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Recent Developments in Federal Income Taxation: The Year 2016

Martin J. McMahon Jr.

University of Florida Levin College of Law, mcmahon@law.ufl.edu

Bruce A. McGovern

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RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION: THE YEAR 2016

Martin J. McMahon, Jr.^{*}
Bruce A. McGovern^{**}

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.

^{*} James J. Freeland Eminent Scholar in Taxation and Professor of Law University of Florida College of Law. We would like to thank Paul Blay and Phillip Martin, both of whom are members of the 2017 Graduate Tax Program LL.M. class at the University Of Florida Levin College of Law, for research and editorial assistance.

^{**} Vice President, Associate Dean, and Professor of Law, South Texas College of Law Houston.

I.	ACCOUNTING	134
	A. Accounting Methods	134
	B. Inventories	136
	C. Installment Method.....	137
	D. Year of Inclusion or Deduction.....	138
II.	BUSINESS INCOME AND DEDUCTIONS	140
	A. Income	140
	B. Deductible Expenses Versus Capitalization.....	142
	C. Reasonable Compensation	143
	D. Miscellaneous Deductions.....	145
	E. Depreciation and Amortization	148
	F. Credits	149
	G. Natural Resources Deductions and Credits.....	151
	H. Loss Transactions, Bad Debts, and NOLs	151
	I. At-Risk and Passive Activity Losses	152
III.	INVESTMENT GAIN AND INCOME	152
	A. Gains and Losses.....	152
	B. Interest, Dividends, and Other Current Income	160
	C. Profit-Seeking Individual Deductions.....	160
	D. Section 121	160
	E. Section 1031	160
	F. Section 1033.....	161
	G. Section 1035.....	162
	H. Miscellaneous.....	162
IV.	COMPENSATION ISSUES	162
	A. Fringe Benefits	162
	B. Qualified Deferred Compensation Plans.....	170
	C. Nonqualified Deferred Compensation, Section 83, and Stock Options	175
	D. Individual Retirement Accounts.....	175
V.	PERSONAL INCOME AND DEDUCTIONS	180
	A. Rates	180
	B. Miscellaneous Income	181
	C. Hobby Losses and Section 280A Home Office and Vacation Homes	183
	D. Deductions and Credits for Personal Expenses	185
	E. Divorce Tax Issues	190
	F. Education.....	192
	G. Alternative Minimum Tax.....	192
VI.	CORPORATIONS	193
	A. Entity and Formation.....	193

	B. Distributions and Redemptions	195
	C. Liquidations.....	196
	D. S Corporations.....	196
	E. Mergers, Acquisitions and Reorganizations	196
	F. Corporate Divisions.....	197
	G. Affiliated Corporations and Consolidated Returns	201
	H. Miscellaneous Corporate Issues	201
VII.	PARTNERSHIPS	201
	A. Formation and Taxable Years.....	201
	B. Allocations of Distributive Share, Partnership Debt, and Outside Basis	201
	C. Distributions and Transactions Between the Partnership and Partners	207
	D. Sales of Partnership Interests, Liquidations and Mergers.....	211
	E. Inside Basis Adjustments	211
	F. Partnership Audit Rules	212
	G. Miscellaneous	215
VIII.	TAX SHELTERS	215
	A. Tax Shelter Cases and Rulings.....	215
	B. Identified “tax avoidance transactions”	222
	C. Disclosure and Settlement.....	223
	D. Tax Shelter Penalties.....	223
IX.	EXEMPT ORGANIZATIONS AND CHARITABLE GIVING	225
	A. Exempt Organizations	225
	B. Charitable Giving	227
X.	TAX PROCEDURE	231
	A. Interest, Penalties, and Prosecutions	231
	B. Discovery: Summonses and FOIA.....	236
	C. Litigation Costs	243
	D. Statutory Notice of Deficiency.....	245
	E. Statute of Limitations	245
	F. Liens and Collections	247
	G. Innocent Spouse	258
	H. Miscellaneous	258
XI.	WITHHOLDING AND EXCISE TAXES	272
	A. Employment Taxes.....	272
	B. Self-employment Taxes.....	272
	C. Excise Taxes.....	274
XII.	TAX LEGISLATION	275
	A. Enacted	275

I. ACCOUNTING

A. Accounting Methods

1. **The Tax Court sides with the taxpayer on application of the completed contract 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.

2. An attempt to transmute ordinary income to capital gain founders on the accounting method change rules. Greiner v. United States, 122 Fed. Cl. 139 (7/22/15). The taxpayer received a stream of contingent payments from an acquiring corporation in exchange for surrendering his compensatory stock options in the target. After reporting the payments as ordinary income under the open transaction doctrine for six years, he sought to change to the closed transaction method, reporting as ordinary income the estimated fair market value of the income stream in the year of the exchange, followed by a return of capital and long-term capital gains as payments were received. The Court of Federal Claims (Judge Campbell-Smith) agreed with the government that the refund was properly denied

because the change of reporting method from open transaction to closed transaction was a change of accounting method for which permission had not been sought under § 446(e). Regardless of which method was used, the amount of total income reported over the years was the same, but the amount (as well as the character) of the income reported in each year differed.

a. Affirmed without opinion. Greiner v. United States, 651 Fed. Appx. 1000 (Fed. Cir. 6/9/16). Without issuing an opinion, the Federal Circuit affirmed the decision of the Court of Federal Claims.

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.

D. Year of Inclusion or Deduction

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

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

a. But the Eagle soars in the Third Circuit. Giant Eagle, Inc. v. Commissioner, 822 F.3d 666 (3d Cir. 5/6/16) ; nonacq., AOD 2016-40 I.R.B. (10/3/16). The Third Circuit, in an opinion (2-1) by Judge Roth, reversed the Tax Court and allowed a current deduction in the year the “fuelperks!” were issued. The Court of Appeals looked to the Pennsylvania common law of unilateral contracts and concluded that the evidence established “the existence—as of year’s end—of both an absolute liability and a near-certainty that the liability would soon be discharged by payment.” Accrued fuelperks! were not expressly permitted to be, and never had been, retracted by Giant Eagle. Relying on *Lukins Steel Co. v. Commissioner*, 442 F.2d 1131 (3d Cir. 1971), the court concluded that “it is irrelevant that neither the total amount of Giant Eagle’s anticipated liability nor the identity of all the customers who eventually applied discounts toward gasoline purchases could be conclusively identified at year’s end.”

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

2. The duty of consistency required the taxpayer to include in income for 2009 gross receipts properly reportable in 2008. Squeri v. Commissioner, T.C. Memo. 2016-116 (6/15/16). In four consolidated cases, the taxpayers were shareholders of a cash-basis subchapter S corporation. The S corporation determined the gross receipts that it reported on Form 1120S using the deposits made into its bank accounts during the calendar year. For example, it determined its gross receipts for 2010 with reference to amounts deposited in its bank account in 2010, even though some

of the checks deposited in January 2010 had been received in 2009, and even though some checks received in late 2010 were not deposited until January 2011. The IRS issued a notice of deficiency in which it determined that the S corporation had improperly computed its gross receipts. For the years 2010 and 2011, the IRS adjusted the gross receipts by excluding deposited amounts that had been received in the prior year and including amounts that had been received during the year but deposited in the following year. For example, the IRS reduced 2010 gross receipts by excluding amounts deposited in January 2010 that had been received in 2009, and increased 2010 gross receipts by including amounts that had been received in 2010 but deposited in January 2011. However, for 2009, the IRS did not make any adjustments. The taxpayers argued that 2009 gross receipts should be reduced by amounts deposited in January 2009 that had been received in 2008. The year 2008 was not before the court and the period of limitations on assessment for 2008 had expired. The Tax Court (Judge Kerrigan) held that, although the gross receipts received in 2008 and deposited in 2009 were properly reportable as gross receipts for 2008, the duty of consistency required the taxpayer to report the gross receipts in 2009. The duty of consistency is an equitable doctrine that prevents a taxpayer from benefiting in a later year from an error or omission in an earlier year that cannot be corrected because the limitations period for the earlier year has expired. As applied by the U.S. Court of Appeals for the Ninth Circuit, to which this decision is appealable, the duty of consistency has three elements: (1) a representation or report by the taxpayer, (2) reliance by the IRS, and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the IRS. These elements, the court held, were satisfied by the taxpayer's filing of Form 1120S reporting the gross receipts for 2009, the IRS's acceptance of the 2008 return that did not reflect the gross receipts, and the expiration of the period of limitations on assessment for 2008.

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Oops, an old revenue ruling is discovered no longer to get it right in light of subsequent legislation. Revenue Ruling 2016-15, 2016-26 I.R.B. 1060 (6/10/16). This revenue ruling clarifies when a real estate developer may exclude COD income under the qualified real property business indebtedness (QRPBI) exclusion in § 108(a)(1)(D). Indebtedness incurred or assumed in connection with property held by a real estate developer as rental property qualifies as QRPBI because the property is

depreciable. But because property held for sale to customers is not depreciable, indebtedness incurred or assumed in connection with property held for sale to customers is not QRPBI, and thus any cancellation of debt with respect to such property is not excludable under § 108. Rev. Rul. 76-86, 1976-1 C.B. 37, which relied on prior law under §§ 108 and 1017 to conclude that a taxpayer could exclude income arising from the cancellation of debt incurred to purchase merchandise for resale, is obsolete.

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

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

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

3. 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

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

Regardless of the possibility that petitioner might own valuable intangible assets, it had invested capital, measured by the book value of its shareholders’ equity, of about \$8 million at the end of 2007 and about \$9.3 million at the end

of 2008. Invested capital of this magnitude cannot be disregarded in determining whether ostensible compensation paid to shareholder employees is really a distribution of earnings. We do not believe that petitioner's shareholder attorneys, were they not also employees, would have forgone any return on invested capital that at least approached, if it did not exceed \$10 million. Thus, petitioner's practice of paying out year-end bonuses to its shareholder attorneys that eliminated its book income fails the independent investor test.

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

2. Shareholder-employees apparently can rake off economic rents as reasonable comp. *H. W. Johnson, Inc. v. Commissioner*, T.C. Memo. 2016-95 (5/11/16). In this reasonable compensation case, the IRS, among other arguments, advanced the proposition that because the corporation's return on equity, after deducting compensation paid to the two shareholder-employees, fell below the industry averages in the years in question, the two shareholder-employees were unreasonably compensated in those years. According to the IRS, an independent investor would have demanded a return more commensurate with the corporation's superior performance. The Tax Court (Judge Gale) agreed with the taxpayer's argument that its return on equity was in line with the industry average and

therefore would have satisfied an independent investor. The IRS cited no authority for the proposition that the required return on equity for purposes of the independent investor test must significantly exceed the industry average when the subject company has been especially successful, and the court found none in the case law. The IRS conceded that the two shareholder-employees “were absolutely integral to petitioner’s successful performance, a performance that included remarkable growth in revenues, assets, and gross profit margins during those years.” The Tax Court concluded that in applying the independent investor test courts have typically found that a return on equity of at least 10 percent tends to indicate that an independent investor would be satisfied and thus payment of compensation that leaves that rate of return for the investor is reasonable. That standard was met on the facts of this case. The IRS effectively conceded the other four factors of *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983)—(1) the employee’s role in the company; (2) a comparison of compensation paid by similar companies for similar services; (3) the character and condition of the company; (4) potential conflicts of interest; and (5) the internal consistency of compensation arrangements—which controlled because an appeal would lie to the Ninth Circuit. In analyzing the fourth factor, the Ninth Circuit emphasizes evaluating the reasonableness of compensation payments from the perspective of a hypothetical independent investor, focusing on whether the investor would receive a reasonable return on equity after payment of the compensation. Accordingly, the Tax Court allowed the deduction.

D. Miscellaneous Deductions

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

taxpayers to both make restitution and pay taxes on income they did not retain.” However, whether § 1341 applied required further proceedings because there was a material question of fact whether Nacchio, who did not plead guilty, believed that he had an unrestricted right to the profits in the year he realized them.

a. On appeal, no tax deduction for the \$44 million forfeiture made the penalty even tougher. Nacchio v. United States, 824 F.3d. 1370 (Fed. Cir. 6/10/16), *rev’g* 115 Fed. Cl. 195 (3/12/14). On appeal, the Federal Circuit, in an opinion by Judge O’Malley, saw things differently and reversed. The Court of Appeals concluded that the forfeiture was a “fine or similar penalty” within the meaning of § 162(f). First, examining the language of the statute under which the amount of the forfeiture was calculated in the criminal proceeding, 18 U.S.C. § 981(a)(2)(B), rather than 18 U.S.C. § 981(a)(2)(A), the court concluded that “the plain language of the statutory provision under which the amount Nacchio forfeited was calculated supports the view that Congress intended the forfeiture to be paid with after-tax dollars.” Second, “Treasury Regulation § 1.162–21(b)(1) defines ‘fine or similar penalty’ for the purposes of § 162(f) as including, *inter alia*, ‘an amount — (i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding.’ ... Nacchio’s criminal forfeiture was imposed pursuant to 18 U.S.C. § 981(a)(1)(C) and 28 U.S.C. § 2461(c), as part of his sentence in a criminal case.” Thus, the forfeiture was punitive, not compensatory, and “[t]he Attorney General’s post-hoc decision to use the forfeited funds for remission did not transform the character of the forfeiture so that it was no longer a ‘fine or similar penalty’ under § 162(f). The decision to use the forfeited funds to compensate the victims was discretionary.” Finally, because establishing deductibility under a section allowing a deduction is a prerequisite to claiming § 1341 relief, Nacchio was not entitled to § 1341 relief. Judgment was entered in favor of the government.

