-NMCA-115, ¶ 13, 150 N.M. 754, 266 P.3d 34 ("We determine legislative intent by first looking at the words chosen by the Legislature and the plain meaning of those words." (alteration, internal quotation marks, and citation omitted)).

{35} We frequently use dictionary definitions to assist in determining the plain meaning of statutory language. *See, e.g., State v. Boyse*, 2013-NMSC-024, ¶ 9, 303 P.3d 830 (“Under the rules of statutory construction, [the appellate courts] first turn to the plain meaning of the words at issue, often using the dictionary for guidance.”). Dictionary definitions of the word “successful” include, “resulting or terminating in success: having the desired effect[.]” *Webster’s Third New International Dictionary of the English Language Unabridged* 2282 (3d ed. 1993), and “accomplishing an aim or purpose[.]” *New Oxford American Dictionary* 1737 (3d ed. 2010). These definitions, as well as the context in which the word “successful” is used in the statute, appear to evince a legislative intent to award attorney fees generated during litigation that secures production of previously denied responsive documents. *See* § 14-2-12(D); *Rio Grande Sun v. Jemez Mountains Pub. Sch. Dist.*, 2012-NMCA-091, ¶ 9, 287 P.3d 318 (holding that “the party who unsuccessfully resists a statutorily-compelled, socially beneficial action” is subject to an award of attorney fees); *see also Faber v. King*, 2015-NMSC-015, ¶ 31, 348 P.3d 173 (stating that a “successful litigant . . . obtain[s] the documents he or she sought in the first place”).

{36} Appellant’s argument that the production of documents already in Appellee’s possession cannot form the basis of “successful” IPRA litigation harkens back to our appellate courts’ application of the “rule of reason” in IPRA litigation, an option now foreclosed by our Supreme Court. *See Republican Party of N.M.*, 2012-NMSC-026, ¶ 16 (“[C]ases applying the ‘rule of reason’ to all of the exceptions enumerated by the Legislature are overruled to the extent they conflict with this [o]pinion.”).

{37} Section 14-2-1(A), which provides public policy exceptions to IPRA’s disclosure requirements, does not include prior possession as a legitimate ground for withholding public records. *See Republican Party of N.M.*, 2012-NMSC-026, ¶ 16 (“[C]ourts now should restrict their analysis to whether disclosure under IPRA may be withheld because of a specific exception contained within IPRA[.]”). Appellant cites no cases supporting the proposition that an IPRA litigant’s possession of a public record negates an agency’s duty to respond. *See In re Adoption of Doe*, 1984-NMSC-024, ¶ 2, 100 N.M. 764, 676 P.2d 1329 (“[Our appellate courts] assume where arguments in briefs are unsupported by cited authority, counsel after diligent search, was unable to find any supporting authority.”).

{38} Additionally, we disagree with Appellant’s position that IPRA’s sole purpose is to make government records—that is, the tangible documents—available to the public. Section 14-2-5 of IPRA provides that “the intent of the [L]egislature in enacting [IPRA] is to ensure . . . that all persons are entitled to the greatest possible *information* regarding the affairs of government[.]” (Emphasis added.) While information can come in the form of tangible documents, it can also be gathered based upon an agency’s denials. *See* § 14-2-11(B) (“If a written request has been denied, the custodian shall provide the requester with a written explanation of the denial.”). Denials are valuable information-gathering tools. With respect to any given record request, the absence of either (1) production of responsive records or (2) a conforming denial based upon a valid IPRA exception sends a strong message to the requester that no responsive public record exists.

{39} Our independent review reveals that numerous other state courts interpret their own public records legislation to require production of responsive documents under these circumstances. *See, e.g., Wichita Eagle & Beacon Pub. Co. v. Simmons*, 50 P.3d 66, 87 (Kan. 2002) (holding that a governmental agency may not “refuse to produce records because such records are available from another or a more ‘appropriate’ source”); *Smith v. Sch. Dist. No. 45*, 666 P.2d 1345, 1349 (Or. Ct. App. 1983) (holding that a “public body may not refuse to produce records subject to inspection under [the act] just because the requester already possesses them”); *Neighborhood All. of Spokane Cty. v. Cty. of Spokane*, 261 P.3d 119, 131 (Wash. 2011) (holding that “[t]he fact that the requesting party possesses the documents does not relieve an agency of its statutory duties”).

{40} As late as January 16, 2013, the district court ordered Appellant to verify by affidavit that all responsive emails to Appellee’s IPRA requests had been produced. Appellant continued to withhold the Colorado emails until June 5, 2013. Because Appellee’s litigation secured the production of previously denied responsive public records, the litigation was “successful” as that word is used in the statute. *See* § 14-2-12(D).

