# 2017 Tax Symposium

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STATE BAR of NEW MEXICO
CENTER FOR LEGAL EDUCATION

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Center for Legal Education
New Mexico State Bar Foundation
P.O. Box 92860
Albuquerque, NM 87199-2860
505-797-6020 or 1-800-876-6227
cleonline@nmbar.org
www.nmbar.org


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# Presenter Biographies

**Benjamin C. Roybal** is a shareholder and director of the Albuquerque law firm of Betzer, Roybal & Eisenberg, PC, where he concentrates on business planning, business transactions and federal and state taxation. His work includes matters relating to planning, organizing and financing corporate and non-corporate business entities, as well as business sales and acquisitions and general commercial matters. Roybal also handles federal and state tax disputes. He received his B.B.A. from the University of New Mexico Anderson School of Management, his J.D., *cum laude*, from the University of New Mexico and his L.L.M. degree in taxation from New York University.

**Bruce McGovern** is a tenured member of the faculty at South Texas College of Law Houston, where he also serves as director of the school's Low Income Taxpayer Clinic. He received his undergraduate degree from Columbia University and his law degree from Fordham University School of Law. After law school, he served as a judicial clerk for Judge Thomas Meskill on the U.S. Court of Appeals for the Second Circuit in New York. He then practiced law with the law firm of Covington & Burling in Washington, D.C. He subsequently earned an LL.M. in Taxation from the University of Florida Levin College of Law, where he taught as a visiting faculty member before joining the faculty at South Texas College of Law Houston. Professor McGovern teaches and writes in the areas of business organizations and taxation. His courses include federal income taxation, U.S. taxation of international transactions, partnership and subchapter S taxation and federal tax procedure. He frequently speaks on recent developments in federal income taxation. Professor McGovern is a member of the Council of the State Bar of Texas Tax Section, a former Chair of the Houston Bar Association Section of Taxation and a fellow of the American College of Tax Counsel.

**Judge James Halpern** was appointed to the Tax Court on July 10, 1990, reappointed Nov. 2, 2005, and became a senior judge on Oct. 16, 2015. He received a B.S. from the Wharton School, University of Pennsylvania, J.D. from the University of Pennsylvania Law School and LL.M. from New York University. Prior to his appointment to the Tax Court, Judge Halpern was a partner at Baker and Hostetler in Washington, D.C. He was an associate at Mudge, Rose, Guthrie & Alexander in New York City from 1972 to 1974. He was an assistant professor of law at the Law School of Washington and Lee University from 1975 to 1976 and St. John's University in New York City from 1976 to 1978. He was a visiting professor at New York University Law School from 1978 to 1979. Judge Halpern was an associate at Roberts and Holland in New York City from 1979 to 1980. Judge Halpern served as Principal Technical Advisor to the Assistant Commissioner (Technical) and Associate Chief Counsel (Technical) for the Internal Revenue Service from 1980 to 1983. Judge Halpern has been teaching as an adjunct professor at the George Washington University Law School since 1984.

**Ed Hymson** is a research fellow at the State Bar of New Mexico. He holds a J.D. from American University Law School, a L.L.M. in tax law from Temple University Law School, and a Ph.D. in economics from UCLA. He practiced commercial and tax law as an associate general counsel for Consolidated Rail Corporation for 18 years.

**Shavon M. Ayala** is the sole-shareholder of Ayala PC, a law practice that serves the entrepreneurial and nonprofit communities, focusing on Business Law with an emphasis on entity, contract, tax, and intellectual property issues. She especially values working with tech-

based and socially conscious companies. She volunteers regularly as an attorney, and generally, and is involved in a number of community projects and local nonprofits. Ayala aims to foster social enterprise, community development, and economic growth through service to her clients and within the community.

**Laurence S. Donahue** is the founding attorney for Law 4 Small Business, PC (L4SB), a law firm based in Albuquerque that has experienced more than 400 percent growth in revenues, clients and online sales each year, for the past four years. With partner offices in San Francisco, Houston, Dallas, Tampa and Chicago, L4SB is poised to become an International brand in licensed legal services in competition with the VC-backed, Internet-based, non-law firms.

**William Slease** is chief disciplinary counsel for the New Mexico Supreme Court Disciplinary Board. In addition to his duties as chief disciplinary counsel, he serves as an adjunct professor at the University of New Mexico School of Law where he has taught employment law, ethics and trial practice skills. He also chairs the New Mexico Supreme Court Lawyer Succession and Transition Committee and serves on the State Bar of New Mexico Commission on Professionalism and is a member and the 2016-17 president of the National Organization of Bar Counsel.

**Oscar Ornelas** is president and founder of the Ornelas Firm and is a licensed tax attorney in New Mexico and Texas. He also is admitted to practice before the U.S. Tax Court. Ornelas graduated from Texas Tech University School of Law and then earned his L.L.M. from the graduate tax program at New York University School of Law. He practiced at one of El Paso's oldest law firms, where he advised small businesses and foreign investors on tax planning matters, tax and entity structuring and restructuring and state and federal tax issues.

# State Tax Update

2017 State Bar Tax Symposium

State Tax Update
Selected Recent Developments

Benjamin C. Roybal
Betzer, Roybal & Eisenberg, P.C.

## Selected Statutory Changes

### 2016 Legislative Changes

#### Corporate Income Tax

Prior law: Due date for corporate income tax return was 15th day of the third month following the end of the tax year (March 15 for calendar year taxpayers).

Amendment: Amends Section 7-2A-9A of the Corporate Income and Franchise Tax Act to conform New Mexico corporate income tax due dates to the due dates for federal returns.[1]

#### Gross Receipts Tax

Prior Law: Sections 7-9-77.1 and 7-9-93 of the Gross Receipts and Compensating Tax Act allow a deduction for receipts from payments by Medicare and certain qualifying insurance companies and managed care organizations for qualifying healthcare services provided by healthcare practitioners. Department regulations allowed certain business entities that provide qualifying healthcare services through qualifying healthcare providers to claim the deduction, but excluded hospitals. HealthSouth Rehabilitation, a rehabilitation hospital, filed various claims for refund for gross receipts tax paid on receipts from payments by Medicare and insurance companies for healthcare services provided by its employed healthcare practitioners. The Department granted HealthSouth's claim for refund for receipts from payments by Medicare for healthcare services provided to Medicare beneficiaries, but denied the refund claims for services provided to otherwise qualifying insurers. HealthSouth protested. After a formal hearing, the Hearing Officer determined that the deduction applied to payments by health insurance companies for healthcare services performed by practitioners employed by HealthSouth and granted HealthSouth's protest (and refund claim).

[1] Beginning in the 2016 tax year, the return due date for calendar year C corporations basis moves from March 15th to April 15th following the end of the taxable year.

2016 Amendment

In response to HealthSouth, the legislature passed (and the governor signed) Senate Bill 6. SB 6, among other things, amended Sections 7-9-77.1 and 7-9-93 to limit the deduction under those sections to receipts *of a healthcare practitioner*. The scope of the amendment is unclear, at best, and has caused great concern and confusion among healthcare providers and practitioners, including providers that practice through business entities, such as professional corporations, business corporations and limited liability companies.

Administrative Response

As a result of the confusion surrounding the meaning of the changes to Sections 7-9-77.1 and 7-9-93 under SB6, in late December 2016, in response to a request for clarification by the New Mexico Medical Society, the Department issued Bulletin 200.30 which provides (in pertinent part) as follows:

> Prior to the HealthSouth D&O, the Taxation and Revenue Department had consistently taken the position that these deductions [under §7-9-77.1 and §7-9-93] were for only the receipts of a health care practitioner. Thus, the Senate Bill 6 amendments do not change, but rather reinstate, the Department's historic interpretation of the law. The bill was not intended to, and does not affect, the deductions under Sections 7-9-77.1 and 7-9-93 NMSA 1978 for receipts of physicians, osteopaths or other health care practitioners who practice as sole proprietors.
>
> The bill does not affect the deductions under Sections 7-9-77.1 and 7-9-93 NMSA 1978 for receipts of corporations, limited liability companies, partnerships and other legal entities from the provision of otherwise qualifying health care services provided by physicians, osteopaths or other health care practitioners who own and are employed by the legal entity. The numerous regulations in place under Section 7-9-93 NMSA 1978 remain in place and are effective as they were always in line with the Department's interpretation of the section.

High-wage jobs tax credit

Prior law: NMSA §7-9-61 et seq. provides tax credits (against gross receipts, compensating and withholding tax) for new high wage jobs—jobs that pay greater than $60,000 in certain jurisdictions, and $40,000 in others; credit available for wages paid to eligible employees by eligible employers; eligible employees are New Mexico residents employed by an eligible employer and who are not related to the eligible employer; eligible employers are those that sold more than 50% of their goods or services produced in New Mexico outside the state or were certified by the economic development department as eligible to receive development training program assistance; the amount of credit is up 10% of wages paid to an eligible employee (up to $12,000 for 4 years per period); taxpayers could aggregate credits for multiple years (single application).

Amendment: Amends Section 7-9G-1 NMSA 1978 several ways:

(1) Modifies the definition of an eligible employer to make clear the credit applies to manufacturing and non-retail service businesses;

(2) Requires applicants to file credit applications annually for the new jobs they create, instead of aggregating multiple years;

(3) Requires taxpayers to maintain increased employment levels in order for jobs to continue to qualify for the credit in the second, third, and fourth years;

(4) Provides for credit extinguishment for taxpayers that cease business in New Mexico while applications are pending; and

(5) Adds additional certification requirements to the application process.

2017 Legislative Changes

Tax Administration Act

Prior law: Taxpayers with unpaid taxes (covered by TAA) could request an installment agreement for up to 5 years.

Amendment: Amends Section 7-1-21A to increase the maximum term for an installment agreement to 72 months.

Prior law: No requirement that taxpayers pay undisputed amount to protest assessment (by design a prepayment dispute resolution procedure).

Amendment: Amends Section 7-1-23 (election of remedies provision) to provide that the taxpayer may either protest the *undisputed* amount or pay the amount of the assessment and file a claim for refund. Amends Section 7-1-24 to require taxpayers to pay the *undisputed* amount in order to protest or enter into an installment agreement for payment *prior to* filing the protest. Also amends Section 7-1-24 to provide that if a protest to a notice of assessment is not filed within the required time, the amount of tax determined to be due becomes final and the taxpayer has waived the right to dispute the amount, unless the taxpayer pays the tax and timely files a claim for refund.

Prior law: Refund claims must include certain information as set by statute; no statutory requirement to include supporting documentation or an amended return for the refund period.[2]

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[2] *Under prior law, a claim for refund was valid if certain statutory requirements met, including:*

> *(1) the taxpayers name, address and identification number; (2) the type of tax for which a refund is being claimed, the credit or rebate denied or the property levied upon; (3) the sum of money or other property being claimed; (4) with respect to refund, the period for which overpayment was made; and (5) a brief statement of the facts and the law on which the claim is based, which may be referred to as the basis for the refund.*

Amendment: Amends Section 7-1-26 to require taxpayers to include documentation supporting and substantiating the claim and basis for the refund; also requires taxpayers to include a copy of an amended return for each tax period covered by the claim; not clear what you do if the claim results from a Department audit and assessment. In addition, and importantly, provides that a claim for refund is not complete if the Department requests additional relevant documentation from the taxpayer that the taxpayer fails to provide.

Prior law: Taxpayers with pending refund claims may elect to protest or file suit if the Department fails to act on the claim within 120 days of filing; taxpayers must file a protest or suit prior to the expiration of 210 days (or refile the claim). Refiling option is only available if not barred by the statute of limitations.

Amendment: Amends Section 7-1-26 to allow protest for inaction after 180 days; eliminates requirement that taxpayer protest or file suit prior to the expiration of 210 days.

Prior law: Tax for purposes of successor in business provisions excludes penalties and interest (see High Country Buick GMC).

Amendment: Amends Section 7-1-61 NMSA 1978 to include penalties and interest in the definition of "tax" overruling High Country Buick GMC.

Prior law: Under Section 7-1-68 no interest paid on refund resulting from certain tax credits

Amendment: Amends Section 7-1-68 to add additional credits to the list barring interest on the refund claim.

## Recent New Mexico Court of Appeals Decision

High Country Buick GMC, Inc. vs. Taxation and Revenue Department of the State of New Mexico, 2016 NMCA-027, 2015 N.M. App. Lexis 127

Taxpayer acquired assets of several auto dealerships from group of companies that were acquired by a secured lender---a former shareholder who recovered the stock of the prior owner when the prior owner's shareholders defaulted under the terms of a note and security agreement. Shortly after the closing of the acquisition of the assets by Taxpayer, the Department assessed Taxpayer for the gross receipts tax, penalties and interest assessed against the prior owner under NMSA 7-1-61 et. seq. Taxpayer protested the assessment contending (among other things) that it was not a successor because it acquired the dealerships from an intervening secured lender and that (if it was) successor in business liability under the act was limited to the tax and not the penalties and interest. The Court of Appeals rejected Taxpayer's intervening secured creditor argument (determining that the exception to successor liability for foreclosures by secured lenders did not apply) and held that Taxpayer was a successor in interest to the prior owner. The Court agreed that the Taxpayer's liability was limited to the tax owed by the predecessor (and did not include penalties and interest).

## Selected 2016 D&Os

No. 16-16: HealthSouth Rehabilitation

HealthSouth Rehabilitation, a rehabilitation hospital, filed various claims for refund for gross receipts tax paid on receipts from payments Medicare and insurance companies for healthcare services provided by its employed healthcare practitioners. The Department granted HealthSouth's claim for refund for receipts from payments by Medicare for healthcare services provided to Medicare beneficiaries, but denied the refund claims for services provided to otherwise qualifying insurers. HealthSouth protested. After a formal hearing, the Hearing Officer determined that the deduction applied to payments by health insurance companies for healthcare services performed by practitioners employed by HealthSouth and granted HealthSouth's protest (and refund claim).

No. 16-42: Weil Construction Inc.

Taxpayer, a construction contractor, constructed a new fire station for the County of Santa Fe in Edgewood. Taxpayer paid gross receipts tax on the receipts derived from performance of the construction services. Subsequently, a local accounting firm was retained to perform a cost segregation study to determine which (if any) of items of tangible personal property sold to the county in connection with the construction project were deductible under NMSA 7-9-54 and applicable tax regulations. After completion of the study, Taxpayer filed an application for refund for gross receipts tax paid on segregated items. The Department failed to timely act on the claim and Taxpayer filed a protest. While the protest was pending, the Department granted a partial refund for receipts from certain items easily removed from the fire station, including window treatments, appliances and fire extinguishers, among other items. After a formal

hearing, the Hearing Officer determined that the items that Taxpayer claimed were deductible sales of tangible personal property were construction materials under the applicable statutes (which, according to the Hearing Officer controlled in this case) and, even if not construction materials, that the Taxpayer had failed to establish it met the requirements of the regulation. Taxpayer's protest was denied.

No. 16-55: ATC Healthcare Services Inc.

Taxpayer, a Franchisor of home care franchises, entered into a franchise agreement with a New Mexico corporation for the operation of a home care services franchise in New Mexico. Under the agreement, the Franchisee was responsible for recruitment, selection, training, testing, hiring, firing and establishing the salary and benefits for the home care employees. The Taxpayer, however, was the legal employer of the home care employees and was responsible for the health care (but not other Franchisee') employees' wages. Taxpayer performed all billing and collected all revenue from the Franchisee's clients, depositing all funds into a separate bank account. Taxpayer used some of the collected funds for payroll for the temporary home care employees, retained some as its share of the home care revenue and for other allowable costs under the franchise agreement and paid the balance (presumably) to the Franchisee (for its share of the revenue). After an audit, the Department assessed Taxpayer for gross receipts tax on the collected revenue, including the revenue used for payroll costs and to pay the Franchisee its share of home care revenue. Taxpayer protested the assessment on numerous grounds. At a formal hearing, the Taxpayer argued, among other things, that the payments from Franchisee's clients and used for payroll or for the Franchisee's share of revenue were received by Franchisor in its capacity as disclosed agent for the Franchisee and thus were not subject to gross receipts tax. Relying extensively on MPC Ltd. vs. the Taxation & Revenue Department, and the lack of evidence that the employees knew that they had the contractual right to proceed against the Franchisee for their wages, the Hearing Officer rejected the Taxpayer's argument that it was acting as disclosed agent for the Franchisee with respect to funds used to pay Taxpayer's employees. For similar reasons, the Hearing Officer rejected the Taxpayers argument that it was acting as disclosed agent for the Franchisee with respect to the funds received and remitted to the Franchisee as its portion of the home care service revenue. Taxpayer's protest was denied (although the protest of penalties was granted).

## Selected 2017 D&Os

No. 17-04: Auto Glass Technologies

Taxpayer, a limited liability company, owned operated an auto glass repair business. Taxpayer's member formerly worked at a similar business operated by her step father ("Former Company") The Former Company got into financial trouble and ultimately ceased operations. At the time it ceased operations the Former Company (presumably) owed the Department for unpaid gross receipts tax, penalty and interest. The Department determined that the Taxpayer was a successor to the former company and assessed Taxpayer for the Former Company's tax liability (plus penalties and interest). Relying (ostensibly) on the multi factor test set forth in applicable regulations (NMAC 3.1.10.16(A)), the Hearing Officer determined that the Taxpayer was a successor to the Former Company because the Taxpayer provided the same service to some of

the same customers, and the same employees worked in both companies. In a partial victory for the Taxpayer, the Hearing Officer rejected the Department's claim that the Taxpayer was liable for penalties and interest as a mere continuation of the Former Company.

No. 17-24: Helmerich & Payne International Drug

The Department assessed Taxpayer for corporate income tax, penalty, and interest (theory unknown). Taxpayer filed a formal protest (contending that the assessment was contrary to law) that included a request for fees and costs. Taxpayer filed a motion for summary judgment. The Department failed to respond to the motion, but abated the assessment. After abatement, Taxpayer renewed its request for costs and fees. The Department denied Taxpayer was entitled to its costs and fees claiming that Taxpayer was not the prevailing party because the Department abated the assessment before the Hearing Officer rendered a decision on the merits. The Hearing Officer rejected the Department's argument and awarded Taxpayer $50,000.00 for costs and fees.

No. 17-25. Louie Casais:

Taxpayer operated a trucking company as a sole proprietorship for many years. In 2003, on the advice of his accountant, Taxpayer formed a limited liability company to own and operate the business. Taxpayer was audited by the Department. The Department determined that Taxpayer owed several hundred thousand dollars in unpaid gross receipts tax and issued an assessment against Taxpayer. Taxpayer protested the assessment. The Department issued a partial abatement of the assessment and Taxpayer withdrew his protest (effectively admitting conclusive liability for the balance of the assessment). Subsequently, before the assessment was paid, Taxpayer ceased all business operations. The Department filed a Claim of Tax Lien against Taxpayer personally for the remaining tax due, penalty, and interest. Taxpayer filed a second protest, this time claiming that the lien should not have been filed against him personally because the business was operated through the limited liability company. The Hearing Officer rejected the Taxpayer's argument finding, among other things, that Taxpayer was unable to establish that the business was transferred to the limited liability company and that the Taxpayer had already admitted conclusive liability under the assessment. The Hearing Officer denied the second protest.

No. 17-29: Ptolemy

Taxpayer, an individual, engaged in cattle operation on a part time basis in New Mexico and Colorado. Taxpayer lost money on the operation for 5 consecutive tax years. The Department's "above the line unit" audited Taxpayer, disallowed the losses (relying on Internet Revenue Code Section 183) and assessed Taxpayer additional income tax, penalties and interest. Taxpayer protested the assessment. The Hearing Office applied the 9 factor test set forth in applicable IRS regulations and found 6 of 9 weighed in favor of Taxpayer. The Hearing Officer granted Taxpayer's protest.

No. 17-32: Martin D. Moore

The Department conducted a Schedule C audit and assessed Taxpayer gross receipts tax, penalties and interest. Taxpayer failed to timely file a protest of the assessment. The Department issued a warrant of levy. The Taxpayer protested the warrant of levy. The Hearing Officer determined that the warrant of levy was properly issued, and, quite properly, did not allow Taxpayer to argue the merits of the assessment at the protest hearing. Note: Hearing Officer took judicial notice that FYI 406 (rights of Taxpayer) *actually provided* to Taxpayer.

## Current Selected Audit Issues

### Gross receipts tax

- Deductions for sales of tangible personal property on non IRB projects
  - Conflicting regulations-IRB; Fixture; Building
  - Scope of building regulation
  - Impact of Weil Construction case

- Taxation of guaranteed payments
  - NMAC §3.2.1.14(S)(4)
  - NMSA §7-9-48
  - §1.707-1(c); Rev Rul. 66-95

- Rent vs. services for independent and assisted living facilities

- Exported services deductions (NMSA §7-9-57)
  - NTTC
  - Other Evidence

### Compensating Tax

- Imposition of compensating tax on the purchase of tangibles that are not incorporated into a construction project
- PLR 405-94-2

### Income Tax

- Above the line income tax deductions for certain businesses
  - Holt Case
  - IRC §183.

7-9-77.1. Deduction; gross receipts tax; certain medical and health care services.

A. Receipts of a health care practitioner from payments by the United States government or any agency thereof for provision of medical and other health services by a health care practitioner or of medical or other health and palliative services by hospices or nursing homes to medicare beneficiaries pursuant to the provisions of Title 18 of the federal Social Security Act may be deducted from gross receipts.

B. Receipts of a health care practitioner from payments by a third-party administrator of the federal TRICARE program for provision of medical and other health services by medical doctors and osteopathic physicians to covered beneficiaries may be deducted from gross receipts.

C. Receipts of a health care practitioner from payments by or on behalf of the Indian health service of the United States department of health and human services for provision of medical and other health services by medical doctors and osteopathic physicians to covered beneficiaries may be deducted from gross receipts.

D. Receipts of a clinical laboratory from payments by the United States government or any agency thereof for medical services provided by the clinical laboratory to medicare beneficiaries pursuant to the provisions of Title 18 of the federal Social Security Act may be deducted from gross receipts.

E. Receipts of a home health agency from payments by the United States government or any agency thereof for medical, other health and palliative services provided by the home health agency to medicare beneficiaries pursuant to the provisions of Title 18 of the federal Social Security Act may be deducted from gross receipts.

F. Prior to July 1, 2024, receipts of a dialysis facility from payments by the United States government or any agency thereof for medical and other health services provided by the dialysis facility to medicare beneficiaries pursuant to the provisions of Title 18 of the federal Social Security Act may be deducted from gross receipts.

G. A taxpayer allowed a deduction pursuant to this section shall report the amount of the deduction separately in a manner required by the department. A taxpayer who has receipts that are deductible pursuant to this section and Section 7-9-93 NMSA 1978 shall deduct the receipts under this section prior to calculating the receipts that may be deducted pursuant to Section 7-9-93 NMSA 1978.

H. The department shall compile an annual report on the deductions created pursuant to this section that shall include the number of taxpayers approved by the department to receive each deduction, the aggregate amount of deductions approved and any other information necessary to evaluate the effectiveness of the deductions. The department shall compile and present the annual

reports to the revenue stabilization and tax policy committee and the legislative finance committee with an analysis of the effectiveness and cost of the deductions and whether the deductions are providing a benefit to the state.

**I.** For the purposes of this section:

**(1)** "clinical laboratory" means a laboratory accredited pursuant to 42 USCA 263a;

**(2)** "dialysis facility" means an end-stage renal disease facility as defined pursuant to 42 C.F.R. 405.2102;

**(3)** "health care practitioner" means:

**(a)** an athletic trainer licensed pursuant to the Athletic Trainer Practice Act;

**(b)** an audiologist licensed pursuant to the Speech-Language Pathology, Audiology and Hearing Aid Dispensing Practices Act;

**(c)** a chiropractic physician licensed pursuant to the Chiropractic Physician Practice Act;

**(d)** a counselor or therapist practitioner licensed pursuant to the Counseling and Therapy Practice Act;

**(e)** a dentist licensed pursuant to the Dental Health Care Act;

**(f)** a doctor of oriental medicine licensed pursuant to the Acupuncture and Oriental Medicine Practice Act;

**(g)** an independent social worker licensed pursuant to the Social Work Practice Act; (h) a massage therapist licensed pursuant to the Massage Therapy Practice Act;

**(h)** a massage therapist licensed pursuant to the Massage Therapy Practice Act;

**(i)** a naprapath licensed pursuant to the Naprapathic Practice Act;

**(j)** a nutritionist or dietitian licensed pursuant to the Nutrition and Dietetics Practice Act;

**(k)** an occupational therapist licensed pursuant to the Occupational Therapy Act;

**(l)** an optometrist licensed pursuant to the Optometry Act;

**(m)** an osteopathic physician licensed pursuant to the Osteopathic Medicine Act;

**(n)** a pharmacist licensed pursuant to the Pharmacy Act;

**(o)** a physical therapist licensed pursuant to Physical Therapy Act;

(p) a physician licensed pursuant to the Medical Practice Act;

(q) a podiatrist licensed pursuant to the Podiatry Act;

(r) a psychologist licensed pursuant to the Professional Psychologist Act;

(s) a radiologic technologist licensed pursuant to the Medical Imaging and Radiation Therapy Health and Safety Act;

(t) a registered nurse licensed pursuant to the Nursing Practice Act;

(u) a respiratory care practitioner licensed pursuant to the Respiratory Care Act; and

(v) a speech-language pathologist licensed pursuant to the Speech-Language Pathology, Audiology and Hearing Aid Dispensing Practices Act;

(4) "home health agency" means a for-profit entity that is licensed by the department of health and certified by the federal centers for medicare and medicaid services as a home health agency and certified to provide medicare services;

(5) "hospice" means a for-profit entity licensed by the department of health as a hospice and certified to provide medicare services;

(6) "nursing home" means a for-profit entity licensed by the department of health as a nursing home and certified to provide medicare services; and

(7) "TRICARE program" means the program defined in 10 U.S.C. 1072(7).

**HISTORY:**

1978 Comp., § 7-9-77.1, enacted by Laws 1998, ch. 96, § 1; 2000 (2nd S.S.), ch. 16, § 1; 2003, ch. 350, § 1; 2003, ch. 351, § 1; 2005, ch. 91, § 1; 2007, ch. 361, § 4; 2014, ch. 56, § 1; 2016 (2nd S.S.), ch. 3, § 4.

**Amendment Notes.**

**The 2014 amendment,** effective July 1, 2014, added F through H and I(6); redesignated former F and F(6) through F(26) as I and I(7) through I(27); and substituted "Chapter 61, Article 12F NMSA 1978" for "Chapter 61, Article 12E NMSA 1978" in I(12).

**The 2016 (2nd S.S.) amendment,** effective Nov. 1, 2016, rewrote A, F and I; added "of a health care practitioner" in B and C; added "of a clinical laboratory" in D; added "of a home health agency" in E; added the second sentence of G; deleted "Beginning in 2020 and every five years thereafter that this section is in effect" at the beginning of the second sentence of H; and made stylistic changes.

7-9-93. Deduction; gross receipts; certain receipts for services provided by health care practitioner.

A. Receipts of a health care practitioner for commercial contract services or medicare part C services paid by a managed health care provider or health care insurer may be deducted from gross receipts if the services are within the scope of practice of the health care practitioner providing the service. Receipts from fee-for-service payments by a health care insurer may not be deducted from gross receipts.

B. The deduction provided by this section shall be applied only to gross receipts remaining after all other allowable deductions available under the Gross Receipts and Compensating Tax Act have been taken and shall be separately stated by the taxpayer.

C. For the purposes of this section:

(1) "commercial contract services" means health care services performed by a health care practitioner pursuant to a contract with a managed health care provider or health care insurer other than those health care services provided for medicare patients pursuant to Title 18 of the federal Social Security Act or for medicaid patients pursuant to Title 19 or Title 21 of the federal Social Security Act;

(2) "health care insurer" means a person that:

(a) has a valid certificate of authority in good standing pursuant to the New Mexico Insurance Code to act as an insurer, health maintenance organization or nonprofit health care plan or prepaid dental plan; and

(b) contracts to reimburse licensed health care practitioners for providing basic health services to enrollees at negotiated fee rates;

(3) "health care practitioner" means:

(a) a chiropractic physician licensed pursuant to the provisions of the Chiropractic Physician Practice Act;

(b) a dentist or dental hygienist licensed pursuant to the Dental Health Care Act;

(c) a doctor of oriental medicine licensed pursuant to the provisions of the Acupuncture and Oriental Medicine Practice Act;

(d) an optometrist licensed pursuant to the provisions of the Optometry Act;

(e) an osteopathic physician or an osteopathic physician's assistant licensed pursuant to the provisions of the Osteopathic Medicine Act;

**(f)** a physical therapist licensed pursuant to the provisions of the Physical Therapy Act;

**(g)** a physician or physician assistant licensed pursuant to the provisions of the Medical Practice Act;

**(h)** a podiatrist licensed pursuant to the provisions of the Podiatry Act;

**(i)** a psychologist licensed pursuant to the provisions of the Professional Psychologist Act;

**(j)** a registered lay midwife registered by the department of health;

**(k)** a registered nurse or licensed practical nurse licensed pursuant to the provisions of the Nursing Practice Act;

**(l)** a registered occupational therapist licensed pursuant to the provisions of the Occupational Therapy Act;

**(m)** a respiratory care practitioner licensed pursuant to the provisions of the Respiratory Care Act;

**(n)** a speech-language pathologist or audiologist licensed pursuant to the Speech-Language Pathology, Audiology and Hearing Aid Dispensing Practices Act;

**(o)** a professional clinical mental health counselor, marriage and family therapist or professional art therapist licensed pursuant to the provisions of the Counseling and Therapy Practice Act who has obtained a master's degree or a doctorate;

**(p)** an independent social worker licensed pursuant to the provisions of the Social Work Practice Act; and

**(q)** a clinical laboratory that is accredited pursuant to 42 U.S.C. Section 263a but that is not a laboratory in a physician's office or in a hospital defined pursuant to 42 U.S.C. Section 1395x;

**(4)** "managed health care provider" means a person that provides for the delivery of comprehensive basic health care services and medically necessary services to individuals enrolled in a plan through its own employed health care providers or by contracting with selected or participating health care providers. "Managed health care provider" includes only those persons that provide comprehensive basic health care services to enrollees on a contract basis, including the following:

**(a)** health maintenance organizations;

(b) preferred provider organizations;

(c) individual practice associations;

(d) competitive medical plans;

(e) exclusive provider organizations;

(f) integrated delivery systems;

(g) independent physician-provider organizations;

(h) physician hospital-provider organizations; and

(i) managed care services organizations; and

(5) "medicare part C services" means services performed pursuant to a contract with a managed health care provider for medicare patients pursuant to Title 18 of the federal Social Security Act.

**HISTORY:**

1978 Comp., § 7-9-93, enacted by Laws 2004, ch. 116, § 6; 2006, ch. 36, § 1; 2007, ch. 361, § 5; 2016 (2nd S.S.), ch. 3, § 5.

**Effective dates.**

Laws 2004, ch. 116, § 8 makes the act effective January 1, 2005.

**Amendment Notes.**

**The 2016 (2nd S.S.) amendment,** effective Nov. 1, 2016, rewrote the first sentence of A, which formerly read: "Receipts from payments by a managed health care provider or health care insurer for commercial contract services or medicare part C services provided by a health care practitioner that are not otherwise deductible pursuant to another provision of the Gross Receipts and Compensating Tax Act may be deducted from gross receipts provided that the services are within the scope of practice of the person providing the service; redesignated the former last sentence of A as B; added "applied only to gross receipts remaining after all other allowable deductions available under the Gross Receipts and Compensating Tax Act have been taken and shall be" in B; redesignated former B as C; in C(3)(e), deleted "licensed pursuant to the provisions of Chapter 61, Article 10 NMSA 1978" preceding "or an osteopathic physician's assistant" and substituted "Osteopathic Medicine Act" for "Osteopathic Physicians' Assistants Act"; and substituted "the Medical Practice Act" for "Chapter 61, Article 6 NMSA 1978" in C(3)(g).

# NEW MEXICO BULLETIN

TAXATION & REVENUE
NEW MEXICO

## Clarification of Amendments to Deductions from Gross Receipts for Certain Medical Services

*2016 Special Session Legislation*

Amendments to the Gross Receipts and Compensating Tax Act, passed by the New Mexico Legislature in Senate Bill 6 in the 2016 Special Session and signed into law by Governor Martinez, became effective on November 1, 2016. This publication addresses the changes to clear up any resulting confusion.

Section 7-9-77.1 NMSA 1978 provides a deduction from gross receipts for certain medical and health care services. Section 7-9-93 NMSA 1978 provides a deduction from gross receipts for certain receipts for services provided by a health care practitioner.

Senate Bill 6 amended both of these Sections to clarify that receipts eligible for either of these deductions **must** be the receipts of a "health care practitioner." These changes legislatively reverse a Decision and Order (D&O) issued by the Administrative Hearings Office, 16-16 HealthSouth Rehabilitation (May 11, 2016), in which a for-profit hospital was allowed to take the deduction provided by Section 7-9-93 NMSA 1978 because of a perceived gray area in the language of the statute at that time.

Prior to the HealthSouth D&O, the Taxation and Revenue Department had consistently taken the position that these deductions were for only the receipts of a health care practitioner. Thus, the SB 6 amendments do not change, but rather reinstate, the Department's historic interpretation of the law. The bill was not intended to, and does not affect, the deductions under Sections 7-9-77.1 and 7-9-93 NMSA 1978 for receipts of physicians, osteopaths or other health care practitioners who practice as sole proprietors.

The bill does not affect the deductions under Sections 7-9-77.1 and 7-9-93 NMSA 1978 for receipts of corporations, limited liability companies, partnerships and other legal entities from the provision of otherwise qualifying health care services provided by physicians, osteopaths or other health care practitioners who own and are employed by the legal entity. The numerous regulations in place under Section 7-9-93 NMSA 1978 remain in place and are effective as they were always in line with the Department's interpretation of the Section.

**New Mexico Taxation and Revenue Department**
**P.O. Box 630**
**Santa Fe, NM 87504-0630**

B-200.30
New 7/2017

# BULLETIN

B-200.30

Visit the Department's web site at http://www.tax.newmexico.gov for forms and instructions.

**ALBUQUERQUE (505) 841-6200**
Taxation and Revenue Department
5301 Central NE
P.O. Box 8485
Albuquerque, NM 87198-8485

**SANTA FE (505) 827-0951**
Taxation and Revenue Department
Manuel Lujan Sr. Bldg.
1200 S. St. Francis Dr.
P.O. Box 5374
Santa Fe, NM 87502-5374

**FARMINGTON (505) 325-5049**
Taxation and Revenue Department
3501 E. Main St., Suite N
P.O. Box 479
Farmington, NM 87499-0479

**LAS CRUCES (575) 524-6225**
Taxation and Revenue Department
2540 S. El Paseo Bldg. #2
P.O. Box 607
Las Cruces, NM 88004-0607

**ALAMOGORDO (575) 437-2322**
**SILVER CITY (575) 388-4403**
**(above calls transfer to Las Cruces office)**

**ROSWELL (575) 624-6065**
Taxation and Revenue Department
400 Pennsylvania Ave., Suite 200
P.O. Box 1557
Roswell, NM 88202-1557

Main Switchboard: (505) 827-0700 (Santa Fe)

**General Information.** FYIs and Bulletins present general information with a minimum of technical language. All FYIs and Bulletins may be obtained without charge from all local tax offices, the Tax Information and Policy Office in Santa Fe and the Department's Internet site.

**This information is as accurate as possible at time of publication. Subsequent legislation, new state regulations and case law may affect its accuracy. For the latest information please check the Taxation and Revenue Department's web site at www.tax.newmexico.gov.**

**This publication provides instructions or general information to the taxpayer. It does not constitute a regulation or ruling as defined under Section 7-1-60, *New Mexico Statutes Annotated*, 1978. Taxpayers and preparers are responsible for being aware of New Mexico tax laws and rules. Consult the Department directly if you have questions or concerns about information provided in this Bulletin.**

**7-1-21. Installment payments of taxes; installment agreements. [Effective until June 16, 2017]**

**A.** Whenever justified by the circumstances, the secretary or the secretary's delegate may enter into a written agreement with a taxpayer in which the taxpayer admits conclusive liability for the entire amount of taxes due and agrees to make monthly installment payments according to the terms of the agreement, but not for a period longer than sixty months. No installment agreement shall prevent the accrual of interest otherwise provided by law.

**B.** The agreement provided for in this section is to be known as an "installment agreement". If entered into after a court acquires jurisdiction over the matter, the agreement shall be part of a stipulated order or judgment disposing of the case.

**C.** At the time of entering into an installment agreement, the secretary shall require the affected taxpayer or person to furnish security for payment of the taxes admitted to be due according to the terms of the agreement, but if the taxpayer does not provide security, the secretary shall cause a notice of lien to be filed in accordance with the provisions of Section 7-1-38 NMSA 1978, and when so filed it shall constitute a lien upon all the property or rights to property of the taxpayer in that county in the same manner as in the case of the lien provided for in Section 7-1-37 NMSA 1978.

**D.** An installment agreement is conclusive as to liability for payment of the amount of taxes specified therein but does not preclude the assessment of any additional tax.

**E.** After entering into the agreement, except in unusual circumstances as require the secretary in his discretion to take further action to protect the interests of the state, no further attempts to enforce payment of the tax by levy or injunction shall be made; however, if installment payments are not made on or before the times specified in the agreement, if any other condition contained in the agreement is not met or if the taxpayer does not make payment of all other taxes for which he becomes liable as they are due, the secretary may proceed to enforce collection of the tax as if the agreement had not been made or may proceed, as provided in Section 7-1-54 NMSA 1978, against the security furnished.

**F.** Records of installment agreements in excess of one thousand dollars ($1,000) shall be available for inspection by the public. The department shall keep the records for a minimum of three years from the date of the installment agreement.

**7-1-21. Installment payments of taxes; installment agreements. [Effective June 16, 2017]**

**A.** Whenever justified by the circumstances, the secretary or the secretary's delegate may enter into a written agreement with a taxpayer in which the taxpayer admits conclusive liability for the entire amount of taxes due and agrees to make monthly installment payments according to the terms of the agreement, but not for a period longer than seventy-two months. No installment agreement shall prevent the accrual of interest otherwise provided by law.

**B.** The agreement provided for in this section is to be known as an "installment agreement". If entered into after a court acquires jurisdiction over the matter, the agreement shall be part of a stipulated order or judgment disposing of the case.

**C.** At the time of entering into an installment agreement, the secretary shall require the affected taxpayer or person to furnish security for payment of the taxes admitted to be due according to the terms of the agreement, but if the taxpayer does not provide security, the secretary shall cause a notice of lien to be filed in accordance with the provisions of Section 7-1-38 NMSA 1978, and when so filed it shall constitute a lien upon all the property or rights to property of the taxpayer in that county in the same manner as in the case of the lien provided for in Section 7-1-37 NMSA 1978.

**D.** An installment agreement is conclusive as to liability for payment of the amount of taxes specified therein but does not preclude the assessment of any additional tax.

**E.** After entering into the agreement, except in unusual circumstances as require the secretary in the secretary's discretion to take further action to protect the interests of the state, no further attempts to enforce payment of the tax by levy or injunction shall be made; however, if installment payments are not made on or before the times specified in the agreement, if any other condition contained in the agreement is not met or if the taxpayer does not make payment of all other taxes for which the taxpayer becomes liable as they are due, the secretary may proceed to enforce collection of the tax as if the agreement had not been made or may proceed, as provided in Section 7-1-54 NMSA 1978, against the security furnished.

**F.** Records of installment agreements in excess of one thousand dollars ($1,000) shall be available for inspection by the public. The department shall keep the records for a minimum of three years from the date of the installment agreement.

**7-1-23. Disputing liabilities; election of remedies. [Effective until June 16, 2017]**

Any taxpayer must elect to dispute the taxpayer's liability for the payment of taxes either by protesting the assessment thereof as provided in Section 7-1-24 NMSA 1978 without making payment or by claiming a refund thereof as provided in Section 7-1-26 NMSA 1978 after making payment. The pursuit of one of the two remedies described herein constitutes an unconditional waiver of the right to pursue the other.

**7-1-23. Disputing liabilities; election of remedies. [Effective June 16, 2017]**

Any taxpayer must elect to dispute the taxpayer's liability for the payment of taxes either by protesting the assessment thereof as provided in Section 7-1-24 NMSA 1978 without making payment of the disputed tax liability or by claiming a refund thereof as provided in Section 7-1-26 NMSA 1978 after making payment of the disputed tax liability. The pursuit of one of the two remedies described herein constitutes an unconditional waiver of the right to pursue the other.

**7-1-24. Disputing liabilities; administrative protest. [Effective until June 16, 2017]**

**A.** A taxpayer may dispute:

**(1)** the assessment to the taxpayer of any amount of tax;

**(2)** the application to the taxpayer of any provision of the Tax Administration Act except the issuance of a subpoena or summons; or

**(3)** the denial of or failure either to allow or to deny a:

**(a)** credit or rebate; or

**(b)** claim for refund made in accordance with Section 7-1-26 NMSA 1978.

**B.** The taxpayer may dispute a matter described in Subsection A of this section by filing with the secretary a written protest. Every protest shall identify the taxpayer and the tax credit, rebate, property or provision of the Tax Administration Act involved and state the grounds for the taxpayer's protest and the affirmative relief requested. The statement of grounds for protest shall specify individual grounds upon which the protest is based and a summary statement of the evidence, if any, expected to be produced supporting each ground asserted; provided that the taxpayer may supplement the statement at any time prior to ten days before the hearing conducted on the protest pursuant to the provisions of the Administrative Hearings Office Act or, if a scheduling order has been issued, in accordance with the scheduling order. The secretary may, in appropriate cases, provide for an informal conference before a hearing of the protest is set by the administrative hearings office or before acting on a claim for refund. In the case of an assessment of tax by the department, a protest may be filed without making payment of the amount assessed.

C. A protest by a taxpayer shall be filed within ninety days of the date of the mailing to or service upon the taxpayer by the department of the notice of assessment or other peremptory notice or demand, the date of mailing or filing a return, the date of the application to the taxpayer of the applicable provision of the Tax Administration Act, the date of denial of a claim pursuant to Section 7-1-26 NMSA 1978 or the last date upon which the department was required to take action on the claim but failed to take action. If a protest is not filed within the time required, the secretary may proceed to enforce collection of any tax if the taxpayer is delinquent within the meaning of Section 7-1-16 NMSA 1978. The fact that the department did not mail the assessment or other peremptory notice or demand by certified or registered mail or otherwise demand and receive acknowledgment of receipt by the taxpayer shall not be deemed to demonstrate the taxpayer's inability to protest within the required time.

D. No proceedings other than those to enforce collection of an amount assessed as tax and to protect the interest of the state by injunction, as provided in Sections 7-1-31, 7-1-33, 7-1-34,

7-1-40, 7-1-53, 7-1-56 and 7-1-58 NMSA 1978, are stayed by timely filing of a protest pursuant to the provisions of this section.

E. Nothing in this section shall be construed to authorize a criminal proceeding or to authorize an administrative protest of the issuance of a subpoena or summons.

**7-1-24. Disputing liabilities; administrative protest. [Effective June 16, 2017]**

A. A taxpayer may dispute:

(1) the assessment to the taxpayer of any amount of tax;

(2) the application to the taxpayer of any provision of the Tax Administration Act except the issuance of a subpoena or summons; or

(3) the denial of or failure either to allow or to deny a:

(a) credit or rebate; or

(b) claim for refund made in accordance with Section 7-1-26 NMSA 1978.

B. The taxpayer may dispute a matter described in Subsection A of this section by filing with the secretary a written protest. Every protest shall identify the taxpayer and the tax credit, rebate, property or provision of the Tax Administration Act involved and state the grounds for the taxpayer's protest and the affirmative relief requested. The statement of grounds for protest shall specify individual grounds upon which the protest is based and evidence supporting each ground asserted; provided that the taxpayer may supplement the statement at any time prior to ten days before the hearing conducted on the protest pursuant to the provisions of the Administrative Hearings Office Act or, if a scheduling order has been issued, in accordance with the scheduling order. The secretary may, in appropriate cases, provide for an informal conference before a hearing of the protest is set by the administrative hearings office or before acting on a claim for refund.

C. In the case of an assessment of tax by the department, a protest may be filed without making payment of the amount assessed; provided that, if only a portion of the assessment is in dispute, any unprotested amounts of tax, interest or penalty shall be paid, or, if applicable, an installment agreement pursuant to Section 7-1-21 NMSA 1978 shall be entered into for the unprotested amounts, on or before the due date for the protest.

D. A protest by a taxpayer shall be filed within ninety days of the date of the mailing to or service upon the taxpayer by the department of the notice of assessment or other peremptory notice or demand, the date of mailing or filing a return, the date of the application to the taxpayer of the applicable provision of the Tax Administration Act, the date of denial of a claim pursuant to Section 7-1-26 NMSA 1978 or the last date upon which the department was required to take

action on the claim but failed to take action.

E. If a protest to a notice of assessment is not filed within the time required:

(1) the amount of tax determined to be due becomes final;

(2) the taxpayer is deemed to have waived and abandoned the right to question the amount of tax determined to be due, unless the taxpayer pays the tax and claims a refund of the tax pursuant to Section 7-1-26 NMSA 1978; and

(3) the secretary may proceed to enforce collection of any tax if the taxpayer is delinquent within the meaning of Section 7-1-16 NMSA 1978.

F. The fact that the department did not mail the assessment or other peremptory notice or demand by certified or registered mail or otherwise demand and receive acknowledgment of receipt by the taxpayer shall not be deemed to demonstrate the taxpayer's inability to protest within the required time.

G. No proceedings other than those to enforce collection of an amount assessed as tax and to protect the interest of the state by injunction, as provided in Sections 7-1-31, 7-1-33, 7-1-34, 7-1-40, 7-1-53, 7-1-56 and 7-1-58 NMSA 1978, are stayed by timely filing of a protest pursuant to the provisions of this section.

H. Nothing in this section shall be construed to authorize a criminal proceeding or to authorize an administrative protest of the issuance of a subpoena or summons.

**7-1-26. Disputing liabilities; claim for credit, rebate or refund. [Effective until June 16, 2017]**

**A.** A person who believes that an amount of tax has been paid by or withheld from that person in excess of that for which the person was liable, who has been denied any credit or rebate claimed or who claims a prior right to property in the possession of the department pursuant to a levy made under authority of Sections 7-1-31 through 7-1-34 NMSA 1978 may claim a refund by directing to the secretary, within the time limited by the provisions of Subsections D and E of this section, a written claim for refund. Except as provided in Subsection I of this section, a refund claim shall include:

**(1)** the taxpayer's name, address and identification number;

**(2)** the type of tax for which a refund is being claimed, the credit or rebate denied or the property levied upon;

**(3)** the sum of money or other property being claimed;

**(4)** with respect to refund, the period for which overpayment was made; and

**(5)** a brief statement of the facts and the law on which the claim is based, which may be referred to as the "basis for the refund".

**B.** The secretary or the secretary's delegate may allow the claim in whole or in part or may deny the claim.

**(1)** If the claim is denied in whole or in part in writing, no claim may be refiled with respect to that which was denied, but the person, within ninety days after either the mailing or delivery of the denial of all or any part of the claim, may elect to pursue one, but not more than one, of the remedies in Subsection C of this section.

**(2)** If the department has neither granted nor denied any portion of a claim for refund within one hundred twenty days of the date the claim was mailed or delivered to the department, the person may refile it within the time limits set forth in Subsection D of this section or may within ninety days elect to pursue one, but only one, of the remedies in Subsection C of this section. After the expiration of the two hundred ten days from the date the claim was mailed or delivered to the department, the department may not approve or disapprove the claim unless the person has pursued one of the remedies under Subsection C of this section.

**C.** A person may elect to pursue no more than one of the remedies in Paragraphs (1) and (2) of this subsection. A person who timely pursues more than one remedy shall be deemed to have elected the first remedy invoked. The person may:

**(1)** direct to the secretary, pursuant to the provisions of Section 7-1-24 NMSA 1978, a written protest that shall set forth:

**(a)** the circumstances of: 1) an alleged overpayment; 2) a denied credit; 3) a denied rebate; or 4) a denial of a prior right to property levied upon by the department;

**(b)** an allegation that, because of that overpayment or denial, the state is indebted to the taxpayer for a specified amount, including any allowed interest, or for the property;

**(c)** demanding the refund to the taxpayer of that amount or that property; and

**(d)** reciting the facts of the claim for refund; or

**(2)** commence a civil action in the district court for Santa Fe county by filing a complaint setting forth the circumstance of the claimed overpayment, denied credit or rebate or denial of a prior right to property levied upon by the department alleging that on account thereof the state is indebted to the plaintiff in the amount or property stated, together with any interest allowable, demanding the refund to the plaintiff of that amount or property and reciting the facts of the claim for refund. The plaintiff or the secretary may appeal from any final decision or order of the district court to the court of appeals.

**D.** Except as otherwise provided in Subsection E of this section, no credit or refund of any amount may be allowed or made to any person unless as the result of a claim made by that person as provided in this section:

**(1)** within three years of the end of the calendar year in which:

**(a)** the payment was originally due or the overpayment resulted from an assessment by the department pursuant to Section 7-1-17 NMSA 1978, whichever is later;

**(b)** the final determination of value occurs with respect to any overpayment that resulted from a disapproval by any agency of the United States or the state of New Mexico or any court of increase in value of a product subject to taxation under the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act or the Natural Gas Processors Tax Act;

**(c)** property was levied upon pursuant to the provisions of the Tax Administration Act; or

**(d)** an overpayment of New Mexico tax resulted from: 1) an internal revenue service audit adjustment or a federal refund paid due to an adjustment of an audit by the internal revenue service or an amended federal return; or 2) making a change to a federal return for which federal approval is required by the Internal Revenue Code;

(2) when an amount of a claim for credit under the provisions of the Investment Credit Act, Laboratory Partnership with Small Business Tax Credit Act or Technology Jobs Tax Credit Act or for the rural job tax credit pursuant to Section 7-2E-1.1 NMSA 1978 or similar credit has been denied, the taxpayer may claim a refund of the credit no later than one year after the date of the denial;

(3) when a taxpayer under audit by the department has signed a waiver of the limitation on assessments on or after July 1, 1993 pursuant to Subsection F of Section 7-1-18 NMSA 1978, the taxpayer may file a claim for refund of the same tax paid for the same period for which the waiver was given, until a date one year after the later of the date of the mailing of an assessment issued pursuant to the audit, the date of the mailing of final audit findings to the taxpayer or the date a proceeding is begun in court by the department with respect to the same tax and the same period;

(4) if the payment of an amount of tax was not made within three years of the end of the calendar year in which the original due date of the tax or date of the assessment of the department occurred, a claim for refund of that amount of tax can be made within one year of the date on which the tax was paid; or

(5) when a taxpayer has been assessed a tax on or after July 1, 1993 under Subsection B, C or D of Section 7-1-18 NMSA 1978 and when the assessment applies to a period ending at least three years prior to the beginning of the year in which the assessment was made, the taxpayer may claim a refund for the same tax for the period of the assessment or for any period following that period within one year of the date of the assessment unless a longer period for claiming a refund is provided in this section.

**E.** No credit or refund shall be allowed or made to any person claiming a refund of gasoline tax under Section 7-13-11 NMSA 1978 unless notice of the destruction of the gasoline was given the department within thirty days of the actual destruction and the claim for refund is made within six months of the date of destruction. No credit or refund shall be allowed or made to any person claiming a refund of gasoline tax under Section 7-13-17 NMSA 1978 unless the refund is claimed within six months of the date of purchase of the gasoline and the gasoline has been used at the time the claim for refund is made.

**F.** If as a result of an audit by the department or a managed audit covering multiple periods an overpayment of tax is found in any period under the audit, that overpayment may be credited against an underpayment of the same tax found in another period under audit pursuant to Section 7-1-29 NMSA 1978, provided that the taxpayer files a claim for refund for the overpayments identified in the audit.

**G.** Any refund of tax paid under any tax or tax act administered under Subsection B of Section 7-1-2 NMSA 1978 may be made, at the discretion of the department, in the form of

credit against future tax payments if future tax liabilities in an amount at least equal to the credit amount reasonably may be expected to become due.

**H.** For the purposes of this section, "oil and gas tax return" means a return reporting tax due with respect to oil, natural gas, liquid hydrocarbons, carbon dioxide, helium or nonhydrocarbon gas pursuant to the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act, the Natural Gas Processors Tax Act or the Oil and Gas Production Equipment Ad Valorem Tax Act.

**I.** The filing of a fully completed original income tax return, corporate income tax return, corporate income and franchise tax return, estate tax return or special fuel excise tax return that shows a balance due the taxpayer or a fully completed amended income tax return, an amended corporate income tax return, an amended corporate income and franchise tax return, an amended estate tax return, an amended special fuel excise tax return or an amended oil and gas tax return that shows a lesser tax liability than the original return constitutes the filing of a claim for refund for the difference in tax due shown on the original and amended returns.

**7-1-26. Disputing liabilities; claim for credit, rebate or refund. [Effective June 16, 2017]**

**A.** A person who believes that an amount of tax has been paid by or withheld from that person in excess of that for which the person was liable, who has been denied any credit or rebate claimed or who claims a prior right to property in the possession of the department pursuant to a levy made under authority of Sections 7-1-31 through 7-1-34 NMSA 1978 may claim a refund by directing to the secretary, within the time limited by the provisions of Subsections F and G of this section, a written claim for refund. At the time the written claim is submitted, except as provided in Subsection K of this section, a refund claim shall include:

**(1)** the taxpayer's name, address and identification number;

**(2)** the type of tax for which a refund is being claimed, the credit or rebate denied or the property levied upon;

**(3)** the sum of money or other property being claimed;

**(4)** with respect to refund, the period for which overpayment was made;

**(5)** a brief statement of the facts and the law on which the claim is based, which may be referred to as the "basis for the refund", which shall include documentation that substantiates the written claim and supports the taxpayer's basis for the refund; and

**(6)** a copy of an amended return for each tax period for which the refund is claimed.

**B.** A claim for refund that meets the requirements of Subsection A of this section shall be deemed to be properly before the department for consideration, regardless of whether the

department requests additional documentation after receipt of the claim for refund; provided that the claim for refund is filed within the time limitations provided in Subsections F and G of this section.

C. If the department requests additional relevant documentation from a taxpayer who has submitted a claim for refund, the claim for refund will not be considered complete until the taxpayer provides the requested documentation. The provisions of Paragraph (2) of Subsection D of this section and of Section 7-1-68 NMSA 1978 do not apply until a refund claim is complete.

**D.** The secretary or the secretary's delegate may allow the claim in whole or in part or may deny the claim. If the:

**(1)** claim is denied in whole or in part in writing, no claim may be refiled with respect to that which was denied, but the person, within ninety days after either the mailing or delivery of the denial of all or any part of the claim, may elect to pursue one, but not more than one, of the remedies in Subsection E of this section; and

**(2)** department has neither granted nor denied any portion of a complete claim for refund within one hundred eighty days of the date the claim was mailed or otherwise delivered to the department, the person may elect to treat the claim as denied and elect to pursue one, but not more than one, of the remedies provided in Subsection D of this section.

**E.** A person may elect to pursue no more than one of the remedies in Paragraphs (1) and (2) of this subsection. A person who timely pursues more than one remedy shall be deemed to have elected the first remedy invoked. The person may:

**(1)** direct to the secretary, pursuant to the provisions of Section 7-1-24 NMSA 1978, a written protest that shall set forth:

**(a)** the circumstances of: 1) an alleged overpayment; 2) a denied credit; 3) a denied rebate; or 4) a denial of a prior right to property levied upon by the department;

**(b)** an allegation that, because of that overpayment or denial, the state is indebted to the taxpayer for a specified amount, including any allowed interest, or for the property;

**(c)** demanding the refund to the taxpayer of that amount or that property; and

**(d)** reciting the facts of the claim for refund; or

**(2)** commence a civil action in the district court for Santa Fe county by filing a complaint setting forth the circumstance of the claimed overpayment, denied credit or rebate or denial of a prior right to property levied upon by the department alleging that on account thereof the state is indebted to the plaintiff in the amount or property stated, together with any interest allowable, demanding the refund to the plaintiff of that amount or property and reciting the facts of the claim for refund. The plaintiff or the secretary may appeal from any final decision or order of the

district court to the court of appeals.

**F.** Except as otherwise provided in Subsection G of this section, no credit or refund of any amount may be allowed or made to any person unless as the result of a claim made by that person as provided in this section:

**(1)** within three years of the end of the calendar year in which:

**(a)** the payment was originally due or the overpayment resulted from an assessment by the department pursuant to Section 7-1-17 NMSA 1978, whichever is later;

**(b)** the final determination of value occurs with respect to any overpayment that resulted from a disapproval by any agency of the United States or the state of New Mexico or any court of increase in value of a product subject to taxation under the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act or the Natural Gas Processors Tax Act;

**(c)** property was levied upon pursuant to the provisions of the Tax Administration Act; or

**(d)** an overpayment of New Mexico tax resulted from: 1) an internal revenue service audit adjustment or a federal refund paid due to an adjustment of an audit by the internal revenue service or an amended federal return; or 2) making a change to a federal return for which federal approval is required by the Internal Revenue Code;

**(2)** when an amount of a claim for credit under the provisions of the Investment Credit Act, Laboratory Partnership with Small Business Tax Credit Act or Technology Jobs and Research and Development Tax Credit Act or for the rural job tax credit pursuant to Section 7-2E-1.1 NMSA 1978 or similar credit has been denied, the taxpayer may claim a refund of the credit no later than one year after the date of the denial;

**(3)** when a taxpayer under audit by the department has signed a waiver of the limitation on assessments on or after July 1, 1993 pursuant to Subsection F of Section 7-1-18 NMSA 1978, the taxpayer may file a claim for refund of the same tax paid for the same period for which the waiver was given, until a date one year after the later of the date of the mailing of an assessment issued pursuant to the audit, the date of the mailing of final audit findings to the taxpayer or the date a proceeding is begun in court by the department with respect to the same tax and the same period;

**(4)** if the payment of an amount of tax was not made within three years of the end of the calendar year in which the original due date of the tax or date of the assessment of the department occurred, a claim for refund of that amount of tax can be made within one year of the date on which the tax was paid; or

(5) when a taxpayer has been assessed a tax on or after July 1, 1993 under Subsection B, C or D of Section 7-1-18 NMSA 1978 and when the assessment applies to a period ending at least three years prior to the beginning of the year in which the assessment was made, the taxpayer may claim a refund for the same tax for the period of the assessment or for any period following that period within one year of the date of the assessment unless a longer period for claiming a refund is provided in this section.

**G.** No credit or refund shall be allowed or made to any person claiming a refund of gasoline tax under Section 7-13-11 NMSA 1978 unless notice of the destruction of the gasoline was given to the department within thirty days of the actual destruction and the claim for refund is made within six months of the date of destruction. No credit or refund shall be allowed or made to any person claiming a refund of gasoline tax under Section 7-13-17 NMSA 1978 unless the refund is claimed within six months of the date of purchase of the gasoline and the gasoline has been used at the time the claim for refund is made.

**H.** If as a result of an audit by the department or a managed audit covering multiple periods an overpayment of tax is found in any period under the audit, that overpayment may be credited against an underpayment of the same tax found in another period under audit pursuant to Section 7-1-29 NMSA 1978, provided that the taxpayer files a claim for refund for the overpayments identified in the audit.

**I.** Any refund of tax paid under any tax or tax act administered under Subsection B of Section 7-1-2 NMSA 1978 may be made, at the discretion of the department, in the form of credit against future tax payments if future tax liabilities in an amount at least equal to the credit amount reasonably may be expected to become due.

**J.** For the purposes of this section, "oil and gas tax return" means a return reporting tax due with respect to oil, natural gas, liquid hydrocarbons, carbon dioxide, helium or nonhydrocarbon gas pursuant to the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act, the Natural Gas Processors Tax Act or the Oil and Gas Production Equipment Ad Valorem Tax Act.

**K.** The filing of a fully completed original income tax return, corporate income tax return, corporate income and franchise tax return, estate tax return or special fuel excise tax return that shows a balance due the taxpayer or a fully completed amended income tax return, an amended corporate income tax return, an amended corporate income and franchise tax return, an amended estate tax return, an amended special fuel excise tax return or an amended oil and gas tax return that shows a lesser tax liability than the original return constitutes the filing of a claim for refund for the difference in tax due shown on the original and amended returns.

**7-1-68. Interest on overpayments. [Effective until June 16, 2017]**

**A.** As provided in this section, interest shall be allowed and paid on the amount of tax overpaid by a person that is subsequently refunded or credited to that person.

**B.** Interest on overpayments of tax shall accrue and be paid at the underpayment rate established pursuant to Section 6621 of the Internal Revenue Code, computed on a daily basis; provided that if a different rate is specified by a compact or other interstate agreement to which New Mexico is a party, that rate shall apply to amounts due under the compact or other agreement.

**C.** Unless otherwise provided by this section, interest on an overpayment not arising from an assessment by the department shall be paid from the date of the claim for refund until a date preceding by not more than thirty days the date of the credit or refund to any person; and interest on an overpayment arising from an assessment by the department shall be paid from the date of overpayment until a date preceding by not more than thirty days the date of the credit or refund to any person.

**D.** No interest shall be allowed or paid with respect to an amount credited or refunded if:

**(1)** the amount of interest due is less than one dollar ($1.00);

**(2)** the credit or refund is made within:

**(a)** fifty-five days of the date of the claim for refund of income tax, pursuant to either the Income Tax Act or the Corporate Income and Franchise Tax Act for the tax year immediately preceding the tax year in which the claim is made;

**(b)** sixty days of the date of the claim for refund of any tax not provided for in this paragraph;

**(c)** seventy-five days of the date of the claim for refund of gasoline tax to users of gasoline off the highways;

**(d)** one hundred twenty days of the date of the claim for refund of tax imposed pursuant to the Resources Excise Tax Act, the Severance Tax Act, the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act, the Natural Gas Processors Tax Act or the Oil and Gas Production Equipment Ad Valorem Tax Act; or

**(e)** one hundred twenty days of the date of the claim for refund of income tax, pursuant to the Income Tax Act or the Corporate Income and Franchise Tax Act, for any tax year more than one year prior to the year in which the claim is made;

(3) Sections 6611(f) and 6611(g) of the Internal Revenue Code, as those sections may be amended or renumbered, prohibit payment of interest for federal income tax purposes;

(4) the credit results from overpayments found in an audit of multiple reporting periods and applied to underpayments found in that audit or refunded as a net overpayment to the taxpayer pursuant to Section 7-1-29 NMSA 1978;

(5) the department applies the credit or refund to an intercept program, to the taxpayer's estimated payment prior to the due date for the estimated payment or to offset prior liabilities of the taxpayer pursuant to Subsection E of Section 7-1-29 NMSA 1978;

(6) the credit or refund results from overpayments the department finds pursuant to Subsection F of Section 7-1-29 NMSA 1978 that exceed the refund claimed by the taxpayer on the return; or

(7) the refund results from a tax credit pursuant to the Film Production Tax Credit Act or a high-wage jobs tax credit.

E. Nothing in this section shall be construed to require the payment of interest upon interest.

**7-1-68. Interest on overpayments. [Effective June 16, 2017]**

A. As provided in this section, interest shall be allowed and paid on the amount of tax overpaid by a person that is subsequently refunded or credited to that person.

B. Interest on overpayments of tax shall accrue and be paid at the underpayment rate established pursuant to Section 6621 of the Internal Revenue Code, computed on a daily basis; provided that if a different rate is specified by a compact or other interstate agreement to which New Mexico is a party, that rate shall apply to amounts due under the compact or other agreement.

C. Unless otherwise provided by this section, interest on an overpayment not arising from an assessment by the department shall be paid from the date of the claim for refund until a date preceding by not more than thirty days the date of the credit or refund to any person; and interest on an overpayment arising from an assessment by the department shall be paid from the date of overpayment until a date preceding by not more than thirty days the date of the credit or refund to any person.

D. No interest shall be allowed or paid with respect to an amount credited or refunded if:

(1) the amount of interest due is less than one dollar ($1.00);

(2) the credit or refund is made within:

(a) fifty-five days of the date of the complete claim for refund of income tax, pursuant to either the Income Tax Act or the Corporate Income and Franchise Tax Act for the tax year immediately preceding the tax year in which the claim is made;

(b) sixty days of the date of the complete claim for refund of any tax not provided for in this paragraph;

(c) seventy-five days of the date of the complete claim for refund of gasoline tax to users of gasoline off the highways;

(d) one hundred twenty days of the date of the complete claim for refund of tax imposed pursuant to the Resources Excise Tax Act, the Severance Tax Act, the Oil and Gas Severance Tax Act, the Oil and Gas Conservation Tax Act, the Oil and Gas Emergency School Tax Act, the Oil and Gas Ad Valorem Production Tax Act, the Natural Gas Processors Tax Act or the Oil and Gas Production Equipment Ad Valorem Tax Act; or

(e) one hundred twenty days of the date of the complete claim for refund of income tax, pursuant to the Income Tax Act or the Corporate Income and Franchise Tax Act, for any tax year more than one year prior to the year in which the claim is made;

(3) Sections 6611(f) and 6611(g) of the Internal Revenue Code, as those sections may be amended or renumbered, prohibit payment of interest for federal income tax purposes;

(4) the credit results from overpayments found in an audit of multiple reporting periods and applied to underpayments found in that audit or refunded as a net overpayment to the taxpayer pursuant to Section 7-1-29 NMSA 1978;

(5) the department applies the credit or refund to an intercept program, to the taxpayer's estimated payment prior to the due date for the estimated payment or to offset prior liabilities of the taxpayer pursuant to Subsection E of Section 7-1-29 NMSA 1978;

(6) the credit or refund results from overpayments the department finds pursuant to Subsection F of Section 7-1-29 NMSA 1978 that exceed the refund claimed by the taxpayer on the return; or

(7) the refund results from a tax credit pursuant to the Investment Credit Act, Laboratory Partnership with Small Business Tax Credit Act, Technology Jobs and Research and Development Tax Credit Act, Film Production Tax Credit Act, Affordable Housing Tax Credit Act or a rural job tax credit or high-wage jobs tax credit.

E. Nothing in this section shall be construed to require the payment of interest upon interest.

## § 3.2.212.22. TANGIBLE PERSONAL PROPERTY IN PROJECTS FINANCED BY INDUSTRIAL REVENUE OR SIMILAR BONDS

A. For the purposes of this section, a "bond project" is an arrangement entered into under the authority of the Industrial Revenue Bond Act, the County Industrial Revenue Bond Act or similar act in which a private person agrees (i) to arrange for the constructing and equipping of a facility for a state or local government by acting as agent for the government in procuring construction services, other services, tangible personal property which becomes an ingredient or component part of a construction project and other tangible personal property necessary for constructing and equipping the facility, (ii) to lease the completed facility from the government and (iii) to buy the facility upon repayment of the bonds. The government agrees to own the facility, to finance the project in whole or in part through the issuance of bonds, to designate the private person as its agent in procuring the necessary property and services, to lease the facility to the private person and to sell the facility to the private person upon repayment of the bonds.

B. Receipts from the sale of tangible personal property to the private person who is acting as agent for the government with respect to the bond project are deductible under Section 7-9-54 NMSA 1978 if the tangible personal property is not an ingredient or component part of a construction project. To be deductible, the bond project tangible personal property must meet all of the following criteria:

(1) the cost of the tangible personal property does not increase the basis, as determined under the provisions of Section 1011 of the Internal Revenue Code in effect on the date the bond project commences, of the structure or other facility included in the definition of construction; and

(2) the tangible personal property is:

(a) not included in, or similar to, the list of structures and facilities specifically itemized in the definition of construction at Section 7-9-3 NMSA 1978; and

(b) classified for depreciation purposes as 3-year property, 5-year property, 7-year property, 10-year property or 15-year property by Section 168 of the Internal Revenue Code in effect on the date the bond project commences or, if the Internal Revenue Code is amended to rename or replace these depreciation classes, would have been classified for depreciation purposes as 3-year property, 5-year property, 7-year property, 10-year property or 15-year property but for the amendment.