2. Would Ralph Lauren agree that his clothing is suitable for “general wear”? Barnes v. Commissioner, T.C. Memo. 2016-79 (4/27/16). The taxpayer worked as a salesman for Ralph Lauren Corp., which required all employees who worked in corporate sales positions to wear Ralph Lauren apparel while representing the company. The taxpayer purchased Ralph Lauren shirts, pants, ties, and suits, the costs of which he deducted as unreimbursed employee expenses on Schedule A. The cost of clothing is deductible as a business expense only if it meets the following three-part test: (1) the clothing is required or essential in the taxpayer’s employment; (2) the clothing is not suitable for general or personal wear; and (3) the clothing is not

so worn. *Hynes v. Commissioner*, 74 T.C. 1266 (1980); *see also Pevsner v. Commissioner*, 628 F.2d 467 (5th Cir. 1980). The Tax Court (Judge Paris) held that the taxpayer could not deduct the cost of his clothing because, although he was required by his employer to wear it, the clothing was suitable for general or personal wear.

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

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

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

4. 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 and Amortization

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

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

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

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

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

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

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

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

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

2. 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.

F. Credits

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

2. 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). The 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, the 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, the 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 and Credits

There were no significant developments regarding this topic during 2016.

H. Loss Transactions, Bad Debts, and NOLs

There were no significant developments regarding this topic during 2016.

I. At-Risk and Passive Activity Losses

1. The statute and regulations clearly said to the taxpayer, “you lose,” but she took it all the way to the Ninth Circuit anyway. Gragg v. United States, 831 F.3d 1189 (9th Cir. 8/4/16). In an opinion by Judge Christen, the Ninth Circuit held that although a taxpayer who qualifies as a real estate professional under § 469(c)(7) is not subject to the § 469(c)(2) per se rule that rental losses are passive, the taxpayer nevertheless must materially participate in real estate rental activities in order to deduct rental losses against nonpassive income. Because the taxpayer, who did qualify as a real estate professional, did not materially participate in the rental activity, the losses were disallowed. Based on the statutory language and Reg. § 1.469-9(e)(1), the court rejected the taxpayer’s argument that, by virtue of her status as a real estate professional, the rental losses were automatically nonpassive and she did not need to prove material participation.

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. 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."

2. 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 the 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). The Treasury and the IRS have issued proposed and temporary regulations regarding (1) the requirement of § 1014(f) that a recipient's basis in certain property acquired from a decedent be consistent with the value of the property as finally determined for federal estate tax purposes, and (2) the reporting requirements of § 6035 for executors or other persons required to file federal estate tax returns. The proposed regulations clearly state that if, after taking into account all available credits other than the credit for prepayment of tax, no estate tax is payable, no property is subject to the basis consistency requirements. Prop. Reg. § 1.1014-10(b)(3). *See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 2015, 27 (JCS-1-16, March 2016). However, for a taxable estate, the basis consistency rules do not apply to (1) property qualifying for the estate tax charitable or marital deductions, and (2) tangible personal property for which an appraisal is not required under Reg. § 20.2031-6(b), which requires an appraisal for "household and personal effects articles having marked artistic or intrinsic value of a total value in excess of \$3,000." Prop. Reg. § 1.1014-10(b)(2). Until the final value of property subject to the consistency rule has been determined, the recipient may use as his unadjusted basis the amount reported to him by the executor, Prop. Reg. § 1.1014-10(c)(2) (the amount reported on Form 8971 as required by § 6035), but if final value is later determined to be different, the beneficiary may be subject to deficiency procedures. "[A]fter discovered or omitted property" not reported on the initial estate tax return or a supplemental return prior to the expiration of the assessment period has a zero basis, as does all property in an estate if no estate tax return has been filed by an estate that is required to file, until either a return is filed or a final value determined by the IRS. Prop. Reg. § 1.1014-10(c)(3).

Prop. Reg. § 1.6035-1 provides very detailed guidance—far more detailed than is noted here—regarding the procedures under new § 6035 requiring the executor of any estate required to file an estate tax return to furnish to the IRS and to each beneficiary acquiring any interest in property included in the gross estate a statement identifying the value of each interest in such property as reported on such return and any other information that the IRS may prescribe. The reporting requirement does not apply if a return is not required to be filed but was filed for the purpose of making a generation skipping tax allocation, a portability election, or any protective filing to avoid

penalties if value is later determined to cause a return to be required. Prop. Reg. § 1.6035-1(a)(2). An executor must file a supplemental statement when “any change [occurs] to the information required to be reported on the Information Return or Statement that causes the information as reported to be incorrect or incomplete.” Prop. Reg. § 1.6035-1(e)(1) and (2). The proposed regulations make it clear that § 6035 applies more broadly than the basis consistency rule of § 1014(f), which applies only to that property included in the gross estate that causes an increase in federal estate tax liability; § 6035 requires reporting of “the value of property included on a required Federal estate tax return,” which includes, for example, an estate that is not taxable due to marital or charitable deductions that reduce the amount of tax otherwise due to less than the allowable unified credit.

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

e. Another reprieve for executors: the statements required by new § 6035(a)(1) and (a)(2) are not due before June 30, 2016. Notice 2016-27, 2016-15 I.R.B. 576 (3/24/16). This notice provides that, for statements required under § 6035(a) to be filed with the IRS or furnished to a beneficiary before 6/30/16, the due date under § 6035(a)(3) is delayed to 6/30/16. According to the notice, this delay is in response to numerous comments received by the 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.

3. Surrendering a Green Card can be very taxing. Topsnik v. Commissioner, 146 T.C. 1 (1/20/16). The taxpayer was a German citizen who was a permanent resident of the United States. In 2004 he sold the stock of a U.S. corporation for a down payment and monthly installments and reported the gain on the § 453 installment method. In 2010, he received equal monthly payments pursuant to the promissory note executed in connection with the sale. On 11/20/10, the taxpayer formally abandoned his lawful permanent resident status. (He completed a U.S. Citizenship and Immigration Services Form I-407, Abandonment of Lawful Permanent Resident Status, which was accepted by the USCIS; he surrendered his green card.) He filed a Form 1040NR, U.S. Nonresident Alien Income Tax Return, for 2010 claiming that the installment sale proceeds were exempt from taxation under the U.S.–Germany Tax Treaty. The IRS asserted a deficiency for 2010 attributable to the gain on his installment sale of stock. The IRS also asserted that the taxpayer was a “covered expatriate” who expatriated in 2010 and was required by § 877A to recognize gain on the deemed sale of his installment obligation on the day before his expatriation. The taxpayer claimed that he was not liable for tax on the installment sale proceeds because he was a German resident who expatriated on 12/31/09, and that he lived in Freiburg, Germany. The Tax Court (Judge Kerrigan) held that the taxpayer expatriated on 11/20/10, when he formally abandoned his status as a lawful permanent resident. Reg. § 301.7701(b)–1(b)(3) provides that when an alien initiates a determination, “resident status is considered to be abandoned when the individual’s application for abandonment (INS Form I-407) ... is filed with the INS.” (The German Competent Authority sent the U.S. Competent Authority letters stating, among other things, that (1) for tax year 2010 the taxpayer was registered in Germany as a person subject to taxation as a nonresident, (2) he did not file a German tax return for 2010, and (3) he did not have a registered residence or habitual abode in Germany in 2010.) Thus, he was liable for tax on gains attributable to the eleven monthly installment payments that he

received during 2010 before his expatriation date. Furthermore, pursuant to § 877A he was liable for tax on gain from the deemed sale of his right to installment sale proceeds on the day before his expatriation date.

4. 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.”

B. Interest, Dividends, and Other Current Income

There were no significant developments regarding this topic during 2016.

C. Profit-Seeking Individual Deductions

There were no significant developments regarding this topic during 2016.

D. Section 121

There were no significant developments regarding this topic during 2016.

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 not bearing 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.

F. Section 1033

There were no significant developments regarding this topic during 2016.

G. Section 1035

There were no significant developments regarding this topic during 2016.

H. Miscellaneous

There were no significant developments regarding this topic during 2016.

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 the Treasury Department (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) a 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.

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).

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. The Treasury and 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. 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. 2003-1 C.B. 359. This revenue procedure does not eliminate a taxpayer’s ability to seek a private letter ruling, but it 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.

3. 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.

4. 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

1. Reducing redundant paperwork to facilitate e-filing.

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

D. Individual Retirement Accounts

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

but at trial, the possession of the stock certificate issued in the name of the IRA was unclear. The record indicated that if the stock certificate had been received by Merrill Lynch within the 60-day period, it would have been accepted. Merrill Lynch reported the transaction on Form 1099-R as a taxable distribution because it had determined that the wire transfer was a distribution to the taxpayer that was not followed by a rollover investment within the 60-day period permitted under § 408(d)(3). The IRS determined that the wire transfer issued by Merrill Lynch constituted a “distribution” from the IRA and was includible in gross income under §§ 408(d) and 72 and that, because the taxpayer had not yet reached age 59½, it was an “early distribution” subject to the § 72(t) 10 percent additional tax. The Tax Court (Judge Gustafson) held that there had not been a distribution from the IRA to the taxpayer and did not uphold the deficiency. The opinion noted that there was no evidence that the taxpayer requested an IRA distribution to himself. “No cash, check, or wire transfer ever passed through [the taxpayer’s] hands, and he was therefore not a literal ‘payee or distributee’ of any amount.” The taxpayer “was, at most, a conduit of the IRA funds.” The court distinguished *Dabney v. Commissioner*, T.C. Memo. 2014-108, which involved a similar wire transfer of self-directed IRA funds to purchase an asset and in which the court found a taxable distribution, on the basis that the asset purchased in *Dabney* (land) was one that the IRA custodian would not permit the IRA to hold. In contrast, the asset purchased in this case, stock of First Personal Financial Corp., was a permissible investment that the IRA already held.

2. SEP IRA SNAFU. Vandenbosch v. Commissioner, T.C. Memo. 2016-29 (2/24/16). The taxpayer maintained a self-directed SEP IRA with Edward D. Jones & Co., L.P. as the custodian. The taxpayer agreed to lend money to a friend and/or the friend’s corporation, and to that end, the taxpayer signed a form titled “Retirement Distribution or Internal Transfer.” He requested that Edward Jones distribute \$125,000 from his SEP-IRA into his joint account with his wife. (He did not elect to have federal and state income tax withheld. He checked a box indicating “I am under the age of 59½. (IRS premature distribution TAX APPLIES ***).”) Edward Jones distributed \$125,000 from the SEP-IRA into the taxpayers’ joint account at Edward Jones. The taxpayer wired \$125,000 from the joint account to his personal account at BankFirst, following which the taxpayer wired \$125,000 from the BankFirst account to his friend’s account at JPMorgan Chase Bank, N.A. The taxpayer and his friend executed a loan agreement and note in their personal capacities, with the taxpayer denominated as the lender. He did not indicate that he was signing on behalf of his SEP-IRA. The taxpayer received a Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reporting a gross distribution of \$125,000; the

form indicated that the withdrawal was an early distribution and that the entire \$125,000 was taxable. The taxpayer reported the transaction as a § 408(d)(3) rollover. The Tax Court (Judge Buch) had no problem in finding that the taxpayer had received a distribution includable in gross income and that the § 72(t) early distribution 10 percent additional tax applied. However, the asserted § 6662 accuracy related penalty was not upheld because the court found that the taxpayers acted with reasonable cause and in good faith in their reliance on the advice of a tax professional. “The Vandenbosches have been using the accounting firm for over 20 years. Dr. Vandenbosch explained to his return preparer what had happened with the distribution and provided his return preparer with the note and information regarding the transfer of funds that ended with [his friend] receiving the funds. The Vandenbosches included with their return a copy of a letter from their tax preparer stating that he did not include the \$125,000 as taxable because he believed it was directly rolled over.”

3. A multi-million dollar “Abusive Roth IRA Transaction” goes south. Polowniak v. Commissioner, T.C. Memo. 2016-31 (2/25/16). The taxpayer had a Roth IRA that he funded with \$2,000. The Roth IRA originally owned 98 percent of a newly formed C corporation, Bevco Investments, Inc., but ultimately came to own 100 percent. From its incorporation to its dissolution, the taxpayer was Bevco’s registered agent, and officer, director, and employee. The taxpayer’s pre-existing wholly owned S corporation, Strategies, and Bevco entered into a subcontracting agreement for the taxpayer’s consulting services. Strategies would pay Bevco 75 percent of the revenue it received from certain contracts with Delphi Automotive Services for the taxpayer’s consulting services. In exchange Bevco would provide certain specified services for Strategies that would be provided personally by the taxpayer. Over the years in issue, Strategies paid approximately \$2.0 million to Bevco. Strategies reported net losses, which were passed through to the taxpayer. The IRS issued deficiency notices based on Strategies’ failure to report its consulting income and determined that the taxpayer was liable for the 6 percent § 4973 excise tax for excess contributions to his Roth IRA. Bevco’s gross receipts were treated as excess contributions. The Tax Court (Judge Paris) held that the payments “from Strategies of the Delphi payments to Bevco were nothing more than a mechanism for transferring value to the Roth IRA.” The subcontracting agreement did not change the services provided to Delphi, and the taxpayer continued to do all of the work as he had done previously. Accordingly, applying substance over form, the amounts transferred from Strategies to Bevco constituted excess contributions to the taxpayer’s Roth IRA, and the § 4973 excise tax applied. Consistently, Strategies’ gross receipts were increased by the amounts

transferred to Bevco and the resulting deficiency upheld. A host of penalties—under § 6651(a)(1) for failure to file Form 5329, under § 6651(a)(2) for failure to pay the excise tax, and under § 6662A for a deficiency attributable to a listed transaction, because the taxpayer's transaction was a listed transaction under Notice 2004-8, 2004-1 C.B. 333—were sustained.

