VIRGINIA
Conference on Federal Taxation

JUNE 6 & 7, 2024

UNIVERSITY OF VIRGINIA DARDEN SCHOOL OF BUSINESS
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OUTLINE OF PROCEEDINGS

SEVENTY-FIFTH ANNUAL

VIRGINIA CONFERENCE ON FEDERAL TAXATION

Presented by

The Virginia Tax Foundation

In Cooperation with

Virginia Society of Certified Public Accountants,

The Virginia Bar Association,

Virginia State Bar

June 6-7, 2024

Administered by Virginia Continuing Legal Education by the Virginia Law Foundation
For information, please contact John Rotman:
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COURSE SCHEDULE

Thursday, June 6, 2024

8:00 Registration and Continental Breakfast

8:30 Opening Remarks

8:40 **FEDERAL TAX UPDATE—Individuals**
Cassady V. Brewer, Bruce McGovern

9:55 Break

10:05 **FEDERAL TAX UPDATE—Business**
Cassady V. Brewer, Bruce McGovern

11:20 Break

11:30 **CONSIDERATIONS IN EMPLOYEE VS PARTNER TREATMENT AND EMPLOYEE VS CONTRACTOR TREATMENT**
Karen Field, RSM

12:30 Lunch

1:15 **GREENBACK FOR GOING GREEN – UPDATE ON THE CURRENT STATUS OF ENERGY TAX CREDITS IN THE INFLATION REDUCTION ACT**
Scott Bragg, Jeff Barbour

2:15 Break

2:25 **PASS THROUGH ENTITY TAX – THE ADVENTURE CONTINUES…**
Lori Roberts

3:55 Break

4:05 **PLANNING AHEAD OF THE SUNSET**
Farhad Aghdami

5:05 Closing Remarks and Adjourn

5:30 Reception

Friday, June 7, 2024

8:00 Continental Breakfast

8:30 Opening Remarks

8:40 **TAX POLICY, PROPOSALS & PROSPECTS: A WASHINGTON UPDATE**
Jeff Kummer

9:40 Break

9:50 **TRANSACTION STRUCTURES INVOLVING S CORPORATIONS**
Daniel F. Carmody, Steven Schneider

10:50 Break

11:00 **WHAT WE'VE LEARNED SO FAR ABOUT THE BBA PARTNERSHIP AUDIT REGIME**
Rochelle Hodes

12:00 Lunch Break

12:45 **INTERNATIONAL TAX: FAQs WHEN ADVISING CROSS-BORDER INDIVIDUALS AND COMPANIES**
Lynn Eller

1:45 Break

1:55 **EQUITY INCENTIVES AND DEFERRED COMPENSATION – OVERVIEW OF STRUCTURES AND PLANNING OPPORTUNITIES**
Taylor French, Robert Wynne

2:55 Break

3:05 **HOT TOPICS IN TAX PRACTICE ETHICS**
Tiffany L. Burton, Timothy M. Todd

5:05 Closing Remarks

5:15 Adjourn

ABOUT THE SPEAKERS

Farhad Aghdami, Williams Mullen / *Richmond*
Farhad Aghdami is the Managing Partner of the Richmond office of Williams Mullen. He focuses his practice on wealth transfer tax planning, business succession planning, income tax planning for individuals and businesses, and fiduciary litigation. He counsels a wide variety of clients including high net worth individuals and families, middle market business owners, institutional fiduciaries, family offices, and charitable entities.

Farhad is a 1989 graduate of the University of Virginia and a 1992 graduate of the Wake Forest University School of Law. Farhad received his LL.M. in taxation from Georgetown University Law Center in 1995.

Farhad is a Fellow in the American College of Trust and Estate Counsel (ACTEC), where he is Chair of the Fiduciary Income Tax Committee, the State Chairs Steering Committee, and a member of the ACTEC Board of Regents. Farhad is Southeast Region Chair and immediate past Virginia State Chair of ACTEC. Farhad is also a member of the Board of Trustees of the Southern Federal Tax Institute (SFTI) where he serves as its Vice President. Farhad has held leadership positions in a number of other professional organizations, including the Virginia Bar Association Wills, Trusts, and Estates Section (Chair, 2011-2013), Fiduciary Income Tax Committee of the ABA Tax Section (Chair, 2003 to 2005), Estate Planning Council of Richmond (President, 2011-2012), Insurance Planning Committee of the ABA Real Property, Probate & Trust Section (Chair, 2003-2004), Trust Administrators Council of Richmond (President, 2004-2005), University of Richmond Estate Planning Advisory Council (Chair, 2004-2009), and Richmond Private Business Study Group (Chair, 2001-2002). Farhad previously served as an adjunct professor at the University of Richmond School of Law and Washington & Lee's School of Law.

Farhad is a co-author of Tax Planning for Family Wealth Transfers During Life, Tax Planning for Family Wealth Transfers at Death, and Structuring Buy-Sell Agreements (2nd Ed.; ThomsonReuters). He is the author of numerous articles that have appeared in tax journals, including The Tax Lawyer and The Journal of Taxation and has been quoted in the New York Times and Virginia Business. Farhad is Co-Chair of the Conner-Zaritsky Advanced Estate Planning Institute sponsored by Virginia CLE. In addition, Farhad regularly speaks at advanced planning conferences and seminars, including those sponsored by the University of Miami-Heckerling Institute, ACTEC, SFTI, the ABA and the American Law Institute.

Farhad is a member of the Board of Trustees of the Virginia Museum of Fine Arts Foundation and Venture Richmond, where he serves as its Board Chair. Farhad is a member of The Forum Club and the 2006 Class of Leadership Metro Richmond. Farhad previously served as Chairman of the Board of Governors of The Community Foundation Serving Richmond and Central Virginia and he previously served on the Board of Trustees of the Medical College of Virginia Foundation, the Valentine Museum, St. Christopher's School, and the Boys and Girls Club of Metro Richmond.

Jeff Barbour, Brown Edwards / *Roanoke*

Jeff is a partner in the Roanoke office of Brown Edwards and specializes in the taxation of consolidated and multi-state corporations and pass-through entities, corporate mergers and acquisitions, individual taxation, small business consulting, and estates and trusts. His experience in these areas includes general tax planning, entity formation and exit strategies, purchase price allocations, and the research of federal and state compliance solutions. Jeff's expertise covers a variety of industries including technology, manufacturing, dealerships, distributors, construction, and real estate. Jeff has over twenty years of experience with Brown Edwards and two years in accounting with a private company. Jeff serves as chair of the firm’s tax department and is a member of the firm’s executive committee.

He graduated from the University of North Carolina at Greensboro in 2003 with a Master of Accountancy specializing in taxation. He graduated summa cum laude in 2002 from Averett University, in Danville, Virginia, with a Bachelor of Business Administration with a concentration in accounting.

He is a Certified Public Accountant licensed in Virginia and is currently a member of the American Institute of Certified Public Accountants, the Virginia Society of Certified Public Accountants, and the Roanoke Chapter of the Virginia Society of Certified Public Accountants. Jeff is a member of the Roanoke Valley Estate Planning Council and the Southwest Virginia Business Development Association. He also serves as Treasurer of the Roanoke Regional Chamber of Commerce and is active in the leadership of his church.

Scott Bragg, Brown Edwards / *Glen Allen*
Scott is a Senior Manager in the Bristol, TN office of Brown Edwards and specializes in the taxation of pass-through entities, mergers and acquisitions, individual taxation, multi-state taxation, and small business consulting. Scott’s expertise covers a variety of industries including real estate, manufacturing, and professional services. Scott joined Brown Edwards in 2022 and brought with him nearly twenty years of experience in public accounting.

He graduated from West Virginia University in 2005 with a Bachelor of Business Administration with a concentration in accounting. His career has included stops in the Washington, DC metro area and Pittsburgh, PA before moving to his current home in Southwest Virginia. He now resides with his wife and three sons in Abingdon, VA.

He is a Certified Public Accountant licensed in Virginia and Tennessee and is currently a member of the American Institute of Certified Public Accountants and the Virginia Society of Certified Public Accountants.

Cassady V. Brewer, Georgia State University College of Law / *Atlanta, GA*
Cassady V. “Cass” Brewer, associate professor of law, teaches Basic Federal Income Taxation, Nonprofit Organizations, Taxation of Business Organizations, Partnership Taxation, and the Law of Social Enterprise. His research primarily focuses upon the legal and tax aspects of the intersection of tax-exempt, nonprofit organizations with for-profit enterprises and commercial activity. In particular, Mr. Brewer writes and speaks extensively on federal income taxation and the legal and tax aspects of the emerging “hybrid” business forms such as the benefit corporation and the low-profit limited liability company.

Mr. Brewer received his LL.M. (Taxation) from New York University, where he served as graduate editor of the Tax Law Review. He is a graduate of the University of Arkansas School of Law, where he was editor-in-chief of the Arkansas Law Review. He received his undergraduate degree from Vanderbilt University. He co-founded the Nonprofit Law Section of the State Bar of Georgia, and he is a past co-chair of the Section. Mr. Brewer also has participated in drafting and amending the Georgia Limited Liability Company and Limited Liability Partnership Acts.

Mr. Brewer is a fellow of the American College of Tax Counsel and previously was a partner in the Tax Group of Morris, Manning & Martin, LLP.

Tiffany L. Burton, Rees Broome, PC / *Tysons Corner*
Tiffany L. Burton, J.D., L.L.M, Shareholder at Rees Broome, PC, Tysons Corner, VA. Tiffany has over 18 years of experience as a tax and corporate attorney representing closely held businesses of all sizes. She advises business and their owners on a broad range of M&A transaction issues and corporate, partnership, and s corporation tax issues, including transaction matters, formations, equity compensation, joint ventures, restructurings, acquisitions, and divestitures. Ms. Burton is the current chair of the Taxation Section of the Virgina State Bar.

Daniel Carmody, Morgan Lewis / *Philadelphia*
Dan Carmody is a Philadelphia-based partner in the private client practice group at Morgan Lewis. Dan focuses on federal income tax issues that arise for families and their closely held businesses. Dan has particular expertise dealing with the taxation of partnerships and S corporations.

Lynn M. Eller, PBMares / *Washington, DC*
Lynn Eller is a leader of the firm's international tax practice. Her knowledge of the complex international tax areas has enabled her to be a program partner for the Virginia Leaders in Export Trade where she advises businesses expanding abroad. She has prepared numerous tax returns for nonresident aliens, U.S. residents that are eligible for the foreign earned income exclusion, and US residents who control foreign corporations. Obtaining the Advanced Professional Certificate in International Taxation (APCIT) designated by the International Bureau of Fiscal Documentation (IBFD) furthered her expertise in international tax from both a US perspective, as well as a worldwide view. She serves as a technical resource for international tax issues and presents seminars for her peers within PBMares.

Ms. Eller's Personal Financial Specialist (PFS) credential indicates she has extensive expertise in assessing the tax implications of investments, retirement plans, insurance and estate planning. In addition, her knowledge of the tax needs of owner-managed businesses has enabled her to be a trusted advisor for clients in the professional services, real estate, healthcare, and manufacturing industries. She seeks to assist business owners in realizing federal and state tax credits and incentives including the research and development credit, domestic production deduction and numerous state incentives.

Ms. Eller is an active member of the American Institute of Certified Public Accountants (AICPA) and the Virginia Society of Certified Professional Accountants (VSCPA), where she

helped found the International Tax and Business Special Interest Group for the Northern Chapter and coordinates CPE and networking for other CPAs.

A licensed Certified Public Accountant, she is a graduate from Virginia Tech in Blacksburg, Virginia.

Karen M. Field, RSM US LLP / *Washington, DC*
Karen Field has over 38 years of experience in the Employee Benefits area. Karen joined the RSM Washington National Tax Compensation and Benefits group after retiring from KPMG's Washington National Tax Compensation & Benefits group. Before joining KPMG, Karen spent many years in IRS National Office TE/GE working on qualified retirement plans (e.g., 401(k) and pension plans), 457 plans, SEPs, nonqualified deferred compensation plan issues and Form 1099 reporting issues. Karen works on both domestic and international compensation and benefits issues. Karen reviews and helps determine the taxation and deductions for equity compensation and nonqualified deferred compensation arrangements (including section 409A, section 457(f) and (b) plans, and certain international plans). She assists with section 280G golden parachute rules, section 162(m) $1 million dollar limit rules, section 4960 determinations, fringe benefits, partnership compensation arrangements, and other employee benefits.
Karen also works with qualified 401(k), IRA/Roth IRA and pension issues, including cross-border pensions, prohibited transaction issues, and deduction issues. Karen speaks at professional conferences around the country, including the AICPA and TEI. She is a member of the Joint TE/GE Council Employee Plans Council, is the past Tax chair for the AICPA Employee Benefits Conference Committee and assists with the AICPA Employee Benefit Technical Resources Panel. She is a current member of the AICPA Tax Reform Section 274 Task Force and the AICPA Section 4960 and Remote Worker response teams.

Rochelle Hodes, Crowe LLP / *Washington, DC*
Rochelle Hodes is a principal in Washington National Tax at Crowe LLP. Prior to joining Crowe, Ms. Hodes was Associate Tax Legislative Counsel in the Office of Tax Policy at the U.S. Treasury Department. While at Treasury, she worked on a variety of matters, including the centralized partnership audit regime enacted by the Bipartisan Budget Act of 2015 (BBA), taxation of digital assets, and implementation of the Tax Cuts and Jobs Act. She began her career as an attorney with the IRS Office of Chief Counsel. Before returning to Treasury, Rochelle spent several years in private practice. Her experience includes assisting clients in resolving federal tax disputes, obtaining private letter rulings, and addressing and responding to regulatory and legislative changes in tax policy.

Ms. Hodes is a frequent speaker and author, including a contributing author for the treatise "IRS Practice and Procedure." In 2017, she was named a 'Tax Person of the Year' for 2017 by Tax Notes for her work at Treasury implementing the BBA partnership audit rules. She received her LL.M from Georgetown University Law Center, her JD from Washington College of Law and her undergraduate degree from the American University. She is a member of the District of Columbia Bar and a fellow with the American College of Tax Counsel. She is the chair of the Administrative Practice Committee of the Tax Section of the American Bar Association and the immediate past chair of the IRS Advocacy and Relations Committee of the Tax Section of the American Institute of Certified Public Accountants.

Jeffrey Kummer, Deloitte Tax LLP / *Washington, DC*
Mr. Kummer has over 20 years of experience in the tax policy arena and is currently responsible for communicating emerging tax developments in the U.S. Congress, the Internal Revenue Service and Treasury Department, and the federal courts to the Firm and its clients. Mr. Kummer oversees the content development of Tax News & Views as well as thought leadership publications on issues such as the U.S. deficit and prospects for fundamental tax reform.

His Capitol Hill experience includes working on tax and budget issues for former U.S. Senator and Senate Finance Committee member Steve Symms, R-Idaho.

Mr. Kummer holds a BS in Political Science from the University of Idaho and an MBA from Johns Hopkins University.

Bruce McGovern, South Texas College of Law Houston / *Houston, TX*
Bruce A. McGovern is a member of the faculty at South Texas College of Law Houston, where he also serves as Director of the school's Low-Income Taxpayer Clinic. Previously, he served for many years as the school's Vice President and Associate Dean for Academic Administration. He received his undergraduate degree from Columbia University and his law degree from Fordham University School of Law. After law school, he served as a judicial clerk for Judge Thomas Meskill on the U.S. Court of Appeals for the Second Circuit in New York. He then practiced law with the law firm of Covington & Burling in Washington, D.C. He subsequently earned an LL.M. in Taxation from the University of Florida Levin College of Law, where he taught as a visiting faculty member before joining the faculty at South Texas College of Law Houston. Professor McGovern teaches and writes in the areas of business organizations and taxation. He is a co-author of the treatise Federal Income Taxation of Individuals (Thomson Reuters 2003 and Supp. 2022) (with Boris I. Bittker, Martin J. McMahon, Jr., and Lawrence A. Zelenak) and a co-author of the casebook Agency, Partnerships, and Limited Liability Companies (Carolina Academic Press 2013) (with Gary S. Rosin and Michael L. Closen). His courses include Federal Income Taxation, U.S. Taxation of International Transactions, Partnership and Subchapter S Taxation, and Federal Tax Procedure. He frequently speaks on recent developments in federal income taxation. Professor McGovern is a member of the Council of the State Bar of Texas Tax Section, a former Chair of the Houston Bar Association Section of Taxation, and a Fellow of the American College of Tax Counsel.

Lorilei J. Roberts, PBMares / *Fairfax*
Lori Roberts leads the firm in providing state and local taxation (SALT) consultation and compliance services for clients, as well as assisting other PBMares professionals with SALT-related concerns. With a deep knowledge of state, local and federal taxation issues and how they relate to each other, Ms. Roberts is adept at helping many types of clients find the best answers to their business and tax situations while remaining fully compliant and taking a proactive approach to maximizing tax benefits. She holds both CPA and CGMA designations.

In addition to her professional work, Ms. Roberts offers her financial and leadership talents to civic and religious organizations. An active volunteer and former Rotarian, Ms. Roberts contributes to mission activities with Rising Hope Mission in Alexandria, Virginia.

Steven R. Schneider, Hogan Lovells / *Washington, DC*
Mr. Schneider is a nationally recognized tax lawyer who focuses his practice on transactional, controversy and tax policy matters. He has significant tax experience in mergers & acquisitions, private equity and real estate funds, qualified opportunity zone funds, bioscience, cross-border tax, partnerships, real estate, REITs, international investors (including sovereigns), and S corporations.

He started his career as a lawyer in the IRS' national office and has had many years of national-level law firm and Big-4 accounting firm experience. Mr. Schneider also previously chaired the ABA Partnership Tax Committee. He has been teaching an advanced tax course on drafting partnership and LLC agreements at Georgetown University Law Center since 2005, is a regular speaker at national tax venues, and has published numerous articles.

Dr. Timothy M. Todd, Ph.D., Liberty University School of Law / *Lynchburg*
Timothy M. Todd, Ph.D., serves as Professor of Law and Associate Dean for Faculty Development & Scholarship at Liberty University School of Law in Lynchburg, Virginia. His areas of teaching include taxation of individuals; taxation of businesses; estate & gift taxation; wills, trusts, and estates; financial planning; business planning; and other transactional law courses. He also serves as a regular Forbes contributor, writing about taxes, tax planning, tax cases, and related areas.

Robert Wynne, McGuireWoods / *Richmond*
Robert is a partner in the Richmond office of McGuireWoods, where he focuses on all areas of executive compensation and employee benefits law. His practice includes equity and non-equity-based incentive arrangements; non-qualified deferred compensation; tax-qualified retirement, health and welfare plans; compensation and benefits issues in the M&A context; multiemployer pension plan withdrawal liability; and issues involving ERISA fiduciary responsibilities. He regularly represents clients in interactions with the IRS, DOL and PBGC, and is experienced with the SEC's executive compensation proxy disclosure rules.

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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Note: This outline was prepared jointly with James M. Delaney, Centennial Distinguished Professor of Law, University of Wyoming College of Law, Laramie, WY.

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 are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in 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.

In the last twelve months, there have been many significant federal income tax developments. The Treasury Department and the IRS provided an abundance of administrative guidance and the courts issued many significant judicial decisions. The Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, enacted on December 29, 2022, includes the SECURE 2.0 Act of 2022, which increases the age at which required minimum distributions (RMDs) must begin to age 73, reduces the penalty for failure to take RMDs, modifies the rules for catch-up contributions to qualified retirement plans, and makes many other significant changes that affect retirement plans. This outline discusses the major administrative guidance issued in the last year, summarizes recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

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I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. Next time you earn points by staying at a hotel or use points to pay for a hotel, think of the tax issues you are creating for the hotel! Hyatt Hotels Corp. v. Commissioner, T.C. Memo. 2023-122 (10/2/23). The major issue in this case is whether the taxpayer, Hyatt Hotels Corporation (Hyatt), had gross income from its rewards program, known during the years in issue as its Gold Passport Program. Hyatt owned approximately 25 percent of Hyatt-branded hotels. The remaining 75 percent were owned by third parties and operated under either a management model, pursuant to which Hyatt employees ran the hotel pursuant to a contract, or a franchise model under which the hotel owner obtained a license to use Hyatt's brand name and other intellectual property. When a hotel guest earned rewards points by staying at a Hyatt-branded hotel, Hyatt required the hotel owner to pay a specified amount into an operating fund held by a Hyatt subsidiary. When a hotel guest used points to pay for a room at a Hyatt-branded hotel, Hyatt would make a compensating payment from the fund to the hotel owner. Hyatt also used the assets of the fund to pay administrative and advertising expenses that it determined were related to the rewards program. Some of the assets in the fund were invested in marketable securities, which resulted in interest and realized gains. According to the court, "Hyatt essentially ignored the fund, including none of its revenue in gross income and claiming no deductions for expenses paid." During an audit, the IRS took the position that Hyatt had to include in gross income the payments made into the fund as well as interest accrued and investment gains realized. The IRS also took the position that Hyatt's treatment of the fund was a method of accounting and that, because Hyatt must change the way in which it treats the fund going forward, a change in accounting method has occurred that requires Hyatt to make a positive § 481 adjustment and include in income the net revenue of the fund from its inception in 1987. Hyatt argued that its treatment of the fund was appropriate because it held the fund as a trustee, agent, or conduit for the hotel owners and was not the owner of the fund for federal income tax purposes. Hyatt also argued in the alternative that, if its treatment of the fund was not appropriate, its treatment of the fund was not a method of accounting and therefore no adjustment under § 481 was required. Finally, Hyatt argued in the alternative that, if it must include the fund's revenue in gross income, it is entitled to offset the fund's gross receipts with the estimated cost of future compensation payments to hotel owners under a regulatory provision known as the trading stamp method.

Gross income issue. The Tax Court (Judge Nega) first held that Hyatt had to include the fund's revenue in its gross income. The court rejected Hyatt's argument that the trust fund doctrine applied. Under the trust fund doctrine, recognized by the court in *Seven-Up Co. v. Commissioner*, 14 T.C. 965 (1950), and refined in subsequent decisions such as *Ford Dealers Advertising Fund, Inc. v. Commissioner*, 55 T.C. 761 (1971), aff'd, 456 F.2d 255 (5th Cir. 1972):

> when a taxpayer (1) receives funds in trust, subject to a legally enforceable restriction that they be spent in their entirety for a specific purpose and (2) does not profit, gain, or benefit from spending the funds for that purpose, then the taxpayer may exclude such funds from gross income.

The court concluded that the second element was not met because Hyatt benefitted from the fund. The court found that Hyatt exercised control over and had discretion with respect to spending from the fund for costs such as advertising, and that, as the largest single owner of Hyatt hotels, Hyatt benefitted from this spending.

Change of accounting method. The court concluded that, although Hyatt had to change from excluding the fund's revenue from gross income to including the revenue in gross income, this change was not a change in Hyatt's method of accounting. A change in accounting method, the court reasoned, involves a change in the proper time for the inclusion of income or the taking a deduction. *See* Reg. § 1.446-1(e)(2)(ii)(b). Hyatt's total exclusion of the fund's revenue from gross income did not involve timing. Accordingly, the court concluded, no § 481 adjustment was required. The government argued that this result was inappropriate because, going forward, Hyatt would deduct expenses of the fund but would not have included the fund's prior revenue in gross income. The court responded that a number of doctrines might preclude Hyatt's deductions. Presumably, the court was referring to the concept that a taxpayer cannot deduct amounts paid from funds that have not been subject to tax.