C. A bond project commences when the governing body of the state or local government takes official action to enter into the arrangement, but no earlier than the adoption of an

inducement resolution.

D. Receipts from the sale of tangible personal property which becomes an ingredient or component part of a construction project, whether the sale is to the private person acting as agent for the government or to the government itself, are not deductible under Section 7-9-54 NMSA 1978.

(2/22/95, 11/15/96; 3.2.212.22 NMAC -- Rn & A, 3 NMAC 2.54.22, 5/31/01)

HIERARCHY NOTES: See 3.2.212 NMAC

**3.2.209.22 NMAC INGREDIENT AND COMPONENT PARTS OF A CONSTRUCTION PROJECT.**

In determining whether tangible personal property will become an ingredient or component part of a construction project, the department will use the following criteria, but not exclusively:

A. Did the tangible personal property become "fixtures" as defined under Subsection I of Section 3.2.1.11 NMAC?

B. Was the person performing the work using the tangible personal property required to be licensed under the Construction Industries Licensing Act, Sections 60-13-1 to 60-13-59 NMSA 1978?

C. Did the work for which the tangible personal property was used require a permit from one or more of the trade boards established by the Construction Industries Licensing Act or from a municipal building or mechanical department?

[6/18/79, 4/7/82, 5/4/84, 4/2/86, 11/26/90, 11/15/96; 3.2.209.22 NMAC - Rn, 3 NMAC 2.51.22 & A, 5/31/01]

## 3.2.1.11. CONSTRUCTION

.....

J. Meaning of "building".

(1) As used in Section 7-9-3.4 NMAC NMAC NMSA 1978, the noun "building" means a roofed and walled structure designed for permanent use but excludes an enclosure so closely combined with the machinery or equipment it supports, houses or serves that it must be replaced, retired or abandoned contemporaneously with the machinery or equipment.

(2) A "building" includes the structural components integral to the building and necessary to the operation or maintenance of the building *but does not include equipment, systems or components installed to perform, support or serve the activities and processes conducted in the building* and which are classified for depreciation purposes as 3-year property, 5-year property, 7-year property, 10-year property or 15-year property by Section 168 of the Internal Revenue Code or, if the Internal Revenue Code is amended to rename or replace these depreciation classes, would have been classified for depreciation purposes as 3-year property, 5-year property, 7-year property, 10-year property or 15-year property but for the amendment.

(3) *Example:* A building may include any of the following equipment, systems or components:

(a) elevators and escalators used in whole or in part to move people;

(b) heating, cooling and air conditioning systems except for air conditioning and air handling systems and components, separately depreciated under Section 168, installed to meet temperature, humidity or cleanliness requirements for the operation of machinery or equipment or the manufacture, processing or storage of products;

(c) electrical systems except for electrical systems and components, separately depreciated under Section 168, installed to power machinery or equipment operated as part of the activities and processes conducted in the building and not necessary to the operation or maintenance of the building; and

(d) plumbing systems except for plumbing systems and components, separately depreciated under Section 168, installed to perform, serve or support the activities and processes conducted in the building, such as for the handling, transportation or treatment of ingredients, chemicals, waste or water for a manufacturing or other process.

Ruling 405-94-2

Issued: July 11, 1994
Effective: July 11, 1994

A ruling has been requested concerning the applicability of certain provisions of the Gross Receipts and Compensating Tax Act to the following facts:

X is a general partnership engaged in four lines of business which are providing construction management services, performing engineering and design services, performing construction services and purchasing and reselling of tangible personal property. X is a licensed general contractor in New Mexico.

D, a manufacturer, is expanding its plant in New Mexico. X has entered into a contract with D. X's contract with D requires X to 1) manage the New Mexico construction of the expansion, 2) combine and install equipment and other tangible personal property at D's plant in New Mexico, 3) perform engineering and design services and 4) perform construction services. E is a political subdivision of New Mexico financing the expansion of D's facilities through industrial revenue bonds. The new plant and equipment are nominally the property of E and D is an agent of E with respect to the completion of the new plant.

In addition to performing construction management, construction, engineering and design and other services, X is obligated to purchase various items of tangible personal property and equipment which are resold to E for installation at D's plant. Some of the tangible personal property and equipment purchased by X will become an ingredient or component part of the construction project and some of the tangible personal property and equipment will not become an ingredient or component part of the construction project. D as agent for E has executed a Type 9 Nontaxable Transaction Certificate to X to cover the purchase of tangible personal property and equipment that will not become an ingredient or component part of the expansion.

X has entered into a subcontract with B, a licensed general contractor in New Mexico. X's subcontract with B is for the purchase of construction services and services to combine and install tangible personal property and equipment that will not become ingredients or component parts of the expansion project. B has entered into subcontracts with various subcontractors (collectively called "Y") and has executed Type 7 NTTCs with Y. B and Y have separately identified the tangible personal property that will become an ingredient or component part of the construction project from the tangible personal property that will not become an ingredient or component part of the construction project. X has contracted directly with Y to purchase the items identified as tangible personal property that will not become an ingredient or component part of a construction project. X then bills D directly for the tangible personal property purchased from Y.

X asks if it may properly execute a Type 2 Nontaxable Transaction Certificate to Y and may Y accept the Type 2 Nontaxable Transaction Certificate in good faith since Y is already in receipt of a Type 7 Nontaxable Transaction Certificate from B?

Section 7-9-47 NMSA 1978 states in part:

> "Receipts from selling tangible personal property may be deducted from gross receipts or from governmental gross receipts if the sale is made to a person who delivers a nontaxable transaction certificate to the seller. The buyer delivering the nontaxable transaction certificate must resell the tangible personal property either by itself or in combination with other tangible personal property in the ordinary course of business."

X may properly execute a Type 2 Nontaxable Transaction Certificate to Y. Even though X and B are licensed general contractors in New Mexico, X is required under the terms of the contract with D to purchase tangible personal property that will not become an ingredient or component part of a construction project. X is selling tangible personal property in the ordinary course of business. In the event X and B are also purchasing both tangible personal property that will become an ingredient or component part of a construction project and tangible personal property that will not become an ingredient or component part of a construction project from Y, X and B should also execute a Type 6 Nontaxable Transaction Certificate with Y in accordance with Section 7-9-51 NMSA 1978.

S. **Owner's receipts from transactions with owned entity are gross receipts:**

(1) When a person who owns all or part of an entity has receipts from the sale of property in New Mexico to, the lease of property employed in New Mexico to or the performance of services in New Mexico for the entity, the person's receipts are gross receipts except when the transaction may be characterized for federal income tax purposes as a contribution of capital. The person's receipts include the actual amount of money received by the person plus the value of any additional consideration. Additional consideration includes forbearance of charges against the person's ownership interest. These gross receipts are subject to the gross receipts tax unless an exemption or deduction applies.

(2) For the purposes of Subsection S of Section 3.2.1.14 NMAC, an "entity" means any business organization or association other than a sole proprietorship.

(3) Example: Q is a partner in a partnership. Q is entitled to 25% of the partnership's profits and losses and to bear 25% of its expenses. Q also operates a stationery store in New Mexico as a sole proprietor. Q's store sells some merchandise to the partnership for the partnership's use. The partnership pays Q the amount charged and apportions 25% of the cost to Q's ownership interest. Q's receipts from the sale are gross receipts and are subject to gross receipts tax unless an exemption or deduction applies. Same facts as above except that Q is not paid by the partnership but instead receives amounts characterized as reimbursements directly from the other partners totaling 75% of the amount charged for the merchandise. Q's ownership account is not charged any expense with respect to this transaction. Q's sole proprietorship has gross receipts from the transaction. The gross receipts equal the sum of the money received from the other partners plus the value of the amount not charged to Q's ownership account by the partnership (in this case one-third of the amount received from the other partners). The deduction provided by Section 7-9-67 NMSA 1978 for refunds and allowances does not apply to this transaction.

***(4) Example: L is a partner in a partnership. L performs services for third parties as part of L's duties as a partner and is compensated for doing so by the partnership. To the extent that such compensation may be treated as wages for federal income tax purposes, L's receipts from the partnership in the form of compensation are exempt.***

(5) Example: C is a corporation and S is C's wholly owned subsidiary corporation. C and S create L, a limited liability company; C and S each own 50% of L. L purchases a 20% interest in P, a limited partnership. C sells goods to P. P pays the amount charged. C has gross receipts from this transaction equal to the amount received for the goods.

**7-9-48. Deduction; gross receipts tax; governmental gross receipts; sale of a service for resale.**

Receipts from selling a service for resale may be deducted from gross receipts or from governmental gross receipts if the sale is made to a person who delivers a nontaxable transaction certificate to the seller. The buyer delivering the nontaxable transaction certificate must resell the service in the ordinary course of business and the resale must be subject to the gross receipts tax or governmental gross receipts tax.

**HISTORY:**

1953 Comp., § 72-16A-14.3, enacted by Laws 1969, ch. 144, § 38; 1992, ch. 100, § 6; 2000, ch. 84, § 2.

**Research References and Practice Aids**

**Cross references.**

Payment; limits; disclosure; nontaxable transaction certificate, 47-14-18 NMSA 1978.

*Treasury Regulations*
*§ 1.707-1 Transactions Between Partner And Partnership.*

1.707-1(c) Guaranteed Payments.

Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of § 1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

**Example (1)**

Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

**Example (2)**

Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C's distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

**Example (3)**

Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

**Example (4)**

Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X's 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

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NOTES

# Federal Tax Update

# RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

Bruce A. McGovern
Professor of Law and Director, Tax Clinic
South Texas College of Law Houston
Houston, Texas 77002
Tele: 713-646-2920
e-mail: bmcgovern@stcl.edu

State Bar of New Mexico Tax Symposium
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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, and Cassady V. ("Cass") Brewer, Associate Professor of Law, Georgia State University College of Law, Atlanta, GA.

*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.*

## I. ACCOUNTING

### A. Accounting Methods

**1. The Tax Court sides with the taxpayer on application of the completed contact method of accounting to development of planned residential communities.** Shea Homes Inc. v. Commissioner, 142 T.C. 60 (2/12/14). The taxpayer was a home builder using the completed contract method allowed by § 460(e) (which provides an exception to the percentage-of-completion method otherwise required); the taxpayer developed large, planned residential communities. The question was whether the subject matter of the contracts consisted only of the houses and the lots on which the houses are built, as argued by the IRS, or the home as well as the larger development, including amenities and other common improvements, as argued by the taxpayer. The contracts were home construction contracts under § 460(e)(6) because Reg. § 1.460-3(b)(2)(iii) provides the cost of the dwelling units includes "their allocable share of the cost that the taxpayer reasonably expects to incur for any common improvements (e.g., sewers, roads, clubhouses) that benefit the dwelling units and that the taxpayer is contractually obligated, or required by law, to construct within the tract or tracts of land that contain the dwelling units." More specifically, the taxpayer's position was that the contracts were completed when they meet the test under Reg. § 1.460-1(c)(3)(i)(A) that the property was used by the customer for its intended purpose and 95 percent of the costs of the development had been incurred. Under this argument, final completion and acceptance pursuant to Reg. § 1.460-1(c)(3)(B) did not occur (excluding secondary items, if any, pursuant to Reg. § 1.460-1(c)(3)(B)(ii)) until the last road was paved and the final bond was released. The Tax Court (Judge Wherry), upheld the taxpayer's position. He rejected the IRS's argument that the common improvements were "secondary items." A key element in the holding was that the taxpayer was required by the contracts and by state law to complete common improvements, and that obligation was secured by "hefty performance bonds."

- The decision might be narrower than it appears on its face. Footnote 24 of the opinion states as follows:

> We are cognizant that our Opinion today could lead taxpayers to believe that large developments may qualify for extremely long, almost unlimited deferral periods. We would caution those taxpayers a determination of the subject matter of the contract is based on all the facts and circumstances. If Vistancia, for example,

attempted to apply the contract completion tests by looking at all contemplated phases, it is unlikely that the subject matter as contemplated by the contracting parties could be stretched that far. Further, sec. 1.460-1(c)(3)(iv)(A), Income Tax Regs., may prohibit taxpayers from inserting language in their contracts that would unreasonably delay completion until such a super development is completed.

a. **And the Ninth Circuit says the Tax Court was correct in holding that homebuyers value amenities.** Shea Homes, Inc. v. Commissioner, 834 F.3d 1061 (9th Cir. 8/24/16). In an opinion by Judge Fernandez, the Ninth Circuit affirmed the Tax Court's decision on the ground that the only issue on which the Tax Court's decision rested was a question of fact—what was the subject matter of the taxpayers' home construction contracts, that is, what were the taxpayers obligated to provide to the buyers—and that the Tax Court's fact finding was not clearly erroneous. The IRS's argument in the Tax Court was limited to "a dispute about the subject matter content of the contracts" and the IRS "took the very crabbed view that the subject matter was limited to the house and the lot." The Tax Court, however, "determined that, as a matter of fact, the subject matter included the house, the lot, "'the development ... and its common improvements and amenities.'" The Court of Appeals observed that "[t]his was not a simple case of buyers purchasing homes and having no substantial interest in whether the development would be and remain the kind of development that they wished to live in for some time in the future," adding that "[e]ach person in the planned community would, indeed, have an interest in the use of other property in the development, and that would include not only the common amenities but also the use that others in the development made of their own properties." Thus, the IRS's argument that "a buyer's contract cannot encompass more than the house and lot or, as a fall-back position, more than the house, the lot, and the common improvements" was rejected.

b. **The Ninth Circuit got it wrong, says the IRS.** A.O.D. 2017-03, 2017-15 I.R.B. 1072 (4/12/17). The IRS has nonacquiesced in the Ninth Circuit's decision in *Shea Homes*. "The Service disagrees with the court's conclusion that the 95-percent completion test can properly be applied with reference to the costs of an entire development or phase. Contract completion and the 95-percent completion test apply on a contract-by-contract basis." The IRS will follow the *Shea Homes* decision in cases appealable to the Ninth Circuit, but will continue to assert its positon in cases appealable to other U.S. Courts of Appeals.

2. **It turns out that 6666, not 666, is the mark of the devil for the IRS.** Burnett Ranches, Ltd. v. United States, 753 F.3d 143 (5th Cir. 5/22/14). Burnett Ranches, Ltd. operated two cattle and horse breeding operations and reported on the cash method. The principal owner, beneficial owner, and the manager, of Burnett Ranches, Anne Burnett Windfohr Marion, interposed an S corporation between herself and one of the two major ranch properties (6666, the Four Sixes) and had a direct interest in and was a beneficiary of a trust that held an interest in the other major ranch property (Dixon Creek). The IRS took the position that Burnett Ranches was a "farming syndicate" required by § 464 to use the accrual method of accounting. Speaking generally, § 464 requires farming partnerships to use the accrual method if they are a farming syndicate, which is generally defined as a partnership (or any other enterprise other than a corporation which is not an S corporation) engaged in the trade or business of farming if either (1) interests in the partnership or enterprise have been offered for sale in any securities offering or (2) more than 35 percent of losses are allocable to limited partners. But because it is targeted at late twentieth century tax shelters, it has a number of exceptions that cover "family farms." The taxpayer maintained that the exception in § 464(c)(2)(A) applied. This exception treats the following interests (among others) as not being held by a limited partner: "in the case of any individual who has actively participated (for a period of not less than 5 years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation. The government conceded that (1) Ms. Marion did "actively participate" in the management of Burnett Ranches' agricultural business for not less than five years previously, and (2) her interest in Burnett Ranches is "attributable to" her active

participation, but argued that the interposition of the S corporation between the entity owning the ranch and Ms. Marion rendered the exception inapplicable. The District Court granted judgment in favor of the taxpayer, and, in an opinion by Judge Wiener, the Fifth Circuit affirmed. The court rejected the government's argument that the interest of the individual actively managing the farm or ranch had to be held by direct legal title for the exception to apply. Focusing on the language of § 464(h)(2)(A), which describes the excepted interest as "In the case of any individual who has actively participated (for a period of not less than five years) in the management of any trade or business of farming, any interest in a partnership or other enterprise which is attributable to such active participation," the court reasoned that by using the language "interest ... attributable to such active participation," "Congress did not restrict sub-subsection (A)'s particular exception to interests of which such an actively participating manager holds legal title in his or her name."

- The Tax Technical Corrections Act of 2014, Pub. L. No. 113-295, Division A, § 221(a)(58)(B)(i), moved the text of § 464(c) as in effect in the years involved in this case to § 461(j). Section 461(j) already existed, but through an apparent typographical error the text was moved to § 461(j) instead of § 461(k).

**a. We're not giving up, says the IRS.** A.O.D. 2017-01, 2017-7 I.R.B. 868 (02/14/2017). The IRS has nonacquiesced in the Fifth Circuit's decision in *Burnett Ranches, Ltd.* "[T]he statute excludes a partnership interest of "any individual" who meets the active participation requirement. The statute does not exclude a partnership interest held by an S corporation, even if the S corporation is owned by an individual who has actively participated." The IRS will follow the *Burnett Ranches* decision in cases appealable to the Fifth Circuit, but will continue to assert its positon in cases appealable to other U.S. Courts of Appeals.

**3. It doesn't have to be a valid method of accounting to be a method of accounting a change of which requires the IRS's consent.** Nebeker v. Commissioner, T.C. Memo. 2016-155 (8/16/16). The taxpayer operated a cash method sole proprietorship that began in 1995. He included payments made by clients in the year payment was received but from 2004 through 2009 deducted the expenses associated with generating that revenue in the year payment was received even if the expenses had been incurred in a prior year. The Tax Court (Judge Goeke) held that the taxpayer's method of deferring deductions was erroneous for a cash method taxpayer, see Reg. § 1.466-1(c)(1)(iv)(a), but it nevertheless was a method of accounting that he consistently used. Thus, the IRS's adjustment to that item for tax years 2006 and 2009 constituted a change in his accounting method, which, because the IRS's consent was not secured under § 446(e), triggered the application of § 481.

**B. Inventories**

**1. If you find yourself waking up at night worrying about the establishment of dollar-value LIFO inventory pools by taxpayers using IPIC pooling methods, you will want to read these proposed regulations.** REG-125946-10, Dollar-Value LIFO Regulations: Inventory Price Index Computation (IPIC) Method Pools, 81 F.R. 85450 (11/28/16). These proposed regulations provide rules regarding the proper pooling of manufactured or processed goods and wholesale or retail (resale) goods by taxpayers that establish dollar-value last-in, first-out (LIFO) inventory pools and use the inventory price index computation (IPIC) pooling method. The proposed regulations amend the IPIC pooling rules to clarify that those rules are applied consistently with the general LIFO pooling rule that manufactured or processed goods and resale goods may not be included in the same dollar-value LIFO pool. Thus, an IPIC-method taxpayer who elects the IPIC pooling method described in Reg. § 1.472–8(b)(4) or (c)(2) and whose trade or business consists of both manufacturing or processing activity and resale activity may not commingle the manufactured or processed goods and the resale goods within the same IPIC pool. The Treasury Department and the IRS have specifically requested comments on the requirement that a taxpayer engaged in both manufacturing and resale activities within the same trade or business is required to use IPIC pooling for both activities. These amendments of the regulations will apply for taxable years ending on or after the date final regulations are published in the Federal Register.

### C. Installment Method

**1. Can an installment sale between related parties ever *not* have the proscribed tax avoidance purpose requisite for denying installment reporting?** Vest v. Commissioner, T.C. Memo. 2016-187 (10/6/16). The taxpayers owned 85 percent of Truebeginnings, LLC, which was an accrual basis partnership for federal tax purposes. According to the reported opinion, Truebeginnings in turn owned 100 percent interests in two other partnerships, H.D. Vest Advanced Systems, LLC (VAS), and Metric, LLC (Metric). (We do not understand how a 100 percent owned LLC can be a partnership rather than a disregarded entity or a corporation, but the opinion says they were partnerships and the issue could not have arisen if they were disregarded entities.) In consideration of 10-year promissory notes, Truebeginnings sold computer equipment to VAS and Metric and sold zero-basis intangible assets with an appraised value of $2,885,175 to VAS. Truebeginnings reported over $3 million of gain on the § 453 installment method. The Tax Court (Judge Lauber) upheld the IRS's conclusion that the sales did not qualify for installment sale treatment pursuant to § 453(g)(1), which disallows installment reporting for installment sales of depreciable property between related persons unless "it is established to the satisfaction of the Secretary that the disposition did not have as one of its principal purposes the avoidance of Federal income tax." I.R.C. § 453(g)(2). TB, VAS, and Metric were clearly "related persons," and the computer equipment and intangible assets that TB sold to VAS and Metric were "depreciable property." The taxpayer failed to carry the burden of proof that tax avoidance "was not among the principal purposes of the asset sale transaction." Judge Lauber reasoned that § 453(g)(2) "resembles other Code sections providing that certain tax treatment will be available only if the taxpayer establishes that the plan or transaction did not have 'as one of its principal purposes the avoidance of Federal income tax,' and that" Tax Court precedent establishes that "a taxpayer in such cases can satisfy his burden of proof only by submitting 'evidence [that] clearly negate[s] an income-tax-avoidance plan.'" *Tecumseh Corrugated Box Co. v. Commissioner*, 94 T.C. 360, 381-382 (1990) (addressing § 453(e)(7)), *aff'd*, 932 F.2d 526 (6th Cir. 1991). The taxpayer's burden in such cases is "a heavy one." *Pescosolido v. Commissioner*, 91 T.C. 52, 56 (1988) (addressing § 306(b)(4)), *aff'd*, 883 F.2d 187 (1st Cir. 1989). In ascertaining the true purpose of the transaction, Judge Lauber stated, the Tax Court accords "more weight to objective facts than to the taxpayer's 'mere denial of tax motivation.'" The enhanced depreciation deductions available to the related buyer is relevant in deciding whether the seller had a principal purpose of avoiding tax. *Guenther v. Commissioner*, T.C. Memo. 1995-280. In this case, the court stated, "[t]he substance of the transaction at issue clearly reveals a principal purpose of tax avoidance."

> Notwithstanding the asset sale, petitioner through TB retained full control over the ad-optimization business. By use of installment reporting, TB aimed to defer for 10 years virtually all the tax on its $3.2 million gain, while VAS and Metric would receive stepped-up bases in, and be able to claim correspondingly large depreciation or amortization deductions on, the assets transferred. ... This tax-avoidance purpose is particularly clear with respect to the intangible assets sold to VAS. Those assets had a zero cost basis in TB's hands, thus yielding zero amortization deductions to it. But VAS claimed a stepped-up basis in those assets of $2,885,175, yielding amortization deductions of $192,345 annually. The enhanced amortization deductions claimed by VAS and Metric, totaling $644,772 for 2008-2010 alone, dwarf the $29,798 gain that TB reported for 2008.

**a. The Fifth Circuit affirms.** Vest v. Commissioner, ___ Fed. Appx. ___ (5th Cir. 6/2/17). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. In response to the taxpayer's argument that the sale of assets from Truebeginnings to the related partnerships had a business purpose, the court stated:

> Even if the sale was motivated by a business purpose, this fact would not necessarily mean that the sale did not also have a principal purpose of tax avoidance. Merely arguing that the sale had a business purpose is not inconsistent

with it also having tax avoidance as one of its principal purposes. Accordingly, Vest has failed to demonstrate clear error on the Tax Court's part

### D. Year of Inclusion or Deduction

1. **Almost as rare as a total solar eclipse: a cash-method taxpayer is entitled to deduct estimated, future expenses.** Gregory v. Commissioner, 149 T.C. No. 2 (7/11/17). The taxpayers, a married couple, held 80 percent of the stock of a cash-method S corporation that owned and operated a landfill in Texas. All landfills, regardless of size, must clean up and restore the site upon their inevitable closing. Closing a landfill and complying with federal, state, and local environmental regulations is an expensive endeavor. For this reason, § 468 generally permits a "taxpayer" owning and operating a landfill to deduct currently estimated "qualified reclamation or closing costs" anticipated in a future year or years. When the future costs actually are paid in a future year, § 468 disallows a deduction to the extent the costs do not exceed the taxpayer's previously established and annually calculated § 468 reserve. (Of course, § 468 is more complicated than the foregoing statements might lead one to believe, but the essence of the statute is to allow landfill owners like the taxpayers' S corporation to take a current deduction for future reclamation and clean-up costs.) From 1996 through 2007, the taxpayers' S corporation had utilized § 468 without challenge by the IRS. For tax years 2008 and 2009, however, the IRS contested the S corporation's § 468 deduction on the grounds that the term "taxpayer" in § 468 refers only to accrual-method taxpayers, not cash-method taxpayers. In a case of first impression, the Tax Court unanimously disagreed with the IRS. In a reviewed (and surprisingly long) opinion by Judge Holmes, the Tax Court held that the term "taxpayer" in § 468 does indeed refer to both accrual-method and cash-method taxpayers. The court relied primarily on the statutory language of § 468, which does not distinguish between cash-method and accrual-method taxpayers. The court also examined several other sources of guidance, including § 7701(a)(14), which defines the term "taxpayer" simply as "any person subject to any internal revenue tax," as well as the legislative history of § 468. Apparently, this was news to the IRS, which argued voluminously to the contrary, but to no avail. In a lengthy concurring opinion, Judge Lauber (joined by Judges Marvel, Gale, Nega, and Ashford) traced the legislative history of § 468 (and § 468A regarding nuclear decommissioning costs), which appeared in preliminary bills as exceptions to the § 461(h) economic performance requirement, and concluded that Congress likely had intended § 468 to be available only to accrual-method taxpayers. Judge Lauber also suggested that, if Treasury had issued regulations that defined "taxpayer" for purposes of § 468 as meaning an accrual-method taxpayer, the result in the case might have been different. In the absence of regulations, Judge Lauber concluded, the court "reasonably concludes that nothing in the text of section 468 necessitates giving the term "taxpayer" a meaning less comprehensive than the ordinary meaning it has elsewhere in the Code.

## II. BUSINESS INCOME AND DEDUCTIONS

### A. Income

1. **Dying is not inconsistent with deducting.** Estate of Backemeyer v. Commissioner, 147 T.C. No. 17 (12/8/16). The Tax Court (Judge Laro) held that the tax benefit rule did not require the recapture of deductions claimed by a taxpayer on his 2010 return for farm supplies property that remained on-hand upon his death in 2011 and the value of which was deducted as an expense by his surviving spouse, who acquired the farm supplies by inheritance, when the supplies were used in 2011. "[N]either Mr. Backemeyer's death nor the distribution of the farm inputs to and their use by Mrs. Backemeyer was fundamentally inconsistent with the premises on which the initial ... deduction for the 2010 tax year was based."

### B. Deductible Expenses versus Capitalization

1. **The long reach of the uniform capitalization rules.** Wasco Real Properties I, LLC v. Commissioner, T.C. Memo. 2016-224 (12/13/16). The Tax Court (Judge Buch) held that real estate taxes on land on which commercial almond trees were planted were subject to capitalization as indirect costs under § 263A:

> Although WRP I deducted its property taxes, those taxes directly benefit the growing of the almond trees and are allocable to the produced property (the almond trees) that will produce income in the future. Allowing a current deduction of the property taxes would distort WRP I's actual income for the subject years and would otherwise allow WRP I to offset its unrelated income. This is precisely the mismatch of expenses and revenues that section 263A was enacted to prevent.

In addition, interest on a loan to acquire the land on which the commercial almond trees were planted was subject to capitalization under § 263A(f). "The land does not have to be the property that is being produced to bring interest on a financing of the land within the reach of section 263A. Rather, pursuant to the command of section 263A(f)(2)(A)(i), the interest that the entities paid on their financing of their land must be capitalized as a cost of their almond trees if the cost of the land is a production expenditure with respect to the almond trees." Capitalized interest is added to the basis of the almond trees, not the land.

### C. Reasonable Compensation

### D. Miscellaneous Deductions

**1. Standard mileage rates for 2017.** Notice 2016-79, 2016-52 I.R.B. 918 (12/13/16). The standard mileage rate for business miles in 2017 goes down to 53.5 cents per mile (from 54 cents in 2016) and the medical/moving rate goes down to 17 cents per mile (from 19 cents in 2016). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2017 (increased from 24 cents in 2016).

### E. Depreciation & Amortization

**1. Perhaps he should have played an antique violin.** Kilpatrick v. Commissioner, T.C. Memo. 2016-166 (8/29/16). The taxpayer, a CPA, claimed deductions, as "office expenses" or "supplies" for the cost of certain antiques—oak armchairs, a desk, a number of paintings, two soup tureens, a chandelier, a lamp, a clock—used in his home office, which the IRS conceded qualified for business deductions under § 280A. He did not elect on his return to deduct the cost under § 179. The Tax Court (Judge Morrison) held that the costs were not § 162 ordinary and necessary business expenses but rather were capital expenditures. Furthermore, the taxpayer was not allowed to take depreciation deductions with respect to the antiques. A depreciation deduction under § 167 is not allowable "'for an asset the value of which is not reduced by the passage of time or by use'" (quoting *Hawkins v. Commissioner*, 713 F.2d 347 (8th Cir. 1983)), and while some antiques might lose their value through use or through the passage of time, the taxpayer failed to prove that his antiques would do so. The court therefore held that his furnishings would retain their value.

**2. Section 280F 2017 depreciation tables for business autos, light trucks, and vans.** Rev. Proc. 2017-29, 2017-14 I.R.B. 1065 (3/24/17). The IRS has published depreciation tables with the 2017 depreciation limits for business use of small vehicles:

| | |
|---|---|
| 2017 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 |
| 2017 Trucks and Vans with § 168(k) first year recovery: | |
| 1st Tax Year | $11,560 |
| 2nd Tax Year | $ 5,700 |
| 3rd Tax Year | $ 3,450 |
| Each Succeeding Year | $ 2,075 |
| 2017 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 |
| 2017 Trucks and Vans (no § 168(k) first year recovery): | |
| 1st Tax Year | $ 3,560 |
| 2nd Tax Year | $ 5,700 |
| 3rd Tax Year | $ 3,450 |
| Each Succeeding Year | $ 2,075 |

**F. Credits**

1. **Nearly fifteen years after the issuance of proposed regulations, Treasury has issued final regulations defining "internal use software."** T.D. 9786, Credit for Increasing Research Activities, 81 F.R. 68299 (10/4/16). Treasury and the IRS have finalized, with only minor changes, proposed amendments (REG-153656-03, Credit for Increasing Research Activities, 80 F.R. 2624 (1/20/15)) to the regulations under § 41(d)(4)(E) that define internal use software. Section 41(d) defines the term "qualified research" for purposes of the § 41 research credit. Section 41(d)(4)(E) generally excludes from the definition of "qualified research" all "research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer," unless the software is for use in either an activity that constitutes qualified research or a production process with respect to which the requirements of § 41(d)(1) (defining qualified research) are met. The 1986 legislative history of § 41(d)(4)(E) provides that the regulations should make the costs of new or improved internal use software eligible for the credit only if the research satisfies, in addition to the general requirements for credit eligibility, an additional three-part high threshold of innovation test: (1) that the software is innovative, (2) that the software development involves significant economic risk, and (3) that the software is not commercially available for use by the taxpayer. Final regulations on internal use software were issued in 2001 (T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (01/03/01)). In response to concerns expressed about the final regulations, Treasury and the IRS subsequently issued proposed regulations (REG-112991-01, Credit for Increasing Research Activities, 66 F.R. 66362 (12/26/01)) that never were finalized. Instead, Treasury and the IRS issued an advance notice of proposed rulemaking (REG-153656-03, Credit for Increasing Research Activities, 69 F.R. 43 (01/02/04)) in which they solicited comments on the definition of internal use software. The 2015 proposed regulations responded to those comments and have now been made final.

- Reg. § 1.41-4(c)(6)(iii) provides that "software is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use if the software is developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business." For this purpose, general and administrative functions are financial management functions (including functions such as accounts payable and receivable, inventory management, and strategic business planning), human resources management functions (including functions such as recruiting, hiring, payroll and benefits), and support services (including data processing, janitorial and other facility services, marketing, legal services, and government compliance). Software that a taxpayer develops primarily for the internal use of a related party (as defined in § 41(f)) is considered internal use software. Conversely, under Reg. § 1.41-4(c)(6)(iv), software is not developed primarily for the taxpayer's internal use if it is not developed for use in general and administrative functions that facilitate or support the conduct of the taxpayer's trade or business, such as: (1) "[s]oftware developed to be commercially sold, leased, licensed, or otherwise marketed to third parties," or (2) "[s]oftware developed to enable a taxpayer to interact with third parties or to allow third parties to initiate functions or review data on the taxpayer's system."
- Under Reg. § 1.41-4(c)(6)(i), research with respect to computer software that is developed by (or for the benefit of) the taxpayer primarily for the taxpayer's internal use is eligible for the research credit only if: (1) the software satisfies the requirements of § 41(d)(1) (defining qualified research), (2) the software is not otherwise excluded from the definition of "qualified research" under § 41(d)(4), and (3) the software satisfies the high threshold of innovation test (set forth in Reg. § 1.41-4(c)(6)(vii)). The final regulations clarify that the internal use software rules of Reg. § 1.41-4(c)(6) do not apply to (1) software developed for use in an activity that

constitutes qualified research, (2) software developed for use in a production process to which the requirements of § 41(d)(1) are met, and (3) a new or improved package of software and hardware developed together by the taxpayer as a single product. Thus, the high threshold of innovation test does not apply to software in these three categories. The final regulations provide a number of examples.

- The final version of Reg. § 1.41-4(c)(6) applies to tax years ending on or after 10/4/16. However, for tax years ending on or after 1/20/15 (the date the 2015 proposed regulations were published in the Federal Register) and beginning before 10/4/16, the IRS will not challenge return positions consistent with all of the provisions of either the final or the 2015 proposed version of Reg. § 1.41-4(c)(6). For tax years ending before 1/20/15, taxpayers can choose to follow all of the provisions of § 1.41-4(c)(6) as set forth in either the 2001 final regulations (T.D. 8930, Credit for Increasing Research Activities, 66 F.R. 280 (01/03/01)) or the 2001 proposed regulations (REG-112991-01, Credit for Increasing Research Activities, 66 F.R. 66362 (12/26/01)).

**G. Natural Resources Deductions & Credits**

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

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

## III. INVESTMENT GAIN AND INCOME

### A. Gains and Losses

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

- Act § 2004(b) also added Code § 6035, 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 martial 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.

**f. Final regulations confirm that the statements required by new § 6035(a)(1) and (a)(2) are not due before June 30, 2016.** T.D. 9797, Consistent Basis Reporting Between Estate and Person Acquiring Property From Decedent, 81 F.R. 86953 (12/2/16). The Treasury Department and the IRS have issued final regulations that merely reiterate the guidance in Notice 2016-27, 2016-15 I.R.B. 576 (3/24/16), and provide that executors or other persons required to file or furnish a statement under § 6035(a)(1) or (2) before 6/30/16 need not have done so until 6/30/16.

- The government issued these final regulations to avoid an issue about the retroactive application of regulations. Under § 7805(b)(1), proposed, temporary and final regulations relating to the internal revenue laws cannot apply to any taxable period ending before the earliest of: (1) the date on which such regulation is filed with the Federal Register; (2) in the case of any final regulation, the date on which any proposed or temporary regulation to which such final regulation relates was filed with the Federal Register; or (3) the date on which any notice substantially describing the expected contents of any temporary, proposed, or final regulation is issued to the public. However, under § 7805(b)(2), this rule does not apply to regulations issued

within 18 months of the date of the enactment of the statutory provision to which the regulation relates. These final regulations were issued within 18 months of 7/31/15, the date of enactment of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, which added to the Code §§ 1014(f) and 6035.

2. **The Tax Court emphasizes that the alchemy of transforming § 1231 gain into capital gain does not render § 1231 assets to be capital assets.** CRI-Leslie, LLC v. Commissioner, 147 T.C. No. 8 (9/7/16). The taxpayer, an LLC treated as a TEFRA partnership, entered into a contract to sell a hotel property that it owned and received a deposit of $9.7 million. The buyer under the contract defaulted and forfeited the $9.7 million deposit, which was retained by the taxpayer. The hotel property was a § 1231 asset, not a capital asset. The taxpayer reported the $9.7 million forfeited deposit as net long-term capital gain, and the IRS asserted a deficiency based on treating the forfeited deposit as ordinary income. The taxpayer argued that its characterization of the forfeited deposit as long-term capital gain was supported by § 1234A, which provides that:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> > (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
> >
> > (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,
>
> shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).

The taxpayer's position was that "Congress clearly intended for section 1234A to apply not only to payments received from contract terminations relating to capital assets but also to payments from terminations relating to section 1231 property." The IRS argued that the "plain and unambiguous wording" of § 1234A requires a narrow interpretation limited to a "capital asset in the hands of the taxpayer." The Tax Court (Judge Laro) agreed with the IRS's position. The court rejected the taxpayer's argument that the legislative history of § 1234A, *see* S. Rept. No. 105-33, at 134 (1997), 1997-4 C.B. (Vol. 2) 1067, 1214, warranted extending § 1234A to § 1231 assets because it demonstrated that Congress enacted § 1234A to "ensure that taxpayers received the same tax characterization of gain or loss whether the property is sold or the contract to which the property is subject is terminated." The court reasoned that "[s]ince section 1234A expressly refers to property that is 'a capital asset in the hands of the taxpayer' and no other type of property, and since property described in section 1231 is excluded explicitly from the definition of 'capital asset' in section 1221, we must conclude that the plain meaning of 'capital asset' as used in section 1234A does not extend to section 1231 property." The court was "unable find anything in the legislative history of section 1234A to support [the taxpayer's] assertion that Congress intended to include section 1231 property within its ambit."

3. **Another case illustrating that you really need to stop developing the property in order to claim successfully that the property is not held primarily for sale to customers.** Boree v. Commissioner, 837 F.3d 1093 (11th Cir. 9/12/16), *aff'g* T.C. Memo. 2014-85 (5/12/14). The taxpayers, a married couple, held land through a limited liability company, Glen Forest, LLC. (The LLC had been formed by the husband, Gregory Boree, a former logger, and another individual, but the other individual later sold his interest to Mr. Boree, after which Mr. Boree and his wife were the sole members of the LLC.) The LLC acquired 1,892 acres of vacant real property in Baker County, Florida. In early 2003, the LLC submitted a proposal with respect to the property to the Baker County Planning and Zoning Department for a planned residential development that would consist of more than one hundred 10-acre lots, to be developed and sold in multiple consecutive phases. From 2003 through 2004, the LLC engaged in various development-related activities, such as seeking exemptions from certain requirements,

forming a homeowners' association and providing for representation of the LLC on the association's board, obtaining county approval of the first three phases of development of the community, applying for an environmental resource permit, and constructing an unpaved road on the property. The LLC sold 15 lots in 2003, 26 lots in 2004, 8 lots in 2005, and none in 2006. From late 2004 through early 2005, the Baker County Board of Commissioners adopted a series of land-use restrictions that affected the LLC's development, including a moratorium on development and a requirement that all roads within subdivisions be paved. To comply with the paving requirement would have cost the LLC approximately $7 million. To make development more economical, Mr. Boree developed and submitted for approval a higher-density development plan featuring residential, commercial and recreational areas, but following the county's adoption in 2006 of a requirement that developers pave certain roads leading to developments, the Borees sold the remaining lots to a developer and realized a gain of approximately $8.5 million. The taxpayers reported their gain as long-term capital gain. In an opinion by U.S. District Judge Coogler (sitting by designation), the Eleventh Circuit affirmed the conclusion of the Tax Court (Judge Foley) that the taxpayers' gain was ordinary income. In reaching this conclusion, the Eleventh Circuit rejected the taxpayers' argument that their purpose in holding the property had changed when the land use restrictions adopted by the county in 2005 and 2006 made development of the property prohibitively expensive, and that the Tax Court therefore had erred in considering their purpose in holding the property during periods of time prior to its sale in 2007. Considering the taxpayer's purpose in holding property in the years leading up to its sale, the court reasoned, is consistent with prior decisions of the Fifth and Eleventh Circuits, including *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir. 1980) and *Sanders v. United States*, 740 F.2d 886 (11th Cir. 1984). Further, the court concluded, the taxpayers' attempts to respond to the land use restrictions by proposing a higher density development and taking other actions are "evidence of strategic and thorough involvement in pursuit of developing the property [that] indicates that the Borees were holding the property for sale in the ordinary course of business right up until they sold it." The court similarly rejected other arguments raised by the taxpayer.

- Although it affirmed the Tax Court's conclusion that the taxpayers held the property primarily for sale to customers, the Eleventh Circuit reversed the Tax Court's imposition of a 20 percent accuracy-related penalty for substantial understatement of income tax under § 6662(b)(2). The Eleventh Circuit concluded that the taxpayers had successfully established a reasonable cause, good faith defense to the penalty by relying on their accountant, whom the court described as someone who enjoyed a good reputation in the community, in part because he served "as a tax professor at the University of Florida Levin College of Law."

**4. The IRS searched unsuccessfully for sale or exchange treatment on Monster.com.** Estate of McKelvey v. Commissioner, 148 T.C. No. 13 (4/19/17). The decedent in this case was the founder and CEO of Monster Worldwide, Inc. (Monster), known for its job-search website, monster.com. In 2008, the decedent entered into variable prepaid forward contracts (VPFC) with two investment banks. Pursuant to the terms of each VPFC, the decedent received a cash payment from each investment bank in exchange for his agreement to deliver Monster shares or their cash equivalents over the course of several future settlement dates. The number of shares of Monster that the decedent was obligated to deliver varied and was determined by a formula that took into account the closing price of Monster shares on the settlement dates. In connection with each VPFC, the decedent pledged a specified number of shares of Monster stock to secure his obligations but could substitute other collateral with the bank's consent. In the same year, prior to the first settlement date, the decedent entered into an agreement with each investment bank pursuant to which the decedent made a cash payment to each bank in exchange for the bank's agreement to extend the settlement dates. Following the decedent's death, his estate delivered the requisite number of Monster shares to the banks. The IRS acknowledged that the initial VPFCs qualified for open transaction reporting under Rev. Rul. 2003-7, 2003-1 C.B. 363. However, the IRS took the position that the agreements pursuant to which the settlement dates were extended: (1) were taxable exchanges of the original VPFCs for the extended VPFCs that resulted in short-term capital gain of $88 million, and (2) resulted in

constructive sales of the underlying Monster shares under § 1259 that gave rise to long-term capital gain of $112.8 million. The Tax Court (Judge Ruwe) held that the extension agreements did not result in taxable exchanges and that the extensions did not constitute constructive sales under § 1259. The court reasoned that, in order for the extensions to constitute taxable exchanges of the VPFCs, "two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent." The first condition, the court concluded, was not satisfied. The VPFCs were not property of the decedent, but rather obligations of the decedent. Once the decedent had received the cash payments under the VPFCs, the decedent had only the obligation to deliver a specified number of Monster shares or their cash equivalent. The court also rejected the government's argument that the extensions resulted in constructive sales of the underlying Monster shares under § 1259. Section 1259(a)(1) provides that, if there is a constructive sale of an appreciated financial position, the taxpayer must recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Under § 1259(c)(1)(C), a constructive sale of an appreciated financial position occurs if a taxpayer "enters into a future or forward contract to deliver the same or substantially identical property," but according to the provision's legislative history, a forward contract does not result in a constructive sale of stock if it calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms." The court reasoned that the IRS's acceptance of open transaction reporting for the initial VPFCs meant that the IRS acknowledged that the initial VPFCs did not trigger a constructive sale under § 1259. Accordingly, the IRS's argument that the extensions resulted in constructive sales under § 1259 "is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs," a finding that the court had already declined to make.

5. **The taxpayers' "pump and dump" refund claim survives despite a bizarre interpretation of the § 165 theft loss regulations by the IRS and the Claims Court.** Adkins v. United States, 856 F.3d 914 (Fed. Cir. 5/8/17), *rev'g* 125 Fed. Cl. 304 (2016). The taxpayers in this refund suit were victims of a so-called "pump and dump" investment scheme carried out between 1997 and 2001. The taxpayers' investment adviser, Donald & Co., would purchase stock on the public markets, advise its clients to do the same, and subsequently sell the artificially inflated stock without informing its clients. In 2000, the taxpayers had a $3.6 million investment portfolio with Donald & Co. By the end of 2001, their investment portfolio had declined in value to only $9,849. In February of 2002, the taxpayers uncovered their investment advisor's fraudulent scheme and instituted arbitration proceedings with the National Association of Securities Dealers (NASD). In 2004, criminal indictments were returned against the principals of Donald & Co. in the U.S. District Court for the Eastern District of New York, and in that same year, several of the principals of Donald & Co. pleaded guilty and were sentenced. Criminal proceedings against other Donald & Co. principals continued until as late as 2009, at which time the taxpayers' NASD arbitration claim concluded. Meanwhile, in 2006, the taxpayers filed a refund claim with the IRS asserting a § 165 theft loss deduction for 2004. The IRS denied the claim on the grounds that in 2004 the taxpayers could not show with "reasonable certainty" their losses would not be recovered in the arbitration proceeding. The U.S. Court of Federal Claims (Judge Sweeney) upheld the IRS's denial of the taxpayers' refund claim, reasoning that the regulations under § 165 require a greater evidentiary showing of no prospect of recovery ("reasonable certainty") in a year following the discovery of a theft loss than in the year of discovery itself ("reasonable prospect"). In her decision, Judge Sweeney relied upon a similar interpretation of the § 165 regulations (by another Claims Court judge) in *Johnson v United States*, 74 Fed. Cl. 360 (2006). Presumably, the Claims Court would have allowed the taxpayers a § 165 theft loss deduction in 2002 when the fraudulent "pump and dump" scheme was initially discovered, but disallowed the deduction in 2004 due to the pendency of the arbitration claim. Fortunately, the U.S. Court of Appeals for the Federal Circuit reversed and remanded the case to the Claims Court for further proceedings. In an opinion by Judge O'Malley, the Court of Appeals reasoned that the regulations under § 165 do not impose different evidentiary standards in the year of discovery of theft versus subsequent years but simply a showing that in the year the theft

loss is claimed there is no reasonable prospect of recovery. Because the IRS and the Claims Court had misinterpreted the law, the case was remanded for further consideration of the taxpayers' refund claim for 2004.

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

**C. Profit-Seeking Individual Deductions**

**D. Section 121**

**E. Section 1031**

1. **The Tax Court confirms that § 1031 is an exception to the principle that substance controls over form.** Estate of Bartell v. Commissioner, 147 T.C. No. 5 (8/10/16). This case involved a reverse like-kind exchange structured before the promulgation of Rev. Proc. 2000-37, 2000-2 C.B. 308 (effective for qualified exchange accommodation arrangements entered into by an exchange accommodation titleholder on or after September 15, 2000). In 1999, Bartell Drug (an S corporation) entered into an agreement to purchase a property (Property #2). To further structuring the disposition of another property already owned by Bartell Drug (Property #1) as a § 1031 like-kind exchange, Bartell Drug assigned its rights in the purchase agreement to a third-party exchange facilitator (EPC) and entered into an agreement with EPC that provided for EPC to purchase Property #2 and gave Bartell Drug a right to acquire Property #2 from EPC for a stated period and price. EPC purchased Property #2 on August 1, 2000, with bank financing guaranteed by Bartell Drug. Bartell Drug then supervised construction of a drugstore on Property #2 using proceeds of the EPC financing guaranteed by Bartell Drug. Upon substantial completion of the construction in June 2001, Bartell Drug leased the store from EPC until Bartell Drug acquired Property #2 on December 31, 2001. In late 2001, Bartell Drug contracted to sell Property #1 to another party. Bartell Drug thereupon entered an exchange agreement with intermediary SS and assigned to SS its rights under the sale agreement and under the earlier agreement with EPC. SS sold Property #1, applied the proceeds of that sale to the acquisition of Property #2 from EPC and transferred Property #2 to Bartell Drug on December 31, 2001. The Tax Court (Judge Gale) held that the transactions qualified as a § 1031 like-kind exchange of Property # 1 for Property #2. The Court rejected the IRS's argument that under a "benefits and burdens" analysis Bartell Drug was the owner of Property #2 long before the formal transfer of title on December 31, 2001 and treated EPC as the owner of Property #2 during the period it held title to the property. *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963), *rev'g* 38 T.C. 215 (1962), and *Biggs v. Commissioner*, 69 T.C. 905 (1978), *aff'd*, 632 F.2d 1171 (5th Cir. 1980), were cited as precedent for the proposition that § 1031 is formalistic, and that the exchange facilitator does not bear the benefits and burdens of ownership during the period it holds title to the property for the purpose of facilitating a like kind exchange on behalf of a taxpayer who contractually does bear the benefits and burdens of ownership does not preclude § 1031 nonrecognition for the deferred exchange. "[G]iven that the caselaw has countenanced a taxpayer's pre-exchange control and financing of the construction of improvements on the replacement property while an exchange facilitator held title to it, *see J.H. Baird Publ'g. Co. v. Commissioner*, 39 T.C. 608, 610-611 (1962), we see no reason why the taxpayer's pre-exchange, temporary possession of the replacement property pursuant to a lease from the exchange facilitator should produce a different result."

a. **If you wish to engage in a reverse like-kind exchange in which the exchange accommodation titleholder holds title to the replacement property for more than 180 days, proceed at your own peril, says the IRS.** A.O.D. 2017-06, 2017-33 I.R.B. 194 (8/23/17). The IRS has nonacquiesced in the Tax Court's decision in *Bartell*. In its nonacquiescence, the IRS emphasized Rev. Proc. 2000-37, 2000-2 C.B. 308, which provides a safe harbor for reverse like-kind exchanges in which replacement property is parked with an exchange accommodation titleholder if certain requirements are met. If all of the requirements are met, then the exchange accommodation titleholder is considered the owner of the property to which it holds title regardless of who bears the benefits and burdens of ownership. One requirement is that the exchange accommodation titleholder must not hold the property for more than 180 days. If the requirements of the revenue procedure are not met, then the determination

whether the taxpayer or the exchange accommodation titleholder is the owner of the property is made without regard to the provisions of the revenue procedure. In *Bartell*, the exchange accommodation titleholder held title to the property for 17 months. In this action on decision, the IRS stated:

> [I]in determining whether a reverse exchange outside the scope of Rev. Proc. 2000-37 meets the requirements of § 1031, the Service will not follow the principle in the court opinions that an exchange facilitator may be treated as the owner of property regardless of whether it possesses the benefits and burdens of ownership. ... Taxpayers that use accommodating parties outside the scope of Rev. Proc. 2000-37 have not engaged in an exchange if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. The Service will not follow the Tax Court's opinion in *Bartell* to the extent the opinion provides otherwise.

**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.

**f. Congress provides relief from the § 4980D excise tax for small employers offering health reimbursement arrangements, imposes new reporting requirements, limits the exclusion from gross income under § 106, and coordinates HRAs with the § 36B premium tax credit.** The 21st Century Cures Act ("Cures Act"), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements.

*Health Reimbursement Arrangements Offered by Small Employers*—Section 18001(a)(1) of the Cures Act amends Code § 9831 by adding subsection (d), which provides that, for purposes of title 26 (other than the Cadillac Tax of § 4980I), a "qualified small employer health reimbursement arrangement" (QSEHRA) is not treated as a group health plan. The effect of this amendment is to allow employers to offer health reimbursement arrangements that meet the definition of a QSEHRA without becoming subject to the excise tax of § 4980D. An arrangement is a QSEHRA if it (1) is offered by an "eligible employer;" (2) subject to certain exceptions, is provided to all "eligible employees" on the same terms, (3) is funded solely by the employer and

does not call for contributions through salary reduction; (4) provides for the payment or reimbursement of documented expenses for medical care (as defined in § 213(d)) incurred by the employee or the employee's family members; and (5) the amount of payments and reimbursements for the year do not exceed $4,950 ($10,000 in the case of an arrangement that also provides for payments or reimbursements for family members of the employee). These dollar limitations will be adjusted for inflation after 2016. An "eligible employer" is an employer that is not an applicable large employer as defined in § 4980H(c)(2) and does not offer a group health plan to any of its employees. An "eligible employee" generally is any employee of the employer, but the terms of the arrangement may exclude from consideration certain employees, such as those who have not completed 90 days of service, those who have not attained age 25, and part-time or seasonal employees. This relief from the § 4980D excise tax applies for years beginning after 12/31/16, which means that employers may begin offering QSEHRAs beginning in 2017.

*New Reporting Obligations*—The Cures Act imposes two new reporting requirements related to health reimbursement arrangements. **First**, Code § 9831(d)(4), as added by § 18001(a)(1) of the Cures Act, provides that an employer funding a QSEHRA for any year must provide to each eligible employee a written notice not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). The notice must include the following information: (1) a statement of the amount of the employee's permitted benefit under the arrangement for the year; (2) statement that the employee should provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit; and (3) a statement that, if the employee is not covered under minimum essential coverage for any month, the employee may be subject to tax under section § 5000A for that month and reimbursements under the arrangement may be includible in gross income. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. **Second**, new Code § 6501(a)(15), as added by § 18001(a)(6) of the Cures Act, requires an employer to report on Form W-2 the amount of each employee's permitted benefit under a QSEHRA. These rules regarding reporting apply to years beginning after 12/31/16. However, the legislation provides that a person shall not be treated as failing to provide the written notice required by § 9831(d)(4) if the notice is provided not later than 90 days after the date of the enactment of the Cures Act.

*Extension of Relief Provided by Notice 2015-17*—Notice 2015-17, 2015-14 I.R.B. 845 (2/18/15), provided a transition rule under which the IRS would 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. Section 18001(a)(7)(B) of the Cures Act provides that the relief under Notice 2015-17 shall be treated as applying to any plan year beginning on or before 12/31/16. This means that employers that are not applicable large employers will not be subject to the § 4980D excise tax as a result of offering an employer payment plan for plan years beginning on or before 12/31/16.

*Limitation on the Exclusion of Code § 106*—New Code § 106(g), as added by § 18001(a)(2) of the Cures Act, provides that, for purposes of Code §§ 105 and 106, payments or reimbursements to an individual for medical care from a QSEHRA shall not be treated as paid or reimbursed under employer-provided coverage for medical expenses under an accident or health plan if, for the month in which the medical care is provided, the individual does not have minimum essential coverage within the meaning of § 5000A(f). The effect of this amendment is that payments or reimbursements under a QSEHRA are included in an individual's gross income if the individual does not have minimum essential coverage.

*Coordination with the § 36B Premium Tax Credit*—Code § 36B(c)(4), as added by § 18001(a)(3) of the Cures Act, makes an individual ineligible for the § 36B premium tax credit for any month if the individual is provided a QSEHRA for the month that constitutes affordable coverage. If the QSEHRA does not constitute affordable coverage, then the employee remains

eligible for the premium tax credit for the month, but the amount of the credit is reduced by the 1/12 of the employee's permitted benefit under the QSEHRA for the year. A QSEHRA constitutes affordable coverage for a month (and therefore makes an employee ineligible for the premium tax credit) if the *excess of* (1) the premium for the month for self-only coverage under the second lowest cost silver plan offered in the relevant individual health insurance market, *over* (2) 1/12 of the employee's permitted benefit under the QSEHRA, *exceeds* 1/12 of 9.69 percent (for 2017) of the employee's household income. (Note that this calculation requires using the cost of self-only coverage, even for employees with insured family members.) The statutory rules provide for adjusting the calculation in the case of employees employed for less than a full year. An employee must provide the amount of his or her permitted benefit to any health insurance exchange to which the employee applies for advance payment of the premium tax credit.

*Application of the Cadillac Tax*—Generally, § 4980I, which was enacted as part of the Affordable Care Act, 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 employer-sponsored coverage") exceeds a specified dollar limit. Subsequent to the enactment of the Affordable Care Act, Congress in 2015 delayed the effective date of the Cadillac Tax to taxable years beginning after 12/31/19. Section 18001(a)(4) of the Cures Act amends Code § 4980I(d)(2)(D) to provide that a QSEHRA is considered "applicable employer-sponsored coverage" for purposes of the Cadillac Tax. Accordingly, the cost of a QSEHRA to the employer must be taken into account in determining the applicability of the Cadillac Tax.

**g. Employers offering Qualified Small Employer Health Reimbursement Arrangements in 2017 need not provide the initial written notice to employees until after the IRS provides guidance.** Notice 2017-20, 2017-11 I.R.B. 1010 (2/27/17). The 21st Century Cures Act, signed by the President on 12/13/16, added Code § 9831(d)(4), which requires each employer that funds a QSEHRA to provide each eligible employee a written notice with specified information not later than 90 days before the beginning of the year (or, if later, the date on which the employee becomes an eligible employee). For 2017, the legislation provides that employers will be treated as complying with this requirement if they provide the notice not later than 90 days after the date of enactment of the Cures Act. The 90th day was 3/13/17. An employer that fails to provide the required notice is subject to a $50 penalty per employee for each incident of failure, subject to a $2,500 calendar year maximum for all failures. Because employers might have difficulty complying with the notice requirement in the absence of guidance, the IRS has announced that employers funding QSEHRAs in 2017 need not provide the initial written notice until after the IRS issues such guidance.

**2. Providers of minimum essential health coverage and employers subject to the Affordable Care Act's shared responsibility payment get a break—statements required to be furnished to individuals for 2016 have a delayed due date, but the date for filing with the IRS remains unchanged.** Notice 2016-70, 2016-49 I.R.B. 784 (11/18/16). 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 to individuals the 2016 Forms 1095-B and 1095-C to 3/2/17. Because of this extension, those furnishing Forms 1095-B and 1095-C do not have, as they normally would, the ability to request a 30-day extension. However, this notice, unlike similar relief granted in prior years, does not extend the due date for filing with the IRS Forms 1094-B, 1095-B, 1094-C, or 1095-C. The due date for filing remains 2/28/17, if not filed electronically, or 3/31/17, if filed electronically. Nevertheless, an automatic 30-day extension of the due date for filing is available by filing Form 8809 on or before the due date.

- Because the extended due dates may delay an individual's receipt of Forms 1095-B or 1095-C, the notice provides that, for 2016, individuals do not need to wait to receive Forms 1095-B and 1095-C before filing their returns. Instead, taxpayers can rely on other information received from their 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. Such individuals should keep the information on which they rely with their tax records but need not send it to the IRS.
- The notice extends transition relief from penalties under §§ 6721 and 6722 for incorrect or incomplete information reported on the return or statement to reporting entities that establish they made good-faith efforts to comply with the information-reporting requirements under §§ 6055 and 6056 for 2016 (both for furnishing to individuals and for filing with the Service). However, no penalty relief is available for failing to file an information return or furnish a statement by the due dates (as extended by the notice).

3. **The Tax Court ices the IRS by allowing the Boston Bruins' 100% deduction for away-game meals as a *de minimis* fringe, while the winning slap shot may be that hotel and banquet facilities can be "leased."** Jacobs v. Commissioner, 148 T.C. No. 24 (6/26/17). The taxpayers, a married couple, own the S corporation that operates the Boston Bruins professional hockey team. When the Bruins travel to away games, the team provides the coaches, players, and other team personnel with hotel lodging as well as pre-game meals in private banquet rooms. Game preparation (e.g., strategy meetings, viewing films, discussions among coaches and players) also takes place during these team meals. The Bruins enter into extensive contracts with away-game hotels, including terms specifying the food to be served and how the banquet rooms should be set up. The taxpayers' S corporation spent approximately $540,000 on away-game meals at hotels over the years 2009 and 2010, deducting the full amount thereof pursuant to §§ 162, 274(n)(2)(B), and 132(e). Section 274(n) generally disallows 50 percent of meal and entertainment expenses, but § 274(n)(2)(B) provides an exception if the expense qualifies as a *de minimis* fringe benefit under § 132(e). Under Reg. § 1.132–7, employee meals provided on a nondiscriminatory basis qualify under § 132(e) if (1) the eating facility is owned or leased by the employer; (2) the facility is operated by the employer; (3) the facility is located on or near the business premises of the employer; (4) the meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and (5) the annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility. The IRS argued that the Bruins' expenses do not qualify under § 132(e) and thus should be limited to 50 percent under § 274(n) because meals at away-game hotels are neither at facilities "operated by the employer," nor "owned or leased by the employer," nor "on or near the business premises of the employer." After easily determining that the other requirements for *de minimus* fringe benefit treatment were met, the Tax Court (Judge Ruwe) focused upon whether, for purposes of § 132(e) and Reg. § 1.132-7, the Bruins' away-game hotels can be considered facilities that are "operated by the employer," "leased by the employer," and "on or near the business premises of the employer." Judge Ruwe held that because away-game travel and lodging are indispensable to professional hockey and because the Bruins' contracts with the hotels specify many of the details regarding lodging, meals, and banquet rooms, the meal expenses are 100 percent deductible as a *de minimis* fringe. The hotel facilities are "operated by

the employer" because the regulations expressly construe that term to include being operated under contract with the employer. The hotel facilities also should be considered "leased" by the employer, the court concluded, due to the extensive contracts and the team's exclusive use and occupancy of designated hotel space. Further, the court concluded that, because away-game travel and lodging is an indispensable part of professional hockey, the hotel facilities should be considered the business premises of the employer.

• **The slap shot to the IRS:** The Tax Court's holding that the Bruins' "lease" the hotel facilities is somewhat at odds with regulations under § 512. Reg. § 1.512(b)-1(c)(5) provides that amounts received for the use or occupancy of space where personal services are rendered to the occupant (e.g., hotel services) does not constitute rent for purposes of the § 512 exclusion from unrelated business taxable income. *See also* Rev. Rul. 80-298, 1980-2 C.B.197 (amounts received by tax-exempt university for professional football team's use of playing field and dressing room along with maintenance, linen, and security services is not rental income for purposes of § 512 exclusion from UBTI). Judge Ruwe's decision may embolden tax-exempt organizations seeking to exclude so-called "facility use fees" (e.g., payments made to an aquarium for exclusive use of its space for corporate events) from UBTI.

**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.

c. **The relief is extended to plan years beginning before 2018.** Notice 2016-57, 2016-40 I.R.B. 432 (9/19/16). 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 2018. The IRS has done so because it anticipates that the proposed regulations (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)) will not be published as final regulations in time for plan sponsors to make plan design decisions based on the final regulations before expiration of the relief provided under Notice 2014-5 (as extended by Notice 2015-28). Therefore, the IRS has extended the relief for an additional year.

2. **If you use an ESOP to attempt to reduce tax liability, failing to pay yourself compensation for services can be costly.** DNA Pro Ventures, 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 Pro Ventures, 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.

a. **The Eighth Circuit sees it the same way.** DNA Pro Ventures, Inc. v. Commissioner, 856 F.3d 557 (8th Cir. 5/9/17). In an opinion by Judge Loken, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision. 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 of DNA Pro Ventures, Inc. to the ESOP's trust in 2008 was an employer contribution that exceeded the contribution limit of § 415. Under § 401(a)(16), a trust is not qualified if the plan provides for benefits or contributions that exceed the limitations of § 415. Accordingly, the ESOP was not qualified under § 401(a) and its related trust therefore was not tax-exempt under § 501(a) for 2008 and the subsequent tax years under audit.

3. **IRA trustees and plan administrators can take the taxpayer's word for it that the taxpayer is eligible for a waiver of the 60-day rollover period.** Rev. Proc. 2016-47, 2016-37 I.R.B. 346 (8/24/16). This revenue procedure provides for a self-certification procedure (subject to verification on audit) that a taxpayer can use to claim eligibility for a waiver with respect to a rollover into a qualified plan or IRA. Under §§ 402(c)(3) and 408(d)(3), any amount distributed from a qualified plan or IRA is excluded from gross income if it is transferred to an eligible retirement plan no later than the 60th day following the day of receipt. A similar rule applies to § 403(a) annuity plans, § 403(b) tax sheltered annuities, and § 457 eligible governmental plans. A taxpayer who fails to meet the 60-day requirement can seek a waiver, pursuant to §§ 402(c)(3)(B) and 408(d)(3)(I), on the grounds that "failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement." Taxpayers seek a waiver by submitting a request for a private letter ruling pursuant to Rev. Proc. 2003-16, 2003-1 C.B. 359. This revenue procedure does not eliminate a taxpayer's ability to seek a private letter ruling, but allows a taxpayer to make a written self-certification to a plan administrator or an IRA trustee provided that three conditions are met: (1) the IRS has not previously denied a waiver request with respect to the rollover, (2) the taxpayer failed to meet the 60-day

requirement because of the taxpayer's inability to complete a rollover due to one or more of several specified reasons, including an error by the financial institution receiving the contribution or making the distribution, the taxpayer's misplacement and failure to cash the distribution check, severe damage to the taxpayer's principal residence, incarceration of the taxpayer, serious illness of the taxpayer or a member of the taxpayer's family, or the death of a member of the taxpayer's family, and (3) the taxpayer makes the contribution to the plan or IRA as soon as practicable after the circumstance justifying the waiver no longer prevents the taxpayer from making the contribution. (This third requirement is deemed to be satisfied if the contribution is made within 30 days after the circumstance justifying the waiver no longer prevents the taxpayer from making the contribution.) The revenue procedure provides a model letter that taxpayers can use for a self-certification. A plan administrator or IRA trustee can rely on a taxpayer's self-certification in determining whether the taxpayer has satisfied the conditions for a waiver of the 60-day rollover requirement unless the administrator or trustee has actual knowledge to the contrary. However, IRA trustees will be required to report on Form 5498 that a contribution was accepted after the 60-day deadline. The self-certification allows a taxpayer to report a contribution as a valid rollover, but the IRS can challenge on audit the taxpayer's eligibility for a waiver and can still seek to impose penalties such as the failure-to-pay penalty of § 6651. The revenue procedure modifies Rev. Proc. 2003-16 by providing that the IRS may grant a waiver during an examination of the taxpayer's income tax return. The revenue procedure is effective on 8/24/16.

a. **The IRS examination division has authority to grant a hardship waiver of the 60-day rollover period, and the IRS's decision is subject to judicial review, says the Tax Court.** Trimmer v. Commissioner, 148 T.C. No. 14 (4/20/17). Shortly after the taxpayer had retired from the New York City Police Department in 2011 and his post-retirement job as a security guard had fallen through, the taxpayer began experiencing symptoms of major depressive disorder. His depression lasted approximately one year. His wife testified that, during this period, he was "'like a lost soul,' and when she came home from work in the evening she would often find him where she had left him in the morning." During this period, the taxpayer received two checks in the total amount of approximately $100,000 from his retirement accounts with the New York City Employees' Retirement System and the New York City Police Pension Fund. The checks stayed on his dresser for about one month before he deposited them in the couple's joint bank account. The funds remained in the bank account for approximately nine months when, on the advice of the couple's tax return preparer, the taxpayer moved the funds into an IRA at the same bank. The IRS issued Notice CP-2000 asserting that the taxpayer had to include the $100,000 in gross income and was subject to the 10 percent penalty tax of § 72(t). The taxpayer responded to the notice with a letter in which he explained that he had experienced depression and that the funds had been moved into an IRA and stated:

> I went through a rough time upon separation from my job, causing me emotional hard times that caused this situation. Penalizing me and my family would not benefit anybody, only cause extreme duress and punish my children who played no part in this situation. I ask you to consider these facts and please come to a fair decision.