REASONABLENESS OF ATTORNEY FEES IN IPRA LITIGATION

{41} IPRA’s enforcement provision also requires courts to grant only “reasonable” attorney fees to successful litigants. *See* § 14-2-12(D) (“The court shall award damages, costs and *reasonable* attorney[] fees[.]” (emphasis added)). The reasonableness of attorney fees is measured against an established set of objective standards and criteria. *Behrens v. Gateway Court, LLC*, 2013-NMCA-097, ¶ 34, 311 P.3d 822. These standards and criteria include:

- (1) the time and labor required—the novelty and difficulty of the questions involved and skill required; (2) the fee customarily charged in the locality for similar services; (3) the amount involved and the results obtained; (4) the time limitations imposed by the client or by the circumstances; and (5) the experience, reputation and ability of the lawyer or lawyers performing the services.

Rio Grande Sun, 2012-NMCA-091, ¶ 13 (internal quotation marks and citation omitted). These criteria relate generally to mathematic calculations that a district court must conduct in the face of competing arguments by the parties: (1) what hourly rate is the lawyer entitled to per hour, (2) how many hours should the project require, and (3) what do other lawyers bill for similar work? *See id.* These quantitative questions are not at issue in this case. Instead, Appellant’s challenge is to the reasonableness of the litigation itself after May 25, 2012—an overarching notion that must be addressed through evaluation of the “results obtained” in the litigation. *Id.* A factual determination by the district court that an IPRA fee request is reasonable when weighed against the results obtained in the litigation will be disturbed only when the award “is contrary to logic and reason.” *Id.* ¶ 10 (alteration, internal quotation marks, and citation omitted).

{42} The purpose of IPRA’s enforcement provision is to “promote compliance and accountability” from governmental entities. *Faber*, 2015-NMSC-015, ¶ 28. The provision effectively amounts to a “fee-shifting statutory scheme[]” that “encourages individuals to enforce

IPRA on behalf of the public” and “ensure[s] that the entire process is virtually costless to a successful litigant.” *Id.* ¶¶ 31-32 (internal quotation marks and citation omitted).

{43} Appellant’s brief in chief correctly notes that “fees incurred in obtaining documents from a state agency are prima facie reasonable.” Appellant then argues that Appellee’s prosecution of the IPRA litigation after May 25, 2012 was not directed at obtaining public records, but instead it was “expended in an effort to verify (or disprove) the sworn assertions of the Secretary of State’s Office that it had fully responded to Appellee’s IPRA request.” To summarize this argument, Appellant stated, “it is flatly unreasonable for a state agency to pay the freight for an IPRA litigant’s paranoia.”

{44} The obvious problem with Appellant’s argument is that Appellee was not being paranoid; Defendants were withholding responsive documents. *See, e.g., Cox v. N. M. Dep’t of Pub. Safety*, 2010-NMCA-096, ¶ 17, 148 N.M. 934, 242 P.3d 501 (“New Mexico’s policy of open government is intended to protect the public from having to rely solely on the representations of public officials that they have acted appropriately.” (internal question marks and citation omitted)). From the initial complaint onward, Appellee claimed that Defendants were wrongfully withholding the Colorado emails. Defendants’ answer essentially acknowledges their possession of the Colorado emails. Despite repeated references to the Colorado emails by Appellee throughout the litigation, Defendants failed to fully produce the records until June 5, 2013. As such, Appellant’s argument that Appellee’s litigation efforts were motivated by goals other than obtaining public records, or by mere paranoia, is not legally sound.

{45} Appellant claims that the Colorado emails are not responsive to Appellee’s IPRA request. As discussed above, we disagree. But to be clear, this opinion does not hold that a governmental entity is required to produce records that it, in good faith, believes to be unresponsive. However, when such withheld records are subsequently revealed and determined to be responsive, those records may become the basis for an award of attorney fees in IPRA litigation. Our IPRA jurisprudence contemplates in camera review in circumstances in which the applicability of a disclosure exception is in question. *See Republican Party of N.M.*, 2012-NMSC-026, ¶ 49 (“Where appropriate, courts should conduct an in camera review of the documents at issue as part of their evaluation of privilege.”). We see no language in the statute or our case law that would prohibit a similar practice with respect to a question of responsiveness.

{46} Appellee’s assessment of the veracity of Defendants’ claim that all responsive documents had been produced was likely, and understandably, colored by Defendants’ initial and ongoing failure to produce the Colorado emails. Against this backdrop, Defendants’ subsequent conduct justified Appellee’s continued efforts to determine the existence of responsive records.

{47} Two examples stand out to this Court. First, early in the litigation, great confusion—among both the parties and within the Secretary of State’s Office—arose as to the existence of the list of 117 and the list of 37. Defendants created this confusion by including these lists in its IPRA privilege log despite later revelations that the lists did not physically exist. While mistakes happen during the course of litigation, it is difficult to comprehend how documents that do not exist in tangible form could appear on an IPRA privilege log; a log that exists solely to request that tangible documents be protected from public disclosure. This confusion could justifiably

raise Appellee's concerns as to the reliability of Defendants' claims of full production. Second is Appellant's submission of a non-responsive affidavit in response to the district court's order aimed, presumably, at curtailing this litigation. On August 17, 2012, the district court issued an order requiring that Appellant (1) produce all emails responsive to Appellee's IPRA requests and (2) provide an affidavit stating that no additional responsive emails exist. In response, Appellant submitted an affidavit stating, essentially, that she, individually, did not send or receive any responsive emails. This affidavit failed to comply with the district court's order, and thereby, its deficiencies raised legitimate questions as to whether other documents existed.