Trading stamp method. Hyatt argued that the trading stamp method permitted Hyatt to reduce the fund's revenue that it includes in gross income by the estimated cost of future compensation payments to hotel owners. The trading stamp method is an exception to the normal rules that require an accrual method taxpayer to include amounts in gross income when the all events test is satisfied. Under the trading stamp method, if an accrual method taxpayer issues trading stamps or premium coupons with sales that are redeemable in merchandise, cash, or other property, then the taxpayer can offset against gross receipts the estimated cost of its future provision of merchandise, cash, or other property. See Reg. § 1.451-4(a)(1). The court rejected Hyatt's argument on the ground that the future hotel stays to which rewards program members were entitled were not merchandise, cash, or other property within the meaning of the regulation.

B. Deductible Expenses versus Capitalization

1. Legal expenses incurred related to the preparation of applications to the FDA for approval of generic drugs are capital expenditures while legal expenses incurred to defend patent infringement suits are currently deductible. Mylan, Inc. v. Commissioner, 156 T.C. 137 (4/27/21). The taxpayer, Mylan, Inc., and its subsidiaries manufacture both brand-name and generic pharmaceutical drugs. Mylan incurred substantial legal expenses in two categories. First, Mylan incurred legal expenses in connection with its applications to the FDA seeking approval of generic drugs. To obtain this approval, Mylan submitted abbreviated new drug applications (ANDAs). The FDA's application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a "paragraph IV certification"). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Mylan incurred substantial legal expenses to prepare the notice letters it sent in connection with its FDA applications. Second, Mylan incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Mylan in response to the notice letters that Mylan sent. Mylan claimed deductions for both categories of legal expenses. The IRS, however, determined that all of Mylan's expenses were capital expenditures under § 263(a). The Tax Court (Judge Urda) held that the legal expenses incurred by Mylan to prepare notice letters were capital expenditures but the legal expenses Mylan incurred to defend patent infringement suits were currently deductible business expenses.

FDA applications for generic drugs and notice letter costs. The court first addressed the issue of whether the costs Mylan incurred to prepare the notice letters it sent in connection with its ANDAs should be capitalized under § 263. The court's analysis focused in large part on the regulations under § 263 regarding intangibles. These regulations require a taxpayer to capitalize both amounts paid to *create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. Reg. § 1.263(a)-4(b)(1)(ii), (v). With respect to creation of an intangible, Reg. § 1.263(a)-4(d)(5)(I) provides:

> A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

With respect to facilitating the acquisition or creation of an intangible, Reg. § 1.263(a)-4(e)(1) provides:

> [A]n amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances.

Mylan and the IRS disputed whether Mylan's legal fees were incurred to "facilitate" the acquisition of a right obtained from a governmental agency and therefore were required to be capitalized. They agreed that the relevant "transaction" was the *acquisition* of an FDA-approved ANDA with a paragraph IV certification. But they disagreed on when this acquisition occurs. Mylan argued that the acquisition of an FDA-approved ANDA occurs when the FDA completes its scientific investigation and issues an approval letter. The IRS asserted that the acquisition of an FDA-approved ANDA with a paragraph IV certification occurs only when the approval letter issued by the FDA becomes effective. The distinction is that the FDA may issue an approval letter but the approval does not grant any rights to the applicant until it becomes effective. Only when the approval becomes effective does the applicant have the right to begin delivery of a generic drug. *See* 21 U.S.C. § 355(a). With respect to Mylan's legal fees incurred in preparing the notice letters relating to the filing of its ANDAs with paragraph IV certifications, the court concluded that these costs were capital expenditures. The notice is a required step in securing FDA approval of an ANDA. According to the court, because the notice requirement was a prerequisite to securing FDA approval, "the legal expenses Mylan incurred to prepare, assemble, and transmit such notice letters constitute amounts incurred 'investigating or otherwise pursuing' the transaction of creating FDA-approved ANDAs … and must be capitalized."

Litigation expenses. The court reached a different conclusion regarding Mylan's litigation expenses, holding that they were currently deductible. The IRS argued that a patent infringement suit is a step in obtaining FDA approval of an ANDA. The court disagreed, however, and reasoned that the outcome of a patent litigation action has no effect on the FDA's review of a generic drug application. The FDA continues its review process during the course of a patent infringement action and may issue a tentative or final approval of an application before the infringement action is finally decided. A successful patent dispute does not guarantee that a generic drug manufacturer will obtain FDA approval of an ANDA. While it is true that a successful challenge by a patent holder will result in a prohibition of the marketing of a generic drug found to infringe, the court reasoned that the coordination of the FDA approval process with the outcome of related patent litigation does not insert the patent litigation into the FDA's ANDA approval process. A patent on a name-brand drug does not prevent FDA approval of a generic version of the drug and patent litigation on the part of the patent holder is not a step in the FDA's approval process for a generic drug. In reaching its conclusion that the litigation expenses incurred by Mylan were currently deductible as ordinary and necessary expenses, the court also applied the "origin of the claim" test, which inquires as to "'whether the origin of the claim litigated is in the process of acquisition", enhancement, or other disposition of a capital asset." *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970); see also *Santa Fe Pac. Gold Co. v. Commissioner*, 132 T.C. 240, 264-265 (2009). Here, the court reasoned, Mylan's legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed the decision of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which held that patent litigation arises out of the exploitation of the invention embodied in the patent and, therefore, costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect

business profits. Because Mylan's legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible.

a. Legal expenses incurred to defend patent infringement suits are currently deductible. Actavis Laboratories, FL, Inc. v. United States, 161 Fed. Cl. 334 (8/19/22). The plaintiff in this case, Actavis Laboratories Florida, Inc. (Actavis), was the substitute agent for Watson Pharmaceuticals, Inc. (Watson). Watson manufactured both branname and generic pharmaceutical drugs. To obtain approval of generic drugs, Watson submitted to the Food and Drug Administration abbreviated new drug applications (ANDAs). The ANDA application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a "paragraph IV certification"). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Watson incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Watson in response to the notice letters that Watson sent. Watson deducted these legal expenses on its 2008 and 2009 tax returns. Following audits of these returns, the IRS issued a notice of deficiency disallowing Watson's deductions on the basis that the costs incurred in defending the patent infringement litigation were capital expenditures under § 263(a). Watson paid the amounts sought by the IRS and, after filing amended returns requesting refunds, brought this action in the U.S. Court of Federal Claims seeking refunds of $1.9 million for 2008 and $3.9 million for 2009.

The U.S. Court of Federal Claims (Judge Holte) held that the legal expenses incurred by Watson in defending the patent infringement litigation were currently deductible. The IRS argued that the costs were capital expenditures under Reg. § 1.263(a)-4(b)(1), which requires taxpayers to capitalize amounts paid to *acquire or create* an intangible and amounts paid to *facilitate* an acquisition or creation of an intangible. According to the government, the costs facilitated the acquisition of an intangible, specifically, an FDA-approved ANDA. The court, however, disagreed. The court relied on the "origin of the claim" test established by the U.S. Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963). As interpreted by a later decision, *Woodward v. Commissioner*, 397 U.S. 572 (1970), the deductibility of litigation expenses under the origin of the claim test depends not on the taxpayer's primary purpose in incurring the costs, but "involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition [of a capital asset] itself." Here, the court reasoned, Watson's legal expenses arose from legal actions initiated by patent holders in an effort to protect their patents. The court followed a long line of decisions, including that of the U.S. Court of Appeals for the Third Circuit in *Urquhart v. Commissioner*, 215 F.2d 17 (3d Cir. 1954), which have held that costs incurred to defend a patent infringement suit are not capital expenditures because they are not costs incurred to defend or protect title but rather are expenses incurred to protect business profits. Because Watson's legal expenses arose out of the patent infringement claims initiated by the patent holders, the court held, they were currently deductible. The court further concluded that Reg. § 1.263(a)-4(b)(1) did not require the costs to be capitalized because Watson's defense of the patent infringement litigation was not a step in the FDA's approval process for a generic drug:

> The FDA's review of an ANDA does not include patent related questions. When a generic drug company files an ANDA with a Paragraph IV certification, it certifies the patents associated with the relevant [drug] are either invalid or will not be infringed by the proposed generic drug. The FDA performs no assessment of that certification as a part of its ANDA review process—"[a]ccording to the agency, it lacks 'both [the] expertise and [the] authority' to review patent claims[.]"

- The court's analysis and conclusions in this case are consistent with those of the Tax Court in *Mylan, Inc. & Subsidiaries v. Commissioner*, 156 T.C. 137 (4/27/21).

b. The Third Circuit has agreed that legal expenses incurred by a taxpayer seeking FDA approval of a generic drug to defend patent infringement suits are currently deductible. Mylan, Inc. v. Commissioner, 76 F.4th 230 (3d Cir. 7/27/23), *aff'g* 156 T.C. 137 (4/27/21). In an opinion by Judge Jordan, the U.S. Court of Appeals for the Third Circuit has affirmed the Tax Court's decision and has held that legal expenses incurred by a taxpayer seeking FDA approval of a generic drug to defend patent infringement suits are currently deductible.

Costs of preparing and sending notice letters to holders of patents on branname drugs. As described earlier, the FDA's approval process for an ANDA requires the applicant to make one of certain types of certifications regarding the status of any existing patents on the relevant branname drug. One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this type of certification is required by the FDA's approval process to notify the holders of patents on relevant branname drugs that it has made this certification. In this case, Mylan incurred legal fees to prepare and send such notice letters. The Tax Court held that these costs were capital expenditures because they facilitated the acquisition of an intangible (an FDA-approved application) within the meaning of Reg. § 1.263(a)-4(b)(1)(v). Neither party appealed this aspect of the Tax Court's decision and the Third Circuit's opinion therefore does not address it.

Costs of defending patent infringement litigation. As described earlier, the taxpayer incurred substantial legal fees in defending patent infringement litigation brought by holders of patents on branname drugs in response to the notice letters that the taxpayer sent. The Tax Court held that these costs were not capital expenditures and that the taxpayer therefore could deduct them currently as ordinary and necessary business expenses. The government appealed this aspect of the Tax Court's decision. On appeal, the Third Circuit affirmed the Tax Court's decision. The court reviewed at length the FDA's approval process for an ANDA. The key question, the court observed, was whether the costs incurred by the taxpayer to defend patent infringement litigation *facilitated* the acquisition or creation of an intangible within the meaning of Reg. §§ 1.263(a)-4(b)(1)(v) and 1.263(a)-4(e)(1)(i). The court noted that the IRS, beginning in 2011, had issued several non-binding memoranda asserting that generic drug companies must capitalize and amortize the costs of defending patent infringement suits filed in response to the type of certifications made by the taxpayer. The court disagreed with the IRS's position. According to the court, whether the FDA approves (or disapproves) an application for approval to market a generic drug does not depend on the outcome of the patent infringement litigation: "The FDA can approve an ANDA for an infringing generic and deny an ANDA for a non-infringing generic." The court quoted with approval the following summary from the Tax Court's opinion:

> The outcome of a [patent infringement] suit has no bearing on the FDA's safety and bioequivalence review. The FDA continues its review process during the pendency of the patent infringement suit and may issue a tentative or final approval before the suit is resolved. The FDA does not analyze patent issues as part of its review, and neither the statute nor regulations suggest that patent issues might block approval of an ANDA. And winning a patent litigation suit does not ensure that the generic drug manufacturer will receive approval, as the FDA can disapprove an ANDA for not meeting safety and bioequivalence standards.

C. Reasonable Compensation

1. Pigs get fat but hogs get slaughtered? Fourth Circuit upholds Tax Court decision that a portion of compensation paid to a C corporation shareholder-employee was unreasonable and nondeductible, but vacates the Tax Court's imposition of underpayment penalties. Clary Hood, Inc. v. Commissioner, 69 F.4th 168 (4th Cir. 5/31/23). The taxpayer in this case was a C corporation formed in 1980 to engage in the land excavation and grading business. The CEO, Clary Hood, and his spouse were 50/50 shareholders of the taxpayer and the sole members of the board of directors. Since its inception, the taxpayer-corporation never paid dividends. (*Uh, oh.*) From 2000 to 2010, the taxpayer-corporation averaged approximately $21 million in annual gross revenue and less than $1 million per year in net income before taxes. During those years, Mr. Hood's annual salary was roughly $130,000, and in some of those years, Mr. Hood received a bonus, the largest of which was approximately $321,000. Then in 2011, at Mr. Hood's direction, the taxpayer-corporation shifted away from residential to commercial projects, and the taxpayer-corporation's revenues grew substantially. By 2015, the taxpayer-corporation's annual revenue grew to $44 million. By 2016, annual revenue grew to $69 million. Nevertheless, Mr. Hood's annual salary was only $168,559 for 2015 and only $196,500 for 2016. (*Uh, oh.*) Accordingly, the taxpayer-corporation decided to pay Mr. Hood a bonus of $5 million for 2015 and another $5 million for 2016. (*Uh, oh.*) The taxpayer-corporation, in consultation with its accountants, determined that the $5 million bonuses paid to Mr. Hood in each of the years 2015 and 2016 were appropriate to reflect the taxpayer-corporation's recent success and to remedy undercompensating Mr. Hood in prior years. On audit, the IRS challenged the taxpayer-corporation's bonuses to Mr. Hood as unreasonable and therefore nondeductible to the extent of $1.3 million for 2015 and $3.6 million for 2016. The IRS also imposed substantial underpayment penalties for years 2015 and 2016 under § 6662.

The Tax Court's Decision. The Tax Court (Judge Greaves) largely sided with the IRS after a six-day trial. *See Clary Hood, Inc. v. Commissioner*, T.C. Memo. 2022-15 (3/2/22). The IRS's expert testified that, although Mr. Hood was undercompensated for the years 2000 to 2012, the taxpayer-corporation had begun to address this discrepancy in 2013 when Mr. Hood was paid $1.4 million in salary and bonuses. The IRS's expert further concluded that by the end of 2014, Mr. Hood had been undercompensated approximately $2.3 million in prior years. The IRS expert's report concluded that reasonable compensation amounts for Mr. Hood would have been roughly $3.7 million for 2015 and roughly $1.4 million for 2016. The taxpayer-corporation submitted two opposing expert reports; however, Judge Greaves determined that the taxpayer-corporation's expert reports deserved "little to no weight" due to "dubious assumptions" underlying the reports and the lack of supporting calculations. Consequently, in a 64-page opinion, Judge Greaves held for the IRS and concluded that the taxpayer-corporation could deduct about $3.7 million of Mr. Hood's $5 million bonus for 2015 and about $1.4 million of Mr. Hood's $5 million bonus for 2016. The Tax Court further determined that the taxpayer-corporation should not be subject to a § 6662 substantial understatement penalty for 2015 because it reasonably relied on professional tax advice in good faith, but for 2016, the taxpayer-corporation could not show reasonable cause and should be subject to a § 6662 substantial understatement penalty for that year. The taxpayer-corporation appealed to the Fourth Circuit.

The Fourth Circuit's Decision. The Fourth Circuit, in an opinion written by Judge Niemeyer, initially recited the applicable law of § 162(a)(1) limiting a taxpayer's deduction for salaries and other compensation to a "reasonable allowance . . . for personal services actually rendered." Judge Niemeyer then highlighted the directive of Reg. § 1.162-7(b) that reasonable compensation is determined by taking into account "all the circumstances." The Fourth Circuit further observed that compensation paid by closely held corporations is subject to "close scrutiny" because such payments may be disguised dividends. Ultimately, the Fourth Circuit stated, the reasonableness of compensation is determined based upon a multi-factor analysis which considers the "totality of the circumstances," including:

> the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; [and] the salary policy of the taxpayer as to all employees.

Moreover, the Fourth Circuit noted that the reasonableness of compensation in closely-held corporations may take into account additional factors such as pay for prior years as well as shareholder-employee guarantees of corporate debt. The Fourth Circuit agreed that the Tax Court (Judge Greaves) properly adopted the multi-factor analysis described above as the test for determining reasonable compensation.

The Fourth Circuit acknowledged that the various factors used to determine reasonable compensation may be viewed from the perspective of a hypothetical independent investor (i.e., whether such an investor would be willing to compensate an employee at the same level). The court declined, however, to accept the taxpayer-corporation's argument that the Fourth Circuit should reverse the Tax Court and adopt the Seventh Circuit's "independent investor" test as the exclusive approach to deciding reasonable compensation cases. In *Menard, Inc. v. Commissioner*, 560 F.3d 620 at 622-623 (7th Cir. 2009), and *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 at 839 (7th Cir. 1999), Judge Posner used the "independent investor" test to allow a taxpayer to establish a "rebuttable presumption" that compensation is reasonable so long as the corporation's shareholders are receiving a sufficiently high rate of return on their investment in the stock of the corporation. According to the taxpayer-corporation, if the Tax Court and the Fourth Circuit adopted the Seventh Circuit's "independent investor" test, they would conclude that Mr. Hood's compensation was reasonable because the taxpayer-corporation generated a 22% rate of return on equity for its shareholders in 2015 and a 36% rate of return on equity for 2016.

The Fourth Circuit then found no error in the Tax Court's application of the multi-factor approach to determining reasonable compensation for Mr. Hood. The Fourth Circuit emphasized, as did the Tax Court, that the taxpayer-corporation had never declared or paid a dividend to its shareholders. The Fourth Circuit also emphasized Mr. Hood's testimony that in 2015 he became aware of the taxpayer-corporation's need from an "income tax" perspective to begin "getting money out of [the] corporation" to prepare for a "changing of the guard." The Tax Court also found that the taxpayer-corporation had no "structured system in place" for determining compensation and that Mr. Hood's compensation was determined for the years in issue solely by himself and his wife as the only members of the board of directors. The Fourth Circuit considered this finding by the Tax Court to be significant, stating it was "glaring" that the taxpayer-corporation's other officers each received bonuses of $100,000 or less for 2015 and 2016, while Mr. Hood received bonuses of $5 million for each of those years. In addition, the Fourth Circuit thought that the Tax Court's reliance on comparability data provided by the IRS's expert was appropriate. The IRS's expert acknowledged that, based on comparability data, Mr. Hood deserved compensation in the 99th percentile for similarly situated taxpayers, but that the $5 million bonuses paid in 2015 and 2016 exceeded even that amount. In sum, the Fourth Circuit found that the taxpayer-corporation had not demonstrated on appeal that the Tax Court's findings or the IRS expert's report were clearly erroneous.

The Fourth Circuit did, however, agree with the taxpayer-corporation that the Tax Court erred in upholding the IRS's imposition of a § 6662 substantial understatement penalty for 2016. The Fourth Circuit believed that the taxpayer-corporation's reliance upon the professional advice of its accountants for 2016 established reasonable cause, just as the Tax Court had found reasonable cause for 2015 based upon the same professional advice provided to the taxpayer-corporation for that year.

Observation. Of course, hindsight is always 20/20, but the authors cannot help but wonder why the taxpayer-corporation in this case was not an S corporation. Perhaps the capital-intensive nature of the excavation and grading business conducted by the taxpayer-corporation argued for C

corporation status and lower corporate-level income tax rates. Yet, the taxpayer-corporation had only two individual shareholders, Mr. Hood and his wife, and seemingly could have been an S corporation. Presumably, because the taxpayer is a C corporation, the IRS will assert that the amount of excess compensation paid to Mr. Hood for 2015 and 2016 constitutes disguised dividends to Mr. Hood and his wife for those years. Thus, the taxpayer-corporation's and Mr. Hood's IRS troubles may not be over.

D. Miscellaneous Deductions

1. Standard mileage rates for 2024. Notice 2024-8, 2024-2 I.R.B. 356 (12/14/23). The standard mileage rate for business miles in 2024 goes up to 67 cents (from 65.5 cents in 2023) and the medical/moving rate goes *down* to 21 cents per mile (from 22 cents in 2023). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation goes up to 30 cents per mile (from 28 cents in 2023). The maximum standard automobile cost may not exceed $62,000 (up from $60,800 in 2023) for passenger automobiles (including trucks and vans) for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2024, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2024 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2024 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

The following table summarizes the optional standard mileage rates:

Category	**2022**		**2023**	**2024**
	Jan.-Jun.	Jul.-Dec.		
Business miles	58.5 cents	62.5 cents	65.5 cents	67 cents
Medical/moving	18 cents	22 cents	22 cents	21 cents
Charitable mileage	14 cents	14cents	14 cents	14 cents

2. Administrative guidance on the prevailing wage and apprenticeship requirements that apply to credits and deductions enacted or modified by the Inflation Reduction Act. The Inflation Reduction Act amended §§ 30C, 45, 45L, 45Q, 48, 48C, and 179D to provide increased credit or deduction amounts for taxpayers who satisfy certain requirements. The same legislation added §§ 45U, 45V, 45Y, 45Z, and 48E to the Code to provide new credits, which also contain provisions for increased credit amounts for taxpayers who satisfy certain requirements. Specifically, increased credit amounts are available under sections 30C, 45, 45Q, 45V, 45Y, 45Z, 48, 48C, and 48E, and an increased deduction is available under section 179D, for taxpayers satisfying certain *prevailing wage and apprenticeship* requirements. Increased credit amounts are available under sections 45L and 45U for taxpayers satisfying certain *prevailing wage* requirements. Generally, if a taxpayer satisfies the prevailing wage and apprenticeship requirements or the prevailing wage requirements, whichever one applies (or meets an exception to these requirements), the amount of the credit or deduction is equal to the otherwise determined amount of the credit or deduction multiplied by five.

a. The IRS has provided initial guidance on the prevailing wage and apprenticeship requirements. Notice 2022-61, 2022-52 I.R.B. 560 (11/30/22). This notice provides guidance on the prevailing wage and apprenticeship requirements that generally apply to

certain provisions of the Code, as amended by the Inflation Reduction Act. As amended by the Inflation Reduction Act, these provisions generally authorize an increased credit or deduction if a taxpayer meets either prevailing wage requirements (as in the case of the credit authorized by § 45L) or prevailing wage and apprenticeship requirements. A facility generally must meet the prevailing wage and apprenticeship requirements to receive the increased credit or deduction amounts under §§ 30C, 45, 45Q, 45V, 45Y, 48, 48E, and 179D if construction (or installation for purposes of § 179D) of the facility begins on or after the date 60 days after the Secretary publishes guidance with respect to the prevailing wage and apprenticeship requirements of the Code. The notice serves as the published guidance establishing the 60-day period and provides that the date that is 60 days after the Secretary published guidance is January 30, 2023. The notice also provides guidance for determining the beginning of construction of a facility for certain credits allowed under the Code, and the beginning of installation of certain property with respect to the energy efficient commercial buildings deduction under the Code. The notice provides that Treasury and the IRS anticipate issuing proposed regulations and other guidance with respect to the prevailing wage and apprenticeship requirements.

b. Proposed regulations provide further guidance on the prevailing wage and apprenticeship requirements. REG-100908-23, Increased Credit or Deduction Amounts for Satisfying Certain Prevailing Wage and Registered Apprenticeship Requirements, 88 F.R. 60018 8/30/23). The Treasury Department and the IRS have issued proposed regulations under a variety of Code provisions to reflect legislative changes enacted in August 2022 by the Inflation Reduction Act. The Inflation Reduction Act amended §§ 30C, 45, 45L, 45Q, 48, 48C, and 179D to provide increased credit or deduction amounts for taxpayers who satisfy certain requirements. The same legislation added §§ 45U, 45V, 45Y, 45Z, and 48E to the Code to provide new credits, which also contain provisions for increased credit amounts for taxpayers who satisfy certain requirements. Specifically, increased credit amounts are available under sections 30C, 45, 45Q, 45V, 45Y, 45Z, 48, 48C, and 48E, and an increased deduction is available under section 179D, for taxpayers satisfying certain *prevailing wage and apprenticeship* requirements. Increased credit amounts are available under sections 45L and 45U for taxpayers satisfying certain *prevailing wage* requirements. Generally, if a taxpayer satisfies the prevailing wage and apprenticeship requirements or the prevailing wage requirements, whichever one applies (or meets an exception to these requirements), the amount of the credit or deduction is equal to the otherwise determined amount of the credit or deduction multiplied by five.