The IRS responded with a letter summarily denying relief that did not mention the availability of a hardship waiver under § 402(c)(3)(B) of the normal requirement that funds withdrawn from a qualified plan be rolled over within 60 days to an eligible retirement plan in order to be excluded from gross income. The taxpayer filed a petition in the Tax Court in response to the IRS's subsequent issuance of a notice of deficiency. The IRS asserted two main arguments: (1) the hardship waiver provision of § 402(c)(3)(B) was inapplicable because the taxpayer had failed to request a private letter ruling pursuant to Rev. Proc. 2003-16, 2003-1 C.B. 359 and therefore the IRS examination division had no authority to determine whether the taxpayer qualified for a waiver; and (2) even if the examination division did have authority to consider a hardship waiver, the IRS's determination concerning the waiver is not subject to judicial review. The Tax Court (Judge Thornton) rejected both of the IRS's arguments and concluded that the taxpayer

was eligible for a hardship waiver of the 60-day rollover requirement. With respect to the authority of the IRS to consider a hardship waiver during an examination, the court reviewed Rev. Proc. 2003-16, 2003-1 C.B. 359, and its modification by Rev. Proc. 2016-47, 2016-37 I.R.B. 346 (8/24/16), and concluded that "the purpose and effect of the 2016 modification of Rev. Proc. 2003-16 [to permit the grant of a waiver during examination] ... was not to create some new authority that had not previously existed for IRS examiners to consider hardship waivers during examinations, but rather to make clear the existence of that authority." According to the court, the IRS had, in fact, made a final determination to deny the taxpayer a hardship waiver. With respect to the issue whether the IRS's determination of eligibility for a hardship waiver is subject to judicial review, the court concluded that the jurisdiction conferred by the taxpayer's filing of a timely petition in response to the notice of deficiency "includes reviewing administrative determinations that are necessary to determine the merits of deficiency determinations." Further, there were no reasons, the court explained, for the court to refrain from reviewing the IRS's exercise of administrative discretion. The appropriate standard of review of the IRS's determination concerning a hardship waiver, according to the court, is abuse of discretion. The court concluded that the IRS—which had "failed to address or even acknowledge any of the facts and circumstances [the taxpayer] set forth in his letter"—had abused its discretion in denying the taxpayer a hardship waiver. Finally, the court concluded based on all of the evidence that the taxpayer qualified for a hardship waiver of the 60-day rollover period. Because the distributions were not included the taxpayer's gross income, the 10 percent penalty tax of § 72(t) also did not apply.

• The taxpayer was represented by students enrolled in the Low Income Taxpayer Clinic at Fordham University School of Law.

**4. Retirement plans can make loans and hardship distributions to victims of natural disasters.**

**a. Relief for Louisiana flood victims.** Announcement 2016-30, 2016-37 I.R.B. 355 (8/30/16). Section 401(k) plans and similar employer-sponsored retirement plans can make loans and hardship distributions to victims of flooding that began in Louisiana on August 11, 2016. Participants in § 401(k) plans, employees of public schools and tax-exempt organizations with § 403(b) tax-sheltered annuities, as well as state and local government employees with § 457(b) deferred-compensation plans, may be eligible to take advantage of these streamlined loan procedures and liberalized hardship distribution rules. IRA participants are barred from taking out loans, but may be eligible to receive distributions under liberalized procedures. Pursuant to this relief, an eligible plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship distribution for a need arising from these Louisiana storms, to an employee, former employee, or certain family members who live or work in one of the parishes identified as part of a covered disaster area because of the Louisiana storms. To qualify for this relief, hardship withdrawals must be made by 1/17/17. To facilitate access to plan loans and distributions, the IRS will not treat a plan as failing to follow procedural requirements for plan loans or distributions imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after 8/11/16 and continuing through 1/17/17, provided the plan administrator (or financial institution in the case of IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. As soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation.

• This relief means that a retirement plan can allow a victim of the Louisiana flooding to take a hardship distribution or borrow up to the specified statutory limits from the victim's retirement plan. It also means that a person who lives outside the disaster area can take out a retirement plan loan or hardship distribution and use it to assist a son, daughter, parent, grandparent or other dependent who lived or worked in the disaster area.

• A plan is allowed to make loans or hardship distributions before the plan is formally amended to provide for such features. Plan amendments to provide for loans or hardship distributions must be made no later than the end of the first plan year beginning after

12/31/16. In addition, the plan can ignore the reasons that normally apply to hardship distributions, thus allowing them, for example, to be used for food and shelter.

- Except to the extent the distribution consists of already-taxed amounts, a hardship distribution made pursuant to this relief will be includible in gross income and generally subject to the 10-percent additional tax of § 72(t).

b. **Relief for victims of Hurricane Matthew.** Announcement 2016-39, 2016-45 I.R.B. 720 (10/21/16). Similar relief allows § 401(k) plans and similar employer-sponsored retirement plans to make loans and hardship distributions to victims of Hurricane Matthew. Pursuant to this relief, an eligible plan will not be treated as failing to satisfy any requirement under the Code or regulations merely because the plan makes a loan, or a hardship distribution for a need arising from Hurricane Matthew, to an employee, former employee, or certain family members who live or work in one of the counties identified as part of a covered disaster area because of Hurricane Matthew. To qualify for this relief, hardship withdrawals must be made by 3/15/17. To facilitate access to plan loans and distributions, the IRS will not treat a plan as failing to follow procedural requirements for plan loans or distributions imposed by the terms of the plan merely because those requirements are disregarded for any period beginning on or after 10/4/16 (10/3/16 for Florida) and continuing through 3/15/17, provided the plan administrator (or financial institution in the case of IRAs) makes a good-faith diligent effort under the circumstances to comply with those requirements. As soon as practicable, the plan administrator (or financial institution in the case of IRAs) must make a reasonable attempt to assemble any forgone documentation. A qualified employer plan that does not provide for them must be amended to provide for loans or hardship distributions no later than the end of the first plan year beginning after 12/31/16.

5. **Some inflation adjusted numbers for 2017.** I.R. 2016-141 (10/27/16).

- 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 is increased to $62,000 to $72,000 (from $61,000-$71,000) for single filers and heads of household, increased to $99,000-$119,000 (from $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, and increased to $186,000-$196,000 (from $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 $186,000-$196,000 (from $184,000-$194,000) for married couples filing jointly, and increased to $118,000-$133,000 (from $117,000-$132,000) for singles and heads of household.
- The annual benefit from a defined benefit plan under § 415 is increased to $215,000 (from $210,000).
- The limit for defined contribution plans is increased to $54,000 (from $53,000).
- The amount of compensation that may be taken into account for various plans is increased to $270,000 (from $265,000), and is increased to $400,000 (from $395,000) for government plans.
- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $62,000 (from $61,500) for married couples filing jointly, increased to $46,500 (from $46,125) for heads of household, and increased to $31,000 (from $30,750) for singles and married individuals filing separately.

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

### D. Individual Retirement Accounts

1. **A lesson on how not to handle a deceased spouse's IRA.** Ozimkoski v. Commissioner, T.C. Memo. 2016-228 (12/19/16). The will of the taxpayer's deceased husband appointed the taxpayer as personal representative and, with minor exceptions, left all of his property to the taxpayer. The taxpayer and her deceased husband each had a traditional IRA with

Wachovia (later acquired by Wells Fargo). The deceased husband's adult son, who was the taxpayer's stepson, petitioned the probate court to revoke the will. In settlement of the stepson's claims, the taxpayer and the stepson agreed that the taxpayer would transfer to the stepson a 1967 Harley Davidson motorcycle and $110,000. The agreement provided that "[a]ll payments shall be net payments free of any tax." Because of the stepson's claims, Wachovia froze the deceased husband's IRA. In 2008, following the settlement, Wachovia transferred approximately $235,000 from the deceased husband's IRA to the taxpayer's IRA. The taxpayer, who was age 53, then withdrew a total of approximately $175,000 from her IRA during 2008, $110,000 of which she paid to the stepson. Wachovia issued a Form 1099-R reporting the distributions as early distributions. The taxpayer filed her 2008 income tax return twenty-four days late and did not include the IRA distributions in her gross income. The IRS issued a notice of deficiency asserting an income tax deficiency of $62,185, a § 72(t) penalty tax for early withdrawal by a taxpayer not yet age 59-1/2 of $17,460, a late-filing penalty of $3,100, and an accuracy-related penalty of $12,437 for substantial understatement of income tax. The taxpayer, who appeared pro se, argued that $110,000 of the distributions should not be included in her gross income because the stepson was entitled to that amount through the probate litigation and resulting settlement. The Tax Court (Judge Paris) first concluded that Wachovia had incorrectly rolled the deceased husband's IRA into the taxpayer's IRA because she was not a named beneficiary of the deceased husband's IRA. In the court's view, Wachovia should have distributed the assets of the deceased husband's IRA to his estate. Nevertheless, the court reasoned that it could not unwind that transaction and had to decide the issues based on the transfers that had actually occurred. The court held that the taxpayer had to include in her gross income all of the 2008 distributions from her IRA, including the $110,000 that she paid to her stepson. The court also upheld the imposition of the § 72(t) penalty tax. Although an exception § 72(t)(2)(A)(ii) provides that the penalty tax does not apply to distributions "made to a beneficiary (or to the estate of the employee) on or after the death of the employee," the court relied on prior decisions, including *Gee v. Commissioner*, 127 T.C. 1 (2006), to conclude that the exception does not apply where, as here, a beneficiary rolls over the funds from a deceased spouse's IRA into his or her IRA and then withdraws funds from his or her IRA. The court also upheld the late-filing penalty because the taxpayer had failed to establish that the late filing was due to reasonable cause and not due to willful neglect. However, the court held that, taking into account all the circumstances, including the taxpayer's experience, knowledge, and education, the taxpayer had established a reasonable cause, good faith defense to the accuracy-related penalty with respect to the portion of the understatement attributable to the $110,000 the taxpayer paid to her stepson (but not with respect to the portion attributable to the remaining $65,000 in distributions).

- It appears to us that, with proper advice and planning, the taxpayer could have avoided both the 10 percent penalty of § 72(t) and the inclusion in her gross income of the $110,000 she paid to her stepson. Rather than transfer the $235,000 balance of her deceased husband's IRA into her own IRA, the taxpayer could have left the funds in her deceased husband's IRA. This should have permitted a direct payment of $110,000 from her deceased husband's IRA to the stepson without inclusion of those funds in her gross income. It also should have permitted her to avoid the 10 percent penalty by taking advantage of the exception in § 72(t)(2)(A)(ii).

2. **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.

a. **The Seventh Circuit agrees.** McGaugh v. Commissioner, 860 F.3d 1014 (7th Cir. 6/26/17), *aff'g* T.C. Memo. 2016-28 (2/24/16). In an opinion by U.S. District Judge DeGuilio (sitting by designation), the U.S. Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision. The government argued on appeal that the taxpayer had constructively received the IRA proceeds and therefore had to include them in gross income. The court rejected this argument:

> McGaugh didn't direct a distribution to a third party; he bought stock. That is a prototypical, permissible IRA transaction. ... Further, there is no indication that McGaugh orchestrated this purchase for the benefit of [First Personal Financial Corp.] or for any reason other than because he wished to obtain stock to be held by his IRA. Thus, there is no evidence that he constructively received funds, either in ordering Merrill Lynch to wire funds to [First Personal Financial Corp.], or in any other respect.

## V. PERSONAL INCOME AND DEDUCTIONS

### A. Rates

### B. Miscellaneous Income

1. **Hallelujah! The government finally recognizes that nonpayment of a debt still owed is not necessarily COD income.** T.D. 9793, Removal of the 36-Month Non-Payment Testing Period Rule, 81 F.R. 78908 (11/10/16). The IRS and Treasury have finalized proposed amendments (REG-136676-13, Removal of the 36-Month Non-Payment Testing Period Rule, 79 F.R. 61791 (10/15/14)) to Reg. § 1.6050P-1 that eliminate the rule that a deemed discharge of indebtedness for which a Form 1099-C, "Cancellation of Debt," must be filed occurs at the expiration of a 36-month non-payment testing period. The Preamble explains the change as follows:

> Because reporting under the 36-month rule may not reflect a discharge of indebtedness, a debtor may conclude that the debtor has taxable income even though the creditor has not discharged the debt and continues to pursue collection. Issuing a Form 1099–C before a debt has been discharged may also cause the IRS to initiate compliance actions even though a discharge has not occurred. Additionally, § 1.6050P–1(e)(9) provides that no additional reporting is required if a subsequent identifiable event occurs. Therefore, in cases in which the Form 1099–C is issued because of the 36-month rule but before the debt is discharged, the IRS does not subsequently receive third-party reporting when the debt is discharged. The IRS's ability to enforce collection of tax for discharge of

indebtedness income may, thus, be diminished when the information reporting does not reflect an actual cancellation of indebtedness.

The final regulations are applicable to information returns required to be filed, and payee statements required to be furnished, after 12/31/16. The deadline for filing information returns and furnishing payee statements for calendar year 2016 is after 12/31/16. Accordingly, the expiration of a 36-month testing period during 2016 does not trigger a requirement to file information returns and furnish payee statements. (This effective date is a change from the proposed regulations, which were proposed to be effective and applicable as of the date of publication of final regulations in the Federal Register.)

2. **An interest in a defined benefit pension plan is not an asset for purposes of determining whether a taxpayer is insolvent and therefore eligible to exclude COD income.** Schieber v. Commissioner, T.C. Memo. 2017-32 (2/9/17). The taxpayer, a retired police officer, received monthly payments from the California Public Employees' Retirement System (CalPERS) defined benefit pension plan. During 2009, a creditor of the taxpayer cancelled $418,596 of debt. On the joint return for 2009 that the taxpayer and his wife filed, they excluded a portion of the cancelled debt from gross income on the basis that they were insolvent. The IRS issued a notice of deficiency in which the IRS determined that the taxpayers had to include in gross income the entire amount of the cancelled debt. Section 108(d)(3) defines "insolvent" as the amount by which a taxpayer's liabilities exceed the fair market value of the taxpayer's assets immediately before the debt is cancelled. The IRS argued that, in determining whether the taxpayers were insolvent, the taxpayers' interest in the CalPERS pension plan must be considered an asset. Taking into account this asset, the IRS argued, the taxpayers were not insolvent. The Tax Court (Judge Morrison) held that the taxpayers' interest in the plan was not an asset for purposes of the insolvency exclusion. The taxpayers' interest in the plan, the court noted, entitled them only to monthly payments, could not be converted to a lump-sum cash amount, and could not be sold or assigned. The taxpayers could neither borrow against the interest nor borrow from the plan. The relevant inquiry established in prior cases such as *Carlson v. Commissioner*, 116 T.C. 87 (2001) for determining whether an item is an asset for this purpose is whether the item gives the taxpayer the ability to pay an immediate tax on income from the cancelled debt, not whether it gives the taxpayer the ability to pay the tax gradually over time. Because the taxpayers' interest in the plan was not considered an asset, they were insolvent by $293,308 and entitled to exclude this portion of the $418,596 cancelled debt.

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

### D. Deductions and Credits for Personal Expenses

1. **Proposed and temporary regulations on deducting casualty losses in the preceding tax year.** T.D. 9789, Election to Take Disaster Loss Deduction for Preceding Year, 81 F.R. 70938 (10/14/16). The Treasury Department and the IRS have issued proposed and temporary regulations under § 165(i), which allows a taxpayer to elect to treat an allowable loss occurring in a disaster area and attributable to a federally declared disaster as a casualty loss sustained in the tax year immediately prior to the tax year in which the disaster occurred (preceding year). The temporary regulations generally provide that the due date for making the § 165(i) election is six months after the due date for filing the taxpayer's federal income tax return for the disaster year (determined without regard to any extension of time to file). The temporary regulations also extend the period of time for revoking a § 165(i) election to ninety days after the due date for making the election. The temporary regulations are effective immediately.

a. **Guidance on the manner of making the § 165(i) election.** Rev. Proc. 2016-53, 2016-44 I.R.B. 530 (10/13/16). This revenue procedure sets forth the rules and procedures regarding the election under § 165(i) (and the revocation of a § 165(i) election) to deduct a disaster loss for the tax year immediately preceding the tax year in which the disaster occurred. Generally, a taxpayer makes the election by deducting the disaster loss on either an original federal tax return or an amended federal tax return for the preceding year. A taxpayer must include with the original or amended return an election statement indicating the taxpayer is

making a § 165(i) election. For an election made on an original return, a taxpayer must provide the information required by section 3.02 of the revenue procedure on Lines 1 or 19 (as applicable) of Form 4684 (Casualties and Thefts). (A taxpayer filing an original federal tax return electronically may attach a statement as a PDF document if there is insufficient space on Form 4684 to provide the required information.) For an election made on an amended return, a taxpayer may provide the required information by any reasonable means.

2. **Proposed regulations address reporting requirements and related issues for education tax credits allowed by § 25A.** REG-131418-14, Reporting for Qualified Tuition and Related Expenses; Education Tax Credits, 81 F.R. 50657 (8/2/16). The Treasury Department and the IRS have issued proposed amendments to (1) the regulations under § 25A and § 6050S to reflect amendments to §§ 25A and 6724 under the Trade Preferences Extension Act of 2015, Pub. L. No. 114-27 (TPEA) and amendments to §§ 25A and 6050S under the 2015 PATH Act, and (2) the regulations under § 25A to update the definition of qualified tuition and related expenses to reflect changes made by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (ARRA), to clarify the prepayment rule in Reg. § 1.25A-5(e), and to clarify the rule for refunds in Reg. § 1.25A-5(f). Among other requirements, the proposed regulations implement the TPEA's requirement for qualified tuition and related expenses paid in tax years beginning after 6/29/15 that taxpayers must receive a Form 1098-T to claim an education credit (the American Opportunity Tax Credit or Lifetime Learning Credit) under § 25A or the deduction under § 222; the 2015 PATH Act's requirement that the American Opportunity Tax Credit is not allowed if the TIN of the student or the taxpayer claiming the deduction is issued after the due date for filing the return or if the return does not include the EIN of the educational institution to which tuition was paid; and the 2015 PATH Act's requirement that educational institutions must report on From 1098-T amounts paid, rather than amounts billed, effective for amounts paid after 12/31/15 for education furnished in academic periods beginning after that date. The proposed regulations will be effective upon publication in the Federal Register as final regulations.

- The IRS previously issued Announcement 2016-17, 2016-20 I.R.B. 853 (4/27/16), which 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.

3. **Standard deduction for 2017.** Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (10/25/16). The standard deduction for 2017 will be $12,700 for joint returns and surviving spouses (increased from $12,600), $6,350 for unmarried individuals and married individuals filing separately (increased from $6,300), and $9,350 for heads of households (increased from $9,300).

4. **A dependency exemption, but not the child tax credit, is available for a permanently and totally disabled child who has attained age seventeen.** Polsky v. United States, 844 F.3d 170 (3d Cir. 12/15/16). The taxpayers, a married couple appearing pro se, had a daughter who was permanently disabled and who was over age seventeen. For the years 2010 and 2011, the taxpayers claimed a child tax credit with respect to their daughter under § 24. The IRS disallowed the credit on the ground that their daughter had attained age seventeen. Section 24(c)(1) allows the credit only for a "qualifying child," defined in § 24(c)(1) as "a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17." The taxpayers argued that the credit nevertheless was available because the cross-reference in § 24(c)(1) to § 152(c) incorporates § 152(c)(3)(B), which states that a child is a qualifying child without regard to the child's age if the child is permanently and totally disabled. In a per curiam opinion, the U.S. Court of Appeals for the Third Circuit affirmed the District Court and held that the child tax credit is available only when the qualifying child both "meets the non-age-related requirements of § 152(c) and 'has not attained age 17.'" Accordingly, the taxpayers were not entitled to the credit. The court quoted from the District Court's opinion:

> Section 24 imports the basic qualifications from § 152(c), and adds an age limitation of seventeen years. ... The age restriction in § 24(c)(1) is intended to end the tax *credit* when the child reaches seventeen years of age. In contrast, the special rule applicable to permanently and totally disabled dependents in § 152(c)(3)(B) is calculated to extend the tax *deduction* as long as the child is disabled. Therefore, the taxpayer can take a dependent deduction regardless of the child's age as long as the child is permanently and totally disabled, but cannot receive a tax credit for a disabled child who, by the close of the taxable year, was seventeen years of age.

**5. Proposed regulations address several issues related to the definition of a dependent.** REG-137604-07, Definition of Dependent, 82 F.R. 6370 (1/19/17). The Treasury Department and the IRS have issued proposed regulations that address several issues related to the definition of a dependent. Section 151 authorizes the deduction of an exemption amount for each dependent as defined in § 152. The term "dependent" also is relevant for purposes of other Code provisions. Generally, the term "dependent" is defined in § 152(a) as a qualifying child or a qualifying relative. The following summary discusses some of the highlights of the proposed regulations.

*Relationship Test (Qualifying Child and Qualifying Relative)*—Under § 152(d)(1), an individual can be a qualifying relative of a taxpayer only if, among other requirements, the individual is not a qualifying child of the taxpayer or any other taxpayer. This rule could prevent a taxpayer from claiming a dependency exemption deduction for an unrelated child that the taxpayer supports, e.g., if the unrelated child and the child's parent both live with the taxpayer. The proposed regulations adopt the rule in Notice 2008-5, 2008-2 I.R.B. 256 (12/18/2007), and provide that an individual is not a qualifying child of a person if that person (1) is not required to file an income tax return under § 6012, and (2) either does not file an income tax return or files an income tax return solely to claim a refund of estimated or withheld taxes.

*Residency Test (Principal Place of Abode)*—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, have the same principal place of abode as the taxpayer for more than one-half of the taxable year. Similarly, under § 152(d), a person other than the taxpayer's spouse can be a qualifying relative of the taxpayer if, among other requirements, the person has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. In Prop. Reg. § 1.152-4(c), "principal place of abode" is defined as "the primary or main home or dwelling where the taxpayer resides." The proposed regulations provide that (1) temporary lodging such as a homeless shelter or relief housing resulting from displacement by a natural disaster may qualify as a person's principal place of abode; (2) a person has the same principal place of abode as the taxpayer despite a temporary absence, defined as occurring "if the taxpayer would have resided at the abode but for the absence and, under the facts and circumstances, it is reasonable to assume that the person will return to reside at the place of abode;" and (3) a person is treated as having the same principal place of abode as the taxpayer for more than one-half of the taxable year if the individual resides with the taxpayer for at least 183 nights during the taxable year (or at least 184 nights during leap years). The proposed regulations provide rules for determining nights of residence.

*Age Test*—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, be younger than the taxpayer and, as of the close of the calendar year, not have attained the age of 19 or be a student who has not attained the age of 24. In Prop. Reg. § 1.152-1(b)(2), the term "student" is defined as an individual who, during some part of each of five calendar months during the calendar year is a full-time student at an educational organization described in § 170(b)(1)(A)(ii)—generally a school that normally maintains a regular faculty and curriculum and has a regular body of students in attendance—or is pursuing a full-time course of institutional on-farm training under the supervision of specified authorities.

*Support Test*—For a person to be a qualifying child of a taxpayer under § 152(c)(1), the person must, among other requirements, not provide more than one-half of the person's own

support. Similarly, under § 152(d), a person can be a qualifying relative of the taxpayer if, among other requirements, the taxpayer provides more than one-half of the person's support. According to Prop. Reg. § 1.152-4(a), "the amount of support provided by the individual, or the taxpayer, is compared to the total amount of the individual's support from all sources." The amount of an individual's support from all sources generally includes support the individual provides and income that is excludable from gross income. The term "support" includes food, shelter, clothing, medical and dental care, education, and similar items for the benefit of the supported individual. Generally, governmental payments and subsidies are treated as support provided by a third party. These include Temporary Assistance for Needy Families (TANF), low-income housing assistance, benefits under the Supplemental Nutrition Assistance Program, Supplemental Security Income payments, foster care maintenance payments, and adoption assistance payments. In contrast, old age benefits under the Social Security Act, which are based on earnings, are treated as support provided by the recipient to the extent the recipient uses the benefits for support. Similarly, SSDI payments to the child of a deceased or disabled parent are treated as support provided by the child to the extent those payments are used for the child's support. The proposed regulations provide that governmental payments used by the intended beneficiary or recipient to support another individual constitute support provided by the intended beneficiary or recipient of the payments. For example, a mother who uses TANF payments to support her children is treated as providing that support. The preamble to the proposed regulations states that the IRS will no longer assert the position it took in *Lutter v. Commissioner*, 61 T.C. 685 (1974), *aff'd per curiam*, 514 F.2d 1095 (7th Cir. 1975), in which the government successfully argued that governmental payments received by a parent and used for the support of children constituted support provided by the government.

*Tiebreaker Rules and Determination of AGI of Joint Filers*—Under the tiebreaker rules of § 152(c)(4), if a person meets the definition of a qualifying child for two or more taxpayers, the taxpayer who is a parent of the person may claim the person as a qualifying child. If more than one parent claims the person as a qualifying child, and if the parents do not file a joint return with each other, then the person is treated as the qualifying child of the parent with whom the person resides for the longest period during the year. If the person resides an equal amount of time with each parent, then the person is treated as the qualifying child of the parent with the highest adjusted gross income. If no eligible parent claims the person as a qualifying child, then the person may be claimed as a qualifying child by another taxpayer only if the taxpayer's adjusted gross income exceeds the adjusted gross income of each eligible parent and (under Prop. Reg. § 1.152-2(g)(1)(ii)) of any other taxpayer who is eligible to claim the person as a qualifying child. For purposes of these rules, Prop. Reg. § 1.152-2(g)(2) provides that the adjusted gross income of each person who files a joint return is the total adjusted gross income shown on the joint return. For example, if daughter, daughter's husband and their three-year-old child live with daughter's mother (grandmother), and if daughter and husband file a joint return showing total adjusted gross income of $45,000, grandmother can claim the child as a qualifying child only if daughter and husband do not do so and grandmother's adjusted gross income exceeds $45,000. This is a change from Publication 501, *Exemptions, Standard Deduction, and Filing Information*, and will be reflected in revisions to Publication 501. Since 2009, Publication 501 has stated that, if a child's parents file a joint return with each other, then the adjusted gross income of each parent is determined by dividing the parents' combined adjusted gross income equally between them.

*Noncustodial Spouse Claiming Dependency Exemption*—Section 152(e)(2)(A) provides that a noncustodial parent can claim the dependency exemption only if "the custodial parent signs a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such custodial parent will not claim such child as a dependent for any taxable year beginning in such calendar year." The IRS generally requires the custodial spouse's written declaration to be on Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*. Under Prop. Reg. § 1.152-5(e)(2)(i), the noncustodial spouse can submit the written declaration with an original return, an amended return, or during an examination of a return. However, a written declaration submitted with an amended return or during an

examination will not satisfy the requirement of § 152(e) if (1) the custodial parent signed the written declaration after the custodial parent filed a return claiming a dependency exemption for the child for the year at issue, and (2) the custodial parent has not filed an amended return to remove the custodial parent's claim of a dependency exemption.

*Childless Earned Income Credit*—The IRS's position since 1995, reflected in Publication 596, *Earned Income Credit*, has been that, if a person meets the definition of a qualifying child for more than one taxpayer but is not treated as the qualifying child of a taxpayer under the tiebreaker rules, then the taxpayer for whom the person is not a qualifying child is precluded from claiming the childless earned income credit (the earned income credit that is available to taxpayers without a qualifying child). The proposed regulations reflect a change in the IRS's position. According to Prop. Reg. § 1.32-2(c)(3)(ii), if a person is not a qualifying child of a taxpayer under the tiebreaker rules, then the person also is not treated as a qualifying child of the taxpayer for purposes of § 32(c)(1)(A), and therefore the taxpayer may claim the earned income credit for a taxpayer without a qualifying child if all other requirements for the earned income credit are satisfied.

*Effective Date*—The regulations are proposed to apply to taxable years beginning after the date final regulations are published in the Federal Register. Pending the issuance of final regulations, taxpayers can choose to apply the proposed regulations in any open tax years.

6. **A grandmother was precluded from claiming her grandchildren as dependents because her good-for-nothing son had done so, and the son's submission of an amended return to the IRS Chief Counsel attorney before trial did not change the result.** Smyth v. Commissioner, T.C. Memo. 2017-26 (2/7/17). The taxpayer, who worked as a certified nursing assistant, provided the financial support for her two young grandchildren and the parents of the grandchildren (the taxpayer's son and daughter-in-law). Her son, daughter-in-law, and grandchildren all lived in the taxpayer's home. Neither the son—referred to as being involved in dealing drugs—nor the daughter-in-law was employed. For the 2012 tax year, the taxpayer claimed her two grandchildren as dependents, head-of-household filing status, the earned income credit, and the child tax credit. Although the taxpayer's son represented to her that he and his wife had not claimed the children as dependents for 2012, this was not true. The IRS issued a notice of deficiency disallowing both the taxpayer's deduction for the two dependents and her earned income credit and child tax credit, and changing her filing status to single. Two weeks before trial, the son delivered to the IRS Chief Counsel attorney an amended return for 2012 on which he did not claim the children as dependents. The Tax Court (Judge Holmes) upheld the government's disallowance of the taxpayer's deduction and credits and its change of the taxpayer's filing status. The court observed that each grandchild was a "qualifying child" within the meaning of § 152(c) of both the taxpayer and the taxpayer's son. Under the tiebreaker rules of § 152(c)(4), if the parents of a qualifying child do not claim the child as a dependent, another individual with respect to whom the child is a qualifying child may do so if the individual's adjusted gross income is higher than that of both parents. Although the taxpayer's adjusted gross income was higher than that of her son and daughter-in-law, the court explained, the fact that her son had filed a return claiming the children as dependents precluded the taxpayer from doing so. The son's amended 2012 return on which the son did not claim the children as dependents did not change the result. Under the relevant regulations, an amended return is filed if it is mailed to the correct IRS Service Center or hand-delivered to a person assigned the responsibility to receive returns in the local IRS office. Submitting the amended return to the IRS Chief Counsel attorney handling the trial, the court reasoned, did not meet either requirement and therefore did not constitute "filing" the return. The court noted that the parent's filing of an amended return in some cases might allow another individual to claim the child as a dependent:

> A few cases imply that an amended return could under the right circumstances be used to give up a previously claimed dependency exemption deduction. In *Brooks*, we suggested that if the taxpayer's daughter had prepared an amended return releasing her claim before the IRS started auditing her mother and had filed it with the IRS before trial, then the court might have reached a different result.

> And in *McBride v. Commissioner*, T.C. Memo. 2015-6, we suggested that a grandfather might be entitled to a dependency exemption deduction for his grandchild if the child's mother had correctly filed an amended return giving up her claim before the IRS was barred from determining a deficiency against her. *Id.* at *4. We note that the Commissioner points out in his brief that allowing a taxpayer to amend his return—and essentially give his dependency exemption deduction to another—after he has already received a refund because of that deduction effectively puts the IRS in an unmanageable situation. We don't have to decide this question now, but will have to think about it carefully when someone in a case like this one actually files an amended return to give up a qualifying-child claim.

7. **He might not have been wearing an orange jumpsuit, but he still earned his income while he was an inmate at a penal institution, and therefore the income was excluded in determining eligibility for the EITC.** Skaggs v. Commissioner, 148 T.C. No. 15 (4/26/17). Section 32(c)(2)(B)(iv) provides that, in determining eligibility for the earned income tax credit, "no amount received for services provided by an individual while the individual is an inmate at a penal institution shall be taken into account." The taxpayer was convicted of several felony offenses, sentenced to 310 months' imprisonment, and taken into custody by the Kansas Department of Corrections. During 2015, the taxpayer resided in the Larned State Hospital, described by the court as "the home of the State security hospital, which was established to treat mentally ill inmates and those committed by the State and to hold them in custody." The taxpayer performed custodial duties at the hospital and filed a return for 2015 on which he reported $2,921 of income and claimed an EITC of $214. The IRS denied the EITC on the ground that the taxpayer had earned the income for services performed while he was an inmate at a penal institution. The Tax Court (Judge Buch) upheld the IRS's denial of the credit. The court noted that neither the statute nor the regulations define the terms "inmate" or "penal institution." Nevertheless, the court concluded that the taxpayer was an inmate at a penal institution. The court reasoned that, although he might not have been subject to some of the restrictions that normally apply to inmates in Kansas correctional facilities (e.g., the taxpayer asserted that he was able to wear his own clothes and had greater discretion with the income he earned), he was still an inmate. The court also concluded, based on the statutes that govern the hospital, that it was a penal institution.

8. **Final regulations provide guidance on eligibility for the § 36B premium tax credit of married taxpayers who are victims of domestic abuse or spousal abandonment and do not file a joint return, allocation rules for reconciliation of advance credit payments and the credit, and guidance on the deduction for health insurance costs of self-employed individuals.** T.D. 9822, Health Insurance Premium Tax Credit, 82 F.R. 34601 (7/26/17). The Treasury Department and the IRS have finalized, with only a minor change, proposed and temporary regulations (T.D. 9683, Rules Regarding the Health Insurance Premium Tax Credit, 79 F.R. 43622 (7/28/14)) regarding the premium tax credit authorized by § 36B for individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through an Affordable Insurance Exchange. The regulations generally apply to taxable years beginning after December 31, 2013.

*Eligibility for the Premium Tax Credit of Married Taxpayers Who Are Victims of Domestic Abuse or Spousal Abandonment*—To be eligible for the premium tax credit, an individual who is married within the meaning of § 7703 must, among other requirements, file a joint return. See I.R.C. § 36B(c)(1)(C). Married individuals who live apart can be treated as not married if they meet the requirements of § 7703(b), but victims of domestic abuse or spousal abandonment might not meet those requirements. Accordingly, absent relief, victims of domestic abuse or spousal abandonment who are married and do not file a joint return (e.g., because of the risk of injury arising from contacting the other spouse, a restraining order that prohibits contact with the other spouse, or inability to locate the other spouse) would be precluded from claiming the premium tax credit. The final regulations provide that a married taxpayer will satisfy the joint

filing requirement of § 36B(c)(1)(C) if he or she uses a filing status of married filing separately and meets three requirements: (1) at the time the individual files the return, the individual lives apart from his or her spouse, (2) the individual is unable to file a joint return because he or she is a victim of domestic abuse or spousal abandonment, and (3) the individual certifies on the return in accordance with instructions that he or she meets the first two requirements. Reg. § 1.36B-2(b)(2)(iii). A taxpayer ceases to be eligible for this relief from the joint filing requirement if he or she qualified for the relief for each of the three preceding taxable years. Reg. § 1.36B-2(b)(2)(v). The final regulations generally define domestic abuse as including "physical, psychological, sexual, or emotional abuse, including efforts to control, isolate, humiliate, and intimidate, or to undermine the victim's ability to reason independently." Reg. § 1.36B-2(b)(2)(iii). A taxpayer is considered a victim of spousal abandonment "if, taking into account all facts and circumstances, the taxpayer is unable to locate his or her spouse after reasonable diligence." Reg. § 1.36B-2(b)(2)(iv).

*Allocation Rules for Reconciliation of Advance Credit Payments and Premium Tax Credit*—An individual who enrolls in coverage through a health insurance exchange can seek advance payment of the premium tax credit authorized by § 36B. The exchange makes an advance determination of eligibility for the credit and, if approved, the credit is paid monthly to the health insurance issuer. An individual who receives advance credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year. If the taxpayer's advance credit payments exceed the actual premium tax credit allowed, then the taxpayer owes the excess as a tax liability. A taxpayer must reconcile the advance credit payments for coverage of all members of the taxpayer's family (defined as the taxpayer, spouse, and dependents) with the premium tax credit the taxpayer is allowed for the taxable year. To compute the premium tax credit and perform the required reconciliation, a taxpayer must know the advance credit payments, the actual premiums paid, and the premiums for the second lowest cost silver plan (the benchmark plan) for all family members. The final regulations provide rules for allocating advance credit payments, premiums, and benchmark plan premiums among family members. This allocation is necessary when: (1) married individuals file separate returns, (2) married individuals become divorced or legally separated during the year, or (3) an individual such as a child is enrolled in a qualified health plan by one taxpayer but another taxpayer claims a personal exemption deduction for the individual. In the latter two situations, the taxpayers can agree on an allocation percentage and, if the taxpayers do not agree, a default allocation percentage is provided.

*Deduction for Health Insurance Costs of Self-Employed Individuals*—A self-employed individual who is enrolled in a qualified health plan and eligible for the premium tax credit may also be allowed a deduction under § 162(*l*) for premiums paid for health insurance covering the taxpayer, the taxpayer's spouse, the taxpayer's dependents, and any child of the taxpayer who has not attained age 27. The final regulations provide rules for taxpayers who claim a § 162(*l*) deduction and also may be eligible for a § 36B credit for the same qualified health plan or plans. Under the final regulations, a taxpayer is allowed a § 162(*l*) deduction for "specified premiums" not to exceed an amount equal to the lesser of (1) the specified premiums less the premium tax credit attributable to the specified premiums, and (2) the sum of the specified premiums not paid through advance credit payments and the additional tax imposed under § 36B(f)(2)(A) and Reg. § 1.36B-4(a)(1) with respect to the specified premiums after the application of the limitation on additional tax in § 36B(f)(2)(B) and Reg. § 1.36B-4(a)(3). See Reg. § 1.162(*l*)-1T(a)(1). The term "specified premiums" generally is defined as premiums for which the taxpayer can otherwise claim a deduction under § 162(*l*) for a qualified health plan covering the taxpayer or another member of the taxpayer's family for a month that a premium tax credit is allowed for the family member's coverage.

**E. Divorce Tax Issues**

1. **A blue moon arrives in the Tax Court—a taxpayer successfully establishes through credible testimony that he was entitled to the dependency exemption, earned income tax credit, and child tax credit.** Tsehay v. Commissioner, T.C. Memo. 2016-

200 (11/3/16). The taxpayer, whose first language was not English and who worked as a custodian at a community college, filed a return on Form 1040A for 2013 through a paid preparer. On the return, the taxpayer claimed head of household filing status, a dependency exemption and the child tax credit for four children, and an earned income tax credit for three children. (It was unclear from the record why the paid preparer had listed different numbers of children for the exemptions and credits.) The IRS issued a notice of deficiency disallowing all of the claimed exemptions and credits. The notice also changed the taxpayer's filing status to single and imposed an accuracy-related penalty under § 6662(a). The IRS took the position that the taxpayer, who had previously been separated from his wife and ordered to pay child support, was a noncustodial parent and therefore subject to § 152(e)(2), which provides that a noncustodial parent can claim the dependency exemption for a child only if the custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent and the noncustodial parent attaches the written declaration to his or her tax return. The taxpayer had failed to submit Form 8332, the form designated for such written declarations, with his income tax return. The Tax Court (Judge Kerrigan) found credible the taxpayer's testimony at trial. The taxpayer testified that, during 2013, he and his wife were married and lived together with their five children in a public housing apartment. Based on this testimony, the court held that the taxpayer was entitled to the dependency exemptions, the child tax credit, and the earned income tax credit. The court rejected the IRS's reliance on a child support order to establish that the taxpayer was a noncustodial parent because the order was entered in August 2015, after the tax year in issue. Regarding his filing status, the taxpayer testified that he and his wife had separated by the time he filed his 2013 return and that he had asked the preparer to list his filing status as married filing separately. The preparer erroneously listed his filing status as head of household. The court held that his filing status could not be changed to single, as the IRS contended, but instead should be married filing separately. Although the erroneous filing status might have supported the accuracy-related penalty, the court held that the taxpayer—who had a language barrier, sought and relied on professional advice, and was separated from his wife when he filed his return—had established a reasonable cause, good faith defense.

• There appears to be some inconsistency in the court's conclusions. A taxpayer whose filing status is married filing separately cannot claim the earned income tax credit.

a. **Oops, the Tax Court must have missed that, says the IRS.** A.O.D. 2017-05, 2017-27 I.R.B. 1 (7/3/17). The IRS has nonacquiesced in the Tax Court's decision in *Tsehay*. Specifically, "the Service will not follow the court's opinion in *Tsehay* in allowing an EITC to a married taxpayer filing separately."

**F. Education**

**G. Alternative Minimum Tax**

## VI. CORPORATIONS

**A. Entity and Formation**

**B. Distributions and Redemptions**

**C. Liquidations**

**D. S Corporations**

1. **A § 267 "looptrap" snares an accrual-method subchapter S corporation with an ESOP shareholder.** Petersen v. Commissioner, 148 T.C. No. 22 (6/13/17). The taxpayers, a married couple, owned stock in an accrual-method S corporation with many employees. As permitted by § 1361(c)(7), an ESOP benefitting the employees also owned stock in the S corporation. The S corporation had accrued and deducted the following amounts with respect to its ESOP participants as of the end of its 2009 and 2010 tax years: for 2009, unpaid wages of $1,059,767 (paid by January 31, 2010) and vacation pay of $473,744 (paid by December 31, 2010); for 2010, unpaid wages of $825,185 (paid by January 31, 2011) and vacation pay of $503,896 (paid by December 31, 2011). Notwithstanding the fact that the S corporation was an accrual-method taxpayer, the IRS asserted under § 267(a)(2) (forced-

matching) that the corporation was not entitled to deduct the foregoing accrued amounts until the year of actual payment and inclusion in gross income by the ESOP's employee-participants. In a case of first impression, the Tax Court (Judge Lauber) agreed with the IRS based upon a plain reading of §§ 67(a)(2), (b), and (e), as well as a determination that the S corporation's ESOP is a "trust" within the meaning of § 267(c). Specifically, § 267(a)(2) generally requires so-called "forced matching" of an accrual-method taxpayer's deductions with the gross income of a cash-method taxpayer to whom a payment is to be made if the taxpayer and the person to whom the payment is to be made are related persons as defined by § 267(b). For an S corporation, pursuant to § 267(e), all shareholders are considered related persons under § 267(b) regardless of how much or how little stock such shareholders actually *or constructively* own. Furthermore, under § 267(c) beneficiaries of a trust are deemed to own any stock held by the trust. Because the assets held by an ESOP are owned by a trust (as required by ERISA, *see* 29 U.S.C. § 1103(a)), the participating employees of the ESOP are treated as shareholders of the S corporation. Hence, the forced-matching rule of § 267(a)(2) applies to accrued but unpaid wages and vacation pay owed to the S corporation's ESOP participants at the end of the year. Judge Lauber noted that this odd situation probably was a "drafting oversight"—in our words, a *looptrap*—because § 318, which defines related parties for certain purposes under subchapter C, excepts tax-exempt employee trusts from its constructive ownership rules. Nevertheless, Judge Lauber wrote, the Tax Court is "not at liberty to revise section 267(c) to craft an exemption that Congress did not see fit to create." Mercifully, however, the Tax Court declined to impose § 6662 negligence or substantial understatement penalties on the taxpayers because the case was one where "the issue was one not previously considered by the Court and the statutory language was not clear" (even though the court obviously relied upon the plain language of § 267 to reach its decision).

### E. Mergers, Acquisitions and Reorganizations

### F. Corporate Divisions

**1. Guidance on north-south transactions in corporate divisions.** Rev. Rul. 2017-9, 2017-21 I.R.B. 1244 (5/3/17). This ruling considers whether transfers of money or property by a parent or subsidiary followed by a subsidiary's distribution of a controlled corporation's stock should be respected as separate transactions or instead integrated in two situations.

*Situation 1.* In the first situation, a parent corporation (P) transfers assets that constitute an active trade or business (conducted by P for at least five years) with a value of $25,000 to a wholly-owned subsidiary, D, which previously was not engaged in the active conduct of a trade or business, in exchange for additional shares of D's stock. Subsequently, D distributes to P as a dividend (and for a valid business purpose) all of the stock, worth $100,000, of D's wholly-owned subsidiary, C, which has been engaged in the active conduct of a trade or business for at least five years. Following these transfers, D continues to operate the business it received from P. If these transfers are integrated, then P's transfer of business assets to D would be treated as made in exchange for 25 percent of the stock of C, which would result in recognition of gain or loss for both P and D. Further, because D would then be treated as distributing only the remaining 75 percent of the stock of C to P, D's distribution of the remaining C stock would not qualify for nonrecognition under § 355 and D therefore would recognize gain under § 311(b). P would be treated as receiving a distribution from D subject to the rules of § 301(c) (a dividend to the extent of D's earnings and profits, followed by recovery of basis, followed by gain). In contrast, if the transfers are respected as separate transactions, then P's transfer of business assets to D in exchange for additional stock of D would qualify for nonrecognition under § 351, and D's distribution of the stock of C to P would qualify for nonrecognition under § 355 (assuming all requirements of §§ 351 and 355 are otherwise satisfied). The ruling concludes that the transfers will be respected as separate transactions and therefore qualify for nonrecognition. The ruling emphasizes that there is nothing to indicate that P's transfer should be properly treated other than in accordance with its form, that each step provides for continued ownership in modified corporate form, that the steps do not resemble a sale, and that none of the interests are liquidated or otherwise redeemed.

*Situation 2.* In the second situation, D and C each have been engaged in the active conduct of a trade or business for at least five years. C declares a dividend and, pursuant to this declaration, transfers to D $15,000 in money and property having a fair market value of $10,000, which D retains. Subsequently, D transfers to C property having a fair market value of $100,000 and a basis of $20,000, and distributes to P all of the C stock owned by D in a transaction qualifying as a reorganization under §§ 368(a)(1)(D) and 355. The ruling states that the initial dividend declaration by C is part of the plan of reorganization. If C's distribution of money and property to D is treated as separate from D's distribution of the C stock to P, then C's distribution to D would be governed by the rules of § 301(c) and D would not recognize gain from its transfer of property to C. If instead C's dividend declaration is considered part of the plan of reorganization, then the distribution by C would constitute boot to D (because D did not distribute it to shareholders in pursuance of the plan of reorganization), and D therefore would recognize gain on the transfer of property to C to the extent of the money and fair market value of property received from C. The ruling concludes that, because C's distribution is made in pursuance of the plan of reorganization, D will be treated as receiving boot subject to recognition of gain. In reaching this conclusion, the ruling relies on *Estate of Bell v. Commissioner*, T.C. Memo. 1971-285, for the proposition that the rules regarding boot are "the exclusive measure of dividend income provided by Congress where cash is distributed to shareholders as an incident of a reorganization."

*Change in Policy on Issuing Private Letter Rulings.* Section 5.02 of Rev. Proc. 2017-3, 2017-1 I.R.B. 130 (12/29/16), provided that the Service would not rule on whether transfers of money, stock, or other property in north-south transactions would be respected as separate transactions. This ruling removes § 5.02 from Rev. Proc. 2017-3, which means that the Service will now issue private letter rulings on this question. The ruling cautions, however, that the Service may decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case.

### G. Affiliated Corporations and Consolidated Returns

**1. The Tax Court invokes a "common law" doctrine to disallow a double deduction for the same economic loss.** Duquesne Light Holdings, Inc. v. Commissioner, T.C. Memo. 2013-216 (9/11/13). Duquesne Light Holdings, Inc. was the common parent of a consolidated group of corporations. Duquesne held 1.2 million shares of AquaSource, Inc., which until 2001 was a wholly-owned member of the group. In 2001, Duquesne sold 50,000 shares of AquaSource to Lehman Brothers—remember them—and claimed a capital loss of approximately $199 million ("2001 stock loss"). Duquesne filed an application for tentative refund, in which it carried back to 2000 a portion of the 2001 stock loss, and the IRS paid a tentative refund of $35 million. In 2002 and 2003, AquaSource, while still a member of the group, sold all of its assets (stock in its wholly-owned subsidiaries) and recognized aggregate capital losses of $252 million ("2002 and 2003 assets losses"), which were claimed on Duquesne's consolidated return, carried back to 2000, and resulted in the IRS paying a tentative refund of $52 million. The IRS determined that the 2001 stock loss on the disposition of 50,000 shares of AquaSource stock (approximately 4% of the stock) recognized by the common parent was a loss attributable to the fact that there was built-in loss in the underlying assets of AquaSource, and that the group was not permitted to take the duplicative portion ($199 million) of the 2002 and 2003 asset losses upon the subsequent sale of AquaSource's assets under the doctrine of *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934). The Tax Court (Judge Chiechi) upheld the IRS's determination, relying in part on its prior opinion in *Thrifty Oil v. Commissioner*, 139 T.C. 198 (2012). In doing so, the court rejected the taxpayer's argument that *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), which held invalid the loss disallowance rule of former Reg. § 1.1502-20, supported allowing deduction of the 2002 and 2003 assets losses, and that the disallowance of double deductions could be effected only through the promulgation of valid regulations. Although the court acknowledged that former Temp. Reg. § 1.1502-35T, which was in effect for the years in question, did not disallow the

losses, the court concluded that nothing prohibited it from disallowing duplicate deductions for the same economic loss under *Charles Ilfeld Co.* Finally, the court held that even though the limitations period on assessment had expired for 2000–the year to which losses had been carried back–the period was still open pursuant to § 6501(h) and § 6501(k), thereby allowing the IRS to assess a deficiency attributable to the disallowance of the loss carryback.

a. **The *Ilfeld* doctrine is alive and well in the Third Circuit, which concluded that the failure of the consolidated return regulations to disallow a loss is not clear authorization for the taxpayer to take a double deduction for the same economic loss.** Duquesne Light Holdings, Inc. v. Commissioner, 861 F.3d 396 (3d Cir. 6/29/17), *aff'g* T.C. Memo. 2013-216 (9/11/13). In an opinion (2-1) by Judge Ambro, the Third Circuit affirmed the Tax Court's decision. The majority opinion construed *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), as standing for the proposition that there is a presumption that statutes and regulations do not allow a double deduction for the same economic loss, and "[t]his presumption must be overcome by a clear declaration in statutory text or a properly authorized regulation." The majority acknowledged that there is some uncertainty whether the *Ilfeld* doctrine applies to taxpayers not filing consolidated returns, but concluded that it "remains good law in the consolidated-return context." The court held that neither the text of § 165, nor the combination of the statutory text with the applicable regulations, authorized the taxpayer to deduct the same economic loss twice. According to the court, the language of § 165(a), which authorizes a deduction for "any loss sustained during the taxable year and not compensated for by insurance or otherwise," is broad and does not meet the *Ilfeld* doctrine's "requirement of explicit approval for duplicating the underlying economic loss." The regulations in effect during the years in question did not preclude Duquesne from deducting the 2002 and 2003 asset losses. One regulation, Reg. § 1.1502-35T, precluded deduction of a loss recognized on the disposition of subsidiary stock to the extent of the duplicated loss if, immediately after the disposition, the subsidiary remained a member of the consolidated group. This regulation did not apply to the 2002 and 2003 asset losses because the subsidiaries that AquaSource sold were not members of the consolidated group after their disposition. Duquesne relied on Reg. § 1.337(d)-2T as authority for its deduction of the 2002 and 2003 asset losses. Paragraph (a)(1) of Reg. § 1.337(d)-2T provided a general rule that "[n]o deduction is allowed for any loss recognized by a member of a consolidated group with respect to the disposition of stock of a subsidiary loss." Paragraph (c)(2) provided that a loss on the disposition of subsidiary stock "is not disallowed" by the general rule "to the extent the taxpayer establishes that the loss or basis is not attributable to the recognition of built-in gain ... on the disposition of an asset (including stock and securities)." Although Reg. § 1.337(d)-2T did not disallow Duquesne's 2002 and 2003 asset losses, the court held that the regulation was insufficient to overcome the presumption of *Ilfeld* because "there is no mention in the regulation of approval for a loss deduction that duplicates another already taken for the same underlying economic loss." The court emphasized that Reg. § 1.337(d)-2T "has nothing to do with loss duplication" because it was accompanied by Notice 2002-18, 2002-1 C.B. 644, which stated that "the IRS and Treasury believe that a consolidated group should not be able to benefit more than once from one economic loss" and would issue another regulation addressing that issue. That other regulation, issued in 2003 retroactive to 2002, was Reg. § 1.1502-35T which, as previously discussed, did not preclude the 2002 and 2003 asset losses. The majority also affirmed the Tax Court's ruling that the IRS's assessment of a deficiency attributable to the disallowance of the loss carryback was not barred by the limitations period on assessment.

• In a dissenting opinion, Judge Hardiman disagreed with several aspects of the majority's reasoning. He took issue with the majority's conclusion that *Ilfeld* requires an explicit authorization of a double deduction:

> That means even if the Code separately allows Deduction A and Deduction B, the taxpayer could not take both deductions unless a provision authorized them both to be taken simultaneously. This triple-authorization requirement, I believe, goes above and beyond any rule envisioned by the Supreme Court.

Judge Hardiman emphasized that *Ilfeld* requires only that a provision of the statute or regulations can "fairly be read to authorize" the double deduction. He concluded that Reg. § 1.337(d)-2T can fairly be read to authorize Duquesne's deduction. "When the IRS writes that a deduction is 'not disallowed,' we should accept that it is not. And without that ambiguity, it is not our place to investigate the structure and purpose of the scheme in order to restyle the language of the regulation." Regarding the interplay of the regulations and the *Ilfeld* doctrine, Judge Hardiman stated:

> [I]t seems unnatural for the IRS to write a regulation that literally authorizes a specific action, only to expect taxpayers to appreciate that the regulation is undermined by common-law doctrines lurking in the shadows.

2. **A U.S. District Court concludes that the members of a consolidated group who bore the economic burden of a tax have a property right in the refund of that tax, and the group's tax allocation agreement did not change that result.** Federal Deposit Insurance Corp. v. FBOP Corp., ___ F. Supp. 3d ___, 119 A.F.T.R.2d 2017-1833 (N.D. Ill. 5/12/17). The common parent of a consolidated group, FBOP Corporation, received two tax refunds in the amounts of $10.3 million and $265.3 million. The $10.3 million refund was produced by estimated tax payments funded by banks that were subsidiary members of the consolidated group for 2009, during which the group experienced a consolidated net operating loss (CNOL) and therefore did not have any liability for federal income tax. The $265.3 million refund was produced by FBOP's filing of amended consolidated returns for 2004 through 2008 to carry back the 2009 CNOL pursuant to 2009 legislation that extended the carryback period. According to the FDIC, all of the 2009 CNOL was attributable to the operating losses of the bank subsidiaries. During 2009, each bank subsidiary was placed into receivership with the FDIC as its receiver. The group's common parent, FBOP, subsequently entered into settlement agreements with its creditors in which FBOP pledged all of its assets as security for previously unsecured debt and ultimately assigned all of its assets to a trustee for the benefit of creditors, including any property interest of FBOP in the tax refunds. The issue in the case is whether the bank subsidiaries have a property interest in the tax refunds, in which case the refunds must be turned over to the FDIC, or instead a contractual right to the refunds, in which case the refunds must be turned over to the trustee for the benefit of FBOP's creditors. In ruling on motions for partial judgment on the pleadings, the court (Judge Durkin) applied Illinois law rather than federal common law but noted that the court might reconsider the choice of law issue in the future. The court held that, under Illinois law, "the party who paid the taxes, or, more accurately, bore the economic burden of the taxes, is the owner of any refunds resulting from those taxes." Further, the court held that the consolidated group's tax allocation agreement did not override this "default rule" of state law. Because the bank subsidiaries bore the economic burden of the taxes that were refunded, the court denied FBOP's motion for judgment on the pleadings and held that the banks (and therefore the FDIC) had property rights in the tax refunds. However, because the court was unable to determine whether the bank subsidiaries had paid the entire amount of the original taxes that led to the $265.3 million refund (and whether the tax allocation agreement required FBOP to distribute all of it to the banks), the court withheld ruling on the FDIC's cross-motion for partial judgment on the pleadings pending further proceedings.

3. **Better be careful in drafting those tax allocation agreements! A subsidiary member of a consolidated group was entitled to a refund produced by the subsidiary's loss because the group's tax allocation agreement was ambiguous and provided that any ambiguity must be resolved in favor of the subsidiary.** In re United Western Bancorp, Inc., ___ F. Supp. 3d ___, 2017 WL 2928031 (D. Colo. 7/10/17). United Western Bancorp, Inc. ("Holding Company") was the common parent of a consolidated group. One member of the consolidated group was a wholly-owned subsidiary, United Western Bank ("Bank"). The Holding Company received a refund of $4.8 million that was produced by carrying back a 2010 consolidated net operating loss (produced by the Bank's loss) to 2008, a year in which the consolidated group had paid tax on income of the Bank. According to the court, "[t]here is no dispute that, to whatever extent a refund was due, it was entirely the result of

revenue generated by the Bank in 2008 and losses incurred by the Bank in 2010 ...." In the same year the 2010 consolidated return was filed, the Bank was placed into receivership with the FDIC as its receiver. Subsequently, the Holding Company became a debtor in a chapter 7 bankruptcy proceeding. The bankruptcy trustee asserted that the refund was an asset of the bankruptcy estate, and the FDIC asserted that the refund was an asset of the Bank. In a thorough and thoughtful opinion, the District Court (Judge Martinez) held that the Bank was entitled to the refund. The court noted that, in *Barnes v. Harris*, 783 F.3d 1185 (10th Cir. 2015), the Tenth Circuit, relying on *In re Bob Richards Chrysler-Plymouth Corp., Inc.*, 473 F.2d 262 (9th Cir. 1973), had held that, in the absence of a contrary agreement, "a tax refund due from a joint return generally belongs to the company responsible for the losses that form the basis of the refund." In this case, however, the consolidated group members had entered into a tax allocation agreement. The District Court ultimately framed the issue as whether, under the tax allocation agreement, the Holding Company was acting as the agent of the Bank or instead had a standard commercial relationship with the Bank. If the former, then the Holding Company was acting as a fiduciary of the Bank and the refund would belong to the Bank; if the latter, then the Bank was a creditor of the Holding Company and the refund would be an asset of the Holding Company's bankruptcy estate. The court concluded that the tax allocation agreement was ambiguous on this point, which triggered a provision in the agreement that required any ambiguity in the agreement to be resolved in favor of the Bank. Accordingly, the court concluded, the Bank had equitable title to the refund. The Holding Company had only legal title to the refund and the refund was not part of the Holding Company's bankruptcy estate.

**H. Miscellaneous Corporate Issues**

1. **Form is substance, says the Sixth Circuit. The IRS is precluded from recharacterizing a corporation's payments to a DISC held by a Roth IRA.** Summa Holdings, Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2/16/17), *rev'g* T.C. Memo 2015-119 (6/29/15). Two members of the Benenson family each established a Roth IRA by contributing $3,500. Each Roth IRA paid $1,500 for shares of a Domestic International Sales Corporation (DISC). These members of the Benenson family were the beneficial owners of 76.05 percent of the shares of Summa Holdings, Inc., the taxpayer in this case and a subchapter C corporation. Summa Holdings paid (and deducted) commissions to the DISC, which paid no tax on the commissions. The DISC distributed dividends to each of the Roth IRAs, which paid unrelated business income tax on the dividends (at roughly a 33 percent rate according to the court) pursuant to § 995(g). (The structure involved a holding company between the Roth IRA and the DISC, but the presence of the holding company appears not to have affected the tax consequences.) This arrangement allowed the balance of each Roth IRA to grow rapidly. From 2002 to 2008, the Benensons transferred approximately $5.2 million from Summa Holdings to the Roth IRAs through this arrangement, including $1.5 million in 2008, the year in issue. By 2008, each Roth IRA had accumulated over $3 million. The IRS took the position that the arrangement was an impermissible way to avoid the contribution limits that apply to Roth IRAs. The IRS disallowed the deductions of Summa Holdings for the commissions paid to the DISC and asserted that, under the substance-over-form doctrine, the arrangement should be recharacterized as the payment of dividends by Summa Holdings to its shareholders, followed by contributions to the Roth IRAs by the two members of the Benenson family who established them. The IRS determined that each Roth IRA had received a deemed contribution of $1.1. By virtue of their level of income, the two Benenson family members were ineligible to make any Roth IRA contributions. Pursuant to § 4973, the IRS imposed a 6 percent excise tax on the excess contributions. The Tax Court (Judge Kerrigan) upheld the IRS's recharacterization. In an opinion by Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit reversed. The court emphasized that "[t]he Internal Revenue Code allowed Summa Holdings and the Benensons to do what they did." The issue was whether the IRS's application of the substance-over-form doctrine was appropriate. The court first expressed a great deal of skepticism about the doctrine:

> Each word of the "substance-over-form doctrine," at least as the Commissioner has used it here, should give pause. If the government can undo transactions that

> the terms of the Code expressly authorize, it's fair to ask what the point of making these terms accessible to the taxpayer and binding on the tax collector is. "Form" is "substance" when it comes to law. The words of law (its form) determine content (its substance). How odd, then, to permit the tax collector to reverse the sequence—to allow him to determine the substance of a law and to make it govern "over" the written form of the law—and to call it a "doctrine" no less.

Although the court expressed the view that application of the substance-over-form doctrine makes sense when a "taxpayer's formal characterization of a transaction fails to capture economic reality and would distort the meaning of the Code in the process," this was not such a case. The substance-over-form doctrine as applied by the IRS in this case, the court stated, was a "distinct version" under which the IRS claims the power to recharacterize a transaction when there are two possible options for structuring a transaction that lead to the same result and the taxpayer chooses the lower-tax option. The court concluded that the IRS's recharacterization of Summa Holding's transactions as dividends followed by Roth IRA contributions did not capture economic reality any better than the taxpayer's chosen structure of DISC commissions followed by dividends to the DISC's shareholders.

2. **Due date of corporate income tax returns: temporary and proposed regulations address the filing date chaos created by Congress**. T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of corporate income tax returns. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require C corporations to file their income tax returns by the 15th day of the fourth month after the close of their taxable year (by subjecting them to § 6702(a)), thus deferring the due date by one month. On the other hand, under amended § 6072(b), S corporations continue to be required to file their tax returns by the 15th day of the third month (March 15 for calendar year S corporations). Pursuant to this statutory directive, Temp. Reg. § 1.6072-2T(a)(1) provides that the income tax return of a C corporation is due on the 15th day of the fourth month following the close of its taxable year and that the income tax return of an S corporation is due on or before the 15th day of the third month following the close of its taxable year. However, pursuant to Temp. Reg. § 1.6072-2T(a)(2), the income tax return of a C corporation that has a taxable year that ends on June 30 is due on the 15th day of the *third* month following the close of its taxable year for taxable years beginning before January 1, 2026. (Yes, that's correct, a ten-year deferred effective date only for C corporations with a fiscal year ending on June 30.) For this purpose, a return for a short period ending on any day in June is treated as a return for a taxable year that ends on June 30. This special rule for C corporations using a June 30 taxable year implements the effective date rule enacted by § 2006(a)(3) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.

- The extended due dates for C corporation returns were changed by § 2006(c) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 through amendments to Code § 6081(b). The temporary regulations reflect these changes. Pursuant to Temp. Reg. § 1.6081-3T, a C corporation is allowed an automatic six-month extension of the due date. However, for periods beginning before January 1, 2026, the automatic extension is 7 months for a C corporation with a taxable year that ends on June 30. Code § 6081(b), as amended by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, provides that the automatic extension is only 5 months for a calendar-year C corporation for periods ending before January 1, 2026. Nevertheless, the temporary regulations provide an automatic 6-month extension for calendar-year C corporations pursuant to § 6081(a), which authorizes the Secretary of the Treasury to grant reasonable extensions of not more than 6 months.

- The temporary regulations apply to corporate returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for corporate taxable years that begin after December 31, 2015. Accordingly, the preamble to the

temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

## VII. PARTNERSHIPS

### A. Formation and Taxable Years

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

**1. Figuring out partners' shares of partnership debt gets complicateder and complicateder as the Treasury and IRS nail down the coffin lid on *Canal*-type transactions.** T.D. 9788, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69282 (10/5/16). The IRS and Treasury have published final and temporary regulations (proposed in REG-119305-11, Section 707 Regarding Disguised Sales, Generally, 79 F.R. 4826 (1/30/14)) under §§ 707 and 752, relating to disguised sales of property to or by a partnership under § 707(a)(2)(B) and concerning the treatment of partnership liabilities under § 752.

*Disguised Sales of Property*—New Temp. Reg. § 1.707-5T(a)(2) provides, for purposes of the disguised sale rules, that the partners' shares of any partnership liabilities, regardless of whether they are recourse or nonrecourse under Reg. § 1.752-1 through 1.752-3, must be allocated in the manner that "excess nonrecourse liabilities" are allocated under Reg. § 1.752-3(a)(3)—which has been amended in T.D. 9787, 81 F.R. 69291 (10/5/16). Reg. § 1.752-3(a)(3) has been amended to provide that, for purposes of determining a partner's share of partnership liabilities in applying the disguised sale rules of § 707(a)(2)(B) and Reg. § 1.707-5(a)(2), regardless of whether they are recourse or nonrecourse, only the default rule for allocating partnership "excess nonrecourse liabilities"—in accordance with the partners' interests in partnership profits—applies, unless another partner bears the economic risk of loss. This means that for purposes of applying the § 707 disguised sale rules, the contributing partner's share of partnership liabilities cannot be determined with reference to that partner's economic risk of loss under Reg. § 1.752-2. The Treasury and IRS believe that for purposes of the disguised sale rules, this allocation method reflects the overall economic arrangement of the partners. According to the preamble, "[i]n most cases, a partnership will satisfy its liabilities with partnership profits, the partnership's assets do not become worthless, and the payment obligations of partners or related persons are not called upon." These rules are designed to be the death knell of leveraged partnership disguised sale transactions ala *Canal Corp. v. Commissioner*, 135 T.C. 199 (2010), to which reference is made in the preamble.

*Effective Date of New Rules for Disguised Sales*—There are complex effective dates that provide for transition; the new rules are completely effective for transactions with respect to which all transfers occur on or after 1/3/17.

*Recourse versus Nonrecourse Debt*—New Temp. Reg. § 1.752-2T(b)(3) continues to provide that "[t]he determination of the extent to which a partner or related person has an obligation to make a payment under [Reg. § 1.752-2(b)(1)] is based on the facts and circumstances at the time of the determination," and that "[a]ll statutory and contractual obligations relating to the partnership liability are taken into account." However, the temporary regulation now carves out an exception under which "bottom dollar" guarantees and indemnities (or their equivalent, termed "bottom dollar payments") will not be recognized. Temp. Reg. § 1.752-2T(b)(3)(ii) and (iii). Temp. Reg. § 1.752-2T(b)(3)(ii)(C) provides:

> [t]he term "bottom dollar payment obligation" includes (subject to certain exceptions): (1) any payment obligation other than one in which the partner or related person is or would be liable up to the full amount of such partner's or related person's payment obligation if, and to the extent that (A) any amount of the partnership liability is not otherwise satisfied in the case of an obligation that is a guarantee or other similar arrangement, or (B) any amount of the indemnitee's or benefited party's payment obligation is satisfied in the case of an obligation which is an indemnity or similar arrangement; and (2) an arrangement with respect to a partnership liability that uses tiered partnerships, intermediaries, senior and subordinate liabilities, or similar arrangements to convert what would

> otherwise be a single liability into multiple liabilities if, based on the facts and circumstances, the liabilities were incurred (A) pursuant to a common plan, as part of a single transaction or arrangement, or as part of a series of related transactions or arrangements, and (B) with a principal purpose of avoiding having at least one of such liabilities or payment obligations with respect to such liabilities being treated as a bottom dollar payment obligation. Any payment obligation under [Reg.] § 1.752-2, including an obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership as described in [Reg.] §1.704-1(b)(2)(ii)(b)(3), may be a bottom dollar payment obligation if it meets the requirements set forth above.

As long as a partner or related person is or would be liable for the full amount of a payment obligation, the obligation will be recognized under Temp. Reg. § 1.752-2T(b)(3) if, taking into account any indemnity, reimbursement agreement, or similar arrangement, that partner or related person is liable for at least 90 percent of the initial payment obligation. Temp. Reg. § 1.752-2T(b)(3)(ii)(B). Also, a payment obligation is not a bottom dollar obligation merely because a maximum amount is placed on the partner's or related person's payment obligation, a partner's or related person's payment obligation is stated as a fixed percentage of every dollar of the partnership liability to which such obligation relates, or there is a right of proportionate contribution running between partners or related persons who are co-obligors with respect to a payment obligation for which each of them is jointly and severally liable. Temp. Reg. § 1.752-2T(b)(3)(ii)(C)(2). Guarantees of a vertical slice of a partnership liability will be recognized.