4. Another case suggesting that the answer to “Why not have a self-directed IRA?” is “Just say ‘No.’” Thiessen v. Commissioner, 146 T.C. 100 (3/29/16). In 2003, the taxpayers rolled over their tax-deferred § 401(k) retirement accounts into newly formed self-directed IRAs. They then caused the IRAs to acquire the initial stock of a newly formed C corporation, and caused the corporation to acquire the assets of an existing business. The taxpayers guaranteed the repayment of a loan to the corporation from the seller of the assets that was part of the acquisition price. The taxpayers reported that the rollover of the retirement funds into the IRAs was nontaxable. The IRS determined that the loan guaranties were prohibited transactions under § 4975(c)(1)(B), resulting in deemed distributions of the IRAs' assets to the taxpayers pursuant to § 408(e)(2). The Tax Court (Judge Marvel) held that the taxpayers' guaranties of the loan were prohibited transactions under § 4975(c)(1)(B), and that consequently the IRAs' assets were deemed to have been distributed to the taxpayers. Peek v. Commissioner, 140 T.C. 216 (2013), was not distinguishable and was followed. Because the taxpayers were not 59½ as of the first day of the year of the deemed distributions, the 10 percent § 72(t) penalty applied. Furthermore, even if its conditions were satisfied (and they were not), § 4975(d)(23)—which provides that § 4975(c)(1)(B) does not apply to the lending of money or other extension of credit between a plan and a disqualified person “in connection with the acquisition, holding, or disposition of any security or commodity, if the transaction is corrected before the end of the correction period”—was inapplicable because the taxpayers' guaranties were not in connection with the acquisition, holding, or disposition of a security or commodity. Finally, § 6501(e) applied to extend to six years the statute of limitations for assessment. The taxpayers' reporting that the rollover was nontaxable was insufficient to advise the IRS of the nature and the amount of the unreported income flowing from the deemed distributions from the IRAs on account of the loan guaranties.

5. 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 59½ 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).

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

1. The Treasury Department and the IRS are trying to get everyone to sing Kumbaya. T.D. 9785. Definition of Terms Relating to Marital Status, 81 F.R. 60609 (9/2/16). The Treasury Department and the IRS have finalized, with some changes, proposed regulations that reflect the holdings of *Obergefell v. Hodges*, 576 U.S. ___, 135 S. Ct. 2584 (2015), *Windsor v. United States*, 570 U.S. ___, 133 S. Ct. 2675 (2013), and Rev. Rul. 2013-17, 2013-38 I.R.B. 201, defining and describing the marital status of taxpayers (REG-148998-13, Definition of Terms Relating to Marital Status, 80 F.R. 64378 (10/23/15)). Reg. § 301.7701-18 amends the current regulations under § 7701 to provide that for federal tax purposes the terms "spouse," "husband," and "wife" mean an individual lawfully married to another individual, and the term "husband and wife" means two individuals lawfully married to each other. These definitions apply regardless of sex. However, the terms "spouse," "husband," and "wife" do not include individuals who have entered into a registered domestic partnership, civil union, or other similar relationship not denominated as a marriage under the law of a state, possession, or territory of the United States; the term "husband and wife" does not include couples who have entered into such a relationship, and the term "marriage" does not include such relationships.

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

B. Miscellaneous Income

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

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

In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory

damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

2. Hallelujah! The government finally recognizes that nonpayment of a debt still owed is not necessarily COD income. T.D. 9793, 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.)

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

1. **“It may have been a fun business, but fun doesn't convert a business to a hobby. If it did, Facebook would be a hobby, Microsoft and Apple would be hobbies, Amazon would be a hobby, etc. ad infinitum.”** *Roberts v. Commissioner*, 820 F.3d 247 (7th Cir. 4/15/16). The taxpayer had been a successful owner and operator of restaurants, bars, and nightclubs. He began withdrawing from those businesses in the mid-1990s, but he remained a paid consultant to the new owners. In 1999 he bought his first horses and embarked on a career as a thoroughbred racehorse owner, breeder and trainer. Over the following years, his stable of racehorses increased; by 2001 he had ten racehorses and a breeding stallion. In 2003 he was licensed as a trainer. In 2006 he acquired a 180-acre farm and invested between \$500,000 and \$600,000 in improvements for the training of racehorses on the property. He trained the horses himself; “he even bathed them himself.” He spent 12 hours a day working with the horses on race days and about 8 hours a day on other days. In addition, he served on the boards of two professional horse-racing associations “in what the Tax Court’s opinion describe[d] as ‘leadership roles.’” However, his venture was not profitable. In 2005 and 2006, the years in issue, he lost \$153,420 and \$30,604, respectively. In 2007 and 2008, which were not at issue, the losses increased to \$98,251 in 2007 and to \$291,888 in 2008. He deducted the losses on his tax returns from his other income, mainly income from consulting in the restaurant business and from renting and selling real estate, but the IRS disallowed the losses for 2005 and 2006 as hobby losses under § 183. The Tax Court (Judge Paris) sustained the IRS’s position and disallowed the losses, even though it found that only the eighth (substantial income from sources other than the activity) and ninth (elements of personal pleasure or recreation) factors in Reg. § 1.183–2 favored the IRS. The Seventh Circuit, in an opinion by Judge Posner, reversed. According to the Court of Appeals, “[t]he Tax Court’s ruling that Roberts’ horse-racing enterprise was a hobby in 2005 and 2006 but became a business in 2007 and remained so in 2008, and apparently has been one in every year since given the IRS’s failure to challenge his horse-racing deductions for any year since 2008, is untenable.” The Court of Appeals found all nine factors in Reg. § 1.183–2 to favor the taxpayer, but was dismissive of the factors, referring to the regulation as “goofy.”

Notice too that the factors in the Treasury Regulation overwhelmingly favor Roberts’ claim that even in 2005 and 2006 his horse-racing enterprise was a business. He conducted it in a businesslike way (factor 1). He prepared by extensive study (to obtain a training license) (factor 2). He

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

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

As for the last factor—“the availability of other investments which would yield a higher return, or which would be more likely to be profitable, is not evidence that an activity is not engaged in for profit. An activity will not be

treated as not engaged in for profit merely because the taxpayer has purposes or motivations other than solely to make a profit. Also, the fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph.” This is sensible since obviously many businessmen derive pleasure, self-esteem, and other nonmonetary “goods” from their businesses, and horse racing is just the kind of business that would generate such “goods” for participants such as the owners and trainers (Roberts is both) of the horses.

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

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

D. Deductions and Credits for Personal Expenses

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

a. The Tax Court says the limits apply per residence: two unmarried co-owners holding residences in joint ownership were restricted to mortgage interest deductions on only \$1.1 million of loans. *Sophy v. Commissioner*, 138 T.C. 204 (3/5/12). The Tax Court (Judge Cohen) decided that the \$1.1 million § 163(h)(3) limitation on indebtedness giving rise to qualified residence interest should be applied on both a per-taxpayer and a per-residence basis with respect to residence owners who are not married to each other, rather than solely on the per-taxpayer basis argued for by the unmarried taxpayers who jointly owned the two residences

in question on which the purchase money mortgages exceeded \$1.1 million. Thus, each of the two taxpayers, who were registered domestic partners under California law, was limited to deducting interest on only \$500,000 of acquisition indebtedness on their two residences and \$50,000 of home equity indebtedness on their principal residence. The decision was based upon congressional intent, as shown by the statute's repeated use of phrases "with respect to any qualified residence" and "with respect to such residence," which would have been superfluous had Congress intended that the limitations be applied on a per-taxpayer basis.

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

We infer this conclusion from the text of the statute: By expressly providing that married individuals filing separate returns are entitled to deduct interest on up to \$550,000 of home debt each, Congress implied that unmarried co-owners filing separate returns are entitled to deduct interest on up to \$1.1 million of home debt each.

The majority opinion also pointed out that applying a per residence ceiling would be largely unworkable in situations where two unmarried taxpayers each had an individual primary residence that was a qualified residence but co-owned a secondary residence that was a qualified residence. Additionally, the majority noted that "[i]f Congress wants to go further and ensure that two or more unmarried taxpayers are treated as a single taxpayer for purposes of a particular deduction or credit, it can do that too," citing the now-expired § 36 first-time homebuyer credit as an example of a provision that did exactly that. The court acknowledged that the provisions of § 163(h)(3) limiting married

taxpayers filing separately to one-half of the amount of debt ceiling allowed to married taxpayers filing jointly results in a marriage penalty, but it was “not particularly troubled.”

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

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

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

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

2. 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.

3. 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 Form 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 §§ 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.

4. 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).

5. 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.

E. Divorce Tax Issues

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

A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument ... and the transfer occurs not more than 6 years after the date on which the marriage ceases. ... Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of

property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

The Tax Court (Judge Colvin) held that the taxpayer's transfer of his ownership interests was "incident to divorce" within the meaning of § 1041(c). In reaching this conclusion, the court rejected the government's argument that the taxpayer's transfer, which occurred more than one year after the date on which the marriage ceased, was not related to the cessation of the marriage because it was not made pursuant to a divorce or separation instrument. The relevant regulation, the court reasoned, contemplates that a transfer not made pursuant to a divorce or separation instrument can be related to the cessation of the marriage if it is "made to effect the division of property owned by the former spouses at the time of the cessation of the marriage." The court also rejected the government's arguments that the transfer was not related to the cessation of the marriage because (1) it took the form of a sale, and (2) the litigation that resulted in the sale concerned a business dispute, as evidenced by the fact that the litigation was brought in the superior court civil part rather than the family court, which had jurisdiction over the taxpayer's divorce.

2. 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.

F. Education

There were no significant developments regarding this topic during 2016.

G. Alternative Minimum Tax

1. What God has joined together let the tax man put asunder! Vichich v. Commissioner, 146 T.C. 186 (4/21/16). The issue in this case was whether § 53(e) allows a taxpayer, to use an AMT credit arising from incentive stock options exercised by a deceased spouse. The taxpayer, Nadine Vichich married William Vichich in 2002, and he died in 2004. William previously had been married to someone else. In 1998 William exercised employer-granted incentive stock options that resulted in AMT liability, which he reported on a 1998 tax return filed jointly with his then wife. (The difference between the exercise price and the fair market value of the stock on

the date of exercise (the spread) is treated as an item of adjustment and is included in the taxpayer's AMTI.) Payment of the AMT liability in 1998 generated a § 53(e) AMT credit carryforward. On her 2009 tax return, Nadine reported an AMT credit derived from William's 1998 AMT credit carryforward that she used to offset her individual income tax liability. The IRS disallowed the claimed AMT credit, and the Tax Court (Judge Nega) upheld the deficiency; Nadine was not entitled to use the AMT credit to offset her individual income tax liability for 2009. The IRS conceded that William was entitled to the credit following his prior divorce, but neither the statute nor the regulations provided an answer as to whether any of the AMT credit transferred to Nadine after William's death. Prior case law established that "[i]t is axiomatic that income is taxed to the person who earns it, and credits and deductions are thus generally not transferable between taxpayers." Furthermore, "[t]he Code treats married taxpayers who file jointly as one taxable unit; however, it does not convert two spouses into one single taxpayer. Joint filing allows spouses to aggregate their income and deductions but 'does not create a new tax personality'." Observing that "the ability to offset one spouse's income with the other's [NOL] loss deductions is available only to spouses who elect to file joint returns," the court found that the same principle should apply to credits.

[B]ecause petitioner could not deduct for a postmarital year an NOL incurred by her husband even during their marriage, much less before it, we conclude, on the basis of the record and the arguments before us, that, she was not entitled to take into account under section 53(b)(1) her husband's premarital adjusted net minimum tax liability in computing her own minimum tax credit for tax year 2009.

VI. CORPORATIONS

A. Entity and Formation

1. Built-in losses cannot be "imported" either from offshore or from a U.S. tax-exempt. T.D. 9759, Limitations on the Importation of Net Built-in Losses, 81 F.R. 17066 (3/28/16). The Treasury and IRS have finalized, with minor changes, proposed regulations under §§ 334(b)(1)(B) and 362(e)(1), dealing with the importation of built-in losses in § 332 subsidiary liquidations and § 351 transfers (REG-161948-05, Limitations on the Importation of Net Built-in Losses, 78 F.R. 54971 (9/9/13)). (These regulations do not deal with § 362(e)(2); Reg. § 1.362-4 deals with § 362(e)(2).) The regulations also finalize proposed amendments to the

regulations under §§ 332 and 351 to reflect statutory changes (REG-163314-03, Transactions Involving the Transfer of No Net Value, 70 F.R. 11903 (3/10/05)). Section 362(e)(1) applies property-by-property to assign each transferred property a fair market value basis rather than the normal § 362(a) transferred basis, if (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer. If a controlled subsidiary is liquidated and (1) there is net built-in loss in the aggregate transferred properties and (2) gain or loss realized by the transferor with respect to the property was not subject to U.S. income tax immediately prior to the transfer, § 334(b)(1)(B) provides the parent with a fair market value basis in properties received in the liquidation.