Prevailing wage and apprenticeship requirements. Generally, a taxpayer satisfies the *prevailing wage* requirements if the taxpayer ensures that laborers and mechanics employed by the taxpayer (or by any contractor or subcontractor) in the construction, alteration, or repair of a facility are paid wages at rates not less than those set forth in applicable wage determinations issued by the Secretary of Labor. Prop. Reg. § 1.45-7(b)(1). For this purpose, the applicable general wage determination is the wage determination in effect for the specified type of construction in the geographic area when the construction, alteration, or repair of the facility begins. Prop. Reg. § 1.45-7(b)(2). A taxpayer satisfies the *apprenticeship requirement* by ensuring that two basic requirements are met. *First*, qualified apprentices must perform not less than the "applicable percentage" of the total labor hours of the construction, alteration, or repair work of any qualified facility (referred to as the labor hours requirement). For this purpose, the applicable percentage is 10 percent, 12.5 percent, or 15 percent, depending on when construction of the facility begins. Prop. Reg. § 1.45-8(b). *Second*, a taxpayer, contractor, or subcontractor who employs four or more individuals to perform construction, alteration, or repair work with respect to the construction of a qualified facility must employ one or more qualified apprentices to perform the work (referred to as the participation requirement). Prop. Reg. § 1.45-8(d). The proposed regulations provide that construction, alteration, or repair does not include *maintenance work* that occurs after the facility is placed in service. For this purpose, maintenance is work that is ordinary and regular in nature and designed to maintain the existing functionality of a facility as opposed

to an isolated or infrequent repair of a facility to restore specific functionality or adapt it for a different or improved use. Prop. Reg. § 1.45-7(d)(2).

Correction of failure to satisfy the prevailing wage and apprenticeship requirements. The proposed regulations permit a taxpayer who claims the increased credit or deduction and who fails to satisfy the *prevailing wage* requirement to cure the failure. To do so, a taxpayer must (1) pay any laborer or mechanic who was not paid a prevailing wage the difference between the prevailing wage required and the amount actually paid plus interest at the federal short-term rate plus 6 percentage points, and (2) pay a penalty of $5,000 for each laborer or mechanic who was not paid a prevailing wage. Prop. Reg. § 1.45-7(c)(1)(i)-(ii). The penalty generally is waived with respect to a laborer or mechanic if the taxpayer makes a correction payment by the earlier of 30 days after the taxpayer becomes aware of the error or the date on which the increased credit is claimed and if certain other requirements are met. Prop. Reg. § 1.45-7(c)(6)(i). The correction payment is increased to three times the normal amount and the penalty is increased to $10,000 per laborer or mechanic if the IRS determines that the failure to satisfy the prevailing wage requirement was intentional. Prop. Reg. § 1.45-7(c)(3). The proposed regulations also provide a mechanism for a taxpayer to cure a failure to satisfy the *apprenticeship requirement*. Prop. Reg. § 1.45-8(e). Generally, a taxpayer can cure such a failure either by submitting requests for apprentices or paying a penalty equal to $50 for each labor hour for which the apprenticeship requirements (either the labor hours requirement or participation requirement) were not satisfied. The $50 per hour penalty is increased to $500 per hour if the IRS determines that the failure to satisfy the apprenticeship requirements was intentional. Prop. Reg. § 1.45-8(e)(2)(ii).

Recordkeeping requirements. The proposed regulations provide guidance on the types of records taxpayers should maintain to demonstrate compliance with the prevailing wage and apprenticeship requirements. At a minimum, to demonstrate compliance with the *prevailing wage* requirement, those records include payroll records for each laborer and mechanic (including each qualified apprentice) employed by the taxpayer, contractor, or subcontractor in the construction, alteration, or repair of the qualified facility. Prop. Reg. § 1.45-12(b). In addition, the proposed regulations provide that records sufficient to demonstrate compliance with the prevailing wage requirement may include eight other categories of records, including identifying information (such as name, social security or tax identification number, address, telephone number, and email address) for each laborer or mechanic (including qualified apprentices) employed. The proposed regulations provide that sufficient records to demonstrate compliance with the apprenticeship requirements may include (1) any written requests for the employment of apprentices from registered apprenticeship programs, including any contacts with the Department of Labor or state apprenticeship agency regarding requests for apprentices, (2) any agreements entered into with registered apprenticeship programs with respect to the construction, alteration or repair of the facility, (3) documents reflecting the standards and requirements of any registered apprenticeship program, including the ratio requirement prescribed by each program, (4) the total number of labor hours worked by apprentices, and (5) records reflecting the daily ratio of apprentices to journeyworkers. Prop. Reg. § 1.45-12(d).

Effective date and period for comments. The proposed regulations would apply to facilities, property, projects, or equipment placed in service in taxable years ending after the date on which final regulations are published as final in the Federal Register and the construction or installation of which begins after the date on which final regulations are published. Nevertheless, taxpayers can rely on the proposed regulations with respect to construction or installation of a facility, property, project, or equipment beginning on or after January 29, 2023, and on or before the date final regulations are published, provided that, beginning after the date that is 60 days after August 29, 2023, taxpayers follow the proposed regulations in their entirety and in a consistent manner. Treasury and the IRS have invited comments on the proposed regulations. Any comments must be submitted by October 30, 2023. A public hearing on the proposed regulations is scheduled for November 21, 2023.

3. Congress has modified the § 179D deduction for making commercial buildings energy efficient for taxable years beginning after December 31, 2022. Section 179D provides a limited deduction for the cost of energy-efficient commercial building property. Generally, these are improvements designed to reduce energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of a commercial building by a specified percentage in comparison to certain standards. The deduction was made permanent by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 102 of the 2021 Consolidated Appropriations Act. Under current law, the lifetime limit on deductions under § 179D is $1.80 per square foot, which is adjusted for inflation for taxable years beginning after 2020. For 2022, this figure is $1.88 per square foot. As in effect for 2022, the improvements must reduce energy and power costs by 50 percent or more in comparison to certain standards. In the Inflation Reduction Act, § 13303, Congress amended § 179D for taxable years beginning after December 31, 2022. As amended, the statute provides that the improvements must reduce energy and power costs by 25 percent in comparison to certain standards (rather than by 50 percent). The amendments also reduce the amount of the deduction to $0.50 per square foot, increased by $0.02 for each percentage point above 25 percent by which the energy improvements reduce energy and power costs, with a maximum amount of $1.00 per square foot. For projects that meet certain prevailing wage and apprenticeship requirements, the deduction is increased to $2.50 per square foot, increased by $0.10 for each percentage point above 25 percent by which the energy improvements reduce energy and power costs, with a maximum amount of $5.00 per square foot. The maximum deduction amount is the total deduction available with respect to the building less deductions claimed with respect to the building in the preceding three years. In the case of buildings to which energy-efficient improvements are made owned by a tax-exempt entity, § 179D(d)(3) of the amended statute directs the Treasury Department to issue regulations that allow the tax-exempt entity to allocate the deduction to the person primarily responsible for designing the property.

- For guidance on the prevailing wage and apprenticeship requirements that make the taxpayer eligible for an increased deduction under § 179D, including proposed regulations issued in August 2023, see item II.D.2 in this outline.

E. Depreciation & Amortization

1. Section 280F 2023 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2024-13, 2024-9 I.R.B. 678 (2/6/24). Section 280F(a) limits the depreciation deduction for passenger automobiles. For this purpose, the term "passenger automobiles" includes trucks and vans with a gross vehicle weight of 6,000 pounds or less. The IRS has published depreciation tables with the 2024 depreciation limits for business use of passenger automobiles acquired after September 27, 2017, and placed in service during 2024:

2024 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	$20,400
2nd Tax Year	$19,800
3rd Tax Year	$11,900
Each Succeeding Year	$ 7,160
2024 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	$12,400
2nd Tax Year	$19,800
3rd Tax Year	$11,900
Each Succeeding Year	$ 7,160

For leased vehicles used for business purposes, § 280F(c)(2) requires a reduction in the amount allowable as a deduction to the lessee of the vehicle. Under Reg. § 1.280F-7(a), this reduction in the lessee's deduction is expressed as an income inclusion amount. The revenue procedure provides a table with the income inclusion amounts for lessees of vehicles with a lease term beginning in 2024. For 2024, this income inclusion applies when the fair market value of the vehicle exceeds $62,000.

F. <u>Credits</u>

1. Congress has modified and extended through 2032 the § 45L credit for eligible contractors that build and sell new energy-efficient homes. Under current law, § 45L provides a credit of $2,000 or $1,000 (depending on the projected level of fuel consumption) an eligible contractor can claim for each qualified new energy-efficient home constructed by the contractor and acquired by a person from the contractor for use as a residence during the tax year. The Inflation Reduction Act, § 13304, extends the credit through 2032 and modifies it for homes acquired after December 31, 2022. As modified, the credit is $2,500 for new homes that meet certain Energy Star efficiency standards and is $5,000 for new homes that are certified as zero-energy ready homes (generally, a home that is able to generate as much (or more) energy onsite than the total amount of energy it consumes). For multifamily dwellings that meet certain Energy Star efficiency standards, the credit is $500 per unit and is $1,000 per unit for zero-energy ready multifamily dwellings. The credit for multifamily dwelling units is increased to $2,500 per unit (or $5,000 per unit for zero-energy ready multifamily dwellings) if the taxpayer ensures that laborers and mechanics employed by contractors and subcontractors in the construction of the residence are paid wages not less than prevailing wages as determined by the Secretary of Labor.

- For guidance on the prevailing wage requirements that make the taxpayer eligible for an increased credit under § 45L, including proposed regulations issued in August 2023, see item II.D.2 in this outline.

2. You can't "fuel" the IRS: cost of goods sold includes fuel excise taxes *net* of credits, not gross excise tax expenses. <u>Growmark, Inc. v. Commissioner</u>, 160 T.C. No. 11 (5/16/23). Readers will recall that taxpayers determine gross income under § 61(a)(3) by subtracting the cost of goods sold ("COGS") from gross inventory sales. *See* Reg. § 1.61-3(a) (stating in part that "'gross income' means the total sales, less the cost of goods sold"). *See also* Reg. § 1.263A-1(e)(3)(ii)(L) (indirect COGS include taxes otherwise allowable as a deduction to the extent such taxes are attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities). Although the genesis of this case involved fuel excise taxes, the ultimate dispute centered on a fundamental federal income tax question of first impression before the Tax Court. To wit, in determining COGS under § 263A, may taxpayers include their <u>gross</u> fuel excise tax expenses under § 4081, or may taxpayers include only their <u>net</u> fuel excise tax expenses after considering corresponding tax credits under § 6426? On its original federal income tax returns for the years in issue (2009 and 2010), the corporate taxpayer in this case included in COGS only its *net* fuel excise tax expenses under § 4081 (after accounting for credits under § 6426). Then, after an IRS audit, notice of deficiency, and Tax Court litigation over other issues (*see Growmark, Inc. v. Commissioner*, T.C. Memo. 2019-161), the only remaining dispute was whether the taxpayer should be allowed to include the gross amount of its fuel excise tax expenses under § 4081 in COGS without taking into account credits under § 6426. If the taxpayer were allowed to increase its COGS by the gross, as opposed to net, amount of its fuel excise tax expense, the taxpayer's overall deficiency for the years in issue would be less. The taxpayer supported its position with highly-technical arguments under the federal fuel excise tax and credit regime of §§ 4081 and 6426, including related federal income tax credits allowable under §§ 6427(e) and 34(a)(3). Essentially, the taxpayer argued that allowing only the net fuel excise tax as part of COGS "devalue[s]" the credit for taxpayers who claim the credit under § 6426 (as the taxpayer had) instead of § 6427(e) or § 34(a)(3). (We will not burden our readers—or ourselves—with a protracted discussion of the inner workings of the fuel excise tax and credit regime applicable to the taxpayer.) The IRS, of course, disagreed with the taxpayer, urging the Tax Court

to follow the reasoning of three Court of Appeals decisions that were similar, but not identical, to the case at hand. *See Exxon Mobil Corp. v. United States*, 43 F.4th 424 (5th Cir. 2022); *Delek US Holdings, Inc. v. United States*, 32 F.4th 495 (6th Cir. 2022), *aff'g* 515 F. Supp. 3d 812 (M.D. Tenn. 2021); *Sunoco, Inc. v. United States*, 908 F.3d 710 (Fed. Cir. 2018), *aff'g* 129 Fed. Cl. 322 (2016). Judge Paris, who wrote the decision for the Tax Court, was persuaded by the IRS's arguments and the reasoning of the Court of Appeals decisions cited above. Judge Paris wrote, "the Court concludes that the words 'allowed as a credit against the tax imposed,' as used in section 6426, refer to a reduction of the tax liability [under § 4081] as opposed to an independent payment of the liability." The Tax Court also relied upon the legislative history of §§ 4081 and 6426 to support its analysis. Thus, in Judge Paris's opinion, only the net amount of the taxpayer's fuel excise tax expense under § 4081 (after offset by the credit under § 6426) is allowed to be taken into account as part of COGS under § 263A and Reg. § 1.263A-1(e)(3)(ii)(L).

G. Natural Resources Deductions & Credits

H. Loss Transactions, Bad Debts, and NOLs

I. At-Risk and Passive Activity Losses

III. INVESTMENT GAIN AND INCOME

A. Gains and Losses

1. The taxpayer's virtual currency assets may have been completely wiped out in 2020 with resulting losses, but this does not mean the government is estopped from taxing the taxpayer's gains realized in virtual currency transactions in earlier years. Kim v. Commissioner, T.C. Memo. 2023-91 (7/20/23). For the years 2013-2017, the IRS received information reports from Coinbase, a virtual currency exchange. They reported the proceeds of the taxpayer's transactions in various virtual currencies, including Bitcoin, Litecoin, and Etherium. The taxpayer timely filed federal income tax returns for 2013-2016 but reported no gains or losses from the virtual currency transactions. On his timely-filed 2018 income tax return, the taxpayer reported on Schedule D $18.6 million of gross proceeds from virtual currency transactions but reported a basis in the assets sold that resulted in a gain of $42,069. The IRS audited the taxpayer's 2013-2017 returns and, when the taxpayer did not supply a computation of his gains and losses from virtual currency transactions, the revenue agent used records from Coinbase to reconstruct them using a first-in, first-out method. Based on these calculations, the revenue agent determined that the taxpayer had short-term capital gain of $75,400 for 2013, short-term capital gain of just over $4 million for 2017, and long-term capital gain of $74,565 for 2017. The IRS issued a notice of deficiency and, in response, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer did not contest the amount or character of the gains calculated by the IRS. Rather, he argued that, in 2020, the virtual currency assets that produced these gains had been wiped out during the early stages of the COVID-19 pandemic, that he had been forced to liquidate his virtual currency positions with resulting large losses, and

> that the actions (or inaction) of the U.S. Government in response to the COVID epidemic "directly caused [that] harm" and that, "under the Clean Hands doctrine of US law," the IRS should be estopped from collecting tax on his 2013 and 2017 gains.

The Tax Court (Judge Lauber) ruled in favor of the government. The taxpayer's argument, the court stated, had no legal basis. The court observed that "[t]he doctrine of estoppel can be invoked against the United States only in the rarest of circumstances." Further, the "unclean hands" principle, the court concluded, did not apply because that principle withholds equitable relief from a party who has acted improperly, and the government in this case was not seeking equitable relief but rather was seeking to recover taxes due from the taxpayer under the Internal Revenue Code. Further, the court reasoned, the annual accounting principle "dictates that a taxpayer's income for a particular year be calculated on the basis of events occurring during that year." Although Congress has allowed corporations to carry capital losses both forward and back under

§ 1212(a)(1), it has chosen to allow individual taxpayers to carry capital losses realized in 2020 only forward, which means that losses the taxpayer might have realized in 2020 are irrelevant in determining his liabilities for 2013-2017.

B. Interest, Dividends, and Other Current Income

C. Profit-Seeking Individual Deductions

D. Section 121

E. Section 1031

F. Section 1033

G. Section 1035

H. Miscellaneous

IV. COMPENSATION ISSUES

A. Fringe Benefits

1. Limits for contributions to health savings accounts for 2024. Rev. Proc. 2023-23, 2023-22 I.R.B. 883 (5/16/23). The IRS has issued the inflation-adjusted figures for contributions to health savings accounts. For calendar year 2024, the annual limitation on deductions under § 223(b)(2)(A) for an individual with self-only coverage under a high deductible health plan is increased to $4,150 (from $3,850 in 2023). For calendar year 2024, the annual limitation on deductions under § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan is increased to $8,300 (from $7,750 in 2023). For this purpose, for calendar year 2024, a "high deductible health plan" is defined under § 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,600 (increased from $1,500 in 2023) for self-only coverage or $3,200 (increased from $3,000 in 2023) for family coverage, and for which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $8,050 for self-only coverage (increased from $7,500 in 2023) or $16,100 for family coverage (increased from $15,000 in 2023).

The following table summarizes the limits for contributions to health savings accounts:

Health Savings Account Limitations				
Category	**Self-Only Coverage**		**Family Coverage**	
	2023	**2024**	**2023**	**2024**
Limit on Deductions for Contributions to HSAs	$3,850	$4,150	$7,750	$8,300
High-Deductible Health Plan				
Minimum Deductible	$1,500	$1,600	$3,000	$3,200
Limit on Out-of-Pocket Expenses	$7,500	$8,050	$15,000	$16,100

B. Qualified Deferred Compensation Plans

1. Some inflation-adjusted numbers for 2024. Notice 2023-75, 2023-47 I.R.B. 1256 (11/1/23).

- The limit on elective deferrals in §§ 401(k), 403(b), and 457 plans is increased to $23,000 (from $22,500) with a catch-up provision for employees aged 50 or older that is $7,500 (unchanged from 2023).

- The limit on contributions to an IRA is increased to $7,000 (from $6,500) with a catch-up provision for those aged 50 or older that is $1,000 (unchanged from 2023). The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $77,000-$87,000 (from $73,000-$83,000) for single filers and heads of household, increased to $123,000-$143,000 (from $116,000-$136,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $230,000-$240,000 (from $218,000-$228,000) 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 $230,000-$240,000 (from $218,000-$228,000) for married couples filing jointly, and increased to $146,000-$161,000 (from $138,000-$153,000) for singles and heads of household.

- The limit on the annual benefit from a defined benefit plan under § 415 is increased to $275,000 (from $265,000).

- The limit for annual additions to defined contribution plans is increased to $69,000 (from $66,000).

- The amount of compensation that may be taken into account for various plans is increased to $345,000 (from $330,000), and is increased to $505,000 (from $490,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $76,500 (from $73,000) for married couples filing jointly, increased to $57,375 (from $54,740) for heads of household, and increased to $38,250 (from $36,500) for singles and married individuals filing separately.

2. Proposed regulations on required minimum distributions. REG-105954-20, Required Minimum Distributions, 87 F.R. 10504 (2/24/22). Treasury and the IRS have issued proposed regulations that address required minimum distributions (RMDs) from qualified retirement plans and annuity contracts and related matters. The proposed regulations would update existing regulations to reflect a number of statutory changes. The most significant of these statutory changes were made by the SECURE Act, enacted on December 20, 2019, as Division O of the 2020 Further Consolidated Appropriations Act. Among other changes, the SECURE Act amended Code § 401(a)(9)(E) to modify the RMD rules for inherited retirement accounts (defined contribution plans and IRAs). The proposed regulations are lengthy and address these and a number of other issues. This outline will focus on only the guidance provided by the proposed regulations on the change made by the SECURE Act to RMDs for inherited retirement accounts. Readers should consult the proposed regulations for additional guidance.

The SECURE Act changes to RMDs from inherited retirement accounts. A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(E) to modify the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs). The amendments require all funds to be distributed by the end of the 10th calendar year following the year of death (the "10-year rule"). The statute contains no requirement to withdraw any minimum amount before that date. Section 401(a)(9)(H)(i)(II), as also amended by the SECURE Act, provides that this rule applies whether or not RMDs to the employee or IRA owner have begun. The current rules, which permit taking RMDs over life expectancy, continue to apply to a designated beneficiary who is an

"eligible designated beneficiary," which is any of the following: (1) a surviving spouse, (2) a child of the participant who has not reached the age of majority, (3) disabled within the meaning of § 72(m)(7), (4) a chronically ill individual within the meaning of § 7702B(c)(2) with some modifications, or (5) an individual not in any of the preceding categories who is not more than 10 years younger than the deceased individual. These changes generally apply to distributions with respect to those who die after December 31, 2019.

The proposed regulations' interpretation of the SECURE Act. The proposed regulations adopt an interpretation of the 10-year rule that appears to differ from the plain language of the statute and from the interpretation of the legislation of most advisors. The statute provides that, when the designated beneficiary is *not* an eligible designated beneficiary, all funds must be distributed by the end of the 10th calendar year following the year of death and that this rule applies whether or not RMDs to the employee or IRA owner have begun. There appears to be no requirement to withdraw any minimum amount before that date. The preamble to the proposed regulations, however, explains that the proposed regulations distinguish between situations in which the employee or IRA owner dies before the required beginning date for distributions, and situations in which death occurs after such date. When the employee or IRA owner dies *before* the required beginning date for distributions, the proposed regulations provide that no distribution is required before the 10th calendar year following the year of death. However, in situations in which the employee or IRA owner dies *after* the required beginning date for distributions, the proposed regulations provide that a designated beneficiary who is *not* an eligible designated beneficiary must take RMDs before the 10th calendar year following the year of death:

> For example, if an employee died after the required beginning date with a designated beneficiary who is not an eligible designated beneficiary, then the designated beneficiary would continue to have required minimum distributions calculated using the beneficiary's life expectancy as under the existing regulations for up to nine calendar years after the employee's death. In the tenth year following the calendar year of the employee's death, a full distribution of the employee's remaining interest would be required.

87 F.R. 10514. This interpretation differs not only from the plain language of the statute and from the interpretation of the legislation of most advisors, but also from IRS Publication 590-B, which was issued for 2021. IRS Publication 590-B (page 11) provides:

> The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2021, the beneficiary would have to fully distribute the IRA by December 31, 2031. The beneficiary is allowed, but not required, to take distributions prior to that date.
>
> The 10-year rule applies if (1) the beneficiary is an eligible designated beneficiary who elects the 10-year rule, if the owner died before reaching his or her required beginning date; or (2) the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, regardless of whether the owner died before reaching his or her required beginning date.

Many of the comments on the proposed regulations urge the IRS to change its interpretation or at least to delay the effective date of the interpretation because many beneficiaries subject to the 10-year rule did not take distributions in 2021.

a. The IRS will not assert that the 50% excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021 or 2022. Notice 2022-53, 2022-45 I.R.B. 437 (10/7/22). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2023 distribution calendar year. The notice also addresses the tax treatment of individuals who failed to

take RMDs in 2021 or 2022 under the interpretation of the 10-year rule set forth in the proposed regulations. Section 4974 provides that, if the amount distributed from a qualified retirement plan during the year is less than the RMD for that year, then an excise tax is imposed equal to 50 percent of the amount by which the RMD exceeds the amount actually distributed. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." It also provides that, if an individual paid an excise tax for a missed RMD in 2021 that constitutes a specified RMD, the taxpayer can request a refund of the excise tax paid. A "specified RMD" is defined as any distribution required to be made in 2021 or 2022 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020 or 2021 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020 or 2021 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020 or 2021 and was taking lifetime or life expectancy distributions.