*Anti-Abuse Rules*—Temp Reg. § 1.752-2T(j)(2) provides an anti-abuse rule that the IRS can apply to assure that if a partner actually bears the economic risk of loss for a partnership liability, partners may not agree among themselves to create a bottom dollar payment obligation so that the liability will be treated as nonrecourse.

*Disclosure requirement*—Temp. Reg. § 1.752-2T(b)(3)(ii)(D) requires the partnership to disclose to the IRS all bottom dollar payment obligations with respect to a partnership liability on a completed Form 8275, Disclosure Statement, attached to the partnership return for the taxable year in which the bottom dollar payment obligation is undertaken or modified.

*Effective Date of New Rules on Recourse vs. Nonrecourse Debt*—Subject to an exception for written binding contracts already in effect, the new rules generally apply to liabilities incurred or assumed by a partnership and payment obligations imposed or undertaken with respect to a partnership liability on or after 10/5/16. A partner whose allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on the date the temporary regulations are finalized can continue to apply the existing regulations under § 1.752–2 with respect to a partnership liability for a seven-year period to the extent that the partner's allocable share of partnership liabilities exceeds the partner's adjusted basis in its partnership interest on 10/5/16.

2. **Proposed Regulations Address Deficit Restoration Obligations and When Partnership Liabilities Are Treated as Recourse Liabilities.** REG-122855-15, Liabilities Recognized as Recourse Partnership Liabilities Under Section 752, 81 F.R. 69301 (10/5/16). The Treasury Department and the IRS have issued proposed regulations that partially withdraw proposed regulations issued in 2014 (REG-119305-11, Section 707 Regarding Disguised Sales, Generally, 79 F.R. 4826 (1/30/14)) and address when certain obligations to restore a deficit balance in a partner's capital account are disregarded under § 704 and when partnership liabilities are treated as recourse liabilities under § 752.

*Current Regulations*—Under Reg. § 1.752-2, a partnership liability is recourse to the extent that any partner or related person bears the economic risk of loss (EROL) for the liability. A partner or related person bears the EROL to the extent the partner or related person would have a payment obligation if the partnership liquidated in a worst-case scenario in which all partnership liabilities are due and all partnership assets generally are worthless. For purposes of determining the extent to which a partner or related person has an obligation to make a payment, an obligation to restore a deficit capital account upon liquidation of the partnership under the

§ 704(b) regulations is taken into account. Further, for this purpose, Reg. § 1.752–2(b)(6) presumes that partners and related persons who have payment obligations actually perform those obligations, irrespective of their net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. However, this presumption is subject to an anti-abuse rule in § 1.752–2(j) pursuant to which a payment obligation of a partner or related person may be disregarded or treated as an obligation of another person if facts and circumstances indicate that a principal purpose of the arrangement is to eliminate the partner's EROL with respect to that obligation or create the appearance of the partner or related person bearing the EROL when the substance is otherwise. This presumption is also subject to a disregarded entity net value requirement under § 1.752–2(k) pursuant to which, for purposes of determining the extent to which a partner bears the EROL for a partnership liability, a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date.

*2014 Proposed Regulations Under* § 752—The 2014 proposed amendments to Reg. § 1.752-2 provided that obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) would not be recognized for purposes of § 752 unless certain recognition factors were present. These factors were intended to ensure that the terms of a payment obligation are not designed solely to obtain tax benefits. For example, one factor required a partner or related person to either maintain a commercially reasonable net worth during the term of the payment obligation or be subject to commercially reasonable restrictions on asset transfers for inadequate consideration. The 2014 proposed amendments to Reg. § 1.752-2 also provided generally that a payment obligation would be recognized only to the extent of the net value of a partner or related person as of the allocation date.

*2016 Proposed Regulations Under* § 752—In response to comments expressing concern about the "all or nothing" approach of the 2014 proposed regulations, the new proposed regulations move the list of recognition factors to an anti-abuse rule in § 1.752–2(j) (other than the recognition factors concerning bottom dollar guarantees and indemnities, which are addressed in concurrently issued temporary regulations under § 752). Under the anti-abuse rule, the factors are weighed to determine whether a payment obligation (other than an obligation to restore a deficit capital account upon liquidation) should be respected. The list of factors in the anti-abuse rule is nonexclusive, and the weight to be given to any particular factor depends on the particular case. The 2016 proposed regulations state that the presence or absence of any particular factor, in itself, is not necessarily indicative of whether or not a payment obligation is recognized under § 1.752–2(b). The 2016 proposed regulations also modify the recognition factors in various ways in response to comments on the 2014 proposed regulations. Finally, the 2016 proposed regulations remove § 1.752–2(k), which currently provides that a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date. Instead, the 2016 proposed regulations create a new presumption under the anti-abuse rule in § 1.752–2(j) under which evidence of a plan to circumvent or avoid an obligation is deemed to exist if the facts and circumstances indicate that there is not a reasonable expectation that the payment obligor will have the ability to make the required payments if the payment obligation becomes due and payable. A payment obligor includes disregarded entities (including grantor trusts). The 2016 proposed regulations add an example to illustrate the application of the anti-abuse rule when the payment obligor is an underfunded entity.

*2016 Proposed Regulations Under* § 704—Section 1.704-1(b)(2)(ii)(c)(2) of the regulations currently provides that a partner's deficit restoration obligation is not respected if the facts and circumstances indicate a plan to circumvent or avoid the partner's deficit restoration obligation. The 2016 proposed regulations add a list of factors to Reg. § 1.704–1(b)(2)(ii)(c) that are similar to the factors in the proposed anti-abuse rule under Reg. § 1.752–2(j). However, these factors are specific to deficit restoration obligations and are intended to indicate when a plan to circumvent or avoid an obligation exists. The weight to be given to any particular factor depends on the particular case and the presence or absence of any particular factor is not, in itself, necessarily indicative of whether or not the obligation is respected. The factors are: (1) the

partner is not subject to commercially reasonable provisions for enforcement and collection of the obligation; (2) the partner is not required to provide (either at the time the obligation is made or periodically) commercially reasonable documentation regarding the partner's financial condition to the partnership; (3) the obligation ends or could, by its terms, be terminated before the liquidation of the partner's interest in the partnership or when the partner's capital account as provided in § 1.704-1(b)(2)(iv) is negative; and (4) the terms of the obligation are not provided to all the partners in the partnership in a timely manner.

*Effective Date*—The 2016 proposed amendments to the regulations will be effective upon the publication of final regulations in the Federal Register. This means that current Reg. § 1.752-2(k)—which provides that a payment obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity as of the allocation date—continues to apply until the publication of final regulations. Otherwise, partnerships and partners may rely on the 2016 proposed amendments prior to the date they are published as final regulations.

### C. Distributions and Transactions Between the Partnership and Partners

**1. Tweaking the disguised sale rules and helping nail down the coffin lid on *Canal*-type transactions.** T.D. 9787, Section 707 Regarding Disguised Sales, Generally, 81 F.R. 69291 (10/5/16). The Treasury and IRS have promulgated final amendments to the regulations under § 707(a)(2)(B), relating to disguised sales, and § 752, relating to the treatment of partnership liabilities, which were proposed in REG-119305-11, Section 707 Regarding Disguised Sales, Generally, 79 F.R. 4826 (1/30/14).

*Disguised Sales Rules*—The amendments to the regulations under § 707 provide a number of clarifications of the § 707 disguised sale rules. **(1)** An ordering rule is added in Reg. § 1.707-5 to provide that the treatment of a transfer should first be determined under the debt-financed distribution exception, and any amount not excluded from Reg. § 1.707-3 under the debt-financed distribution exception should be tested to see if such amount would be excluded from Reg. § 1.707-3 under a different exception in Reg. § 1.707-4. **(2)** The proposed regulations provided that the exception in Reg. § 1.707-4 for preformation capital expenditures up to 20 percent of fair market value of the property and the exception to the limitation where the fair market value of the property does not exceed 120 percent of basis apply property-by-property. The final regulations adopt this rule but permit aggregation to the extent: (i) the total fair market value of the aggregated property (of which no single property's fair market value exceeds 1 percent of the total fair market value of such aggregated property) is not greater than the lesser of 10 percent of the total fair market value of all property, excluding money and marketable securities (as defined under § 731(c)), transferred by the partner to the partnership, or $1,000,000; (ii) the partner uses a reasonable aggregation method that is consistently applied; and (iii) the aggregation of property is not part of a plan a principal purpose of which is to avoid §§ 1.707-3 through 1.707-5. **(3)** The amendments also provide a rule coordinating the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures. For purposes of defining qualified liabilities under Reg. § 1.707-3, the term "'capital expenditures'" has the same meaning as the term "'capital expenditures'" generally does, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures. The final regulations add that to the extent any qualified liability under Reg. § 1.707-5(a)(6) is used by a partner to fund capital expenditures and economic responsibility for that borrowing shifts to another partner, the exception for preformation capital expenditures does not apply. Under the final regulations, capital expenditures are treated as funded by the proceeds of a qualified liability to the extent the proceeds are either traceable to the capital expenditures under Reg. § 1.163-8T or are actually used to fund the capital expenditures, irrespective of the tracing requirements under Reg. § 1.163-8T. **(4)** The final regulations provide a "step-in-the-shoes" rule for applying the exception for preformation capital expenditures and for determining whether a liability is a qualified liability under § 1.707-5(a)(6) when a partner acquires property, assumes a liability, or takes property subject to a liability from another person in connection with a nonrecognition transaction under §§ 351, 381(a), 721, or 731. The final regulations supersede Rev. Rul. 2000-

44, 2000–2 C.B. 336, which allowed "step-in-the-shoes" treatment when a corporation that acquires assets in a transaction described in section 381(a) succeeds to the status of the transferor corporation for purposes of applying the exception for preformation capital expenditures and determining whether a liability is a qualified liability under § 1.707-5(a)(6). **(5)** The amendments to the regulations add to the list of qualified liabilities that, pursuant to Reg. § 1.707-5, may be assumed without triggering the disguised sale rules liabilities that were not incurred in anticipation of the transfer of the property to a partnership, but that were incurred in connection with a trade or business in which property transferred to the partnership was used or held, but only if all the assets related to that trade or business are transferred (other than assets that are not material to a continuation of the trade or business). **(6)** The amendments to the regulations clarify the anticipated reduction rule in Reg. § 1.707-5(a)(3) by providing that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction. **(7)** As amended, Reg. § 1.707-5(a)(5) does not take into account qualified liabilities as consideration in transfers of property treated as a sale when the total amount of all liabilities other than qualified liabilities that the partnership assumes or takes subject to is the lesser of 10 percent of the total amount of all qualified liabilities the partnership assumes or takes subject to, or $1,000,000. **(8)** The final regulations add additional rules regarding tiered partnerships.

*Effective Date of Final Regulations Under § 707*—The final regulations under § 707 apply to any transaction with respect to which all transfers occur on or after 10/5/16.

*Partner's Share of Nonrecourse Liabilities*—Reg. § 1.752-3(a)(3) has been amended to provide that, for purposes of determining a partner's share of partnership liabilities in applying the disguised sale rules of § 707(a)(2)(B) and Reg. § 1.707-5(a)(2), regardless of whether they are recourse or nonrecourse, only the default rule for allocating partnership "excess nonrecourse liabilities"—in accordance with the partners' interests in partnership profits—applies, unless another partner bears the economic risk of loss. This means that for purposes of applying the § 707 disguised sale rules, the contributing partner's share of partnership liabilities cannot be determined with reference to that partner's economic risk of loss under Reg. § 1.752-2. For purposes of applying § 704, all of the methods for allocating partnership "excess nonrecourse liabilities" continue to be allowed.

*Effective Date of Final Regulations Under § 752*—Subject to an exception for written binding contracts already in effect, the final regulations under § 752 generally apply to liabilities that are incurred by a partnership, that a partnership takes property subject to, or that are assumed by a partnership on or after 10/5/16.

### D. Sales of Partnership Interests, Liquidations and Mergers

**1. The Tax Court gives the IRS a lesson on the intersection of partnership and international taxation: subject to the exception in § 897(g), a foreign partner's gain from the redemption of its interest in a U.S. partnership was not income effectively connected with the conduct of a U.S. trade or business.** Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner, 149 T.C. No. 3 (7/13/17). The taxpayer, a corporation organized under the laws of Greece, held a 15 percent interest (later reduced to 12.6 percent) in Premier Chemicals, LLC, an LLC organized under Delaware law and classified for federal tax purposes as a partnership. The taxpayer accepted Premier's offer to redeem its partnership interest and received a total of $10.6 million, half of which was paid in 2008 and half in January 2009. The taxpayer and Premier agreed that the payment in January 2009 was deemed to have been paid on December 31, 2008, and that the taxpayer would not share in any profits or losses in 2009. The taxpayer realized $1 million of gain from the 2008 redemption payment and $5.2 million from the 2009 redemption payment. The taxpayer filed a return on Form 1120-F for 2008 on which it reported its distributive share of partnership items, but did not report any of the $1 million realized gain from the 2008 redemption payment. The taxpayer did not file a U.S. tax return for 2009 and thus did not report any of the $5.2 million realized gain from the 2009 redemption payment. The IRS issued a notice of deficiency in which it asserted that all of the $6.2 million of realized gain was subject to U.S. tax because it was U.S.-source income effectively connected with the conduct of a U.S. trade or business. The taxpayer conceded that

$2.2 million of the gain was subject to U.S. taxation pursuant to § 897(g), which treats amounts received by a foreign person from the sale or exchange of a partnership interest as amounts received from the sale or exchange of U.S. real property to the extent the amounts received are attributable to U.S. real property interests. The taxpayer's concession left $4 million of realized gain in dispute. The Tax Court (Judge Gustafson) held that the $4 million of disputed gain was not income effectively connected with the conduct of a U.S. trade or business and therefore was not subject to U.S. taxation. (The court found it unnecessary to interpret the tax treaty in effect between the U.S. and Greece because U.S. domestic law did not impose tax on the gain and the IRS did not contend that the treaty imposed tax beyond U.S. domestic law.) In reaching this conclusion, the court addressed several issues.

The court first analyzed the nature of the gain realized by the taxpayer. Under § 736(b)(1), payments made in liquidation of the interest of a retiring partner that are made in exchange for the partner's interest in partnership property are treated as a distribution to the partner. Treatment as a distribution triggers § 731(a)(1), which provides that a partner recognizes gain from a distribution to the extent the amount of money received exceeds the partner's basis in the partnership interest and directs that the gain recognized "shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner." Pursuant to § 741, gain recognized from the sale or exchange of a partnership interest is "considered as gain or loss from the sale or exchange of a capital asset" except to the extent provided by § 751. (The IRS did not contend that § 751 applied.) The taxpayer asserted that these provisions lead to the conclusion that the taxpayer's gain must be treated as arising from the sale of a single asset, its partnership interest, which is a capital asset. The government argued that the taxpayer's gain must be treated as arising from the sale of separate interests in each asset owned by the partnership. Otherwise, the government argued, the rule in § 897(g), which imposes U.S. tax to the extent amounts received from the sale of a partnership interest are attributable to U.S. real property interests, would be rendered inoperable. The court agreed with the taxpayer. Section 897(g), the court explained,

> actually reinforces our conclusion that the entity theory is the general rule for the sale or exchange of an interest in a partnership. Without such a general rule, there would be no need to carve out an exception to prevent U.S. real property interests from being swept into the indivisible capital asset treatment that section 741 otherwise prescribes.

The court noted that this conclusion is consistent with the court's prior decision in *Pollack v. Commissioner*, 69 T.C. 142 (1977).

The court next addressed whether the $4 million of disputed gain was effectively connected with the taxpayer's conduct of a U.S. trade or business. Pursuant to § 875(1), the taxpayer was considered to be engaged in a U.S. trade or business because the partnership of which it was a partner, Premier, was engaged in a U.S. trade or business. Accordingly, the issue was narrowed to whether the disputed gain was effectively connected with that trade or business. Because foreign-source income is considered effectively connected with a U.S. trade or business only in narrow circumstances, which the IRS acknowledged were not present, the taxpayer's disputed gain could be considered effectively connected income only if it was U.S.-source income. Pursuant to the general rule of § 865(a), income from the sale of personal property by a nonresident is foreign-source income. The IRS asserted that an exception in § 865(e)(2) applied. Under this exception, if a nonresident maintains an office or other fixed place of business in the United States, income from a sale of personal property is U.S.-source if the sale is attributable to that office or fixed place of business. The court assumed without deciding that Premier's U.S. office would be attributed to the taxpayer under § 864(c)(5). Accordingly, the issue was whether the gain was attributable to Premier's U.S. office. Under § 864(c)(5)(B), income is attributable to a U.S. office only if the U.S. office is a material factor in the production of the income and the U.S. office "regularly carries on activities of the type from which such income, gain, or loss is derived." The court concluded that neither of these requirements was satisfied. The court examined Reg. § 1.864-6(b)(2)(i) and concluded that, although Premier's business activities

might have had the effect of increasing the value of the taxpayer's partnership interest, those business activities did not make Premier's U.S. office a material factor in the production of the taxpayer's gain. Further, the court concluded, even if the U.S. office was a material factor, Premier did not regularly carry on activities of the type from which the gain was derived because "Premier was not engaged in the business of buying or selling interests in itself and did not do so in the ordinary course of business." Because the disputed gain was not U.S.-source income, it was not effectively connected with the conduct of a U.S. trade or business and therefore not subject to U.S. taxation.

- In reaching its conclusion that the taxpayer's gain was not effectively connected with the conduct of a U.S. trade or business, the court rejected the IRS's contrary conclusion in Rev. Rul. 91-32, 1991-1 C.B. 107. In that ruling, according to the court, the IRS concluded

> that gain realized by a foreign partner from the disposition of an interest in a U.S. partnership should be analyzed asset by asset, and that, to the extent the assets of the partnership would give rise to effectively connected income if sold by the entity, the departing partner's pro rata share of such gain should be treated as effectively connected income.

The court characterized the analysis in the ruling as "cursory" and declined to follow it.

- The taxpayer should have reported some of its gain in 2008, should have filed a 2009 U.S. tax return reporting gain in 2009, and should have paid tax with respect to both years because all of the gain realized from the 2008 distribution and some of the gain realized from the 2009 distribution was attributable to U.S. real property interests held by the U.S. partnership, Premier. Nevertheless, the court declined to impose either the failure-to-file penalty of § 6651(a)(1) or the failure-to-pay penalty of § 6651(a)(2) because the taxpayer had relied on the advice of a CPA and therefore, in the court's view, established a reasonable cause, good faith defense.

### 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.

**b. The "thawed" version of the centralized partnership audit rules is here, and all 277 pages of the new rules still stink for partnerships and partners (but at least the regs didn't change much, and the Federal Register version is only 69 pages)!** REG-136118-15, Centralized Partnership Audit Regime, 82 F.R. 27334-01 (6/14/17). As we all know by now, effective for tax years beginning after December 31, 2017, the old TEFRA partnership audit rules (in §§ 6221-6231) and Electing Large Partnership rules (in §§ 6240-6242, 6245-6248, 6251-6252, and 6255) have been repealed and replaced by a new "Centralized Partnership Audit Regime" contained in §§ 6221-6223, 6225-6227, 6231-6235, and 6241. The IRS originally released proposed regulations under the new regime in January 2017, but the Trump administration's regulatory freeze forced those regulations to be withdrawn just two days after they were released. The Treasury Department has now reissued the proposed regulations in substantially the same form as the version released in January. Only two minor changes were made from the original version of the proposed regulations issued in January: (i) an example with respect to netting ordinary income and depreciation was deleted (see the January version of Prop. Reg. § 301.6225-1(f) Ex. 3), and (ii) the portion of the regulations seeking comments concerning tiered partnership "push-out" adjustments (discussed below) was expanded. The scope and complexity of the new "Centralized Partnership Audit Regime" preclude in-depth coverage here, but the highpoints are summarized below.

*The Practical Effect.* Virtually all partnership agreements (including, of course, most LLC operating agreements) should be amended to reflect the new Centralized Partnership Audit Regime. The new regime cannot be ignored because it fundamentally alters the obligations of the partnership and the partners to each other and to the IRS.

*Overview.* The new rules implement an entity-level audit process that allows the IRS to assess and collect the taxes from the partnership unless the partnership properly elects out of the regime or properly "pushes out" the tax liability to its partners. Under the new centralized process, the IRS audits the partnership's items of income, gain, loss, deduction, and credit, and the partners' distributive shares thereof, for a partnership's taxable year (the "reviewed year"). Then, the IRS sends the partnership a "notice of proposed partnership adjustment" ("NOPPA"). *See* § 6221; Prop. Reg. § 301.6221(a)-1. Thereafter, the partnership has a 330-day period (subject to agreed-upon extensions) to respond to the IRS's proposed adjustments, including the ability to request modifications (discussed below) to any proposed tax liability imposed upon the partnership. Next, at the conclusion of the audit process the IRS sends a "final notice of partnership adjustment" ("FPA") to the partnership (the "adjustment year"). Absent filing a petition in the Tax Court, the tax liability (including penalties) of the partners relating to the reviewed year must be satisfied by the partnership in the adjustment year. *See* § 6231; Prop. Reg. § 301.6231-1. The partnership, not the partners, is liable for any finally determined underpayment of tax (an "imputed underpayment" as defined by the regulations) by the partners from the reviewed year even if those partners are not the same as the partners in the adjustment year. *See* § 6225(a)-(b); Prop. Reg. 301.6225-1.

*Modifications to Partnership Level Adjustment.* Modifications to a proposed partnership-level adjustment can be asserted by the partnership based upon mitigating factors (e.g., tax-

exempt partners, amended returns filed by partners from the reviewed year, lower tax rates applied to some partners, etc.). To assert such modifications, the partnership must submit a "request for modification with respect to a partnership adjustment" to the IRS within 270 days (subject to consensual extension) of the date of the NOPPA. *See* § 6225(c); Prop. Reg. § 301.6225-2. The purpose of allowing partnership-asserted modifications is to determine as accurately as possible the amount of tax owed by the partners as a result of the partnership-level adjustment without requiring the IRS to assess and collect the tax separately from each partner (as was the case under TEFRA). Accordingly, as compared to TEFRA, the new regime substantially eases the IRS's administrative burden with respect to partnership audits and collection of taxes, but correspondingly increases the administrative burden imposed upon partnerships and their partners. Expect the audit rate of partnerships to increase under the new regime.

*"Push-Out" Election.* As an alternative to assessment and collection of tax from the partnership, the partnership may elect to "push out" the imputed underpayment to the appropriate partners from the reviewed year. The affected partners then become liable for the tax attributable to the imputed underpayment rather than the partnership itself. The push-out election must be made by the partnership representative within 45 days (not subject to extension) of the mailing of the final partnership adjustment ("FPA") under § 6231. *See* § 6226; Prop. Reg. § 301.6226-1.

*Some Finer Points.* Special rules govern the treatment of adjustments from a reviewed year that do not result in an imputed underpayment and are therefore otherwise taken into account by the partnership and the partners in the adjustment year. *See* Prop. Reg. § 301.6225-3. Moreover, the impact of the adjustments on capital accounts and outside basis across reviewed years and adjustment years is reserved under the proposed regulations. See Prop. Reg. § 301.6225-4. The new regime also imposes tougher rules on partners who treat items inconsistently with the partnership's treatment of such items. *See* § 6222; Reg. § 301.6222-1.

*Partnership Representatives.* Unlike the familiar "tax matters partner" designation under TEFRA, the new regime permits any person (even a non-partner) with a substantial presence in the U.S. to be designated the "partnership representative" in the audit, assessment, and collection process. The partnership representative is designated by the partnership for each tax year on its annual information return (Form 1065). Moreover, any action taken by the partnership representative vis-à-vis the IRS is binding upon the partnership regardless of the partnership agreement or state law to the contrary. See § 6223; Prop. Reg. §§ 301.6223-1, 301.6223-2.

*Election Out of the New Regime for Small Partnerships.* Partnerships with 100 or fewer partners may elect out of the new regime, but not if the partnership has another partnership or certain other flow-through entities as a partner, possibly including single-member LLCs (the effect of which currently is unknown under the proposed regulations). Depending upon certain special rules, S corporations may or may not disqualify a partnership from electing out of the new regime. *See* § 6621(b); Prop. Reg. § 301.6621(b)-1. Eligible partnerships that elect out of the new regime will subject their partners to pre-TEFRA audit procedures (i.e., partners will be audited and assessed separately and possibly inconsistently).

*Pre-2018 Election Into the New Regime.* The reissued proposed regulations do not affect the ability of partnerships to elect into the new regime for tax years beginning before January 1, 2018, but after November 2, 2015. See T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16).

2. **A TEFRA partnership's failure to challenge penalties does not preclude a partner from raising a reasonable cause, good faith defense to penalties in a partner-level proceeding.** McNeill v. United States, 118 A.F.T.R.2d 2016-5645 (10th Cir. 9/6/16). The taxpayer invested in and was the tax matters partner of TEFRA partnerships used as vehicles for distressed asset/debt (DAD) tax shelters. In a partnership-level proceeding, the IRS issued a notice of final partnership administrative adjustment that imposed several million dollars in penalties and interest. As the tax matters partner, the taxpayer brought an action in federal district court, but that action was dismissed without prejudice and the taxpayer never sought to reinstate it. The IRS determined that the taxpayer's share of the partnership's liability was approximately $7.5 million, which he paid. The taxpayer filed a refund action in a federal district

court and argued that he had a reasonable cause, good faith defense, pursuant to § 6664(c) (based on reliance on professional advice), to approximately $4.6 million in penalties and related interest. The District Court held that the taxpayer was precluded from asserting defenses by § 6230(c)(4), which provides:

> 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 ... 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.

(Emphasis added). In an opinion by Judge Gorsuch, the Tenth Circuit reversed. According to the Tenth Circuit, the third sentence of the relevant provision states that a partner "shall be allowed to assert any partner level defenses," and this overrides the language in the preceding sentence stating that determinations concerning penalties at the partnership level are conclusive. The court noted that the government's position on the availability of defenses in partner-level proceedings seems to have changed over time and is not well defined. For example, the court noted, in *Klamath Strategic Investment Fund v. United States*, 568 F.3d 537 (5th Cir. 2009), the government argued that the reasonable cause, good faith defense is a partner-level defense that can be asserted only in partner-level proceedings. Accordingly, the court reversed and remanded to the District Court.

- Judge Phillips dissented. He reasoned that the third sentence in § 6230(c)(4) does not override the conclusive determination of penalties at the partnership level. According to Judge Phillips, the third sentence should be read "as ensuring that partners can always bring partner-level defenses subject to any conclusive determinations being applied in those partner-level proceedings."

a. **On remand, the taxpayers successfully established a partner-level defense to the accuracy-related penalty.** McNeill v. United States, 119 A.F.T.R.2d 2017-943 (D. Wyo. 2/24/17). In the course of investing in the DAD tax shelter and deducting the losses that it produced, the taxpayers had received an opinion from a law firm and advice from Ernst & Young. On remand from the Tenth Circuit, the U.S. District Court (Judge Freudenthal) concluded, based on the taxpayers' efforts to determine their tax liability and their reliance on professional advice, that the taxpayers had established a reasonable cause, good faith defense to the accuracy-related penalty.

3. **The "Buch" stops here in this hypertechnical TEFRA case and offers a lesson in taking your lumps instead of testing the IRS's patience.** Malone v. Commissioner, 148 T.C. No. 16 (5/1/17). The taxpayer failed to report his distributive share of partnership items in 2005 consisting of $3.2 million of ordinary income and $3.5 million of long-term capital gain. Under § 6222(a), partners in a partnership subject to the TEFRA audit rules must report partnership items consistent with the partnership's return unless the partner timely files a Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request. Accordingly, the IRS subsequently issued a notice of deficiency to the taxpayer for these partnership items as well as certain other non-partnership adjustments, including *in an amended answer* (Uh-oh!) the § 6662(a) negligence penalty. In an order dated June 5, 2012, the Tax Court granted the IRS's motion to strike the partnership items from any deficiency proceedings for lack of jurisdiction (meaning that the assessment against the taxpayer for these items was upheld), but reserved judgment on whether the § 6662(a) negligence penalty remained subject to the court's jurisdiction. The taxpayer then filed a motion with the Tax Court to dismiss the § 6662(a) negligence penalty with respect to the partnership items, but the IRS objected pointing out in an "amendment to [the] amended answer" that the § 6662(a) penalties were being asserted only with

respect to the taxpayer's failure to report the partnership items. The crux of the taxpayer's argument was that § 6230(a)(2)(A)(i) excludes from deficiency procedures penalties relating to adjustments to partnership items. In an opinion by Judge Buch, however, the Tax Court held that this case did not involve an adjustment to partnership items. The partnership items of $3.2 million of ordinary income and $3.5 million of long-term capital gain were not adjusted. Instead, the IRS's assertion of the § 6662(a) negligence penalty for the taxpayer's failure to report partnership items remains to be determined by the Tax Court. *To be continued...?*

**G. Miscellaneous**

1. **The IRS finally gets tired of issuing private letter rulings: guidance for master limited partnerships on activities with respect to minerals or natural resources that produce qualifying income.** T.D. 9817, Qualifying Income From Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 82 F.R. 8318 (1/24/17). The Treasury Department and the IRS have finalized, with some changes, proposed regulations under § 7704(d)(1)(E) regarding the types of activities with respect to minerals or natural resources that generate qualifying income for publicly traded partnerships (REG-132634-14, Qualifying Income From Activities of Publicly Traded Partnerships With Respect to Minerals or Natural Resources, 80 F.R. 25970 (5/6/15)). Section 7704(a) provides that a publicly traded partnership is treated for federal tax purposes as a corporation, but § 7701(c) provides an exception for certain publicly traded partnerships if 90 percent or more of the partnership's gross income consists of qualifying income. Partnerships that qualify for this exception are not automatically classified as corporations and are eligible for the pass-through regime of subchapter K. Under § 7704(d)(1)(E), qualifying income includes income "derived from the exploration, development, mining or production, processing, refining, transportation ..., or the marketing of any mineral or natural resource ...." Under the final regulations, only "qualifying activities" produce qualifying income. Qualifying activities include both the activities enumerated in the statute, which the regulations refer to as "section 7704(d)(1)(E) activities," and support activities that are intrinsic to section 7704(d)(1)(E) activities, which the regulations refer to as "intrinsic activities." The final regulations provide detailed guidance on which activities qualify as section 7704(d)(1)(E) activities and intrinsic activities. Generally, an activity is an intrinsic activity if the activity is: (1) specialized to support the section 7704(d)(1)(E) activity, (2) essential to the completion of the section 7704(d)(1)(E) activity, and (3) requires the provision of significant services to support the section 7704(d)(1)(E) activity. According to the preamble to the final regulations, Treasury and the IRS issued these regulations because of a significant increase in the number of requests for private letter rulings seeking guidance on whether income from certain activities is qualifying income under § 7704(d)(1)(E). The final regulations define qualifying activities in a manner that may be, at least in some respects, narrower than in private letter rulings the IRS previously issued.

• Based on the many comments submitted on the proposed regulations, the final regulations make several favorable changes to the proposed regulations. Two of the more significant changes relate to the definition of "section 7704(d)(1)(E) activities." First, the proposed regulations provided an exclusive list of operations that qualified as section 7704(d)(1)(E) activities. In contrast, the final regulations provide a general definition of each of the eight listed active terms in § 7704(d)(1)(E) (exploration, development, mining or production, processing, refining, transportation, and marketing) followed by a non-exclusive list of examples of each one. Nevertheless, the preamble to the final regulations cautions that "the Treasury Department and the IRS do not intend that these final regulations be interpreted or applied in an expansive manner ... [but] should be interpreted and applied in a manner that is consistent with their plain meaning and the overall intent of Congress to restrict the [§ 7701(c)] exception ...." Second, the final regulations create a new category, referred to as "additional activities," the income derived from which is considered derived from a section 7704(d)(1)(E) activity. Income from additional activities includes income received to reimburse a partnership for its costs in performing a section 7704(d)(1)(E) activity, income from certain passive interests or non-operating interests, and income from providing blending or additization services with respect to certain products. The final

regulations generally retain the definition of an "intrinsic activity" found in the proposed regulations, but make certain favorable changes to the "specialized" and "significant services" prongs of the intrinsic activities test, such as clarifying that these prongs can be met through employees of affiliates or subcontractors as long as they are being compensated by the partnership.

• The final regulations generally apply to income earned by a partnership in a taxable year beginning on or after 1/19/17, but provide a ten-year transition period. Under the transitional rule, a partnership can treat income from an activity as qualifying income during the period that ends on the last day of the partnership's taxable year that includes 1/19/27 if one of the following conditions is met : (1) the partnership received a private letter ruling holding that income from the activity is qualifying income; (2) prior to 5/6/15, the partnership was publicly traded, engaged in the activity, treated the activity as giving rise to qualifying income under § 7704(d)(1)(E), and that income was qualifying income under the statute as reasonably interpreted prior to the issuance of the proposed regulations; (3) prior to 5/6/15, the partnership was publicly traded and had entered into a binding agreement for construction of assets to be used in the activity that would give rise to income that was qualifying income under the statute as reasonably interpreted prior to 5/6/15; or (4) the partnership is publicly traded and engages in the activity after 5/6/15 but before 1/19/17, and the income from that activity is qualifying income under the proposed regulations. According to the preamble to the proposed regulations, both the legislative history and the IRS's interpretations prior to the issuance of the proposed regulations are taken into account in determining whether an interpretation is reasonable. The final regulations clarify that a technical termination of a partnership under § 708(b)(1)(B) does not end the transition period.

2. **Due date for partnership income tax returns: temporary and proposed regulations reflect Congress's belief that some partners might not need filing extensions any more.** T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date and extended due date of partnership income tax returns (Form 1065). The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, § 2006(a), amended Code § 6072(b) to require partnerships to file their income tax returns by the 15th day of the third month following the close of the taxable year (March 15 for calendar year partnerships), thus accelerating the due date by one month. Act § 2006(b) directs the Treasury to modify the regulations to provide that the maximum extension for a partnership return will be a 6-month period ending on September15 for calendar year partnerships. Pursuant to this statutory directive, Temp. Reg. § 1.6031(a)-1T(e)(2) provides that "the return of a partnership must be filed on or before the date prescribed by § 6072(b)." (The temporary regulations do not explicitly address the due date of Form 8804—Annual Return for Partnership Withholding Tax—but the 2016 instructions for Form 8804 indicate that the due date is the 15th day of the third month following the close of the taxable year.) Pursuant to Temp. Reg. § 1.6081(a)-2T(a)(1), a partnership is allowed an automatic 6-month extension to file both Form 1065 and Form 8804 by filing a timely application. No extension beyond the automatic extension is permitted.

• The temporary regulations apply to returns and extension requests filed on or after July 20, 2017, but the statutory amendments made by the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 apply to returns for partnership taxable years that begin after December 31, 2015. Accordingly, the preamble to the temporary regulations provides that taxpayers can elect to apply the regulations to returns filed for periods beginning after December 31, 2015.

## VIII. TAX SHELTERS

### A. Tax Shelter Cases and Rulings

1. **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.

b. **But the First Circuit looks past the STARS and sees a lack of economic substance.** Santander Holdings USA, Inc. v. United States, 844 F.3d 15 (1st Cir. 12/16/16). In an opinion by Judge Lynch, the First Circuit reversed the District Court and held that the government was entitled to summary judgment in its favor as to the lack of economic substance of the STARS transaction. Judge Lynch's opinion states that the court largely agreed "with the reasoning of the Federal Circuit opinion in *Salem [Financial, Inc. v. United States*, 786 F.3d 932 (Fed. Cir. 5/14/15)] rejecting the claims that the Trust transaction had economic substance and substantially rely on its analysis." The government did not contest the taxpayer's claimed interest deductions on the loan from Barclays, and therefore the effect of the First Circuit's decision is to deny the taxpayer's foreign tax credits. The court remanded for a trial limited to the issue of penalties.

2. **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.

a. **Who needs a business purpose? As long as the transaction had economic substance, it was not a sham transaction.** Wells Fargo & Co. v. United States, 119 A.F.T.R.2d 2017-1976 (D. Minn. 5/24/17). Following the trial of this case, the jury found that the STARS tax shelter in which the taxpayer participated consisted of two separate transactions: a loan from Barclays Bank to the taxpayer, which generated interest deductions, and the taxpayer placing assets in a trust, which required payment of U.K. taxes and generated foreign tax credits. The issue for the court following trial was whether each transaction was a sham. In *IES Indus., Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001), the Eighth Circuit, drawing on its prior decisions, stated that "a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test)." One reading of this test is that, to avoid characterization as a sham transaction, a transaction must meet both the business purpose and the economic substance portions of the test. The jury found that the trust structure that generated foreign tax credits had neither a non-tax business purpose nor a reasonable possibility of pre-tax profit, and therefore the court concluded that the trust transaction was a sham and disallowed the foreign tax credits. With respect to the loan transaction, however, the jury found that, although Wells Fargo entered into the loan solely for tax-related reasons, the loan had a reasonable possibility of pre-tax profit. The court therefore had to address whether a transaction that fails the business purpose portion of the Eighth Circuit's sham transaction test but meets the economic substance portion of the test should be treated as a sham. The court (Judge Schiltz) held that the loan transaction was not a sham and upheld the taxpayer's interest deductions. In reaching this conclusion, the court reasoned that "a doctrine that is intended to counter the creative and ever-evolving abuse of the tax code must necessarily be flexible" and that "[r]educing the sham-transaction doctrine to two mechanical, all-or-nothing tests would deprive the doctrine of the flexibility needed to accomplish its purpose." A flexible approach, the court stated, is consistent with the U.S. Supreme Court's formulation of the sham-transaction doctrine in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), which "reads more like a list of factors to weigh than a series of boxes to check."

- The court's decision stands for the proposition that a transaction

for which a taxpayer does not have a business purpose can avoid characterization as a sham transaction if it has economic substance. Will the Eighth Circuit agree?

- Two U.S. Courts of Appeals previously have upheld the interest deductions produced by the loan portion of the STARS transaction. *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). In a third case, the government did not contest the District Court's grant of summary judgment to the taxpayer with respect to the interest deductions. *Santander Holdings USA, Inc. v. United States*, 844 F.3d 15 (1st Cir. 12/16/16).
- The court also upheld a 20 percent negligence penalty against the taxpayer for the underpayments associated with the disallowance of its foreign tax credits. The taxpayer argued that it was not subject to the penalty pursuant to Reg. § 1.6662-3(b)(1), which provides that a "return position that has a reasonable basis as defined in paragraph (b)(3) of this section is not attributable to negligence." Paragraph (b)(3) of the regulation provides that a return position generally has a reasonable basis if it is "reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments) ...." However, Wells Fargo stipulated that it would not make any contention that relied on its efforts to determine its proper tax liability arising out of the STARS transaction. Thus, the question was whether it was "enough for Wells Fargo to show that its return position had a reasonable basis under the authorities referenced in § 1.6662-3(b)(3)," or whether it had to "prove that it actually consulted those authorities in preparing its tax return." The court viewed the regulation as ambiguous on this issue and therefore treated the Treasury Department's interpretation of its own regulation as controlling. The court held that the taxpayer had to prove that it actually consulted the authorities that, in the taxpayer's view, provided a reasonable basis for its return position. The court expressed the view that "[i]t is difficult to know how a taxpayer could 'base' a return position on a set of authorities without actually consulting those authorities, just as it is difficult to know how someone could 'base' an opinion about the best restaurant in town on Zagat ratings without actually consulting any Zagat ratings."

**B. Identified "tax avoidance transactions"**

**1. Micro-captive insurance transactions are "transactions of interest" that might be on their way to being listed.** Notice 2016-66, 2016-47 I.R.B. 745 (11/1/16) This notice identifies certain captive insurance arrangements, referred to as "micro-captive transactions," as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. Generally, these arrangements involve a person who owns an insured business and that same person or a related person also owns an interest in the insurance company providing coverage. The insured business deducts the premiums paid to the insurance company, and the insurance company, by making the election under § 831(b) to be taxed only on taxable investment income, excludes the premiums from gross income. An insurance company making the § 831(b) election can receive up to $2.2 million in premiums annually (adjusted for inflation after 2015). The notice describes the coverage under these arrangements as having one or more fo the following characteristics:

> (1) the coverage involves an implausible risk; (2) the coverage does not match a business need or risk of Insured; (3) the description of the scope of the coverage in the Contract is vague, ambiguous, or illusory; or (4) the coverage duplicates coverage provided to Insured by an unrelated, commercial insurance company, and the policy with the commercial insurer often has a far smaller premium.

The Treasury Department and the IRS believe these transactions have a potential for tax avoidance or evasion but lack enough information to determine whether the transactions should be identified specifically as a tax avoidance transaction. Transactions that are the same as, or substantially similar to, the transaction described in § 2.01 of the notice are identified as "transactions of interest" for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective 11/1/16. Persons entering into these transactions after that date must disclose the transaction as described in Reg. § 1.6011-4.

### C. Disclosure and Settlement

### D. Tax Shelter Penalties

**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.'"

**a. The Federal Circuit sees it the same way.** Diversified Group, Inc. v. United States, 841 F.3d 975 (Fed. Cir. 11/10/16). In an opinion by Chief Judge Prost, the U.S. Court of Appeals for the Federal Circuit affirmed the Claims Court's decision. The plaintiff argued that the $24.9 million § 6707 penalty was divisible because it was calculated based upon each client's aggregate investment in the tax shelter. The plaintiff emphasized that a separate Form 8264 (the form by which a tax shelter is registered) necessarily would be required for each client's investment because it would be impossible to fill out a Form 8264 for the entire tax shelter on the first day it was offered for sale because, at that time, many of the details that the form requires are unknown. Accordingly, the plaintiff argued, each filing should be considered a separate instance of tax shelter registration under § 6111. The court concluded, however, that § 6707 penalties are not divisible into the individual transactions or investors that may comprise a single tax shelter:

> Section 6707(a) provides that "if a person ... fails to register such tax shelter ... such person shall pay a penalty with respect to such registration." This language makes clear that liability for a § 6707 penalty arises from the single act of failing to register the tax shelter (which, under Temp. Treas. Reg. § 301.611-1T, A-1, A-47, is failing to file the necessary Form(s) 8264). This omission creates a single source of liability, regardless of how many individuals or transactions are involved in the tax shelter. Liability cannot be sub-divided beyond this.

**b. A District Court in New York reaches the same conclusion.** Larson v. United States, 118 A.F.T.R.2d 2016-7004 (S.D.N.Y 12/28/16). The IRS assessed more than $160 million in penalties against the taxpayer under § 6707 for failure to register two tax shelters as required by § 6111. The tax shelters involved were the Foreign Leveraged Investment Program ("FLIP"), also known as the Offshore Portfolio Investment Strategy ("OPIS"), and the Bond Linked Issue Premium Structure ("BLIPS"). The penalties were later reduced to $67.6 million to reflect payments made by other persons who were jointly and severally liable. The taxpayer paid $1.4 million and brought this action seeking a refund of the $1.4 million and abatement of all assessed penalties. The District Court (Judge Caproni), relying on the holdings in *Diversified Group, Inc. v. United States*, 841 F.3d 975 (Fed. Cir. 11/10/16) and *Pfaff v. United States*, 117 A.F.T.R.2d 2016-981 (D. Colo. 3/10/16), held that the § 6707 penalties imposed on the taxpayer were not divisible. Because the taxpayer had not paid the full amount of the tax for

which he sought a refund, as required by the full payment rule of *Flora v. United States*, 357 U.S. 63 (1958), the court granted the government's motion to dismiss for lack of subject matter jurisdiction. In reaching this conclusion, the court rejected the taxpayer's argument that application of the full payment rule to his situation violated the due process clause of the Fifth Amendment. He argued that, taking into account his inability to challenge the penalty in the Tax Court because of the absence of a notice of deficiency, application of the full payment rule violated his right to due process because he could not pay the penalty and could not seek review of his claim without paying the penalty. The court similarly rejected the taxpayer's claim for judicial review under the Administrative Procedure Act, in which the taxpayer asserted that the IRS's penalty assessment and denial of his refund claim were arbitrary, capricious, and an abuse of discretion, and his argument that the § 6707 penalty was an excessive fine that violates the Eighth Amendment. Finally, the court dismissed for failure to state a claim the taxpayer's claim to compel the IRS to give him information relating to payments from others who are jointly and severally liable.

## IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

### A. Exempt Organizations

**1. Form 1023-EZ regulations finalized.** T.D. 9819, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 82 F.R. 29730 (6/30/17). Originally issued as proposed and temporary regulations in 2014 (T.D. 9674, Guidelines for the Streamlined Process of Applying for Recognition of Section 501(c)(3) Status, 79 F.R. 37630 (7/2/14)), these final regulations authorize without substantive change a streamlined process that certain small organizations may use to apply for recognition of tax-exempt status under § 501(c)(3). Essentially, the final regulations allow the IRS to promulgate Form 1023-EZ for "eligible organizations" to meet the notice requirements of § 508 for purposes of obtaining recognition of tax-exempt status under § 501(c)(3). Detailed annual or other guidance issued by the IRS defines "eligible organizations" allowed to file Form 1023-EZ. For 2017, Rev. Proc. 2017-5, § 6.05, 2017-1 I.R.B. 230, generally provides that an "eligible organization" is one that (1) has projected annual gross receipts of $50,000 or less in the current year and the next two years, (2) $50,000 or less of actual receipts for each of the past three years for which it was in existence, and (3) has total assets the fair market value of which does not exceed $250,000. For purposes of this last eligibility requirement, a good faith estimate of the fair market value of the organization's assets is sufficient. Notwithstanding the foregoing, Rev. Proc. 2017-5 contains a lengthy list of organizations that cannot submit Form 1023-EZ, including churches, schools, colleges, and hospitals. Form 1023-EZ must be submitted electronically and the user fee for doing so is $275, as opposed to the $850 user fee charged to organizations submitting a regular Form 1023. Organizations that submit Form 1023-EZ ordinarily will file an annual Form 990-N (e-postcard) instead of the regular Form 990 required of larger § 501(c)(3) organizations. The final regulations amend Reg. §§ 1.501(a)-1, 1.501(c)(3), and 1.508-1, and they are effective July 1, 2017.

### B. Charitable Giving

**1. 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."

a. **You say mandatory, I say discretionary. Let's call the whole deduction off.** 15 West 17th Street LLC v. Commissioner, 147 T.C. No. 19 (12/22/16). The partnership claimed a $64,490,000 charitable contribution deduction for the contribution of a conservation easement. The opinion is silent regarding whether the taxpayer failed to secure from the donee organization and maintain in its files a "contemporaneous written acknowledgment" as required by § 170(f)(8)(A), which as specified in § 170(f)(8)(B), among other things must state whether the donee provided the donor with any goods or services in exchange for the gift. But there is an inference from the context of the arguments that it did not do so. On audit, the IRS disallowed the charitable contribution deduction. After the case was docketed in the Tax Court, the donee organization submitted an amended Form 990 that included the information specified in § 170(f)(8)(B). The partnership moved for partial summary judgment, contending that filing by the donee eliminated the need for the taxpayer to have received a "contemporaneous written acknowledgment" as required by § 170(f)(8)(A) to substantiate the gift. This argument was grounded on § 170(f)(8)(D), which waives the contemporaneous written receipt requirement "if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe," that includes the information specified in § 170(f)(8)(B). The IRS and Treasury have not issued any regulations under § 170(f)(8)(B), but the partnership argued the regulations under which the donee organizations' Form 990 was filed satisfied the statutory requirement. In a reviewed opinion (8-3-6) by Judge Lauber, the Tax Court held that § 170(f)(8)(D) provides a discretionary, rather than mandatory, delegation of rule-making authority, and that § 170(f)(8)(D) is not self-executing in the absence of the regulations to which the statute refers. In the absence of such regulations, the requirements of § 170(f)(8)(A) applied and the motion for summary judgment was dismissed. The majority opinion stated that the partnership had not "cited, and our own research has discovered, no case in which a court has held to be self-executing a Code provision containing a discretionary delegation that refers to regulations that the Secretary 'may prescribe.' Conversely, every judicial decision that has held a Code provision to be self-executing in the absence of regulations has involved a mandatory delegation that included the word 'shall.'"

- Judge Gustafson, in a dissent in which Judges Colvin, Foley, Vasquez, Paris and Morrison joined, would have found the statutory requirement of § 170(f)(8)(D) to have been met by virtue of the information required by § 170(f)(8)(B) being included on the donee organization's return under § 6033, the informational requirements for which are provided in Reg. § 1.6033-2.

- Judge Foley's dissent, in which Judges Colvin, Vasquez, Gustafson, Paris and Morrison joined, would have held that § 170(f)(8)(D) abrogates the requirement that the donor comply with § 170(f)(8)(A) as long as the donee files a return that contains the information described in § 170(f)(8)(B), which was done in this case.

2. **Certain syndicated conservation easement transactions entered into after 2009 are listed transactions and taxpayers who have invested in them must disclose them for each tax year in which they participated.** Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). This notice identifies certain syndicated conservation easement transactions entered into after 2009 as listed transactions. In these transactions, a promoter typically markets interests in a pass-through entity that owns real property. The pass-through entity grants a conservation easement on the real property based on an appraisal that, in the IRS's view, greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property. The charitable contribution deduction resulting from the grant of the conservation easement flows through to the investors in the pass-through entity. The effect of these transactions is that an investor in the pass-through entity receives a charitable contribution deduction that significantly exceeds the amount invested. The IRS plans to challenge these transactions based on the overvaluation of the conservation easement and also may challenge them based on the partnership anti-abuse rule, economic substance, or other rules or doctrines. Transactions that are the same as, or substantially similar to, the transactions described in § 2 of the notice are identified as "listed transactions" for purposes of Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112 effective 12/23/16. A person entering into these transactions on or after 1/1/10 must disclose the transactions as described in Reg. § 1.6011-4 for each taxable year in which the person participated in the transactions, provided that the period of limitations for assessment of tax has not expired on or before 12/23/16.

a. **Participants in listed syndicated conservation easement transactions have until October 2, 2017, to disclose their participation in years for which returns were filed before December 23, 2016.** Notice 2017-29, 2017-20 I.R.B. 1243 (4/27/17). This notice extends the due date for participants to disclose their participation in the syndicated conservation easement transactions described in Notice 2017-10, 2017-4 I.R.B. 544 (12/23/16). Generally, under Reg. § 1.6011-4(e)(2)(i), if a transaction becomes a transaction of interest or a listed transaction after a taxpayer has filed a return reflecting the taxpayer's participation in the transaction, the taxpayer must disclose the transaction within 90 calendar days after the date on which the transaction became a listed transaction or a transaction of interest. Notice 2017-10 extended this period to 180 days for listed syndicated conservation easement transactions, which meant that disclosures were due (for years for which returns already had been filed) on 6/21/17. In this notice, the IRS has extended the due date from 6/21 to 10/2/17. The notice cautions that the due date for disclosure with respect to returns filed after the date Notice 2017-10 was issued (12/23/17) and for disclosure by material advisors is unchanged and remains 5/1/17. The notice also provides that donees in these syndicated conservation easement transactions are not considered material advisors under § 6111.

3. **If you are donating a used motor vehicle, boat, or airplane, you better not neglect to obtain and attach to your return Form 1098-C, says the Tax Court.** Izen v. Commissioner, 148 T.C. No. 5 (3/1/17). On 4/14/16, during a pending Tax Court proceeding, the taxpayer filed an amended federal income tax return for 2010 and claimed a charitable contribution deduction of $338,080 for his donation of a 50 percent interest in a 1969 model Hawker-Siddley DH125-400A private jet to the Houston Aeronautical Heritage Society (Society), an organization exempt from tax under § 501(c)(3), which operates a museum at the William P. Hobby Airport. The taxpayer included with his amended return: (1) an acknowledgment letter dated 12/30/10 and signed by the president of the Society; (2) a Form 8283, *Noncash Charitable Contributions*, dated 4/13/16 and executed by the managing director of the Society; (3) a copy of an "Aircraft Donation Agreement" allegedly executed on 12/31/10 by the president of the Society (but not by the taxpayer); and (4) an appraisal dated 4/7/11, stating that the fair market value of the taxpayer's 50 percent interest in the aircraft, as of 12/30/10, was $338,080. The IRS moved for summary judgment and asserted that the taxpayer was not entitled to the charitable contribution deduction because he had failed to satisfy the substantiation requirements of § 170(f)(12), which applies to contributions of used motor vehicles, boats, and airplanes. Section 170(f)(8) requires a contemporaneous written acknowledgement from the donee organization as a condition for deducting charitable

contributions of $250 or more, but § 170(f)(12) imposes more stringent substantiation requirements. Section 170(f)(12) requires a more detailed contemporaneous written acknowledgment and, unlike § 170(f)(8), requires the taxpayer to include the acknowledgment with the return that includes the deduction. The statute directs the donee organization to provide to the government the information contained in the acknowledgment, and the IRS has designated for this purpose Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, a copy of which is to be provided to the donor. The taxpayer did not submit Form 1098-C with his amended return. The Tax Court (Judge Lauber) concluded that the documentation the taxpayer did submit with his amended return did not comply with the requirements of § 170(f)(12). Accordingly, the court disallowed the taxpayer's deduction.

4. **It took some time, but finally we "gotcha," says the IRS, in this infamous charitable contribution case involving billionaire and Miami Dolphins' owner Stephen Ross and the University of Michigan.** RERI Holdings I, LLC v. Commissioner, 149 T.C. 1 (7/3/17). In a TEFRA case that has gone on for some time and has produced at least one other noteworthy holding (see below), the IRS prevailed in denying a $33 million charitable contribution deduction to a partnership in which Stephen Ross, owner of the Miami Dolphins, was a partner. The property was donated to the University of Michigan, Mr. Ross's alma mater. The partnership had paid only $2.95 million for the property a little over a year prior to its donation. In fact, at some point after the donation the University of Michigan sold the property for only $1.94 million. These facts, of course, displeased the IRS greatly, and the IRS convinced the Tax Court to deny the partnership's charitable contribution deduction on technical grounds (as discussed below). Moreover, contrary to decisions of the Fifth and Ninth Circuits, the Tax Court (Judge Halpern) determined that the partners of the partnership potentially are liable for aggregate gross valuation misstatement penalties of about $11.8 million.

The facts of the case are complicated, but essentially reveal that for tax year 2003 the partnership claimed a $33 million charitable contribution deduction under § 170(a)(1) for a donation to the University of Michigan. The donated property consisted of a remainder interest in a disregarded single-member LLC that the partnership owned and that held underlying real property. On its Form 8283, Noncash Charitable Contributions, the partnership failed to report its "cost or adjusted basis" for the donated property as required by Reg. § 1.170A-13(c)(4)(ii)(E), instead leaving the line on the form completely blank. Judge Halpern ruled that this failure to comply either strictly or substantially with the regulations is fatal to a claimed charitable contribution deduction, thereby denying the deduction in full. Lastly, for purposes of determining potential penalties, the Tax Court held that the correct value of the property at the time of the donation was approximately $3.5 million.

Regarding the IRS's assertion of the 40 percent penalty under § 6662(h) for "gross valuation misstatements" (valuation of 400 percent or more of correct value), the partnership argued that § 6662 should not apply because the $33 million charitable contribution deduction was completely disallowed and hence was not "attributable to" a valuation misstatement. *See, e.g., Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990), *rev'g* T.C. Memo. 1988-408; *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), *aff'g* T.C. Memo. 1988-416. Judge Halpern's opinion, however, relies upon the Tax Court's more recent decision in *AHG Investments, LLC v. Commissioner*, 140 T.C. 73 (2013), in which the court declined to follow *Heasley* and *Gainer*. Judge Halpern noted that both the Fifth and Ninth Circuits have expressed reservations about *Heasley* and *Gainer*, and because any appeal by the partnership (due to its dissolution in 2004) would be to the U.S. Court of Appeals for the Federal Circuit, the Tax Court was free to follow its decision in *AHG Investments*. Judge Halpern then determined that the correct fair market value of the donated property should have been roughly $3.5 million, i.e., $29.5 million less than the value claimed by the partnership. Therefore, subject to partner-level § 6662(e)(2) calculations ($5,000 underpayment threshold per partner), the partners of the partnership potentially are liable for penalties aggregating as much as $11.8 million (40 percent of the $29.5 million valuation overstatement).

• The IRS probably thought it should have won this case previously on a similar technicality. In *RERI Holdings I, LLC v. Commissioner*, 143 T.C. 41 (2014),

the IRS had cleverly argued on a summary judgment motion that the partnership's "qualified appraisal" (*see* § 170(f)(11)) of the property was fatally flawed. Specifically, the IRS had argued that although the partnership obtained an otherwise qualified appraisal, the partnership's appraisal valued a remainder interest in the underlying real property, not the remainder interest in the disregarded single-member LLC that held the real property. The remainder interest in the disregarded single-member LLC was the property the partnership donated to the University of Michigan, not the real property itself. Thus, argued the IRS, the partnership's otherwise qualified appraisal was for *the wrong property* (even though under § 7701 the single-member LLC was completely disregarded for all other tax purposes)! But, in 2014 Judge Halpern did not let the IRS win so easily. Judge Halpern accepted the IRS's argument that a charitable contribution of an interest in a disregarded single-member LLC should be viewed differently (and perhaps valued differently) than a charitable contribution of the underlying asset(s). Judge Halpern so held even while acknowledging that a single-member LLC otherwise is ignored for federal tax purposes. Judge Halpern's opinion relied heavily on the Tax Court's earlier decision in a gift tax case involving a disregarded single-member LLC. *See Pierre v. Commissioner*, 133 T.C. 24 (2009), *supplemented by* T.C. Memo. 2010-106. Nevertheless, perhaps to avoid so-easily granting summary judgment against the taxpayer and in favor of the IRS in 2014, Judge Halpern reasoned that there was an unresolved issue of material fact whether a valuation of the real property held by the partnership's disregarded single-member LLC could "stand proxy" for the otherwise required "qualified appraisal." Surprisingly, though, Judge Halpern's decision in the earlier *RERI* ruling raises the prospect of a disregarded single-member LLC interest being regarded and valued separately for purposes of determining charitable contributions under § 170.

## X. TAX PROCEDURE

### A. Interest, Penalties, and Prosecutions

1. **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.

a. **The Sixth Circuit agrees.** United States v. Detroit Medical Center, 833 F.3d 671 (6th Cir. 8/12/16). The IRS refunded FICA taxes paid by the plaintiff, a not-for-profit corporation, for periods prior to 4/1/05 following the IRS's ruling that medical residents were eligible for the student exemption from FICA taxes. The IRS paid interest on the employer portion of the FICA taxes at the statutory rate provided by § 6621(a)(1) for corporations (the federal short-term rate plus 2 percentage points, reduced to 0.5 percentage points to the extent the overpayments exceed $10,000). The plaintiff asserted that, because it is a nonprofit corporation, it should not be treated as a corporation for this purpose. Instead, it asserted, it was entitled to interest at the higher statutory rate provided for non-corporate taxpayers (the federal short-term rate plus 3 percentage points). According to the plaintiff, it was entitled to additional interest of approximately $9.1 million. In an opinion by Judge Sutton, the Sixth Circuit held that nonprofit corporations are "corporations" for purposes of determining the rate of interest on overpayments. Accordingly, the court affirmed the District Court's grant of the government's motion for summary judgment.

b. **The Seventh Circuit jumps on the bandwagon.** Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 854 F.3d 930 (7th Cir. 4/25/17). In a case raising the same issue, the United States Court of Appeals for the Seventh Circuit, in an opinion by Judge Easterbrook, concluded that a nonprofit corporation is entitled to interest on a tax overpayment at the statutory rate provided by § 6621(a)(1) for corporations.

2. **If an NOL falls in the forest and no one is around to hear it, does it reduce interest on a deficiency? Interest accrues on a deficiency without reduction for a subsequent year's NOL carried back to the deficiency year until the NOL comes into existence.** United States v. Beane, 841 F.3d 1273 (11th Cir. 11/23/16). The taxpayer in this case owed interest on a deficiency in 1998 taxes, payment of which was due on 4/15/99. The taxpayer

had a net operating loss in 2000 which was carried back to 1998. Among other issues, the question was whether interest on the 1998 deficiency should be calculated by using (1) the amount of the deficiency in 1998 taxes from 4/15/99 through 4/15/01, when the 2000 net operating loss became effective, or (2) the amount of the deficiency ultimately calculated by the Tax Court, which reflected a reduction by the 2000 net operating loss carryback starting as of 4/15/99? Stated differently, the issue was whether, for purposes of the interest calculation, the net operating loss carryback was effective as of 4/15/99 or 4/15/01? In an opinion by Judge Hull, the Eleventh Circuit held that the net operating loss carryback was not effective until it came into existence in 2001. In reaching this conclusion, the court relied on *Manning v. Seeley Tube & Box Co. of N.J.*, 338 U.S. 561 (1950) as well as § 6601(d)(1), which provides:

> If the amount of any tax imposed by subtitle A is reduced by reason of a carryback of a net operating loss or net capital loss, such reduction in tax shall not affect the computation of interest under this section for the period ending with the filing date for the taxable year in which the net operating loss or net capital loss arises.

Accordingly, interest on the 1998 deficiency was calculated for the period prior to 4/15/01 without reduction to reflect the 2000 net operating loss carryback.

3. **A majority of the Tax Court refuses to call a procedural foot-fault on the IRS, but not all the judges see it that way.** Graev v. Commissioner, 147 T.C. No. 16 (11/30/16). The taxpayers had claimed a charitable contribution deduction for the donation of a facade conservation easement that ultimately was disallowed by the Tax Court (140 T.C. 377 (2013)). The IRS examining agent determined that the taxpayers were liable for the § 6662(h) 40 percent gross valuation misstatement penalty, and he prepared a penalty approval form for which he obtained written approval from his immediate supervisor. On that form only the § 6662(h) 40 percent penalty was asserted. The agent prepared a notice of deficiency that included the 40 percent penalty. However, before the notice of deficiency was issued, a Chief Counsel attorney reviewed a draft and, through a memorandum approved by his supervisor, the attorney advised that an alternative § 6662(a) 20 percent accuracy-related penalty should be added to the notice. The notice of deficiency was revised to include the 20 percent § 6662(a) accuracy-related penalty, the calculation of which in the notice of deficiency yielded a zero 20 percent penalty to avoid stacking with the 40 percent penalty. The notice of deficiency was issued as revised, but the revised notice with the alternative 20 percent penalty was not reviewed or approved by the examining agent's supervisor. After the IRS conceded that the 40 percent gross valuation misstatement penalty did not apply, it asserted the alternative 20 percent accuracy-related penalty as a non-zero amount, sine the stacking issue no longer existed. The taxpayers argued that, because the notice of deficiency showed a zero amount for the § 6662(a) 20 percent penalty, the IRS failed to comply with the requirements of § 6751(a), which requires that a computation of the penalty be included in the notice of deficiency, and § 6751(b), which requires that the "initial determination of ... [the] assessment" of the penalty be "personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate," and that these failures barred assessment of the 20 percent penalty. In a reviewed opinion by Judge Thornton, the Tax Court (9-3-5) held that: (1) the notice of deficiency complied with the requirements of § 6751(a); (2) because the penalty had not yet been assessed, the taxpayers' argument that the IRS failed to comply with § 6751(b)(1) was premature; and (3) the 20 percent accuracy-related penalty for a substantial understatement applied. With respect to the first holding, regarding compliance with § 6751(a), the court reasoned as follows:

> The notice of deficiency clearly informed petitioners of the determination of the 20% penalty (as an alternative) and clearly set out the computation (albeit reduced to zero, as it had to be then, to account for the greater 40% penalty). The notice of deficiency thus complied with section 6751(a).
>
> Moreover, even if petitioners were correct that the IRS failed to include a computation of a penalty as required by section 6751(a), such a failure would not

> invalidate a notice of deficiency. In similar contexts this Court has held that procedural errors or omissions are not a basis to invalidate an administrative act or proceeding unless there was prejudice to the complaining party.

With respect to the third holding regarding application of the 20 percent accuracy-related penalty, the court rejected the taxpayers' defenses and concluded that: (1) the taxpayers had not established that they had reasonable cause for claiming the charitable contribution deductions and acted in good faith; (2) "the authorities that support [the taxpayers'] deductions for the cash and conservation easement contributions are not substantial when weighed against the contrary authorities;" and (3) the taxpayers had no reasonable basis for their return position and had not adequately disclosed on their return the relevant facts concerning their deductions because they had not disclosed a side letter from the National Architectural Trust (NAT) (the easement holder) obligating the NAT to refund the taxpayers' cash contribution and work to remove the easement if the IRS disallowed entirely their charitable contribution deductions for the easement.

- A concurring opinion by Judge Nega (with whom Judges Goeke and Pugh joined) would have reached the same result as the majority on the ground that the taxpayers were not prejudiced, and would have left "to another case the more detailed statutory analysis performed by both the majority and the dissent."
- A dissent by Judge Gustafson (joined by Judges Colvin, Vasquez, Morrison and Buch) would not have sustained the penalty on the ground that the IRS failed to comply with § 6751(b)(1) because "the responsible revenue agent included a 20% accuracy-related penalty on the notice of deficiency without first obtaining the 'approv[al] (in writing)' of his 'immediate supervisor'."

**a. But the Second Circuit serves the Tax Court some *Chai*.** Chai v. Commissioner, 851 F.3d 190 (2d Cir. 3/20/17), *aff'g in part, vacat'g in part, and rev'g in part* T.C. Memo. 2015-42 (3/11/15). The taxpayer in this case received in 2003 a $2 million payment for serving as an accommodation party in connection with tax shelters. The taxpayer did not report the payment as income and took the position that the $2 million was a nontaxable return of capital. The IRS issued a notice of deficiency for 2003 increasing the taxpayer's income by the $2 million payment and asserting both a deficiency in self-employment tax and a 20 percent accuracy-related penalty. (The notice of deficiency did not assert a deficiency in income tax because the taxpayer had offsetting losses from a partnership subject to the TEFRA audit rules. Those losses ultimately were disallowed at the partnership level and the IRS amended its answer in this Tax Court proceeding to assert a deficiency in income tax. This sequence of events led to several interesting procedural issues with respect to the deficiency in income tax.) In his post-trial briefing in the Tax Court, the taxpayer raised for the first time the same argument regarding the penalty as the taxpayer had raised in *Graev v. Commissioner*, 147 T.C. No. 16 (11/30/16), i.e., that the IRS was barred from assessing the 20 percent accuracy-related penalty because it had failed to comply with the requirement of § 6751(b) that the "initial determination of ... [the] assessment" of the penalty must be "personally approved (in writing) by the immediate supervisor ... or such higher level official as the Secretary may designate." The Tax Court (Judge Cohen) refused to address this argument on the basis that it was untimely because the taxpayer had raised it for the first time post-trial. In an opinion by Judge Wesley, the Second reversed the Tax Court's ruling on the penalty issue. (The Second Circuit affirmed the Tax Court's ruling that the $2 million payment was subject to self-employment tax and vacated its ruling that it had no jurisdiction to consider the increased deficiency in income tax asserted by the IRS. In light of the taxpayer's concession that the $2 million was includible in gross income, the Second Circuit remanded with instructions to uphold the additional income tax deficiency.) The Second Circuit found the view of the majority in *Graev* on the penalty issue unpersuasive and sided with the dissenting judges in *Graev*. The court focused on the language of § 6751(b) and concluded that it is ambiguous regarding the timing of the required supervisory approval of a penalty. Because of this ambiguity, the court examined the statute's legislative history and concluded that Congress's purpose in enacting the provision was "to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle." That purpose, the court reasoned, undercuts the

*Graev* majority's conclusion that approval of the penalty can take place at any time, even just prior to assessment. The court held "that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Further, the court held "that compliance with § 6751(b) is part of the Commissioner's burden of production and proof in a deficiency case in which a penalty is asserted. ... Read in conjunction with § 7491(c), the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's *prima facie* case."