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

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

B. Distributions and Redemptions

1. Non-arm's length transactions between commonly controlled corporations results in a festival of taxation. Key Carpets, Inc. v. Commissioner, T.C. Memo. 2016-30 (2/25/16). Mr. and Mrs. Johnson owned all of the stock of Key Carpets, Inc., which sold carpets to businesses. Key Carpets was very successful. Mr. Johnson owned all of the stock of Clean Hands Co., Inc., which was attempting to develop a voice-activated hand washing monitoring system. Both businesses operated out of the same building. For the years in question, Clean Hands employed a computer technician who developed the voice-activated hand washing monitoring system. Mr. Johnson owned the patent on this system but testified that he thought Key Carpets owned the system. In addition to assisting with the development of the hand washing monitoring system, the Clean Hands computer technician provided information technology (IT) services to Key Carpets. The computer technician did not maintain a time log for 2008; he testified that he estimated "with a reasonably high degree of accuracy" that 85 percent to 95 percent of his time at Clean Hands was spent working on the hand washing monitoring system. Clean Hands paid the computer technician a salary of \$100,000 in 2007 and \$90,000 in 2008. Key Carpets paid Clean Hands throughout the years at issue for purportedly developing the hand washing monitoring system and providing Key Carpets with IT services—\$130,300 in 2007 and \$128,222 in 2008—and deducted those amounts for "computer service and consulting." The IRS asserted deficiencies against both Key Carpets and the Johnsons on the grounds that the payments by Key Carpets to Clean Hands were not ordinary and necessary business expenses, but were constructive dividends. The Tax Court (Judge Paris) upheld the deficiencies with respect to 85 percent of the amounts of the payments; only 15 percent of the amounts paid to Clean Hands by Key Carpets were actually paid for IT service provided to Key Carpets by Clean Hands' computer technician. Because Key Carpets had no actual ownership interest in the hand washing monitoring system, Key Carpets' transfer of funds to Clean Hands provided significant economic benefit to Mr. Johnson and his business, Clean Hands. Thus, following *Stinnett's Pontiac Serv., Inc. v. Commissioner*, T.C. Memo. 1982-314, *aff'd*, 730 F.2d 634 (11th Cir. 1984), which held that when a shareholder was required to make capital contributions and caused a related company to pay the contributions, the payments were for the personal benefit of the common shareholder and thus a constructive dividend, Johnson received a constructive dividend. Section 6662 accuracy related penalties were upheld.

2. Clarifying the amount of deemed taxable stock dividends. We guess there was a problem. REG-133673-15, Deemed

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

C. Liquidations

There were no significant developments regarding this topic during 2016.

D. S Corporations

There were no significant developments regarding this topic during 2016.

E. Mergers, Acquisitions and Reorganizations

There were no significant developments regarding this topic during 2016.

F. Corporate Divisions

1. Congress kisses-off REIT spinoffs. The 2015 PATH Act, § 311(a), added new § 355(h), which provides that § 355 generally does not apply to any distribution if either the distributing corporation or controlled corporation is a REIT. If, however, both the distributing corporation and the controlled corporation are REITs immediately after the distribution, the distribution still may qualify under § 355. A second exception applies if (1) the distributing corporation was a REIT at all times during the 3-year period ending on the date of the distribution, (2) the controlled corporation was a taxable REIT subsidiary of the distributing corporation at all times during that period, and (3) the distributing corporation controlled (directly or indirectly) the controlled corporation at all times during that period. Section 355(h) applies to distributions after 12/6/15 unless the transaction was described in a ruling request initially submitted to IRS on or before 12/7/15, the request was not withdrawn, and the ruling was not issued or denied as of 12/7/15.

a. TRA '86 strikes back at REIT conversions—with a vengeance. T.D. 9770, *Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]*; Final and Temporary Regulations, 81 F.R. 36793 (6/8/16); REG-126452-15, *Certain Transfers of Property to Regulated Investment Companies [RICs] and Real Estate Investment Trusts [REITs]*, 81 F.R. 36816 (6/8/16). Temp. Reg. § 1.337(d)-7T provides that a C corporation engaging in a conversion transaction (as defined in § 1.337(d)-7(a)(2)(ii)—“the qualification of a C corporation as a RIC or REIT or the transfer of property owned by a C corporation to a RIC or REIT”) involving a REIT within the ten-year period following a related § 355 distribution is treated as making an election to recognize gain and loss as if it had sold all of the converted property to an unrelated party at fair market value on the deemed sale date (as defined in Reg. § 1.337(d)-7(c)(3)). In these situations, § 1374 treatment is not available as an alternative to recognizing any gain with respect to the converted property on the deemed sale date. The temporary regulations also provide that a REIT that is a party to a § 355 distribution occurring within the ten-year period following a conversion transaction for which a deemed sale election has not been made recognizes any remaining unrecognized built-in gains and losses resulting from the conversion transaction (after taking into account the impact of § 1374 in the interim period, as described subsequently).

- There are two exceptions to the general rules. The temporary regulations do not apply if both the distributing corporation and the controlled corporation are REITs immediately after the date of the § 355 distribution and at all times during the two years thereafter.

Second, the temporary regulations also do not apply to certain § 355 distributions in which the distributing corporation is a REIT and the controlled corporation is a taxable REIT subsidiary.

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

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

Device Test Factors—**First**, the Treasury and IRS have concluded that the presence of business assets, whether or not held for five years, generally does not raise any more device concerns than the presence of assets used in a five-year active business. Thus, a proposed change to the nature and use of assets device factor in Reg. § 1.355-2(d)(2)(iv) would focus on assets used in a business (as defined in proposed § 1.355-2(d)(2)(iv)(B)) rather than only assets used in an active business meeting the five-year history requirement of § 355(b). **Second**, conversely, the Treasury and IRS have concluded that device potential exists if either (1) Distributing or Controlled owns a large percentage of assets not used in business operations compared to total assets or (2) Distributing's and Controlled's percentages of these assets differs substantially. Accordingly, the proposed regulations would provide thresholds for determining whether the ownership of nonbusiness assets and/or differences in the nonbusiness asset percentages (the percentage of a corporation's total assets that are nonbusiness assets) for Distributing and Controlled are evidence of device. If neither Distributing nor Controlled has nonbusiness assets that are 20 percent or more of its total assets, the ownership of nonbusiness assets ordinarily would not be evidence of device. Furthermore, a difference in the nonbusiness asset percentages for Distributing and Controlled ordinarily would not be evidence of device if such difference is less than 10 percentage points or, in the case of a non-pro rata distribution, if the difference is attributable to a need to equalize the value of the Controlled stock and securities distributed and the consideration exchanged therefor by the distributees. **Third**, the nondevice factor in § 1.355-2(d)(3)(ii), which relates to corporate business purpose for a transaction as evidence of

nondevice, would be revised to provide that a corporate business purpose that relates to a separation of (a) nonbusiness assets from (b) one or more businesses or from business assets would not be evidence of nondevice, unless the business purpose involves an exigency that requires an investment or other use of the nonbusiness assets in a business. Absent such an exigency, such separations are not consistent with the intent of Congress to prevent § 355 from applying to a distribution that is used principally as a device.

Per Se Device—Prop. Reg. § 1.355-2(d)(5) would provide that a transaction is a per se device (notwithstanding the presence of any other nondevice factors, for example, a corporate business purpose or stock being publicly traded and widely held) if designated percentages of Distributing's or Controlled's total assets are nonbusiness assets. The test is multi-pronged. A per se device exists if both (1) the nonbusiness asset percentage of Distributing or Controlled is 66⅔ percent or more, and (2) the nonbusiness asset percentage of Distributing or Controlled is (a) 66⅔ percent or more but less than 80 percent, and the nonbusiness asset percentage of the other corporation (Controlled or Distributing, as the case may be) is less than 30 percent, (b) 80 percent or more but less than 90 percent, and the nonbusiness asset percentage of the other corporation is less than 40 percent; or (c) 90 percent or more, and the nonbusiness asset percentage of the other corporation is less than 50 percent.

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

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

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

3. “The Treasury Department and the IRS recognize that determining whether an acquisition of control has substance for federal tax purposes can be difficult and fact-intensive.” Rev. Proc. 2016-40, 2016-32 I.R.B. 228 (7/15/16). This revenue procedure provides fact

patterns (safe harbors) in which the IRS will not assert that a distributing corporation, D, lacks control of another corporation, C, within the meaning of § 355(a)(1)(A). There's no way to paraphrase it, so we quote it:

SECTION 3. TRANSACTIONS TO WHICH THIS REVENUE PROCEDURE APPLIES

This revenue procedure applies to transactions in which—

(1) D owns C stock not constituting control of C;

(2) C issues shares of one or more classes of stock to D and/or to other shareholders of C (the issuance), as a result of which D owns C stock possessing at least 80 percent of the total combined voting power of all classes of C stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of C;

(3) D distributes its C stock in a transaction that otherwise qualifies under § 355 (the distribution); and

(4) C subsequently engages in a transaction that, actually or in effect, substantially restores (a) C's shareholders to the relative interests, direct or indirect, they would have held in C (or a successor to C) had the issuance not occurred; and/or (b) the relative voting rights and value of the C classes of stock that were present prior to the issuance (an unwind).

SECTION 4. SAFE HARBORS

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

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

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

(1) There is no agreement, understanding, arrangement,

or substantial negotiations (within the meaning of § 1.355-7(h)(1)) or discussions (within the meaning of § 1.355-7(h)(6)) concerning the transaction or a similar transaction (applying the principles of § 1.355-7(h)(12) and (13), relating to similar acquisitions), at any time during the 24-month period ending on the date of the distribution; and

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

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

G. Affiliated Corporations and Consolidated Returns

There were no significant developments regarding this topic during 2016.

H. Miscellaneous Corporate Issues

There were no significant developments regarding this topic during 2016.

VII. PARTNERSHIPS

A. Formation and Taxable Years

There were no significant developments regarding this topic during 2016.

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), *corrected*, 81 F.R. 80993 (11/17/16). 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, "but such share shall not exceed the partner's share of the partnership liability under section 752 and applicable regulations (as limited in the application of § 1.752-3(a)(3) to this paragraph (a)(2))." 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, and that no portion of any partnership liability for which another partner bears the risk of loss can be allocated to the contributing partner under the profit-share method. 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 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. Tax planning goes awry in Old Virginny. SWF Real Estate LLC v. Commissioner, T.C. Memo. 2015-63 (4/2/15). SWF Real Estate LLC owned farm land in Virginia on which it granted a conservation easement to a qualified donee. In connection with the grant of the easement, which would earn approximately \$3.5 million of State of Virginia conservation tax credits, SWF Real Estate entered into a transaction with Virginia Conservation Tax Credit Fund LLLP in which Virginia Conservation made a capital contribution to SWF Real Estate LLC (thereby converting it to a partnership from a disregarded entity) of \$1,802,000 for a 1 percent interest and an allocation of \$3,400,000 of State of Virginia conservation tax credits. The contribution was computed as 53 cents per \$1 of Virginia tax credits allocated to Virginia Conservation. The 99 percent was allocated only \$300,000 of Virginia tax credits. The parties entered into an indemnity agreement under which SWF Real Estate and the one partner other than Virginia Conservation (the previous partners of the partnership) were jointly and severally liable to indemnify Virginia Conservation if the Virginia tax credits were disallowed. The other partner of the partnership also had the option to purchase all, but not less than all, of Virginia Conservation's membership interest in SWF on or any time after January 1, 2010 at a price to be agreed upon by the parties or, if not agreed upon, 1 percent of the net fair market value of SWF Real Estate's assets at exercise. The IRS took the position that SWF Real Estate sold Virginia tax credits to Virginia Conservation in exchange for cash, thus engaging in a disguised sale under section 707 and that the capital contributions to the partnership were ordinary income to SWF. The Tax Court (Judge Wells) upheld the IRS's position because it found that the facts were "squarely in point" with *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), *rev'g* T.C. Memo. 2009-295, and that after applying the *Golsen* rule (*Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir.1971)), and that under the factors of Reg. § 1.707-3(b) the transfer of Virginia tax credits by SWF Real Estate to Virginia Conservation in exchange for money should be characterized as a disguised sale pursuant to 707(a)(2)(B). First, because the amount of Virginia

Conservation's capital contribution to SWF Real Estate was based directly on the amount of Virginia tax credits to be transferred or allocated to Virginia Conservation, Virginia Conservation could precisely determine the number of Virginia tax credits it could expect to receive on the basis of the amount of money it contributed to SWF Real Estate. Reg. § 1.707-3(b)(2)(i). Second, Virginia Conservation had a legally enforceable right to the later transfer of Virginia tax credits; under the subscription agreement and operating agreement, Virginia Conservation's capital contribution would entitle it to specific dollar amount of Virginia tax credits in exchange, and if SWF Real Estate and the other partner failed to fulfill the terms of those agreements, Virginia Conservation could have pursued breach of contract claims. Reg. § 1.707-3(b)(2)(ii). Third, Virginia Conservation's right to receive the credits was secured by the indemnity agreement. Reg. § 1.707-3(b)(2)(iii). Fourth, on the facts, SWF Real Estate held Virginia tax credits, beyond the reasonable needs of its business, that were expected to be available to make the transfer to Virginia Conservation. Reg. § 1.707-3(b)(2)(iv). Fifth, SWF Real Estate's transfer of Virginia tax credits to Virginia Conservation was disproportionately large in relationship to Virginia Conservation's general and continuing interest in SWF Real Estate's profit; Virginia Conservation held a 1% interest in partnership profits and losses and net cash flow, but was ultimately allocated 92% of the Virginia tax credits available to SWF Real Estate. Reg. § 1.707-3(b)(2)(ix). Sixth (and lastly), after receiving the Virginia tax credits, Virginia Conservation was free to use or transfer the credits as it desired; it had no further obligations to SWF Real Estate with regard to the Virginia tax credits. Reg. § 1.707-3(b)(2)(x). The court went on to hold, after detailed analysis of the rights and obligations of the parties, that the sale occurred in 2005, the year that SWF Real Estate and Virginia Conservation entered into the agreement, not in 2006, the year in which the State of Virginia awarded the tax credits and in which SWF Real Estate distributed the credits to Virginia Conservation. As of December 31, 2005, Virginia Conservation "owned" the tax credits, and even though Virginia Conservation's cash contribution was held by an escrow agent until 2006, under the "economic benefit" theory, the income had been realized in 2005 because SWF Real Estate's right to the escrowed funds was vested on or before December 31, 2005.