- The notice does not explicitly address what RMD must occur in 2023. The issue is whether, in 2023, a beneficiary who failed to take an RMD in 2021 or 2022 must take the 2023 RMD and also any RMDs previously missed. The notice does not explicitly require missed RMDs to be withdrawn. The notice provides only that the IRS will not assert that an excise tax is due from those who failed to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations. In the authors' view, the notice implies that, in 2023, only the 2023 RMD must be withdrawn. For example, if an employee or IRA owner died in 2021 with a designated beneficiary who was not an eligible designated beneficiary, that beneficiary should have begun taking RMDS in 2022, which should continue through 2030 (the ninth year after the employee or IRA owner's death), and the remaining balance of the account should be fully withdrawn in 2031. The authors' interpretation is that the beneficiary in this example should simply begin taking RMDs in 2023 (calculated as if they had begun in 2022), which should continue through 2030, and the remaining balance of the account should be fully withdrawn in 2031. The final regulations may provide further guidance on this question.

b. The IRS has granted a further reprieve: the Service will not assert that the excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021, 2022, or 2023. Notice 2023-54, 2023-31 I.R.B. 382 (7/14/23). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2024 calendar year. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." A "specified RMD" is defined as any distribution required to be made in 2021, 2022, or 2023 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020, 2021, or 2022 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020, 2021, or 2022 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021, 2022, or 2023 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020, 2021, or 2022 and was taking lifetime or life expectancy distributions.

- The notice also grants relief to those who attained age 72 in 2023 and received distributions from January 1 through July 31, 2023, that are mischaracterized as RMDs. Taxpayers who attain age 72 in 2023 are not required to begin taking RMDs for 2023 because Congress increased the age at which RMDs must begin to age 73 for those who attain age 73 after 2022. The Notice gives such taxpayers until September 30, 2023, to deposit such amounts in an eligible retirement plan and treat the deposits as a tax-free rollover. This aspect of the notice is discussed in more detail below in connection with the discussion of the change in the age at which RMDs must begin.

c. The IRS has granted a further reprieve: the Service will not assert that the excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021, 2022, 2023, or 2024. Notice 2024-35, 2024-19 I.R.B. 1051 (4/16/24). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2025 calendar year. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." A "specified RMD" is defined as any distribution required to be made in 2021, 2022, 2023, or 2024 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020, 2021, 2022, or 2023 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021, 2022, 2023, or 2024 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020, 2021, 2022, or 2023 and was taking lifetime or life expectancy distributions.

3. Congress has increased the age at which RMDs must begin to 73 and eventually to age 75. A provision of the SECURE 2.0 Act, Division T, Title I, § 107 of the Consolidated Appropriations Act, 2023, amended Code § 401(a)(9)(C)(i)(I) to increase the age at which required minimum distributions (RMDs) from a qualified plan (including IRAs) must begin from 72 to 73. Pursuant to this amendment, RMDs must begin by April 1 of the calendar year following the later of the calendar year in which the employee attains age 73 or, in the case of an employer plan, the calendar year in which the employee retires. This latter portion of the rule allowing deferral of RMDs from employer plans until retirement does not apply to a 5-percent owner (as defined in § 416). The increase in the age at which RMDs must begin to age 73 applies to distributions required to be made after December 31, 2022, with respect to individuals who attain age 73 after such date. Thus, an individual who attained age 72 in 2022 must take his or her first RMD by April 1, 2023, but an individual who attains age 72 in 2023 need not take the first RMD until April 1, 2025. The legislation further increases the age at which RMDs must begin to age 75 for individuals who attain age 75 after 2032.

a. Those born in 1951 (and who therefore attain age 72 in 2023) and who received distributions from January 1 through July 31, 2023, that are mischaracterized as RMDs have until September 30, 2023, to deposit such amounts in an eligible retirement plan and treat the deposit as a tax-free rollover. Notice 2023-54, 2023-31 I.R.B. 382 (7/14/23). Plan administrators and other payors made the Service aware that automated payment systems would need to be updated to reflect the legislative change in the age at which RMDs must begin. Because such changes could take time, it is possible that those born in 1951 and who therefore attain age 72 in 2023 would receive distributions in 2023 that are mischaracterized as RMDs (and therefore normally ineligible for rollover). This notice grants relief targeted at this situation. For employer-sponsored plans, the notice provides that (1) payors or plan administrators will not be treated as having failed to satisfy applicable requirements based on failure to treat a distribution as an eligible

rollover distribution merely because the plan made a distribution from January 1, 2023, through July 31, 2023, to a participant born in 1951 (or the participant's surviving spouse) that would have been an RMD if Congress had not increased the age at which RMDs must begin from 72 to 73, and (2) participants born in 1951 who received such a distribution have until September 30, 2023, to roll over the mischaracterized distribution. For IRAs, the notice provides similar relief and specifies that IRA owners born in 1951 (or the owner's surviving spouse) who received a distribution from the IRA from January 1, 2023, through July 31, 2023, that would have been an RMD if Congress had not increased the age at which RMDs must begin from 72 to 73 can roll over the mischaracterized distribution to an eligible retirement plan if they do so by September 30, 2023. Although IRA owners normally can make only one tax-free rollover in a 12-month period, the notice provides that IRA owners entitled to the relief provided by the notice can roll over the mischaracterized distribution even if they have already rolled over a distribution in the previous 12 months. A rollover of the mischaracterized distribution, however, will preclude the IRA owner from rolling over another distribution in the succeeding 12 months (but could still make a direct trustee-to-trustee transfer as described in Rev. Rul. 78-406, 1978-2 CB 157).

4. The penalty for failing to take an RMD is now 25% (and possibly 10%) rather than 50 percent. If a taxpayer fails to take the full amount of a required minimum distribution (RMD) from a qualified retirement plan (including an IRA), § 4974(a) imposes an excise tax. The tax is a percentage of the amount by which the RMD exceeds the actual amount distributed during the year. Before legislative changes made in 2022, the percentage was 50 percent. A provision of the SECURE 2.0 Act, Division T, Title III, § 302 of the Consolidated Appropriations Act, 2023, amended Code § 4974(a) to reduce the percentage to 25 percent. New § 4974(e) further reduces the percentage to 10 percent if an individual receives all of their past-due RMDs and files a tax return that reflects the excise tax on such RMDs before the earliest of three dates: (1) the date of mailing of a notice of deficiency with respect to the excise tax, (2) the date on which the excise tax is assessed, or (3) the last day of the second taxable year that begins after the close of the taxable year in which the excise tax is imposed (apparently, the close of the second taxable year after the year of the missed RMD). These changes apply to taxable years beginning after December 29, 2022, the date of enactment of the SECURE 2.0 Act.

5. RMDs are no longer required for Roth accounts in employer-sponsored plans. A provision of the SECURE 2.0 Act, Division T, Title III, § 325 of the Consolidated Appropriations Act, 2023, amended Code § 402A(d) by adding new § 402A(d)(5), which makes Roth accounts in employer-sponsored retirement plans exempt from the requirement that required minimum distributions (RMDs) begin at age 73. Before this change, although RMDs were not required for Roth IRAs, they were required for Roth accounts in employer-sponsored retirement plans. This change is effective for taxable years beginning after December 31, 2023, but does not apply to distributions required for 2023 that are permitted to be paid after 2023.

6. Go ahead and steal your spouse's identity, at least for purposes of receiving RMDs. A provision of the SECURE 2.0 Act, Division T, Title III, § 327 of the Consolidated Appropriations Act, 2023, amended Code § 401(a)(9)(B)(iv) to provide that, if a retirement account participant dies before reaching the age at which RMDs must begin and has designated a spouse as the sole beneficiary, then the spouse may make an irrevocable election to be treated as the participant for purposes of receiving RMDs. Making this election allows the surviving spouse to defer RMDs until the deceased spouse would have reached the age at which RMDs must begin. For example, if a husband passes away at age 63 and is survived by his wife who is age 68 and is his sole designated beneficiary, then she can elect to be treated as her husband for purposes of receiving RMDs. This means that she can defer taking RMDs from the account until her husband would have reached age 73 (a period of 10 years in this example) rather than when she attains age 73. This change is effective for calendar years beginning after December 31, 2023.

7. Individuals who are ages 60-63 will be able to make additional catch-up contributions to employer-sponsored plans beginning in 2025. Section 414(v) allows individuals who are age 50 and older to make so-called "catch-up" contributions to employer-sponsored retirement plans such as § 401(k) plans in addition to the basic amount ($22,500 in 2023) that individuals are allowed to contribute. The limit on catch-up contributions is $7,500 in 2023 and is adjusted annually for inflation. A provision of the SECURE 2.0 Act, Division T, Title I, § 109 of the Consolidated Appropriations Act, 2023, amended Code § 414(v)(2) to allow individuals who are ages 60 to 63 at the close of the taxable year to make larger catch-up contributions up to the "adjusted dollar amount," which is defined in new § 414(v)(2)(E). As defined, the adjusted dollar amount is equal to the greater of $10,000 or 150 percent of the regular catch-up contribution amount for 2024. This $10,000 figure will be adjusted annually for inflation after 2025. This change is effective for taxable years beginning after 2024.

- The ability of those ages 60 to 63 to make larger catch-up contributions to employer-sponsored plans will take effect in 2025. In that year, the limit on such catch-up contributions will be the greater of $10,000 or 150 percent of the regular catch-up contribution limit for 2024. Because the regular catch-up contribution limit is already $7,500 in 2023, and 150 percent of that figure is $11,250, the larger catch-up contribution limit for those ages 60 to 63 will be greater than $10,000 in the first year it is effective.

8. Effective in 2024, all catch-up contributions to employer-sponsored plans must be deposited in a Roth account if the participant had wages in the preceding year of more than $145,000. A provision of the SECURE 2.0 Act, Division T, Title VI, § 603 of the Consolidated Appropriations Act, 2023, amended Code § 414(v) by adding new § 414(v)(7). New § 414(v)(7) provides that, if a participant in an employer-sponsored retirement plan had wages in the preceding calendar year from the employer sponsoring the plan that exceeded $145,000, then the participant cannot make catch-up contributions unless those contributions are designated Roth contributions. This $145,000 figure will be adjusted for inflation in tax years beginning after 2024. The legislation further provides that, if this new "Roth-only" rule applies to any participant for the year, then no participant in the plan can make catch-up contributions unless the plan offers all participants a Roth option. This rule effectively will force employer-sponsored plans to offer Roth options to their participants. These changes apply to taxable years beginning after December 31, 2023.

a. Apparently, the IRS can simply ignore the effective date of a legislative change. The IRS has announced a two-year "administrative transition period" that has the effect of delaying the effective date of the "Roth-only" rule for catch-up contributions until taxable years beginning after 2025. Notice 2023-62, 2023-37 I.R.B. 817 (8/25/23). In response to concerns expressed by taxpayers regarding the timely implementation of the new "Roth-only" rule (new § 414(v)(7)) enacted as part of the Consolidated Appropriations Act, 2023, for catch-up contributions by employees with wages in the preceding calendar year that exceeded $145,000, the IRS has effectively delayed the effective date of the Roth-only rule. As enacted, the Roth-only rule applies to taxable years beginning after December 31, 2023. In this notice, however, the IRS has announced a two-year "administrative transition period." Specifically, until taxable years beginning after December 31, 2025:

> (1) … catch-up contributions will be treated as satisfying the requirements of section 414(v)(7)(A), even if the contributions are not designated as Roth contributions, and (2) a plan that does not provide for designated Roth contributions will be treated as satisfying the requirements of section 414(v)(7)(B).

The notice also announces that the Treasury Department and the IRS plan to issue further guidance to assist taxpayers with the implementation of the new Roth-only rule. The guidance expected to be issued includes:

- "Guidance clarifying that section 414(v)(7)(A) of the Code would not apply in the case of an eligible participant who does not have wages as defined in section 3121(a) (that is, wages for purposes of the Federal Insurance Contributions Act (FICA)) for the preceding calendar year from the employer sponsoring the plan." Thus, a partner or other self-employed person, neither of whom receives wages from the business, would not be subject to the Roth-only rule.
- "Guidance providing that, in the case of an eligible participant who is subject to section 414(v)(7)(A), the plan administrator and the employer would be permitted to treat an election by the participant to make catch-up contributions on a pre-tax basis as an election by the participant to make catch-up contributions that are designated Roth contributions." Apparently, this approach would permit the plan administrator and the employer to treat an employee as having elected to make catch-up contributions to a Roth account even though the employee actually elected to make catch-up contributions on a pre-tax basis.
- "Guidance addressing an applicable employer plan that is maintained by more than one employer (including a multiemployer plan). The guidance would provide that an eligible participant's wages for the preceding calendar year from one participating employer would not be aggregated with the wages from another participating employer for purposes of determining whether the participant's wages for that year exceed $145,000 (as adjusted). For example, under that guidance, if an eligible participant's wages for a calendar year were: (1) $100,000 from one participating employer; and (2) $125,0000 from another participating employer, then the participant's catch-up contributions under the plan for the next year would not be subject to section 414(v)(7)(A) (even if the participant's aggregate wages from the participating employers for the prior calendar year exceed $145,000, as adjusted). The guidance also would provide that, even if an eligible participant is subject to section 414(v)(7)(A) because the participant's wages from one participating employer in the plan for the preceding calendar year exceed $145,000 (as adjusted), elective deferrals made on behalf of the participant by another participating employer that are catch-up contributions would not be required to be designated as Roth contributions unless the participant's wages for the preceding calendar year from that other employer also exceed that amount."

The Treasury Department and the IRS have invited comments regarding the matters discussed in the notice and any other aspect of the new Roth-only rule. Comments must be submitted on or before October 24, 2023.

9. Subject to certain exceptions, § 401(k) and § 403(b) plans established on or after December 29, 2022, must automatically enroll eligible participants beginning in 2025. A provision of the SECURE 2.0 Act, Division T, Title I, § 101 of the Consolidated Appropriations Act, 2023, amended the Code by adding new § 414A. New § 414A requires that § 401(k) and § 403(b) plans automatically enroll participants, i.e., participants are enrolled unless they elect not to participate. To meet the requirements of § 414A, the percentage of compensation contributed by participants must be at least 3 percent and not more than 10 percent in the first year of participation. Whatever the initial percentage of compensation contributed, the plan must provide that the percentage is increased by 1 percentage point per year until the percentage contributed is at least 10 percent and not more than 15 percent of compensation. A participant can elect not to participate or to contribute less than these amounts. Certain plans are not subject to new § 414A. These include (1) § 401(k) and § 403(b) plans established before the date of enactment of the SECURE 2.0 Act (December 29, 2022), (2) plans maintained by employers that have been in existence fewer than 3 years, (3) plans maintained by employers that normally employ 10 or fewer employees, and (4) governmental plans (within the meaning of § 414(d)) and church plans (within the meaning of § 414(e)). The new rules apply to plan years beginning after December 31, 2024.

10. Is a water bottle or a low-value gift card all it takes to get employees to participate in an employer-sponsored retirement plan? Go ahead and offer these sorts of de minimis financial incentives, says Congress. Generally, § 401(k)(4) and § 403(b)(12)(A) preclude a § 401(k) or § 403(b) plan from being tax-qualified if the employer offers any benefit that is conditioned on an employee's election to defer (or not defer) amounts to the plan. This prohibition is subject to limited exceptions and does not preclude employers from offering matching contributions. A provision of the SECURE 2.0 Act, Division T, Title I, § 113 of the Consolidated Appropriations Act, 2023, amended § 401(k)(4) and § 403(b)(12)(A) to provide that the prohibition on offering benefits conditioned on the employee's participation does not apply to a "de minimis financial incentive" as long as the incentive is not paid for with plan assets. The legislation does not define the term "de minimis financial incentive." The legislative history of the provision suggests that low-value gift cards would qualify. The new rules apply to plan years beginning after the date of enactment of the SECURE 2.0 Act (December 29, 2022).

11. Beginning in 2024, the § 72(t) 10% penalty for early withdrawal from a retirement plan will not apply to distributions of up to $1,000 for "necessary personal or family emergency expenses." Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title I, § 115 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(I), which allows an individual to treat one distribution per calendar year as an "emergency personal expense distribution" that is not subject to the 10-percent additional tax. An individual who takes an emergency personal expense distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The maximum amount that can be treated as an emergency personal expense distribution is $1,000. An individual who treats a distribution as an emergency personal expense distribution cannot treat a distribution in any of the three succeeding taxable years as such a distribution unless either (1) the previous distribution is fully repaid to the plan, or (2) the aggregate contributions by the employee to the plan after the previous distribution equal or exceed the amount of the previous distribution that has not been repaid. An emergency personal expenses distribution is defined as

> any distribution from an applicable eligible retirement plan … to an individual for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses.

These rules apply to distributions made after December 31, 2023.

12. Beginning in 2024, survivors of domestic abuse can withdraw up to $10,000 from a retirement plan without being subject to the § 72(t) 10% penalty for early withdrawal. Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title III, § 314 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(K), which allows an individual to treat a distribution as "an eligible distribution to a domestic abuse victim" that is not subject to the 10-percent additional tax. An individual who takes such a distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The maximum amount that can be treated as an eligible distribution to a domestic abuse victim is the lesser of $10,000 or 50 percent of the present value of the accrued benefit of the employee under the plan. The $10,000 limitation will be adjusted for inflation for taxable years beginning after 2024. An eligible distribution to a domestic abuse victim is defined as a

> distribution … from an applicable eligible retirement plan [that] is made to an individual during the 1-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner."

For this purpose, "domestic abuse" is defined as

> physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

These rules apply to distributions made after December 31, 2023.

13. Beginning in 2023, terminally ill individuals can withdraw funds from a retirement plan without being subject to the § 72(t) 10% penalty for early withdrawal. Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. A provision of the SECURE 2.0 Act, Division T, Title III, § 326 of the Consolidated Appropriations Act, 2023, amended § 72(t)(2) by adding § 72(t)(2)(L), which provides that distributions to a terminally ill individual on or after the date on which a physician has certified the individual as having a terminal illness are not subject to the 10-percent additional tax. An individual who takes such a distribution can repay it during the 3-year period beginning on the day after the date on which the distribution was received to any eligible retirement plan to which a rollover contribution could be made. The term "terminally ill individual" has the same meaning as it does in § 101(g)(4)(A) except that "84 months" is substituted for "24 months," which means that a "terminally ill individual" is defined as

> an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification.

New § 72(t)(2)(L)(iii) provides that an employee is not considered to be a terminally ill individual unless the employee provides sufficient evidence to the plan administrator in the form and manner required by the Secretary of the Treasury.

These rules apply to distributions made after the date of enactment of the SECURE 2.0 Act, which was December 29, 2022.

14. BTW, the IRS says NFTs are NSFW in IRAs or self-directed ERISA plans. OMG! Notice 2023-27, 2023-25 I.R.B 634 (3/21/23). The IRS and Treasury have announced that future guidance will be issued regarding the treatment of certain nonfungible tokens ("NFTs") as "collectibles" under § 408(m). According to the IRS:

> [a]n NFT is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset.

Put differently, NFTs are akin to electronic works of art, such as digital images, animations, or videos, that are bought and sold via the internet. Each NFT is a unique, one-of-a-kind digital asset or one-in-a-series of authorized digital copies. So-called "blockchain" technology identifies ownership and facilitates transfers of NFTs via the internet, like the way that cryptocurrency (which, BTW, is a "fungible" digital asset) is used to pay for goods and services via the internet. If an asset (digital or otherwise) is a "collectible" under § 408(m), then the acquisition of such an asset by an IRA or § 401 self-directed qualified plan is treated as distribution of the asset at cost to the account holder, with the attendant tax consequences. Furthermore, the sale or exchange of a "collectible" that is a capital asset held long-term is subject to the maximum 28% capital gains rate under § 1(h)(4) and (5). Whether an asset is a "collectible" also is relevant for other sections of the Code, including § 45D (new markets tax credit) and § 1397C (enterprise zone business defined). Certain coins and bullion are excluded from the definition of a "collectible" under § 408(m)(3). In Notice 2023-27, the IRS and Treasury have announced that future guidance will determine whether an NFT is a § 408(m) "collectible" by applying a "look-through" analysis. Thus, the IRS and

Treasury will define an NFT as a "collectible" if the associated right or asset underlying the NFT would be a "collectible" under § 408(m). The notice elaborates:

> For example, a gem is a section 408(m) collectible under section 408(m)(2)(C), and therefore an NFT that certifies ownership of a gem constitutes a section 408(m) collectible. Similarly, an NFT does not constitute a section 408(m) collectible if the NFT's associated right or asset is not a section 408(m) collectible. For example, a right to use or develop a "plot of land" in a virtual environment generally is not a section 408(m) collectible, and therefore, an NFT that provides a right to use or develop the "plot of land" in the virtual environment generally does not constitute a section 408(m) collectible.

The notice also raises the issue of whether an NFT digital file itself (apparently, apart from its associated right or asset) constitutes a "work of art" such that it would be considered a "collectible" within the meaning of § 408(m)(2)(A). Notice 2023-27 states that the IRS and Treasury are considering this issue further. The notice also lists no less than ten different questions regarding NFTs for which the IRS and Treasury invite comments, as well as any other aspects of NFTs relating to their treatment as "collectibles" that commentators consider relevant. Comments were due by June 19, 2023.

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

1. The taxpayer took a shot at a deduction for deferred compensation but only scored an A-I-R B-A-L-L! A-I-R B-A-L-L! A-I-R B-A-L-L! Hoops, LP v. Commissioner, T.C. Memo. 2022-9 (2/23/22). In a memorandum opinion, the Tax Court (Jude Nega) has held that an accrual method partnership could not deduct unpaid salary and wages relating to deferred compensation owed to two players (Zach Randolph and Michael Conley) for the Memphis Grizzlies of the NBA. The taxpayer-partnership, Hoops, LP ("Hoops") sold the Memphis Grizzlies' NBA franchise and substantially all of its assets to a buyer in 2012. The buyer assumed substantially all of the liabilities and obligations of Hoops as part of the acquisition, including the obligation to pay approximately $10.7 million (discounted to present value) in nonqualified deferred compensation to the two players. Hoops had included the accrued $10.7 million liability in its amount realized in connection with the sale. Hoops did not deduct the $10.7 million on its originally filed partnership tax return on Form 1065 for 2012. Instead, Hoops filed an amended return on Form 1065-X for 2012 in October of 2013 claiming the $10.7 million accrued liability as a deduction. Following an audit, the IRS issued a notice of final partnership administrative adjustment disallowing the deduction, and Hoops petitioned the Tax Court. The parties stipulated that the $10.7 million accrued liability was nonqualified deferred compensation governed by the catch-all "other plans" provision of § 404(a)(5). Section 404(a)(5) and the regulations under that provision allow a deduction for payments under such nonqualified deferred compensation plans "only in the taxable year of the employer in which or with which ends the taxable year of an employee in which an amount attributable to such contribution is includible in [the employee's] gross income." Reg. § 1.404(a)-12(b)(1). Hoops argued that the timing rule in § 404(a) is incorporated into the economic performance requirement of § 461(h), and due to the sale, the deduction was accelerated under Reg. § 1.461-4(d)(5)(i) which provides:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

Alternatively, Hoops argued that if the $10.7 million liability was not deductible upon the sale, then it should not have been included in Hoops's amount realized as part of the sale. The IRS argued in response that Reg. § 1.404(a)-12(b)(1), not § 461(h) or Reg. § 1.461-4(d)(5)(i), controlled to allow the deduction only when the deferred compensation is paid and includable in

the players' gross income regardless of whether economic performance had occurred or whether the liability was considered part of Hoops's amount realized in connection with the sale.