**4. Return preparers need to be extra careful with not only the earned income tax credit, but also with the child tax credit, additional child tax credit, and the American Opportunity Tax Credit.** T.D. 9799, Tax Return Preparer Due Diligence Penalty Under Section 6695(g), 81 F.R. 87444 (12/5/16). The Treasury Department and the IRS have issued proposed and temporary regulations that amend Reg. § 1.6695-2 to implement changes made by the Protecting Americans from Tax Hikes Act of 2015. These changes extend the § 6695(g) preparer due diligence requirements to returns or claims for refund including claims of the child tax credit (CTC), additional child tax credit (ACTC), and American Opportunity Tax Credit (AOTC), in addition to the earned income credit (EIC). As a result of these changes, one return or claim for refund may contain claims for more than one credit subject to the due diligence requirements. Each failure to comply with the due diligence requirements set forth in the regulations results in a penalty, and therefore more than one penalty could apply to a single return or claim for refund. Examples in the temporary regulations illustrate how multiple penalties could apply when one return or claim for refund is filed. Revisions to Form 8867 have been made for 2016 so that it is a single checklist to be used for all applicable credits. The temporary regulations are effective on 12/5/16.

**5. A de minimis safe harbor permits payors to avoid penalties for incomplete or incorrect information returns and payee statements without correcting them unless the payee elects for the safe harbor not to apply.** Notice 2017-9, 2017-4 I.R.B. 542_ (1/4/17). Section 6721 imposes penalties for failure to timely file information returns or failure to include complete or correct information on such returns. Section 6722 imposes penalties for similar failures with respect to furnishing payee statements. The penalties are reduced if the failures are corrected within 30 days of the date prescribed for filing the return or furnishing the statement. Both provisions contain an exception for de minimis failures under which the penalties do not apply if a failure to provide complete or correct information is corrected on or before August 1 of the calendar year in which the return or statement is due and the number of information returns or payee statements otherwise subject to penalties does not exceed the greater of 10 or one-half of 1 percent of the total number of information returns or payee statements the person is required to file during the calendar year. Section 202 of the Protecting Americans from Tax Hikes Act of 2015 amended §§ 6721 and 6722 to provide a safe harbor with respect to the de minimis exception. Under the safe harbor, an error on an information return or payee statement does not need to be corrected to avoid a penalty if the error relates to an incorrect dollar amount and differs from the correct amount by no more than $100 ($25 with respect to an amount of tax withheld). Sections 6721(c)(3)(B) and 6722(c)(3)(B) provide that the safe harbor does not apply if a payee makes an election that the safe harbor not apply. Thus, if a payee makes this election, the error must be corrected to avoid penalties. The notice (1) provides the requirements for making the election, (2) clarifies that the de minimis error safe harbor does not apply in the case of an intentional error or if a payor fails to file an information return or furnish a payee statement, and (3) requires payors to retain certain records. The notice also solicits comments regarding the rules contained in the notice and regarding any potential abuse of the de minimis error safe harbor. Generally, the payee must make the election using any reasonable method prescribed by the payor (or, if there is no prescribed method, in writing), include information specified in the notice such as the payee's name, address and taxpayer identification number, and make the election with respect to payee statements required to be furnished in the calendar year in which the payee makes the election (or alternatively, with respect to payee statements required to be furnished in the calendar year of the election and

succeeding calendar years). The notice applies with respect to information returns required to be filed, and payee statements required to be furnished, after 12/31/16. The notice provides that regulations incorporating the rules set forth in the notice will be issued to implement the de minimis error safe harbor and the payee election. To the extent the regulations incorporate the rules set forth in the notice, the regulations will be effective retroactively to the effective date of the notice. Although the notice does not impose a requirement for payors to notify payees regarding the de minimis error safe harbor and the available election, the regulations are expected to impose this requirement.

6. **Better be careful who you hire as CFO, and raise all your arguments against liability as a responsible person at the summary judgment stage, not afterwards.** McClendon v. United States, 119 A.F.T.R. 2d 2017-1037 (S.D. Tex. 3/6/17). The government successfully established through a motion for summary judgment that the taxpayer, a physician, was liable under § 6672 for a $4.3 million penalty equal to the amount of unpaid federal employment taxes owed by his medical practice. The CFO he had hired had embezzled funds and ultimately pleaded guilty to felony counts of theft. When the taxpayer learned of the unpaid taxes, he made a loan to the practice to allow it to make payroll, and these funds went to the employees rather than the government. The government used this preferential payment as the basis for establishing that the taxpayer had willfully violated his duty to pay the taxes due. The taxpayer moved for reconsideration and argued that his liability should be limited to the $100,000 preferential payment that was the basis for his liability. The court rejected this argument for two reasons. First, the taxpayer had failed to raise it in response to the government's motion for summary judgment. Second, even if he had raised it in a timely manner, the taxpayer had failed to meet his burden to prove the absence of funds available to pay the taxes due:

> At the summary judgment stage, as now, Dr. McClendon did not try to prove up the funds available to [the practice] or show that whatever funds existed were encumbered so that he had no obligation to pay them to the IRS. Instead, he effectively argues that, at summary judgment, it was the government's burden to demonstrate his liability for each dollar of the penalty. Not so. Dr. McClendon was presumptively liable for the balance of the IRS penalty assessed against him. The government moved for summary judgment and argued that the evidence did not create a genuine factual dispute material to deciding whether the IRS penalty was properly assessed. That discharged the government's summary judgment burden. Dr. McClendon, who would bear the burden at trial, then had the burden to submit or identify record evidence showing that he was not liable.

7. **Fraudulent is in the eye of the beholder. Even though the check had a restrictive endorsement on the back, the sender did not willfully file a fraudulent Form 1099 when the recipient did not communicate his rejection of the check.** Shiner v. Turnoy, 850 F.3d 923 (7th Cir. 3/16/17). The appellant in this case was an insurance broker who had sold insurance policies to the in-laws of an attorney whose practice focuses on tax and estate planning. The attorney demanded that the broker share with him one-half of the commissions that the broker had earned on certain policies. In response, the broker sent the attorney a check on 12/17/12 in the amount of $149,000 with a notation on the back indicating that, by cashing the check, the attorney accepted the payment in full satisfaction of any claims. The attorney did not cash the check and instead brought an action against the broker in state court the following day for breach of contract, but did not serve process on the broker until 1/30/13. By that time, on the advice of his CPA, the broker had submitted to the IRS a Form 1099 reporting the $149,000 payment to the attorney. The breach of contract action ultimately was resolved in the broker's favor. The attorney also brought this action in federal district court asserting that the broker had filed a fraudulent information return and therefore was liable to the attorney under § 7434, which authorizes a civil action for damages against a person who willfully files a fraudulent information return. The U.S. District Court held in favor of the attorney and ordered the broker to pay damages of approximately $16,000. The relevant regulation, Treas. Reg. § 1.6041-1(h),

provides that a check is income for tax purposes only if "credited or set apart to a person without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made." The District Court apparently viewed the broker's restrictive endorsement on the check as a substantial limitation or restriction and concluded that the broker should not have filed the Form 1099. In an opinion by Judge Posner, the U.S. Court of Appeals for the Seventh Circuit reversed. The broker had not willfully filed a fraudulent information return, the court reasoned, because the broker had filed the Form 1099 more than a month after sending the check to the attorney, who during that period "had neither asked [the broker] for a new check—a check without a restrictive endorsement—nor otherwise communicated to [the broker] a rejection of the check. [The attorney's] inaction gave [the broker] a solid basis for believing that [the attorney] had accepted the check ... despite the restrictive endorsement, so [the broker's] filing of the Form 1099 could not have been 'willfully ... fraudulent,' as required by 26 U.S.C. § 7434."

8. **"As" and "as if" do not mean the same thing, says the Tax Court. A deficiency is not reduced by prior assessments of restitution ordered in a criminal prosecution.** Muncy v. Commissioner, T.C. Memo. 2017-83 (5/17/17). The taxpayer, who at one point claimed that his wages were not taxable because he was a "'a sovereign, living soul' who was not a citizen of the United States ... and not a party to the United States Constitution," pleaded guilty to one count of willful attempt to evade and defeat tax for 2004. The plea agreement stated that it did not bar any civil or administrative claim, including tax matters, that it was binding only on the U.S. Attorney's Office for the Eastern District of Arkansas and the taxpayer, and that it did not bind any other federal or state administrative or regulatory authority. In connection with the criminal proceeding, the U.S. District Court ordered the taxpayer to pay criminal restitution for the years 2003 through 2005. The IRS subsequently assessed the restitution pursuant to § 6201(a)(4). The IRS also issued a notice of deficiency for several tax years, including 2003 through 2005. For those years, the notice of deficiency reduced the taxpayer's corrected tax liability by the amounts of criminal restitution. In the Tax Court, however, the IRS took the position that the criminal restitution did not reduce the deficiency for the years in question. The Tax Court (Judge Nega) agreed with the government. The court reasoned that the term "deficiency" generally is defined in § 6211(a) as the excess of (1) the correct tax for the year over (2) the amount of tax shown due on the return plus "the amounts previously assessed (or collected without assessment) as a deficiency." Criminal restitution, the court concluded, is not an "amount[] previously assessed ... as a deficiency." The court based its conclusion on § 6201(a)(4), which provides—for criminal restitution paid after August 16, 2010—that the IRS shall assess criminal restitution "in the same manner as if such amount were such tax." The court also relied on § 6213(b)(5), which provides that a notice of assessment of criminal restitution is not considered a notice of deficiency and is not subject to normal deficiency procedures. According to the court, "[a]lthough neither section 6201(a)(4) nor section 6213(b)(5) explicitly provides that assessed restitution amounts may not be considered in the definition of a deficiency under section 6211, we believe common sense dictates that they not be included as "amounts previously assessed ... as a deficiency" for purposes of that section. This result is consistent with *Weber v. Commissioner*, T.C. Memo. 1995-125, a decision issued before the enactment of § 6201(a)(4).

- The result in this case does not mean that the taxpayer will pay twice for the same tax liability. The court noted that "[a]ny amount paid to the IRS as restitution for taxes owed must be deducted from any civil judgment the IRS obtains to collect the same tax deficiency." Thus, criminal restitution paid with respect to a specific year does not reduce the amount of the deficiency for that year, but the IRS must subtract the restitution paid from the amount it collects for the year.

9. **What is the meaning of "same taxpayer" under § 6621(d) when corporations merge (Part Deux)? Or, see what happens when different interest rates apply to overpayments and underpayments (which has never made any sense since 1986 anyway)!** Ford Motor Co. v. United States, 119 A.F.T.R.2d 2017-1998 (Fed. Cl. 5/30/17). Enacted in 1998, § 6621(d) states simply: "To the extent that, for any period, interest is payable

under subchapter A [underpayments] and allowable under subchapter B [overpayments] on equivalent underpayments and overpayments by the same taxpayer of tax imposed by this title, the net rate of interest under this section on such amounts shall be zero for such period." In theory, § 6621(d) accounts for and corrects the disparity between the higher interest rate imposed on underpayments and the lower interest rate applied to overpayments as long as the "same taxpayer" has made the payments. (Note: The IRS always has allowed interest netting for the same taxpayer for the same tax year.) Nevertheless, this straightforward concept and the simple language of § 6621(d) belie the difficult questions that arise regarding determinations of the "same taxpayer" in the merger and acquisition context. It seems to us that the controversy and confusion in this area are the result of two extreme views: The IRS interprets § 6621(d) very narrowly so that the term "same taxpayer" requires the same taxpayer identification number. Corporate taxpayers, however, interpret the term more broadly so that virtually any consolidation of corporate entities where one corporation has an overpayment and another has an underpayment meets the "same taxpayer" requirement. A reasoned approach would allow "same taxpayer" treatment if the corporate entities combine via a § 368(a)(1)(A) merger (regardless of the surviving corporation's taxpayer identification number), but not for other types of consolidations where corporate entities remain separately responsible for pre- and post-acquisition liabilities. *Read on only if you wish to risk incurring brain damage.*

*Ford and its FSC.* Ford Motor Company ("Ford") made an overpayment for 1992 while its former Netherlands foreign sales corporation, Ford Export Services B.V. ("Export"), made underpayments for 1992 through 1998 (excepting 1994). As a foreign sales corporation ("FSC") and a tax "Dodge" (pun intended) sanctioned under prior law, Export did not engage in substantial business activities. Export did perform enough activity to qualify under the FSC rules, but no physical transfers of money between Export and Ford occurred. Instead, transactions between Ford and Export were "reflected as entries on [Ford's and Export's] books of account or accounting and tax records." Between 1999 and 2005, Ford paid the IRS any underpayments owed by Export, plus interest accruing at the standard underpayment interest rate, while in 2008 the government credited the 1992 overpayment due to Ford, plus interest accruing at the standard overpayment interest rate.

*Ford's 2008 claim for refund.* Meanwhile, in 2003 after the favorable rules for FSCs were repealed, Export elected to be treated as a disregarded entity owned entirely by Ford. This election of disregarded entity status had the tax effect of liquidating all of Export's assets and liabilities into Ford pursuant to Reg. § 301.7701-3(g)(1)(iii). Then, in August 2008 after the IRS had credited Ford's 1992 overpayment plus interest at the overpayment rate, Ford filed a claim for refund to recover $11,740,528 from the IRS. Ford's position was that the "net interest rate of zero under [Subsection] 6621(d) [should] be applied to the underpayments and overpayments" of Export and Ford as the "same taxpayer." The IRS disallowed Ford's 2008 refund claim noting that Export and Ford filed separate returns under different taxpayer identification numbers; therefore, the "same taxpayer" requirement was not met.

*Ford's 2010 claim for refund.* Undaunted, after a series of transactions in 2010 that resulted in the assets and liabilities of Export becoming part of Ford, in November 2010 Ford filed a second claim for refund but this time for $20,410,788. Ford argued that Export's eventual consolidation into Ford satisfied the "same taxpayer" requirement of § 6621(d). The IRS, though, again disallowed Ford's claim on the basis that Export and Ford still were not the "same taxpayer" because the 2010 transactions "did not result in [Ford] being both liable ... for the tax that [Export] underpaid and entitled to a credit or refund of the tax that [Export] overpaid." Thus, according to the IRS, there had not been a "merger" of Export and Ford. Now exasperated, Ford filed a refund suit in the U.S. Court of Federal Claims on May 28, 2014, seeking to recover $20,410,788 under § 6621(d). The dispute came before Judge Lettow on cross-motions for summary judgment.

*The landscape of interest netting.* This is not an entirely new issue. According to Judge Lettow's opinion, two cases, *Energy E. Corp. v. United States*, 645 F.3d 1358 (Fed. Cir. 2011) and *Wells Fargo & Co v. United States*, 827 F.3d 1026 (Fed. Cir. 2016), *rev'g in part and aff'g in part*, 119 Fed. Cl. 27 (2014), establish how the interest netting rules of § 6621(d) should work.

**(1)** If the surviving corporation in a merger or mergers has overpayments and underpayments across open tax years, interest netting is permitted. *Wells Fargo* supports this rule, and the IRS agrees because the overpayments and underpayments are made by a taxpayer with the same taxpayer identification number across the open years. (OK. This makes perfect sense to us. These were the facts of "Situation Two" in *Wells Fargo*.)

**(2)** Oddly, though, if across open years one corporation has made an overpayment and another has made an underpayment, interest netting under § 6621(d) does not apply (according to the Federal Circuit) even if the two corporations subsequently merge under § 368(a)(1)(A). *Wells Fargo* supports this rule as well (contrary to the opinion of the lower court), and the IRS agrees because the taxpayer identification numbers of the overpaying and underpaying corporations are different at the time of the payments. (Our take: This makes no sense if the assets and liabilities of the two merging corporations become one. These are, though, the facts of "Situation One" in *Wells Fargo* where the IRS won.)

**(3)** If a surviving corporation with an underpayment acquires the stock of another corporation with an overpayment (even if it subsequently files a consolidated return with the acquired subsidiary), interest netting is not permitted because the two corporations were not the "same taxpayer" at the time of the separate payments. In other words, a corporation apparently cannot "acquire" another corporation's overpayment via a stock purchase for purposes of § 6621(d) even if consolidated returns are subsequently filed. *Energy E. Corp.* supports this rule. (Our take: Although Judge Lettow's opinion does not elaborate, this rule makes sense too because after a stock purchase, even if the parent files a consolidated return with the acquired subsidiary, the parent is liable only for the subsidiary's post-acquisition taxes. See Reg. § 1.1502-6. The IRS presumably agrees with this approach because the taxpayer identification numbers of the underpaying and overpaying corporations remain different in this type of consolidation.)

**(4)** On the other hand, if a corporation has an overpayment for an open tax year and merges *into* a surviving corporation that subsequently makes an underpayment, § 6621(d) interest netting is allowed. *Wells Fargo* "Situation Three" supports this rule. (Our take: This rule makes perfect sense because, in a merger, the assets and liabilities of the acquired corporation become the assets and liabilities of the acquiring corporation. Nonetheless, it seems completely inconsistent with the court's holding for "Situation One" in *Wells Fargo*, and it seems the IRS would disagree as well because the corporation's taxpayer identification number at the time of the overpayment is different from the corporation's taxpayer identification number at the time of the underpayment.)

*The Claims Court's ruling.* As if matters could get any more confusing, in Ford's § 6621(d) refund claim, Ford was the surviving entity throughout a series of consolidations and had an overpayment while Ford's FSC subsidiary had an underpayment. Naturally, Ford (having made the overpayment and being owed interest by the IRS) contended that it was the "same taxpayer" as Export (having made the underpayment and therefore owing a greater amount of interest to the IRS). Strategically, though, Ford did not dispute the courts' holdings in either *Energy E. Corp.* or *Wells Fargo*. Instead, Ford made the novel argument that because Export was not really an active corporation since it was just a FSC set up to avoid taxes (legitimately, of course), Export's separate corporate existence should be ignored, and Export should be considered the "same taxpayer" as Ford for purposes of § 6621(d). After hearing cross motions for summary judgment, Judge Lettow decided (not surprisingly) that under basic principles of tax law—specifically, *Moline Properties*—Ford and Export are separate and therefore not the "same taxpayer" for purposes of § 6621(d). Ford's $20,410,788 refund claim thus was denied.

*What does all this mean for corporate taxpayers with overpayments and underpayments?* The rules applicable to corporate taxpayers under § 6621(d) are a mess under current caselaw

(i.e., *Ford*, *Wells Fargo*, and *Energy E. Corp.*). In our view, "same taxpayer" treatment under § 6621(d) should apply across open years if the overpaying and underpaying corporations combine pursuant to a § 368(a)(1)(A) straight merger but probably not otherwise. Guidance from Congress or Treasury would be helpful, but don't hold your breath there.

**B. Discovery: Summonses and FOIA**

1. **In an effort to absolve itself of liability for withholding taxes pursuant to § 3402(d), an employer succeeded in getting access to IRS records of workers it classified as independent contractors.** Mescalero Apache Tribe v. Commissioner, 148 T.C. No. 11 (4/5/17). During an audit, the IRS asserted that the Mescalero Apache Tribe (the Tribe) had improperly classified some of its several hundred workers as independent contractors and therefore was liable, pursuant to §§ 3402(a) and 3403, for the taxes that it should have withheld from their wages. Under § 3402(d), an employer is not liable for withholding taxes if, despite the lack of withholding, the taxes are actually paid. The Tribe attempted to ascertain whether the workers had paid the taxes by following the standard procedure required by the IRS, i.e., by asking the workers to complete IRS Form 4669, Statement of Payments Received. However, the Tribe was unable to find 70 of its workers. In the Tax Court, the Tribe moved to compel discovery of the IRS's records of these workers to ascertain whether they paid the taxes in question. The IRS argued that it was precluded from disclosing the information sought by the Tribe because it was return information, the disclosure of which is prohibited by § 6103(a). In a unanimous reviewed opinion by Judge Holmes, the Tax Court held that disclosure of the information sought by the Tribe was permitted by the exception in § 6103(h)(4)(C), which permits disclosure in a federal or state judicial or administrative proceeding pertaining to tax administration:

> if such return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer which directly affects the resolution of an issue in the proceeding.

The court also rejected the government's argument that, even if the information was disclosable, it was not discoverable because § 3402(d) places the burden on the employer to prove the payment of taxes and requiring the IRS to disclose the information sought by the Tribe would amount to a shifting of the burden of proof. Under Tax Court Rule 70(b), the court noted, information is discoverable "regardless of the burden of proof involved."

- The Tax Court noted differing views among the U.S. Courts of Appeals on the issue of *to whom* return information can be disclosed under the exceptions in § 6103(h)(4). The Fifth Circuit has interpreted § 6103(h)(4) to authorize disclosure only to officials of the Treasury Department or the Department of Justice. *Chamberlain v. Kurtz*, 589 F.2d 827 (5th Cir. 1979). The Tenth Circuit has rejected this view. *First Western Government Securities, Inc. v. Commissioner*, 796 F.2d 356 (10th Cir. 1986). Because the Tax Court's decision in this case most likely will be heard by the Tenth Circuit, the court explained, it chose to follow the precedent set in *First Western*.

- The Tax Court declined to consider whether disclosure was authorized by § 6103(h)(4)(B), which authorizes disclosure "if the treatment of an item reflected on such return is directly related to the resolution of an issue in the proceeding." The term "return information" does not appear in this provision. The court noted that both the Federal and Sixth Circuits have concluded that § 6103(h)(4)(B) does not authorize disclosure of return information that is not reflected on a return, and that the Tenth Circuit seems to have reached a contrary conclusion. *United States v. NorCal Tea Party Patriots*, 817 F.3d 953, 961-62 (6th Cir. 2016); *In re United States*, 669 F.3d 1333, 1339-40 (Fed. Cir. 2012); *Tavery v. United States*, 32 F.3d 1423, 1427-28 (10th Cir. 1994). The Tax Court declined to address the issue on the grounds that it was unnecessary to do so in light of its conclusion that disclosure was authorized by § 6103(h)(4)(C).

2. **The taxpayer may have the "green solution," but the IRS gets the "green light" to continue its audit of this Colorado marijuana dispensary.** The Green Solution Retail, Inc. v. United States, 855 F.3d 1111 (10th Cir. 5/2/17). The United States Court of Appeals for the Tenth Circuit, in an opinion by Judge McHugh, held that the Anti-Injunction Act ("AIA") and the Declaratory Judgment Act ("DJA") bar a marijuana dispensary's suit to enjoin

the IRS from auditing its business records. The IRS's examination of the taxpayer, a Colorado-based marijuana dispensary, sought to determine if § 280E applies to disallow certain of the taxpayer's claimed deductions and credits. Under § 280E, otherwise allowable business deductions and credits are denied to taxpayers trafficking in a "controlled substance" under federal law. Marijuana remains a controlled substance under federal law (the "Controlled Substances Act") even though it has been legalized for medical or recreational use (or both) in at least 28 states. The taxpayer argued that the AIA and DJA do not apply and the IRS thus should be prohibited from examining the taxpayer's business records on two grounds. First, the Tenth Circuit's prior decision in *Lowrie v. United States*, 824 F.2d 827, 830 (10th Cir. 1987), which held that the AIA bars actions seeking to enjoin "activities leading up to, and culminating in, ... assessment" (such as an IRS audit) was implicitly overruled by the Supreme Court of the United States in *Direct Marketing Ass'n v. Brohl*, ___ U.S. ___, 135 S.Ct. 1124 (2015). *Direct Marketing* involved a suit by taxpayers seeking to enjoin Colorado taxing authorities from obtaining information from online retailers about the retailers' customers. The Court held in *Direct Marketing* that the Tax Injunction Act ("TIA"), which generally prohibits federal injunctions against state tax assessment and collection actions, did not bar a federal suit seeking to enjoin Colorado from demanding information about customers from the online retailers. After a detailed examination of the language of the AIA as compared to the TIA, the Tenth Circuit determined that its decision in *Lowrie* was not implicitly overruled by *Direct Marketing*. Further, the Tenth Circuit determined that if the AIA bars the taxpayer's suit, then the DJA—which bars declaratory judgments in certain federal tax cases—similarly bars the taxpayer's suit because the acts are "coterminous." Therefore, at least in the Tenth Circuit, the AIA and DJA continue to bar taxpayer suits seeking to enjoin the IRS from "activities leading up to, and culminating in, ... assessment" (such as an IRS audit). Second, the taxpayer in this case made a somewhat strained argument that, by seeking to determine in an audit whether the taxpayer was engaged in a federal crime under the Controlled Substances Act, the IRS was acting outside of its authority. Moreover, the taxpayer argued that § 280E imposes a "penalty," not a "tax," and that the AIA and DJA prohibit only actions seeking to enjoin the assessment or collection of a federal "tax." The Tenth Circuit quickly dispensed of these claims by the taxpayer and upheld the District Court's dismissal the taxpayer's suit to enjoin the IRS's audit.

### C. Litigation Costs

**1. Attorneys, don't count on asserting a claim for administrative costs under § 7430 to recover fees not paid by the client. Only a party to the underlying proceeding can be a "prevailing party" entitled to administrative costs.** Greenberg v. Commissioner, 147 T.C. No. 13 (11/9/16). The petitioner, an attorney, was owed fees for representing a client before the IRS. His client agreed that the attorney would receive any administrative fees awarded under § 7430. The petitioner first submitted to the IRS a letter requesting administrative costs on behalf of his client, but later submitted another letter requesting the award on his own behalf. After a conference with IRS Appeals, the IRS denied the request. In the Tax Court, the attorney originally argued that the client had assigned to him the right to pursue the award and that he therefore had the right to seek attorney's fees on his own behalf. He later conceded that the Anti-Assignment Act bars the assignment of a legal suit against the U.S. government and argued instead that he was pursuing the claim as it related to his own rights and not on behalf of his former client. The Tax Court (Judge Pugh) held that it lacked jurisdiction to review the IRS's denial of the application for administrative costs. The court reviewed the statutory language and legislative history of § 7430 as well as judicial precedent interpreting it and concluded that, to be a "prevailing party" within the meaning of § 7430, a person must be a party to the underlying administrative proceeding. The attorney in this case was not a party to the underlying administrative proceeding and therefore was not the proper party to file a Tax Court petition. Accordingly, the court granted the government's motion to dismiss for lack of jurisdiction.

**D. Statutory Notice of Deficiency**

1. **Rumors of the death of tax exceptionalism are greatly exaggerated. A notice of deficiency need not comply with the APA's requirement that an agency provide reasoned explanation for its action.** QinetiQ US Holdings, Inc. v. Commissioner, 845 F.3d 555 (4th Cir. 1/6/17), *aff'g* T.C. Memo. 2015-123 (7/2/15). In 2002, an S corporation issued stock to two individuals. The stock was subject to the terms of a shareholders agreement that restricted transfers of the shares and gave the corporation the option to purchase the shares upon the executive's death, disability or termination of employment. The purchase price varied based on the individuals' length of employment and the event that triggered the option to purchase. The corporation terminated its S election effective in 2007 and, in 2008, was acquired by merger into QinetiQ US Holdings, Inc., the taxpayer in this case. Immediately prior to the merger, the acquired corporation waived its rights with respect to stock transfer restrictions or partially vested stock. In its taxable year ending 3/31/09, the taxpayer (the acquiring corporation) deducted $117.7 million—the value of the stock that had been transferred to one of the individuals in 2002—as wages pursuant to § 83(h). The taxpayer's position was that the transfer of stock had been nontransferable and subject to a substantial risk of forfeiture until 2008. The IRS issued a notice of deficiency stating "that the IRS had determined that QinetiQ 'ha[d] not established that [it was] entitled' to a deduction 'under the provisions of [26 U.S.C.] § 83,' and that QinetiQ's taxable income for the year thereby was increased by '$117,777,501.'" The notice of deficiency provided no further explanation. The Tax Court (Judge Goeke) held that the taxpayer was not entitled to the deduction because the stock had not been transferred in connection with the performance of services as required by § 83 and that, even if it had been, the stock was not subject to a substantial risk of forfeiture. In an opinion by Judge Keenan, the Fourth Circuit affirmed. The Fourth Circuit first addressed the taxpayer's argument that the notice of deficiency was invalid because it was a final agency action that failed to provide a reasoned explanation for the agency's decision, as required by the U.S. Supreme Court's interpretation of the Administrative Procedure Act in *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502 (2009). The Fourth Circuit rejected this argument because it failed to take into account "the unique system of judicial review provided by the Internal Revenue Code for adjudication of the merits of a Notice of Deficiency." Some agency-specific statutes, the court reasoned, "provide materially different procedures for judicial review that predate the APA's enactment." The Internal Revenue Code's authorization of de novo review of a notice of deficiency in the Tax Court is one example of this kind of statute. In light of this, the court concluded:

> the APA's general procedures for judicial review, including the requirement of a reasoned explanation in a final agency decision, were not intended by Congress to be superimposed on the Internal Revenue Code's specific procedures for de novo judicial review of the merits of a Notice of Deficiency.

The Court also rejected the taxpayer's argument that the notice of deficiency was insufficient to satisfy the requirement of § 7522(a) that the notice "describe the basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice." After reviewing situations in which courts had and had not viewed flaws in notices of deficiency as rendering them invalid, the court held that the notice of deficiency issued to the taxpayer had satisfied the basic requirements of the statute. Finally, the court affirmed the Tax Court's holding that the stock issued by the taxpayer had not been subject to a substantial risk of forfeiture, but declined to address whether it had been transferred in connection with the performance of services.

2. **This case might raise more questions than it answers. A notice of deficiency that erroneously set forth a deficiency of zero was a valid notice of deficiency.** Dees v. Commissioner, 148 T.C. No. 1 (2/2/17). The taxpayer claimed on his 2014 federal income tax return a refundable premium tax credit pursuant to § 36B, which the IRS disallowed. The IRS issued a notice of deficiency that stated: "We determined that there is a deficiency in your income tax which is listed above." Above that language, the notice listed the deficiency as zero. The attached computation pages decreased refundable credits but erroneously computed a

bottom-line deficiency of zero. In one place, the notice of deficiency stated "A decrease to refundable credit results in a tax increase." The taxpayer filed a petition in the Tax Court in response to the notice of deficiency to challenge the disallowance of the credit. The court ordered the IRS to explain whether the deficiency was zero and subsequently issued an order to show cause why the case should not be dismissed for lack of jurisdiction on the ground that the IRS had failed to determine a deficiency. The IRS explained the zero amount as a clerical error. The Tax Court, in a reviewed opinion (7-3-7) by Judge Buch, held that the notice of deficiency was valid and that the court therefore had jurisdiction over the case. The court reviewed its prior decisions regarding the validity of notices of deficiency and framed the analysis as follows:

> In the holdings of these cases we see a two-pronged approach to the question of the validity of the notice of deficiency. First, we look to see whether the notice objectively put a reasonable taxpayer on notice that the commissioner determined a deficiency in tax for a particular year and amount. If the notice, viewed objectively, sets forth this information, then it is a valid notice. ... Accordingly, if the notice is sufficient to inform a reasonable taxpayer that the Commissioner has determined a deficiency, our inquiry ends there; the notice is valid. But what if, as here, the notice is ambiguous? Then our caselaw requires the party seeking to establish jurisdiction to establish that the Commissioner made a determination and that the taxpayer was not misled by the ambiguous notice.

Elsewhere in its opinion, the court characterized the analysis of an ambiguous notice as looking "beyond the notice to determine whether the Commissioner made a determination and whether the taxpayer knew or should have known that the Commissioner determined a deficiency." In this case, the court concluded, although the notice of deficiency was ambiguous, the IRS had established that it had determined a deficiency and that the taxpayer was not misled by the notice. As evidence that the taxpayer was not misled, the court highlighted the fact that the taxpayer had filed a Tax Court petition, which made clear that the taxpayer understood that the IRS had disallowed his refundable credit.

- In a concurring opinion, Judge Marvel, joined by Judge Paris, expressed concern with the analysis in the court's opinion. Judge Marvel disagreed with the proposition that the court's prior decisions "support[] a test that looks, in part, to whether the taxpayer knew or should have known that the Commissioner determined a deficiency or was misled." References in prior decisions to a taxpayer's knowledge or being misled, she stated, were dicta that should not be elevated to a test. "The opinion of the Court has concluded, on the basis of the record as a whole, that, although the notice of deficiency was ambiguous, respondent determined an income tax deficiency with respect to petitioner and the notice is valid. No other analysis is needed or should be required."
- In a lengthy concurring opinion, Judge Ashford argued that the relevant statutory provisions, §§ 6212, 6213 and 6214, do not support the analysis in the court's opinion and instead dictate that the court's jurisdiction depends on the issuance of a notice of deficiency, but does not depend on the notice's contents. Judge Ashford distinguished between the IRS's determination of a deficiency and its issuance of the notice of deficiency: "the notice of deficiency is a predicate for our jurisdiction, but our jurisdiction does not derive from or attach to the notice of deficiency; our jurisdiction is instead over the Commissioner's determination that there is a deficiency." Finally, Judge Ashford expressed the view that the appropriate remedy for a notice of deficiency with inadequate information is not to decline jurisdiction over the case, but to shift to the IRS the burden of proof on any matter not reflected in the notice or stated incorrectly in the notice. "In short, I believe we can exercise jurisdiction over this case within the statutory confines Congress established ... ."
- Judge Foley wrote a dissenting opinion joined by six other judges (Judges Colvin, Vasquez, Gale, Goeke, Gustafson, and Morrison). The dissenting opinion takes the position that the notice of deficiency did not fairly advise the taxpayer that the IRS had determined a deficiency of a specific amount, and therefore was invalid.
- Judge Gustafson wrote a separate dissenting opinion joined by

five other judges (Judges Colvin, Foley, Vasquez, Goeke, and Morrison) to express his disagreement with the statement in the court's opinion that the notice in this case was not a $0 deficiency notice because the attachments to the notice informed the taxpayer that he had a decrease to refundable credits, which results in a tax increase. After discussing the statutory definition of a deficiency, Judge Gustafson concluded: "If the difference between the tax imposed and the 'excess' defined in section 6211(a) and (b) is zero, then by definition there is no deficiency. A notice that reports such a zero is not a notice of deficiency; it is a notice of no deficiency." Because the IRS had not mailed a notice of deficiency, he reasoned, the case should be dismissed for lack of jurisdiction.

**E. Statute of Limitations**

**1. Veterans have extra time to claim refunds for taxes improperly withheld from amounts received for combat-related injuries.** The Combat-Injured Veterans Tax Fairness Act of 2016 (2016 CIVTFA), Pub. L. No. 114-292, was signed by the President on 12/16/16. Section 104(a)(4) and (b) exclude from gross income amounts received as a pension, annuity, or similar allowance for a combat-related injury. In *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va. 1991), the court held that a lump sum disability-related severance payment received by a veteran was excluded from the recipient's gross income under § 104(a)(4). Despite these authorities, since 1991, the Department of Defense has withheld taxes from severance pay for wounded veterans. The 2016 CIVTFA directs the Secretary of Defense to ensure that taxes are not withheld prospectively. In addition, the legislation directs the Secretary of Defense, within one year of the date of enactment, to identify all severance payments from which taxes were improperly withheld, notify each recipient of the improper withholding, and provide each recipient with instructions on filing amended returns to recover these amounts. The legislation extends the limitations period of § 6511(a) on filing claims for refund to the date that is one year after the required notification of improper withholding and eliminates the restriction of § 6511(b)(2) that would normally apply on the amount of tax recoverable.

**2. The one-year statute of limitations with respect to the penalty for failing to report a listed transaction does not begin to run until Form 8886 is filed.** May v. United States, 119 A.F.T.R. 2d 2017-1785 (9th Cir. 5/16/17). On audit, the IRS determined that the taxpayer had failed to report a "listed transaction" by filing a Form 8886, Reportable Transaction Disclosure Statement, with the IRS and, as required by Reg. § 1.6011-4(e), a copy with the Office of Tax Shelter Analysis ("OTSA"). A "listed transaction" is one that is the same as, or substantially similar to, a tax avoidance transaction under § 6011. The IRS assessed a penalty against the taxpayer under § 6707A, but the penalty was assessed more than one year after the IRS had sufficient information from which to determine that the taxpayer had engaged in a listed transaction. Section 6501(c)(10)(A) provides in relevant part that the IRS must assess a § 6707A penalty against a taxpayer who fails to disclose a listed transaction within one year of the date that "the Secretary is furnished the information so required" by § 6011. The taxpayer argued and the United States District Court for the District of Arizona (Judge Wake) agreed that the IRS's assessment was time-barred. On the government's appeal to the U.S. Court of Appeals for the Ninth Circuit, however, in a memorandum opinion, the majority of a three-judge panel reversed, holding that "the information so required" should be interpreted to refer to the Form 8886. According to the majority, the one-year limitations period under § 6501(c)(10)(A) for assessing a penalty under § 6707A does not begin to run until the taxpayer files Form 8886 with the IRS and a copy with the OTSA. Because the taxpayer had not filed Form 8886, the limitations period never began to run and the IRS's assessment of the penalty was timely.

- Judge Clifton dissented. He argued that the majority's position "exalts form over substance" and means that "it doesn't actually matter when the relevant information was provided to the appropriate IRS agents because the provision of information doesn't count unless it is presented to the IRS on Form 8886."

**F. Liens and Collections**

**1. Does the date on the notice or the date on the envelope control when the period for responding begins to run?** Weiss v. Commissioner, 147 T.C. No. 6 (8/17/16). In this collection due process case the taxpayer sought review of the IRS's determination to uphold a

notice of intent to levy. Before the IRS may levy against a taxpayer's property, it must provide written notice of the proposed levy and inform the taxpayer of his right to a CDP hearing. Section 6330(a)(2) requires that a levy notice must be sent or delivered to the taxpayer "not less than 30 days before the day of the first levy," and § 6330(a)(3)(B) requires the notice to inform the taxpayer in simple and nontechnical terms of his right "to request a hearing during the 30-day period" specified in § 6330(a)(2). An IRS Revenue Officer attempted to deliver to the taxpayer in person a Final Notice of Intent to Levy, but was deterred by a dog blocking the driveway. The Revenue Officer chose instead to mail the notice by certified mail two days later without generating a new notice. The taxpayer argued that the period of limitations on collection of these liabilities expired in July 2009 based on the contention that he intentionally filed his request for a CDP hearing one day late, and thus was entitled only to an "equivalent hearing" rather than to the CDP hearing that the IRS afforded him. If the taxpayer's contentions were correct, the period of limitations on collection would not have been suspended during the CDP process, and his tax liabilities would appear to have been uncollectible. The Tax Court (Judge Lauber) held that when the date appearing on a levy notice is earlier than the date of mailing, the 30-day period prescribed by § 6330(a)(2) and (3)(B) is calculated by reference to the date of mailing. The statutory directive that levy and lien notices should be drafted "in simple and nontechnical terms" does not require invalidation of a levy notice when there is a mismatch between the letter date and the mailing date. On the facts of the case, the taxpayer's request for a CDP hearing was timely because he mailed his Form 12153 to the IRS, and under §§ 7502 and 7503 it was deemed received by the IRS, within 30 days of the IRS's mailing of the levy notice, even though it was mailed more than 30 days after the date on the notice itself. Accordingly, the period of limitations on collection was suspended pursuant to § 6330(e)(1) when the taxpayer timely requested a CDP hearing.

2. **The taxpayer may have been misled by a scam promising huge returns from African diamonds, but prevailed in arguing that the IRS's failure to consider a collection alternative in a CDP hearing was an abuse of discretion.** Leslie v. Commissioner, T.C. Memo. 2016-171 (9/14/16). In connection with divorce proceedings, the taxpayer entered into a marital separation agreement with her husband that entitled her to 10 percent of whatever fee her husband, an attorney, would receive from representing the University of California Regents as plaintiffs in a class action against Enron. Her former husband ultimately received a fee of more than $50 million, and the taxpayer became entitled to $5.5 million. The Tax Court (Judge Holmes) held that the $5.5 million was taxable alimony rather than a nontaxable property settlement, but concluded that the taxpayer had not actually or constructively received this amount in 2009 (or any other years before the court). The court also concluded that the taxpayer was eligible for a $400,000 theft loss deduction for a payment "to an internet scamster who claimed he would invest it for her in an African diamond scheme but who made off with the money," and that she was subject to failure-to-file penalties for some years despite serious mental illness. The opinion is significant, however, for its holding on the IRS's ability to raise new arguments to justify its rejection of collection alternatives in a CDP hearing. After the IRS filed a notice of federal tax lien and issued a final notice of intent to levy, the taxpayer requested a CDP hearing and, in that hearing, both sought to contest the underlying tax liability and requested an installment agreement. In the CDP hearing, the taxpayer submitted amended returns for two of the years involved and also submitted a complete Form 433-A complete with all supporting documentation, except that she submitted information regarding life and health insurance premiums for only three months rather than for six months as the settlement officer had requested. Although the settlement officer generated an allowable expense worksheet showing that the taxpayer could afford a monthly payment of $5,500, the IRS issued a notice of determination upholding the collection action. The notice of determination did not analyze collection alternatives. In the Tax Court, the IRS argued that the settlement officer acted within her discretion in denying collection alternatives because the taxpayer had failed to supply the requested additional information regarding health and life insurance premiums. The court applied the doctrine of *Securities and Exchange Commission vs. Chenery Corp.*, 332 U.S. 194 (1947), 318 U.S. 80 (1943), which it described as "an administrative law principle that says a court, in

reviewing a determination which an 'administrative agency alone is authorized to make, must judge the propriety if such an action solely on the grounds invoked by the agency.'" The notice of determination did not cite the lack of health and life insurance information as a reason to deny collection alternatives. Because the settlement officer had failed to consider collection alternatives despite having all information necessary to do so, the court held that the failure to consider collection alternatives was an abuse of discretion. The court remanded to the IRS Appeals Office to hold a supplemental hearing.

• This case illustrates that the Tax Court applies the *Chenery* doctrine in cases in which the IRS has issued a notice of determination following a CDP hearing. In contrast, the Tax Court (Judge Gustafson) recently held in *Ax v. Commissioner*, 146 T.C. No. 10 (4/11/16) that neither the Administrative Procedure Act (5 U.S.C. §§ 701-706 (judicial review)) nor the *Chenery* doctrine bar the IRS from raising new grounds to support a notice of deficiency beyond those grounds originally stated in the notice.

3. **It's going to cost more to submit that offer in compromise.** REG-108934-16, User Fees for Offers in Compromise, 81 F.R. 70654 (10/13/16). The Treasury Department and the IRS have issued proposed regulations that would significantly increase the user fee for processing an offer in compromise. Currently, the general user fee for an offer in compromise is $186. However, no fee is charged for an offer in compromise based solely on doubt as to liability, or if the taxpayer is a low income taxpayer (defined as a taxpayer who has income at or below 250 percent of the federal poverty guidelines). Under the proposed regulations, the general fee for an offer in compromise would increase to $300, but no change would be made for offers in compromise based on doubt as to liability or those submitted by a low income taxpayer. The preamble to the proposed regulations provides a great amount of detail on how the increased user fee was determined, including the cost of the services provided. These regulations are proposed to be effective for offers in compromise submitted on or after 2/27/17.

4. **The fees for installment agreements are going up!** T.D. 9798, User Fees for Installment Agreements, 81 F.R. 86955 (12/2/16). The Treasury Department and the IRS have finalized without change proposed regulations (REG-108792-16, User Fees for Installment Agreements, 81 F.R. 56543 (8/22/16)) that significantly increase the user fees for entering into an installment agreement. Prior to the effective date of these regulations: (1) 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; (2) the 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; and (3) the fee for restructuring or reinstating an installment agreement is $50. Under the final regulations, the fee for low income taxpayers remains the same, but the general fee increases to $225, the direct debit fee increases to $107, and the fee for restructuring or reinstating an installment agreement increases to $89. In addition, the regulations establish two new user fees for online payment agreements. The general user fee for a taxpayer who sets up an installment agreement online is $149, and the fee for a direct debit online payment agreement is $31. These regulations apply to installment agreements entered into, restructured, or reinstated on or after 1/1/17.

5. **A taxpayer cannot challenge in a CDP hearing the imposition of a penalty under § 6707A for failure to report participation in a listed transaction after being provided the opportunity for a conference with IRS Appeals.** Keller Tank Services II, Inc. v. Commissioner, 848 F.3d 1251 (10th Cir. 2/21/17). 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 that the taxpayer was subject to a penalty under § 6707A for failure to report participation in a listed transaction. The taxpayer filed a protest and had a telephone conference with an IRS Appeals Officer, who decided that the penalty should be sustained. The IRS then assessed the tax and issued a final notice of intent to 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 an unpublished order, the Tax Court (Judge Carluzzo) granted the government's motion for summary judgment and held that, under the relevant regulation (Reg. § 301.6330-1(e)(3), Q&A E2), which the court previously had upheld in *Lewis v. Commissioner*, 128 T.C. 48 (2007), the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). In an opinion by Judge Matheson, the U.S. Court of Appeals for the Tenth Circuit affirmed. Under the relevant regulation, the court explained, 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 assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6330(c)(2)(B), is ambiguous, and in step two that Reg. § 301.6330-1 is a reasonable interpretation of the statute.

a. **The Fourth Circuit agrees.** Iames v. Commissioner, 850 F.3d 160 (4th Cir. 3/7/17). In an opinion by Judge Wilkinson, the U.S. Court of Appeals for the Fourth Circuit reached the same conclusion as the Tenth Circuit in *Keller Tank Services, II, Inc. v. Commissioner*, 848 F.3d 1251 (10th Cir. 2/21/17), i.e., that the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax in question was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). The Fourth Circuit explained:

> It is clear that the option to request a hearing with the Office of Appeals before the Commissioner assesses the tax counts as "an opportunity to dispute [one's] tax liability." First, taxpayers in these hearings have a genuine chance to explain why they should not be held to the amount requested by the Commissioner. Second, the Office of Appeals is an independent decisionmaker. As the Tax Court noted in *Lewis*, the law establishing Section 6330 also "mandate[d] that an independent appeals function exist within the IRS," Lewis, 128 T.C. at 59, suggesting that the Office of Appeals is "more than just a rubber stamp for the Commissioner's determinations," *id.* at 60. Finally, the Office of Appeals conducts both the preassessment hearing and the CDP hearing. We conclude that the former precludes the latter when it comes to tax liability.

The court also addressed § 6330(c)(4), which provides in part that an issue may not be raised at a CDP hearing if "the issue was raised and considered at a previous hearing under section 6320 or in any other previous administrative or judicial proceeding" and "the person seeking to raise the issue participated meaningfully in such hearing or proceeding." The court held that § 6330(c)(4) also barred the taxpayer from challenging his liability in the CDP hearing.

b. **As does the Seventh Circuit.** Our Country Homes Enterprises, Inc. v. Commissioner, 855 F.3d 773 (7th Cir. 5/3/17). In an opinion by Judge Kanne, the U.S. Court of Appeals for the Seventh Circuit reached the same conclusion as the Fourth and Tenth Circuits in a case involving the § 6707A penalty for failure to report participation in a listed transaction, i.e., that the taxpayer's opportunity for a conference with IRS Appeals prior to the assessment of the tax in question was a prior opportunity to dispute the underlying tax liability for purposes of § 6330(c)(2)(B). Like the Fourth Circuit, the Seventh Circuit held that § 6330(c)(4) also barred the taxpayer from challenging its liability in the CDP hearing.

6. **The Fifth Circuit upholds an order of foreclosure and sale with respect to a residence despite an ownership interest held by the taxpayer's children.** United States v. Davis, 119 A.F.T.R.2d 2017-529 (5th Cir. 3/9/17). The government successfully established in a prior proceeding in federal district court in 2008 that S.P. Davis was jointly and severally liable under § 6672 for a penalty equal to the amount of unpaid federal employment taxes owed by three medical companies that he co-owned. Mr. Davis was ordered to pay to the government

$3,327 per month. When he failed to comply with the order, the government filed suit in 2012 in federal district court pursuant to § 7403 to foreclose federal tax liens on the residence that Mr. Davis owned in Louisiana as community property with his wife. His wife died intestate in 2013. As a result of her death, Mr. Davis remained the owner of 50 percent of the residence and acquired a right, known as a "usufruct" under Louisiana law, in the other 50 percent. A usufruct is a right to enjoy property belonging to another similar to a life estate in common law jurisdictions. The two adult children of Mr. Davis and his wife each inherited a 25 percent ownership interest, known under Louisiana law as a naked ownership interest, in the portion of the property in which Mr. Davis had a usufruct. Mr. Davis moved for partial summary judgment in the District Court and argued that, if the house were sold, his two children each should be entitled to one-fourth of any sale proceeds that remain after satisfaction of a prior mortgage held by a bank, which the government conceded had priority over the federal tax lien. The District Court denied the motion and entered an order of foreclosure and sale. In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit affirmed. The court rejected Mr. Davis's argument that the District Court erred in failing to exercise its discretion to prohibit the sale and seizure of the residence. The court referred to *United States v. Rodgers*, 461 U.S. 677 (1983), in which the U.S. Supreme Court concluded that § 7403 leaves room for the exercise of reasoned discretion to decline to order a sale of the property, but cautioned that this discretion "should be exercised rigorously and sparingly, keeping in mind the Government's paramount interest in prompt and certain collection of delinquent taxes." In light of Mr. Davis's failure to comply with the order to make monthly payments, the court concluded, it could not say that the District Court had committed reversible error in refusing to exercise its limited discretion. The rights of the two children in the property, the court reasoned, were inferior to the federal tax lien, which attached to the entire community property while their mother was alive. The residence was subject to seizure and sale because, under Louisiana law, which determines the property interests to which the federal tax lien attached, the tax lien in question was a separate obligation incurred during the community property regime that can be satisfied from community property even after termination of the regime.

7. **Economic hardship relief from a levy is not available to a corporate taxpayer.** Lindsay Manor Nursing Home, Inc. v. Commissioner, 148 T.C. No. 9 (3/23/17). The taxpayer, a corporation that operated a nursing home in rural Oklahoma, failed to pay its federal withholding and employment taxes for the fourth quarter of 2013. In response to the IRS's final notice of intent to levy, the taxpayer requested a CDP hearing and submitted a letter to the IRS settlement officer challenging the appropriateness of the levy on the grounds of economic hardship. The taxpayer argued that it was operating at a loss and could not "survive or provide essential care services to its patients if the IRS is able to file a levy against every available source of income." The IRS settlement officer declined to consider the economic hardship argument because, under the relevant regulation, Reg. § 301.6343-1(b)(4)(i), relief is available only on account of economic hardship of an individual taxpayer. The regulation provides that the IRS must release a levy if one of several conditions is satisfied, including the following:

> The levy is creating an economic hardship due to the financial condition of an individual taxpayer. This condition applies if satisfaction of the levy in whole or in part will cause an individual taxpayer to be unable to pay his or her reasonable basic living expenses.

The IRS settlement officer issued a notice of determination upholding the collection action. The taxpayer filed a petition in the Tax Court and moved for summary judgment on the grounds that the regulation's limitation of economic hardship relief to individuals is contrary to the statute (§ 6343(a)(1)(D)) and therefore invalid and that the settlement officer had abused her discretion by failing to consider its request for economic hardship relief. The Tax Court (Judge Paris) upheld the validity of the regulation and concluded that the settlement officer had not abused her discretion. The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 6343(a)(1)(D), is ambiguous, and in step two

that Reg. § 301.6343-1(b)(4)(i) is a permissible construction of the statute. In its analysis of *Chevron* step one, the court examined not only the plain language of the statute but also its legislative history. (The U.S. Supreme Court's decision in *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000), suggests that courts should consider legislative history in connection with *Chevron* step one rather than step two, but there is some uncertainty on this point. The Tax Court previously has noted this ambiguity. *Square D Co. v. Commissioner*, 118 T.C. 299, 310 & n.6 (2002), *aff'd*, 438 F.3d 739 (7th Cir. 2006).) Accordingly, the court denied the taxpayer's motion for summary judgment.

- Although the court concluded that economic hardship relief from a levy is not available to a corporate taxpayer, it noted that taxpayers other than individuals are entitled to the protection of § 6330(c)(3)(C), which requires an appeals officer conducting a CDP hearing to consider "whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary." The court stated:

> This conclusion [regarding the lack of economic hardship relief under § 6343(a)(1)(D)], however, does not foreclose nonindividual taxpayers from relief in circumstances where the proposed collection action, if sustained, could result in some form of economic difficulty. These economic realities and consequences of the Commissioner's proposed collection action are properly considered for all taxpayers as part of the intrusiveness analysis within the section 6330(c)(3)(C) balancing test—namely whether the intrusiveness caused by sustaining the proposed collection action outweighs the Government's need for the efficient collection of taxes.

a. **With economic hardship relief out of the way, the government succeeds in its quest to levy.** Lindsay Manor Nursing Home, Inc. v. Commissioner, T.C. Memo. 2017-50 (3/23/17). In a separate, memorandum opinion, Judge Paris addressed the taxpayer's remaining grounds for its motion for summary judgment and the government's motion for summary judgment. The court rejected the taxpayer's arguments that the IRS settlement officer (1) abused her discretion in rejecting the taxpayer's request for an installment agreement, (2) failed adequately to consider whether the proposed collection action balances the need for the efficient collection of taxes with the taxpayer's legitimate concern that the collection action be no more intrusive than necessary, as required by § 6330(c)(3)(C), and (3) was not impartial. The court denied the taxpayer's motion for summary judgment and granted the government's motion.

8. **Don't get your hopes up if the IRS cashes the check. It doesn't mean they accepted the offer in compromise.** Whitesell v. Commissioner, T.C. Memo. 2017-84 (5/18/17). After they filed a petition in the Tax Court, the taxpayer and his wife submitted Form 656-L, Offer in Compromise (Doubt as to Liability) with a check for $3 million for their federal income tax liabilities for 2006 through 2012. The taxpayers modified Form 656-L by crossing out certain items and making handwritten notations. The IRS deposited the check and, after sending an initial letter informing them that it was returning their offer in compromise (OIC), sent a letter confirming that it had "closed its file on their OIC and was in the process of refunding their $3 million deposit because of the modified terms and conditions." The taxpayers argued that, under the Uniform Commercial Code, the IRS had accepted their OIC when it negotiated the check and did not reject the OIC within 90 days of receipt. The Tax Court (Judge Paris) held that there was no objective manifestation of mutual assent by the parties to settle the taxpayers' federal tax liabilities and therefore no settlement for the court to enforce. The court observed that the IRS is not bound by state statutes such as the UCC and that the IRS does not necessarily accept an offer by cashing a check. The court also noted that the IRS had followed its own guidelines regarding handling payments or deposits submitted with an OIC by depositing the check and later refunding the amount submitted when the IRS rejected the taxpayers' OIC.

9. **The Tax Court has jurisdiction to review the IRS's determination to uphold an accuracy-related penalty in a CDP hearing, even though it would not have deficiency jurisdiction over the penalty, which related to adjustments to partnership items**

**of a TEFRA partnership.** McNeill v. Commissioner, 148 T.C. No. 23 (6/19/17). The taxpayer invested in a distressed asset/debt (DAD) tax shelter by purchasing an 89.1 percent interest in GUISAN, LLC , which was classified for federal tax purposes as a partnership. GUISAN was a member of LABAITE, LLC, a TEFRA partnership. LABAITE claimed a large loss in 2003 from the DAD transaction, of which the taxpayer's share was more than $10 million. In a partnership-level audit of LABAITE, the IRS issued to LABAITE's partners a notice of final partnership administrative adjustment (FPAA) that reflected an adjustment to LABAITE's partnership items and imposed an accuracy-related penalty under § 6662 with respect to the claimed loss. GUISAN was not the tax matters partner (TMP) of LABAITE. Nevertheless, the taxpayer, as TMP of GUISAN, caused GUISAN to bring an action in a U.S. District Court for review of the FPAA. The taxpayer made a deposit of $4.9 million, which was sufficient to satisfy the taxpayer's liability only for the asserted deficiency and interest related to the disallowed loss; it did not satisfy the taxpayer's liability for the asserted accuracy-related penalty. The U.S. District Court subsequently dismissed the action on the taxpayer's own motion and, in doing so, declined to adjudicate any partner-level defenses. Because the accuracy-related penalty had not been paid, the IRS assessed the penalty and ultimately issued both a final notice of intent to levy and a notice of federal tax lien filing. In response, the taxpayer requested a collection due process hearing. In the CDP hearing, the IRS settlement officer (1) took the position that the taxpayer could not raise partner-level defenses to the accuracy-related penalty because the taxpayer had had a prior opportunity to contest the liability, and (2) issued a notice of determination upholding the proposed collection action. The taxpayer filed a petition in the Tax Court. Pursuant to §§ 6221 and 6230(a)(2)(A)(i), the Tax Court's deficiency jurisdiction does not extend to penalties that relate to adjustments to partnership items. The regulations issued under § 6221 provide that "[p]artner-level defenses to such items can only be asserted through refund actions following assessment and payment." Reg. § 301.6221-1(c). Because the asserted accuracy-related penalty in this case was based on an adjustment to partnership items, the Tax Court would not have jurisdiction in a deficiency proceeding to rule on the taxpayer's claimed partner-level defenses to the penalty. Nevertheless, the Tax Court (Judge Paris) held that it had jurisdiction to review the IRS's notice of determination. In 2006, Congress amended § 6330(d)(1) to make the Tax Court the only court in which a taxpayer can seek review of an IRS notice of determination issued after a CDP hearing. As amended, § 6330(d)(1) provides that "the Tax Court shall have jurisdiction with respect to such matter." In prior decisions, the court explained, it had interpreted this amendment as conferring jurisdiction on the court to review collection determinations even when the court lacked original jurisdiction over the underlying liability. "With respect to petitioner's section 6662(a) accuracy-related penalty, this penalty is another example of an item not subject to the Court's deficiency jurisdiction under section 6221 but nonetheless reviewable by the Court in the context of its section 6330 jurisdiction." The court ruled only on the question of jurisdiction and will issue a separate opinion on the merits.

- The taxpayer invested in a DAD tax shelter during 2002 as well, and successfully asserted partner-level defenses to the accuracy-related penalty for that year in a refund action. See *McNeill v. United States*, 119 A.F.T.R.2d 2017-943 (D. Wyo. 2/24/17).

**G. Innocent Spouse**

**1. Publix: "Where Shopping is a Pleasure." And, if you secretly sell $200,000 of Publix stock to fund an extramarital affair, your ex is entitled to innocent spouse relief and a tax refund.** Taft v. Commissioner, T.C. Memo. 2017-66 (4/18/17). The taxpayer, a registered nurse, was married to a man who worked for Publix Supermarkets, Inc.. Her husband received company stock as part of his compensation. Over many years, the stock grew in value to over $200,000. After he was fired by Publix, he began liquidating his stock in 2010 to fund an extramarital affair. He concealed from her both the stock transactions and his affair. Their longtime accountant prepared the couple's 2010 joint return, which reflected a $25,000 sale of Publix stock and approximately $200,000 in income from pensions and annuities. The return failed to reflect $4,874 in taxable dividends received by the husband. Because the taxpayer's husband did not want her to discover the stock liquidation, he directed

their accountant to file their 2010 joint return electronically without the taxpayer's approval or review. Although the taxpayer was unaware of it, the IRS later assessed the additional tax due on the unreported dividends. After the taxpayer discovered the affair in 2011, she initiated divorce proceedings and discovered that her husband had liquidated all of his Publix stock and had wasted most of the family's retirement savings. The divorce became final in 2013, following which the taxpayer filed her 2012 return and claimed a refund of $1,570. The IRS withheld her refund and applied it to the unpaid joint liability for 2010 resulting from the unreported dividends. The taxpayer asserted a claim for innocent spouse relief from the 2010 liability by filing Form 8857, in response to which the IRS determined that she was entitled to relief under § 6015(c), which limits the requesting spouse's liability for any deficiency on the joint return to that portion of the deficiency attributable to the requesting spouse. According to the IRS, the entire deficiency was attributable to the taxpayer's former husband. However, because § 6015(g)(3) provides that a taxpayer who obtains innocent spouse relief under § 6015(c) cannot obtain a refund, the IRS declined to issue the taxpayer's requested refund. The Tax Court (Judge Vasquez) held that the taxpayer was entitled to innocent spouse relief under § 6015(b) and therefore was entitled to a refund. Generally, to obtain relief under § 6015(b), a joint filer must establish that: (1) there is an understatement of tax attributable to erroneous items of the nonrequesting spouse, (2) he or she did not know and had no reason to know of the understatement, (3) taking into account all facts and circumstances, it would be inequitable to impose joint and several liability on the requesting spouse, and (4) he or she requested innocent spouse relief within two years after the IRS began collection activities. The IRS took the position that the taxpayer had reason to know of the understatement (second element) and had not established that it would be inequitable to hold her liable (third element). To determine whether the taxpayer had reason to know of the understatement, the court applied a four-factor test that considers the requesting spouse's level of education, his or her involvement in the family's business and financial affairs, the presence of lavish or unusual expenditures compared to the family's prior spending patterns, and "the culpable spouse's evasiveness and deceit concerning the couple's finances." The court concluded that all four factors favored the taxpayer and that she therefore had no reason to know of the understatement of tax. The court also concluded that, taking into account the concealment undertaken by the taxpayer's former husband and the lack of any significant benefit to the taxpayer from the understatement, it would be inequitable to impose liability on the taxpayer.

2. **Never, ever, never rely upon IRS correspondence concerning the law, and school your students and junior colleagues about the harsh reality that there is no equitable relief in tax from jurisdictional requirements.** Rubel v. Commissioner, 856 F.3d 301 (3d Cir. 5/9/17), *aff'g* Rubel v. Commissioner, No. 9183-16 (U.S. Tax Court 7/11/16). In a case that went all the way to the U.S. Court of Appeals for the Third Circuit, the taxpayer, admirably represented by the Federal Tax Clinic at the Harvard Legal Services Center, claimed innocent spouse relief under § 6015 for the years 2005 through 2008. The IRS had denied the taxpayer's requests for each year via four separate notices of determination issued in January 2016. Section 6015(e)(1)(A) provides that a taxpayer who seeks innocent spouse relief may petition the Tax Court and that the Tax Court "shall have jurisdiction" if the petition is filed within specified time limits and no later than 90 days after the date the IRS mails the notice of determination. For the years 2006 through 2008, the taxpayer's petition in Tax Court was due by April 4, 2016. For 2005, the taxpayer's petition was due by April 12, 2016. Meanwhile, after receiving the notices, the taxpayer submitted additional information to the IRS concerning her claim for innocent spouse relief. The IRS again denied the taxpayer's claim via letter dated March 3, 2016; however, the letter misrepresented the due date for filing a petition in the Tax Court stating: "Please be advised this correspondence doesn't extend the time to file a petition with the U.S. Tax Court. Your time to petition the U.S. Tax Court began to run when we issued you our final determination [in January] and will end on Apr. 19, 2016. However, you may continue to work with us to resolve your tax matter." The taxpayer subsequently filed a petition in the Tax Court on April 19, 2016, and the IRS moved the Tax Court to dismiss the taxpayer's claim for lack of jurisdiction (because the petition was outside the 90-day period). The Tax Court agreed with the

IRS and dismissed the petition. The taxpayer appealed to the Third Circuit arguing for equitable relief and estoppel against the IRS due to the misrepresentation in the March 3, 2016, IRS letter. The Third Circuit affirmed the Tax Court's dismissal of the case stating: "[T]he ninety-day deadline is jurisdictional and cannot be altered 'regardless of the equities' of the case."

a. **Another case confirming that you cannot rely on what the IRS tells you about the filing deadline! The 90-day period for filing a Tax Court petition seeking review of an IRS determination denying innocent spouse relief is jurisdictional and not subject to equitable tolling.** Matuszak v. Commissioner, 862 F.3d 192 (2d Cir. 7/5/17), *aff'g Matuzak v. Commissioner*, No. 471-15 (U.S. Tax Court 12/29/15). The IRS issued a notice of determination denying the taxpayer's request for innocent spouse relief. Under § 6015(e)(1)(A), the taxpayer then had 90 days from the date of mailing of the notice of determination to file a petition in the Tax Court. The taxpayer filed her petition in the Tax Court one day late. The Tax Court (Judge Marvel) granted the government's motion to dismiss the petition. The Tax Court subsequently denied the taxpayer's motion to vacate. See *Matuszak v. Commissioner*, No. 471-15 (7/29/16). In doing so, the Tax Court rejected the taxpayer's argument that the 90-day period for filing the petition could and should be equitably tolled because she had relied on erroneous verbal advice from IRS agents concerning the deadline for filing the petition. The taxpayer argued that recent developments in jurisdictional jurisprudence warranted overruling *Pollock v. Commissioner*, 132 T.C. 21 (2009), in which the court had concluded that the 90-day period of § 6015(e)(1)(A) is jurisdictional and not subject to equitable tolling. The Tax Court, however, declined to do so. The Tax Court noted that, in *Guralnik v. Commissioner*, 146 T.C. 230 (6/2/16), it had recently rejected a similar argument for changing its view on the jurisdictional nature of the 30-day period in § 6330(d)(1) for seeking review in the Tax Court of an IRS notice of determination following a CDP hearing. In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit affirmed the Tax Court's decision. The Second Circuit acknowledged that recent decisions from the U.S. Supreme Court have distinguished between jurisdictional rules, which are not subject to equitable tolling, and non-jurisdictional claim-processing rules, which are. Nevertheless, the Second Circuit concluded that the 90-day period specified in § 6015(e)(1)(A) is jurisdictional. The court emphasized that the language of the statute provides that "the Tax Court shall have jurisdiction" if the petition is filed within the 90-day period. The court also noted that, in *Maier v. Commissioner*, 360 F.3d 61 (2d Cir. 2004), it had previously recognized the jurisdictional nature of § 6015 by concluding that the statute did not confer jurisdiction on the Tax Court over petitions seeking review of innocent spouse determinations filed by the non-electing spouse.

- The taxpayer was represented on the appeal by the Federal Tax Clinic at the Harvard Legal Services Center.

3. **The taxpayer might have filed the wrong form to request innocent spouse relief, but it nevertheless was an "informal claim" for refund that allowed her to obtain a refund of amounts paid within the previous two years.** Palomares v. Commissioner, ___ Fed. Appx. ___, 119 A.F.T.R.2d 2017-2021 (9th Cir. 5/31/17), *rev'g* T.C. Memo. 2014-243. The IRS applied the taxpayer's tax refunds, including those for 2006 and 2007, to an outstanding tax liability for 1996, a year during which the taxpayer had filed a joint return with her then-husband. In July 2008, with the assistance of a volunteer attorney, the taxpayer mistakenly filed Form 8379, Injured Spouse Allocation, which is used by a taxpayer filing a joint return to protect a refund on the joint return, rather than Form 8857, Request for Innocent Spouse Relief. The IRS responded two months later with a letter in which the IRS informed the taxpayer that she had improperly filed Form 8379 and that she might have intended to file Form 8857, a copy of which the IRS enclosed. The taxpayer did not file Form 8857 until September 2010. The IRS granted the taxpayer partial innocent spouse relief and issued refunds of tax the taxpayer had paid within the two-year period preceding her 2010 filing of Form 8857. However, the IRS denied her claim for refund of the 2006 and 2007 payments applied to the 1996 liability on the ground that her claim was untimely under § 6511(a), which requires a claim for refund to be filed within three years after the return is filed or within two years after the tax is paid, whichever is later. The taxpayer had not filed Form 8857 within three years of filing the 1996 joint return, which meant

that she could recover only tax paid within the two-year period preceding her filing of a claim for refund through the request for innocent spouse relief. The Tax Court (Judge Gerber) held that the taxpayer could not obtain a refund of the 2006 and 2007 payments applied to the 1996 liability because (1) her September 2010 request for innocent spouse relief was filed more than two years after those taxes were paid, and (2) her July 2008 filing of Form 8379, Injured Spouse Allocation, could not be considered an "informal" claim for refund because it did not convey sufficient information to notify the IRS that the taxpayer was seeking relief from joint and several liability for the 1996 tax year and a refund of amounts applied against that liability. In a memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit reversed. The Ninth Circuit reasoned that the taxpayer's July 2008 filing of Form 8379 fairly apprised the IRS that she was seeking innocent-spouse relief from her 1996 liability because the IRS—which had been applying her separate refunds to the 1996 joint liability—informed her that she had to file Form 8857 in order to request innocent spouse relief. Although the taxpayer's Form 8379 indicated that she was seeking a refund only of her 2007 overpayment, the court expressed the view that there was "no serious question that the IRS was on notice of her 2006 overpayment as well." The court remanded and directed the Tax Court to order the IRS to issue the refunds for 2006 and 2007.