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

a. Things continue to go poorly in Ole Virginny for taxpayers trying to pull a fast one. *Route 231, LLC v. Commissioner*, 810 F.3d 247 (4th Cir. 1/8/16). The Court of Appeals for the Fourth Circuit, in

an opinion by Judge Agee, affirmed the Tax Court's decision that the § 707(a)(2)(B) disguised sale rules applied to treat as a disguised sale a transaction involving a contribution of cash to a partnership by a new partner followed by an allocation and distribution to that partner of State of Virginia conservation tax credits earned by the partnership. The court rejected the taxpayer's argument that the Tax Court improperly relied on *Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129 (4th Cir. 2011), and applied the factors of Reg. § 1.707-3 to affirm the Tax Court's conclusion that a disguised sale had occurred. "Viewing all the circumstances surrounding this transaction, and in particular the terms of the amended operating agreements, the Tax Court did not err in finding that 'Route 231 would not have transferred \$7,200,000 of Virginia tax credits to Virginia Conservation but for the fact that Virginia Conservation had transferred \$3,816,000 to it' and vice versa." In reaching its holding, the court stated as follows:

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

2. 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

There were no significant developments regarding this topic during 2016.

E. Inside Basis Adjustments

There were no significant developments regarding this topic during 2016.

F. Partnership Audit Rules

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

a. The early bird catches the worm (or is that eats the worm at the bottom of the tequila bottle?). T.D. 9780, Election into the Partnership Audit Regime Under the Bipartisan Budget Act of 2015, 81 F.R. 51795 (8/5/16). The Treasury and IRS have promulgated Temp. Reg. § 301.9100-22T dealing with the time, form, and manner for making an election to have the new partnership audit regime, §§ 6221-6223, 6225-6227, 6231-6235, and 6241, enacted in the Bipartisan Budget Act of 2015, apply to returns filed for tax years beginning after 11/2/15 and before 1/1/18. Under Temp Reg. § 301.9100-22T(b) an election to have the new partnership audit regime apply must be made within 30 days of the date of the written notice from the IRS that the partnership return has been selected for examination. The election must be in writing, signed by the tax matters partner, and must include the name, taxpayer identification number, address, and telephone number of the individual who signs the statement, as well as the partnership's name, taxpayer identification number, and tax year to which the statement applies. The statement must include representations that the partnership is not insolvent and does not reasonably anticipate becoming insolvent, the partnership is not currently and does not reasonably anticipate becoming

subject to a title 11 bankruptcy petition, and the partnership has sufficient assets, and reasonably anticipates having sufficient assets, to pay the potential imputed underpayment that may be determined during the partnership examination. The election must designate the partnership representative (§ 6223). An election may not be revoked without the IRS's consent. Temp. Reg. § 301.9100-22T(c) allows a partnership that has not been issued a notice of selection for examination to make an election with respect to a partnership return for the purpose of filing an administrative adjustment request under § 6227 (as amended); this election may only be made after 12/31/17. The temporary regulation is effective on 8/5/16.

2. Al Davis led the Raiders to three Super Bowl championships and was inducted into the Pro Football Hall of Fame, but was not able to persuade the Ninth Circuit that the IRS's breach of its closing agreement rendered the assessment invalid or that the limitations period on assessment had expired. *Davis v. United States*, 811 F.3d 335 (9th Cir. 1/25/16). The taxpayer had the largest interest in the Oakland Raiders, a limited partnership subject to the TEFRA audit rules, and also was the president of A.D. Football, Inc., the limited partnership's sole general partner and tax matters partner. For the years at issue, the partnership and the IRS entered into a closing agreement to settle Tax Court litigation. The closing agreement required the IRS to make computational adjustments to determine the settlement's effect on each partner's tax liability. Paragraph Q of the closing agreement provided that each partner would have at least 90 days to review and comment on the computational adjustments and at least 60 days to review and comment on revised computational adjustments before the IRS assessed the tax resulting from the adjustments. Stipulations reflecting the closing agreement and signed by the attorney for the petitioner (the partnership and its TMP) were filed in the Tax Court and the Tax Court approved and entered stipulated decisions on 6/6/06. The IRS subsequently issued computational adjustments and issued revised computational adjustments on 8/27/07. Because the limitations period on assessment was about to expire, the IRS did not give the partners 60 days to review the revised computational adjustments and instead assessed tax against the taxpayer for three taxable years on 9/4/07. The IRS collected the assessed tax by applying refunds due to the taxpayer for earlier taxable years, and the taxpayer brought this refund action. The taxpayer argued that the IRS had breached the closing agreement and that the breach rendered the assessment of tax invalid. The District Court held in favor of the taxpayer. In an opinion by Judge Hurwitz, the Ninth Circuit reversed. The government conceded on appeal that it had breached the closing agreement. Nevertheless, the court rejected the taxpayer's argument that the language of § 7121(b)(2), which provides that closing agreements are "final

and conclusive,” dictates that the remedy for the IRS’s breach is invalidation of the assessment. The court reasoned that closing agreements are contracts, and that the remedy for the IRS’s breach of contract is damages, a remedy that the taxpayer had not sought: “The IRS’s failure to perform its contract with the Partnership cannot relieve Davis of his statutory obligation to pay taxes; nothing in the Closing Agreement provided that any taxes assessed on the partners pursuant to statute would be rendered invalid if the government failed to perform.” The court also held that the assessment was timely. The court rejected the taxpayer’s argument that the stipulated decisions entered by the Tax Court on 6/6/06 were each a “settlement agreement with the partner” within the meaning of § 6231(b)(1)(C) that triggered a one-year limitation period on assessment under § 6229(f). “[W]e conclude that the IRS does not ‘enter into a settlement agreement with the partner’ when it enters into a settlement agreement with the TMP and the individual partner is bound merely by operation of the tax court’s decision to which the partner is a party. Here, the stipulations were not agreements with Davis individually. ... Thus, the stipulations, like the Closing Agreement, were agreements only between the IRS and the Partnership.” The court concluded that, pursuant to § 6229(d), the limitations period on assessment expired one year and 90 days after the stipulated decisions were entered, and that this period expired on 9/4/07, the day on which the IRS assessed tax.

3. 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, 836 F.3d 1282 (10th Cir. 9/6/16). The taxpayer invested in and was the tax matters partner of TEFRA partnerships used as vehicles for distressed debt 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.”

G. Miscellaneous

There were no significant developments regarding this topic during 2016.

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. The taxpayer came to regret his decision to organize his business as a C corporation, and a midco transaction failed to solve the problem. *Tricarichi v. Commissioner*, T.C. Memo. 2015-201 (10/14/15). The taxpayer was the sole shareholder of a C corporation, West Side Cellular, Inc. After lengthy litigation regarding network access, West Side received a settlement of \$65 million and was required both to terminate its business as a retail provider of cell phone service and to end all service to its customers. To reduce the impact of corporate-level tax, the taxpayer engaged in a midco transaction in which a Cayman Islands affiliate of Fortrend International LLC purchased the stock of West Side for approximately \$11.2 million more than the corporation's net asset value (the value of its assets less its estimated federal tax liabilities) and then used a distressed debt strategy to generate a

bad debt deduction of \$42.4 million to eliminate West Side's tax liabilities. In the notice of deficiency issued to West Side, the IRS determined a deficiency of \$15.2 million based on its disallowance of the corporation's bad debt deduction and asserted an accuracy-related penalty of roughly \$62,000 and a gross valuation misstatement penalty of \$5.9 million. The Tax Court (Judge Lauber) held the taxpayer liable as a transferee for West Side's federal tax liability, the accuracy-related penalty, and the gross valuation misstatement penalty. In order for a shareholder to have transferee liability for a corporation's tax liability, the court stated, two requirements must be satisfied:

(1) the shareholder must be liable for the corporation's debts under some provision of state law, and (2) the shareholder must be a "transferee" within the meaning of § 6901. With respect to the first requirement, the court held that the taxpayer was liable as a transferee under Ohio law (the Uniform Fraudulent Transfer Act) for the corporation's tax deficiency as well as the penalties:

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

With respect to the second requirement, the court disregarded the form of the transaction and concluded that the taxpayer was a transferee within the meaning of § 6901 because the taxpayer had in substance directly received West Side's cash. Any appeal of the court's decision will be directed to the Ninth Circuit.

a. How about a little salt in that wound? The taxpayer also is liable for pre-notice interest of \$13.9 million. Tricarichi v. Commissioner, T.C. Memo. 2016-132 (7/18/16). In a supplemental opinion, the Tax Court (Judge Lauber) upheld the government's calculation of pre-notice interest, i.e., interest that accrued on the corporation's unpaid federal income tax liability from the date on which payment was due from the corporation in March 2004 to the date on which the IRS issued the notice of liability to the taxpayer in June 2012. The government asserted that the taxpayer's liability for pre-notice interest must be determined under federal law and computed in accordance with the rules for interest on underpayments in § 6601. According to the government, the pre-notice interest amounted to \$13.9 million. The taxpayer contended that his liability for pre-notice interest

must be determined under state law, and that under state law his liability for pre-notice interest was zero. The court reviewed prior decisions addressing liability for pre-notice interest, including *Lowy v. Commissioner*, 35 T.C. 393 (1960) and *Estate of Stein*, 37 T.C. 945 (1962), and concluded that courts have applied state law to determine liability for pre-notice interest only when the transferee has received an amount less than the transferor's liability:

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

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

3. The Sixth Circuit says that a listed transaction actually does deliver the desired tax benefits. But the court admonishes the government that it possibly could have won had it argued lack of economic substance or had promulgated prophylactic regulations. Wright v. Commissioner, 809 F.3d 877 (6th Cir. 1/7/16), *rev'g* T.C. Memo. 2011-292 (12/22/11). The taxpayer entered into a series of mutually offsetting over-the-counter foreign currency options in euros and Danish kroner—a euro put and a krone call, and a euro call and krone put. (Because the krone is closely tied to the euro, both calls should largely offset each other, as should both puts.) The taxpayer claimed a loss by marking to market under § 1256 the euro put option upon his assignment of the option to a charity, but took the position that the transfer of the offsetting over-the-counter option in the minor currency (the Danish krone) was not a § 1256 contract (because krone positions are not traded through regulated futures contracts) and thus not subject to the mark-to-market rules. The IRS disallowed the loss because the transaction is a listed transaction. Notice 2003-81, 2003-2 C.B. 1223, *modified and supplemented*, Notice 2007-71, 2007-2 CB 472. Relying on its prior decision in *Summitt v. Commissioner*, 134 T.C. 248 (2010), the Tax Court held that the taxpayer could not recognize the loss on the assignment of the euro put option because,

as argued by the IRS, the option was not a “foreign currency contract” under § 1256. That reasoning, which also was the government’s argument in the Court of Appeals, was grounded on the theory that to be a § 1256 contract, a “contract must mandate at maturity either a physical delivery of a foreign currency or a cash settlement based on the value of the currency.” The Sixth Circuit, in an opinion by Judge Rogers, reversed the Tax Court’s holding. Judge Rogers concluded that “[w]hile the Tax Court’s disallowance of the Wrights’ claimed tax loss makes sense as a matter of tax policy, the plain language of the statute clearly provides that a foreign currency option can be a ‘foreign currency contract.’ ... Section 1256 provides that a ‘foreign currency contract’ is a contract ‘the settlement of which depends’ upon the value of a foreign currency even if that contract does not mandate that any such settlement occur. I.R.C. § 1256(g)(2)(A)(i).” Judge Rogers finished his opinion with an insightful missive on statutory interpretation.

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

Congress may have wanted to create a different result when Congress added the “settlement” prong to § 1256.

Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 105, 98 Stat. 494. Congress explained that prior to this amendment a contract “require[d] delivery of a [major] foreign currency” to meet the “foreign currency definition.” H.R. Rep. No. 98-432, pt. 2, at 1646 (1984), *reprinted in* 1984 U.S.C.C.A.N. 697, 1269. The House report indicates that Congress amended § 1256 to allow a contract that provides for a settlement in an amount determined by the value of the foreign currency, rather than actual delivery of the currency, to meet the “delivery” requirement of the “foreign currency contract” definition. *Id.* Congress may have wanted a contract that provides for settlement in cash to fall within the “foreign currency contract” definition only if that contract mandates settlement at maturity. If Congress had wanted to expand the definition of a “foreign currency contract” to include only such contracts, Congress could have amended § 1256(g)(2)(A)(i) to provide that a “foreign currency contract” is a contract “which requires delivery of, or *which requires* a settlement which depends on the value of, a foreign currency.” But Congress did not amend § 1256 in this way.

The fact that tax policy does not appear to support allowance of the Wrights’ claimed loss is not sufficient to reform the statutory language, for two reasons. First, the court’s attempt to reform § 1256 might unintentionally permit other tax-avoidance schemes. Second, Congress provided two escape hatches to guard against the type of adverse tax policy outcome at issue here. In particular, Congress allows the Secretary of the Treasury to prescribe regulations to exclude any type of contract from the “foreign currency contract” definition if the inclusion of this type of contract would be “inconsistent” with the purposes of § 1256. I.R.C. § 1256(g)(2)(B). The Secretary therefore could prevent future taxpayers from relying on § 1256 to mark to market foreign currency options by issuing a regulation that excludes foreign currency options from the definition of a “foreign currency contract.” Further, Congress also allows the Commissioner to prevent taxpayers from claiming tax losses based upon transactions involving offsetting foreign currency options by challenging specific transactions under the economic substance doctrine, as lacking in economic substance. *See* I.R.C. § 7701(o) (providing that a transaction shall be treated as having economic substance only if “the transaction

changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position" and "the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction"). These statutorily provided bases for dealing with tax shelters that may violate the underlying policy of the Internal Revenue Code make it doubly inappropriate for this court to try to achieve such a result by torturing the plain language of the statute.

B. Identified "tax avoidance transactions"

1. 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 of 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

There were no significant developments regarding this topic during 2016.

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.