Judge Nega's Opinion. Judge Nega agreed with the IRS and relied on the regulations under § 461 and § 446, which provide that "[a]pplicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred [under § 461(h)] is taken into account." Reg. §§ 1.461-1(a)(2)(i), 1.446-1(c)(1)(ii)(A). Judge Nega therefore reasoned that § 404(a)(5) and Reg. § 1.404(a)-12(b)(1) controlled to disallow the partnership's deduction unless and until the deferred compensation was paid and includable in the gross income of the players. Judge Nega cited the Ninth Circuit's decision in *Albertson's, Inc. v. Commissioner*, 42 F.3d 537, 543 (9th Cir. 1994), *aff'g* 95 T.C. 415 (1990), as support. In *Albertson's*, the Ninth Circuit relied upon legislative history to determine that Congress enacted § 404(a) expressly to match the timing of an employer's deduction and an employee's inclusion of nonqualified deferred compensation. Furthermore, regarding whether the $10.7 million deferred compensation liability should have been included in Hoops's amount realized upon the sale, Judge Nega determined that it should, citing the general rules of §§ 1001(a), 1001(b), and Reg. § 1.1001-2(a)(1), which provide that a taxpayer's amount realized includes liabilities from which the taxpayer is discharged as a result of transferring property.

Comment. Hoops argued that the $10.7 million nonqualified deferred compensation arrangement should not be considered a "liability" includable in amount realized under § 1001(b) and Reg. § 1.1001-2(a)(1). Support for this position can be found in § 108(e)(2), which provides that "[n]o income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction." Similarly, § 357(c)(3)(i) provides that an obligation is not treated as a liability for purposes of § 351 if the payment thereof "would give rise to a deduction." And, Reg. § 1.752-1 provides that an obligation is not treated as a liability for purposes of § 752 unless it (i) creates or increases the basis of any of the obligor's assets (including cash); (ii) gives rise to an immediate deduction to the obligor; or (iii) gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. The court, however, rejected Hoops's argument and held that, under the general rules of § 1001(b) and Reg. § 1.1001-2(a)(1), "Hoops was required to take into account the amount of the deferred compensation liability in computing its gain or loss from the sale."

Appeal: Hoops has appealed to the U.S. Court of Appeals for the Seventh Circuit.

a. Upon replay review, the call on the court is confirmed by the Seventh Circuit: No basket (a/k/a deduction)! Hoops, LP v. Commissioner, 77 F.4th 557 (7th Cir. 8/9/23) *aff'g* T.C. Memo. 2022-9 (2/23/22). On appeal, in an opinion by Judge Scudder, the U.S. Court of Appeals for the Seventh Circuit agreed with the Tax Court that § 404(a)(5) controlled the outcome in this case and disallowed any deduction for Hoops unless and until the deferred compensation is included in the gross income of the players. Hoops made the same argument to the Seventh Circuit that it made in the Tax Court, i.e., that Reg. § 1.461-4(d)(5)(i) allows acceleration of the deduction for the deferred compensation obligation in the context of a sale of a trade or business. As noted earlier, Reg. §1.461-4(d)(5)(i) provides:

> If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer.

Judge Scudder disagreed, though, reasoning that the above-quoted regulation applies where economic performance has not occurred. Here, there was no dispute that economic performance had occurred because the deferred compensation was attributable to the players' past services rendered in prior NBA seasons. Judge Scudder wrote:

> Therein lies the fundamental flaw in Hoops's argument: it was not § 461(h)'s economic performance requirement that prevented Hoops from taking the deduction in 2012, but the rule in § 404(a)(5) governing nonqualified deferrecompensation plans.

Hoops further urged the Seventh Circuit to consider the practical implications of its decision. Specifically, Hoops argued that the deduction could be lost altogether (even though it clearly would be allowed if Hoops paid the deferred compensation at the time of sale) if the buyer, the Memphis Grizzlies, fails to pay the players or fails to communicate to Hoops the fact that the players have been paid. Judge Scudder responded:

> But any risk of losing the deferred compensation deduction is foreseeable, especially given the clear instructions from Congress in § 404(a)(5). We agree with the Commissioner's suggestion that Hoops could have avoided this tax-deduction problem in many ways—by adjusting the sales price to reflect the deductibility, contributing to qualified plans for the players to take earlier deductions, or renegotiating the players' contracts and accelerating their compensation to the date of the sale.

Comment. As noted above, Hoops argued in the Tax Court that the $10.7 million nonqualified deferred compensation arrangement should not be considered a "liability" includable in amount realized under § 1001(b) and Reg. § 1.1001-2(a)(1) in connection with the sale. Hoops apparently did not make this argument before the Seventh Circuit, so Judge Scudder did not address the issue. In the authors' opinion, the problem in this case stems from Hoops's inclusion of the $10.7 million deferred compensation obligation in amount realized upon the sale to the Memphis Grizzlies. If Hoops had not so included the $10.7 million "liability" in amount realized—based upon the authorities discussed by the authors above—then Hoops's gain on the sale would have been correspondingly decreased, thereby avoiding the adverse effect of § 404(a)(5).

D. <u>Individual Retirement Accounts</u>

1. Want to give the funds in your IRA to charity? Congress has made it even easier. Section 408(d)(8)(A) permits individuals who have reached age 70-1/2 to transfer up to $100,000 per year directly from one or more IRAs to one or more public charities or private operating foundations and treat the amounts transferred as tax-free distributions from the IRA. A provision of the SECURE 2.0 Act, Division T, Title III, § 307 of the Consolidated Appropriations Act, 2023, amended Code § 408 by adding § 408(d)(8)(G), which indexes the $100,000 annual limit for inflation for taxable years beginning after 2023. In addition, the legislation permits a taxpayer, beginning in 2023, to make a one-time $50,000 distribution directly from an IRA to a "split-interest entity" and make a one-time election to treat the contributions as if they were qualified charitable distributions made directly to a charitable entity. For this purpose, a split-interest entity is defined as (1) a charitable remainder unitrust that is funded exclusively by qualified charitable distributions, (2) a charitable remainder annuity trust that is funded exclusively by qualified charitable distributions, or (3) charitable gift annuity trust that is funded exclusively by qualified charitable distributions and that begins fixed payments of 5 percent or greater not more than one year from the date of funding.

2. The $1,000 limit on catch-up contributions to IRAs will be indexed for inflation beginning in 2024. Section 219(b)(5)(B) allows individuals who are age 50 or older to make so-called "catch-up" contributions to IRAs in addition to the basic amount that individuals are allowed to contribute ($6,500 in 2023). According to § 219(b)(5)(B)(ii), the limit on catch-up contributions is $1,000. The limit on the basic amount that individuals are permitted to contribute has long been adjusted annually for inflation but, until recent legislation, the limit on catch-up contributions was not. A provision of the SECURE 2.0 Act, Division T, Title I, § 108 of the Consolidated Appropriations Act, 2023, amended Code § 219(b)(5)(C) by adding § 219(b)(5)(C)(iii), which indexes the $1,000 annual limit on catch-up contributions for inflation for taxable years beginning after 2023.

3. Unless You Are the IRS, "I am the last guy in the world that you want to f[ool] with." James Caan as "Frank" in *Thief* (1981). Estate of Caan v. Commissioner, 161 T.C. No. 6 (10/18/23). The taxpayer in this case was the estate of the well-known actor, James Caan, star of many movies including *The Godfather* (1972), *Rollerball* (1975), *Misery* (1990), *Elf* (2003), and the upcoming *Fast Charlie* (2023). James Caan died in 2022, but the facts relevant to this case arose in 2014-2017. During that time, Caan's financial and business affairs were handled by a firm in California, Philpott, Bills, Stohl, and Meeks, LLP ("PBSM"). Caan held two IRAs with UBS as custodian in 2014 and most of 2015. One of Caan's IRAs held a nontraditional asset, a partnership interest in a private hedge fund. The IRA custodian, UBS, was required by § 408(i) to report annually to the IRS the fair market value of the IRA's interest in the hedge fund. Because the interest in the hedge fund was not publicly traded, the IRA custodial agreement required Mr. Caan to specify to UBS each year the fair market value of the hedge fund interest. PBSM generally acted as Caan's agent in these circumstances, received Caan's mail, and liaised with Caan's other professional and financial advisors. The following events then occurred in 2015, 2016, and 2017:

- In January 2015 (and thereafter, as noted below), PBSM did not provide UBS with the value of Caan's hedge fund interest for the year ended 2014. In this regard, the UBS IRA custodial agreement provided as follows: "The Client acknowledges, understands and agrees that if the Custodian does not receive a fair market value as of the preceding December 31, the Custodian shall distribute the Investment to the Client and issue an IRS Form 1099-R for the last available value of the Investment."
- In March and August of 2015, UBS sent PBSM letters requesting the hedge fund interest's fair market value as of December 31, 2014. UBS received no response from PBSM with respect to either letter.
- Meanwhile in June of 2015, Caan's personal financial advisor at UBS, Michael Margiotta, moved to Merrill Lynch.
- UBS alerted PBSM again in October 2015 that unless corrective action was taken it would resign as IRA custodian of the hedge fund interest effective November 23, 2015, and distribute the interest to Caan. UBS received no response from PBSM with respect to the October letter.
- Also in October of 2015, Margiotta convinced Caan to transfer the assets in his two UBS IRAs to a rollover IRA at Merrill Lynch. Caan signed the necessary paperwork, and then UBS transferred the assets, except for the illiquid hedge fund interest, to Caan's Merrill Lynch rollover IRA. The interest in the hedge fund was not transferred because the National Securities Clearing Corporation system normally used for IRA-to-IRA transfers does not accommodate unregistered securities and other nontraditional IRA assets.
- In December 2015, UBS notified PBSM of its resignation as IRA custodian and the corresponding distribution of the hedge fund interest to Caan effective as of November 25, 2015. UBS's December letter to PBSM stated that Caan had sixty days from November 25, 2015, to rollover the hedge fund interest into another IRA. UBS's December letter advised PBSM and Caan to contact the hedge fund itself to re-register the interest into Caan's name or have it registered in the name of another IRA custodian.
- Later (presumably early in 2016), in accordance with the IRA custodial agreement, UBS issued Mr. Caan (via PBSM) a 2015 Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reflecting the November 25, 2015, IRA distribution of $1,910,903, the hedge fund interest's reportable year-end value for 2013.
- PBSM and Merrill Lynch did not discover until October 2016 that the hedge fund interest had not been transferred to Caan's Merrill Lynch rollover IRA.
- In December 2016, PBSM and Merrill Lynch instructed the hedge fund itself (which handled transfers and redemptions of partnership interests in the fund) to liquidate Caan's interest for cash and transfer the cash to Caan's Merrill Lynch rollover IRA.
- Then, in 2017, three separate cash transfers totaling $1,532,605.46 then were made from the hedge fund to Caan's Merrill Lynch rollover IRA.

Caan's 2015 federal income tax return reported all of his 2015 IRA rollovers from UBS to Merrill Lynch, including the distribution of the hedge fund interest, but took the position that the hedge fund interest was rolled over to Merrill Lynch along with Caan's other IRA assets previously held at UBS. Upon examination—no doubt based upon the 2015 Form 1099-R issued by UBS—the IRS disagreed with Caan's position regarding the rollover of the hedge fund interest. Accordingly, in 2018 the IRS issued Caan a notice of deficiency for 2015 concerning the reported UBS IRA distribution of the hedge fund interest. Caan timely filed a petition in Tax Court. Around the same time the petition was filed, Caan requested a private letter ruling from the IRS granting him a waiver of the 60-day IRA rollover period with respect to the distributed interest in the hedge fund. *See* IRC § 408(d)(3)(I). The IRS denied the requested private letter ruling, citing the "same property" requirement for IRA rollovers under § 408(d)(3)(A)(i) and (D) as interpreted by *Lemishow v. Commissioner*, 110 T.C. 110, 113 (1998), *supplemented by* 110 T.C. 346 (1998) (IRA rollover treatment disallowed where taxpayer received Keogh and IRA distributions of cash, used the cash to buy stock, and then deposited the stock in a new IRA). Thus, the issues before the Tax Court were (i) whether UBS distributed the hedge fund interest to Caan in 2015 and (ii) if so, whether the distribution was taxable and in what amount.

The Estate's Arguments. Caan's estate made three principal arguments that the UBS "distribution" (as described above) of the hedge fund interest was nontaxable to Caan in 2015 or, if taxable at all, was not $1,910,903 as reported by UBS on the Form 1099-R issued to Caan for 2015. The estate first argued that, despite UBS's resignation letter to the contrary, UBS never actually distributed the hedge fund interest to Caan (i.e., it was a "phantom distribution" over which Caan had no control). And, even if UBS did distribute the interest, the distribution qualified for rollover treatment under § 408(d)(3). The estate also argued that the 2015 Form 1099-R sent by UBS was "a useless, inaccurate, [and] unreliable document" not determinative of the tax treatment or value of Caan's hedge fund interest for 2015. Finally, the estate argued that the IRS erred in denying Caan's private letter ruling request for a waiver of the normal 60-day IRA rollover period with respect to the hedge fund interest. Caan's estate cited § 408(d)(3)(I) as support for its argument. IRC § 408(d)(3)(I) states in relevant part that the IRS may waive the 60-day rollover requirement where failure to do so "would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement."

Tax Court Opinion. With respect to Caan's argument that he never received a distribution of the hedge fund interest from UBS because he never had control over the interest or, alternatively, that any such distribution qualified for rollover treatment under § 408(d)(3), Judge Copeland disagreed. Judge Copeland pointed to UBS's December 2015 letter specifically advising PBSM and Caan to contact the hedge fund itself for purposes of re-registering the interest into Caan's name or having the interest registered in the name of another IRA custodian. Judge Copeland elaborated:

> There are three problems with the way the [hedge fund interest] was handled. First, and most importantly, in liquidating the [hedge fund interest] Mr. Caan changed the character of the property; yet section 408(d)(3)(A)(i) required him to contribute the [hedge fund interest] itself, not cash, to another IRA in order to preserve its tax-deferred status. See *Lemishow*, 110 T.C. at 113; Treas. Reg. § 1.408-4(b)(1). Second, the contribution of the cash proceeds from the liquidation occurred long after the January 25, 2016, deadline. And finally, the [hedge fund's] three transfers [of cash] to the Merrill Lynch IRA constituted three separate contributions; yet section 408(d)(3)(B) allows for only one rollover contribution in any one-year period, making only the first transfer potentially eligible for a tax-free rollover.

With respect to the estate's argument that UBS's 2015 Form 1099-R erroneously reported a distribution to Caan of $1,910,903, Judge Copeland *partially* agreed. Judge Copeland reasoned that, as discussed above, UBS did in fact distribute the hedge fund interest to Caan on November 25, 2015; however, the value of the distribution for income tax purposes was $1,548,010, not the

$1,910,903 value reported by UBS and not the $1,532,605.46 in cash proceeds resulting from the liquidation of the interest in 2017. Judge Copeland based his decision on the IRS's position that the hedge fund's 2014 ending capital account for Caan's partnership interest was $1,548,010 (presumably, a booketo-market value). Moreover, Caan's estate had not proposed or proven any other value. Thus, Judge Copeland set the amount of Caan's 2015 taxable distribution from his UBS IRA at $1,548,010.

Lastly, Judge Copeland held that the IRS properly denied Caan's private letter ruling request for a waiver of the 60-day rollover period concerning the hedge fund interest. Before so holding, though, Judge Copeland acknowledged that the estate's argument regarding the IRS's denial raised two issues of first impression for the Tax Court: (i) whether the court had jurisdiction to review the IRS's denial, and (ii) if so, the proper standard of review. Concerning whether the Tax Court had jurisdiction to review the IRS's denial, Judge Copeland relied upon *Trimmer v. Commissioner*, 148 T.C. 334 (2017), a case with similar circumstances but arising under § 402 (not § 408) in connection with a distribution from an employer plan. The court in *Trimmer* held that the Tax Court had jurisdiction to review the IRS's denial of a hardship waiver under § 402(c)(3) pursuant to its power to redetermine deficiencies under § 6213. Furthermore, *Trimmer* established that the appropriate standard of review with respect to the IRS's denial in that case was abuse of discretion. Therefore, Judge Copeland concluded that *Trimmer* applied to permit the court to review the IRS's denial under § 408(d)(3)(I) of Caan's private letter ruling waiver request using an abuse of discretion standard. Judge Copeland then considered the circumstances surrounding the IRS's denial of Caan's waiver request under § 408(d)(3)(I). Based upon those circumstances, Judge Copeland determined that the IRS had not abused its discretion. Judge Copeland reasoned that in this case the property distributed from Caan's IRA, the hedge fund interest, subsequently was converted to cash, and thus no IRA rollover was available to Caan under the "same property" rule of § 408(d)(3)(A)(i) and (D) as interpreted by *Lemishow*. Judge Copeland wrote, "It cannot be an abuse of discretion for the IRS to deny a waiver where granting the waiver would not have helped the taxpayer in any way."

4. Honey, I shrunk the IRAs! Being incarcerated is bad enough without learning that your wife has depleted your IRAs and other accounts and filed for divorce and that the IRS seeks to collect tax on the withdrawals Balint v. Commissioner, T.C. Memo. 2023-118 (9/25/23). The taxpayer was incarcerated from late 2013 through January 6, 2015. While incarcerated, he wrote a letter to his wife that stated:

> You do need to get power-of-attorney!! ASAP!! Call Glen Abbott & explain the situation. He will help us! And remember, it's confidentia[l] so don[']t be worried. Tell him I want to give you everything! House, cars, motorcycles & my bank accounts—all of them in your name, making me beneficiary! He will know what to do. You need to do this now!! In case something happens to me. And the state can[']t take it when this is all over. Call now!! Meet with him & get it done. I will have to sign, but he will know how to take care of that with me here. Ok!! Now! . . . So you won[']t lose anything [&] you have access to everything. Use this letter if he needs it!

His attorney, Glenn Abbott, then prepared a proposed power of attorney for the taxpayer's signature. The power of attorney was broadly worded and gave his wife "full power and authority to perform any act, power, or duty that I may now or hereafter have and to exercise any right that I now have or may hereafter acquire." It specifically authorized her to withdraw money from financial and retirement accounts, to make gifts of his property, and to engage in acts that otherwise would constitute prohibited self-dealing. Pursuant to this authority, his wife withdrew large amounts of money from the taxpayer's IRAs and his pension and annuity accounts and transferred the money from the couple's joint checking account into her own separate bank account. She used the funds to move from their residence in Florida to Kentucky, to renovate a house there, and to pay living expenses and care for her ailing mother. She then initiated a proceeding for divorce. After the taxpayer was released from prison in early 2015, he filed a federal income tax return for

2014 with the filing status of married filing separately on which he reported all withdrawals from the accounts, including those taken by his wife, as income because he received information returns (presumably Forms 1099-R) that reported the withdrawals as taxable to him. When he could not pay the balance due, the IRS issued a final notice of intent to levy, in response to which the taxpayer requested a collection due process (CDP) hearing. The IRS Settlement Officer who conducted the CDP hearing issued a notice of determination sustaining the proposed levy, and the taxpayer then filed a petition in the U.S. Tax Court. While the taxpayer's case in the Tax Court was pending, the taxpayer filed his own action for divorce and the state court issued an order in which it concluded that his wife should be liable for tax on the amounts she withdrew because the taxpayer did not benefit from the withdrawals and they were made without his knowledge or consent.

Issues. The Tax Court (Judge Gale) addressed two issues: (1) whether the government was bound through the doctrines of res judicata or collateral estoppel by the state court's order that the wife was liable for the tax due on the withdrawals, and (2) whether the taxpayer had to include the disputed withdrawals in gross income.

No preclusive effect of state court order. The Tax Court concluded that the government was not bound by the state court's order through the doctrines of res judicata or collateral estoppel. Both doctrines, the court reasoned, generally require identity of parties, i.e., the party against whom the doctrine is asserted must have been a party to the prior action in order for the prior action to bind the party. The government, the court concluded, was not a party to the taxpayer's divorce proceeding, and therefore was not bound by the state court's order that his wife should be liable for tax on the amounts she withdrew.

No gross income from the disputed withdrawals. The taxpayer argued that he should not have to include approximately $159,811 that his wife had withdrawn from his IRAs and life insurance policy. The Tax Court held that these distributions were not includible in the taxpayer's gross income under § 408(d)(1), which provides that the "payee or distributee" must include in gross income in the manner provided under § 72 any amount paid or distributed out of an individual retirement plan. The court reasoned that the taxpayer was not a payee or distributee within the meaning of § 408(d)(1) because he had not authorized the withdrawals and did not benefit from them. Although the power of attorney signed by the taxpayer was broadly worded and gave his wife authority to make gifts of his property and to engage in acts that otherwise would be prohibited self-dealing, the court interpreted the power of attorney as limiting her authority to actions undertaken for the purpose of financial or estate planning for the taxpayer's benefit or for qualifying for public assistance for which the taxpayer might be eligible. The relevant language in the power of attorney, the court concluded,

> strictly construed, does not amount to an openended authorization for [the taxpayer's wife] to exercise her authority under the POA for her own benefit. Instead, its clear implication is that [she] was authorized to take actions that would benefit herself only if the benefit to her was incidental to planning undertaken primarily to benefit petitioner, or to ensuring that petitioner would qualify for public assistance.

In reaching its conclusion that the taxpayer did not have to include the disputed amounts in gross income, the court relied on its prior decision in *Roberts v. Commissioner*, 141 T.C. No. 569 (2013), in which the court concluded that a taxpayer did not have to include in gross income IRA withdrawals taken by his wife, who had forged the taxpayer's signature on the withdrawal requests. The court also relied on prior decisions in which it had held that a taxpayer did not have to include in gross income amounts withdrawn from retirement or other financial accounts by the taxpayer's agent when the agent's actions were unauthorized and the taxpayer received no economic benefit from the withdrawn funds. *See Grant v. Commissioner*, T.C. Memo. 1995-29; *Wilkinson v. Commissioner*, T.C. Memo. 1993-336. The court upheld the IRS's levy, but only to the extent of the taxpayer's correct tax liability after reduction for the tax attributable to the amounts withdrawn by his wife.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. If you can understand half of the terminology in this ruling, you are ahead of the game. A cash method taxpayer who receives additional units of cryptocurrency as a reward for participating in a validation process by staking the taxpayer's holdings through a cryptocurrency exchange has gross income equal to the fair market value of the units received in the year in which the taxpayer gains dominion and control over the validation rewards. Rev. Rul. 2023-14, 2023-33 I.R.B. 484 (7/31/23). This ruling addresses the tax consequences for a cash-method taxpayer who receives units of cryptocurrency as a reward for performing so-called validation services in connection with cryptocurrency transactions. Many cryptocurrencies such as Bitcoin use blockchain technology. Generally, blockchain, which is one form of distributed ledger technology, is a storage technology that is used for saving data on decentralized networks. Blockchain stores information in batches called blocks, which are linked together in a sequential way. The creation of new blocks on a blockchain requires the participation of multiple validators who validate the legitimacy of transactions. The validators receive as a reward one or more newly-created units of the cryptocurrency native to the blockchain. In one form of this validation process, those validating stake their holdings in cryptocurrency. If the validation is successful, the validator receives a reward. If the validation is unsuccessful, the validator may forfeit some or all of the staked units. The ruling addresses a set of facts in which a cash method taxpayer stakes 200 units of a cryptocurrency, validates a new block of transactions, and receives 2 units of cryptocurrency asa reward. The ruling concludes as follows:

> If a cash-method taxpayer stakes cryptocurrency native to a proof-of-stake blockchain and receives additional units of cryptocurrency as rewards when validation occurs, the fair market value of the validation rewards received is included in the taxpayer's gross income in the taxable year in which the taxpayer gains dominion and control over the validation rewards. The fair market value is determined as of the date and time the taxpayer gains dominion and control over the validation rewards. The same is true if a taxpayer stakes cryptocurrency native to a proof-of-stake blockchain

The ruling cautions that it does not address issues that might arise under any rules not cited in the ruling, including § 83.