### H. Miscellaneous

#### 1. The constitutional status of the Tax Court.

**a. The Tax Court is an Article I court that is independent of the Executive and Legislative branches.** Freytag v. Commissioner, 501 U.S. 868 (6/27/91). Justice Blackmun, speaking for the five-judge majority, held that the assignment of a complex tax shelter case by the 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." The majority characterized the Tax Court as exercising judicial power:

> The Tax Court exercises judicial, rather than executive, legislative, or administrative, power. It was established by Congress to interpret and apply the Internal Revenue Code in disputes between taxpayers and the Government. By resolving these disputes, the court exercises a portion of the judicial power of the United States.
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> . . .
>
> The Tax Court's function and role in the federal judicial scheme closely resemble those of the federal district courts, which indisputably are "Courts of Law."
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> . . .
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> The Tax Court remains independent of the Executive and Legislative Branches. Its decisions are not subject to review by either the Congress or the President. Nor has Congress made Tax Court decisions subject to review in the federal district courts. Rather, like the judgments of the district courts, the decisions of the Tax Court are appealable only to the regional United States courts of appeals, with ultimate review in this Court.

- 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.

b. **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, in an opinion by 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," the D.C. Circuit held that "the judicial power of the United States is not limited to the judicial power defined under Article III." It further held that the Tax Court, as a legislative court, is nevertheless part of the Executive Branch of government, and therefore the President's power to remove Tax Court judges did not violate separation of powers principles:

> We need not explore the precise circumstances in which interbranch removal may present a separation-of-powers concern because this case does not involve the prospect of presidential removal of officers in another branch. Rather, the Kuretskis have failed to persuade us that Tax Court judges exercise their authority as part of any branch other than the Executive. Consequently, if a President were someday to exercise the authority under 26 U.S.C. § 7443(f) to remove a Tax Court judge for cause, the removal would be entirely consistent with separation-of-powers principles.

c. **Congress speaks, but its meaning is far from clear.** The 2015 Protecting Americans Against Tax Hikes Act, § 441, amended 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."

d. **We need not decide which branch of government we're in, says the Tax Court, but we agree with the D.C. Circuit that the presidential power to remove Tax Court judges for cause does not infringe on the constitutional separation of powers.** Battat v. Commissioner, 148 T.C. No. 2 (2/2/17). The taxpayers in this case filed a petition in the Tax Court in response to a notice of deficiency and moved to disqualify all Tax Court judges. The taxpayers made the same argument made by the taxpayers in *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 6/20/14), i.e., 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) violates separation of powers principles. In a lengthy opinion that examines the history of the various statutory provisions that govern the Tax Court and prior judicial decisions that address the Tax Court's constitutional status, the Tax Court (Judge Colvin) denied the taxpayers' motion. In contrast to the approach of the court in *Kuretski*, which concluded that no separation of powers problem existed because the Tax Court is part of the Executive branch, the Tax Court concluded that it need "not ... address the branch placement of the Tax Court ...." Instead, the Tax Court reasoned that "even though Congress has assigned to the Tax Court a portion of the judicial power of the United States, *Freytag v. Commissioner*, 501 U.S. at 890, the portion assigned to the Tax Court includes only public law disputes and does not include matters which are reserved

by the Constitution to Article III courts." Thus, the President's removal of a Tax Court judge would not affect "any matter within the portion of 'the judicial Power of the United States' that is necessarily exercised by Article III judges." The taxpayers in this case resided in Florida at the time they filed their petition, and therefore any appeal of this decision will be heard by the U.S Court of Appeals for the Eleventh Circuit.

e. **The Tax Court reiterates its holding in *Battat v. Commissioner* and holds that the accuracy-related penalties imposed by § 6662A do not violate the Eighth Amendment.** Thompson v. Commissioner, 148 T.C. No. 3 (2/2/17). The taxpayers in this case, like those in *Battat v. Commissioner*, 148 T.C. No. 2 (2/2/17), moved to disqualify the Tax Court judge on the ground 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) violates separation of powers principles. The Tax Court (Judge Wherry) denied the motion in reliance on the court's decision in *Battat*. The Tax Court also rejected the taxpayers' argument that the penalty imposed by § 6662A on any reportable transaction understatement violates the Excessive Fines Clause of the Eighth Amendment to the Constitution. Although the taxpayers apparently represented to the court that any appeal of the court's decision would be heard by the U.S. Court of Appeals for the Eleventh Circuit, the court's opinion states that the taxpayers resided in California when they filed their petition and that any appeal therefore would be heard by the U.S. Court of Appeals for the Ninth Circuit.

2. **The D.C. Circuit found that registered (?) tax return preparers were entitled to be unqualified. The IRS had de gall to require character, competence, and continuing education for "independent" tax return preparers who only needed PTINs to continue preparing error-laden tax returns for their unsophisticated clientele.** Loving v. IRS, 742 F.3d 1013 (D.C. Cir. 2/11/14), *aff'g* 920 F. Supp. 2d 108 (D. D.C. 2/1/13). The D.C. Circuit (Judge Kavanaugh) held that regulations issued in 2011 under 31 U.S.C. § 330 that imposed new character, competence, and continuing education requirements on tax return preparers were "foreclose[d] and render[ed] unreasonable" by the statute, and thus failed at the *Chevron* step 1 standard. They would have also failed at the *Chevron* step 2 standard because they were "unreasonable in light of the statute's text, history, structure, and context."

- Judge Kavanaugh's opinion found six problems with the 2011 regulations: (1) tax return preparers were not "representatives" because they are not "agents" and, thus, lack "legal authority to act on the taxpayer's behalf"; (2) the preparation and filing of a tax return did not constitute "practice ... before the Department of the Treasury" because that term implies "an investigation, adversarial hearing, or other adjudicative proceeding"; (3) the history of the statutory language originally enacted in 1884 "indicated that the statute contemplated representation in a contested proceeding"; (4) the regulation was inconsistent with the "broader statutory framework," (?!) in which Congress had enacted a number of statutes specifically directed at tax-return preparers and imposing civil penalties, which would not have been necessary if the IRS had authority to regulate tax-return preparers; (5) the statute would have been clearer had it granted power "for the first time to regulate hundreds of thousands of individuals in the multi-billion dollar tax-preparation industry" ["the enacting Congress did not intend to grow such a large elephant in such a small mousehole"]; and (6) the IRS's past approach showed that until 2011 it never maintained that it had authority to regulate tax return preparers.
- Judge Kavanaugh concluded: "The IRS may not unilaterally expand its authority through such an expansive, atextual, and ahistorical reading of Section 330."
- The DOJ is mulling over whether to seek *en banc* review.

a. **In light of the IRS loss in *Loving v. IRS*, a new, voluntary Annual Filing Season Program to give tax return preparers the ability to claim they hold "a valid Annual Filing Season Program Record of Completion" and that they have "complied with the IRS requirements for receiving the Record of Completion."** Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14). In order to encourage unenrolled tax return preparers, i.e., those who are not attorneys, CPAs or EAs, to complete continuing education courses in order to get a better understanding of federal tax law, the carrot of being able to claim superiority to the ordinary run-of-the-mill slob tax return preparers is offered. The requirements for this voluntary program

include a six-hour refresher course, with a 100-question test at the end, plus other continuing education of two hours of ethics and ten hours of federal tax law topics. Holders of the Record of Completion may not use the terms "certified," "enrolled," or "licensed" to describe the designation.

b. **The AICPA's challenge to the Annual Filing Season Program fails, but the court signals that others might successfully challenge it.** American Institute of Certified Public Accountants vs. Internal Revenue Service, 118 A.F.T.R.2d 2016-5350 (D.D.C. 8/3/16). The AICPA challenged as unlawful the voluntary Annual Filing Season Program established by the IRS in Rev. Proc. 2014-42, 2014-29 I.R.B. 192 (6/30/14), and the U.S. Court of Appeals for the District of Columbia ruled that the AICPA had standing to bring the challenge. *American Institute of Certified Public Accountants vs. Internal Revenue Service*, 804 F.3d 1193 (D.C. Cir. 10/30/15). In that opinion, the D.C. Circuit declined to address an issue raised by the IRS for the first time on appeal: that the AICPA's grievance does not "fall within the zone of interests protected or regulated by the statutory provision it invokes." On remand, the District Court (Judge Boasberg) held that the AICPA failed the zone of interests test because its grievance (which the court characterized as the grievance of the AICPA's members) is neither regulated nor protected by the relevant statute. Accordingly, the court granted the IRS's motion to dismiss. The court characterized the grievance of the AICPA and its members as competitive injury from brand dilution, i.e., that the AFS Program would dilute the credentials of the AICPA's members by introducing a government-backed credential and government-sponsored public listing. The relevant statute, the court concluded, is 31 U.S.C. § 330(a), which authorizes the Secretary of the Treasury to regulate the practice of representatives of persons before the Treasury Department and to require that certain conditions be satisfied, such as good character, before admitting a person to practice. The AICPA is not a representative of persons within the zone of interests *regulated* by the statute, the court concluded, because to satisfy this requirement the party must be regulated by the particular regulatory action being challenged. To demonstrate that it is in the zone of interests *protected* by the statute, the AICPA would have to demonstrate either that it is an intended beneficiary of the statute or that it is a "suitable challenger" to enforce the statute. The AICPA did not contend that it was an intended beneficiary of the statute, and the court concluded that the AICPA was not a suitable challenger. The court reasoned that the purpose of 31 U.S.C. § 330(a) is consumer protection, and that the AICPA's interest in avoiding intensified competition as a result of the AFS Program was not congruent with that purpose. "On the contrary, AICPA members' competitive interests are on a collision course with Congress's interest in safeguarding consumers."

- Although it dismissed the AICPA's challenge, the court added:

> A final word. While AICPA does not have a cause of action under the APA to bring this suit, the Court has little reason to doubt that there may be other challengers who could satisfy the rather undemanding strictures of the zone-of-interests test.

3. **The Tenth Circuit stirs the previously muddied 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, 828 F.3d 1094 (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.

e. **The Third Circuit also declines to consider whether a late-filed return always renders a tax debt nondischargeable and instead applies the *Beard* test.** Giacchi v. United States, 856 F.3d 244 (3d Cir. 5/5/17). In an opinion by Judge Roth, the Third Circuit held that the tax liability of the taxpayer, who filed his federal income tax returns for 2000, 2001, and 2002 after the IRS had assessed tax for those years, was not dischargeable in bankruptcy. The court declined to consider whether the "one-day-late" rule embraced by the First, Fifth and Tenth Circuits is correct. Instead, the court applied 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 court stated:

> Forms filed after their due dates and after an IRS assessment rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law. This is because the purpose of a tax return is for the taxpayer to provide information to the government regarding the amount of tax due. ... Once the IRS assesses the taxpayer's liability, a subsequent filing can no longer serve the tax return's purpose, and thus could not be an honest and reasonable attempt to comply with the tax law.

4. **The Tax Court rejects the IRS's first try at denying a whistleblower award to the guy who handed it $74 million from Wegelin & Company on a platter.** Whistleblower 21276-13W v. Commissioner, 144 T.C. 290 (6/2/15). The Tax Court (Judge Jacobs) held that the fact that a whistleblower supplied information to other federal agencies, including an IRS operating division, before submitting the information to the Whistleblower Office on Form 211 did not, as a matter of law, render the whistleblower ineligible for an award under § 7623(b). At the time the whistleblower began cooperating with the IRS, FBI, and a United States Attorney's office to obtain an indictment of a foreign business for assisting U.S. taxpayers to evade taxes, the whistleblower was unaware of any whistleblower award program. "The Targeted Business was indicted, with a subsequent superseding indictment, for conspiring with U.S. taxpayers and others to hide more than $1.2 billion in secret accounts, and the income generated therefrom, from the IRS. The Targeted Business pleaded guilty, as [the whistleblower] predicted. As part of its guilty plea, the Targeted Business paid the United States approximately $74 million." (Although the opinion refers to the "Targeted Business," the facts recited in the opinion lead to the obvious conclusion that the "Targeted Business" was the Swiss bank Wegelin & Company.) The court rejected the IRS's argument that a whistleblower is ineligible for a § 7623(b) award if he or she provides the information to an operating division of the IRS before submitting the information, via a Form 211, to the Whistleblower Office. Because it had rejected the claim as untimely, the Whistleblower Office did not conduct a review, investigation, or evaluation of the merits of petitioners' claims for award. The court ordered that "the parties should have an opportunity to resolve these cases on the basis of our holding herein [and are required] to file a status report in accordance with an order to be issued."

a. **The Tax Court rejects the IRS's second (and presumably final) attempt to avoid paying the full amount due to the whistleblower in this case.** Whistleblower 21276-13W v. Commissioner, 147 T.C. No. 4 (8/3/16). Following the Tax Court's prior order that the parties attempt to resolve their differences (144 T.C. 290 (6/2/15)), the IRS and the petitioners, a married couple, agreed that the petitioners are eligible for a whistleblower award of

24 percent of the collected proceeds (i.e., the proceeds eligible for an award), but disagreed as to the amount of the collected proceeds. The targeted taxpayer paid to the government approximately $74 million, which consisted of tax restitution ($20 million), a criminal fine ($22 million), and civil forfeitures representing fees received from U.S. clients ($32 million). The parties agreed that the tax restitution payment constituted collected proceeds, but disagreed as to whether payments of the criminal fine and civil forfeitures constituted collected proceeds. Section 7623(b)(1) provides that a whistleblower award is:

> at least 15 percent but not more than 30 percent of the collected proceeds (including penalties, interest, additions to tax, and additional amounts) resulting from the action (including any related actions) or from any settlement in response to such action.

The IRS argued that the plain language of § 7623 dictates that only proceeds assessed and collected under a provision of title 26 may be used to pay a whistleblower award because § 7623 relates solely to violations of federal tax laws, and therefore criminal fines and civil forfeitures (which are not assessed under title 26) are not "collected proceeds" within the meaning of § 7623(b)(1). The IRS also argued that, if forfeitures could be used for payment of the whistleblower award, an irreconcilable conflict would be created between the whistleblower statute in title 26 and the provisions of title 42 regarding criminal fines and those of title 31 regarding civil forfeitures that specify the purposes for which moneys collected in this case under title 18 may be used. In a very thorough opinion, the Tax Court (Judge Jacobs) held that § 7623(b)(1), which "is straightforward and written in expansive terms," does not limit "collected proceeds" to amounts assessed and collected under title 26. The court similarly rejected the IRS's second argument, which the court characterized as arising "from a fundamental misinterpretation of the plain language of the statute." According to the court, § 7623(b)(1) "does not refer to, or require, the availability of funds to be used in making an award."

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.

a. **The IRS prepares to implement passport denial and revocation procedures.** On June 2, 2017 the IRS updated its website with information about upcoming implementation procedures for Code § 7345, added by the FAST Act, which provides that having a "seriously delinquent tax debt" is grounds for denial, revocation, or limitation of a passport.: https://perma.cc/YBB2-H73Y. The IRS also added a generic paragraph about passport revocation to its Notice of Intent to Levy, both CP 90 and CP 504 (the CDP and non-CDP notices, respectively). On June 7 and June 14, the National Taxpayer Advocate (NTA) published blog posts in which she criticized the IRS's approach. See https://perma.cc/6GSE-GSHQ and https://perma.cc/3DFP-HCRQ. More formal guidance should be forthcoming, but practitioners should review the IRS website and the NTA's blog posts so affected clients can be alerted.

Under the IRS's planned approach, the IRS will certify taxpayers with a "seriously delinquent debt" to the State Department automatically when certain criteria are met and the total amount owed passes $50,000. Taxpayers will not receive a warning letter immediately prior to certification. For many taxpayers the Notice of Intent to Levy will arrive long before a passport certification, perhaps years before. Once certification has happened, the taxpayer cannot get it reversed by simply paying down the balance to under the threshold.[2]

6. **The IRS establishes a new fast-track mediation procedure for offer-in-compromise and trust fund recovery penalty cases in the Small Business/Self-Employed division.** Rev. Proc. 2016-57, 2016-49 I.R.B. 786 (11/18/16). This revenue procedure establishes a fast-track mediation procedure, known as SB/SE Fast Track Mediation—Collection (FTMC), that replaces the fast-track mediation procedure set forth in Rev. Proc. 2003-41, 2003-1 C.B. 1047. The prior fast-track mediation procedure was available to taxpayers with cases in either examination or collection, but use of the program was infrequent, especially for cases in examination after the IRS in 2011 implemented a fast-track settlement program for examination cases in the Small Business/Self Employed Division. See Announcement 2011-15, 2011-4 I.R.B. 430 (12/30/10). The new FTMC program preserves fast-track mediation for cases in collection. According to the revenue procedure, "FTMC may be used only when all other collection issues are resolved but for the issue(s) for which FTMC is being requested. The issue(s) to be mediated must be fully developed with clearly defined positions by both parties so the unagreed issues can be resolved quickly (usually within 30 or 40 calendar days)." The revenue procedure provides examples of when FTMC is and is not appropriate. For example, in OIC cases, FTMC is appropriate to determine issues such as the value of a taxpayer's assets (including those held by third parties), and in trust fund recovery penalty cases for issues such as whether a person was required to collect, truthfully account for, and pay over income, employment or excise taxes. A request for FTMC is made after an issue has been fully developed (and before collection has made a final determination regarding the issue) by submitting Form 13369, which must be signed by both the taxpayer (or authorized representative) and the Collection Group Manager. Written summaries of both the taxpayer's and collection's positions must accompany the form. The request is submitted to IRS Appeals and, if the request for FTMC is approved, the case is assigned to an Appeals employee who serves as a mediator. The Appeals mediator does not have settlement authority and serves only as a facilitator. The revenue procedure notes that the prohibition on *ex parte* communications between Appeals and other IRS employees does not apply to communications arising in FTMC because Appeals personnel "are not acting in their traditional Appeals settlement role," but provides that communications by either party with the Appeals mediator outside the mediation session are prohibited. The revenue procedure also provides that "[t]he parties to the mediation may not make a stenographic record, audio or video tape recording, or other transcript of the mediation session." Following the mediation session, the Appeals mediator will prepare a brief written report. The revenue procedure is effective 11/18/16. Rev. Proc. 2003-41, 2003-1 C.B. 1047, is obsoleted.

7. **The Seventh Circuit's advice to law firms: don't wait until the last day to file a Tax Court petition and then mail an envelope without an official postmark! Nevertheless, the petition in this case was timely.** Tilden v. Commissioner, 846 F.3d 882 (7th Cir. 1/13/17), *rev'g* T.C. Memo 2015-188 (9/22/15). The last day for the taxpayer, who was represented by counsel, to file a Tax Court petition was April 21, 2015. A member of the law firm's staff printed a label from Stamps.com dated April 21, 2015 and stated that she delivered the envelope to the Postal Service in Salt Lake City, Utah, on that date. The Tax Court received the petition on April 29. The Tax Court (Judge Armen) dismissed the petition as having been untimely filed by relying on Reg. § 301.7502-1(c)(1)(iii)(B)(3), which provides:

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[2] We thank Christine Speidel, staff attorney with Vermont Legal Aid and Director of the Vermont Low-Income Taxpayer Clinic, for alerting us to this development and for writing the summary of it.

> If the envelope has a postmark made by the U.S. Postal Service in addition to a postmark not so made, the postmark that was not made by the U.S. Postal Service is disregarded, and whether the envelope was mailed in accordance with this paragraph (c)(1)(iii)(B) will be determined solely by applying the rule of paragraph (c)(1)(iii)(A) of this section [regarding envelopes nearing U.S. postmarks].

The envelope with the taxpayer's petition was entered into the Postal Service's tracking system for certified mail on April 23, which the Tax Court treated as a postmark and therefore the date of filing. In an opinion by Judge Easterbrook, the Seventh Circuit reversed and remanded. The regulation applied by the Tax Court, the Seventh Circuit reasoned, applies only when the envelope bears both a U.S. Postal Service postmark and a non-U.S. Postal Service postmark, which was not the case here. In the court's view, the Tax Court should have applied the rules of Reg. § 301.7502-1(c)(1)(iii)(B)(1)-(2), which address situations in which an envelope bears only a non-U.S. Postal Service postmark. Generally, these rules treat the date of the private postmark as the date of mailing if the item is received by the relevant agency not later than the time when a properly addressed and mailed envelope sent by the same class of mail would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service. The court also held that the time limit set forth in § 6213(a) for filing a Tax Court petition is jurisdictional. Finally, the court admonished the law firm for its handling of the situation:

> [W]e have to express astonishment that a law firm (Stoel Rives, LLP, of Salt Lake City) would wait until the last possible day and then mail an envelope without an official postmark. A petition for review is not a complicated document; it could have been mailed with time to spare. And if the last day turned out to be the only possible day (perhaps the firm was not engaged by the client until the time had almost run), why use a private postmark when an official one would have prevented any controversy? A member of the firm's staff could have walked the envelope to a post office and asked for hand cancellation. The regulation gives taxpayers another foolproof option by providing that the time stamp of a private delivery service, such as FedEx or UPS, is conclusive.

8. **Although the IRS clearly messed up in disclosing the taxpayers' return information, its liability was limited to $1,000 and punitive damages were not available.** Minda v. United States, 851 F.3d 231 (2d Cir. 3/24/17). Following an audit of the taxpayers, an IRS employee prepared an examination report proposing adjustments to their 2007 tax liability. The IRS sent the report, which included the taxpayer's names, social security numbers, and financial information, to the wrong party. The attorney for the person who received it submitted a letter to the IRS concerning the disclosure and sent a copy of the letter to the taxpayers. The taxpayers brought this action pursuant to § 7431(a)(1), which permits a taxpayer whose return or return information has been unlawfully disclosed to bring a civil action against the United States for damages. Section 7431(c) provides in part that, in the event of an unlawful disclosure, the United States is liable for the greater of (1) "$1,000 for each act of unauthorized inspection or disclosure of a return or return information with respect to which such defendant is found liable," or (2) the sum of any actual damages and, "in the case of a willful inspection or disclosure or an inspection or disclosure which is the result of gross negligence, punitive damages." In the District Court, the government conceded its liability and the District Court awarded statutory damages to each of the taxpayers in the amount of $1,000. On appeal, the taxpayers, who suffered no actual damages, argued that they were entitled to $1,000 for each *item* of return information disclosed in the examination report. They also argued that they were entitled to punitive damages. In an opinion by Judge Chin, the U.S. Court of Appeals for the Second Circuit affirmed. The court rejected the taxpayers' argument they were entitled to $1,000 for the IRS's disclosure of each item of return information as contrary to the plain language of the statute, which authorizes damages for "each act" of disclosure. The court also held that they were not entitled to punitive damages—which are available only for a willful disclosure or a disclosure

due to gross negligence—because "nothing in the record suggest[ed] that this was anything other than the result of simple negligence or carelessness."

9. **The IRS announces that certain ITINS will expire after 2017.** In news release IR-2017-109 (6/21/17), the IRS announced that ITIN numbers with middle digits 70, 71, 72 or 80 will expire at the end of 2017, and that it is accepting renewal applications from affected taxpayers. The IRS is sending over a million renewal notices to these taxpayers beginning in August 2017. See IRS News Release IR-2017-128 (8/8/17).

a. **The IRS makes changes to the Acceptance Agent program.** In 2016 and 2017, the IRS made changes to its Acceptance Agent procedures to assist taxpayers in renewing or obtaining ITINs. Certified Acceptance Agents (CAA) can now authenticate the passport and birth certificate for dependents. See New ITIN Acceptance Agent Program Changes. Also, lack of access to Acceptance Agents oversees was a concern and the subject of a National Taxpayer Advocate legislative recommendation in her 2016 Annual Report to Congress. In April 2017 the IRS announced that it would permit taxpayers to use CAAs located abroad (see IRS e-News for Tax Professionals Issue 2017-16), and it rescinded the termination of foreign CAAs. See NTA Fiscal Year 2018 Objectives Report to Congress, Volume One, Area of Focus No. 7, p. 73, n. 25.[3]

10. **Due date of Forms W-2, W-3, and 1099-MISC that report nonemployee compensation: temporary and proposed regulations address the revised due date.** T.D. 9821, Return Due Date and Extended Due Date Changes, 82 F.R. 33441 (7/20/17). Treasury and the IRS have issued proposed, temporary, and final regulations regarding the due date for forms in the Form W-2 series, Form W-3 series, and Forms 1099-MISC that report nonemployee compensation. The Protecting Americans from Tax Hikes Act of 2015 ("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 was 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). These regulations implement this statutory directive and provide that these information returns must be filed by January 31 of the calendar year for which the information is being reported, regardless of whether the returns are filed on paper or electronically.

- Information returns on Form 1099-MISC that do not report nonemployee compensation are not affected by this change and are due on February 28 of the year following the calendar year for which the information is being reported, or on March 31 if filed electronically.
- The temporary regulations apply to information returns filed on or after July 20, 2017, but the statutory amendments made by the 2015 PATH Act apply to information returns relating to calendar years beginning in 2016. Thus, the changes to the due date were effective for information returns filed in 2017 with respect to calendar year 2016.

## XI. WITHHOLDING AND EXCISE TAXES

### A. Employment Taxes

### B. Self-employment Taxes

1. **Advice for those wishing to minimize self-employment tax liability through the S corporation "Edwards/Gingrich loophole"—failure to have the S corporation contract with those making the payments can be fatal.** Fleischer v. Commissioner, T.C. Memo. 2016-238 (12/29/16). The taxpayer, a financial consultant who

[3] We thank Christine Speidel, staff attorney with Vermont Legal Aid and Director of the Vermont Low-Income Taxpayer Clinic, for writing the summary of the ITIN and Certified Acceptance Agent developments.

developed investment portfolios, formed an S corporation of which he was the sole shareholder and the president, secretary, and treasurer. He entered into an employment agreement with the S corporation, pursuant to which he was paid an annual salary. In each of the years in question, the taxpayer included just under $35,000 in gross income as compensation for services and reported nonpassive income on Schedule E ranging from $11,924 to $147,642. The taxpayer did not report any self-employment tax due. The gross receipts of the S corporation were largely attributable to a representative agreement into which the taxpayer entered with Linsco/Private Ledger Financial Services (LPL) and a broker contract into which he entered with MassMutual Financial Group. The taxpayer entered into both contracts himself, i.e., the S corporation was not a party to either contract. In fact, the taxpayer entered into the contract with LPL before the S corporation came into existence. The IRS issued a notice of deficiency in which the IRS asserted that the taxpayer should have reported the gross receipts as self-employment income on Schedule C attached to his individual income tax returns for the years in issue. The Tax Court (Judge Paris) agreed with the government. The court framed the question as "who controls the earning of the income" and stated that two elements must be satisfied for a corporation (rather than its service-provider employee) to be the controller of the income: (1) the individual providing the services must be an employee of the corporation whom the corporation can direct and control in a meaningful sense, and (2) a contract or similar indicium recognizing the corporation's controlling position must exist between the corporation and the person or entity using the services. In this case, the court reasoned, the second element was not satisfied because there was no contract or other indicium that the S corporation exhibited control over the taxpayer. The court rejected the taxpayer's argument that it was impossible for LPL and MassMutual to enter into contracts with the S corporation because the corporation was not a registered entity under the securities laws and regulations.

2. ♪♫**Doctor, doctor, give me the news he's got a [good] case the IRS will lose.**♫♪ **The distributive share of income of a physician-member of an LLC operating a surgery center was passive income and not subject to self-employment tax.** Hardy v. Commissioner, T.C. Memo. 2017-16 (1/17/17). The taxpayer, a plastic surgeon who performed surgeries in various facilities, paid $163,974 to become a member of a limited liability company (classified for federal tax purposes as a partnership) with a 12.5 percent interest. The seven other members of the LLC also were physicians. The LLC, referred to as MBJ, operated a surgery center equipped for physicians to perform procedures that required either local or general anesthesia. The taxpayer performed approximately 50 percent of his surgeries in his office (located next to MBJ), 20 percent at MBJ, and the remainder at other facilities. MBJ hired its own employees, none of whom were shared with the taxpayer's practice, and the taxpayer never managed MBJ and had no day-to-day responsibilities there. Patients who elected to have their surgeries performed at MBJ paid three separate fees: (1) for the services of the surgeon performing the surgery, (2) for the services of an anesthesiologist, and (3) a facility fee payable to MBJ. The taxpayer received distributions from MBJ regardless of whether he performed any surgeries there and his distribution was not dependent on the number of surgeries he performed at MBJ. For years prior to 2008, the taxpayer (whose return was prepared by a CPA) reported his distributive share of MBJ's income as nonpassive. For the years 2008 through 2010, the taxpayer reported his distributive share of MBJ's income as passive income and paid self-employment tax. The IRS issued a notice of deficiency disallowing the taxpayer's passive activity loss deduction for each of these years. The Tax Court (Judge Buch) held that the taxpayer's distributive share of MBJ's income was passive income. The court concluded that the taxpayer did not materially participate in MBJ's activity of operating a surgery center and rejected the IRS's arguments that the taxpayer either had already or was required to group his ownership interest in MBJ with his medical practice. The court analyzed Reg. § 1.469-4(f) and Technical Advice Memorandum 201634022 (8/19/16), which involved facts similar to those of the taxpayer and his interest in MBJ. The court concluded: "While some facts support treating [the taxpayer's] ownership interest in MBJ and his medical practice as a single economic unit, the weight of the evidence supports treating them as separate units."

- The court also held that the taxpayer's distributive share of

MBJ's income for the years in question was not subject to self-employment tax. (The court permitted the taxpayer to amend the pleadings to conform to the evidence presented at trial in order to make this argument.) Under § 1402(a), a partner's distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment the distributive share of income of a limited partner (other than guaranteed payments for services). The court discussed its decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), in which the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive share of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore "they were not acting as investors in the law firm." In contrast, the court reasoned, the taxpayer in this case was an investor in MBJ:

> Although [the taxpayer] performs surgeries at MBJ, he is not involved in the operations of MBJ as a business. In contrast to the partners in [*Renkemeyer*], who are lawyers practicing law and receiving distributive shares based on those fees from practicing law, [the taxpayer] is receiving a distribution based on the fees that patients pay to use the facility. The patients separately pay [the taxpayer] his fees as a surgeon, and they separately pay the surgical center for use of the facility in the same manner as with a hospital.

a. **Mamma Mia! I guess I should have been a doctor if I wanted to avoid employment taxes! A law firm member-manager's distributive share of income in excess of a base-salary-equivalent guaranteed payment was subject to self-employment taxes.** Castigliola v. Commissioner, T.C. Memo. 2017-62 (4/12/17). Unlike the doctor in *Hardy v. Commissioner*, T.C. Memo. 2017-16 (1/17/17), the taxpayers in this case did not qualify for the § 1402(a)(13) "limited partner" exclusion from self-employment tax. The taxpayers were members of a law firm organized as a member-managed Mississippi professional limited liability company ("PLLC"). The PLLC had not made an S election and hence was treated as a partnership for federal tax purposes. For tax years 2008 through 2010, the taxpayers received guaranteed payments ($125,000 to $150,000 each) that were commensurate with a survey of salaries paid other attorneys in the Pascagoula, Mississippi area. (Note: The Social Security wage base limitation was $102,000 for 2008, and $106,800 for 2009 and 2010.) The profits of the law firm PLLC in excess of the guaranteed payments were allocated and distributed to the taxpayers according to their unwritten operating agreement. (Note: The opinion does not indicate the amount of the excess profits over the guaranteed payments, but the total deficiency for all three taxpayers for all three years was approximately $50,000. Rough math thus would indicate that the excess over the guaranteed payments was approximately $500,000 per year.) The Tax Court (Judge Paris) relied heavily upon *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) to hold that the "member-manager" taxpayers were not equivalent to "limited partners" and therefore could not qualify for the § 1402(a)(13) exclusion from self-employment tax. The court declined, though, to uphold the IRS's assertion of substantial understatement and negligence penalties against the taxpayers. With respect to the negligence penalty, the court concluded that the taxpayers, through their reliance on their CPA, had established a reasonable cause, good faith defense for the years in issue, which pre-dated the court's decision in *Renkemeyer*. Bottom line: It appears to us that it is virtually impossible for lawyers practicing in a law firm taxed as a partnership to claim an exclusion from self-employment tax under the § 1402(a)(13) "limited partner" exclusion. Absent clear guidance from Congress, however, these cases may continue to be litigated in the context of LLCs and LLPs. Subchapter S corporations, on the other hand, apparently may continue to play the self-employment tax game.

3. **In this employment tax refund case concerning non-qualified stock options, Judge Posner tells railroads to take a hike, but Judge Manion dissents because "money remuneration" and "stock" were different in 1934; however, both apparently agree that "wampum" and "sheep" can be money (and no, we are not making this up)!** Wisconsin Central Ltd. v. United States, 856 F.3d 490 (5/8/17). Beginning in 1996, the taxpayer railroad companies began including non-qualified stock options in the compensation plans for

their employees. The taxpayers previously had withheld and paid employment taxes (under the Railroad Retirement Tax Act, § 3231) when employees exercised non-qualified stock options, but subsequently the taxpayers filed claims for refunds with the IRS, which were denied. The United States District Court for the Northern District of Illinois (Judge Feinerman) also denied the taxpayers' refund claim, and the taxpayers appealed to the Seventh Circuit. The taxpayers argued that stock options are not "compensation" because they are not "money remuneration" within the meaning of § 3231. Section 3231(e)(1) defines taxable compensation as "any form of money remuneration paid to an individual for services rendered as an employee to one or more employers." Based upon this language, Judge Posner, writing for the majority, explained that even though the term "money remuneration" may not have commonly been understood to include stock when the Railroad Retirement Tax Act was passed in 1937, today stock and stock options are well-accepted forms of compensation and hence taxable under § 3231. Judge Posner wrote, "The dictionary definition of money may remain constant while the instruments that comprise it change over time: sheep may have once been a form of money; now stock is." In short, Judge Posner interprets the term "money remuneration" in § 3231 to be an evolving concept that changes with the times. Judge Manion, however, dissented, arguing that the 1934 edition of Webster's Dictionary defined money as "[a]nything customarily used as a medium of exchange and measure of value, as sheep, wampum, copper rings, quills of salt or of gold dust, shovel blades, etc." Thus, in Judge Manion's view, non-qualified stock options are not "money remuneration" and hence not subject to tax under § 3231. *We presume, somewhat sarcastically, that Judge Posner and Judge Manion would agree that "wampum" and "sheep" were taxable in 1937 under § 3231 and would be taxable today as well, although according to their opinions the law is unsettled on this point.*

**4. The IRS wins three battles but loses the war in this withholding trust fund tax case; a CPA firm may have been the taxpayers' salvation.** Byrne v. United States, 857 F.3d 319 (6th Cir. 5/15/17). The two taxpayers were CEO and President of a manufacturing company that they, the company's controller, and other investors purchased in October 1998. Early in 1999, the taxpayers became aware that the company's controller had mishandled payroll tax payments (i.e., making biweekly instead of semiweekly payments) for several months resulting in a large penalty assessment by the IRS. As a result of the controller's continued mishandling of the company's finances, in April and July of 2000 the taxpayers hired two new employees to assist the controller. In October 2000, the IRS sent the company a notice of a penalty for $98,622.32 for unpaid trust-fund taxes for the first quarter of 2000. These unpaid taxes plus interest were paid in November 2000. In December 2000, the company's independent CPA firm issued a "clean" audit letter regarding the company's financial statements through September 30, 2000; however, the letter noted that the company had "flaws" in its accounting practices. Subsequently, in January of 2001, the company's lender discovered that not only had the company missed payroll tax payments for the last three quarters of 2000, but the controller had falsely overstated accounts receivable records to hide the company's financial difficulties. In April 2001, the company filed for bankruptcy protection and ultimately was liquidated. Then, in July 2005, the IRS assessed $855,668.35 responsible person penalty taxes against the taxpayers under § 6672. The taxpayers subsequently paid a portion of the penalty taxes and filed refund claims instituting this action. The U.S. Court of Appeals for the Sixth Circuit previously had affirmed the District Court's ruling that the taxpayers were responsible persons for purposes of § 6672(a), but remanded the case to the District Court to determine if the taxpayers had acted willfully as required by the statute. *Byrne v. United States*, 498 Fed. Appx. 555 (6th Cir. 2012). After a bench trial, the District Court held that the taxpayers had acted willfully because they recklessly disregarded the risk that the trust fund taxes were not being paid. In an opinion by Judge Batchelder, a three-judge panel of the Sixth Circuit reversed the District Court and held as a matter of first impression that (i) a determination of "willfulness" under § 6672 is a question of "ultimate fact" subject to de novo review on appeal, and (ii) even if the taxpayers were negligent, and possibly even reckless, in their failure to determine whether trust fund taxes were being paid, their belief that the trust fund taxes had been paid was reasonable under the circumstances and therefore they had not acted willfully within the meaning of § 6672. In particular, the Sixth

Circuit pointed to the hiring of two employees to assist the controller in 2000 and the taxpayers' reliance upon the "clean" audit letter issued by the company's CPA firm in December 2000.

- In reaching its decision, the Sixth Circuit apparently aligns itself with a similar "reasonable belief" exception adopted by the Second Circuit, noting:

> In many circuits, "[r]eckless disregard includes failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid." *Morgan v. United States*, 937 F.2d 281, 286 (5th Cir. 1991) (per curiam); *see also Greenberg v. United States*, 46 F.3d 239, 244 (3rd Cir. 1994); *Denbo v. United States*, 988 F.2d 1029, 1033 (10th Cir. 1993); *Godfrey v. United States*, 748 F.2d 1568, 1577 (Fed. Cir. 1984) . . . But the Second Circuit recognizes an exception to § 6672(a) liability when a responsible person "believed that the taxes were in fact being paid, so long as that belief was, in the circumstances, a reasonable one." *Id.* (citation and internal quotation marks omitted). The Fifth Circuit has also held that taxpayers who act with reasonable cause may be able to defeat a finding of willfulness. *See Conway v. United States*, 647 F.3d 228, 234, 235 (5th Cir. 2011) (finding that reasonable reliance on the advice of counsel may constitute reasonable cause under some circumstances).

### C. Excise Taxes

## XII. TAX LEGISLATION

### A. Enacted

1. **Congress enacts a big break for small employers that offer health reimbursement arrangements.** The 21st Century Cures Act ("Cures Act"), Pub. L. No. 114-255, was signed by the President on 12/13/16. Among other changes, the Cures Act made several modifications to the rules related to health reimbursement arrangements. These include (1) exempting health reimbursement arrangements that meet the definition of a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA) from the § 4980D excise tax; (2) imposing new reporting requirements related to QSEHRAs; (3) requiring the inclusion in an employee's gross income of payments or reimbursements under a QSEHRA for employees that do not have minimum essential coverage; (4) limiting or potentially eliminating the § 36B premium tax credit for employees covered by a QSEHRA; and (5) requiring that the employer's cost for a QSEHRA be taken into account in determining the applicability of the Cadillac Tax. These changes generally are effective for years beginning after 12/31/16.

2. **Veterans have extra time to claim refunds for taxes improperly withheld from amounts received for combat-related injuries.** The Combat-Injured Veterans Tax Fairness Act of 2016 (2016 CIVTFA), Pub. L. No. 114-292, was signed by the President on 12/16/16. Section 104(a)(4) and (b) exclude from gross income amounts received as a pension, annuity, or similar allowance for a combat-related injury. In *St. Clair v. United States*, 778 F. Supp. 894 (E.D. Va. 1991), the court held that a lump sum disability-related severance payment received by a veteran was excluded from the recipient's gross income under § 104(a)(4). Despite these authorities, since 1991, the Department of Defense has withheld taxes from severance pay for wounded veterans. The 2016 CIVTFA directs the Secretary of Defense to ensure that taxes are not withheld prospectively. In addition, the legislation directs the Secretary of Defense, within one year of the date of enactment, to identify all severance payments from which taxes were improperly withheld, notify each recipient of the improper withholding, and provide each recipient with instructions on filing amended returns to recover these amounts. The legislation extends the limitations period of § 6511(a) on filing claims for refund to the date that is one year after the required notification of improper withholding and eliminates the restriction of § 6511(b)(2) that would normally apply on the amount of tax recoverable.

NOTES

# Special Aspects of Litigating Before the U.S. Tax Court

# What Has the U.S. Tax Court Been Doing? An Update

By James S. Halpern

James S. Halpern is a senior judge with the Tax Court. Presented here are his May 5 remarks at the 2016 Laurence Neal Woodworth Memorial Lecture in Washington.

## A. Introduction

The title of my talk is: "What Has the United States Tax Court Been Doing? An Update." It is an update because, in June 1945, J. Edgar Murdock, presiding judge of the Tax Court of the United States, authored an article in the American Bar Association Journal entitled: "What Has the Tax Court of the United States Been Doing?"[1] In considering what to talk about today, it struck me that, as almost three quarters of a century has passed since Judge Murdock's report, it would not be rushing things if I provided an update.

First, let me assure you that much remains unchanged. The Tax Court continues to serve a unique and important role in the Federal government's tax collection process. The Court provides an impartial tribunal for the adjudication of tax disputes before assessment of the tax (and the government's ability to invoke its powerful extrajudicial means of seizing property to satisfy tax debts). It also creates a body of precedents that interpret Federal tax law uniformly across the country. The Court's fundamental role has not changed since Judge Murdock wrote in 1945. Indeed, it has not changed since Congress created the Court's predecessor, the Board of Tax Appeals, in 1924. But while our fundamental role has not changed, we have changed some of the specific ways we carry out that role. Congress has also enhanced our status as a tribunal independent of the tax collector and has given us new jurisdictions that expand our unique and critical role as a prepayment forum.

The Tax Court's post-1945 history can be characterized as a period of change within continuity. For instance, Congress has changed some of the formal characteristics of the Court to dispel any perception of partiality. In 1969, Congress eliminated the Court's designation as an executive branch agency and established the newly named United States Tax Court (a change made to conform to the general way in which Federal courts are named) as an article I (or legislative) court.[2] In 2015, to reemphasize our independence, Congress added to our governing statute, the Internal Revenue Code, the following sentence: "The Tax Court is not an agency of, and shall be independent of, the executive branch of the Government."[3] But those changes, while not insignificant, did not change the Court's fundamental role: It (like its predecessor) has never been controlled by those charged with collecting taxes.

Also, the aspect of our fundamental role as a prepayment forum has only been enhanced by Congress' repeated additions to our jurisdiction. We may now review a so-called innocent spouse's claim for equitable relief outside of our traditional deficiency jurisdiction,[4] and a taxpayer may now appeal to us the Commissioner's determination to proceed with collection following a so-called collection due process (CDP) hearing.[5]

The expansion of our jurisdiction into review of discretionary and equitable agency determinations has brought to the fore questions of the scope and standard of review to be applied to those determinations and has made it more difficult for the Court

[1]31 A.B.A. J. 297 (1945).

[2]Tax Reform Act of 1969, Pub. L. No. 91-172, section 951, section 7441, 83 Stat. 487, 730 (codified as amended at I.R.C. section 7441 (2012)). As discussed below, the Court was originally established in 1924 as the Board of Tax Appeals, "an independent agency in the executive branch of the Government." Revenue Act of 1924, ch. 234, section 900(k), 43 Stat. 253, 338. The Board's name was, without any change in its status, changed to the Tax Court of the United States by the Revenue Act of 1942, ch. 619, section 504, section 1100, 56 Stat. 798, 975.

[3]Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113, section 441, section 7441, 129 Stat. 3040, 3126. S. Rep. No. 114-14, at 10 (2015), explains the sentence added to I.R.C. section 7441 as being necessary to remove any uncertainty about the independence of the Tax Court caused by statements in *Kuretski v. Commissioner*, 755 F.3d 929 (D.C. Cir. 2014), that the Tax Court is not part of the Article III Judicial Branch and is an independent executive agency.

[4]*See* I.R.C. section 6015(e), (f). Unless otherwise indicated, all references and citations to sections of the Internal Revenue Code (I.R.C.) are to the Internal Revenue Code of 1986, as amended.

[5]*See* I.R.C. section 6330(d)(1).

to maintain its traditional aloofness from the Administrative Procedure Act (APA).

The Court's own initiatives in recent years to provide greater access to low-income and *pro se* taxpayers have facilitated taxpayers' opportunities to be heard before assessment and collection.

Developments since 1945 have included two noteworthy changes in the way the Court establishes a uniform body of precedents. One change is doctrinal, and the other is practical. The doctrinal change, creation of the *Golsen* doctrine, involved a limited change to the Court's previously articulated doctrine, that the Court should decide all cases as it thought right.[6] *Golsen* holds that the Tax Court will follow a court of appeals' decision that is squarely on point where appeal from the Tax Court's decision lies to that court of appeals and to that court alone.[7] I believe that Judge Murdock would have readily accepted the *Golsen* doctrine.

The second, practical, change is the Court's increasing practice of citing its own memorandum opinions as precedential. Judge Murdock would be less likely to have approved that development. The classification of opinions by precedential weight serves an important signaling function. The Court's relatively indiscriminate citation of memorandum and division opinions risks confusion and frustrates the signaling function that classification ought to achieve. I propose that the Court return to its historical custom of not citing memorandum opinions as legal precedent.

Looking to the future, planned reductions in IRS taxpayer assistance may increase taxpayers' resort to the Tax Court. While we strongly support measures to maintain and increase taxpayer access to the Tax Court, cutbacks in programs that encourage resolution of controversies at the administrative level may prove to be inefficient.

Before expanding on the aspects of the Tax Court's post-1945 history that I have summarized, I would like to spend a few minutes discussing the origin of the Court's predecessor, the Board of Tax Appeals, and the purposes it was created to serve. I will also discuss the development of certain aspects of the Court's procedures, such as the Court's conference procedure. That discussion will pave the way for particular consideration of how, for the most part, the post-1945 changes that I have outlined serve Congress' purposes in creating the Board of Tax Appeals and its successor, the United States Tax Court.

[6]*See Lawrence v. Commissioner*, 27 T.C. 713, 717 (1957), *rev'd*, 258 F.2d 562 (9th Cir. 1958).

[7]*Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

Also, before proceeding, I would like to acknowledge my debt to Professors Harold Dubroff and Brant J. Hellwig for their superb study of the Tax Court's historical origins and its evolution as a court. Their work, "The United States Tax Court, An Historical Analysis," revised and expanded second edition, was commissioned by the Tax Court and was published by the Government Printing Office in 2014.[8] It is an invaluable resource both for students of the history of the Tax Court and for practitioners exploring the origins of the Court's jurisdictions and the history of its procedures.

### B. Origin and Enduring Aspects

**1. Origin and purposes of the Board of Tax Appeals.** The significance of Congress' establishment of the Board of Tax Appeals in 1924 to provide an impartial prepayment forum for the resolution of tax disputes and to create a uniform body of precedents cannot be overstated.

It has long been recognized that the sovereign may act extra-judicially to collect a tax debt. The usual rule in tax disputes is "payment first and litigation afterwards."[9] The reason for the usual rule is clear: "Taxes are the lifeblood of government."[10] The Supreme Court used that phrase in a 1935 case dealing with equitable recoupment of an estate tax payment.[11] It used the phrase to explain why the sovereign is not restricted to an action at law to collect an unpaid tax and may act administratively to collect the tax:

> [T]axes are the lifeblood of government, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection. The assessment is given the force of a judgment, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt.[12]

And while due process may require at least post-collection judicial review of the taxpayer's

[8]Harold Dubroff & Brant J. Hellwig, The United States Tax Court, An Historical Analysis (2d ed., rev. & expanded 2014).

[9]*E.g.*, *Appeal of Everett Knitting Works*, 1 B.T.A. 5, 6 (1924).

[10]I must acknowledge that my thoughts on this particular point and on the procedural due process aspects of tax collection were stirred by the National Taxpayer Advocate's, Nina E. Olson's, 2010 Erwin N. Griswold Lecture Before the American College of Tax Counsel, Taking the *Bull* by Its Horns: Some Thoughts on Constitutional Due Process in Tax Collection (Jan. 23, 2010), reprinted in 63 Tax Law. 227 (2010).

[11]*Bull v. United States*, 295 U.S. 247, 259 (1935).

[12]*Id.* at 259-60.

liability,[13] the Supreme Court made clear in a Civil War era income tax case that the Constitution's promise that no person shall be deprived of property without due process of law does not prevent the Federal government's extra-judicial seizure and sale of a taxpayer's property to satisfy his tax debt.[14]

The Commissioner of Internal Revenue has long been vested by Congress with extraordinary powers to enforce tax collection by distraint.[15] Recognizing that the lack of any right to litigate the liability before collection might seem wrong or unnecessarily harsh, the Supreme Court nevertheless stated in 1880 that it was for Congress to correct any perceived evil.[16]

With the advent of the modern income tax in 1913,[17] and the addition of a complex excess profits tax in 1917,[18] and in light of the explosive growth in the need for revenues brought on by the World War, it became clear that some form of independent review of contested tax-deficiency determinations was desirable before the Commissioner could assess the deficiency and take administrative action to collect the professed debt.

Between 1918 and 1924, a succession of preassessment reviewing bodies within the Bureau of Internal Revenue proved to be unsuccessful.[19] Charles D. Hamel, the first chairman of the Board of Tax Appeals, humorously illustrated the problem with review by the Bureau as follows:

> A New York magistrate once took a cab from the Grand Central station to his court house. The cabby overcharged him and threatened him with dire casualty if he did not pay the sum demanded. The judge paid him, and as he entered the court house he instructed a policeman standing in the doorway to arrest the cabby and bring him into the court. He then went in and ascended the bench, and presently the policeman appeared in front of him with the cabby. When the cabby looked up and recognized the man on the bench he said: "Holy Moses, judge and complainant, what kind of a show have I got."[20]

Chairman Hamel believed that the attitude of the cabby had been that of a great number of taxpayers who had deficiencies in tax assessed against them by subordinates of the Commissioner and whose only appeal before paying the deficiency had been to the Commissioner or his subordinates. Taxpayers, he believed, did not trust that any internal review procedure could be impartial because of the Commissioner's natural zeal to collect as much revenue as possible and his and his subordinates' inclination, therefore, to decide all doubtful questions against the taxpayer.[21]

Congress established the Board of Tax Appeals in 1924.[22] Three principal factors were important in shaping the 1924 legislation giving rise to the Board.[23] As I have already noted, those three factors have continued to shape the role of the Board and its successor.

The first was Congress' recognition of the need for expert and impartial review of tax disputes. The Board was thus created as an independent agency of the executive branch rather than as part of the Treasury Department.[24]

The second was Congress' desire to have a tribunal that would create a uniform body of precedents that would aid in the future interpretations of the tax law. As a result, the Board was required to publish its reports and to conduct its proceedings publicly in accordance with judicial-type procedures.[25]

The third was Congress' conviction that taxpayers should have the opportunity to litigate the question of tax liability before the disputed tax had to be paid.

The act creating the Board gave taxpayers the right to appeal the Commissioner's determination of a tax deficiency to the Board before the Commissioner could assess the deficiency and take administrative action to collect it.[26] The act provided that no part of any deficiency determined by the Commissioner but disallowed as such by the Board could be assessed. Instead, the Commissioner would have to begin a proceeding in court, without

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[13]"Where only property rights are involved, mere postponement of the judicial enquiry is not a denial of due process, if the opportunity given for the ultimate judicial determination of the liability is adequate." *Phillips v. Commissioner*, 283 U.S. 589, 596-97 (1931).

[14]*Springer v. United States*, 108 U.S. 586, 593 (1880).

[15]*See, e.g.*, I.R.C. sections 6321 (assessed and unpaid taxes become a lien on the taxpayer's property), 6331 (levy and distraint), 6335 (sale of seized property). Suits to restrain assessment or collection of tax are prohibited; *see also* I.R.C. section 7421(a) ("*Prohibition of suits to restrain assessment or collection.*").

[16]*Springer v. United States*, 108 U.S. at 594.

[17]Act of Oct. 3, 1913, ch. 16, section II(A)(1), 38 Stat. 114, 166.

[18]Act of Mar. 3, 1917, ch. 159, section 201, 39 Stat. 1000, 1000-01.

[19]*See* Dubroff & Hellwig, *supra* note 8, at 38-48.

[20]Charles D. Hamel, *The United States Board of Tax Appeals*, 2 Nat'l Income Tax Mag. 293 (1924).

[21]*Id.*

[22]*See* Revenue Act of 1924, ch. 234, section 900(a), 43 Stat. 253, 336.

[23]*See* Dubroff & Hellwig, *supra* note 8, at 271.

[24]Revenue Act of 1924 section 900(k), 43 Stat. at 338.

[25]*Id.* section 900(h).

[26]*Id.* section 274(a), 43 Stat. at 297.

assessment, for collection of the amount disallowed.[27] Thus, creation of the Board marked a significant concession of power by Congress, reversing the almost timeless rule that, in dealing with the sovereign over taxes: "payment first and litigation afterwards."[28]

**2. Success of the board.** The popularity of the prepayment forum that Congress created in 1924 was obvious from the beginning. During the Board of Tax Appeal's first fiscal year, ending in 1925, the Board docketed 5,220 cases, closed 1,702 cases, and was left with 3,518 cases pending.[29] The Board was not in 1925, and the Court is not now, the only venue in which a taxpayer may, in the first instance, litigate a tax dispute with the Federal government. A refund action may be brought in the United States district courts or in the United States Court of Federal Claims.[30] IRS Chief Counsel statistics for FY 2015 show a total of approximately 31,200 tax cases pending in the Tax Court, district courts, and the Court of Federal Claims.[31] Of that total, approximately 97 percent were pending in the Tax Court, approximately 2 percent were pending in the district courts, and approximately 0.6 percent were pending in the Court of Federal Claims.[32]

The Tax Court is the forum in which the vast majority of first-instance Federal tax litigation is brought for the simple reason that invoking the Court's deficiency jurisdiction generally stops the Commissioner from assessing and collecting a deficiency in tax until the opportunity to petition the Court has expired or, if a petition is filed, the Court's determination of a deficiency becomes final.[33]

Originally, the jurisdiction of the Board covered only income, estate, gift, and excess profits taxes.[34] Then, as now, there were other taxes, mainly excise taxes, that were not subject to pre-assessment judicial review, apparently because those taxes raised little revenue and because Congress thought that the questions arising under them were too insignificant to warrant pre-assessment review. In some circumstances those taxes are now subject to Tax Court prepayment review pursuant to our authority to review CDP determinations.

**3. A uniform body of precedents.** One of Congress' purposes in creating the Board of Tax Appeals was to have an adjudicatory body that would create a uniform body of precedents that would aid in future interpretations of Federal tax law. Uniformity, in the sense of consistency, could be achieved only if the Board were to speak with one voice and were to remain consistent in its opinions over time. Congress' answer to the consistency issue was to include in the Board's governing statute a review procedure that, after some clarification, has remained mostly unchanged since 1928.[35] The Board bound itself to its prior opinions by following the doctrine of stare decisis.[36]

The 1928 Act, provided, as does the Internal Revenue Code today, that a division of the Court (which divisions for many years have consisted of only one member) shall hear and make a determination with respect to the proceeding or motion before the Court and its report of such determination "constitutes its final disposition of the proceeding."[37] The division's report is then open for the full Court to review if the Chief Judge so directs.[38] If so reviewed, the Court will make its own report; if not so reviewed, the division's report will become the report of the Court after 30 days.[39] Thus, uniformity among the divisions of the Court, which, in the first instance, are charged with disposing of proceedings initiated before the Court, is achieved either by a division report that, by default, becomes the report of the Court after 30 days without the Chief Judge having directed Court review or by the displacement of the division's report by a report of the Court following the Chief Judge's direction for review. Indeed, if a division's report is referred for review by the Chief Judge, the division report will be no part of the record of the case.[40] In any event, *all* reports of the Tax Court are reports of the Court

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[27]*Id.* section 274(b).

[28]*E.g.*, *Appeal of Everett Knitting Works*, 1 B.T.A. 5, 6 (1924).

[29]Dubroff & Hellwig, *supra* note 8, at 905.

[30]*See* 28 U.S.C. sections 1346(a)(1) (district courts), 1491(a)(1) (United States Court of Federal Claims) (2012).

[31]Office of Chief Counsel, Internal Revenue Serv. (CC:FM:PMD:MA), Presentation to the American Bar Association Tax Section Court Procedure Committee, FY 2015 data, 3 (2016).

[32]*Id.*

[33]*See* I.R.C. section 6213(a). Some prepayment (or partial-payment) actions are heard by a bankruptcy court on an objection to an IRS proof of claim or in an adversary proceeding. *See* 11 U.S.C. section 505(a) (2012).

[34]Revenue Act of 1924, ch. 234, sections 274, 308, 312, 316, 900, 43 Stat. 253, 297, 308, 310, 312, 336.

[35]*Compare* Revenue Act of 1928, ch. 852, section 601, sections 906, 907(a), (b), 45 Stat. 791, 871-72, *with* I.R.C. sections 7459, 7460.

[36]*See, e.g.*, *Security State Bank v. Commissioner*, 111 T.C. 210, 213 (1998) ("The doctrine of stare decisis generally requires that we follow the holding of a previously decided case, absent special justification."), *aff'd*, 214 F.3d 1254 (10th Cir. 2000); *Allen v. Commissioner*, B.T.A.M. (P-H) para. 33,071 (1933) ("Under the doctrine of stare decisis we follow our own decisions until reversed by some appellate court, or until we conclude we were in error.").

[37]*Compare* Revenue Act of 1928 section 601, section 906(a), *with* I.R.C. section 7460(a).

[38]I.R.C. section 7460(b).

[39]*Id.*

[40]*Id.*

and are *not* reports by individual judges or divisions of the Court. Congress, thus, assured that the Court speaks with one voice.

By the way, the term "report" for what in another court might be called a judgment, decision, or opinion originated in the Revenue Act of 1928, as a substitute for the term "decision."[41] That change in terminology, which was not intended as a significant change in substance, was made in part to dispel the public's misunderstanding of the nature of the Board's review of a division's disposition of a proceeding assigned to it.[42] Some outside the Board considered that review to be the equivalent of a *de novo* hearing on the merits, at which they demanded the right to be heard.[43] Congress strove to dispel that misunderstanding by amendments in the Revenue Act of 1928, which clearly indicate the internal nature of the review procedure and the finality of a division's disposition of a proceeding assigned to it.[44]

And what of a party wishing to be heard in any Court review of a division's report? Both the taxpayer and the Secretary must be given notice and opportunity to be heard on any proceeding instituted before the Tax Court.[45] And as to any demand by a party to participate in Court review, since 1928 the statute has specifically provided that, if the parties have been given the opportunity to be heard before a division of the Court, they shall have no notice of, nor the opportunity to be heard during, Court review of a report, "except upon a specific order of the chief judge."[46] I know of no such order ever having been issued.

Finally, the term "decision" is used in the statute today to refer to the order entered by the Court specifying the amount of a deficiency or the disposition of certain other types of cases over which we have jurisdiction.[47] And it is entry of decision, not promulgation of a report, that starts the clock running on the time to appeal a decision.[48]

Conference procedures today resemble the procedures reported by Judge Murdock in 1945.[49] And while, during the first two years of the Board's existence, in order to achieve a high degree of adherence to Board precedents, the entire Board reviewed *all* reports,[50] the volume of cases soon made that impracticable.[51] Reports the Chief Judge designates for review are circulated among the judges for study during the week before a conference scheduled for that review. At the conference, the report is discussed and voted upon. If adopted, it is, like all of our reports, subject to editing for style consistent with the Court's style manual. It is then published along with any concurring or dissenting opinions. If not adopted, the authoring judge is offered the opportunity to rewrite the report and to present the rewritten report for review. If the authoring judge declines the opportunity, the Chief Judge assigns to another judge the task of submitting a report. To the extent relevant to the legal analysis used in the revised report, facts as found by the judge officiating at the trial of the case are accepted by the judge assigned to draft a new report, and only issues of law are reconsidered.[52] As finally adopted, the report is published along with any dissenting and concurring opinions.

In a 2001 law review article, then Chief Judge Mary Ann Cohen provided insight into the principles that guide a Chief Judge's exercise of discretion to cause review of a division report. I will not repeat what she said here, but I have included it in a footnote.[53]

**4. Memorandum opinions.** The Board of Tax Appeals began issuing memorandum opinions in late 1927,[54] one year before Congress expressly authorized the practice in the Revenue Act of 1928.[55] The

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[41]*See* Revenue Act of 1928 section 601, *amending* Revenue Act of 1926, ch. 27, sections 906(b), 907(b), 44 Stat. 9, 106-07.

[42]*See* Dubroff & Hellwig, *supra* note 8, at 755 n.197, 757-58.

[43]*Id.*

[44]*See* S. Rep. No. 70-960, at 37-38 (1928), *as reprinted in* 1939-1 C.B. (Part 2) 409, 435; H.R. Rep. No. 70-1882, at 21 (1928), *as reprinted in* 1939-1 C.B. (Part 2) 444, 452.

[45]I.R.C. section 7458.

[46]*Id.*; *see also* Revenue Act of 1928, section 601, section 907(a).

[47]*See* I.R.C. section 7459(c).

[48]I.R.C. section 7483.

[49]Murdock, *supra* note 1, at 298.

[50]J. Gilmer Korner, *The United States Board of Tax Appeals*, 11 A.B.A. J. 642, 643 (1925).

[51]*See* Dubroff & Hellwig, *supra* note 8, at 88-89.

[52]*See, e.g., A.E. Staley Mfg. Co. & Subsidiaries v. Commissioner*, 105 T.C. 166, 181 n.1 (1995) ("The trial portion of this case was conducted by Judge Mary Ann Cohen, and the facts are as found by Judge Cohen."), *rev'd and remanded*, 119 F.3d 482 (7th Cir. 1997).

[53]As then Chief Judge Cohen explained:

> We use certain rules of thumb. Court review is directed if the report proposes to invalidate a regulation, overrule a published Tax Court case, or reconsider, in a circuit that has not addressed it, an issue on which we have been reversed by a court of appeals. . . .
>
> Court review is also directed in cases of widespread application where the result may be controversial, where the Chief Judge is made aware of differences in opinion among the judges before the opinion is released, or, occasionally, where a procedural issue suggests the desirability of obtaining a consensus of the judges. Court review is not available on motion of the parties, before or after the opinion has been released.

Mary Ann Cohen, *How to Read Tax Court Opinions*, 1 Hous. Bus. & Tax L.J. 1, 5-6 (2001).

[54]*See* Dubroff & Hellwig, *supra* note 8, at 750.

[55]Revenue Act of 1928, ch. 852, section 601, section 907(b) 45 Stat. 791, 872.

two recognizable features of those early memorandum opinions are that they are very brief and, unlike today's, they include no subheadings.[56] In that respect, those early memorandum opinions meet the definition of a "memorandum opinion" as: "[A]n opinion that briefly reports the court's conclusion, usu. without elaboration because the decision follows a well-established legal principle or does not relate to any point of law."[57]

A few of the early memorandum opinions were published in the B.T.A. reporter.[58] The usual practice, however, was, as it is now, to set forth in an end-of-volume list in the official reporter each proceeding disposed of by memorandum opinion. The number of such dispositions was small in the early years. For approximately the first half of 1929, we reported 31 docket numbers as "Disposed of Upon Memoranda."[59] By 1945, however, the quantity of memorandum dispositions had increased dramatically. In the last 8 months of 1945, the rechristened Tax Court of the United States listed 324 docket numbers as "Proceedings Disposed of Upon Memorandum Opinions,"[60] which, if annualized, is 486 docket numbers so disposed of.

In Judge Murdock's 1945 A.B.A. Journal article, he addressed the intended scope of memorandum opinions as follows: "Memorandum Opinions . . . are *supposed* to be limited to those having no value as precedent. They include any case decided solely upon the authority of another, cases involving subjects already well covered by opinions appearing in the bound volumes of the reports, failure of proof cases, and *some others*."[61] He added: "Doubts as to whether a case should be in memorandum form or printed are resolved in favor of printing."[62] Finally, he invited counsel finding some precedent of value in a memorandum opinion to cite it in his brief.[63]

In the mid 1940s, it was not the Tax Court's custom to cite memorandum opinions.[64] Nevertheless, it made perfect sense for Judge Murdock to invite counsel to cite memorandum opinions to the Court if counsel deemed the opinion to contain some precedent of value so that the Court could take into account how it had decided the same question in the past.

### C. Post-1945 Changes in the Court

By the time Judge Murdock reported in 1945, the enduring aspects of the Tax Court as an impartial, pre-assessment judicial forum responsible for developing a uniform body of case law had been established. Post-1945 changes for the most part only strengthen those enduring aspects.

**1. Low-income and self-represented taxpayers.** Let me begin my discussion of those changes by reporting on what the Court, together with the Commissioner, practitioners, and others, has been doing to make the Tax Court more accessible to self-represented taxpayers, who constitute the majority of petitioners seeking relief from the Court.

Petitioners appearing *pro se* filed 82 percent of all of the petitions received by the Tax Court in FY 2015. Many of those petitioners elected to have their proceedings conducted pursuant to a simplified procedure for taxpayers with disputes involving $50,000 or less who elect that procedure.[65] Such so-called small tax cases are heard subject to relaxed rules of procedure and evidence, the results are not subject to appeal by either party, the cases may be resolved with a decision and a brief summary of the reasons therefore, and the cases may not serve as precedent.[66] In FY 2015, 48 percent of the Court's cases were filed as small tax cases. But Congress' edict for a simplified procedure for relatively small-dollar disputes does not by itself solve the problems faced by low-income, often self-represented, petitioners. Many still need help in what may be a first-time, and often intimidating, appearance before a court.

Over 40 years ago, tax practitioners began to assist self-represented petitioners before the Tax

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[56]*See, e.g., McDonald Printing Co. v. Commissioner*, B.T.A.M. (P-H) para. 28,013 (1928); *Powers House Co. v. Commissioner*, B.T.A.M. (P-H) para. 28,011 (1928).

[57]*Memorandum Opinion*, Black's Law Dictionary (10th ed. 2014).

[58]In the 1928-1930 volumes of the B.T.A. Reporter, I have identified the following eleven published items with the heading "Memorandum Opinion": 10 B.T.A. 3 (1928); 12 B.T.A. 865 (1928); 12 B.T.A. 1195 (1928); 13 B.T.A. 552 (1928); 15 B.T.A. 608 (1929); 16 B.T.A. 1437 (1929); 16 B.T.A. 1069 (1929); 18 B.T.A. 919 (1930); 18 B.T.A. 1044 (1930); 20 B.T.A. 222 (1930); 20 B.T.A. 808 (1930).

[59]15 B.T.A. 1453 (1929); 16 B.T.A. 1474-75 (1929).

[60]5 T.C. 1389-91 (1945).

[61]Murdock, *supra* note 1, at 299 (emphasis added).