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

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

1. Final regulations on program-related investments. T.D. 9762, Examples of Program-Related Investments, 81 F.R. 24014 (4/25/16). The Treasury and IRS have finalized, with minor changes, proposed

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

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

determination. (An organization must secure a determination of status by following procedures under § 506(f)). Section 6652(c)(4) penalties apply for failure to file the Notice. The regulations affect only § 501(c)(4) organizations that are organized after 12/18/15, and certain § 501(c)(4) organizations in existence on that date. The text of the temporary regulations serves as the text of the proposed regulations set forth in a related notice of proposed rulemaking, REG-101689-16, Requirement To Notify the IRS of Intent To Operate as a Section 501(c)(4) Organization, 81 F.R. 45088 (7/12/16).

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

B. Charitable Giving

1. **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, the Treasury and 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, the Treasury and the IRS have withdrawn the proposed regulations. The withdrawal indicates that the 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. Pigs get fat and hogs get slaughtered. Carroll v. Commissioner, 146 T.C. 196 (4/27/16). The taxpayers granted an otherwise qualifying conservation easement to a qualified donee. However, the conservation easement deed provided that if the conservation purpose was extinguished because of an unexpected change in circumstances surrounding the donated property, the donee organization would be entitled to a proportionate share of extinguishment proceeds at least equal to (1) the value of the easement at the time of the contribution over (2) the fair market value of the property at the time of the contribution and that the value of the easement on the effective date “shall be the deduction for federal income tax purposes allowable by reason of this grant, pursuant to Section 170(b) of the Code.” The IRS disallowed the deduction on the ground that the easement was not protected in perpetuity because Reg. § 1.170A–14(g)(6)(ii), which permits a “single—and exceedingly narrow—exception to the requirement that a conservation easement impose a perpetual use restriction,” requires that the grantee’s proportionate interest upon extinguishment of a conservation easement be a percentage determined by (1) the fair market value of the conservation easement on the date of the gift (numerator), over (2) the fair market value of the property as a whole on the date of the gift. The Tax Court (Judge Ruwe) upheld the IRS’s disallowance of the deduction. Reg. § 1.170A–14(g)(6)(ii) is “designed in case of extinguishment both (1) to prevent taxpayers from reaping a windfall if the property is destroyed or condemned and they get the proceeds from insurance or condemnation and (2) to assure that the donee organization can use its proportionate share of the proceeds to advance the cause of historic preservation elsewhere.” Because the formula in the conservation easement deed employed a formula that differed from the

formula in Reg. § 1.170A-14(g)(6)(ii), in the event of an extinguishment of the conservation easement, the grantee would not be guaranteed a proportionate share of extinguishment proceeds as required by Reg. § 1.170A-14(g)(6)(ii). In the event of extinguishment, if the deduction for the conservation easement was disallowed for a reason other than valuation (and the IRS had unsuccessfully raised a number of other grounds for disallowing the deduction), the taxpayers or their heirs could argue that they never received a tax deduction and, therefore, the donees would not be entitled to any extinguishment proceeds. Finally, the taxpayers could not circumvent the strict requirement of Reg. § 1.170A-14(g)(6) by showing that the probability of extinguishment is so remote as to be negligible under Reg. § 1.170A-14(g)(3). The court upheld a 20 percent accuracy-related penalty for substantial understatement of income under § 6662(a) and (b)(2) and held that the taxpayers did not qualify for the reasonable cause, good faith defense of § 6662(c)(1): they “offered no evidence which would explain why the terms of the conservation easement varied from the requirements of section 1.170A-14(g)(6), Income Tax Regs., nor do they clarify why Dr. Carroll[, who personally handled the conservation easement,] failed to seek competent advice from a tax attorney or other adviser to ensure the conservation easement’s compliance with pertinent regulations.”

3. 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.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

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

controlling question of law exists, so that an interlocutory appeal ... may materially advance the ultimate termination of the litigation.”

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

4. What is the meaning of “same taxpayer” when corporations merge? Wells Fargo & Co v. United States, 827 F.3d 1026 (Fed. Cir. 6/29/16), *rev’g in part and aff’g in part*, 117 Fed. Cl. 30 (6/27/14). Section 6621(d) allows “global netting” on interest rates for tax overpayments and tax underpayments by the “same taxpayer” to address the disparity between the higher interest rate imposed on tax underpayments and the lower interest rate applied when the government pays a refund on tax overpayments. On a motion for summary judgment, the Court of Federal Claims (Judge Firestone) held that the term “same taxpayer” includes both predecessors of the surviving corporation in a statutory merger. Section 6621(d) allows interest netting regardless of whether the overlapping overpayments and underpayments involve corporations that were separate prior to the merger; following a merger, the entities become one and the same as a matter of law and thus become the “same” for purposes of interest netting. The Court of Federal Claims rejected the government’s argument that § 6621(d) netting applies only when the overpayment and underpayment were made by the taxpayer with the same TIN at the time of the payments. The Court of Appeals for the Federal Circuit, in an opinion by Judge Stoll, affirmed in part and reversed in part. The Court of Appeals held that where before a merger of two corporations one had made an overpayment and the other had an underpayment, they do not meet

the “same taxpayer” requirement under § 6621(d), and interest netting is not allowed—because both the underpayment and overpayment occurred prior to the merger of the underpaying and overpaying entities, the payments were made by two separate corporations. But where before a merger the corporation acquired in the merger had an overpayment and after the merger the acquiring corporation has an underpayment, the “same taxpayer” requirement of § 6621(d) has been met, and interest netting is allowed.

5. 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.

6. 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, since 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'."

7. 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.

B. Discovery: Summonses and FOIA

1. Turnabout is fair play. Summoned individuals might have the right to grill IRS agents regarding their motives in issuing the summons. United States v. Clarke, 134 S. Ct. 2361 (6/19/14), *cert. denied*, 137 S.Ct. 625 (1/9/17). In the course of a partnership audit the IRS issued a summons to four individuals associated with the partnership whom the IRS believed had information and records relevant to the audit. The individuals refused to comply and the IRS sought enforcement of the summons. In the enforcement proceedings, the summonsed individuals asserted that the IRS had issued the summons for an improper purpose, namely to punish the partnership for refusing to extend the statute of limitations, and sought enforcement for an improper purpose, specifically, that the IRS decided to enforce the summonses, subsequent to the partnership filing suit in Tax Court, to “evad[e] the Tax Court[’s] limitations on discovery” and thus gain an unfair advantage in that litigation. In support of their request for an opportunity to question the IRS agents about their motives, the summonsed individuals submitted an affidavit from the attorney of another partnership associate, who had complied with a summons issued at the same time, which reported that only the IRS attorneys handling the Tax Court case, and not the original investigating agents, were present at the interview of his client. The District Court denied the request and ordered compliance, but the Eleventh Circuit reversed. 517 Fed. Appx. 689 (11th Cir. 4/18/13), finding that the District Court’s refusal to allow the summonsed individuals to examine IRS agents constituted an abuse of discretion. In support of that ruling, the Court of Appeals cited Fifth Circuit precedent holding that a simple “allegation of improper purpose,” even if lacking any “factual support,” entitles a taxpayer to “question IRS officials concerning the Service’s reasons for issuing the summons.” The Supreme Court, in a unanimous opinion by Justice Kagan, vacated the Court of Appeals decision and remanded the case. After initially repeating that under *United States v. Powell*, 379 U.S. 862 (1981), and its progeny “summons enforcement proceedings are to be ‘summary in nature,’” and “that courts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of ‘oversee[ing] the [IRS’s] determinations to investigate,” and “absent contrary evidence, the IRS can satisfy that

standard by submitting a simple affidavit from the investigating agent,” the Court went on to hold as follows:

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

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

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

a. On remand, the Eleventh Circuit concluded that the alleged motives of the IRS for issuing the summonses could be improper, but the individuals involved failed to show facts giving rise to a plausible inference of improper motive. United States v. Clarke, 816 F.3d 1310 (11th Cir. 3/15/16). Following the U.S. Supreme Court’s remand to the Eleventh Circuit, the Eleventh Circuit remanded to the District Court, which denied the request of the summonsed individuals for an evidentiary hearing and enforced the summons on the grounds that (1) none of the improper purposes alleged by the individuals was an improper motive to issue a summons as a matter of law, and (2) the individuals had failed to show facts giving rise to a plausible inference of improper motive regarding issuance of

the summons. *United States v. Clarke*, 115 A.F.T.R.2d 2015-836 (S.D. Fla. 2/18/15). In an opinion by Judge Dubina, the Eleventh Circuit affirmed. The Eleventh Circuit first addressed what constitutes an improper motive for issuing a summons as a matter of law and held that the District Court had erred in its analysis. According to the Eleventh Circuit, issuing a summons for the sole purpose of retaliating against a taxpayer or for the sole purpose of circumventing the limitations on Tax Court discovery would constitute improper motives for issuing a summons. Nevertheless, the court emphasized, “the circumstances under which a taxpayer could successfully allege improper circumvention of tax discovery are exceptionally narrow.” Next, the Eleventh Circuit concluded that the District Court’s refusal to hear additional evidence on remand was “appropriate in light of the summary nature of a summons enforcement proceeding” and did not amount to an abuse of discretion. Finally, the court held that the District Court had correctly concluded that the submissions of the summonsed individuals raised no plausible inference of improper motive.

2. 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. 8/17/16). 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. Will the Seventh Circuit jump on the bandwagon? Medical College of Wisconsin Affiliate Hospitals, Inc. v. United States, 118 A.F.T.R.2d 2016-5798 (E.D. Wis. 9/14/16). In a case raising the same issue, the United States District Court for the Eastern District of Wisconsin (Judge Clevert) concluded that statutory interest rate for a nonprofit corporation is the statutory rate provided by § 6621(a)(1) for corporations. The court's decision is appealable to the Seventh Circuit.

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

connection with its audit of 1987. After reviewing *Reineman* and *Digby*, the Seventh Circuit concluded that “[t]his case is more like *Digby* than *Reineman*. ... [T]he net operating loss carryforward on the 2010 tax return cannot be verified unless the IRS inspects the 2009 records.” Accordingly, the court upheld the District Court’s order requiring the taxpayer to produce the records.

4. The First Circuit declines to create a split in the Circuits and holds that, pursuant to the required records exception to the Fifth Amendment privilege against self-incrimination, a taxpayer must produce records required by the Bank Secrecy Act. *United States v. Chen*, 815 F.3d 72 (1st Cir. 2/29/16). In the course of investigating the 2008 tax liability of Mr. Chen and his wife, the IRS served a summons that required him to appear for an interview with an IRS agent and to produce financial and banking records. Mr. Chen appeared but invoked his Fifth Amendment privilege against self-incrimination and failed to provide the requested documents. The government filed a petition in the federal district court to enforce the summons. The District Court granted the government’s petition as to documents the taxpayer was required to keep under the Bank Secrecy Act (BSA) and, after reviewing *in camera* other documents not required by the BSA, issued an order directing Mr. Chen to produce those documents as well. In an opinion by Judge Lynch for a panel that included retired U.S. Supreme Court Justice David Souter sitting by designation, the First Circuit affirmed as to documents Mr. Chen was required to keep under the BSA but vacated and remanded for further explanation as to the other documents the District Court ordered Mr. Chen to produce. The First Circuit held that the required records doctrine, which is an exception to the Fifth Amendment privilege against self-incrimination, applies to the recordkeeping scheme of the BSA. Specifically, the court held that the three-part test established by *Shapiro v. United States*, 335 U.S. 1 (1948) and *Grosso v. United States*, 390 U.S. 62 (1968) for determining whether the required records doctrine applies was satisfied: (1) the government’s inquiry must be essentially regulatory, (2) the information is to be obtained by requiring the preservation of records that are of a kind the regulated party has customarily kept, and (3) the records must have assumed public aspects that render them at least analogous to public documents. The court acknowledged that the government was not engaging in impermissible targeting of activity that is criminal or almost always criminal because “Chen’s keeping an offshore bank account is not inherently criminal.” However, with respect to the District Court’s order, issued without explanation following its *in camera* review, that Mr. Chen produce personal and corporate domestic financial records not required to be kept by the BSA, the First Circuit vacated and remanded to the District Court for an explanation of its ruling.

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

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

6. Who will be looking at the information your client provided in response to a summons and asking your client questions

during the summons interview? It might not be an IRS employee. T.D. 9778, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 81 F.R. 45409 (7/14/16). The Treasury Department and the IRS have finalized, with only one minor change, proposed and temporary regulations under § 6103(n) (T.D. 9669, Participation of a Person Described in Section 6103(n) in a Summons Interview Under Section 7602(a)(2) of the Internal Revenue Code, 79 F.R. 34625 (6/18/14)). Section 6103(n) and Reg. § 301.6103(n)-1(a) permit the disclosure of returns and return information to any person for purposes of tax administration to the extent necessary in connection with the acquisition of property or certain services (such as processing, storage and reproduction) related to returns or return information. The final regulations clarify that such persons with whom the IRS or Chief Counsel contracts for services

may receive and review books, papers, records, or other data produced in compliance with [a] summons [issued by the IRS] and, in the presence and under the guidance of an IRS officer or employee, participate fully in the interview of the witness summoned by the IRS to provide testimony under oath.

The final regulations state that full participation in an interview includes “being present during summons interviews; questioning the person providing testimony under oath; and asking a summoned person’s representative to clarify an objection or assertion of privilege.” The final regulations apply to summons interviews conducted on or after 7/14/16, and the temporary regulations, which set forth the same rule, apply to summons interviews conducted on or after 6/18/14.

- Following the issuance of proposed and temporary regulations in 2014, the Tax Section of the State Bar of Texas submitted comments on the proposed regulations in which the Tax Section recommended that Treasury remove the provision that permits persons providing services to question a witness under oath or ask the witness’s representative to clarify an objection or assertion of privilege. Removing this provision, the Tax Section stated, would “result in a more orderly proceeding and a cleaner, more comprehensible transcript of the interview” and also “avoid the unsettled question of whether a private contractor has the legal authority to examine a witness.” 2014 TNT 180-24 (9/16/14). The preamble to the final regulations responds that § 7602(a) grants the IRS broad information gathering authority and that “[n]othing in section 7602(a) prohibits participation by a contractor in a summons interview, nor does it prescribe procedures that the IRS must follow during the summons interview.”