2. Are those refunds of state or local taxes or other payments received from state governments included in gross income? Maybe, says the IRS. Notice 2023-56, 2023-38 I.R.B. 824 (8/30/23). In 2022, some states made payments to individuals residing in those states. The payments generally were related to the COVI19 pandemic. The IRS issued a news release on February 10, 2023, IR-2023-23, to provide certainty for the 2023 filing season for 2022 returns. The news release provided that, in the best interest of sound tax administration, the IRS would not challenge a taxpayer's exclusion of these payments from gross income. The news release identified 17 states that qualified for this treatment. That guidance, however, applied only for tax year 2022. This notice provides guidance for 2023 and future years. The notice addresses the general tax treatment of a state refund of tax. If the payment is a refund of tax, then it is not included in a taxpayer's gross income except to the extent required by the tax benefit rule, i.e., to the extent the taxpayer deducted the payment and received a tax benefit from the deduction in a prior year. (A state payment if considered a refund of tax only to the extent that the payment is limited to taxes paid. *See, e.g.*, *Maines v. Commissioner*, 144 T.C. 123 (2015).) The notice also addresses payments received from states that are eligible for exclusion under the general welfare exclusion. To qualify for the general welfare exclusion, state payments must (1) be paid from a governmental fund, (2) be for the promotion of general welfare (that is, based on the need of the individual or family receiving such payments), and (3) not represent compensation for services absent a specific Federal income tax exclusion. The notice provides examples of payments that qualify, such as

payments to eligible residents under an "Energy Relief Payment Program" to help those low-income residents who may not otherwise be able to afford to pay their heating bills.

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

1. Taxpayer's horse-breeding activity is a hobby subject to deduction limitations under § 183 because the taxpayer covered year-over-year losses from his trust fund, ignored cost-saving strategies because he was "not so much [concerned about] income and expenses," threw "pretty lavish parties" attended by people "you would never meet otherwise," intermingled personal and company expenses (including wedding costs), and lived rent-free on the company farm. Skolnick v. Commissioner, 62 F.4th 95 (3rd Cir. 3/8/23) *aff'g* T.C. Memo. 2021-139. The headline more or less sums up this case from the U.S. Court of Appeals for the Third Circuit in which the court affirmed the Tax Court's decision. The taxpayers were owners of a horse-breeding farm conducted through an LLC classified as a partnership for federal income tax purposes. The LLC had operated at a loss for twelve consecutive years before the taxpayers were audited by the IRS for losses claimed via the LLC with respect to their taxable years 2010-2013. The IRS assessed a deficiency on the grounds that IRC § 183 applied to disallow any deductions in excess of the income from the LLC for the years 2010-2013. The taxpayers petitioned the Tax Court, which upheld the proposed deficiency. *See Skolnick v. Commissioner*, T.C. Memo. 2021-139 (Judge Lauber). The taxpayers appealed to the Third Circuit, alleging that the Tax Court misapplied the nine-factor test under Reg. § 1.183-2(b) for determining whether an activity is engaged in for profit: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any; (8) the financial status of the taxpayer; and (9) elements of personal pleasure or recreation. Judge Lauber of the Tax Court found that five factors (1, 6, 7, 8, and 9) favored the IRS, three factors (3, 4, and 5) were neutral, and only one factor (2) favored the taxpayers. The Third Circuit, in an opinion written by Judge Hardiman, essentially agreed with Judge Lauber's analysis of the nine factors and found no clear error in the Tax Court's ultimate conclusion that the taxpayers' horse breeding activity was not engaged in for profit for years 2010-2013 within the meaning of IRC § 183. On the one hand, Judge Hardiman reiterated the facts stated in the headline above, especially the LLC's long history of operating losses prior to and after the period 2010-2013 (factor 6). Judge Hardiman also reasoned that, as Judge Lauber emphasized, factor 8 (financial status of the taxpayer) favored the IRS because the taxpayers continually used trust funds and income from other activities to prop up the LLC's year-over-year losses. On the other hand, Judge Hardiman was mildly critical of Judge Lauber's analysis of factor 7 (occasional profits) because the taxpayers were able to show that a thirparty paid $325,000 for a 15% interest in the LLC in 2001 and the LLC made a small profit in 2016 from the sale of an interest in one breeding horse. Ultimately, though, Judge Hardiman ruled that Judge Lauber had not erred in holding that factor 7 favored the IRS. Similarly, Judge Hardiman critiqued Judge Lauber's analysis of factor 9 (elements of personal pleasure or recreation). Judge Hardiman did not view the evidence as supporting the conclusion that the opportunity for socializing, as opposed to making a profit, was the primary motive of the taxpayers vis-à-vis the LLC's activities. Nevertheless, considering that the LLC's farm was used rent-free by the taxpayers as a residence and that personal expenditures (including wedding costs) were intermingled with horse-breeding expenses, Judge Hardiman agreed with Judge Lauber that factor 9 favored the IRS. Lastly, concerning a separate issue of whether the taxpayers were entitled to NOL carryforwards from years prior to 2010, Judge Hardiman ruled that Judge Lauber had not clearly erred in finding that the taxpayers failed to adequately substantiate such carryforward losses.

a. "Pease" limitation of § 67 regarding miscellaneous itemized deductions sinks hobby loss expenses otherwise allowable under § 183(b)(2) for taxpayer's yacht chartering activity. Gregory v. Commissioner, 69 F.4th 762 (11th Cir. 5/30/23) *aff'g* T.C. Memo.

2021-115 (Judge Jones). The taxpayer in this case engaged in a yacht chartering activity where expenses equaled or exceeded the taxpayer's gross income from the activity during taxable years 2014 and 2015. During the audit and in the Tax Court, the taxpayer and the IRS agreed that the taxpayer's yacht chartering activity during the years in issue was subject to the hobby loss rules of IRC § 183. Consequently, the taxpayer and the IRS further agreed that any deductible expenses from the yacht chartering activity during those years were subject to the gross income limitation of § 183(b)(2). The taxpayer and the IRS disagreed, however, whether the deductions otherwise allowable under § 183(b)(2) are (i) permitted above-the-line as an offset against gross income in determining adjusted gross income under IRC § 62 or (ii) subject to the so-called "Pease" limitation of IRC 67(a) (allowing "miscellaneous itemized deductions" below-the-line only to the extent the deductions exceed a floor of 2 percent of the taxpayer's adjusted gross income). Because the taxpayer earned substantial taxable income during the years in issue—over $19 million in 2014 and over $80 million in 2015—the "Pease" limitation had the effect of disallowing the taxpayer's yacht chartering expenses entirely, even if the expenses were allowable in part under IRC § 183(b)(2). [*Note*: The 2-percent "Pease" limitation applied to the taxable years at issue in this case, but beginning in 2018 through 2025, "miscellaneous itemized deductions" are completely disallowed under IRC § 67(g). Thus, under current law, the taxpayer's yacht chartering expense deductions otherwise allowable under § 183(b)(2) would be disallowed entirely under § 67(g) regardless of the taxpayer's adjusted gross income.] The taxpayer moved for partial summary judgment in Tax Court arguing that the "Pease" limitation does not apply to hobby loss deductions under § 183(b)(2). The IRS argued to the contrary, and Judge Jones of the Tax Court agreed with the IRS, thereby disallowing the taxpayer's hobby loss deductions that otherwise would be permitted under IRC § 183(b)(2).

Appeal: On appeal to the Eleventh Circuit, the taxpayer made several arguments that § 183(b)(2) hobby loss deductions are not "miscellaneous itemized deductions" subject to § 67. First and foremost, the taxpayer argued that IRC § 183 should be read on a standalone basis to allow hobby activity expenses as above-the-line deductions offsetting hobby activity gross income. Put differently, the taxpayer argued that § 183 should be read as a corollary to § 162 which allows trade or business expenses above the line as an offset against trade or business gross income in determining adjusted gross income under § 62. Thus, according to the taxpayer, § 183 is merely a qualifier designed to limit hobby activity deductions to hobby activity gross income, but otherwise § 183 operates like § 162. The Eleventh Circuit (Judge Brasher), however, disagreed, stating: "Section 183(b)(2) permits a deduction otherwise disallowed by Section 183(a) and identifies its amount. But the deduction allowed by Section 183(b)(2) is its own thing, not a trade or business expense." Further, Judge Brasher reasoned that, as Judge Jones of the Tax Court had concluded, that § 183(b)(2) "is a benchmark for capping the deduction—it is not a command to apply hobby loss deductions against a taxpayer's total gross income." Judge Brasher then turned to the statutory scheme of IRC §§ 62 (defining "adjusted gross income"), 63 (defining "itemized deductions"), and 67 (defining "miscellaneous itemized deductions"). Judge Brasher concluded that because § 62 does not list § 183 as one of the deductions allowable in computing adjusted gross income, and because § 63 does not carve out § 183 deductions for special treatment (unlike the special treatment given the standard deduction, the § 199A QBI deduction, and the § 170 charitable deduction), hobby loss deductions are subject to the "Pease" limitation of § 67. Judge Brasher cited as support (i) Reg. § 1.67-1T(a)(1)(iv) ["expenses for an activity for which a deduction is otherwise allowable under section 183"]; (ii) two lower-court cases [i.e., *Purdey v. United States*, 39 Fed. Cl. 413, 417 (1997); *Strode v. Comm'r*, 109 T.C.M. (CCH) 1599 (2015)]; and (iii) commentary [i.e., B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶ 30.4.2 (July 2022)].

Next, the taxpayer argued that the Eleventh Circuit's opinion in *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984), compelled the conclusion that § 183 deductions are above-the-line and not subject to the "Pease" limitation. The court in *Brannen* held that § 183 applies to allow deductions, not to exceed gross income, for expenses connected with an activity that is not "entered into with the dominant hope and intent of realizing a profit." Judge Brasher clarified, though, that

Brannen was decided before the enactment of the "Pease" limitation of § 67, and *Brannen* should not be read to mean that § 183 allows an above-the-line deduction for hobby activity expenses notwithstanding the statutory scheme of §§ 62, 63, and 67.

Next, the taxpayer argued that subjecting § 183(b)(2) deductions to the "Pease" limitation of § 67 contravenes Congressional intent. Pointing to legislative history, the taxpayer contended that § 183 originally was enacted to prevent wealthy taxpayers from generating artificial losses, not to prevent taxpayers from deducting legitimate hobby loss expenses. Judge Brasher countered, though, that by enacting the "Pease" limitation of § 67, Congress explicitly intended to limit a taxpayer's ability to benefit from already-existing deductions that the Code otherwise provided.

Finally, the taxpayer made additional arguments that the Tax Court's and the Eleventh Circuit's interpretation of § 183 is inconsistent with other principles of statutory construction; however, Judge Brasher found none of the taxpayer's arguments convincing, primarily because the court did not find that § 183 and the statutory scheme of §§ 62, 63, and 67 were ambiguous.

Judge Wilson concurred with Judge Brasher's opinion but wrote separately to clarify that he would reach the same result by examining the legislative history of the Tax Cuts and Jobs Act of 2017 ("TCJA"). In relevant part, the Conference Report to the TCJA lists "[h]obby expenses, but generally not more than hobby income," as one type of deduction that would be disallowed under § 67(g) until 2026. *See* H.R. Rep. No. 115-466, at 273, 276 (2017).

D. Deductions and Credits for Personal Expenses

1. Standard deduction for 2024. Rev. Proc. 2023-34, 2023-48 I.R.B. 1287 (11/9/23). The standard deduction for 2024 will be $29,200 for joint returns and surviving spouses (increased from $27,700), $14,600 for unmarried individuals and married individuals filing separately (increased from $13,850), and $21,900 for heads of households (increased from $20,800). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater of $1,300 (increased from $1,250) or the sum of $450 (increased from $400) and the individual's earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,950 (increased from $1,850) for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,550 (increased from $1,500) for married taxpayers ($3,100 on a joint return if both spouses are age 65 or older).

The following table sets forth the standard deduction for each filing status a taxpayer might have:

Filing Status	2022	2023	2024
Single/MFS	$12,950	$13,850	$14,600
Head-of-Household	$19,400	$20,800	$21,900
MFJ and Surviving Spouses	$25,900	$27,700	$29,200

2. Congress has increased and made more widely available the § 36B premium tax credit for 2021 and 2022, eliminated the need to repay excess advance premium tax credits for 2020, and has made the credit available for 2021 to those who receive unemployment compensation. The 2021 American Rescue Plan made several significant changes to the premium tax credit authorized by § 36B. This credit is available to individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through a health insurance exchange. *First*, for taxable years beginning in 2021 or 2022, § 9661 of the legislation amends Code § 36B(b)(3)(A) by adding new clause (iii), which increases the amount of the credit at every income level and makes the credit available to those whose household income is 400 percent or higher of the federal poverty line. *Second*, for any taxable year beginning in 2020,

§ 9662 of the legislation suspends the rule of § 36B(f)(2)(B), which requires repayment of excess premium tax credits. An individual who receives advance premium tax credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year and, normally, pursuant to § 36B(f)(2)(B), must repay any excess credit received. This repayment obligation does not apply for 2020. *Third*, for taxable years beginning in 2021, § 9663 of the legislation amends § 36B by adding new subsection (g), which caps the household income of those receiving unemployment compensation at 133 percent of the federal poverty line. This has the effect of making such persons eligible for the maximum amount of premium tax credit.

a. Congress has extended certain changes related to the § 36B premium tax credit through 2025. The Inflation Reduction Act, § 12001, extends through 2025 the effective date of Code §§ 36B(b)(3)(A)(iii) and 36B(c)(1)(E), which increase the amount of the credit at every income level and make the credit available to those whose household income is 400 percent or higher of the federal poverty line.

3. Congress has modified and extended through 2032 the § 25C credit for certain energy-efficient improvements to a taxpayer's principal residence. The changes apply to property placed in service after December 31, 2022. The Inflation Reduction Act, § 13301, extended with some modifications the § 25C credit for certain energy-efficient home improvements to a taxpayer's principal residence. As modified, the credit is 30 percent (increased from 10 percent) of the amount paid or incurred by a taxpayer for qualified energy efficiency improvements (such as insulation materials or systems, exterior windows, and exterior doors), 30 percent of the amount paid or incurred by a taxpayer for residential energy property expenditures (such as high-efficiency furnaces, water heaters, and air conditioning systems), and 30 percent of the amount paid or incurred for a home energy audit. Although energy-efficient roofs formerly were treated as qualified energy efficiency improvements, they are no longer treated in this manner (and therefore are not eligible for the § 25C credit) under the revised statute. The credit is subject to an annual per-taxpayer limit of $1,200 and an annual $600 per-item limit. In addition, the maximum annual credit is $600 for all exterior windows and skylights and $500 for all exterior doors (with a per-door limit of $250). The maximum credit for a home energy audit is $150. For geothermal and air source heat pumps and biomass stoves, the annual limit on the credit is $2,000. The changes made by the Inflation Reduction Act generally apply to property placed in service after December 31, 2022. As extended, the credit is available for property placed in service before January 1, 2033.

4. Congress has extended through 2034 the § 25D credit for residential clean energy property. The Inflation Reduction Act, § 13302, extended the § 25D credit for qualified solar electric property, qualified solar water heating property, qualified fuel cell property, qualified small wind energy property, qualified geothermal heat pump property, and qualified biomass fuel property. Generally, these properties must be installed in a dwelling unit located in the United States that is used by the taxpayer as a residence. In the case of qualified fuel cell property, the dwelling unit must be used by the taxpayer as a principal residence. For qualified biomass fuel property, the credit is available only for property placed in service through 2022. Beginning in 2023, a credit is available for a new category, qualified battery storage technology. The credit for all categories of eligible property is 30 percent for property placed in service in 2022 through 2032 and phases down to 26 percent for property placed in service in 2033 and to 22 percent for property placed in service in 2034.

5. We agree: "The facts of this case are undisputed and disturbing." The taxpayers could not deduct $1.2 million they paid to their daughter/stepdaughter, who defrauded them and other individuals and is now in prison. Gomas v. United States, 132 A.F.T.R.2d 2023-5165, 2023 WL 4562503 (M.D. Fla. 7/17/23). Normally, the authors do not report on many U.S. District Court cases; however, with a line like the above taken directly from the court's opinion, at least one of us became too curious to resist. Essentially, the taxpayers in this case, a retired, married couple, were swindled out of nearly $2 million by their ne'er-do-well daughter/step-daughter, Suzanne Anderson (Anderson), over a two-year period. To pay this amount to Anderson, the taxpayers withdrew nearly $1.2 million from an IRA and a separate pension account in 2017. The taxpayers' original return for 2017 reported the amounts withdrawn as income and they paid the corresponding income tax liability. In 2020, the taxpayers filed an amended return seeking a refund of approximately $412,000 by claiming a deduction equal to the withdrawn amounts. The IRS denied their claim for a refund and the taxpayers brought this suit in U.S. District Court seeking a refund. As discussed below, the court, although sympathetic to the taxpayers' situation, denied their claim.

Factual background. The taxpayers had owned a business (operated through a limited liability company) that sold pet food online. In 2016, the taxpayers decided to retire and "turned the business over" to Anderson. According to the court's opinion, the limited liability company conducting the business was dissolved and its bank accounts closed. The assets of the business—presumably not significant due to online sales—were given to Anderson to carry on the business. Over the course of 2017 through 2019, Anderson convinced them, via numerous fraudulent misrepresentations, to withdraw about $1.2 million from their IRA and a separate pension fund and transfer the funds to her to support the business. Specifically, Anderson convinced the taxpayers that they were being sued by former customers and that she needed to hire an attorney to defend the business and to prevent the taxpayers from being arrested due to past business dealings. Anderson even forged documents and created a fake email address for the attorney she had "hired." Finally, in August of 2019, the taxpayers uncovered Anderson's elaborate scheme, she was arrested, and she currently is serving a 25-year sentence in a Florida state prison.

Court's analysis. On cross-motions for summary judgment, the District Court (Judge Barber) reluctantly held for the IRS and disallowed the taxpayers' refund claim. The court first noted that the taxpayers were precluded from claiming a theft-loss deduction. Section 165(h)(5), enacted as part of the 2017 Tax Cuts and Jobs Act, provides:

> [i]n the case of an individual, except as provided in subparagraph (B) [relating to personal casualty gains], any personal casualty loss which (but for this paragraph) would be deductible in a taxable year beginning after December 31, 2017, and before January 1, 2026, shall be allowed as a deduction under subsection (a) only to the extent it is attributable to a Federally declared disaster . . . .

The court reasoned that, although taxpayers historically were entitled to deduct theft losses in the year in which the loss was discovered (see § 165(e)), § 165(h)(5) precluded the taxpayers from claiming a theft loss deduction. The taxpayers in this case discovered the loss in 2019, a year to which § 165(h)(5) applies. The court then turned to the question whether the taxpayers were entitled to a deduction in 2017, the year for which they had filed the amended return. The taxpayers argued that they were entitled to deduct the amounts they had transferred to Anderson in 2017 under two theories. *First*, they asserted that they did not enjoy the benefit of the amounts withdrawn from the IRA and pension fund in 2017 and therefore should not be required to include the withdrawn amounts in gross income. Judge Barber recognized that Anderson, not the taxpayers, ultimately received the withdrawn funds; however, the taxpayers nevertheless were the "distributees" for federal income tax purposes under § 408. The taxpayers authorized and received the distributions before transferring the amounts to Anderson. The court contrasted the taxpayers' situation to that in *Roberts v. Commissioner*, 141 T.C. 569 (2013), in which the court held that a taxpayer was not the distributee with respect to amounts withdrawn from his IRAs by his wife through forged withdrawal requests and used exclusively by her. Thus, the taxpayers in this case

were taxable on the distributions. *See Nice v. United States*, 124 A.F.T.R.2d 2019-6403, 2019 WL 5212281 (E.D. La. 2019) (finding elderly woman with dementia was the taxable distributee of IRA disbursements even though son used and spent mother's IRA funds for personal enjoyment). *Second*, the taxpayers argued that the amounts transferred to Anderson should be treated as deductible trade or business expenses under § 162. Judge Barber ruled, though, that the amounts transferred to Anderson were not deductible business expenses because, at the time the transfers were made, the taxpayers were retired and were no longer carrying on the trade or business. The fact that the taxpayers believed the amounts they paid to Anderson would be used to pay legal fees related to their past business operations, the court reasoned, did not entitle them to a deduction because none of the amounts paid were used to pay actual business expenses.

The taxpayers have appealed to the U.S. Court of Appeals for the Eleventh Circuit.

Comment: The court's opinion does not discuss, and neither the IRS nor the taxpayers may have cited, Rev. Rul. 2009-9, 2009-14 I.R.B. 735. Rev. Rul. 2009-9 famously was issued to benefit taxpayers who suffered so-called "Ponzi scheme" losses at the hands of Bernie Madoff. Rev. Rul. 2009-9 held that, although these losses were theft losses deductible in the year in which the theft was discovered, the losses were deductible under § 165(c)(2), not § 165(c)(3), because they were attributable to a "transaction entered into for profit." Therefore, the theft losses involved were not personal casualty losses and were not subject to the limitations on personal casualty losses in § 165(h). Under this reasoning, such losses would not be subject to the temporary disallowance rule of § 165(h)(5) quoted above. At least one author of this outline is curious as to whether the taxpayers' theft losses, especially given that they related to a former business conducted for profit, should be allowable in 2019 (the year of discovery) under § 165(c)(2) as interpreted by the IRS in Rev. Rul. 2009-9.

E. Divorce Tax Issues

F. Education

1. Beginning in 2024, beneficiaries of § 529 college savings plans that have been open for more than 15 years will be able to roll over up to $35,000 during their lifetime from the 529 plan to a Roth IRA (subject to annual Roth IRA contribution limits). A provision of the SECURE 2.0 Act, Division T, Title I, § 126 of the Consolidated Appropriations Act, 2023, amended Code § 529(c)(3) by adding § 529(c)(3)(E), which permits distributions from a § 529 college savings account to be tax-free if they are rolled over to a Roth IRA maintained for the benefit of the designated beneficiary of the § 529 account provided that certain requirements are met. The requirements are that (1) the § 529 account must have been maintained for the 15-year period ending on the date of the distribution, (2) the distribution does not exceed the amount contributed to the § 529 plan (plus earnings) before the 5-year period ending on the date of the distribution, and (3) the distribution is paid in a direct trustee-to-trustee transfer to a Roth IRA maintained for the benefit of the designated beneficiary of the § 529 account. The amount rolled over each year is subject to two limitations. *First*, the amount rolled over cannot exceed the annual limit on Roth IRA contributions for the designated beneficiary reduced by the aggregate contributions made during the year to all IRAs maintained for the benefit of the designated beneficiary. For example, the limit on Roth IRA contributions for 2023 is $6,500. If the designated beneficiary of a § 529 account contributes $1,000 to a traditional IRA for the year, then the maximum amount that the individual could roll over from the § 529 account to the Roth IRA would be $5,500. *Second*, the amount rolled over in the current year and in all prior years cannot exceed $35,000, i.e., the lifetime limit on rollovers from the § 529 account to a Roth IRA is $35,000. This change applies to distributions from § 529 accounts made after December 31, 2023.