[62]*Id.*

[63]*Id.*

[64]*See, e.g., Monroe v. Commissioner*, 7 T.C. 278, 286 n.4 (1946), in which, in response to the taxpayer's citation of a memorandum opinion in support of his argument, we observed: "[I]t is contrary to the custom of the Tax Court to cite memorandum opinions, and when such opinions are cited in briefs, they are not ordinarily referred to in a printed opinion of the Court because such opinions represent only a decision on facts upon rules of law already established."

[65]*See* I.R.C. section 7463.

[66]*Id.* (a), (b).

Court.[67] Taxpayer assistance efforts received a significant boost in 1998 when Congress enacted Internal Revenue Code section 7526.[68] Section 7526 authorizes the Secretary of the Treasury to make grants of matching funds to assist "qualified low income taxpayer clinics."[69] Qualified low-income taxpayer clinics are organizations described in the statute that, among other things, represent low-income taxpayers in Federal tax disputes for free or for a nominal fee.[70] In February 2016, the IRS announced $10.72 million in 2016 matching grants to 129 clinic recipients.[71]

At our 74 trial locations, clinic representatives and volunteer bar representatives appear at the calendar call and are available to offer advice to and, possibly, to assist self-represented petitioners. It is standard procedure at the start of the calendar call for the presiding judge to introduce those practitioners and to invite self-represented petitioners to meet with one. We will then delay calling that petitioner's case until the meeting is completed.

We have endeavored to make our Web site informative and useful for low-income taxpayers. Under the tab "Taxpayer Information," on our Web site, we provide detailed information about initiating and conducting a Tax Court case, including a video walking a taxpayer through the steps from receiving a deficiency notice to appealing an adverse decision.[72] One section of the video dramatizes portions of a trial, so that the taxpayer can see what will be expected of him at trial.

We have modified our pretrial procedures to better inform low-income petitioners of the pendency of their cases and to facilitate interaction between the petitioner and clinic representatives. We include a standard notice with our mailings to petitioners notifying them of local clinics. We notify low-income petitioners of local clinics three times before calendar call.

**2. Expanding jurisdiction.** I would like next to discuss our expanded jurisdiction and some issues that expansion has presented.

From the Court's beginning until the 1970s, our jurisdiction was principally to redetermine deficiencies in income, estate, and gift taxes. Beginning in the 1970s, Congress added to our jurisdiction new subject matters and new forms of relief. In 1974, Congress gave us the authority to issue declaratory judgments relating to the qualification of retirement plans for advantageous tax treatment.[73] In 1976, Congress added authority for us to issue declaratory judgments with respect to the status and classification of certain tax-exempt organizations,[74] which authority was expanded in 2015 to include the status and classification of all section 501(c) and (d) organizations.[75] Also in 1976, Congress authorized us to review IRS refusals to abate interest in collection cases[76] and to order the Secretary to release the identity of persons to whom written determinations pertain.[77] In 1982, Congress authorized us to award taxpayers reasonable administrative and litigation costs.[78] More recently, Congress has given us authority to review taxpayer challenges to a wide array of agency actions, including adjustments to partnership tax returns,[79] collection actions,[80] employment status determinations,[81] innocent spouse relief determinations,[82] whistleblower claims,[83] and passport denials and revocations for seriously tax-delinquent taxpayers.[84]

Particularly noteworthy is Congress' 1998 addition to our jurisdiction of the authority to review the Commissioner's decision following a CDP hearing to proceed by lien or levy to deprive a taxpayer of

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[67]*See* Keith Fogg, *Taxation with Representation: The Creation and Development of Low-Income Taxpayer Clinics*, 67 Tax Law. 3 (2013).

[68]Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, section 3601, 112 Stat. 685, 774-76.

[69]I.R.C. section 7526(a).

[70]*See id.* (b)(1).

[71]Internal Revenue Serv., IR-2016-32, IRS Announces Low Income Taxpayer Clinic Grant Recipients (Feb. 26, 2016).

[72]*Taxpayer Information*, United States Tax Court, http://www.ustaxcourt.gov/taxpayer_info_intro.htm (last visited May 2, 2016).

[73]Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, section 1041(a), 88 Stat. 829, 949 (codified as amended at I.R.C. section 7476).

[74]Tax Reform Act of 1976, Pub. L. No. 94-455, section 306, 90 Stat. 1520, 1717 (codified as amended at I.R.C. section 7428).

[75]Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, section 406(a), section 7428(a)(1), 129 Stat. 2242, 3120.

[76]Tax Reform Act of 1976 section 1212, 90 Stat. at 1712 (codified as amended at I.R.C. section 6404).

[77]Tax Reform Act of 1976 section 1201(a), 90 Stat. at 1660 (codified as amended at I.R.C. section 6110(d)(3)).

[78]Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, section 292, 96 Stat. 324, 572 (codified as amended at I.R.C. section 7430).

[79]*Id.* section 402(a), 96 Stat. at 653-55, 656-57 (codified as amended at I.R.C. sections 6226, 6228(a)).

[80]Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-205, section 3401, 112 Stat. 683, 747-50 (codified as amended at I.R.C. sections 6320, 6330).

[81]Taxpayer Relief Act of 1997, Pub. L. No. 105-34, section 1231, 111 Stat. 788, 1020-23 (codified as amended at I.R.C. section 7436).

[82]Internal Revenue Service Restructuring and Reform Act of 1998 section 3201, 112 Stat. at 734 (codified as amended at I.R.C. section 6015).

[83]Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, section 406(a), section 7623, 120 Stat. 2922, 2958-59 (codified at I.R.C. section 7623(b)(4)).

[84]Fixing America's Surface Transportation (FAST) Act, Pub. L. No. 114-94, section 32101(a), 129 Stat. 1729, 1749 (codified at I.R.C. section 7345).

his property in satisfaction of his tax debt.[85] Generally, tax collection questions arise separately from, and subsequent to, the determination of the taxpayer's liability for the tax. If the taxpayer did not receive a statutory notice of deficiency for the tax or otherwise have the opportunity to dispute his tax liability, then the taxpayer may raise in a CDP hearing not only strictly collection matters but also the taxpayer's underlying liability for the tax.[86] Congress thus extended our jurisdiction as a prepayment forum to non-deficiency taxes that, previously, escaped judicial review except in a refund procedure or, perhaps, in a bankruptcy action.[87]

A principal difference between our legacy jurisdiction and our new areas of jurisdiction is that our new jurisdictions often require us to review equitable determinations and exercises of agency discretion. Our jurisdiction to consider CDP claims[88] and to review agency determinations of innocent spouse status[89] exemplify those aspects of our expanded jurisdiction.

In reviewing agency actions, Federal district courts generally look to the APA, which establishes the default standards for judicial review of agency rulemaking, adjudication, and other forms of agency action.[90] The Tax Court, however, has for the most part held itself aloof from the APA, declaring in 2004 that "[t]the APA has never governed proceedings in the Court (or in the Board of Tax Appeals)."[91] I believe that not to be true for the reasons Judge Holmes and I stated in *Ewing v. Commissioner*.[92] Briefly, the IRS is an agency within the meaning of the APA,[93] and, under the APA, a person "aggrieved" by the IRS's action is, thus, "entitled to judicial review . . . in a court of the United States"[94] so long as the IRS action is "reviewable by statute" or is otherwise "final agency action for which there is no other adequate remedy in a court."[95] The Tax Court is "a court of the United States"[96] and, for review of the IRS's actions, a "reviewing court" subject to the APA's judicial review provisions.[97] The APA's default provisions apply to a court's review of agency action unless Congress has directed otherwise by statute.[98]

The APA addresses both the *standard* and *scope* of a court's review of agency action.[99] The default *standard* for review is the familiar abuse of discretion standard.[100] The APA provides two exceptions to that default standard. First, it commands that a reviewing court must set aside agency action "unwarranted by the facts to the extent that the facts are subject to trial *de novo* by the reviewing court."[101] Second, with respect to formal rulemaking, formal adjudication, and other actions "on the record of an agency hearing provided by statute," it commands that agency action "unsupported by substantial evidence" must be set aside.[102]

The APA suggests that the default *scope* of review is the record made before the administrative agency.[103] And, if the record before the agency does not support the agency action, or there are other defects in the record, the proper remedy is to remand the action to the agency for additional investigation or explanation.[104]

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[85]Internal Revenue Service Restructuring and Reform Act of 1998 section 3401(a) (liens), (b) (levy), 112 Stat. at 746-50 (codified as amended at I.R.C. sections 6320 & 6330, respectively). In 2006, Congress made us the exclusive court to hear such appeals. Pension Protection Act of 2006, Pub. L. No. 109-280, section 855, section 6330(d), 120 Stat. 780, 1019.

[86]*See* I.R.C. section 6330(c)(2)(B).

[87]*See* Dubroff & Hellwig, *supra* note 8, at 482 & n.246.

[88]*See* I.R.C. section 6330(d).

[89]*See* I.R.C. section 6013(e).

[90]*See* 5 U.S.C. sections 701-706 (2012).

[91]*Robinette v. Commissioner*, 123 T.C. 85, 96 (2004), *rev'd*, 439 F.3d 455 (8th Cir. 2006); *accord Porter v. Commissioner*, 130 T.C. 115, 117 (2008) ("Since its enactment in 1946 the APA has generally not governed proceedings in this Court (or in its predecessor, the Board of Tax Appeals).").

[92]122 T.C. 32, 56-71 (2004) (Halpern and Holmes, JJ., dissenting), *rev'd in part, vacated in part*, 439 F.3d 1009 (9th Cir. 2006). *See also* Stephanie Hoffer & Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 Minn. L. Rev. 221 (2014), for an illuminating discussion of the Tax Court and the APA's default judicial review standards.

[93]5 U.S.C. section 701(b)(1).

[94]*Id.* section 702.

[95]*Id.* section 704.

[96]*Id.* section 702; *see Freytag v. Commissioner*, 501 U.S. 868, 888 (1991) (holding that the Tax Court is a "Cour[t] of Law" under the appointments clause). Recently, the Court of Appeals for the D.C. Circuit rejected a constitutional challenge to the President's removal power for Tax Court judges, holding that the Tax Court is not a court exercising the Article III "judicial power of the United States" when deciding cases but, rather, it is an Article I legislative court exercising Article II executive powers when deciding cases. *Kuretski v. Commissioner*, 755 F.3d 929, 943 (D.C. Cir. 2014). Albeit as dicta, the court dispels the fear that the Tax Court is, itself, an "agency" and not "a court of the United States" for purposes of the APA. *Id.* at 944.

[97]5 U.S.C. section 706.

[98]*See Dickinson v. Zurko*, 527 U.S. 150, 154 (1999) ("[A] reviewing court must apply the APA's court/agency review standards in the absence of an exception.").

[99]*See* 5 U.S.C. section 706.

[100]*Id.* section 706(2)(A) (providing that the reviewing court must set aside agency action that is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law").

[101]*Id.* section 706(2)(F).

[102]*Id.* section 706(2)(E).

[103]*See id.* section 706(2) (flush language); *see also Camp v. Pitts*, 411 U.S. 138, 142 (1973) (Where the standard of review under 5 U.S.C. section 706(2)(A) is abuse of discretion, "the focal point for judicial review should be the administrative record already in existence, not some new record made initially in the reviewing court.").

[104]*Fla. Power & Light Co. v. Lorian*, 470 U.S. 729, 744 (1985).

To be sure, the APA's governance of the Tax Court review of IRS actions does not mean that the standard of review is always abuse of discretion or the scope of review is always no wider than the administrative record. Those are the default standards, and the pertinent question in considering the Tax Court's exercise of a particular area of its jurisdiction is whether by statute Congress has expressly overridden the default standard.

A petition for the redetermination of a deficiency in tax is a petition for the review of an agency action that should be governed by the APA.[105] Both the Tax Court[106] and the courts of appeals[107] appear to agree that such petitions are subject to a *de novo* standard of review that is not delimited by the administrative record. And while that position may be viewed as having been grandfathered under the APA,[108] the IRS's governing statute provides considerable evidence that Congress intended the Tax Court to depart from the APA default standards.[109] That does not mean that the APA does not apply to deficiency cases. The APA still governs, but the default standards give way to the alternative judicial review provisions governing trials of factual issues mandated by the agency's governing statute: The administrative record does not delimit the scope of review (trial *de novo*), and the standard of review is *de novo* (unwarranted by the facts).[110]

A significant addition to our jurisdiction is our authority to review the Commissioner's denial of equitable relief to so-called innocent spouses.[111] The statute does not provide the scope or standard of our review. After initially determining in 2002 that the appropriate *standard* of review is abuse of discretion,[112] we determined in 2004 that, while the appropriate standard of review is abuse of discretion, we apply that standard (*i.e.*, determine whether the Commissioner abused his discretion) on the basis of a *de novo* record.[113] In 2009, we concluded that, as a result of a change in the applicable statute, we must review the Commissioner's decision with "a de novo standard of review as well as a de novo scope of review."[114] The Federal courts of appeals are not in agreement as to what standards apply to the Tax Court's review of equitable innocent spouse claims.[115]

We also review the Commissioner's determinations in CDP cases.[116] Again, the statute does not provide the scope or standard of our review. We have relied on legislative history and not on the APA default to determine that the *standard* of review is abuse of discretion when the underlying liability is not at issue.[117] Nor do we follow the APA default with respect to *scope* of review, holding that in some instances we are not limited to the administrative record.[118] We have been reversed on that latter decision.[119]

Congress has provided neither the scope nor the standard of review with respect to our new jurisdiction to review the Commissioner's certifications relating to passport denials and revocations for seriously tax-delinquent taxpayers.[120] Likewise, Congress has provided neither the scope nor the standard of review with respect to our jurisdiction to review whistleblower award determinations.[121]

The Supreme Court has addressed when a reviewing court may depart from the APA's default standards for review of an agency action.[122] "Recognizing the importance of maintaining a uniform

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[105]5 U.S.C. section 703, addressing the form and venue of a proceeding for judicial review of an agency action, includes the "special statutory review proceeding relevant to the subject matter in a court specified by statute." Recently, in *Ax v. Commissioner*, 146 T.C. No. 10, slip op. at 15 (T.C. Apr. 11, 2016), referring to 5 U.S.C. section 703, we stated: "A deficiency case is one such 'special statutory review proceeding', and the Tax Court is the 'court specified by statute.'"

[106]*See, e.g., Ewing v. Commissioner*, 122 T.C. 32, 38 (2004), *rev'd in part, vacated in part*, 439 F.3d 1009 (9th Cir. 2006) ("Under section 6213(a) and its predecessors, we (and earlier, the Board of Tax Appeals) have 'redetermined' deficiencies de novo, not limited to the Commissioner's administrative record, for more than 75 years.").

[107]*See Wilson v. Commissioner*, 705 F.3d 980, 1003 n.3 (9th Cir. 2013) (Bybee, J., dissenting) (citing cases in support of the notion that "[t]he Tax Court's review of tax deficiencies has, for largely historical reasons, been held to be de novo").

[108]*See id.*

[109]*See* Hoffer & Walker, *supra* note 94, at 255-56.

[110]5 U.S.C. section 706(2)(F) (2012).

[111]I.R.C. section 6015(e)(1)(A), (f).

[112]*Jonson v. Commissioner*, 118 T.C. 106, 125 (2002), *aff'd on other grounds*, 353 F.3d 1811 (10th Cir. 2003).

[113]*Ewing v. Commissioner*, 122 T.C. 32, 43-44 (2004) ("the APA record rule does not apply to section 6015(f) determinations in this Court"), *rev'd in part, vacated in part*, 439 F.3d 1009 (9th Cir. 2006).

[114]*Porter v. Commissioner*, 132 T.C. 203, 206-10 (2009).

[115]The D.C. and Fifth Circuits agreed with the Tax Court's 2002 position that abuse of discretion is the proper standard of review. *Mitchell v. Commissioner*, 292 F.3d 800, 807 (D.C. Cir. 2002); *Cheshire v. Commissioner*, 282 F.3d 326, 338 (5th Cir. 2002). A divided Eleventh Circuit agreed with the Tax Court's 2004 position that the Tax Court is not bound by the record rule. *Commissioner v. Neal*, 557 F.3d 1262, 1268-76 (11th Cir. 2009). A divided Ninth Circuit upheld the Tax Court's current position, i.e., *de novo* standard and scope of review. *Wilson v. Commissioner*, 705 F.3d 980 (9th Cir. 2013).

[116]I.R.C. section 6330(d)(1).

[117]*See Goza v. Commissioner*, 114 T.C. 176, 181-82 (2000).

[118]*E.g., Robinette v. Commissioner*, 123 T.C. 85, 95-101 (2004), *rev'd*, 439 F.3d 455 (8th Cir. 2006).

[119]*Robinette v. Commissioner*, 439 F.3d at 459-62; *see also Murphy v. Commissioner*, 469 F.3d 27, 30-31 (1st Cir. 2006).

[120]I.R.C. section 7345(c).

[121]*Id.* section 7623(b)(4).

[122]*See Dickinson v. Zurko*, 527 U.S. 150 (1999).

approach to judicial review of administrative action," the Court has instructed reviewing courts to "apply the APA's court/agency review standards in the absence of an exception" in the agency's governing statute.[123] To depart from an APA default standard, the agency's organic statute must show "more than a possibility of a . . . [different] standard, and indeed more than even a bare preponderance of evidence"; the exception "must be clear."[124]

It is difficult any longer plausibly to argue that the Tax Court is aloof from the APA default judicial review standards. In *Mayo Foundation for Medical Education & Research v. United States*,[125] one question was the deferential standard of review to be applied to tax regulations. A unanimous Supreme Court held that *Chevron*[126] deference applies with full force to tax regulations, stating that it was "not inclined to carve out an approach to administrative review good for tax law only," and noting that it had "expressly '[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.'"[127] Recently, in *Ax v. Commissioner*,[128] although stopping short of acknowledging that the Tax Court is a reviewing court for purposes of the APA, we acknowledged that a deficiency case is a "special statutory review proceeding" within the meaning of APA section 703 and that the Tax Court is, within the meaning of that provision, the "court specified by statute."[129] Although acknowledging only that our decision "in a deficiency case" is not at odds with APA section 706, the report is evidence that we are rethinking our absolutist stand that the APA does not govern proceedings in the Tax Court.[130]

One final thought with respect to the APA. Many years ago, when I was a young tax lawyer, I asked an older, more experienced tax practitioner whether the APA was of much relevance to Federal tax law. He said it was not, because, if it was, we would know something about it. Times have changed. It is time for the Tax Court to concede error and to consider itself bound by the APA's judicial review procedures — just like all of the other Federal courts that review Federal agency action.

**3. *Golsen* doctrine.** In 1970, the Tax Court made a doctrinal change in how we establish a uniform body of precedents. We are a court with national jurisdiction, and we have always understood Congress to have intended us to decide cases uniformly, regardless of where, in our national jurisdiction, the case may arise.[131] However, maintaining uniformity has proved difficult since, with respect to appeals, Congress inverted the triangle so that, from a single national jurisdiction, Tax Court appeals spread out among 12 courts of appeals, each for a different circuit, or portion, of the United States.[132] Moreover, appellate venue may not be certain because the statute permits parties in all cases to appeal by mutual agreement to any of those appellate courts.[133] Also, more than one petitioner in a case may have the right to appeal, and each may have the right to appeal to a different court of appeals.[134]

Early on, the Tax Court concluded that it "should decide all cases as it thought right."[135] In 1957, in *Lawrence v. Commissioner*, we surveyed the history of that position and reconsidered what we should do when an issue comes before the Court a second time, after a court of appeals has reversed a prior Tax Court decision on the same point.[136] We decided that, while certainly we should consider the reasoning of the reversing court of appeals, we ought not follow the decision if we believed it incorrect.[137] Thus, we could adhere to our own precedent under the doctrine of stare decisis, even when reversed on appeal.

In 1970, in *Golsen v. Commissioner*,[138] we created a narrow exception to the *Lawrence* doctrine, applicable when a case in the Tax Court is appealable to a court of appeals that has taken a position on precisely the same issue. Without conceding that we

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[123]*Id.* at 154.

[124]*Id.* at 154-55; *see also* Hoffer & Walker, *supra* note 94, at 244.

[125]562 U.S. 44 (2011).

[126]*Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

[127]*Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. at 55 (quoting *Dickinson v. Zurko*, 527 U.S. at 154).

[128]146 T.C. No. 10 (T.C. Apr. 11, 2016).

[129]*Id.* slip op. at 15.

[130]*See, e.g., Robinette v. Commissioner*, 123 T.C. 85, 96 (2004) ("The APA has never governed proceedings in the [Tax] Court (or in the Board of Tax Appeals)."), *rev'd*, 439 F.3d 455 (8th Cir. 2006); *Porter v. Commissioner*, 130 T.C. 115, 117 (2008) ("Since its enactment in 1946 the APA has generally not governed proceedings in this Court (or in its predecessor, the Board of Tax Appeals).").

[131]*Lawrence v. Commissioner*, 27 T.C. 713, 718 (1957), *rev'd*, 258 F.2d 562 (9th Cir. 1958).

[132]I.R.C. section 7482(a) establishes jurisdiction for review of Tax Court decisions in the "United States Courts of Appeals (other than the United States Court of Appeals for the Federal Circuit)." Section 7482(b) prescribes venue.

[133]*See* I.R.C. section 7482(b)(2).

[134]*See, e.g., Estate of Israel v. Commissioner*, 108 T.C. 208, 226 (1997) (Tax Court not bound by *Golsen* since I.R.C. section 7482(b)(1) allowed for multiple possible venues where coexecutors resided in different circuits), *rev'd and remanded sub nom. Estate of Israel v. Commissioner of I.R.S.*, 159 F.3d 593 (D.C. Cir. 1998).

[135]*See Lawrence v. Commissioner*, 27 T.C. at 717.

[136]*Id.*

[137]*Id.* at 719-20; *see also Lardas v. Commissioner*, 99 T.C. 490, 494 (1992) (explaining *Lawrence* doctrine).

[138]54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

lacked the authority to render a decision inconsistent with any court of appeals (including the one to which an appeal would lie), we recognized that it would be futile and wasteful to do so where it surely would be reversed.[139] Pursuant to the *Golsen* doctrine, the Tax Court will follow a court of appeals' decision that is squarely on point where appeal from the Tax Court's decision lies to that court of appeals and to that court alone.[140]

The *Golsen* doctrine, properly understood, is grounded *not* on recognition of the court of appeals' decision as binding precedent *but*, instead, *is* grounded in notions of efficiency and "better judicial administration"[141] — that is, the recognition that it would be futile and wasteful to render a decision that would surely be reversed.[142] Thus, *Golsen* does not bind us to follow precedent that we may judge to have lost its vitality yet has not been overruled or precedent that allows itself of some distinction. In *Lardas v. Commissioner*,[143] for instance, we did not follow a circuit precedent when it was not clear to us that the circuit court would disagree with our analysis.

In *Golsen*, we crafted only a narrow exception to *Lawrence*. In *Lawrence*, Judge Murdock, the author of that report, admonished us: "Stick to your guns!" *Golsen* amended that admonition only slightly; we now say: "Stick to your guns (except where it would be futile)!" Judge Murdock might readily have accepted *Golsen*'s gloss on the *Lawrence* doctrine.

**4. Memorandum opinions.** Since Judge Murdock reported in 1945, the Court's practice with respect to memorandum opinions has changed dramatically. Memorandum opinions have come to predominate Tax Court decision making, and published reports are exceptional. More illuminating than to compare the absolute numbers of proceedings that in any year we disposed of by memorandum opinions is to look at the changing *ratio* of memorandum opinions to published reports.[144] The annual number of published reports has fallen precipitously as the annual number of memorandum opinions has increased, so that the ratio of published to unpublished reports has decreased dramatically. I set forth in an appendix a breakdown at ten year intervals and for the last five years of the number of published reports versus memorandum opinions. The trend is an increasing ratio of memorandum opinions to published reports. In 1935, the ratio was almost equal, 1.36 memorandum opinions to one published report. In 2015, it was 8.13 memorandum opinions to each published report.

Not only has the ratio of memorandum opinions to published reports increased dramatically, but the Court has abandoned its custom of not citing memorandum opinions and, indeed, has made changes that facilitate their citation.

In April 1954 we began numbering memorandum opinions serially, *e.g.*, T.C. Memo. 1954-1, T.C. Memo. 1954-2, and so forth. Since September 1995, we have made our memorandum opinions accessible on our Web site. In June 2012, we announced a uniform method of citing pages in memorandum opinions and stated that we would follow the announced method for spot-citing memorandum opinions.[145] With minor exceptions, our memorandum opinions no longer briefly report a conclusion without elaboration. Almost all memorandum opinions are subdivided into "Findings of Fact" and "Opinion" or "Background" and "Discussion."

The official position of the Tax Court appears to be that, with respect to memorandum opinions, we are not bound by the doctrine of stare decisis.[146] Yet, that position notwithstanding, Tax Court case law, for decades, has simultaneously affirmed a significant persuasive value for memorandum opinions.[147] For example, in one memorandum opinion,

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[139]*Id.* at 756-57; *see also Lardas v. Commissioner*, 99 T.C. at 495 (explaining *Golsen*).

[140]*Golsen v. Commissioner*, 54 T.C. at 757; *see also Lardas v. Commissioner*, 90 T.C. at 495 (cautioning that, "bearing in mind our obligation as a national court, . . . we should be careful to apply the *Golsen* doctrine only under circumstances where the holding of the Court of Appeals is squarely on point").

[141]*Golsen v. Commissioner*, 54 T.C. at 757.

[142]*Lardas v. Commissioner*, 99 T.C. at 495.

[143]*Id.*

[144]In changing focus from proceedings disposed of by memorandum opinions in any period to the number of memorandum opinions in that period, it must be kept in mind that the number of memorandum opinions may be less since more than one proceeding (i.e., docket entry) can be addressed in a single memorandum opinion. Likewise for published opinions.

**(Footnote continued in next column.)**

[145]*See* Press Release, United States Tax Court, The Tax Court Announces a Uniform Method of Spot-citing Memorandum Opinions (June 26, 2012) (available at *Press Releases*, United States Tax Court, http://ustcintranet/press.htm (last visited May 2, 2016)). We described memorandum opinions much as Judge Murdock did in 1945, *viz*, "*generally* . . . [addressing] cases that do not involve novel legal issues and in which the law is settled or the result is factually driven."

[146]*E.g.*, *Huffman v. Commissioner*, 126 T.C. 322, 350 (2005) ("memorandum opinions are not binding"), *aff'd*, 518 F.3d 357 (6th Cir. 2008); *Dunaway v. Commissioner*, 124 T.C. 80, 87 (2005) (memorandum opinions "not binding precedent"); *Nico v. Commissioner*, 67 T.C. 647, 654 (1977) (memorandum opinions not "controlling precedent"), *aff'd in part, rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977); *Singer v. Commissioner*, T.C. Memo. 2016-48, 2016 WL 985580, at *14 (memorandum opinions are "nonbinding precedent").

[147]*E.g.*, *McGah v. Commissioner*, 17 T.C. 1458, 1459-60 (1952), *rev'd*, 210 F.2d 769 (9th Cir. 1954); *Convergent Techs., Inc. v. Commissioner*, T.C. Memo. 1995-320, 1995 WL 422677.

after declaring that another memorandum, "being a memorandum opinion of . . . [the] Court," was "not controlling precedent," we opined that "given the substantial similarity of the factual foundation," there was "no reason why we should not follow the same analytical approach that we utilized" in that other memorandum opinion.[148] Recently, in a fiduciary liability case, we grappled with the question of who bore the burden of proof as to the estate's insolvency.[149] Not only did we cite to several memorandum opinions provided by both sides on that question of law because of the lack of a dispositive division opinion, but we designated the resulting report apparently settling that question of law as a nonprecedential memorandum opinion.[150]

The classification of opinions by precedential weight serves an important signaling function. The Court's relatively indiscriminate citation of memorandum and published opinions risks confusion and frustrates the signaling function that classification ought to achieve. In both cases cited above, the *prior* memorandum opinions that the Court found persuasive were misclassified since there was no underlying published report on which they relied. The *resulting* memorandum opinions were misclassified for the same reason.

I do not, however, favor as a solution that we end the confusion by ending the use of memorandum opinions, publishing *all* of our reports in the Tax Court reports. We enjoy a large volume of cases, and, truly, many of them fit Judge Murdock's description of cases fit for memorandum opinions because they are governed by another case, or by well-settled published reports of the Court, or involve a failure of proof. There are of course other cases fit for disposition by unpublished report, and, by custom and necessity, the Chief Judge must make that decision. We should maintain our classification system because it serves a useful "signaling" function, advising readers of the significance we give to our opinions.

I do, however, favor reviving the custom of our not citing memorandum opinions. A possible exception is where the Court is distinguishing a prior memorandum opinion to show that, contrary to a party's argument, the Court's present decision is not inconsistent with its prior application of settled law.

If no published report can be found to support a point of law, then a judge should set forth the analysis of any relevant memorandum opinions, but he should indicate the report for publication in order that the precedential value of his analysis adopted from the memorandum opinions be established as authoritative precedent subject to appropriate deference under the doctrine of stare decisis.

The Chief Judge reviews and classifies all reports and can assure that we adhere to our revived custom of not citing memorandum opinions. Undoubtedly, she will keep in mind Judge Murdock's admonition that doubts as to whether a case should be in memorandum form or printed are resolved in favor of printing.

Implementing my suggestion will take time, but I think that we can recover the ground that we have lost in far fewer years than it took for us to lose it.

### D. What the Future May Hold

Before I close, I would like to say just a few things about the IRS's plans for the future of tax administration. As reported by the National Taxpayer Advocate, Nina Olson, the IRS has directed significant resources to creating a "future state" plan that details how the agency will operate in the next five years.[151] Implicit in the plan, she reports, "is an intention on the part of the IRS to substantially reduce telephone and face-to-face interaction with taxpayers."[152] Taxpayers will be encouraged to interact with the agency through online accounts or with the assistance of third parties like tax return preparers or tax software companies.[153] She worries that that approach will increase compliance costs for millions of taxpayers and, as taxpayers lose their ability to speak with IRS employees either by telephone or at walk-in centers, will increase taxpayer frustration with the system.[154] She notes that, while some pre-filing contacts may require only generic answers, post-filing contacts are almost always account-specific and require IRS employees to study the details of the taxpayer's account to respond.[155]

So, what is the implication for the Tax Court? As taxpayers grow frustrated with the IRS, they are likely to turn to the Tax Court for relief, where filing fees are minimal and the service is personal. Indeed, recent comments by the IRS's Chief Counsel may be a harbinger. Tax Analysts reported on March 14, 2016, that IRS Chief Counsel William J. Wilkins had announced plans to hire additional attorneys who

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[148]*Convergent Techs., Inc. v. Commissioner*, T.C. Memo. 1995-220, 1995 WL 422677, at *8.

[149]*See Singer v. Commissioner*, T.C. Memo. 2016-48.

[150]*Id.*

[151]2015 Nat'l Taxpayer Advoc. Ann. Rep. vol. 1, at 3 (can be found at http://www.TaxpayerAdvocate.irs.gov/2015Annual Report; last visited, May 3, 2016).

[152]*Id.*

[153]*Id.*

[154]*Id.* at 3-4.

[155]*Id.* at 4.

will work on the Tax Court's small-case docket.[156] Mr. Wilkins attributed the increase to an uptick in the number of small cases, although he could not say whether the uptick was temporary or permanent. My suspicion is that, given taxpayer frustration with budget-driven IRS service curtailments, the uptick is permanent.

Recourse to the Tax Court is a high-cost alternative to resolving disputes that, in many cases, could more efficiently be resolved by telephonic or face-to-face contact within the agency.

## E. Conclusion

Since Judge Murdock reported in 1945, our history has been one of change within continuity. Our unique role of providing an impartial, prepayment judicial forum responsible for developing a uniform body of case law has been continued and enhanced. Congress has added to our jurisdiction, and we, together with others, have facilitated access to the Tax Court for low-income and unrepresented taxpayers. We are adjusting to our new responsibilities to review equitable determinations and exercises of agency discretion. I hope that we will reconsider our reliance on memorandum opinions.

My last quarter century as a judge on the United State Tax Court has been the highlight of my professional career. What other kind of job is there that lets you wear a costume to work, listen to stories all day, and write endings.

## F. Appendix

**Ratio of T.C. Published Reports to Memorandum Opinions**

| Year | Published | Memorandum | Ratio |
|---|---|---|---|
| 1935 | 344 | 467 | 1 to 1.36 |
| 1945 | 261 | 385 | 1 to 1.48 |
| 1955 | 274 | 336 | 1 to 1.23 |
| 1965 | 134 | 328 | 1 to 2.45 |
| 1975 | 205 | 373 | 1 to 1.82 |
| 1985 | 137 | 630 | 1 to 4.60 |
| 1995 | 64 | 610 | 1 to 9.53 |
| 2005 | 34 | 299 | 1 to 8.79 |
| 2011 | 47 | 300 | 1 to 6.38 |
| 2012 | 42 | 360 | 1 to 8.57 |
| 2013 | 38 | 296 | 1 to 7.79 |
| 2014 | 45 | 259 | 1 to 5.76 |
| 2015 | 31 | 252 | 1 to 8.13 |
| **Totals** | **1,656** | **4,895** | **1 to 2.96** |

[156]William R. Davis, "IRS to Hire More Attorneys to Handle Small-Case Docket," *Tax Notes*, Mar. 14, 2016, p. 1282.

NOTES

# New Partnership Audit Rules, and the Partnership and LLC Agreement Provisions They Make Necessary

Forthcoming, Southern Law Journal

# STATUTORY CHANGES IN PARTNERSHIP TAX AUDITS AND THE RESULTING NEED FOR CHANGES IN PARTNERSHIP AGREEMENTS

EDWARD B. HYMSON[1]

## I. INTRODUCTION.

In November, 2015, Congress repealed the Tax Equity and Fiscal Responsibility Act of 1982[2] (TEFRA) partnership audit rules and provided new partnership audit rules (also applicable to Limited Liability Companies (LLC) electing to be taxed as partnerships) effective for tax years beginning after December 31, 2017.[3] The Bipartisan Budget Act of 2015[4] and technical amendments included in the 2016 Consolidated Appropriations Act[5] (collectively BBA) rewrote the Internal Revenue Code (I.R.C.) partnership audit provisions and inserted conforming amendments elsewhere in the code.[6] In May, 2017, the Internal Revenue Service (IRS) issued proposed regulations, to be used until final regulations are issued and sought comments due in August 14 of the same year.[7] The BBA imposes an audit regime that is fundamentally different from the partnership audit regimes that preceded it. Implementation of the BBA depends on the extensive structure of rules that the Internal Revenue Service (IRS) has presented for comment and implementation.

The BBA statutory provisions and IRS regulations impose on partnerships (as opposed to individual partners) the obligation to identify and pay any deficiency[8] unless the partnership meets the conditions required to elect out of the BBA audit rules[9] or chooses to shift payment to partners.[10] Individual partners are bound by the partnership level rulings on tax liability.[11] Each partnership must elect a single partnership representative (PR) who is the sole point of contact with the IRS during the audit and whose actions bind both the partnership and its individual partners.[12] Any deficiency is paid by the partnership in the year the adjustment becomes final, rather than by the individual partners, unless the partnership elects to push out payment of deficiencies found when the partnership is audited to those who were partners in the reviewed

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[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); repealed by Pub. L. 114-74 § 1101(a),(b).

[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 (2015).

[7] Centralized Partnership Audit Regime (REG-136118-15); 82 FR 27334; IRS-2017-0009; 26 CFR 301.

[8] I.R.C. § 6221(a).

[9] I.R.C. § 6221(b).

[10] I.R.C. § 6226

[11] I.R.C. § 6221(b)(1).

[12] I.R.C. § 6223(a).

year.[13] Both the BBA and implementing regulations substantially upend the prior system of auditing individual partners, changing both procedures and each individual partner's substantive rights.

The new BBA tax audit structure makes it desirable to include in partnership and LLC agreements provisions that address how the partnership will handle the elections inter-partner obligations, and relations between the partnership, its partners, and the IRS under the new audit and assessment procedures. Partnership and LLC agreements should address who will be the PR and his or her obligations to the partnership and partners. The agreements should consider the obligation of reviewed year partners to audit year partners and to each other. Finally, agreements should address who will be responsible for payment of deficiencies, interest, and penalties.

The provisions of the BBA and its implementing regulations are described in the next section. The following section suggests partnership agreement provisions that address issues raised by the new tax audit rules and resulting changes in relations among partners or LLC members and their entities.

## II. Summary of BBA Changes to Partnership Audit Rules.

### *A. The IRS Determines Partnership Tax Adjustments at the Partnership Level Unless the Partnership Elects Out of the Regulations; I.R.C. § 6221.*

Adjustments to items of partnership income, gain, loss, deduction, or credit for the partnership taxable year and all partner distributive shares are assessed, adjusted, and collected at the partnership level instead of from individual partners.[14] However, a partnership required to furnish 100 or fewer partner statements in a tax year to qualified partners may elect on its return to be excluded from the BBA rules (elect out) by notifying the IRS and each partner of the election.[15] To elect out all partners be qualified partners. Qualified partners include individuals, C corporations, foreign entities that would be treated as a C corporation if they were domestic entities, domestic partnerships and LLCs, S corporations, and the estate of a deceased partner.[16] Each shareholder of an S corporation must be furnished a statement, disclosed to the IRS, and receive one of the 100 or fewer partner statements permitted if the partnership chooses to elect out of the BBA audit regulations.[17] Single member LLC (disregarded entity) partners disqualify the partnership from electing out.[18] The IRS is directed to prescribe the manner of disclosure of name and taxpayer identification number of partners and S corporation shareholders.[19] The IRS is given authority to identify acceptable additional classes of foreign or domestic partners.[20]

Eligibility to elect out is measured by the number of statements furnished to eligible partners during the year, not simply the number of partners and S corporation shareholders.[21] The count includes both the statements issued to an S corporation and all statements issued to S corporation

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[13] I.R.C. § 6226.
[14] I.R.C. § 6221(a). The definitions for each of these terms are found at Prop. Treas. Reg. §301.6221(a)-1(b).
[15] I.R.C. § 6221(b)(1).
[16] *Id.*
[17] I.R.C. § 6221(b)(2).
[18] Prop. Treas. Reg. § 301.6221(b)-1(b)(3)(ii).
[19] I.R.C. § 6221(b)(1),(2)(A).
[20] I.R.C. §§ 6221(b)(2)(B),(C).
[21] Prop. Treas. Reg. §§ 301.6221(b)-1(a),(b)(1)(ii).

shareholders.[22] Thus, for example, a partnership that has 50 partners, including one S corporation partner with 50 shareholders has issued 101 statements, one to each partner including the S corporation, and one to each S corporation shareholder. It therefore does not qualify for election out of the partnership rules.[23]

The process of counting the number of statements issued can become quite complex.[24] For example, if a husband and wife separately own an interest in a partnership, they are counted as two partners because they receive separate statements.[25] However, a husband and wife who hold the partnership interest as community property and receive one statement are counted as one partner even though each owns a one half interest in the partnership share.[26] If a partner sells his or her interest to a non-partner during the tax year, both the selling partner and the purchasing partner receive statements for that year.[27] If issuing the two statements results in more than 100 statements being issued by the partnership the partnership cannot elect out of the regulations.[28] Similarly, if a partnership that would otherwise have issued 100 statements has to issue 101 statements because a partner dies during the tax year and one must be issued to the deceased partner for the period the partner was alive and another to his or her estate for part of the year covering the period after death the partnership becomes disqualified from electing out.[29]

An S corporation is an eligible partner even if one or more of its shareholders is not an eligible partner.[30] However, trusts, ineligible foreign entities, disregarded entities,[31] a nominee for another, or an estate of a deceased person other than a deceased partner are ineligible and disqualify the partnership from electing out.[32] A foreign entity is an eligible entity if it would be treated as a C corporation if it were a domestic entity.[33] Thus, the foreign entity qualifies if it is an association taxable as a per se corporation,[34] a corporation by default,[35] or a corporation by election.[36]

To elect out of the BBA regulations, the electing partnership must disclose to the IRS information about each person that was a partner at any time during the taxable year, including each partner's name, taxpayer identification number, Federal tax classification, a statement that each partner is eligible, and all other information the IRS requests.[37] It must also disclose the same information for each shareholder of an S corporation partner.[38] Finally, the partnership must notify each partner of the election within 30 days of making it.[39]

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[22] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(ii).
[23] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 4.
[24] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii).
[25] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 1.
[26] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 2.
[27] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 3.
[28] *Id.*
[29] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 5.
[30] Prop. Treas. Reg. §§ 301.6221(b)-2(b)(3)(i); 301.6221(b)-3(iv), Ex. 2.
[31] Described in Treas. Reg. § 301.7701-2(c)(2)(i).
[32] Prop. Treas. Reg. § 301.6221(b)-2(b)(3)(ii).
[33] Prop. Treas. Reg. § 301.6621(b)-2(b)(3)(iii).
[34] Treas. Reg. § 301.7701-2(b)(1),(3)-(8).
[35] Treas. Reg. § 301.7701-3(b)(2)(i)(B).
[36] Treas. Reg. § 301.7701-3(c).
[37] Prop. Treas. Reg. § 301.6621(b)-(3)(c)(2).
[38] *Id.*
[39] Prop. Treas. Reg. § 301.6621(b)-(3)(d).

A partnership that has elected out of the BBA rules and is a partner of a partnership that has not elected out is subject to the BBA rules with respect to its interest in the non-electing partnership.[40]

### *B. Each Partner's Tax Return Must be Consistent with the Partnership Tax Return; I.R.C. § 6222.*

Each partner must treat each item on his or her tax return that is attributable to a partnership consistently with its treatment on the partnership return.[41] Consistency includes consistent amount, timing, and characterization of each item.[42] The rule applies to a partnership partner, even if that partner is itself a partnership that has elected out of the partnership rules with respect to its own partners.[43] Each partner's return must be consistent with the partnership's return and all Schedule K-1 partnership statements it issues even if the partnership incorporating the information from a K-1 has itself elected out of the rules unless the partner files notice of inconsistent treatment.[44]

Any discrepancy is treated as an underpayment caused by a mathematical or clerical error[45] unless the partner receives incorrect information from the partnership[46] or the partner files a notification of inconsistent treatment with the partner's return.[47] Treatment as a mathematical error means that the partner may not challenge IRS adjustment of the inconsistently reported items on a partner's return or determination of the resulting underpayment.[48] A partner's inconsistent treatment is permitted only with respect to those items specifically identified in the partner's notice of inconsistent treatment.[49] A partner must file a notice of inconsistent treatment if the partnership does not file a return and the partner takes into account partnership items when filing his or her return.[50] A notice of inconsistent return may not be used with respect to an administrative adjustment by the partnership.[51] It also may not be used with respect to a final decision in a proceeding before the IRS.[52] An adverse decision with respect to a partner's inconsistent position is not binding on the partnership unless the partnership is a party to the proceeding.[53]

If a partner receives incorrect information from the partnership and files a return relying on that inconsistent information, the partner is treated as if he or she gave notice of inconsistent treatment.[54] To utilize this exception to the general rule a partner must show that treatment was consistent with the information on the Schedule K-1 the partner received and make an election in

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[40] Prop. Treas. Reg. § 301.6621(b)-3(d)(2) Ex. 2.
[41] I.R.C. § 6222(a).
[42] Prop. Treas. Reg. § 301.6622-1(a)(1).
[43] Prop. Treas. Reg. § 301.6622-1(a)(2).
[44] Prop. Treas. Reg. § 301.6622-1(a)(5) Ex. 6.
[45] I.R.C. § 6222(b); Prop. Treas. Reg. § 301.6622-1(b)(2).
[46] I.R.C. § 6222(c)(2).
[47] I.R.C. § 6222(c)(1); Prop. Treas. Reg. § 301.6622-1(c)(1).
[48] Prop. Treas. Reg. § 301.6622-1(b)(1).
[49] Prop. Treas. Reg. §§ 301.6622-1(c)(1),(3).
[50] Prop. Treas. Reg. § 301.6622-1(a)(3).
[51] Prop. Treas. Reg. § 301.6622-1(c)(2).
[52] *Id.*
[53] Prop. Treas. Reg. § 301.6622-1(c)(4)(ii)
[54] Prop. Treas. Reg. § 301.6622-1(d)(1)(i).

writing within 60 days of receiving notice of the inconsistency.[55] If a treatment on a Schedule K-1 is unclear, upon audit the partner may file a statement of inconsistent position and explain why the partner's treatment is consistent with the schedule provided by the partnership.[56]

### *C. BBA Tax Audits Occur at the Partnership Level, Are Managed Solely by the Partner Representative, and Bind All Partners to the Audit Results; I.R.C. § 6223.*

Each partnership must designate either a partner or any other person with a substantial presence in the U.S. as its PR.[57] The PR has the sole authority to act on behalf of the partnership with respect to an audit by the IRS.[58] The actions of the PR as well as any final decision in a proceeding with respect to the partnership are binding on the partnership, all partners in the partnership, and all other persons whose tax liability is directly or indirectly determined by the IRS' decision.[59] The IRS may select the PR if the partnership does not.[60] There may be only one PR for each partnership taxable year; however, the PR may resign, be removed by the partnership in accordance with the terms of a partnership agreement, and replaced at the beginning of an audit or on filing an Administrative Adjustment Request (AAR).[61] Any person[62] with a substantial presence in the U.S., who is available to meet in person with the IRS, has a U.S. street address and telephone number, and U.S. taxpayer identification number may be a PR.[63] The partnership must designate a PR separately for each tax year.[64] A PR may resign by notifying the partnership and the IRS in writing of the resignation and may include designation of a successor PR with the resignation.[65] If no successor PR is named, the partnership will have an opportunity to designate the successor PR.[66]

An entity (such as an accounting or law firm) may be a PR only if the entity, in consultation with the partnership, appoints a single person to act for that entity as the entity partnership representative (EPR) for all purposes.[67] The EPR is appointed when the entity is designated.[68] An EPR may resign and may designate a successor, if the EPR does not, the partnership will be given an opportunity to designate a successor.[69] If the designated entity does not appoint an EPR the IRS may determine the EPR.[70]

A partnership may revoke a designation of a PR at commencement of an audit when the IRS serves a notice of administrative proceeding (NAP) on the partnership or when the partnership

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[55] Prop. Treas. Reg. §§ 301.6622-1(d)(1)(i), (ii),(d)(2)(i).
[56] Prop. Treas. Reg. § 301.6622-1(d)(2)(iii),(d)(3), Ex.
[57] I.R.C. § 6223(a).
[58] *Id.*
[59] Prop. Treas. Reg. § 301.6223-2(a). Thus partnership and all partners are bound by the actions of the PR and by any final decision in a proceeding brought with respect to the partnership; I.R.C. § 6223(b).
[60] *Id.*
[61] Prop. Treas. Reg. §§ 301.6223-1(a),(d)(2).
[62] I.R.C. § 7701(a)(1).
[63] Prop. Treas. Reg. §§ 301.6223-1(b),(2).
[64] Prop. Treas. Reg. § 301.6223-1(c),(1).
[65] Prop. Treas. Reg. § 301.6223-1(d)(1).
[66] *Id.*
[67] Prop. Treas. Reg. § 301.6223-1(b),(3)(i).
[68] Prop. Treas. Reg. §§ 301.6223-1(b),(3)(ii). The EPR is designated on the partnership return, *Id.*
[69] Prop. Treas. Reg. § 301.6223-1(d)(3).
[70] *Id.*

files an AAR.[71] During an administrative proceeding a revocation must include designation of a new PR.[72] A partnership may revoke a designation by notifying the PR and the IRS in writing and designating a successor.[73] The general partner who was a partner at the end of a tax year may sign a revocation of PR; a partner other than a general partner may sign a revocation of PR only if no general partner remains who is eligible to sign the revocation.[74] A member-manager of an LLC is treated as a general partner and a non-manager member is treated as other than a general partner.[75] If a PR is designated by the IRS, it can only be revoked by the partnership with the approval of the IRS.[76] The revocation and appointment must be made in writing, under penalties of perjury, stating that the partner is authorized to revoke the designation of PR, has provided a copy of the revocation to the PR whose designation is being revoked, and the designation of a new PR.[77] If the IRS determines there is no PR, the partnership has 30 days to select a new PR before the IRS selects one for the partnership.[78] If the IRS selects a PR, it will do so based on the majority of interest of partners, general knowledge of tax matters, administrative operation of the partnership, the person's access to partnership books and records, and whether the person is a U.S. person.[79]

Termination of a PR does not affect the validity of decisions the PR made prior to the effective date of termination.[80] Except for a partner PR, no partner or other person may participate in an examination or other proceeding involving the partnership without the permission of the IRS.[81] No state law, partnership agreement, or other agreement may limit the authority of the PR or EPR.[82] Any partner recourse against a PR must be based on breach of contractual provisions in the partnership agreement or on breach of law.

### *D. The IRS May Adjust Partnership Tax Liability and Partners' Distributive Shares of Income, Gain, Loss, Deduction, or Credits; I.R.C. § 6225.*

The IRS may adjust any tax liability including adjustments to any partners' distributive share of tax liability.[83] A partnership adjustment is any adjustment to any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof.[84] The amount of the adjustment the IRS determines to be underreported is the imputed underpayment.[85] The adjustments follow an IRS audit, negotiations between the partnership's PR and the IRS, and requests by the partnership for modification based on additional information provided by individual partner amendments to initial returns or through the PR.

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[71] Prop. Treas. Reg. §§ 301.6223-1(e)(2),(6)Ex. 1.
[72] Prop. Treas. Reg. §§ 301.6223-1(d)(1),(e)(6) Ex. 2.
[73] Prop. Treas. Reg. § 301.6223-1(e)(1). Failure to designate a successor PR makes the revocation invalid, *Id.*
[74] Prop. Treas. Reg. § 301.6223-1(e)(3)(i).
[75] Prop. Treas. Reg. § 301.6223-1(e)(3)(ii).
[76] Prop. Treas. Reg. § 301.6223-1(e)(r).
[77] Prop. Treas. Reg. § 301.6223-1(f)(1).
[78] *Id.*
[79] Prop. Treas. Reg. § 301.6223-1(f)(6).
[80] Prop. Treas. Reg. § 301.6223-2(b).
[81] Prop. Treas. Reg. § 301.6223-2(c). *See also* Prop. Treas. Reg. § 301.6223-2(d) Ex. 1-5.
[82] *Id.*
[83] I.R.C. § 6225(a);
[84] I.R.C. § 6241(2) (2018); Prop. Treas. Regs. §§ 301.6221(a)-1(b)(1),(2); Prop. Treas. Reg. §§ 301.6241-1(a)(1),(6).
[85] I.R.C. § 6225(a); I.R.C. § 6242(b)(2018). Prop. Treas. Reg. § 301.6241-1(a)(3).

Imputed underpayments are determined initially by netting all adjustments of tax items and multiplying the net amount by the highest statutory rate of tax for the reviewed year, which is the year to which the item being adjusted relates.[86] When the IRS completes its initial audit it issues a notice of proposed partnership adjustment (NOPA) based on application of the highest statutory tax rate to the amount it claims is owed by all partners.[87] The imputed underpayment is then negotiated with the PR and is determined after exchange of information, review of partner provided evidence of tax rates applicable to each individual partner, and any appeal.[88] The applicable rates of tax are applied to each partner's distributive share.[89] Adjustments that only affect partners' distributive shares are disregarded and are not netted.[90] Adjustments are taken in the adjustment year, which is the year in which a decision as to an imputed underpayment becomes final[91] and all challenges have been adjudicated and determined, either by IRS final partnership adjustment, or by final court decision.[92] Adjustments taken in the adjustment year include adjustments to partners' distributive shares even if there is no net underpayment by the partnership.[93]

Imputed underpayments are grouped into different categories and adjustments are computed for each group; they are then netted.[94] The imputed underpayment paid by the partnership is calculated by multiplying the total netted partnership adjustment by the rate of Federal income tax adjusted to reflect the applicable tax rate of different partners.[95] There are four groupings used by the IRS in its analysis, 1) reallocation grouping of distributive shares, 2) credit grouping of items that are taken as credits on a partnership return, 3) creditable expenditure grouping, and 4) a residual grouping (that can be made up of sub-groupings) of any remaining adjustments.[96]

Each partnership adjustment that reallocates the distributive share of an item from one or more partners to other partners is a separate reallocation grouping.[97] Adjustments within each grouping are netted together; they are not netted against other groupings.[98] Only positive adjustments are taken into account in calculating the total netted partnership adjustments.[99] Net non-positive adjustments in a grouping (i.e. those that do not result in an imputed underpayment) are disregarded.[100] There can be more than one imputed underpayment.[101] General imputed underpayments are computed separately from specific imputed underpayments.[102]

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[86] I.R.C. § 6225(b)(1); I.R.C. § 6225(d)(1).
[87] Prop. Treas. Reg. § 301.6225-1(a)(2).
[88] *Id.* The negotiation process proceeds through use of an Administrative Adjustment Request (AAR), discussed infra; *see* Prop. Treas. Reg. § 301.6225-2(d).
[89] I.R.C. §§ 6225(b)(3),(4). If partner distributive shares vary from item to item the portion of an imputed adjustment to which different tax rates apply is determined by assuming the distributive share of each partner when the partnership is sold at fair market value; [89] I.R.C. § 6225(c)(4)(B)
[90] I.R.C. § 6225(c)(2).
[91] Prop. Treas. Reg. § 301.6241-1(a)(1).
[92] I.R.C. § 6225(d)(2).
[93] Prop. Treas. Reg. §§ 301.6225-1(a)(3),(b); 301.6225-2(f) Ex. 3.
[94] Prop. Treas. Reg. § 301.6225-1(d)(1).
[95] Prop. Treas. Reg. §§ 301.6225-1(c)(1),(2).
[96] Prop. Treas. Reg. § 301.6225-1(d)(2)(i-v).
[97] Prop. Treas. Reg. § 301.6225-1(d)(2)(ii).
[98] Prop. Treas. Reg. § 301.6225-1(d)(e)(3)(i)
[99] Prop. Treas. Reg. § 301.6225-1(d)(e)(3)(iii).
[100] Prop. Treas. Reg. § 301.6225-1(d)(2)(ii).
[101] Prop. Treas. Reg. § 301.6225-1(e)(1)(i).
[102] Prop. Treas. Reg. § 301.6225-1(e)(2)(i). *See also* Prop. Reg. §§ 301.6225-1(f) Ex. 2,3 for illustrations.

There is only one general imputed underpayment category, calculated based on all adjustments other than specific imputed underpayment categories.[103] There can be multiple specific imputed underpayment categories, which are adjustments to items allocated to one partner or group of partners that had similar characteristics or participated in similar transactions, special allocations or allocations involving some, but not all, partners.[104]

For example, an increase of $5 above reported income and an increase of $10 above reported expenses results in a zero adjustment because the negative adjustment caused by the increase in reported expenses is ignored in netting to the extent it exceeds the increase in income.[105] When the IRS finds that income reported as long term capital gain is actually ordinary income tax, liability increases by the full amount of the tax rate multiplied by ordinary income.[106] Because the decrease in capital gain was a non-positive adjustment in a separate category from the increase in ordinary income, only the increase in ordinary income, a net positive adjustment is counted.[107] Negative adjustments resulting in lower tax liability may be reflected in an audit only if they are in the same category as positive adjustments and only to the extent they offset positive adjustments. If the statute of limitations has not run, pursuant to an audit, partners may file amended returns to take advantage of reductions in tax liability found by the IRS and not reflected in the final partnership adjustment.[108]

A partnership may request one or more modifications of a proposed imputed underpayments set forth in a NOPA[109] as a result of 1) individual partner amended returns accompanied by full payment or requesting a refund[110] 2) modification with respect to a tax exempt partner,[111] 3) modifications based on a tax rate lower than the highest applicable tax rate, such as substituting a corporate tax rate for a personal tax rate,[112] 4) tax treatment of passive losses of publicly traded partnerships, [113] 5) modification of the number and composition of imputed underpayments,[114] 6) partnerships with partners that are qualified investment entities[115] describing treatment of underpayment as deficiency dividends,[116] 7) Partner closing agreements for which payment was made that have been entered into with the IRS,[117] and 8) modifications not otherwise described that the partnership requests and to which the IRS agrees.[118]

A tax rate modification reduces the tax rate applied that is used to calculate the total netted partnership adjustment with respect to an imputed underpayment.[119] Other modifications are treated as rate modifications if they affect the rate applied to a partnership adjustment.[120] To

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[103] Prop. Treas. Reg. § 301.6225-1(e)(2)(ii).
[104] Prop. Treas. Reg. § 301.6225-1(e)(2)(iii).
[105] Prop. Treas. Reg. § 301.6225-1(f) Ex. 1.
[106] Prop. Treas. Reg. § 301.6225-1(f) Ex. 4.
[107] *Id.*
[108] Prop. Treas. Reg. § 301.6225-2(d)(2)(v)(A). It may be after the statute of limitations has run if it relates to adjustments in a partnership imputed underpayment, *see* Prop. Treas. Reg. § 301.6225-2(d)(2)(v)(B).
[109] Prop. Treas. Reg. § 301.6225-2(a).
[110] Prop. Treas. Reg. §§ 301.6225-2(d)(2).
[111] Prop. Treas. Reg. § 301.6225-2(d)(3).
[112] Prop. Treas. Reg. § 301.6225-2(d)(4).
[113] Prop. Treas. Reg. § 301.6225-2(d)(5).
[114] Prop. Treas. Reg. § 301.6225-2(d)(6).
[115] Under I.R.C. § 860.
[116] Prop. Treas. Reg. § 301.6225-2(d)(7).
[117] Prop. Treas. Reg. § 301.6225-2(d)(8).
[118] Prop. Treas. Reg. § 301.6225-2(d)(9).
[119] Prop. Treas. Reg. § 301.6225-2(b)(3).
[120] *Id.*

determine the modification, each partner's distributive share of the imputed underpayment is identified, the applicable tax rate for that partner to the partner's distributive share is computed, and individual adjustments are summed.[121] If special allocations are altered by the imputed underpayment determination, the adjustment is determined by calculating the amount of gain or loss reflecting each partner's distributive share after adjustment that would have resulted if the partnership had sold all of its assets at their fair market value at the close of the reviewed year.[122]

Taxpayer requests for modification must be submitted in accordance with the applicable IRS forms and instructions.[123] Each submission must state and substantiate the facts supporting the request in accordance with the requirements the IRS provides based on the applicable specific facts and circumstances.[124] The information required can include a detailed description of the structure, allocations, ownership and ownership changes of each of its direct, indirect, and pass through partners as well as the terms of the partnership agreement for each tax year.[125] The modification request must be filed within 270 days after the mailing date of the NOPPA unless the IRS agrees to extend the period or it is waived by mutual agreement.[126]

A partnership takes adjustments that do not result in an imputed underpayment into account in the adjustment year, generally as a reduction in non-separately stated income or loss.[127] Separately stated items[128] are taken into account by the partnership as a reduction or increase.[129] Adjustments to credits are taken into account as separately stated items.[130] If a reallocation adjustment among partners does not result in an imputed underpayment it is handled[131] as a separately or non-separately stated item.[132] If a reviewed year partner is not an adjustment year partner the adjustment is allocated to the successor of the reviewed year partner if identifiable; if not, for example, if the interest was sold back to the partnership, it is allocated among the remaining partners.[133] However, if the partnership elects to push payment out to the individual partners,[134] then the reviewed year partners take the adjustments into account individually in the adjustment year rather than pursuant to the provisions of I.R.C. § 6225.[135]

### *E. Each Partnership May Push Out of Payment of Imputed Underpayments to Reviewed Year Partners; I.R.C. § 6226.*

Within 45 days of a notice of final partnership adjustment the partnership may notify the IRS and all partners for the reviewed year that each reviewed year partner will have to pay the

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[121] Prop. Treas. Reg. § 301.6225-2(b)(3)(iii).
[122] Prop. Treas. Reg. § 301.6225-2(b)(3)(iv).
[123] Prop. Treas. Reg. § 301.6225-2(c)(1).
[124] Prop. Treas. Reg. § 301.6225-2(c)(2)(i).
[125] Prop. Treas. Reg. § 301.6225-2(c)(2)(ii).
[126] Prop. Treas. Reg. § 301.6225-2(c)(3).
[127] Prop. Treas. Reg. §§ 301.6225-3(a), (b)(1).
[128] Under I.R.C. § 702.
[129] Prop. Treas. Reg. § 301.6225-3(b)(2).
[130] Prop. Treas. Reg. § 301.6225-3(b)(3).
[131] In accordance with the provisions of I.R.C. § 702
[132] Prop. Treas. Reg. § 301.6225-3(b)(4).
[133] *Id.*
[134] Pursuant to I.R.C. § 6226.
[135] The adjustment is taken into account in accordance with Prop. Treas. Reg. § 301.6226-3 rather than in accordance with Prop. Treas. Reg. § 301.6225-3(a),(b); Prop. Treas. Reg. § 301.6225-3(b)(6).

partner's distributive share of the final partnership adjustment.[136] If the partnership appeals the imputed underpayment to court it must still make the election to push out to reviewed year partners the payment of the assessment within 45 days of the mailing date of the final partnership assessment.[137] The partnership making the election "furnishes to each partner of the partnership for the reviewed year and to the Secretary [i.e. the IRS] 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)… ."[138] Once made, the election may only be revoked with consent of the IRS.[139]

Each reviewed year partner pays the tax in the taxable year which includes the date the statement of final adjustment is issued.[140] The additional taxes due include the amount that tax would have increased in the reviewed year and in subsequent years affected by the change in taxes for the reviewed year.[141] The partners are also liable for penalties and interest.[142] Interest is determined at the partner level from the due date for the reviewed year of the underpayment at the rate determined in I.R.C. § 6621(a)(2) (the short term Federal funds rate) plus 5 percent instead of 3 percent otherwise required by that provision.[143]

If the IRS issues more than one imputed underpayment,[144] the partnership may elect to push out to partners one or all of the imputed underpayments assessed.[145] The election, the individual partners become obligated to take into account their share of partnership adjustments, including penalties and interest.[146] If the partnership makes the election, the individual partners, rather than the partnership itself, become liable for payment of both their share of partnership liabilities and liabilities allocated to individual partners.[147] The election must be signed by the PR and include; 1) the name and Taxpayer Identification Number (TIN) of the partnership, 2) the taxable year to which the election relates, 3) a copy of the final partnership adjustment or adjustments and to which the alternate payment request applies, 4) each reviewed year partner's name, address, and correct TIN, and 5) other information requested on applicable IRS forms.[148] Each partner's allocable share of the partnership imputed underpayment is binding on the partner.[149]

A partnership pushing out payment to the partners must provide notice to each reviewed year partner and copy the IRS in a statement separate from partner K-1 adjustments or other statements that identifies each partner's share of partnership adjustments with respect to the imputed underpayment for each reviewed year.[150] The statements must be provided within 60 days of the later of the expiration of the time to file a petition for court review or the date of the court's final decision.[151] The partnership must be reasonably diligent in trying to locate the

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[136] I.R.C. § 6226(a)(1); Prop. Treas. Reg. § 301.6226-1(c)(3).
[137] Prop. Treas. Reg. § 301.6226-1(e).
[138] I.R.C. § 6226(a)(2).
[139] *Id.*
[140] I.R.C. § 6226(b)(1).
[141] I.R.C. §§ 6226(b)(2),(3).
[142] I.R.C. §§ 6226(c)(1),(2).
[143] I.R.C. § 6226(c)(2).
[144] See Prop. Treas. Reg. § 301.6225-1(e).
[145] Prop. Treas. Reg. § 301.6226-1(a).
[146] Prop. Treas. Reg. § 301.6226-1(c)(1).
[147] Prop. Treas. Reg. § 301.6226-1(c)(2).
[148] Prop. Treas. Reg. § 301.6226-1(c)(4).
[149] Prop. Treas. Reg. § 301.6226-1(d).
[150] Prop. Treas. Reg. § 301.6226-2(a).
[151] Prop. Treas. Reg. § 301.6226-2(b)(1).

correct address of each reviewed year partner if a statement sent to the partner's last known address is returned as undeliverable.[152] If the partnership makes an error in a statement provided it may provide a corrected statement to the partner with a copy to the IRS.[153] If the error is found within the 60 day period correction is made automatically; however, if the correction is found after the 60 day period the IRS must approve issue of the corrected statement or statements.[154] If the error is discovered by the IRS, it may require the partnership to provide corrected statements.[155] The statements to partners (and the IRS) must include: 1) partner name and TIN, 2) current or last known address, 3) share of items as originally reported for the reviewed year, 4) share of partnership adjustments, 5) modifications applicable to reviewed year partner, 6) amounts attributable to adjustments of tax attributes for any intervening year resulting from adjustments in the reviewed year, 7) penalties, additions to tax, or other additional amounts, 8) safe harbor amount, and, if applicable, interest safe harbor amount, 9) date statement is furnished, 10) partnership taxable year to which the adjustments relate, and 11) any other information the IRS specifies.[156] Generally, the adjustments are reported to each reviewed year partner in the same manner as each adjusted item was originally allocated to the reviewed year partner.[157] If the item was not previously reported on the partnership return, it is reported as it would have been reported if included.[158] If an adjustment involves a specific allocation "to a specific partner or in a specific manner" is determined by the determination that makes the specific adjustment.[159]

The regulations state, "[i]f the reviewed year partner filed an amended return ... or entered into a closing agreement ... and the imputed underpayment ... was determined without regard to the adjusted items in the amended return or in the closing agreement, such adjustments are disregarded for purposes of determining each reviewed year partners share of the adjustments under paragraph (f)(1) of this section." The regulations continue by stating, "[h]owever, these modifications are listed separately on the statements described in paragraph (a) [addressing the statements required by paragraphs (e) and (f) of § 301.6226-2] of this section."[160] It is not clear from this language whether the closing agreement exempts the partner from further obligations or the adjustments are offsets to any adjustment otherwise required by the underpayment. Penalties and additions to tax are reported to reviewed year partners in the same proportion as each partner's share of the adjustment itself.[161]

The partnership is required to calculate a safe harbor amount of not less than zero for each reviewed year partner.[162] The regulations state, "[t]he safe harbor amount ...is calculated in the same manner as the imputed underpayment under § 301.6225-1 except that each reviewed year partner's share of the partnership adjustments on the statement...are substituted as the partnership adjustments taken into account for purposes of determining the imputed

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[152] Prop. Treas. Reg. § 301.6226-2(b)(2). *See also* Prop. Treas. Reg. § 301.6226-2(c), Ex. 1, 2.
[153] Prop. Treas. Reg. § 301.6226-2(d)(1).
[154] Prop. Treas. Reg. § 301.6226-2(d)(2).
[155] Prop. Treas. Reg. § 301.6226-2(d)(3).
[156] Prop. Treas. Reg. § 301.6226-1(e)(1-11).
[157] Prop. Treas. Reg. § 301.6226-1(f)(1)(i).
[158] Prop. Treas. Reg. § 301.6226-1(f)(1)(ii).
[159] Prop. Treas. Reg. § 301.6226-1(f)(1)(iii).
[160] Prop. Treas. Reg. § 301.6226-1(f)(2).
[161] Prop. Treas. Reg. § 301.6226-1(f)(3).
[162] Prop. Treas. Reg. § 301.6226-1(g)(1).

underpayment under § 301.6225-1."[163] Any partner's amended return or closing agreement and imputed underpayment to which Prop. Treas. Reg. § 301.6226-1 applies is determined without regard to the adjustments on the amended return or closing agreement when determining a partner's safe harbor amount.[164] However, an exception is contained in the next section which states, "if the reviewed partner filed an amended return or a closing agreement and the imputed underpayment under section 6225 to which an election under § 301.6226-1 applies is determined without regard to the adjustments taken into account on the amended return or in the closing agreement, such adjustments are disregarded in determining that partner's safe harbor amount."[165] The interest safe harbor amount for individuals with calendar taxable years is calculated from the due date without extensions of the original return to the due date for the additional payment.[166] An example in the regulations illustrates that payment in an amended return is taken into account in determining the partner's remaining payment obligation.[167]

The initial tax paid by a partner is increased by any additional tax in subsequent years, penalties, and interest.[168] The additional tax is the aggregate of the adjustment amounts of the general I.R.C. § 6226 rules[169] or the safe harbor amount if the alternative simplified safe harbor election is made.[170] The correction amount for the reviewed year is the amount by which the partner's tax increases by taking into account the partnership adjustments allocated to the partner.[171] The computation corrects for any amendment to the reviewed year tax made by the partner[172] as well as any other amounts previously collected[173] and any rebates.[174] A qualified investment entity may issue deficiency dividends to its investors.[175] A reviewed year partner may elect to pay the safe harbor amount instead of computing the additional reporting year tax.[176] Interest on the amount of the correction (including penalties) is added for the time from the year or years in which an adjustment occurred until the amount is paid.[177] The interest rate is computed using the underpayment rate defined at I.R.C. § 6621(a)(2) substituting 5 percentage points above the defined rate instead of 3 percentage points found in I.R.C. § 6221(a)(2)(B). [178]

### *F. Administrative Adjustment Requests May Either Amend Previously Filed Returns or Modify Initial Tax Rates Used to Compute Underpayments; I.R.C. § 6227.*

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[163] Prop. Treas. Reg. § 301.6226-1(g)(2)(i).
[164] Prop. Treas. Reg. § 301.6226-1(g)(2)(ii)(A).
[165] Prop. Treas. Reg. § 301.6226-1(g)(2)(ii)(B).
[166] Prop. Treas. Reg. § 301.6226-1(g)(2)(iii).
[167] *See* Prop. Treas. Reg. § 301.6226-3(g) Ex. 5.
[168] Prop. Treas. Reg. § 301.6226-3(a).
[169] Under Prop. Treas. Reg. § 301.6226-3(b).
[170] Under Treas. Reg. § 301.6226-3(c).
[171] Prop. Treas. Reg. § 301.6226-3(b)(2).
[172] Prop. Treas. Reg. § 301.6226-3(b)(2)(i)(A).
[173] Prop. Treas. Reg. § 301.6226-3(b)(2)(i)(B).
[174] Prop. Treas. Reg. § 301.6226-3(b)(2)(ii).
[175] In accordance with I.R.C. § 860; Prop. Treas. Reg. § 301.6226-3(b)(4).
[176] Prop. Treas. Reg. § 301.6226-3(c).
[177] Prop. Treas. Reg. § 301.6226-3(d).
[178] Prop. Treas. Reg. § 301.6226-3(d)(4). *See also* the examples illustrating how the computations are made at Prop. Treas. Reg. § 301.6226-3(f).