C. Litigation Costs

1. Calculating attorney's fees where there are no attorney's fees charged. Rev. Proc. 2016-17, 2016-11 I.R.B. 436 (2/29/16). This revenue procedure provides guidance regarding the recovery of administrative and litigation costs by individuals and organizations that provide pro bono representation to taxpayers. The hourly rate used to calculate an attorney fee award for pro bono representatives who charge hourly rates in their ordinary course of business will generally be limited to the lesser of the statutory hourly rate set forth in § 7430(c)(1)(B)(iii) or their hourly billing rate, unless they can establish that a special factor, as described in § 7430(c)(1)(B)(iii), applies. The rate for individuals who provide pro bono representation but do not charge an hourly rate for representing taxpayers in the ordinary course of business is the statutory hourly rate under § 7430(c)(1)(B)(iii). The rate for students authorized to practice before the IRS pursuant to Circular No. 230 or to practice before the United States Tax Court under the supervision of a practitioner through the United States Tax Court's Clinical, Student Practice and Calendar Call Program, and by paralegals or other persons qualified to perform paralegal work who are assisting pro bono representatives is thirty-five percent of the statutory hourly rate provided for representatives under § 7430(c)(1)(B)(iii). The revenue procedure is effective for all motions for costs under § 7430 filed on or after 2/29/16, but taxpayers can elect to follow it for motions for costs filed prior to 2/29/16 and pending before the court on that date.

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

the rules in Reg. § 301.7430-7 regarding qualified offers generally apply to qualified offers made in administrative court proceedings described in § 7430 after 12/24/03.

3. Which year is behind the valuation door? Alterman Trust v. Commissioner, 146 T.C. 226 (5/2/16). The taxpayer was a trust that had substantially prevailed on the merits in a prior proceeding (T.C. Memo. 2015-231) in which the court held that the trust was not liable as a transferee for a corporation's 2003 income tax liability. In this proceeding, the trust sought reasonable administrative and litigation costs as a prevailing party under § 7430. The Tax Court (Judge Buch) held that the trust was precluded from being considered a prevailing party by § 7430(c)(4)(A)(ii), which provides that a person can be a prevailing party only if they meet the requirements of 28 U.S.C. § 2412(d)(2)(B). Section 2412(d)(2)(B) requires that an individual have a net worth that does not exceed \$2 million at the time the civil action is filed. The trust argued that its net worth should be determined as of the date it filed the Tax Court petition or on one of two alternative dates, on all of which it met the \$2 million net worth requirement. The court rejected these arguments based on § 7430(c)(4)(D)(i)(II), which provides that, in the case of a trust, the net worth requirement "shall be determined as of the last day of the taxable year involved in the proceeding." In a transferee liability proceeding, the court concluded, the taxable year involved in the proceeding is the taxable year stated in the notice of liability as the year to which the liability relates, the year 2003, and on the last day of 2003 the trust did not meet the net worth requirement.

4. 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

There were no significant developments regarding this topic during 2016.

E. Statute of Limitations

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

for the taxpayers' 2001 tax returns in 2008. The Tax Court (Judge Cohen) held that the mitigation provisions did apply and upheld the deficiency. The argument focused on whether certain conditions found in § 1311(b) applied to the facts.

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

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

(B) in case the amount of the adjustment would be assessed and collected in the same manner as a deficiency under section 1314, there is adopted in the determination a position maintained by the taxpayer with respect to whom the determination is made, and the position *** maintained by the taxpayer in the case described in subparagraph (B) is inconsistent with the erroneous inclusion, exclusion, omission, allowance, disallowance, recognition, or nonrecognition, as the case may be.

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

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

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

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.

F. Liens and Collections

1. Constructive receipt of a deficiency notice for someone who played two of the three monkeys. Onyango v. Commissioner, 142 T.C. 425 (6/24/14). Section 6330(c)(2)(B) allows a taxpayer to contest the underlying tax liability in a CDP hearing only if he did not actually receive a deficiency notice or otherwise have an opportunity to dispute the liability. In

this case, on several occasions the Postal Service attempted unsuccessfully to deliver a deficiency notice that had been mailed to him at his legal residence by certified mail, return receipt requested. On at least two occasions the Postal Service left notices of attempted delivery of the certified mail which contained the notice of deficiency at the address of the taxpayer's legal residence, and informed the taxpayer that it had certified mail to deliver to him and that he had to sign a receipt for that mail before the Postal Service would deliver it to him. The taxpayer declined to check on a regular basis his mailbox at his legal residence and to retrieve on a regular basis any Postal Service mail items delivered there. After several unsuccessful attempts to deliver the certified mail, the Postal Service returned it to the IRS. The Tax Court (Judge Chiechi) held that a taxpayer who is reasonably able and had multiple opportunities to check his mail and intentionally fails to do so for the purpose of avoiding receipt of the deficiency notice cannot contend that for purposes of § 6330 he did not receive the deficiency notice. Accordingly, the taxpayer was not permitted to contest his underlying tax liability in the CDP hearing.

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

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

2. And the court says the IRS's "boilerplate" assertion of frivolity wasn't very funny. Ryskamp v. Commissioner, 797 F.3d 1142 (D.C. Cir. 8/14/15). The taxpayer owed unpaid income taxes for several years and did not respond to the IRS's demand for payment. The taxpayer requested a § 6330 CDP hearing, but the IRS denied him a CDP hearing based on its unexplained determination that all the reasons he gave for requesting a hearing were frivolous and contended that its frivolousness determination was not

subject to judicial review. (Section 6330(g) provides that if any “portion of a request for a hearing” is frivolous or reflects the taxpayer’s desire to delay or impede the administration of the federal tax laws, the Appeals Office may treat such portion as if it were never submitted, and it “shall not be subject to any further administrative or judicial review.”) The Tax Court held that it had jurisdiction to review whether the IRS correctly treated the taxpayer’s arguments as frivolous, and the D.C. Court of Appeals, in a 2-1 opinion by Judge Pillard, affirmed the jurisdictional issue, as well as the Tax Court’s holding that the IRS’s “boilerplate letter” rejecting the taxpayer’s arguments as frivolous, but “in which there was no statement . . . as to why [his] reasons for the request . . . were illegitimate,” was inadequate.

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

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

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

a. In light of *Ryskamp*, IRS Chief Counsel attorneys are advised not to contest in the Tax Court and the D.C. Circuit the Tax Court’s jurisdiction to review the IRS’s denial of CDP hearing requests as frivolous, but Counsel will advise the Department of Justice to continue to pursue the issue in other Circuits. Chief Counsel Notice CC-2016-008 (4/4/16) (available at <https://perma.cc/LT7T-GDZS>). This Chief Counsel Notice states that “Counsel continues to maintain the position that the Tax Court lacks jurisdiction to review a petition filed from the denial of a

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

3. Sometimes lack of Tax Court jurisdiction is a taxpayer victory. LG Kendrick, LLC v. Commissioner, 146 T.C. 17 (1/21/16). The Tax Court (Judge Marvel) rejected the IRS’s argument, and held that a supplemental notice of determination following a §§ 6320/6330 CDP hearing does not provide the basis for Tax Court jurisdiction to review the determination when the original notices of determination did not include a determination to sustain a collection activity for a particular period or liability and thus did not confer jurisdiction on the Tax Court. Because an invalid notice of determination does not provide a basis for Tax Court jurisdiction, the IRS can proceed with the collection action only if it subsequently issues a valid notice with attendant appeal rights. § 6330(c)(3); *Smith v. Commissioner*, 124 T.C. 36, 44 (2005) (describing invalid notices of determination as “void and of no effect”). With respect to other notices of determination that were valid, the court had jurisdiction and upheld the IRS’s determinations.

4. The IRS can trust the Postal Service where the Code doesn’t demand more. Bongam v. Commissioner, 146 T.C. 52 (2/11/16). The IRS issued a Notice of Federal Tax Lien Filing and Your Right to a Hearing,

which was sent by certified mail to the taxpayer's last known address in Bowie, Maryland. The taxpayer timely requested a CDP hearing, using an address in Washington, D.C. Following the CDP hearing, on 4/30/14 the IRS sent to the taxpayer by certified mail a Notice of Determination denying relief, which was mailed to the taxpayer at the Washington address, but which was returned to the IRS as undeliverable on 6/16/14. Without changing the date on the Notice, on 8/4/14 the IRS remailed it (including the envelope in which it had originally been posted) to the taxpayer by regular mail to the Maryland address. (The taxpayer never filed a change-of-address form with the IRS or otherwise indicated to the IRS that he wanted to have his last known address changed to the Washington address.) The taxpayer received the Notice on 8/22/14, and petitioned the Tax Court within 30 days of both the date on which he actually received the Notice and the date on which the Notice was remailed to him. The IRS argued that the Tax Court lacked jurisdiction because the Notice originally sent to the taxpayer at the Washington, D.C. address was invalid because it had not been mailed to his "last known address." The Tax Court (Judge Lauber) agreed that the Notice, as originally mailed to the taxpayer on 4/30/14, was invalid, because it was not sent to his "last known address" and it was not actually received by him. However, the Notice, as remailed on 8/4/14, was properly mailed and valid; thus the taxpayer's 30-day period for petitioning the Tax Court did not start to run before that date, and he timely filed his petition. The court held that § 6330(d) does not require that the IRS send a Notice of Determination by certified mail to the taxpayer's last known address or that the IRS deliver the Notice in any particular way—unlike §§ 6320(a) and 6330(a), which specify three permissible modes of notifying the taxpayer of liens and levies. Section 6330(d)(1) merely provides that the Tax Court will have jurisdiction if a taxpayer files a petition "within 30 days of a determination." "This language does not limit the manner in which the IRS may notify the taxpayer that a determination has been made." That the date appearing on the Notice did not match the date on which the Notice was successfully mailed to the taxpayer was irrelevant. Accordingly, the 30-day window prescribed by § 6330(d)(1) for filing a petition for redetermination was calculated by reference to the date of mailing of the Notice that was successfully sent to the taxpayer's Maryland address by regular mail on 8/4/14. That the Notice was sent by regular mail was not relevant.

5. State law, rather than federal common law, governs successor liability for employment taxes. WRK Rarities, LLC v. United States, 165 F. Supp. 3d 631 (N.D. Ohio 2/29/16). William R. Kimpel was the sole owner and president of a corporation that operated a jewelry store known as Kimpel's Jewelry and Gifts (KJG). The corporation entered chapter 11 bankruptcy proceedings, which were later dismissed when it failed to make

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

6. A Notice of Determination of Worker Classification is "generally subject to deficiency procedures," and therefore a pre-assessment conference with IRS Appeals does not preclude challenging the underlying tax liability in a CDP hearing. Hampton Software Development, LLC v. Commissioner, T.C. Memo. 2016-38 (3/3/16). Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability in a CDP hearing only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." In this case, the IRS determined on audit that the taxpayer should have classified a worker as

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

7. According to the Eleventh Circuit, the IRS is required to make a pre-assessment determination of a taxpayer's liability as a responsible person under § 6672 when the taxpayer submits a protest, and its failure to do so might render the assessment invalid. Romano-Murphy v. Commissioner, 816 F.3d 707 (11th Cir. 3/7/16), *vacating and remanding*

T.C. Memo. 2012-330 (11/29/12). The taxpayer served as the chief operating officer of a healthcare staffing business. The IRS sent to her a Letter 1153 (notice of proposed assessment) informing her that the IRS intended to hold her responsible for a penalty equal to more than \$346,000 of the business's unpaid employment taxes pursuant to § 6672(a). The taxpayer submitted a written protest and requested a conference with IRS Appeals. Due to an unexplained error, the IRS never forwarded the protest to IRS Appeals and the taxpayer was not provided with a pre-assessment conference or a final administrative determination as to her protest. Instead, the IRS assessed the tax and issued a notice of intent to levy and notice of federal tax lien, in response to which the taxpayer requested a collection due process hearing. During the CDP hearing, the IRS Appeals Office observed that the taxpayer had not had a pre-assessment opportunity to contest her liability and therefore conducted a post-assessment review of the issues the taxpayer had raised in her protest. Following this review, the IRS issued a notice of determination sustaining the proposed collection. The taxpayer sought review in the Tax Court, which sustained the IRS's determination. The taxpayer moved to vacate on the ground that the IRS can collect a tax only after a valid assessment, and that the assessment in her case was invalid because the IRS had failed to give her a pre-assessment hearing and determination when she filed her timely protest. The Tax Court (Judge Morrison) concluded that, notwithstanding the IRS's failure to make a pre-assessment determination of liability under § 6672(a) in response to the taxpayer's protest, § 6672 did not prohibit the IRS's assessment. The Tax Court accordingly denied the taxpayer's motion to vacate. In an opinion by Judge Jordan, the Eleventh Circuit held that the IRS erred in failing to make a pre-assessment determination of the taxpayer's liability under § 6672(a) in response to her protest. The Eleventh Circuit vacated the Tax Court's judgment and remanded for a determination whether the IRS's error was harmless or instead rendered the assessment invalid (or required some lesser form of corrective action). In reaching its conclusion that the IRS was required to make a pre-assessment determination of liability in response to the taxpayer's protest, the court relied on several sources of authority. The court first concluded that § 6672(b)(3)—which provides that, "if there is a timely protest of the proposed assessment," the period of limitations on assessment shall not expire before "the date 30 days after the Secretary makes a final administrative determination with respect to such protest"—contemplates a pre-assessment determination of liability (and notice of such determination to the taxpayer) if a timely protest has been filed. The court therefore rejected the IRS's argument "that it may simply ignore, disregard, or discard a taxpayer's timely protest to a § 6772(b) pre-assessment notice if it so chooses." Assuming for the sake of argument that the language of the statute is ambiguous, the court reviewed the relevant regulations and

concluded that Reg. §§ 301.7430-3(d) and 301.6320-1(e)(4) “require the IRS to make a pre-assessment determination (though not necessarily through the provision of a hearing) about a taxpayer’s § 6672(a) liability when timely protest is made.” These regulations, the court concluded, are entitled to *Chevron* deference and are binding on the government as well as the taxpayer. Finally, the court regarded Reg. § 601.106(a)(1)(iv) and relevant provisions of the Internal Revenue Manual as persuasive authority that supported its conclusion.