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

1. **Wait, what? A taxpayer gets a "do-over"? This corporate taxpayer was allowed to disavow the form of its two-step acquisition transaction by subsequently treating the separate steps as a single § 351 transaction with boot, thereby *post hoc* generating a partial basis step-up in intangible assets it received in exchange for its stock and resulting in larger amortization deductions.** Complex Media, Inc. v. Commissioner, T.C. Memo. 2021-14 (3/31/21). This lengthy and complex 100-plus page Tax Court memorandum decision could well have been a reviewed opinion, and as the reader will discover below, perhaps should have been. Essentially, the corporate taxpayer, Complex Media, Inc., engaged in two separate acquisitive transactions. The first was a § 351 exchange in which the taxpayer acquired certain intangible assets from a partnership in exchange for the taxpayer's common stock. In the second transaction, the taxpayer paid cash (approximately $2.7 million) and granted a "deferred payment" obligation ($300,000) to the partnership to redeem some of the common stock issued in the § 351 exchange. (The cash and deferred payment obligation then were used by the partnership to redeem one reluctant partner's partnership interest.) Complex Media and the partnership from it acquired the intangible assets agreed in the relevant documentation of the transaction to treat the partnership's contribution of assets in exchange for Complex Media's stock as a transaction eligible for nonrecognition pursuant to § 351(a) and to treat Complex Media's redemption of a portion of the shares issued to the partnership as a separate redemption of stock. On its corporate tax return for the year in which the § 351 exchange took place, Complex Media treated the transaction consistently with the manner in which it had agreed to do so (i.e., as a transaction eligible for nonrecognition pursuant to § 351(a) and as a separate redemption of some of the stock it had issued in the § 351 exchange) by reporting that it had taken a carryover basis in the acquired intangible assets pursuant to § 362(a). On its corporate tax returns for the subsequent three years, however, Complex Media effectively treated the two separate steps as a single § 351 exchange, reporting the cash and deferred payment obligation as § 351(b)(1) boot paid for a portion of the intangible assets of the partnership acquired in the exchange. Doing so allowed the taxpayer to step up its basis in the acquired intangible assets under § 362(a), leading to larger amortization deductions with respect to the intangibles under § 197. The taxpayer would not have been entitled to step up the basis in the intangible assets if the cash and deferred payment obligation were not boot in the § 351 exchange but instead were funds used to redeem some of the taxpayer's stock issued in the § 351 exchange. Over the IRS's objection, the taxpayer argued, and the Tax Court (Judge Halpern) agreed, that the two steps could be treated as one, even if the taxpayer's chosen form was a § 351 exchange of property solely for stock followed by a separate redemption of some of the stock issued in the § 351 exchange. Thus, with Judge Halpern's blessing, the taxpayer in *Complex Media* was able to *post hoc* recast the taxpayer's chosen form of a corporate acquisition to obtain a better tax result than as originally structured and agreed. We will spare the reader pages and pages of analysis regarding the relatively low bar the courts have set for the IRS to recast a taxpayer's chosen form of a transaction for tax purposes versus the much higher bar set for taxpayers to disavow their chosen form to achieve more favorable tax treatment. Suffice it to say that taxpayers are rarely allowed "do-overs" to report transactions for tax purposes in a manner that is inconsistent with their chosen form. Judge Halpern also agreed with Complex Media that the $300,000 deferred payment obligation granted to the partnership could be valued at its face amount rather than at a discount. Valuing the deferred payment obligation at face increased the § 351(b)(1) boot, thereby increasing subsequent amortization deductions taken by the taxpayer. Thus, *Complex Media* is a relatively important and surprising case, albeit a Tax Court memorandum decision.

a. Although it took a while, the IRS has decided to "disavow" Judge Halpern's decision in *Complex Media*. A.O.D. 2023-11 I.R.B. 529 (3/13/23). The IRS has announced that it will not follow *Complex Media* regarding a taxpayer's ability to disavow the chosen form of a transaction for tax purposes, especially if the taxpayer "does not fully, properly, and consistently report the transaction." Furthermore, the IRS will not follow *Complex Media* in determining the fair market value of debt (i.e., the deferred payment obligation) for purposes of § 351(b)(1).

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. A new fast-track program for corporate private letter rulings can result in rulings being issued in a compressed timeframe, generally 12 weeks. Rev. Proc. 2023-26, 2023-33 I.R.B. 486 (7/26/23). The IRS has made permanent its fast-track program for private letter rulings solely or primarily under the jurisdiction of the Associate Chief Counsel (Corporate). The new program replaces, with minor changes, the pilot program established in Rev. Proc. 2022-10, 2022-6 I.R.B. 473. If fast-track processing is available, then

> the IRS will endeavor to complete the processing of the letter ruling request and, if appropriate, to issue the letter ruling within the time period specified by the branch representative or branch reviewer. The specified period will be 12 weeks unless a shorter or longer period is designated by the branch reviewer …

The revenue procedure specifies that a taxpayer seeking fast-track processing must request a pre-submission conference and must submit required information before the conference, including the reason for requesting fast-track processing and the length of time requested (if other than 12 weeks). The revenue procedure strongly recommends that taxpayers submit fast-track requests as an encrypted e-mail attachment in order to avoid delays resulting from submitting requests by mail or by delivery in physical form. The new fast-track program is available for letter ruling requests received by the IRS after July 26, 2023.

VII. PARTNERSHIPS

A. Formation and Taxable Years

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

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

1. Judge Gustafson revisits *Grecian Magnesite*, but this time rules against this non-U.S. taxpayer selling her partnership interest due to § 751. Rawat v. Commissioner, T.C. Memo 2023-14 (2/7/23). We previously have written about the entity-theory versus aggregate-theory dust-up between the IRS and non-U.S. persons selling interests in partnerships conducting business in the U.S. For example, in *Grecian Magnesite Mining, Industrial & Shipping Co., S.A. v. Commissioner*, 149 T.C. 63 (2017), the Tax Court (Judge Gustafson) ruled against the IRS (and against the IRS's position in Rev. Rul. 91-32, 1991-1 C.B. 107) to hold that a non-U.S. person's gain from the sale of an interest in a partnership conducting a U.S. trade or business is not U.S.-source income (because the partnership interest is personal property) and therefore is not subject to U.S. taxation unless such gain (i) is captured by § 897(g) (gain attributable to U.S. real property) or (ii) is captured by § 865(e)(2) (gain attributable to a U.S. office or fixed place of business). The IRS in *Grecian Magnesite* had argued that a non-U.S. person's gain from the sale of an interest in a partnership conducting business in the U.S. should be analyzed under the aggregate-theory of partnership taxation, meaning that the gain would be considered U.S. source income because it is attributable to the underlying U.S. assets held by the partnership. *See* Rev. Rul. 91-32, 1991-1 C.B.

107. Nevertheless, Judge Gustafson declined to adopt the IRS's reasoning (labeling the IRS's analysis in Rev. Rul. 91-32 as "cursory") and ruled for the taxpayer. Importantly, *Grecian Magnesite* did not address whether the result might be different if the partnership conducting business in the U.S. held inventory items subject to § 751.

Rawat Decision by Judge Gustafson. In *Rawat v. Commissioner*, T.C. Memo 2023-14 (2/7/23), Judge Gustafson got the chance to address the issue left open in *Grecian Magnesite*: whether gain from a non-U.S. person's sale of an interest in a partnership holding inventory items and conducting business in the U.S. is considered U.S. source income by virtue of § 751 and the U.S. income-sourcing rules of §§ 861-865. This time, the Tax Court (again, Judge Gustafson) adopted the IRS's aggregate-theory argument and held against the taxpayer. The taxpayer in *Rawat* was a Canadian citizen and nonresident of the U.S. during 2007 and 2008. In 2008, the taxpayer sold her interest in a partnership doing business in the U.S. in exchange for a promissory note with a face amount of $438 million. The principal of the promissory note was not payable until 2028. The IRS sought to tax $6.5 million of the taxpayer's gain ("inventory gain") in 2008 because that amount was attributable to § 751 inventory items held by the partnership and allocable to the taxpayer's partnership interest. The taxpayer argued that, because the inventory gain was realized and recognized prior to the enactment of § 864(c)(8) (see below), the Tax Court's decision in *Grecian Magnesite* controlled. The IRS disagreed, arguing that the inventory gain, unlike the gain in *Grecian Magnesite*, was subject to § 751, thereby rendering the gain as U.S. source income under §§ 861-865 and the IRS's aggregate theory asserted in *Grecian Magnesite*. This time around, Judge Gustafson ruled for the IRS and against the taxpayer. Judge Gustafson reasoned that, although § 751 is not a sourcing rule, the rule in § 741 generally treating the sale of a partnership interest as the disposition of a capital asset is expressly subject to the § 751 carve-out for inventory items. Then, examining the special sourcing rules under §§ 861(a)(6) (sale or exchange of inventory property) and 865(b) (exception for inventory property), Judge Gustafson concluded that the taxpayer's inventory gain from the sale of her partnership interest should be considered U.S.-source income subject to U.S. tax notwithstanding the Tax Court's holding in *Grecian Magnesite* regarding more general § 741 gain.

The final word: 2017 Tax Cuts and Jobs Act Overturns Grecian Magnesite and Supports the Tax Court's Holding in Rawat. Regardless of the Tax Court's holdings in *Grecian Magnesite* and *Rawat*, readers may recall that the 2017 Tax Cuts and Jobs Act, § 13501, amended § 864(c) by adding § 864(c)(8) effective for dispositions after November 27, 2017. Section § 864(c)(8) provides that gain or loss (after 11/27/17) on the sale or exchange of all (or any portion of) a partnership interest owned by a nonresident alien individual or a foreign corporation in a partnership engaged in any trade or business within the U.S. is treated as effectively connected with a U.S. trade or business (and therefore taxable by the U.S. unless provided otherwise by treaty) to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The amount of gain or loss treated as effectively connected under this rule is reduced by the amount of such gain or loss that is already taxable under § 897 (relating to U.S. real property interests). Thus, § 864(c)(8) overturns the Tax Court's holding in *Grecian Magnesite* effective for partnership-interest gain recognized after November 27, 2017, and supports the Tax Court's holding in *Rawat* for partnership-interest inventory gain recognized before or after November 27, 2017.

E. Inside Basis Adjustments

F. Partnership Audit Rules

1. ♪♬ Ooh, a storm is threatening … my very life today. If I don't get some shelter … ooh yeah, I'm gonna fade away. ♬♪ Keene-Stevens v. Commissioner, 72 F.4th 1015 (9th Cir. 7/3/23), *rev'g and remanding* T.C. Memo 2020-118. The Ninth Circuit (holding for the IRS) has reversed the Tax Court (which had held for the taxpayers) in a case in which the taxpayers were "sheltering" between the normal deficiency determination procedures of §§ 6213 and 6214 and the now-repealed TEFRA "oversheltered return" procedures of § 6234 (hereinafter "TEFRA

§ 6234). Essentially, prior TEFRA § 6234 provided a procedural solution in the unusual situation where (i) the taxpayer was contesting in the Tax Court (pursuant to §§ 6213 and 6214) a proposed IRS individual-level deficiency assessment based upon items attributable solely to the taxpayer's personal return for a taxable year or years ("non-partnership items") and (ii) regardless of the outcome of the individual-level proceeding in Tax Court under §§ 6213 and 6214, the taxpayer ultimately might not be found to have a "deficiency" for the taxable year or years due to pass-through losses claimed as a partner in a partnership subject to a pending TEFRA partnership audit for the same taxable year or years ("partnership items"). TEFRA § 6234(a) solved the problem by authorizing a special declaratory judgment action in the Tax Court concerning non-partnership items upon the taxpayer's receipt of an IRS "notice of adjustment" if:

1. a taxpayer files an oversheltered return for a taxable year,
2. the Secretary makes a determination with respect to the treatment of items (other than partnership items) of such taxpayer for such taxable year, and
3. the adjustments resulting from such determination do not give rise to a deficiency (as defined in section 6211) but would give rise to a deficiency if there were no net loss from partnership items.

An "oversheltered return" was defined by TEFRA § 6234(b) as a partner's return that showed no taxable income for a taxable year <u>and</u> showed a "net loss from partnership items." The term "net loss from partnership items" was not defined in the statute. Lastly, as contemplated by TEFRA § 6234(c), the taxpayer eventually could file a petition in Tax Court seeking a readjustment of the taxpayer's "deficiency" (as preliminarily determined in the TEFRA § 6234(a) declaratory judgment action) once the taxpayer's allocable share of partnership items finally was determined in the TEFRA-partnership-level proceeding. (TEFRA § 6234 was enacted in 1997 to overturn the Tax Court's 1989 decision in *Munro v. Commissioner*, 92 T.C. 71 (1989), in which the Tax Court held that claimed partnership losses must be "completely ignored" in a deficiency proceeding concerning the taxpayer's non-partnership losses.)

Facts: In this case, taxpayers, a married couple, did not timely file federal income tax returns for the years 2006 through 2012. More precisely, and importantly for the outcome in the case, the taxpayers did not file any federal income tax returns whatsoever for 2007 and 2012 (because the returns provided were unsigned). The taxpayers filed late returns for 2006 and the years 2008 through 2011. None of the returns showed a federal tax liability because the taxpayers used current and carryforward losses from a TEFRA partnership in which they were partners to offset any gross income reported on their personal returns. After audit, the IRS issued individual-level notices of deficiency to the taxpayers for the years in issue, asserting both back taxes and penalties. The taxpayers timely filed petitions in the Tax Court. Before trial, the Tax Court (Judge Halpern) granted the IRS's motion to dismiss for lack of jurisdiction so much of the case as related to partnership items and ordered the IRS to provide recomputed deficiencies reflecting the dismissal of partnership items from the case. At trial, the taxpayers presented no evidence that any of the IRS's proposed recomputed deficiencies with respect to non-partnership items for the years in issue were erroneous. Presumably, the taxpayers were not concerned with the IRS's proposed non-partnership item adjustments because they had more than enough partnership-item losses (from the TEFRA partnership in which they were partners) to offset any such adjustments. Regardless, over the IRS's objection, Judge Halpern upheld only the IRS's proposed non-partnership item adjustments against the taxpayers for 2006 and 2008. Judge Halpern did not sustain the IRS's proposed non-partnership item deficiencies or penalties for the other years in issue (2007 and years 2009 through 2012), reasoning as follows:

> The oversheltered return rules provided in [TEFRA § 6234] do not apply for petitioners' 2007 and 2012 taxable years because they did not file returns for those years. And section 6234 does not apply for petitioners' 2009, 2010, or 2011 taxable years because the adjustments in the notice of deficiency for each year would not result in a deficiency in petitioners' joint income tax liability even if petitioners had not claimed a net loss from partnerships for the year.

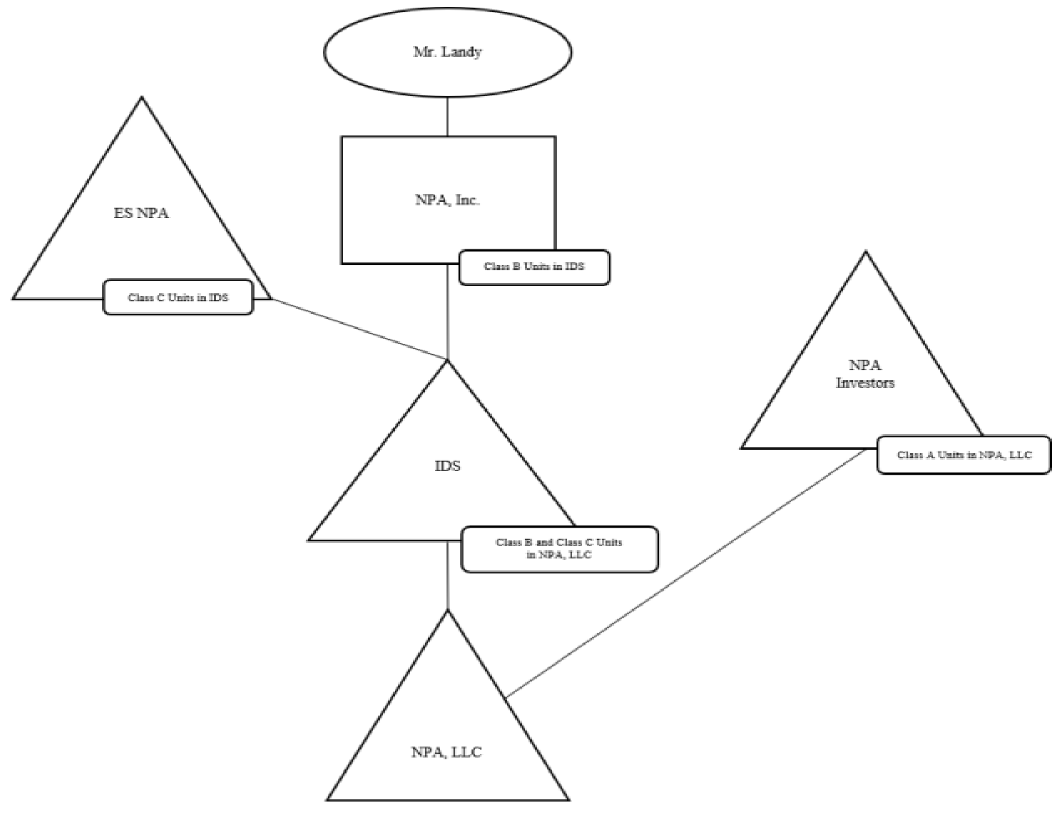
The taxpayers appealed to the Ninth Circuit and the IRS cross-appealed. The taxpayers' appeal was dismissed for failure to prosecute, which resulted in the IRS's adjustments for 2006 and 2008 being upheld. Thus, only the IRS's proposed adjustments for 2007 and 2009 through 2012 were the subject of the Ninth Circuit's decision.

Ninth Circuit: The Ninth Circuit, in an opinion by Judge Clifton, reversed and remanded the case to the Tax Court for redetermination of the taxpayers' deficiencies and penalties for 2007 and years 2009-2012. With respect to tax years 2007 and 2012, the Ninth Circuit held that the unsigned, unfiled tax returns, on which the TEFRA partnership losses were reported by the taxpayers, were legally invalid because they had not been filed and executed under penalties of perjury. Therefore, those unsigned, unfiled returns could not be used to offset non-partnership item income in an individual deficiency proceeding with respect to those years. Furthermore, with respect to 2009-2011, the Ninth Circuit determined that the Tax Court erred by concluding that the oversheltered return rules of TEFRA § 6234 did not apply. Instead, the Ninth Circuit determined that Judge Halpern should have included in the calculation of "net loss from partnership items" (one of the requirements for triggering Tax Court jurisdiction under TEFRA § 6234) the portions of the net-operating-loss carryover deductions that were composed of eligible partnership losses in prior years. If Judge Halpern had done so, then the Tax Court would have had jurisdiction under TEFRA § 6234 to decide the IRS proposed non-partnership item adjustments, if any, to the taxpayer's returns for 2009-2011.

G. Miscellaneous

1. This memorandum opinion from the Tax Court affirms the applicability of Rev. Proc. 93-27 (partnership profits interest issued for services) in a tiered partnership structure, but the real dispute was whether there was a proper "book up" of the partners' capital accounts. ES NPA Holding, LLC v. Commissioner, T.C. Memo. 2023-55 (5/3/23). The authors discuss relatively few memorandum opinions of the Tax Court; however, this case is one which the authors believe is noteworthy—perhaps more so for what the opinion does not address than what it does. The ostensible dispute in the case concerned whether a partnership interest issued for services met the safe harbor of Rev. Proc. 93-27, 1993-2 C.B. 343, as clarified by Rev. Proc. 2001-43, 2001-2 C.B. 191. As readers may recall, Rev. Proc. 93-27 and Rev. Proc. 2001-43 generally provide that the receipt of a partnership interest for services is nontaxable to the recipient so long as the interest in question does not share in liquidation proceeds assuming a hypothetical liquidation of the partnership immediately following the grant of the partnership interest (i.e., that the partnership interest is a true "profits interest," not a "capital interest"). If the requirements of Rev. Proc. 93-27 are met, then the IRS will not contest that the issuance of a partnership profits interest in exchange for services is nontaxable.[1] In this case, the Tax Court (Judge Weiler) held over the IRS's objection that Rev. Proc. 93-27 applied in the context of an intricate tierepartnership structure used in an acquisitive transaction. For details, see below.

Facts. The facts of the case are complex, and to fully appreciate the issues and arguments at stake, the intricacies of the tiered partnership structure must be understood. The ownership diagram provided by Judge Weiler is very helpful in this regard and easily worth a thousand words:



[1] Technically speaking, the safe harbor of Rev. Proc. 93-27 applies to partnership profits interests issued for services only if certain limiting conditions are met: (1) the profits interest must not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) the recipient partner must not dispose of the profits interest within two years of receipt; and

The tiered partnership structure depicted above related to the acquisition of a seventy-percent interest in a consumer loan portfolio held by Joshus Landy through a wholly-owned corporation, NPA, Inc. Oversimplifying to avoid writer's cramp, the capital for the acquisition was provided by a group of outside investors (NPA Investors, LLC). Mr. Landy's corporation, NPA, Inc., contributed its entire consumer loan portfolio to a secontier partnership, IDS, LLC, which in turn contributed the portfolio to a first-tier partnership, NPA, LLC. Then, the investors, through NPA Investors, LLC, purchased a seventy-percent interest in the consumer loan portfolio by paying cash of roughly $21 million to the secontier partnership, IDS, LLC, in exchange for a seventy-percent partnership interest in NPA, LLC. NPA, Inc., Mr. Landy's corporation, retained the remaining thirty-percent interest in the consumer loan portfolio by holding the residual thirty-percent interest (valued at approximately $9 million) in the secontier partnership, IDS, LLC. In connection with the acquisition, certain advisors to the transaction, as members of a thirtier partnership, ES NPA Holding, LLC, were issued a partnership interest in the secontier partnership, IDS, LLC, in exchange for past and future services provided to the first-tier acquisition partnership, NPA, LLC. The central issue in the case was whether the partnership interest issued to the advisors via ES NPA Holding, LLC was in fact a "profits interest" qualifying as nontaxable under the safe harbor rules of Rev. Proc. 93-27.

IRS Arguments. The IRS made two arguments as to why Rev. Proc. 93-27 did not apply. The IRS's primary argument was that Rev. Proc. 93-27 was inapplicable because the partnership interest issued to the thirtier partnership, ES NPA Holding, LLC, was granted by the secontier partnership, IDS, LLC, *not* the first-tier partnership, NPA, LLC, for which the past and future services were performed. With respect to this argument, Judge Weiler held that Rev. Proc. 93-27 nonetheless applied because the IRS's reading of the ruling was too narrow. Specifically, Judge Weiler pointed to other language in Rev. Proc. 93-27 supporting a broader reading. Section 4.01 of Rev. Proc. 93-27 states that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the [IRS] will not treat the receipt of such an interest as a taxable event for the partner or the partnership." Judge Weiler held that the above-quoted language supported the broader reading of Rev. Proc. 93-27 advocated by ES NPA Holding, LLC, the recipient of the partnership interest. The IRS's alternative argument, and perhaps the IRS's real concern, is that the partnership interest issued by the secontier partnership, IDS, LLC, to the thirtier partnership, ES NPA Holding, LLC, was in fact a "capital interest" because the consumer loan portfolio acquired by the first-tier partnership, NPA, LLC, was undervalued. The IRS, supported by a valuation expert, contended that the consumer loan portfolio should have been valued at approximately $48.5 million, meaning that ES NPA Holding, LLC would receive as much as $12 million upon a hypothetical liquidation of the tiered partnership structure, not $0 as reflected in ES NPA Holding, LLC's capital account in the secontier partnership, IDS, LLC. In other words, the IRS was arguing that the "book up" performed in connection with the formation of the tiered partnership structure was insufficient, so the service provider, ES NPA Holding, LLC, received a "capital interest" not a "profits interest" within the meaning of Rev. Proc. 93-27. Judge Weiler, though, disagreed, holding that the valuation agreed to by the parties to the transaction—roughly $21 million purchased by the investors via NPA Investors, LLC plus approximately $9 million in value retained by Mr. Landy via NPA, Inc.'s thirty-percent interest in the secontier partnership, IDS, LLC—was the best evidence of the valuation of the consumer loan portfolio. Hence, Judge Weiler concluded that Rev. Proc. 93-37 applied, and the service provider, ES NPA Holding, LLC, received a nontaxable partnership profits interest in connection with the transaction.