Any partnership may correct errors found in an item or items of a previously filed return by filing an Administrative Adjustment Request (AAR).[179] The administrative adjustment is both determined and taken into account in the partnership taxable year in which the request is made.[180] It is computed in the same manner as adjustments paid by either the partnership[181] or by the individual partners from the reviewed year.[182] If the adjustment is a reallocation among partners that would not result in an imputed underpayment it must be pushed out to the partners.[183] "A partner may not file an AAR except if the partner is doing so on behalf of the partnership in the partner's capacity as the partnership representative...or if the partner is a partnership-partner [a partnership that holds an interest in another partner[184]] filing an AAR under § 301.6227-3(c)."[185]

The partnership must file an AAR not more than 3 years after the later of the date on which the partnership return for the requested year is filed or the last day for filing a partnership return for that year (without extension).[186] A request for administrative adjustment cannot be filed after commencement of an administrative proceeding by the IRS.[187] The AAR filed with the IRS must include the adjustments requested, any notification required to be made reviewed year partners, and any other information requested by the IRS.[188] Statements provided to partners by the partnership resulting from an AAR are binding on the partners.[189] The AAR may be adjusted along with all other components of a partnership return if the IRS subsequently commences an administrative proceeding.[190]

Whether an AAR results in an imputed underpayment[191] in the reviewed year[192] and the amount of that underpayment is determined in accordance with the rules under Prop. Treas. Reg. § 301.6225-2(d)(4).[193] Once the IRS has determined an imputed underpayment the partnership may request modification of the amount of an imputed underpayment, to adjust tax rates through, treatment of tax-exempt partners,[194] modification of the applicable tax rate,[195] treatment of specified passive activity losses,[196] and deficiency dividends for qualified investment entities.[197] any modification, 2) describe the effect of the modification on the imputed underpayment, 3)

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[179] I.R.C. § 6227(a).
[180] I.R.C. § 6227(b).
[181] I.R.C. § 6227(b)(1); *see also* Prop. Treas. Reg. § 301.6227-2(b).
[182] I.R.C. § 6227(b)(2); *see also* Prop. Treas. Reg. § 301.6227-2(c). If treatment under I.R.C. § 6226 is elected, the increase in markup over the § 6621 interest rate remains at 3 percent instead of rising to 5 percent; I.R.C. § 6226(b)(2).
[183] I.R.C. § 6227(b)(2); *see also* Prop. Treas. Regs. §§ 301.6227-3; 301.6241-1(a)(9).
[184] Prop. Treas. Reg. § 301.6241-1(a)(7).
[185] Prop. Treas. Reg. § 301.6227-3(a).
[186] I.R.C. § 6227(c); *see also* Prop. Treas. Reg. § 301.6227-1(b).
[187] *Id.*
[188] Prop. Treas. Reg. § 301.6227-1(c)(2); Prop. Treas. Reg. § 301.6227-1(d). The notices to partners must also be provided to the IRS and must include the contents generally required in notices to partners and stated in Prop. Treas. Reg. § 301.6227-1(e).
[189] Prop. Treas. Reg. § 301.6227-1(f).
[190] Prop. Treas. Reg. § 301.6227-1(g).
[191] Defined at Prop. Treas. Reg. § 301.6241-1(a)(3).
[192] Defined at Prop. Treas. Reg. § 301.6241-1(a)(8).
[193] Prop. Treas. Reg. § 301.6227-2(a)(1).
[194] Prop. Treas. Reg. § 301.6225-2(d)(3).
[195] Prop. Treas. Reg. § 301.6225-2(d)(4).
[196] Prop. Treas. Reg. § 301.6225-2(d)(5).
[197] Prop. Treas. Reg. §§ 301.6225-2(d)(7); 301.6227-2(a)(2).

explain the basis of the modification, and 4) provide documentation to support eligibility for the modification.[198] Whether adjustments result in an imputed underpayment or not the partnership must provide new statements to each partner and provide copies of the statements to the IRS.[199]

Payment to the IRS is due on the date adjustments are requested[200] unless the partnership elects to push payment out to the reviewed year partners.[201] If the election to push payments out to partners is made, each partner pays its share of the adjustments requested in the imputed underpayment resulting from the adjustment requested in the AAR.[202] The additional tax is paid on the due date in the reporting year.[203] If the partner is entitled to a refund because of an overpayment, the partner must file for it in a refund proceeding.[204]

### *G. Rules Applicable To Notice of Proceedings and Notice of Adjustments; I.R.C § 6231.*

To initiate an audit the IRS provides the partnership and its PR a notice of administrative proceeding at the partnership level with respect to an adjustment of any item.[205] That notice is followed by a notice of proposed partnership adjustment,[206] and a notice of final partnership adjustment resulting from such proceeding.[207] The notice of final partnership adjustment can be mailed no earlier than 270 days after the notice of proposed partnership adjustment.[208] Only one notice of final partnership adjustment is permitted for a taxable year unless the IRS finds fraud, malfeasance, or misrepresentation of a material fact.[209] By agreement with the partnership a notice of final adjustment may be rescinded, in which case, no notice is deemed to have been issued.[210]

### *H. Assessment, Collection, and Payment Occurs in the Adjustment Year; I.R.C. § 6232.*

An imputed underpayment is assessed and collected with respect to the reviewed year to be paid as if it were imposed for the adjustment year.[211] If a partnership files an administrative adjustment, it is paid in the tax year at the time the request for administrative adjustment is filed.[212] No assessment, levy, or collection proceeding may be begun until 90 days after the later of issue of a notice of final adjustment, or, if the final notice is appealed, a final court decision;[213]

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[198] Prop. Treas. Reg. § 301.6227-2(a)(2)(ii)(A-D).
[199] Prop. Treas. Reg. § 301.6227-2(d).
[200] Prop. Treas. Reg. § 301.6227-2(b)(1).
[201] Prop. Treas. Reg. § 301.6227-2(c).
[202] Prop. Treas. Reg. § 301.6227-3(a).
[203] Prop. Treas. Reg. § 301.6227-3(b)(1).
[204] Prop. Treas. Reg. § 301.6227-3(b)(3) Ex. 2.
[205] I.R.C. § 6231(a)(1).
[206] I.R.C. § 6231(a)(2).
[207] I.R.C. § 6231(a)(3).
[208] *Id.*
[209] I.R.C. § 6231(b)(1). Note; however, that a notice of correction of a mathematical error is not considered a notice for this purpose, I.R.C. § 6232(d)(1)(A).
[210] I.R.C. § 6231(c).
[211] I.R.C. § 6232(a).
[212] *Id.*
[213] I.R.C. § 6232(b). A premature action by the IRS may be enjoined by a court; I.R.C. § 6232(c).

however, the partnership can waive the restriction.[214] If the partnership is notified that an adjustment to an item is required due to a mathematical or clerical error, rules similar to the rules of I.R.C. § 6213(b)(1),(2) apply.[215]

### *I. Interest and Penalties Imposed; I.R.C. § 6233.*

Interest and penalties are determined from the day after the return due date for the reviewed year and ending on the return due date on which payment must be made.[216] Penalties are "determined at the partnership level as if such partnership had been an individual subject to tax.[217] If the imputed underpayment is not paid by the due date additional interest and penalties accrue on the unpaid tax in the adjustment year.[218] Penalties are determined in accordance with I.R.C. § 6651(a)(2), which treats the penalty as an underpayment of tax under Chapter 68, Part II, subchapter A.[219]

### *J. Partnership Judicial Review of Final IRS Adjustment; I.R.C. § 6234.*

Within 90 days after the date on which a notice of final partnership adjustment is mailed, the partnership may file a petition for adjustment with the Tax Court, District Court of the United States for the district of the partnership's principal place of business, or Court of Federal Claims.[220] The partnership must deposit the amount of the underpayment with the IRS on the date of filing a petition with the District Court or Court of Federal Claims.[221] The deposit is not treated as a payment for purposes other than chapter 67.[222] The courts have jurisdiction to determine partnership income, gain, loss, deduction, or credit, allocation among the partners, and penalties.[223] A decision from any of the three courts is appealable.[224] If a court dismisses the action, the dismissal is treated as upholding the notice of final partnership adjustment.[225]

### *K. Period of Limitations on Making Adjustments; I.R.C. §6235.*

The period of limitations on adjustments is generally 3 years from the later of the date the return was filed or the due date for the return without extensions.[226] If the imputed underpayment is modified by the partnership filing an AAR to revise the return or propose a

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[214] I.R.C. § 6232(d)(2).
[215] I.R.C. § 6232(d)(1)(A). A partnership is a partner in another partnership, failure to comply with a final notice or final court decision is treated as a mathematical or clerical error for collection purposes to which I.R.C. § 6213(a)(2) does not apply; § I.R.C. § 6232(d)(1)(B).
[216] I.R.C. § 6233(a)(2).
[217] I.R.C. § 6233(a)(3).
[218] I.R.C. §§ 6233(b)(1),(2).
[219] I.R.C. § 6233(b)(3). Defenses to imposition of penalties are discussed at Prop Treas. Reg. 301.6221(a)-1(c)(1),(2). They generally follow the traditional defenses against penalties, including reasonable cause; but not reasonable cause with respect to accuracy related penalties.
[220] I.R.C. § 6234(a).
[221] I.R.C. § 6234(b)(1).
[222] I.R.C. § 6234(b)(2).
[223] I.R.C. § 6234(c)
[224] I.R.C. § 6234(d).
[225] I.R.C. § 6234(e).
[226] I.R.C. § 6235(a)(1).

change in applicable tax rates, the period of limitations extends for 270 days from any modification plus any extension requested and granted.[227] It is also extended for 270 days after the IRS issues a notice of proposed partnership adjustment.[228] The period of limitations may be extended by agreement between the IRS and the partnership.[229] If the partnership files a false or fraudulent partnership return, fails to file a return, or the IRS files a return for the partnership, an adjustment may be made at any time.[230] If there is a substantial understatement of 25 percent or more of gross income, the period of limitations is extended to 6 years.[231] If the IRS mails a notice of final partnership adjustment, the period of limitations is suspended for the period during which a court action may be brought plus 1 year.[232]

### *L. Miscellaneous Matters Addressed; I.R.C. § 6241.*

Partnership refers to any partnership required to file a tax return.[233] A partnership adjustment is any adjustment in any item or any partner's distributive share.[234] Return due date is the date prescribed for filing the partnership return for a taxable year determined without regard to extensions.[235] Payments required to be made by a partnership for underpayment of taxes are nondeductible.[236] A partnership having a principal place of business outside the U.S. is treated as located in the District of Columbia.[237]

As discussed above, if a partnership is a debtor placed in bankruptcy the running of a period of limitations for making a partnership adjustment,[238] or assessment[239] is suspended until 60 days after the suspension ends for adjustments or assessments. [240] Collection actions[241] are suspended until 6 months after the suspension ends.[242] The period of limitations extends 60 days beyond of the end of the bankruptcy suspension for purposes of seeking judicial review.[243] During a bankruptcy suspension the IRS may issue a notice of administrative proceeding, notice of partnership adjustment, notice of final partnership adjustment, demand for tax returns, or assessment of tax imputed underpayment, or notice and demand for payment of an assessment.[244]

"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."[245]

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[227] I.R.C. § 6235(a)(2).
[228] I.R.C. § 6235(a)(3).
[229] I.R.C. § 6235(b).
[230] I.R.C. §§ 6235(c)(1),(3),(4).
[231] I.R.C. § 6235(c)(3). The extension is subject to the provisions of I.R.C. § 6501(e)(1)(a).
[232] I.R.C. § 6235(d).
[233] I.R.C. § 6241(1).
[234] I.R.C. § 6241(2).
[235] I.R.C. § 6241(3).
[236] I.R.C. § 6241(4).
[237] I.R.C. § 6241(5).
[238] Under I.R.C. § 6235.
[239] Under I.R.C. § 6501.
[240] Prop. Treas. Reg. §§ 301.6241-1(a)(3); 301.6241-2(a)(1).
[241] Under I.R.C. § 6502.
[242] Prop. Treas. Reg. §§ 301.6241-1(a)(3); 301.6241-2(a)(1).
[243] Prop. Treas. Reg. § 301.6241-2(a)(3).
[244] Prop. Treas. Reg. § 301.6241-2(a)(4).
[245] I.R.C. § 6241(8).

The BBA provides that I.R.C. § 6031(b) requiring preparing a partnership return and providing the information to each partner by March 15 of the tax year has an additional provision that now provides, "Except as provided in the procedures under section 6225(c) [relating to modifying underpayments] 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."[246]

If a partnership ceases to exist, the former partners must take the partnership adjustment into account, the partnership is no longer liable for amounts resulting from a partnership adjustment.[247] The former partners are not required to take a partnership adjustment into account if they have elected to elect out of the partnership rules under I.R.C. § 6221(b), because it is under the non-BBA rules.[248] The IRS makes the determination of when a partnership ceases to exist.[249] The determination is made if the partnership terminates[250] or does not have the ability to pay any amount due (that is, the amount is not collectable).[251] Full payment of the obligation occurs when all amounts from the partnership adjustment are paid.[252] If partial payment occurs before the partnership ceases to exist the partner are only required to pay the portion not paid by the partnership.[253] If a partnership partner ceases to exist, the partners of the no longer extant partnership partners are the liable for payment.[254] If there no partners in the adjustment year, the partners during a prior year become liable.[255] The IRS may issue statements to partners or former partners of a partnership that does not issue statements.[256]

No deduction is allowed for any imputed underpayment, penalty payment, or interest required; it is treated instead as an expenditure of the partnership.[257]

## III. PROVISIONS THAT SHOULD BE CONSIDERED IN PARTNERSHIP AGREEMENTS TO ADDRESS THE BBA AUDIT PROVISIONS.

### A. *Partnership Agreement Provisions Related to Opting Out of the BBA Partnership Audit Regulations; I.R.C. § 6221.*

The partnership agreement should first address is whether it is eligible to elect out of the centralized audit provisions of the BBA regulations.[258] If so, the partnership agreement should provide a mechanism with which to decide whether it chooses to do so or specify that it will do so. If the BBA provisions do not apply, the IRS must audit each partner individually, rather than just auditing the partnership and imposing any resulting imputed underpayment against it.[259]

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[246] I.R.C. § 6241(e).
[247] Prop. Treas. Reg. §§ 301.6241-3(a)(1),(2).
[248] Prop. Treas. Reg. § 301.6241-3(a)(3).
[249] Prop. Treas. Reg. § 301.6241-3(b)(1).
[250] Pursuant to I.R.C. § 708(b)(1)(a).
[251] Prop. Treas. Reg. § 301.6241-3(b)(2).
[252] Prop. Treas. Reg. § 301.6241-3(c)(1).
[253] Prop. Treas. Reg. § 301.6241-3(c)(2).
[254] Prop. Treas. Reg. § 301.6241-3(d)(1).
[255] Prop. Treas. Reg. § 301.6241-3(d)(2).
[256] Prop. Treas. Reg. § 301.6241-3(e).
[257] Prop. Treas. Reg. § 301.6241-4(a).
[258] Pursuant to I.RS.C. § 6221.
[259] *See* I.R.C. § 6501.

Many partners may be unfamiliar with the BBA audit rules, thus, the agreement should explain that under the BBA rules, the partnership is audited, imputed underpayments are imposed on the partnership, and partners are bound by the result unless they elect out of the BBA procedures. The explanation should be followed by the provisions for opting out, including imposition of limits on the number of partners, on who can be a partner, and on transfers of partnership interests that preserve the partnership's right elect out. Provisions to be considered if opting out is an option follow.

1. Agreement Restrictions on Who Can Be a Partner.

If the partnership wants to elect out of the BBA requirements the agreement should include a provision that restricts ownership of partnership interests to only those who would not disqualify the partnership from electing out.[260] The agreement should limit partnership to individuals, C corporations, domestic partnerships and LLCs, S corporations, the estate of a deceased partner, and foreign entities that would be classified as a C corporation if domestic.[261] Trusts, disregarded entities, including single member LLCs,[262] a nominee for another, or an estate of a deceased person other than a deceased partner are ineligible and disqualify the partnership from electing out so the agreement should prohibit such entities from becoming or being partners.[263] Since a foreign entity is an eligible entity only if it would be treated as a C corporation if it were a domestic entity,[264] the agreement should require that a foreign entity may be partner only if it qualifies as an association taxable as a per se corporation,[265] a corporation by default,[266] or a corporation by election and makes the election.[267]

Restrictions on who can be a partner (to prevent partners who would disqualify the partnership) must be accompanied by a provision restricting sale of a partnership interest to prospective partners who would not disqualify the partnership from opting out. Restricting sales of partnership interests to other partners or to the partnership itself, and to prospective partners previously approved by the partnership is an essential provision if the partnership wants to be able to elect out.

2. **Restrictions on the Number of Partners**

The number of partnership statements must be limited to 100 or fewer to preserve the partnership's right to elect out.[268] Since a sale of an interest to a new partner results in issue of two statements, as does issue of statements to a deceased partner of part of a year and the partner's estate for the remainder, as the number of partners approaches 100, the likelihood of disqualification increases. If an S corporation is a partner, all of its shareholders are counted in determining the number of statements issued. To keep the number of statements issued, the partnership must have a mechanism that restricts the number of shareholders an S corporation

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[260] *See* I.R.C. § 6221(b)(1).
[261] *Id.*
[262] Described in Treas. Reg. § 301.7701-2(c)(2)(i).
[263] Prop. Treas. Reg. § 301.6221(b)-2(b)(3)(ii).
[264] Prop. Treas. Reg. § 301.6621(b)-2(b)(3)(iii).
[265] Treas. Reg. § 301.7701-2(b)(1),(3)-(8).
[266] Treas. Reg. § 301.7701-3(b)(2)(i)(B).
[267] Treas. Reg. § 301.7701-3(c).
[268] I.R.C. § 6221(b)(1).

partner may have.[269] The agreement should also require the S corporation to include the limitation on number of shareholders in its own bi-laws and require the S corporation to provide and evidence of the restriction as a condition of being a partner.[270] Enforcement problems may make such provisions ineffective. The Agreement should explain that the partnership cannot issue more than 100 K-1 statements to be eligible to elect out.[271]

Both the selling partner and the purchasing partner receive statements for the tax year,[272] as does a deceased partner and his or her estate.[273] Avoiding disqualification from opting out effectively requires that the number of partners be kept below 100. In addition, the right of a partner to sell an interest in the partnership to other than the partnership or another existing partner must be regulated to assure sale does not cause more than 100 schedules to be issued. This can be accomplished by 1) imposing limits on partnership sales to other than the partnership or another partner, 2) limiting the number of sales to other than the partnership in a tax year, 3) keeping the number of partners sufficiently below 100 to allow for voluntary sales and involuntary increase in number of statements, and 4) placing restrictions on to whom sales may be made to only qualified purchasers and S corporations meeting the number of statements restrictions and the constraints discussed above. Alternatively, a provision requiring all sales of partnership interests to the partnership could also prevent issue of one too many statements. The partnership agreement should include notification requirements to the IRS and to each partner that reflect the restrictions and comply with IRS notification rules. A partnership that is a partner in another partnership that has not elected out is bound by the partnership level determination of imputed underpayments[274] as its other partners are. A partnership electing out that is a partner in a partnership not electing out should disclose that limitation in its partnership agreement.[275]

### *B. Partnership Agreement Provisions Describing Binding Results of Partnership Audits on Partners and the Limitations on Partner Participation; I.R.C. § 6222.*

The partnership agreement should summarize the BBA statutory requirements; 1) the partnership itself, and all partners, are responsible for any failure of the partnership to pay any imputed underpayment, 2) only the PR may participate in the audit to determine partnership and partner tax liabilities,[276] 3) the partnership will resolve the amount of any imputed underpayment and resulting additional tax liability and pay it in the year of resolution or push payment out to reviewed year partners for payment in the year the amount is resolved, and 4)) every partner must file his or her tax return consistently with the terms of the partnership's return.[277] Including the provisions helps define partner rights and obligations concerning the audit process. Putting them on notice of both limits on participation in audits and limits on taking inconsistent positions minimizes costs associated with partners taking inconsistent positions on their returns.

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[269] *See* Prop Treas. Reg. § 301.6221-2(b)(2)(iii).
[270] I.R.C. § 6221(b).
[271] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(ii).
[272] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 3.
[273] Prop. Treas. Reg. § 301.6221(b)-2(b)(2)(iii), Ex. 5.
[274] The amount of the adjustment determined to be underreported is the imputed underpayment, I.R.C. § 6225(a); I.R.C. § 6242(b)(2018). Prop. Treas. Reg. § 301.6241-1(a)(3).
[275] Prop. Treas. Reg. § 301.6622-1(a)(2).
[276] I.R.C. §§ 6222(a),(c).
[277] *See* Prop. Treas. Reg. § 301.6622-1(b)(c) with respect to notices of inconsistent treatment.

Partnership liability for actions in tax audits is also minimized by including provisions providing for advance notification of partners by the partnership of positions to be taken before the IRS and opportunity for each partner to address disagreements with the PR before the partnership files its return and before the PR provides responds to an IRS NOPA. The agreement should require each partner to promptly notify the partnership of any error in any proposed partnership return or other communication with the IRS. The partnership may also want to consider a provision imposing on any partner who files inconsistently any additional audit cost to the partnership associated with the partner doing so. Partners should be required to provide notification to the partnership as well as to the IRS if, notwithstanding provisions requiring consistent tax treatment, a partner files a notice of inconsistent treatment of any item.[278]

### *C. Agreement Provisions Addressing Selection and Removal of the PR, The PR's Responsibilities to the Partners, and Partner Direction of the PR; IRC § 6223.*

A partnership agreement should specify how the PR will be chosen as well as whether the PR will be a partner, an outside tax professional, or an EPR in an accounting firm.[279] The agreement should specify what qualifications the PR should possess, for example, have tax preparation and audit experience, be a tax accountant, or a tax attorney. The agreement should identify any additional tax expertise the partnership or PR may employ to provide assistance. The agreement can provide that the PR will be elected by agreement of the partners, chosen by a managing partner, or will be an EPR from an accounting firm selected by the partnership or managing partner.[280] The partnership agreement may impose obligations on the PR, as a condition of taking the position, to review proposed positions on tax returns and in IRS audits with partners or partnership managers before taking them. Since the statute does not permit contract or state law limits on PR actions before the IRS,[281] the agreement should identify terms to be included in the partnership's contract with the PR, particularly if the PR is an EPR from an outside firm.

The partnership agreement should identify the grounds for removal and replacement of a PR. If a PR resigns or has to be replaced the agreement should explain how the partnership will select the replacement PR. The obligations of a PR resigning or being replaced should be specified in the partnership agreement and in the contract with the PR. The partnership should identify the procedures the IRS imposes in its forms and regulations for partnership audit, replacing the PR so partners understand the rules and restrictions in the IRS regulations.[282]

While the partnership agreement cannot alter or undo whatever agreement the PR reaches with the IRS, the partnership may include in its contract with the PR restrictions on the PR's actions, violations of which are made actionable for breach of contract against the PR. The partnership agreement should require that the partnership contract with the PR, make the PR a fiduciary, require the PR not to discriminate among partners to the extent that such non-discrimination is consistent with the PR's overall responsibility to the partnership and is permitted by the IRS. The partnership may also negotiate for indemnification of the partnership against errors caused by the PR's active or passive negligence in dealing with the IRS.

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[278] *Id.*

[279] I.R.C. § 6223(a); Prop. Reg. § 301.6223-2(a).

[280] Prop. Treas. Reg. §§ 301.6223-1(c),(1),(d)(1) .

[281] See Prop. Treas. Reg.§301.6223-1(a).

[282] See Prop. Treas. Reg.§301.6223-1(b).

### *D. Agreement Provisions Addressing Whether the Partnership or Reviewed Year Partners Pay Imputed Underpayments; I.R.C. §§ 6225 and 6226.*

Whether partnership itself or the reviewed year partners be liable for additional taxes identified in an imputed underpayment (whether or not they liquidated their partnership interest before the adjustment year) or the partnership should be liable for those taxes should be the subject of a provision in the partnership agreement. Pushing out payment of imputed underpayments to reviewed year partners addresses problems associated with transfers of ownership that occur between filing reviewed year tax returns IRS audits resulting in additional taxes in the adjustment year. If taxes are not pushed out to reviewed year partners does the selling partner remain liable for additional taxes due and any reallocation of tax liability among partners, or does the purchasing partner assume those liabilities as a condition of purchasing the partnership interest? Whether payment is pushed out to reviewed year partners or not the partnership agreement should address the interaction between 1) individual partner distributive shares,[283] 2) distribution of partnership tax liabilities when distributive shares are reallocated (which must be pushed out to reviewed year partners under IRS rules),[284] and 3) liabilities of adjustment year partners when the partners are different from the reviewed year partners.[285] The partnership agreement should explain what partners are liable for the partnership's payment of imputed underpayments since one of the factors the IRS looks at with respect to liability for imputed underpayments is the partnership agreement.[286] The agreement should explain whether the partnership will impose on reviewed year partners the obligation to pay imputed underpayments even if the partnership must initial pay them, or it may pay the additional taxes itself in the adjustment year and impose the burden on adjustment year partners.[287] Adjustments among partners must always be pushed out to the individual reviewed year partners under the BBA.[288]

If the partnership decides not to push out payments to reviewed year partners, the partnership agreement should require that partners selling their interest enter into an indemnity requirement with the partnership, under which either the buyers agree to be obligated to pay the former partner's share of assessments or the seller agrees to remain liable for imputed underpayments applicable to years when the seller was a partner.[289] Any selling partner's indemnity to a buying partner could be guaranteed by a bond that survives sale of a partnership interest. Alternatively, the partnership agreement could specifically require those purchasing a partnership interest to assume liability for their share of imputed underpayments and AARs the partnership pays. The partnership agreement should explain in detail the how additional payments resulting from imputed underpayments and AARs will be made.[290]

The partnership agreement should describe the procedures, reference the code provisions related to those procedures, and specify that partners agree to be bound by the terms of the procedure. Specific contracts with each partner specifying the obligations should be considered,

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[283] Prop. Treas. Reg. §§ 301.6225-2(b)(3)(i-iv).
[284] I.R.C. § 6227(b)(2); *see also* Prop. Treas. Regs. §§ 301.6227-3; 301.6241-1(a)(9).
[285] *Id. See also* Prop. Treas. Reg. §§ 301.6225-3(a), (b)(1).
[286] *See* Prop. Treas. Reg. § 301.6225-2(c)(2)(ii).
[287] *See* I.R.C. § 6226(a)(1).
[288] I.R.C. § 6227(b)(2).
[289] I.R.C. §§ 6226(a)(2),(b)(1).
[290] I.R.C. §§ 6226(b)(2),(3).

even if the partnership agreement is structured to elect out of the BBA regulations[291] a description of the default rules applicable if the partnership finds it cannot elect out should be included so all partners are placed on notice of potential continuing liabilities.

A partnership provision providing that imputed underpayments and AAR payments will be pushed out to reviewed year partners simplifies the process considerably, even though the partnership remains secondarily liable.[292] The partnership agreement should also address the increase in the interest rate imposed when payment is pushed out to reviewed year partners to avoid misunderstandings as to the additional cost associated with pushing out payment.[293]

### *E. Partnership Agreements Should Address How Stand Alone Administrative Adjustments and Administrative Adjustments in Response to a NOPA Are Handled; I.R.C. § 6227.*

Under the BBA Rules only the partnership through its PR may amend a partnership tax return.[294] Since partners must normally file personal returns consistently with the contents of the partnership return, errors must generally be corrected by the partnership.[295] The partnership agreement should address partners' rights to demand the partnership and its PR file an AAR to correct errors both affecting the partnership return and reflecting an individual partner's return. The AAR for such changes must occur before the IRS issues a NOPA (or as an adjustment pursuant to a NOPA).[296]

Because the IRS applies the highest tax rates to underpayments identified in a NOPA and shifts the burden to the partnership to identify whatever lower rates are applicable to specific partners, a provision is needed to in the partnership agreement that explains how to identify and document the tax rates applicable to each partner so the partnership can file an AAR to secure the reduced rates.[297] The partnership provision must explain how to secure from the partners the necessary information on tax rates and necessary documentation applicable to each partner's specific tax situation to minimize partnership (and often partner) tax liability.[298] It is unclear whether or how a partner or the partnership can file an AAR to reflect the actual tax rate applicable to the partner, as opposed to identifying the highest tax rate, personal, corporate, or capital that is applicable. The partnership agreement should provide a process the partnership must go through and the data required of each individual partner. Even if the partnership pushes out tax liability to individual reviewed year partners the partnership must go through the process to complete the audit and to secure the amounts of additional tax and tax rates the individual partners must pay.[299] With respect to locating partners and former partners the partnership agreement should require partners to keep the partnership informed of how they can be contacted after liquidating a partnership interest to meet the "reasonable effort to locate" requirement of the regulations.[300]

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[291] Under either I.R.C. § 6221, or § 6225.
[292] Under I.R.C. § 6226.
[293] I.R.C. § 6226(c)(2).
[294] Prop. Treas. Reg. § 301.6227-3(a).
[295] I.R.C. § 6222(a).
[296] *Id.*
[297] For initial tax rate determination see I.R.C. § 6225(b)(1); I.R.C. § 6225(d)(1).
[298] Pursuant to I.R.C. § 6226.
[299] I.R.C. §§ 6221, 6227; Prop. Treas. Regs. §§ 301.6227-1-3.
[300] Prop. Treas. Reg. § 301.6226-1-3.

### *F. Refunds to Partners.*

It is clear that "§ 301.6227-3(b)(2) allows the reviewed year partner to claim a refund where the partnership incorrectly allocated items from the partnership in the reviewed year and provides that when a partner (other than a pass-through partner) takes into account adjustments requested in an AAR, and those adjustments result in a decrease in tax, the partner may use that decrease to reduce the partner's chapter 1 tax for the taxable year which includes the date the statement was furnished to the partner (reporting year), and may make a claim for refund of any overpayment that results.[301] What is not completely clear is whether a taxpayer or a PR can request a refund through an AAR or otherwise for any other reduction in taxes identified in the audit process that more than offsets any increase found in an imputed underpayment.

The right of a partner (as opposed to the PR), to file an amended return presumably follows approval of a modification requested by the PR and approved by the IRS. "A reviewed year partner ... must file all amended returns required for modification under paragraph (d)(2) of this section with the IRS. ... . [T]he partnership representative provides to the IRS in the form and manner prescribed by the IRS an affidavit from the partner ... that each amended return required to be filed under paragraph (d)(2) of this section has been filed (including the date on which such amended returns were filed) and that the full amount of tax, penalties, additions to tax, additional amounts, and interest was paid (including the date on which such amounts were paid)."[302]

"An amended return filed under ... this section claiming a refund may be filed after the expiration of period of limitations under section 6511, provided all partnership adjustments allocated to the partner (or indirect partner) filing the amended return are taken into account on such amended return, the only items reported on the amended return are items attributable to such partnership adjustments, and the partner files all required amended returns described in paragraph (d)(2)(iv) of this section."[303] This implies that a partner may file for a refund if he or she is entitled to one to correct for the inability of the partnership to include negative adjustments.

If the partnership elects to have reviewed year partners pay the imputed underpayment,[304] each reviewed year partner must take into account its share of adjustments requested in an AAR if the partnership makes an election under Prop. Treas. Reg. § 301.6227-2(c) to have its reviewed year partners take such adjustments into account with respect to such AAR.[305] "Each reviewed year partner receiving a statement ... must take into account adjustments reflected in the statement in the taxable year that includes the date the statement is furnished (reporting year) in accordance with paragraph (b) of this section."[306]

For example, suppose that in 2022, partner A, an individual, received a statement from partnership for partnership's 2020 taxable year. The only adjustment shown on the statement is an increase in ordinary losses. Taking into account the adjustment, A determines that for 2022 (the reporting year) he has a reduction of $100. A's chapter 1 tax for 2022 (without regard to any additional reporting year tax) is $150. A's chapter 1 tax for 2022 is reduced to $50 ($150 chapter

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[301] Centralized Partnership Audit Regime (REG-136118-15) 82 FR 27334, 27369 (2017).
[302] Prop. Treas. Reg.§ 301.6225-2(d)(2)(iii).
[303] Prop. Treas. Reg. 301.6225-2(d)(2)(v)(B).
[304] Prop. Treas. Rul. § 301.6227-3
[305] Prop. Treas. Reg. § 301.6227-3(a).
[306] *Id.*

1 tax without regard to the additional reporting year tax plus <$100> additional reporting year tax)."[307]

If, instead, A's chapter 1 tax for 2022 is $75, A's chapter 1 tax for 2022 is reduced by the <$100> of additional reporting year tax. Accordingly, A's chapter 1 tax for 2022 is $0 ($75 chapter 1 tax without regard to any additional reporting year tax plus <$100> of additional reporting year tax). A owes no chapter 1 tax for 2022, and A may make a claim for refund with respect to the overpayment of $25.[308] In neither case are the examples clear what tax rate is applied, the maximum in the category being taxed or the taxpayer's actual marginal rate for the year.

If the principle that the taxpayer should be placed in the position the taxpayer would have been in if the partnership and the partners filed correctly initially, each partner should be able to file for any refunds due after computing the partner's tax in accordance with the corrections identified by the IRS and the taxpayer's particular tax position. Whether this is what the IRS regulations permit remains to be clarified.[309]

## Conclusion:

The BBA and the new regulations describe a new IRS audit structure applicable to partnerships. The partnership, rather than individual partners become the focus of the audit and of payment for any imputed under payments unless the partnership elects out. Payment is made by the partnership unless the partnership pushes out payment in the year the review becomes final to the individual reviewed year partners. The process under which all of this occurs is spelled out in the regulations; however, a number of issues remain to be resolved. Additional issues will require further clarification. One hopes the IRS will be tolerant of taxpayers' good faith misunderstanding of the intent of the regulations and quick to provide clarification.

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[307] Prop Treas. Reg. § 301.6227-3(b)(3) Ex. 1.

[308] Prop Treas. Reg. § 301.6227-3(b)(3) Ex. 2.

[309] *See* Tax Section, *New York State Bar Association, Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015*, May 25, 2016.

## Appendix
## Glossary of Terms

1. Adjustment year: The taxable year in which an adjustment becomes final, either because of a court decision, an administrative adjustment request, or an un-appealed notice of final partnership adjustment.[310]
2. Adjustment year partner: Any person who held an interest in a partnership at any time during the adjustment year.[311]
3. Administrative Adjustment Request (AAR): A request filed by the PR to correct errors on a partnership return for a prior year in the amount of one or more items of income, gain, loss, deduction, credit, or distributive share of the partnership for any partnership taxable year and taken into account in the partnership taxable year in which the AAR is made.[312]
4. Entity Partnership Representative (EPR): An individual through whom the entity partnership representative acts as the designated individual.[313]
5. Imputed underpayment: The amount determined to be underreported in accordance with the regulatory provisions of Prop. Treas. Reg. § 301.6225-1.[314]
6. Indirect partner: Any person who has an interest in a partnership through their interest in one or more pass-through partners.[315]
7. Partnership Representative (PR): A partner or other person with a substantial presence in the U.S who shall have sole authority to act on behalf of the partnership in an IRS tax audit.[316]
8. Partnership adjustment: Any adjustment to any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof.[317]
9. Partnership partner: A partnership that holds an interest in another partnership.[318]
10. Pass-through partner: A pass-through entity that holds an interest in a partnership, including a partnership, a foreign entity classified as a partnership, an S corporation, a trust other than a disregarded entity or one wholly owned by one person, or an estate.[319]
11. Reviewed year: The partnership taxable year to which a partnership adjustment relates.[320]
12. Reviewed year partner: Any person who held an interest in a partnership at any time during the reviewed year.[321]

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[310] Prop. Treas. Reg. § 301.6241-1(a)(1).
[311] Prop. Treas. Reg. § 301.6241-1(a)(2).
[312] Prop. Treas. Reg. *§ 301.6227-1*
[313] Prop. Treas. Reg. § 301.6223-1(b),(3)(i).
[314] Prop. Treas. Reg. § 301.6241-1(a)(3).
[315] Prop. Treas. Reg. § 301.6241-1(a)(4).
[316] I.R.C. §§ 6223(a),(b).
[317] Prop. Treas. Reg. § 301.6241-1(a)(6).
[318] Prop. Treas. Reg. § 301.6241-1(a)(7).
[319] Prop. Treas. Reg. § 301.6241-1(a)(5).
[320] Prop. Treas. Reg. § 301.6241-1(a)(8).
[321] Prop. Treas. Reg. § 301.6241-1(a)(9).

13. Tax attribute: Anything that can affect, the amount or timing of an item of income, gain, loss, deduction, or credit of a partnership or a partner, such as basis, holding period, character of income, gain, loss, deduction, credit, carryovers or carrybacks.[322]

[322] Prop. Treas. Reg. § 301.6241-1(a)(10).

Discussion Draft:

# Getting to the "Correct Return Position" Under the Proposed June Partnership Audit Regulations

## I. Introduction:

In November, 2015, Congress repealed the Tax Equity and Fiscal Responsibility Act of 1982[1] (TEFRA) partnership audit rules and provided new partnership audit rules (also applicable to Limited Liability Companies (LLC) electing to be taxed as partnerships) effective for tax years beginning after December 31, 2017.[2] The Bipartisan Budget Act of 2015[3] and technical amendments included in the 2016 Consolidated Appropriations Act[4] (collectively BBA) rewrote the Internal Revenue Code (IRC) partnership provisions and inserted conforming amendments elsewhere in the IRC.[5] On June 13, 2017, the Internal Revenue Service (IRS) issued proposed regulations, to be used until final regulations are issued and sought comments that were due on August 14 of the same year.[6]

This paper explores partnership and partner efforts to secure tax treatment after Internal Revenue Service (IRS0 audit that produces results similar to those that would have been produced had the partnership and partners correctly computed partnership and partner tax liabilities when they initially filed their returns, the *correct return position*. At present, uncertainty about how partners may recover overpayments made to the IRS that are excluded from computation of imputed underpayments[7] represents a major bar to getting to the correct return position. This paper presents the author's views on techniques that may be implemented by partnerships, partners, or both, to get to that position. It is intended as a vehicle to stimulate thought and discussion, not as the final word on what can be done or whether doing what is outlined below will result in a dispute with the IRS.

In May, 2016, the Tax Section of the State Bar of New York issued a report on the BBA statutory provisions affecting partnership audit concluding that depending on the IRS regulations as ultimately approved, "... the way in which the imputed underpayment is computed and the fact that the computations do not take into account the interaction of the partnership-level adjustments with the individual partners' other tax attributes means that the amount collected may be materially different from the tax that the partners would have paid if they had taken the adjustments into account under the normal substantive tax rules , a position they describe as the correct return position. The New York Stat Tax Collection concluded that implementation of the

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[1] P.L. 97-248 (1982); repealed by Pub. L. 114-74 § 1101(a),(b).
[2] I.R.C. § 6241(g) (2018).
[3] Pub. L. No 114-74, §§ 1101(a), (b), (c).
[4] Pub. L. No. 114-113, Div. Q § 411.
[5] I.R.C. §§ 6221-6241 (2015).
[6] Centralized Partnership Audit Regime (REG-136118-15); 82 FR 27334; IRS-2017-0009.
[7] Prop. Treas. Reg. § 1.6225-1(c)(2)(ii); Prop. Treas. Reg. § 301.6225-1(d)(2)(ii).

BBA as drafted could result in over-collection or under-collection unless the IRS drafter rules to prevent that outcome.[8]

The New York State Bar Tax Section concluded, "[w]e believe that I.R.C. § 6225 can be implemented in a way that achieves [the goal of coming close to the Correct Return Position] ...by treating I.R.C. § 6225 as a withholding tax mechanism, similar to the regime that currently exists under I.R.C. § 1446 with respect to effectively connected taxable income of a partnership that is allocable to foreign partners ... [Withholding Tax Approach]. Under this approach, the payment by the partnership would ensure that the IRS collected an initial amount that approximates the total tax due; after the IRS had collected this initial amount, each partner would then properly take into account its share of the audit adjustments along with a credit for the corresponding amount of initial taxes paid by the partnership and settle up with the IRS by paying any additional taxes due or claiming a refund of any amount overpaid. .... If this is not what I.R.C. § 6225 means, then this procedural rule will frequently result in tax obligations that differ significantly from those provided for by the substantive rules of the Code."[9] The proposed regulations do not adopt that approach.

In comments filed on August 18, 2017 in response to the proposed rules issued by the IRS on June 13, 2017[10] the New York State Bar Tax Section implied that while the proposed regulations permit the partnership to file for some refunds, partners still could not get to the point where they would have been had they filed correctly in the first place (penalties and interest excepted). The New York State Bar Tax Section urged that the ability to do so through an Administrative Adjustment Request (AAR) should be liberalized to permit filing an AAR after receipt of a Final Partnership Adjustment.[11]

The proposed rules do not clearly provide a structure under which something close to the Correct Return Position occurs other than by chance.[12] Instead, inferences in the proposed regulations suggest how a combination of specific corrections and possible implied rights for partners to file amended returns consistent with partnership notifications may get partners close to the correct return position in at least some instances. The extent to which the current regulations offer possible approaches to reaching the correct return position are explored in this paper. Some of the approaches may require litigation to confirm whether they are valid or not.

## II. Without Partnership or Partner Adjustments, Imputed Underpayment Netting Process Can Produce Results that Differ from the Correct Return Position.

Netting all negative items against all positive items can produce an imputed underpayment that "is very different from the taxes that would be due under the Correct Return Position... ."[13]

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[8] New York State Bar Association Tax Section, *Report on the Partnership Audit Rules of the Bipartisan Budget Act of 2015*, Report No. 1347, 3-4, May 25, 2016 (hereinafter; *NY State Bar Report, May 25, 2016*).
[9] *NY State Bar Report, May 25, 2016*, 4-5.
[10] 82 FR 27334: PP. 27334-27402; REG-136118-15, June 13, 2017.
[11] New York State Bar Association Tax Section, *Report on Proposed Regulations Implementing the Centralized Partnership Audit and Collection Regime*, Aug. 18, 2017, 29-31; (hereinafter, *NY State Bar Report, Aug. 18, 2017*)
[12] *NY State Bar Report, Aug. 18, 2017*, 7-8.
[13] *NY State Bar Report, May 25, 2016*, 66.

The issue is whether the regulations provide a vehicle under which the difference can be corrected by subsequent action of the partnership or partners.

The regulations provide some guidance on negative adjustments. In general, partnership adjustments[14] that do not result in an imputed underpayment[15] are taken into account by a partnership in the adjustment year[16] in accordance with the following rules:[17]

1. A partnership adjustment that does not result in an imputed underpayment is taken into account as a reduction in non-separately stated income or as an increase in non-separately stated loss for the adjustment year depending on whether the adjustment is to an item of income or loss in accordance with the following rules:[18]

2. Separately Stated Items. If a partnership adjustment to an item that is required to be separately stated under I.R.C. § 702, the adjustment is taken into account by the partnership in the adjustment year as a reduction or as an increase in such separately stated item.[19]

3. Credits. A partnership adjustment to a credit shown on the partnership return for the reviewed year,[20] the adjustment is taken into account by the partnership in the adjustment year as a separately stated item.[21]

4. Reallocation adjustments. A partnership adjustment that does not result in an imputed underpayment[22] is taken into account by the partnership in the adjustment year as a separately stated item or a non-separately stated item, as required by I.R.C. § 702. Reallocation adjustments are allocated to adjustment year partners who are also reviewed year partners with respect to whom the amount was reallocated. If any reviewed year partner with respect to whom an amount was reallocated is not also an adjustment year partner, any adjustment that would otherwise be allocated to such reviewed year partner is allocated to that partner's successor(s) to the reviewed year partner. If the partnership cannot identify such a successor that portion of the adjustment is allocated among the adjustment year partners in accordance with their distributive shares.[23]

5. Adjustments taken into account by partners as part of the modification process. If, as part of modification,[24] a reviewed year partner (or an indirect partner[25] that holds its interest in the partnership through its interest in the reviewed year partner) takes into account an

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[14] Prop. Treas. Reg. § 301.6241-1(a)(6).
[15] Prop. Treas. Reg. § 301.6225-1(c)(2).
[16] Prop. Treas. Reg. § 301.6241-1(a)(1).
[17] Prop. Treas. Reg. § 301.6225-3(a).
[18] Prop. Treas. Reg. § 301.6225-3(b)(1).
[19] Prop. Treas. Reg. § 301.6225-3(b)(2).
[20] Prop. Treas. Reg. § 301.6241-1(a)(8).
[21] Prop. Treas. Reg. § 301.6225-3(b)(3).
[22] Pursuant to § 301.6225-1(c)(2)(i).
[23] Prop. Treas. Reg. § 301.6225-3(b)(4).
[24] Prop. Treas. Reg. § 301.6225-2.
[25] Prop. Traeas. Reg. § 301.6241-1(a)(4).

IRS approved modification adjustment that would otherwise not result in an imputed underpayment, such adjustment is not taken into account by the partnership in the adjustment year.[26]

6. Effect of election under I.R.C. § 6226. If a partnership makes a valid election under to push out payment of an imputed underpayment or overpayment to reporting year partners,[27] "with respect to an imputed underpayment, "a partnership adjustment that does not result in an imputed underpayment and that is described in § 301.6225-1(c)(2)(i) or (c)(2)(ii) is taken into account by the reviewed year partners in accordance with § 301.6226-3 and is not taken into account under [Prop. Treas. Reg. 301.6225-3(b)]."[28]

The regulations contemplate that both positive and negative adjustments to credits will be made at the partnership level and imposed on adjustment year partners, or, if adjustments are pushed out to reviewed year partners. The rules provide that a net positive adjustment results if the net amount of adjustments within a grouping or subgrouping, except with respect to the credit grouping[29] is greater than zero.[30]

A. How Are Increases in Decreases in the Amount of Tax Credits Reflected?

A partnership adjustment to a credit shown on the partnership return for the reviewed year is taken into account by the partnership in the adjustment year as a separately stated item.[31] The credit grouping includes all adjustments to items that are claimed or could be claimed by a partnership as a credit on the partnership's return.[32]

The New York State Bar Tax Section New York State Bar Tax Section New York State Bar Tax Section explains that imputed underpayment is computed

> "by taking into account any adjustments to items of credit as an increase or decrease, as the case may be, in the amount [of the imputed underpayment] determined under [I.R.C. §6225(b)(1)A)]. Read literally, this means that additional credits reduce the I.R.C. § 6225(a) imputed underpayment dollar for dollar and a reduction in credits increases the I.R.C. § 6225(a) imputed underpayment dollar for dollar. The Code provides for a number of different credits, with complex (and differing) regimes that often take into account multiple components in computing the allowable credit (or required recapture). Some of these computations are done at the partnership level, others at the partner level,

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[26] Prop. Treas. Reg. § 301.6225-3(b)(5).
[27] Prop. Treas. Reg. § 301.6226-1.
[28] The actual language is: "Effect of election under section 6226. If a partnership makes a valid election under § 301.6226-1 with respect to an imputed underpayment, "a partnership adjustment that does not result in an imputed underpayment and that is described in § 301.6225-1(c)(2)(i) or (c)(2)(ii) is taken into account by the reviewed year partners in accordance with § 301.6226-3 and is not taken into account under this section." Prop. Treas. Reg. 301.6225-3(b)(6).
[29] Described in Prop. Treas. Reg. § 301.6225-1(d)(3)(ii)(C).
[30] Prop. Treas. Reg. § 301.6225-1(d)(3)(ii)(B).
[31] Prop. Treas. Reg. § 301.6225-3(b)(3).
[32] Prop. Treas. Reg. 1.6225-1(d)(2)(iii).

and some at either or both levels. It is not clear how the statutory formula is intended to interact with these regimes."[33]

To take one obvious example in the regulations, the Foreign Tax Credit is claimed if the taxpayer at the partner level elects to treat eligible expenditures on foreign taxes as credits rather than as deductions, (the default rule).[34] The partnership allocates expenditures on taxes to partners, who then take them as tax credits or deductions.[35] Since a deduction does not reduce tax liability to the same extent as a credit, this has the potential for distortions in favor of the taxpayer.

Use of foreign tax credits is subject to limits calculated and applied at the partner level pursuant to I.R.C. § 904.[36] Each partner is allowed to carry credits back and forward from the year they are generated; the regulations do not address how these complexities should be taken into account.[37] Presumably, if the adjustment of credits is pushed out to the reviewed year partners, they can adjust credits to the extent that an adjustment is appropriate in the adjustment year. This will not necessarily the same adjustment that would occur had the change been made in the reviewed year. It may be possible to adjust credits by amending reviewed year and intervening year tax returns in conformity with the adjustment year partnership adjustments provided to partners. However, such a possibility is not addressed in the regulations.

B. Reflecting Increases and Decreases in Tax Resulting from Reallocation of Deductions from One Partner to Another.

A partnership adjustment does not result in an imputed underpayment; 1) if the adjustment relates to a distributive share reallocation that is disregarded;[38] 2) after grouping and netting adjustments, the result is a net non-positive adjustment;[39] 3) the calculation[40] results in an amount that is zero or less than zero.[41] A partnership adjustment does not result in an imputed underpayment if the adjustment relates to a distributive share reallocation that is disregarded;[42] after grouping and netting adjustments, the result is a net non-positive adjustment.[43] The same is

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[33] *NY State Bar Report, May 25, 2016,* 74. *See also* example in BBA Bluebook, at 64 (discussed in text at note 170), as well as BBA Bluebook, at 63, which notes: "An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of Federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year. Any adjustments to items of credit are taken into account as an increase or decrease of the product of this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law." *NY State Bar Report, May 25, 2016,* 74-75 [The last sentence (which references limitations and restrictions on netting) seems to apply to the increase or decrease in losses, not to the adjustments to items of credits.]

[34] I.R.C. § 703(b)(3).

[35] *NY State Bar Report, May 25, 2016,* 75-6.

[36] I.R.C. § 904; Treas. Reg. § 1.904-5(h)(1).

[37] *NY State Bar Report, May 25, 2016,* 76.

[38] Under Prop. Treas. Reg. § 1.6225-1(d)(2)(ii).

[39] As described in Prop. Treas. Reg. § 1.6225-1(d)(3)).

[40] Under Prop. Treas. Reg. § 1.6225-1(c)(1).

[41] Prop. Treas. Reg. § 1.6225-1(c)(2)(i)-(iii).

[42] Under Prop. Treas. Reg. § 1.6225-1(d)(2)(ii).

[43] As described in Prop. Treas. Reg. § 1.6225-1(d)(3)).

true if a calculation[44] results in an amount that is zero or less than zero.[45] The partnership allocates reallocation adjustments to adjustment year partners who are also reviewed year partners.[46] If any reviewed year partner is not also an adjustment year partner, the reviewed year partner's allocation is allocated to that partner's successor(s).[47] If the partnership cannot identify the successor(s) that portion is allocated among the adjustment year partners in accordance with their distributive shares.[48]

If the results are addressed in partnership level adjustments[49] they do not necessarily reflect conditions affecting partner taxes in the reviewed year. The same is true of they are pushed out to the reporting year partners who take the positive or negative adjustments into effect in the adjustment year.[50] An alternative not mentioned (or prohibited) in the regulations would be for the partnership to push the results out to the reviewed year partners and for the reviewed year partners to take the adjustment as an amendment to reviewed year tax returns.

Support for such a position is found in I.R.C. §§ 702(a) and 703(a)(1), which require certain items used to compute an individual's tax liability be segregated and separately stated on the partnership return for the reviewed year. These code provisions apply to items whose taxable status is affected by the individual partner's tax situation.[51] Partnership adjustments that do not result in an imputed underpayment are taken into account by a partnership in the adjustment year in accordance with Prop. Treas. Reg. § 301.6225-3(b).[52] A partnership adjustment that does not result in an imputed underpayment is generally taken into account as a reduction in non-separately stated income or as an increase in non-separately stated loss for the adjustment year depending on whether the adjustment is to an item of income or loss.[53] A partnership adjustment to an item that is required to be separately stated under I.R.C. § 702 is taken into account by the partnership in the adjustment year as a reduction in such separately stated item or as an increase in such separately stated item, but not necessarily in the manner originally contemplated by I.R.C. § 702.[54]

A partnership reallocation adjustment that does not result in an imputed underpayment[55] is taken into account by the partnership in the adjustment year as a separately stated item or a non-separately stated item, as required by I.R.C. § I.R.C. § 702.[56] The adjustment is allocated to adjustment year partners who are also reviewed year partners with respect to whom the amount

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[44] Under Prop. Treas. Reg. § 1.6225-1(c)(1).
[45] Prop. Treas. Reg. § 1.6225-1(c)(2)(i)-(iii).
[46] Prop. Treas. Reg. § 301.6225-3(b)(4).
[47] Prop. Treas. Reg. § 301.6225-3(b)(4).
[48] Prop. Treas. Reg. § 301.6225-3(b)(4).
[49] Prop. Treas. Reg. § 301.6225-3(b)(4).
[50] Prop. Treas. Reg. § 301.6225-1(b).
[51] Martin J. McMahon, Jr, Daniel L. Simmons, Paul R. McDaniel, *Federal Income Taxation of Business Organizations*, 5th Ed. (2014), at 4.
[52] Prop. Treas. Reg. § 301.6225-3(a).
[53] Prop. Treas. Reg. § 301.6225-3(b)(1).
[54] Prop. Treas. Reg. § 301.6225-3(b)(2).
[55] Pursuant to Prop. Treas. Reg. § 301.6225-1(c)(2)(i).
[56] Prop. Treas. Reg. § 301.6225-3(b)(4).

was reallocated.[57] If a partnership makes a valid I.R.C. § 6226 election with respect to an imputed underpayment, a partnership adjustment that does not result in an imputed underpayment is taken into account by the reviewed year partners in accordance with Prop. Treas. Reg. § 301.6226-3 (pushing out payment to reviewed year partners).[58] In other words, the partners whose income goes up have more income subject to tax and those whose income goes down have less income subject to tax.

C. Accounting for Decreases in Taxes Due to Timing Differences When Computing Tax Liability for Years between the Reviewed Year and the Adjustment Year.

I.R.C. § 6226 requires the reviewed-year partners must include in their adjustment year taxes the additional taxes for the reviewed year plus all corresponding adjustments for the years between the reviewed year and the adjustment year. However, the regulations require the partner to take into account only the increases in taxes in the year, not decreases, except for specifically permitting changes in tax credits and reallocations among partners.[59] Since shifts in income or deductions between years is likely to cause both negative and positive adjustments in different years the principles of negative and positive adjustment Prop. Treas. Reg. §§ 301.6225-3(a),(b) would apply but for the prohibition of negative adjustments in the adjustment.

The example in the regulation seems to suggest that increased deductions after a timing adjustment shifts a deduction from an earlier to a later year are lost. In the example in the regulations partnership reported a $100 deduction with respect to the same type of expense on both its 1919 and 2020 partnership returns. In its administrative proceeding with respect to Partnership's 2019 and 2020 years the IRS determined that Partnership improperly accelerated accrual of a portion of the expenses into 2019 that should have been taken into account in 2020. In 2019, Partnership should have reported a deduction of $75 with respect to the expenses ($25 adjustment). In 2020, Partnership should have reported a deduction of $125 with respect to these expenses (<$25> adjustment). The IRS claims the adjustments for 2019 and 2020 are not netted with each other in the adjustment year.[60] The 2019 adjustment of $25 is multiplied by 40 percent resulting in an imputed underpayment of $10 for Partnership's 2019 taxable year. The $25 increase in the deduction for 2020 is an adjustment that does not result in an imputed underpayment. Therefore, there is no imputed underpayment for 2020.[61] Since the adjustment is paid in the adjustment year, the two items cannot offset one another. Only the imputed underpayment is taken into account and additional taxes are assessed.[62]

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[57] Prop. Treas. Reg. § 301.6225-3(b)(4) (if the reviewed year partner is not an adjustment year partner, it is allocated to the successor in interest, and if no successor in interest, to the adjustment year partners according to distributive shares).

[58] Prop. Treas. Reg. § 301.6225-3(b)(6).

[59] I.R.C. 6226(b)(2)(B); *NY State Bar Report, May 25, 2016,* 86. Tax credits are addressed at Prop. Treas. Reg. § 301.6225-1(c)(ii), Prop. Treas. Reg. § 301.6225-1(d)(2)(ii); reallocations are addressed at Prop. Treas. Reg. § 301.6225-1(d)(2)(ii).

[60] Pursuant to Prop. Treas. Reg. § 301.6225-1 (c)(4).

[61] Prop. Treas. Reg. § 301.6225-1(f), Example 1.

[62] Imputed underpayment is calculated solely with respect to a single taxable year and may not be netted against adjustments from another taxable year, Prop. Treas. Reg. § 301.6225-1(c)(4). *NY State Bar Report, May 25, 2016,* 8.

The partnership may be able to increase its deduction by filing an amended return for 2020 since its expenses increased in that year. The partners, who would receive amended K-1 forms that they could use to file their own amended returns. The amendment must be made by the partnership on an amended return and reported to the partners as a corrected K-1 since the partners must file consistently with the partnership.[63] Reductions in income and increases in expense can be reflected by the partnership in the year they occur if the statute has not run. It has not been affirmatively determined by the IRS or courts whether the partnership or partners can file amended returns after the imputed underpayment is assessed and paid to secure a refund for the increases in costs disregarded in the computation of imputed underpayment.[64]

In the context of Prop. Treas. Reg. § 301.6225-2 referring to a modification of imputed underpayment, that starts by referring to a partnership that has received a NOPPA under I.R.C. § 6231 the regulations state that a partnership may request modification of a proposed imputed underpayment.[65] The section then continues by explaining a modification will be approved only if amended returns for all taxable years are filed.[66] Finally, the section states "an amended return[67] claiming a refund may be filed after the expiration of period of limitations under I.R.C. § 6511, provided all partnership adjustments allocated to the partner (or indirect partner) filing the amended return are taken into account on such amended return, the only items reported on the amended return are items attributable to such partnership adjustments, and the partner files all required amended returns described in Prop. Treas. Reg. § 301.6225-2 (d)(2)(iv)."[68] It seems clear that the only amended returns that may be filed after expiration of the period of limitations relate to amendments involving a modification of imputed underpayment. Whether amendments can be filed after an imputed underpayment is assessed to reduce taxes in a year affected by a timing reallocation is less than clear. Support for the proposition may be found in language permitting adjustments to reflect reductions in income or increases in deductions.[69] On the other hand, the regulations also state

It is not clear how amended return, discussed above, differs from an Administrative Adjustment Request (AAR). The regulations describe an AAR. Under an AAR::

> "A partnership may file a request for an administrative adjustment with respect to one or more items of income, gain, loss, deduction, or credit of the partnership ... and any partner's distributive share thereof ... for any partnership taxable year. When filing an administrative adjustment request (AAR), the partnership must determine whether the adjustments requested in the AAR result in an imputed underpayment ... for the reviewed year .... .... If the adjustments requested in the AAR do not result in an imputed

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[63] *See* Prop. Treas. Reg. § 301.6222.1(a),(b).
[64] Prop. Treas. Reg. § 1.6225-1(c)(2)(ii),(iii).
[65] Prop. Treas. Reg. § 301.6225-2(a).
[66] Prop. Treas. Reg. § 301.6225-2 (d)(2)(iv).
[67] Filed under Prop. Treas. Reg. § 301.6225-2(d)(2).
[68] Prop. Treas. Reg. § 301.6225-2(d)(2)(v)(B).
[69] *See* Prop. Treas. Reg. §§ 301.6225-3(b)(1)-(5).

underpayment ... , such adjustments must be taken into account by the reviewed year partners ... in accordance with § 301.6227-3."[70]

"An AAR may only be filed by a partnership with respect to a partnership taxable year after a partnership return for that taxable year has been filed with the Internal Revenue Service (IRS). A partnership may not file an AAR with respect to a partnership taxable year more than three years after the later of the date the partnership return for such partnership taxable year was filed or the last day for filing such partnership return (determined without regard to extensions). In no event may an AAR be filed for a partnership taxable year after a notice of administrative proceeding with respect to such taxable year has been mailed by the IRS under section 6231."[71]

Are all amended returns AARs? It would seem not. The Regulations talk about both. Nonetheless, when a partnership may file an amended return for a year that is affected by an administrative adjustment remains unclear.

D. When the IRS Finds that Capital Gain is Ordinary Income How Do the Regulations Treat Potential Offsetting Deductions in Capital Gain?

Under the BBA, when capital gain is reduced and ordinary income is increased, there is an increase in income and it is taxed at the highest personal or corporate income rate; however, the BBA does not specifically permit a corresponding reduction in capital gain in the adjustment.[72] Do the regulations permit partners to file amended returns if they can utilize the reduction in capital gain? The statute seems to permit an increase in ordinary income but ignores the capital loss occasioned by the reclassification from capital gain to ordinary income occurs.[73] The statute does not address whether or how the partnership or partners can recover the tax loss associated with a reduction in Capital Gain when it pays the increased tax associated with reclassifying the capital gain as ordinary income.[74]

When there is a shift between ordinary income and capital gain there are, in part, partnership adjustments[75] that do not result in an imputed underpayment[76] and, presumably, are taken into account by a partnership in the adjustment year.[77] If so, the adjustment may be taken into account as a partnership adjustment that does not result in an imputed underpayment. The adjustment could be a reduction in non-separately stated income or as an increase in non-separately stated loss for the adjustment year depending on whether the adjustment is to an item of income or loss.[78] If the adjustment is to an item that is required to be separately stated under

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[70] Prop. Treas. Reg. § 301.6227-1(a).
[71] Prop. Treas. Reg. § 301.6227-1(b).
[72] *NY State Bar Report, May 25, 2016,* 68-70.
[73] *NY State Bar Report, May 25, 2016,* 68.
[74] *NY State Bar Report, May 25, 2016,* 70.
[75] Prop. Treas. Reg. § 301.6241-1(a)(6).
[76] Prop. Treas. Reg. § 301.6225-1(c)(2).
[77] Prop. Treas. Reg. § 301.6225-3(a).
[78] Prop. Treas. Reg. § 301.6225-3(b)(1).

I.R.C. § 702, the adjustment is taken into account by the partnership in the adjustment year as a reduction or as an increase in such separately stated item.[79]

It also appears that a partnership making a valid election under Prop. Treas. Reg. § 1.6226-1 is not liable for the imputed underpayment to which the election applies on the date such election is made.[80] Further, "adjustments that do not result in an imputed underpayment ...[81] are not taken into account by the partnership in the adjustment year and instead are included in the reviewed year partners' share of the partnership adjustments reported to the reviewed year partners of the partnership."[82] Reflecting the adjustments on the partnership return would then permit partners to take the adjustment into account in the adjustment year. Presumably, if the statute had not run, they could also take it into account in the reporting year as an amended return, at least if the partnership can amend the reporting year partnership return.

E. Tax Rates Lower than the Maximum Tax Rate For the Category of Income Tax Being Assessed.

What rights do partners have to secure refunds when a partner's marginal tax rate in either the reviewed year or the adjustment year is lower than the rate on which the imputed underpayment was based? Can a partner file for refund when there is a difference between the tax rates used to compute the imputed underpayment and the taxpayer's marginal rate? Can the partners take decreases in marginal tax rate into account to seek a refund of the taxes paid by the partnership? If payment is pushed out to partners, can they take it in the form of an amended return reflecting the lower marginal rate? The bar would seem to be that the limit imposed on modifications is that the corporate rate or personal capital gains rate that substitutes for the personal tax rate in a modification is required to be made at the highest applicable rate.[83] Thus, it is not clear whether partners can file for refunds on their allocated portion of an imputed underpayment if the marginal tax rate they pay is lower than the maximum personal, capital gain, or corporate tax rate on which the computation of imputed underpayment was based.[84]

If they can receive a refund, since any additional tax is paid in the assessment year, any refund would presumably be associated with a lower marginal tax rate in the assessment year, not in the reviewed year. Could a the partner could file an amended return in the refund year? That is probably not allowable under the rules after an IRS audit begins.

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[79] Prop. Treas. Reg. § 301.6225-3(b)(2).
[80] Prop. Treas. Reg. § 301.6226-1(b)(2).
[81] Described in Prop. Treas. Reg. § 301.6225-1(c)(2)(i) and (ii).
[82] Prop. Treas. Reg. § 301.6225-1(b)(2).
[83] I.R.C. § 6625(b). A partnership may request modification of the tax rate to reflect income tax for a C corporation, capital gains rates, presence of a non-profit partner, or qualified dividends attributable to a reviewed year partner. However, "in no event may the lower rate determined under the preceding sentence be less than the highest rate in effect with respect to the type of income and taxpayer," Prop. Treas. Reg. § 301.6225-2(d)(4).
[84] Prop. Treas. Reg. § 301.6225-1(c)(1)(1); Prop. Treas. Reg. § 301.6225-2 d)(4).

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# No Longer Business as Usual: Alternative Legal Service Providers and the Online Based Movement

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# Quill Corp v. North Dakota: The Commerce Clause, Due Process, and the Sales and Use Tax Implications

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# Ethical Considerations Related to Alternative Legal Service Providers and the Online Based Movement

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