8. 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.

9. The taxpayer may have been misled by a scam promising huge returns from African diamonds, but prevails 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. 153 (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.

10. 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 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.

11. 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.

G. Innocent Spouse

There were no significant developments regarding this topic during 2016.

H. Miscellaneous

1. 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.”

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.

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

liabilities for 2000 and 2001 had been discharged. Section 523(a)(1) of the Bankruptcy Code excludes from discharge any debt for a tax or customs duty:

(B) with respect to which a return, or equivalent report or notice, if required—

- (i) was not filed or given; or
- (ii) was filed or given after the date on which such return, report, or notice was last due, under applicable law or under any extension, and after two years before the date of filing of the petition;

An unnumbered paragraph at the end of Bankruptcy Code § 523(a), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provides that, for purposes of § 523(a):

the term ‘return’ means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared under section 6020(a) of the Internal Revenue Code ... but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code

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

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

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

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

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

Code § 523(a) requires applying the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) to determine whether a late-filed return constitutes a “return” for purposes of 11 U.S.C. § 523(a). The court concluded that the Bankruptcy Court, which had held that the taxpayers’ late-filed returns were “returns” within the meaning of the statute, had relied on a version of the *Beard* test that did not reflect the correct legal standard. Accordingly, the court remanded to the Bankruptcy Court for further consideration.

c. The Eleventh Circuit declines to decide whether a late-filed return always renders a tax debt nondischargeable in bankruptcy. *In re Justice*, 817 F.3d 738 (11th Cir. 3/30/16). In an opinion by Judge Anderson, the Eleventh Circuit declined to adopt what it called the “one-day-late” rule embraced by the First, Fifth and Tenth Circuits because it concluded that doing so was unnecessary to reach the conclusion that the taxpayer’s federal income tax liability was nondischargeable in bankruptcy. The taxpayer filed his federal income tax returns for four tax years after the IRS had assessed tax for those years and between three and six years late. The court concluded that it need not adopt the approach of the First, Fifth and Tenth Circuits because, even if a late-filed return can sometimes qualify as a return for purposes of Bankruptcy Code § 523(a), a return must satisfy the four-factor *Beard* test (*Beard v. Commissioner*, 82 T.C. 766 (1984), *aff'd*, 793 F.2d 139 (6th Cir. 1986)) in order to constitute a return for this purpose, and the taxpayer’s returns failed to satisfy this test. One of the four factors of the *Beard* test is that there must be an honest and reasonable attempt to satisfy the requirements of the tax law. The Eleventh Circuit joined the majority of the other circuits in concluding that delinquency in filing a tax return is relevant to whether the taxpayer made such an honest and reasonable attempt. “Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law.” The taxpayer in this case, the court stated, filed his returns many years late, did so only after the IRS had issued notices of deficiency and assessed his tax liability, and offered no justification for his late filing. Accordingly, the court held, he had not filed a “return” for purposes of Bankruptcy Code § 523(a) and his tax debt was therefore nondischargeable.

d. The Ninth Circuit holds that a taxpayer’s tax debt cannot be discharged in bankruptcy without weighing in on the issue whether a late-filed return always renders a tax debt nondischargeable. *In re Smith*, 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.

3. 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.”

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

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

5. The IRS continues successfully to be stingy with whistleblower awards. Whistleblower 22716-13W v. Commissioner, 146 T.C. 84 (3/14/16). A whistleblower's cooperation with the Department of Justice and the IRS Criminal Investigation Division led to a taxpayer agreeing, by guilty plea, to pay an FBAR civil penalty substantially in excess of \$2,000,000 and a small amount of restitution, reflecting unpaid federal income tax on income derived from Swiss bank accounts. The petitioner sought a whistleblower award, which the IRS denied. Under § 7623(b)(5)(B), a whistleblower is entitled to a nondiscretionary award only "if the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed \$2,000,000." The issue in this case was whether the FBAR civil penalties which are imposed and collected under 31 U.S.C. § 5321, rather than under the Internal Revenue Code, constitute "additional amounts" for purposes of ascertaining whether the \$2,000,000 threshold has been met. The Tax Court (Judge Lauber) held that the term "additional amounts" as used in § 7623(b)(5)(B) means only the civil penalties set forth in chapter 68, subchapter A, of the Internal Revenue Code, captioned "Additions to the Tax and Additional Amounts." FBAR civil penalties are not "additional amounts" within the meaning of § 7623(b)(5)(B) and are not "assessed, collected, and paid in the same manner as taxes." Thus, FBAR payments must be excluded in determining whether the \$2,000,000 "amount in dispute" requirement has been satisfied. Accordingly the court upheld the IRS's denial of any award.

6. What should have been a slam dunk for the IRS turned into an embarrassing loss: an IRS revenue agent who pleaded guilty to tax evasion established that there was no tax deficiency for the year in question. Senyszyn v. Commissioner, 146 T.C. 136 (3/31/16). The taxpayer was an IRS revenue agent who became involved in the business affairs of a real estate developer. The developer brought a civil suit for fraud in which the developer asserted that the taxpayer had embezzled a total of \$1 million. In a subsequent federal criminal investigation, an IRS revenue agent determined that, during 2003, the taxpayer had taken from the developer \$252,726 more than he had returned. The taxpayer signed an agreement with the U.S. Attorney in which the taxpayer agreed to plead guilty and to stipulate at sentencing that he "knowingly and willfully did not include about \$252,726.00 in additional taxable income that he acquired in 2003." As agreed, the taxpayer pleaded guilty to the tax evasion charge. Based primarily on this omitted income, the IRS subsequently issued a notice of deficiency for 2003 asserting a deficiency in federal income tax, a fraud penalty against the taxpayer, and an accuracy-related penalty against his spouse. At trial, the taxpayer successfully established that the IRS's analysis of the funds he had received was inaccurate. The Tax Court (Judge Halpern) found that, during

2003, the taxpayer had returned to the developer more funds than he had received from the developer. Accordingly, the court held, the evidence presented by the IRS did not support the asserted deficiency. The court also held that an amended return for 2003 filed by the taxpayers, on which the taxpayers reported an additional \$252,726 of income, could not be treated as an admission that would support the deficiency because the return also reported an additional deduction of \$476,005. The court also declined to apply the doctrine of collateral estoppel to uphold the deficiency. The use of collateral estoppel to uphold the deficiency in this case, the court reasoned, should be regarded as an offensive (rather than defensive) use of collateral estoppel because the taxpayer was a defendant in the prior criminal case. Under *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979), trial courts have broad discretion in permitting the offensive use of collateral estoppel, and should not do so “when the purposes of the doctrine do not support its application.” The court concluded that the purposes of the doctrine—protecting litigants from the burden of relitigating an identical issue and promoting judicial economy—“would not be served by upholding a deficiency unsupported by the evidence presented.” Although the taxpayer’s criminal conviction established the existence of an underpayment for 2003, the conviction did not establish its exact amount and therefore the court in this proceeding necessarily had to determine the amount of the deficiency. Because the taxpayers were not liable for a deficiency, the fraud and accuracy-related penalties based on the asserted deficiency were moot.

7. Was Dad invited for Thanksgiving dinner even though he filed a Form SS-8 asking the IRS to determine his employment status in the family business? *B G Painting, Inc. v. Commissioner*, T.C. Memo. 2016-62 (4/5/16). The IRS notified the taxpayer’s president that one of the taxpayer’s workers had filed a Form SS-8 asking the IRS to determine his employment status. In the taxpayer’s response, the president informed the IRS that the worker was his father and provided other requested information. The IRS issued Letter 4991 to the worker and a Letter 4991-A to the taxpayer notifying them of its determination that the worker was an employee rather than an independent contractor. The taxpayer filed a petition in the Tax Court, and the IRS moved to dismiss for lack of jurisdiction. The Tax Court (Judge Dawson) granted the government’s motion to dismiss.

Section 7436(a) confers jurisdiction on this Court only with regard to determinations that are made by the IRS in connection with an audit of a taxpayer. Other IRS determinations of employment status that are not made as part of a taxpayer audit, including those made in the context of

private letter rulings or Forms SS-8, are not subject to review by this Court under section 7436(a).

The Letter 4991 issued by the IRS, the court explained, was not a notice of determination that would confer jurisdiction on the court. Further, under the first part of the four-part test established in *American Airlines, Inc. v. Commissioner*, 144 T.C. 24 (2015), for determining jurisdiction under § 7436(a), the IRS must make an examination in connection with an audit. The court noted that it had previously held in *Staffmore, LLC v. Commissioner*, T.C. Memo. 2013-187, “that IRS review of information provided in a Form SS-8 submission is not considered an ‘audit’ or ‘examination.’”

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

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

10. Tax is still a little bit different from general administrative law in some respects. *Ax v. Commissioner*, 146 T.C. 153 (4/11/16). The Tax Court (Judge Gustafson) held that neither the Administrative Procedure Act (5 U.S.C. §§ 701-706 (judicial review)) nor *Securities and Exchange Commission v. Chenery Corp.*, 318 U.S. 80 (1943) bar the IRS from raising new grounds to support a notice of deficiency beyond those grounds originally stated in the notice.

Petitioners’ proposal—that a deficiency case be confined to issues in the NOD—would be a radical innovation that not only is at odds with the statutes discussed above but that also would change longstanding practice. Under Rule 142(a)(1), “The burden of proof shall be upon the petitioner, except as

otherwise provided by statute or determined by the Court; and except that, in respect of any new matter *** pleaded in the answer, it shall be upon the respondent.” (Emphasis added.) The rules have so provided as to “new matter” since soon after deficiency litigation first began to be held in this Court’s predecessor, the Board of Tax Appeals (“BTA”). This provision as to the burden of proof on “new matter” persisted when the BTA became the Tax Court of the United States in 1942—and it was therefore in effect when Congress enacted the APA. The “new matter” provision persisted in 1969 after the Court was reconstituted as an Article I court to be known as the United States Tax Court. When Congress in 1998 addressed tax litigation procedure by enacting section 7491 (entitled “Burden of Proof”) to shift the burden of proof in some circumstances, the Tax Court rules then provided, as they had for decades and still do, that burden of proof on “new matter” was on the respondent.

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

11. A snowy day at the Tax Court. Guralnik v. Commissioner, 146 T.C. 230 (6/2/16). The taxpayer filed a petition in the Tax Court challenging the IRS’s notice of determination sustaining collection action. The taxpayer sent the petition on February 13, 2015 by Federal Express using a delivery method that did not qualify for the “timely mailed is timely filed” rule of § 7502(a). Although the petition should have been delivered on February 17, 2015, which was the deadline for filing the petition, all federal offices, including the Tax Court, were closed on that day because of a snowstorm. The petition was delivered to the court on the first day the court was open following the storm, February 18, 2015. The government moved to dismiss for lack of jurisdiction because the taxpayer did not file the petition within the 30-day period prescribed by § 6330(d). In a unanimous, reviewed opinion by Judge Lauber, the Tax Court denied the motion. The court looked to Federal Rule of Civil Procedure 6(a)(3)(A), which provides that if the clerk’s office is inaccessible on the last day for filing, then the time for filing is extended to the first day that is not a Saturday, Sunday, or legal holiday on

which the clerk's office is accessible. Although the Tax Court's rules do not address this situation, Tax Court Rule 1(b) provides:

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

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

12. 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 2011-5, 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.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

There were no significant developments regarding this topic during 2016.

B. Self-employment Taxes

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

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

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

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

2. 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 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.

C. Excise Taxes

1. In Steven Spielberg’s 1971 film entitled “Duel,” a large tanker truck terrorizes a car driven by Dennis Weaver. These proposed regulations address the excise tax implications. REG-103380, Excise Tax; Tractors, Trailers, Trucks, and Tires; Definition of Highway Vehicle, 81 F.R. 18544 (3/31/16). The Treasury and IRS have issued proposed amendments to regulations regarding: (1) the definition of a “highway vehicle” for purposes of various excise tax provisions (Prop. Reg. § 48.0–4); (2) the tax imposed by § 4051 on the retail sale of certain highway-type tractors and chassis and bodies for highway-type trailers and trucks (Prop. Reg. §§ 48.4051–0, –1, –2 and 48.4052–1); and (3) the tax imposed by § 4071 on the sale by a manufacturer of a taxable tire with a maximum rated load capacity greater than 3,500 pounds (among other proposed regulations, Prop. Reg. §§ 48.4071–1, –2, –3 and 48.4072–1). The proposed regulations update, restate and reorganize temporary regulations that were published in 1983 (T.D. 7882, Floor Stocks Credits or Refunds and Consumer Credits or Refunds With Respect to Certain Tax-Repealed Articles; Excise Tax on Heavy Trucks; 48 F.R. 14361 (4/4/83)) and have been periodically amended. The proposed

regulations are necessary to reflect statutory changes and address relevant court decisions. The proposed regulations change the result in *Horton Homes, Inc. v. United States*, 357 F.3d 1209 (11th Cir. 2004), which held that so-called “toters,” which are tractor units designed specifically to tow manufactured homes, are not tractors subject to the excise tax imposed by § 4051. The proposed regulations will apply on and after the date final regulations are published in the Federal Register.

XII. TAX LEGISLATION

A. Enacted

1. 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.