{48} Given both the responsiveness of the Colorado emails and the confusion created by Defendants' conduct throughout the litigation, we cannot say that the district court's ruling as to the reasonableness of the fees generated by Appellee during the litigation constituted an abuse of discretion. Because Appellee's actions were reasonable, the district court's award of attorney fees for the period of time between May 25, 2012 and the conclusion of the litigation is consistent with the enforcement provision of IPRA.

THE IMPACT OF A SETTLEMENT OFFER ON THE ACCRUAL OF ATTORNEY FEES IN IPRA LITIGATION

{49} On September 29, 2011, Appellee sent a letter to Defendants for the purpose of "exploring settlement possibilities[.]" This letter was expressly not an offer of settlement but presented conditions under which Appellee would consider settlement. Nearly a year later, Appellee sent a new letter in conformance with Rule 11-408 NMRA that offered to settle the litigation if Defendants complied with five conditions. Two of the five conditions required that Defendants acknowledge "that there are no records that prove that 117 foreign nationals were illegally registered to vote in New Mexico elections" and "that there are no records that prove that thirty-seven (37) foreign nationals had voted in New Mexico elections" as indicated in Appellant's March 15, 2011 statement. Appellant argues that no additional attorney fees should have accrued following Appellee's settlement offer because the terms of the offer did not require that Defendants produce additional responsive records.

{50} "It is the policy of the law and of the State of New Mexico to favor settlement agreements." *Navajo Tribe of Indians v. Hanosh Chevrolet-Buick, Inc.*, 1988-NMSC-010, ¶ 3, 106 N.M. 705, 749 P.2d 90. Settlements entered by the parties "essentially represent contractual agreements." *Lewis v. City of Santa Fe*, 2005-NMCA-032, ¶ 11, 137 N.M. 152, 108 P.3d 558. A valid contract must be supported by an offer, acceptance, consideration, and mutual assent. *Flemma v. Halliburton Energy Servs., Inc.*, 2013-NMSC-022, ¶ 28, 303 P.3d 814. While consideration is an essential component to any contract, courts generally do not weigh the terms of a contract in determining its validity. *See Figueroa v. THI of N.M. at Casa Arena Blanca, LLC*, 2013-NMCA-077, ¶ 18, 306 P.3d 480 ("[E]very person . . . is entitled to dispose of his property in such manner and upon such terms as he chooses; and whether his bargain be wise and discreet or otherwise, or profitable or unprofitable, are considerations not for the courts of justice, but for the party himself to deliberate upon." (internal quotation marks and citation omitted)).

{51} Appellant appears to argue that the terms of Appellee's settlement offer indicate that Appellee was abusing the IPRA process to extricate inherently political statements. We disagree. The record before this Court indicates that Appellee believed it was entitled to certain public records in Defendants' possession and was willing to negotiate away that right in exchange for alternate concessions.

{52} Even if Appellant's assertion were correct, it does not provide legal support for terminating the accrual of attorney fees after the settlement offer in this case. Nothing precludes an IPRA request from being motivated by something other than a desire to possess the tangible document that is delivered by the responding governmental entity. This fact does not diminish a party's right to the tangible document or to leverage that right in settlement negotiations.

{53} Defendants declined to accept the terms of the settlement offer. As such, Appellee was entitled to continue litigating in order to secure all records responsive to its IPRA requests. Naturally, additional attorney fees accrued during the pendency of the litigation. Neither our independent research, nor Appellant's briefing, establishes legal support for the proposition that the terms of a settlement offer must be inherently connected to the substantive law from which a claim arises. *See In re Doe*, 1984-NMSC-024, ¶ 2 ("[Our appellate courts] assume where arguments in briefs are unsupported by cited authority, counsel after diligent search, was unable to find any supporting authority."). Appellee is entitled to attorney fees accrued after Defendants rejected Appellee's settlement offer.

ABUSE OF DISCRETION

{54} Because we see no misapplication of law in the district court proceedings, we review the district court's award of attorney fees for abuse of discretion. The district court's order expressly stated that "counsel's hours spent in this case for which [Appellee] seeks compensation were all reasonable and necessary to [Appellee's] successful prosecution of this IPRA lawsuit." Appellee expended resources throughout the litigation in an effort to force the production of responsive records. Appellee's efforts were successful and culminated in the final production of responsive records on June 5, 2013. We cannot conclude that the district court's award of attorney fees was "clearly contrary to the logical conclusions demanded by the facts and circumstances of the case." *Sims*, 1996-NMSC-078, ¶ 65.

CONCLUSION

{55} Because the district court's award of attorney fees did not constitute an abuse of discretion, we affirm. Additionally, we conclude that Appellee is entitled to appellate attorney fees and remand to the district court for proceedings consistent with this conclusion.

{56} **IT IS SO ORDERED.**

JAMES J. WECHSLER, Judge

WE CONCUR:

JONATHAN B. SUTIN, Judge

TIMOTHY L. GARCIA, Judge

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