Comment: Perhaps the real import of ES NPA Holding, LLC v. Commissioner is not that Rev. Proc. 93-37 applies in a tiered partnership structure. The authors believe that most practitioners

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(3) the profits interest is not in a "publicly traded partnership" within the meaning of § 7704(b). These limiting conditions were not applicable to the facts of the case.

have assumed as much. Instead, perhaps the most important lesson of the case is that partnerships issuing interests in exchange for the performance of services should take care to accurately substantiate capital account "book ups," thereby safeguarding against an argument by the IRS that the interest so issued was a taxable "capital interest" instead of a nontaxable "profits interest."

2. Hot penalty relief for "hot asset" reporting by partnerships with respect to 2023 § 751(a) exchanges. Notice 2024-19, 2024-5 IRB 627 (1/11/24). This notice announces penalty relief under § 6722 (failure to furnish correct payee statements) for partnerships that missed the January 31, 2024, deadline for providing a copy of the recently revised IRS Form 8308 (Report of a Sale or Exchange of Certain Partnership Interests) to the transferor and transferee of a "751(a) exchange" occurring during calendar year 2023. Form 8308 is required to be filed as an attachment to a partnership's Form 1065 (U.S. Return of Partnership Income) for the taxable year of the partnership that includes the last day of the calendar year in which the "§ 751(a) exchange" took place. Form 8308 is due at the time for filing the partnership return, *including extensions*; however, Form 8308 was revised in October of 2023, and new Part IV of Form 8308 requires a partnership to report, among other items, the partnership's and the transferor partner's share of § 751 gain and loss, collectibles gain under § 1(h)(5), and unrecaptured § 1250 gain under § 1(h)(6). The newly released Part IV of Form 8308 prompted concerns from tax advisors that the affected partnerships might not have the information required by Part IV of Form 8308 by the January 31, 2024, due date. These concerns ultimately resulted in the penalty relief announced in Notice 2024-19. By way of background, a "751(a) exchange" within the meaning of the notice is defined as "a sale or exchange of an interest in the partnership (or portion thereof) in which any money or other property received by a transferor from a transferee in exchange for all or part of the transferor's interest in the partnership is attributable to § 751 property." As readers undoubtedly know, § 751 property of a partnership consists of so-called "hot assets" -- unrealized receivables or inventory items described in § 751(a). Code § 6050K and Reg. § 1.6050K-1 generally require a partnership with § 751 property to provide information to each transferor and transferee of a sale or exchange of an interest in the partnership (or portion thereof). The required information is contained in a properly completed IRS Form 8308, including Part IV thereof, which ordinarily should be attached to the partnership's Form 1065 for the year of the 751(a) exchange. Reg. § 1.6050K-1(c)(1) further provides that each partnership required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (a) January 31 of the year following the calendar year in which the § 751(a) exchange occurred, or (b) 30 days after the partnership has received notice of the exchange as specified under Code § 6050K and Reg. § 1.6050K-1. A partnership must use a copy of the completed Form 8308 as the required statement unless the Form 8308 contains information for more than one § 751(a) exchange. Reg. § 1.6050K-1(c)(1) provides that if the partnership does not use a copy of the Form 8308 as the required statement, the partnership must furnish a statement that includes the information required to be shown on the Form 8308 with respect to the § 751(a) exchange to which the person to whom the statement is furnished is a party. Subject to a reasonable cause exception in § 6724, Code § 6722 imposes a penalty for failure to furnish correct payee statements on or before the required date, and for any failure to include the information required to be shown on the statement or the inclusion of incorrect information. For this purpose, "payee statements" include statements required to be furnished to transferors and transferees under § 6050K. *See* § 6724(d)(2)(P). The penalty relief from § 6722 announced in Notice 2024-19 is subject to certain conditions as follows:

- The relief only applies to failure to timely furnish a copy of the Form 8308 (or the required information contained therein) to the transferor and transferee as required by § 6722. The notice does not provide penalty relief under § 6721 for failure to timely file Form 8308 as an attachment to a partnership's Form 1065.
- The relief applies solely for failure to furnish Form 8308 with a completed Part IV by the due date specified in § 1.6050K-1(c)(1) for a partnership that (1) timely and correctly furnishes to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of (a) January 31, 2024, or (b)

30 days after the partnership is notified of the § 751(a) exchange, and (2) furnishes to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under Reg. § 1.6050K-1(c), by the later of (a) the due date of the partnership's Form 1065 (including extensions), or (b) 30 days after the partnership is notified of the § 751(a) exchange.

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

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

New "2.5 times" proportionate outside basis rule will limit the charitable deduction for conservation contributions by pass-through entities. New § 170(h)(7)(A) generally provides that a partner's charitable contribution deduction for a qualified conservation contribution by a partnership (whether via a direct contribution or as an allocable share from a lower-tier partnership) cannot exceed "2.5 times the sum of [such] partner's relevant basis" in the partnership. The term "relevant basis" is defined by new § 170(h)(7)(B)(i) to mean that portion of a partner's "modified basis" which is allocable (under rules similar to those used under § 755) to the real property comprising the qualified conservation contribution. "Modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752. Thus, reading between the lines and subject to further guidance, relevant basis appears to equate to an investor's cash investment (a/k/a initial tax and book capital account) in a syndicated conservation easement partnership. Many syndicated conservation easement partnerships claim that investors may secure a charitable deduction that is five times their cash investment. New § 170(h)(7)(A) thus limits the charitable deduction to "2.5 times" an investor's cash contribution, making a syndicated conservation easement much less attractive. New § 170(h)(7) also contains three exceptions: (i) partnerships making conservation easement contributions after a three-year holding period applicable at the partnership- and partner-level, including through tiered partnerships; (ii) "family partnerships" (as defined) making conservation easement contributions; and (iii) partnerships making conservation easement contributions relating to historic structures. *See* IRC §§ 170(f)(19), 170(h)(7)(C)-(E). Moreover, new § 170(h)(7)(F) authorizes Treasury to issue regulations applying similar rules to S corporations and other pass-through entities. Related provisions of the legislation make dovetailing amendments to (i) § 170(f) (charitable contribution substantiation and reporting requirements); (ii)

§§ 6662 and 6664 (underpayment penalties attributable to valuation misstatements); (iii) § 6011 (reportable transactions); and (vi) §§ 6235 and 6501 (statute of limitations). New § 170(h)(7) applies to qualified conservation contributions made by partnerships and other pass-through entities after December 29, 2022.

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

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

Extinguishment Clauses. *Section 1.04* of the notice sets forth the IRS's litigating position with respect to extinguishment clauses in conservation easement deeds. The IRS's litigating position is that, upon destruction or condemnation of conservation easement property and the collection of any proceeds therefrom, Reg. § 1.170A-14(g)(6)(ii) (the "extinguishment regulation") requires the charitable donee to share in the proceeds according to a "proportionate benefit fraction" set forth in the conservation easement deed. (Keep in mind, however, that the validity of the extinguishment regulation has been called into question. The Eleventh and Sixth Circuits have reached opposite conclusions regarding whether Treasury and the IRS complied with the Administrative Procedures Act in promulgating the regulation. *Compare Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21) (extinguishment regulation invalid) *with Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 3/14/22) (extinguishment regulation valid). Thus far, the Supreme Court of the United States has declined to resolve the circuit split. See *Oakbrook Land Holdings, LLC v. Commissoner*, ___ U.S. ___, 143 S. Ct. 626 (1/9/2023).) The IRS's view of the allowed language in the conservation easement deed has been fairly narrow, requiring that the proportionate benefit fraction be fixed and unalterable *as of the date of the donation* according to the following ratio: the value of the conservation easement as compared to the total value of the property subject to the conservation easement. Therefore, according to the IRS and as upheld by several court decisions, if the conservation easement deed either (i) allows the donor to reclaim from the charitable donee any portion of the donated conservation easement property in exchange for substitute property of equivalent value or (ii) grants the donor credit for the fair market value of subsequent improvements to the donated conservation easement property, the proportionate benefit fraction language in the deed is flawed and the charitable deduction must be disallowed. *See, e.g., Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (2018), including its companion case, *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (deed allowed substituted property), *aff'd in part, vac'd in part, rev'd in part*, 978 F.3d 1200 (11th Cir. 2020); *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (2018) (deed reduced charitable donee's benefit for subsequent improvements made by taxpayer donor); *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019). *Section 4.01* of Notice 2023-30 then sets forth what

the IRS considers acceptable language regarding the proportionate benefit fraction as is relates to extinguishment clauses in conservation easement deeds.

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

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

b. Proposed Regulations Issued. REG–112916–23, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 88 F.R. 80910 (11/20/23). The Treasury Department and the IRS have issued proposed regulations under amended Code § 170(h)(7) and the related information reporting rule of Code § 170(f)(19). The proposed regulations affect partnerships and S corporations that claim qualified conservation contributions, and partners and S corporation shareholders that receive a distributive share or pro rata share, as applicable, of a noncash charitable contribution. More specifically, the proposed regulations provide further guidance regarding the statutory disallowance rule of § 170(h)(7), including definitions, appropriate methods to calculate the "relevant basis" of a partner or an S corporation shareholder, the three statutory exceptions, and related reporting requirements. In addition, the proposed regulations provide new requirements for partners and S corporation shareholders that receive a distributive share or pro rata share of any noncash charitable contribution made by a partnership or S corporation, regardless of whether the contribution is a qualified conservation contribution (and regardless of whether the contribution is of real property or other noncash property). The substantive portions of the proposed regulations relating primarily to § 170(h)(7) (§§ 1.170A–14(j) through (n), 1.706–3, and 1.706–4) are proposed to apply retroactively to contributions made after December 29, 2022 (because the regulations were issued within 18 months of the enactment of Code § 170(h)(7)). *See* IRC § 7805(b)(1)-(2) (promptly issued regulations). Other provisions of the proposed regulations relating to more general reporting requirements for noncash contributions of partnerships and S corporations (§ 1.170A–16) are proposed to apply after the date of publication (November 20, 2023).

2. Capital gain income but no charitable deduction: The taxpayer waited too long to pull the trigger on a charitable donation of stock and ends up shooting himself in the foot. Estate of Hoensheid v. Commissioner, T.C. Memo. 2023-34 (3/15/23). This fact-intensive and fact-sensitive case reminds us that the anticipatory assignment of income doctrine is alive and well, especially in connection with last minute donations of stock to charity before closing. The idea in these transactions, of course, is to donate a portion of a taxpayer's highly-appreciated, low-basis stock to charity in advance of a planned sale of the stock, claim the charitable contribution deduction for the fair market value of the donated stock, and then have the charity sell the donated stock (simultaneously with the sale of the donor's retained stock) at the subsequent closing of the stock purchase transaction. The taxpayer thereby obtains a charitable contribution deduction for the fair market value of the donated stock while avoiding tax on the inherent capital gain in the contributed stock. *See, e.g., Rauenhorst v. Commissioner*, 119 T.C. 57 (2002). *See also* Rev. Rul. 78-197, 1978-1 C.B. 83. The conventional wisdom in this area is that a taxpayer may wait to donate the stock to charity until after a letter of intent has been signed but should donate before the definitive stock acquisition agreement is executed. In this case, however, the Tax Court (Judge Nega) determined that the taxpayer nevertheless waited too late, even though he donated the stock

sometime before the execution of the stock purchase agreement and the simultaneous closing. It did not help the taxpayer's case that he had sent an email to his tax advisor stating "I do not want to transfer the stock until we are 99% sure we are closing." The taxpayer apparently was concerned that if he gave away a portion of his stock too soon, his brothers, who owned the remaining stock in the corporation, might outvote him in connection with the anticipated sale. Furthermore, the documents and facts were unclear and there was a substantial dispute between the taxpayer and the IRS as to the precise date of the transfer of the donated stock to the charity. Even worse, it appeared that some of the documents may have been backdated by the taxpayer. After a lengthy analysis of the facts, Judge Nega ultimately determined that the transfer of the donated shares took place two days before closing. It also did not help the taxpayer's case that he and his brothers stripped the corporation of virtually all of its cash via a declared dividend (colloquially known as a "boot-strap" sale) one day before the closing, yet the charity, which according to the taxpayer received a stock certificate for the donated shares previously, received no portion of the dividend. In eventually holding for the IRS regarding the anticipatory assignment of income issue, Judge Nega concluded:

> To avoid an anticipatory assignment of income on the contribution of appreciated shares of stock followed by a sale by the donee, a donor must bear at least some risk at the time of the contribution that the sale will not close. On the record before us, viewed in the light of the realities and substance of the transaction, we are convinced that [the taxpayer's] delay in transferring the [donated] shares until two days before closing eliminated any such risk and made the sale a virtual certainty.

Judge Nega also determined that the taxpayer, as argued by the IRS, had not satisfied the qualified appraisal requirements of § 170(f)(11)(A)(i). Judge Nega therefore denied the taxpayer's claimed charitable contribution deduction for the donated shares, even though the charity received a portion of the proceeds of the stock sale attributable to the shares it held as of closing. *Ouch!* We commend the case to readers who are advising taxpayers in connection with these transactions, but we decline to try to capture here and discuss the myriad factual nuances of a forty-nine-page Tax Court Memorandum decision. For a more detailed analysis of the facts and Judge Nega's reasoning, see Zaritsky, *Bad Timing of Charitable Gift and Sale Creates Major Income Tax Problems*, 35 Tax'n Exempts 27 (July/Aug. 2023).

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Is the IRS ever going to learn that the § 6751(b) supervisory approval requirement is not met unless the required supervisory approval of a penalty occurs *before* the initial determination that formally communicates the penalty to the taxpayer? Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (1/16/20). The taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. Approximately three months after the 30-day letter was issued, the revenue agent's supervisor approved the penalty by signing a Civil Penalty Approval Form. Following unsuccessful discussions with IRS Appeals, the IRS assessed the penalty and issued a notice of levy. The taxpayer requested a collection due process (CDP) hearing with Appeals, following which Appeals issued a notice of determination sustaining the proposed levy. In response to the notice of determination, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer filed a motion for summary judgment on the basis that the IRS had failed to comply with the supervisory approval requirement of § 6751(b). Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Tax Court (Judge Gustafson) granted the taxpayer's motion. The court first concluded that the supervisory approval

requirement of § 6751(b) applies to the penalty imposed by § 6707A. Next, the court concluded that the supervisory approval of the §6707A penalty in this case was not timely because it had not occurred before the IRS's initial determination of the penalty. The parties stipulated that the 30-day letter issued to the taxpayer reflected the IRS's initial determination of the penalty. The supervisory approval of the penalty occurred three months later and therefore, according to the court, was untimely. The IRS argued that the supervisory approval was timely because it occurred before the IRS's *assessment* of the penalty. In rejecting this argument, the court relied on its prior decisions interpreting § 6751(b), especially *Clay v. Commissioner*, 152 T.C. 23 (2019), in which the court held in a deficiency case "that when it is 'communicated to the taxpayer formally … that penalties will be proposed', section 6751(b)(1) is implicated." In *Clay*, the IRS had issued a 30-day letter when it did not have in hand the required supervisory approval of the relevant penalty. The IRS can assess the penalty imposed by § 6707A without issuing a notice of deficiency. Nevertheless, the court observed "[t]hough Clay was a deficiency case, we did not intimate that our holding was limited to the deficiency context." The court summarized its holding in the present case as follows:

> Accordingly, we now hold that in the case of the assessable penalty of section 6707A here at issue, section 6751(b)(1) requires the IRS to obtain written supervisory approval before it formally communicates to the taxpayer its determination that the taxpayer is liable for the penalty.

The court therefore concluded that it had been an abuse of discretion for the IRS Office of Appeals to determine that the IRS had complied with applicable laws and procedures in issuing the notice of levy. The court accordingly granted the taxpayer's motion for summary judgment.

a. "We are all textualists now," says the Ninth Circuit. When the IRS need not issue a notice of deficiency before assessing a penalty, the language of § 6751(b) contains no requirement that supervisory approval be obtained before the IRS formally communicates the penalty to the taxpayer. Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 29 F.4th 1066 (9th Cir. 3/25/22), *rev'g* 154 T.C. 68 (1/16/20). In an opinion by Judge Bea, the U.S. Court of Appeals for the Ninth Circuit has reversed the decision of the Tax Court and held that, when the IRS need not issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval of the penalty before assessment of the penalty provided that approval occurs when the supervisor still has discretion whether to approve the penalty. As previously discussed, the taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. After the taxpayer had submitted a letter protesting the proposed penalty and requesting a conference with IRS Appeals, and approximately three months after the revenue agent issued the 30-day letter, the revenue agent's supervisor approved the proposed penalty by signing Form 300, Civil Penalty Approval Form. The Tax Court held that § 6751(b)(1) required the IRS to obtain written supervisory approval before it formally communicated to the taxpayer its determination that the taxpayer was liable for the penalty, i.e., before the revenue agent issued the 30-day letter. On appeal, the government argued that § 6751(b) required only that the necessary supervisory approval be secured before the IRS's *assessment* of the penalty as long as the supervisory approval occurs at a time when the supervisor still has discretion whether to approve the penalty. The Ninth Circuit agreed. In agreeing with the government, the court rejected the Tax Court's holding that § 6751(b) requires supervisory approval of the *initial determination* of the assessment of the penalty and therefore requires supervisory approval before the IRS formally communicates the penalty to the taxpayer. According to the Ninth Circuit, "[t]he problem with Taxpayer's and the Tax Court's interpretation is that it has no basis in the text of the statute." The court acknowledged the legislative history of § 6751(b), which indicates that Congress enacted the provision to prevent IRS revenue agents from threatening penalties as a means of encouraging taxpayers to settle. But the text of the statute as written, concluded the Ninth Circuit, does not support the interpretation of the statute advanced by the Tax Court and the taxpayer. The court summarized its holding as follows:

> Accordingly, we hold that § 6751(b)(1) requires written supervisory approval before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment. Since, here, Supervisor Korzec gave written approval of the initial penalty determination before the penalty was assessed and while she had discretion to withhold approval, the IRS satisfied § 6751(b)(1).

The court was careful to acknowledge that supervisory approval might be required at an earlier time when the IRS must issue a notice of deficiency before assessing a penalty because, "once the notice is sent, the Commissioner begins to lose discretion over whether the penalty is assessed." The IRS can assess the penalty in this case, imposed by § 6707A, without issuing a notice of deficiency.

Dissenting opinion by Judge Berzon. In a dissenting opinion, Judge Berzon emphasized that the 30-day letter the revenue agent sent to the taxpayer was an operative determination. The letter indicated that, if the taxpayer took no action in response, the penalty would be assessed. Judge Berzon analyzed the text of the statute and its legislative history and concluded as follows:

> In my view, then, the statute means what it says: a supervisor must personally approve the "initial determination" of a penalty by a subordinate, or else no penalty can be assessed based on that determination, whether the proposed penalty is

> objected to or not. 26 U.S.C. §§ 6751(b)(1). That meaning is consistent with Congress's purpose of preventing threatened penalties never approved by supervisory personnel from being used as a "bargaining chip" by lower-level staff, S. Rep. No. 105-174, at 65 (1998); see *Chai v. Commissioner*, 851 F.3d 190, 219 (2d Cir. 2017), which is exactly what happened here.

Because the 30-day letter was an operative determination, according to the dissent, "supervisory approval was required at a time when it would be meaningful-before the letter was sent."

b. Is the tide turning in favor of the government? The Eleventh Circuit has held that, when the IRS must issue a notice of deficiency before assessing tax, the government can comply with the requirement of § 6751(b) that there be written supervisory approval of penalties by securing the approval at any time before assessment of the penalty. Kroner v. Commissioner, 48 F. 4th 1272 (11th Cir. 9/13/22), *rev'g* T.C. Memo. 2020-73. In an opinion by Judge Marvel, the U.S. Court of Appeals for the Eleventh Circuit has held that, when the IRS must issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval at any time before assessment of the penalty. The court's holding is contrary to a series of decisions of the Tax Court and contrary to a decision of the U.S. Court of Appeals for the Second Circuit. Section 6751(b)(1) provides:

> No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

Second Circuit's reasoning in Chai v. Commissioner. In *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), the Second Circuit focused on the language of § 6751(b)(1) and concluded that it is ambiguous regarding the timing of the required supervisory approval of a penalty. Because of this ambiguity, the court examined the statute's legislative history and concluded that Congress's purpose in enacting the provision was "to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle." That purpose, the court reasoned, undercuts the conclusion that approval of the penalty can take place at any time, even just prior to assessment. The court held "that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Further, the court held "that compliance with § 6751(b) is part of the Commissioner's burden of production and proof in a deficiency case in which a penalty is asserted. … Read in conjunction with § 7491(c), the written approval requirement of § 6751(b)(1) is appropriately viewed as an element of a penalty claim, and therefore part of the IRS's prima facie case."

Tax Court's prior decisions in other cases. In *Graev v. Commissioner*, 149 T.C. 485 (2017), a reviewed opinion by Judge Thornton, the Tax Court (9-1-6) reversed its earlier position and accepted the interpretation of § 6751(b)(1) set forth by the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017). Since *Graev*, the Tax Court's decisions have focused on what constitutes the *initial determination* of the penalty in question. These decisions have concluded that the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See, e.g.*, *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021). Accordingly, if the IRS notifies the taxpayer that it intends to assert penalties in a document such as a revenue agent's report, and if the IRS fails to secure the required supervisory approval before that notification occurs, then § 6751(b)(1) precludes the IRS from asserting the penalty.

Facts of this case. In the current case, *Kroner v. Commissioner*, the taxpayer failed to report as income just under $25 million in cash transfers from a former business partner. The IRS audited and, at a meeting with the taxpayer's representatives on August 6, 2012, provided the taxpayer

with a letter (Letter 915) and revenue agent's report proposing to increase his income by the cash he had received and to impose just under $2 million in accuracy-related penalties under § 6662. The letter asked the taxpayer to indicate whether he agreed or disagreed with the proposed changes and provided him with certain options if he disagreed, such as providing additional information, discussing the report with the examining agent or the agent's supervisor, or requesting a conference with the IRS Appeals Office. The letter also stated that, if the taxpayer took none of these steps, the IRS would issue a notice of deficiency. The IRS later issued a formal 30-day letter (Letter 950) dated October 31, 2012, and an updated examination report. The 30-day letter provided the taxpayer with the same options as the previous letter if he disagreed with the proposed adjustments and stated that, if the taxpayer took no action, the IRS would issue a notice of deficiency. The 30-day letter was signed by the examining agent's supervisor. On that same day, the supervisor also signed a Civil Penalty Approval Form approving the accuracy-related penalties. The IRS subsequently issued a notice of deficiency and, in response, the taxpayer filed a timely petition in the U.S. Tax Court.

Tax Court's reasoning in this case. The Tax Court (Judge Marvel) upheld the IRS's position that the cash payments the taxpayer received were includible in his gross income but held that the IRS was precluded from imposing the accuracy-related penalties. The Tax Court reasoned that the August 6 letter (Letter 915) was the IRS's initial determination of the penalty and that the required supervisory approval of the penalty did not occur until October 31, and therefore the IRS had not complied with § 6751(b).

Eleventh Circuit's reasoning in this case. The Eleventh Circuit rejected the reasoning of the Tax Court as well as the reasoning of the Second Circuit in *Chai v. Commissioner*:

> We disagree with Kroner and the Tax Court. We conclude that the IRS satisfies Section 6751(b) so long as a supervisor approves an initial determination of a penalty assessment before it assesses those penalties. *See Laidlaw's Harley Davidson Sales, Inc. v. Comm'r*, 29 F.4th 1066, 1071 (9th Cir. 2022). Here, a supervisor approved Kroner's penalties, and they have not yet been assessed. Accordingly, the IRS has not violated Section 6751(b).

The Eleventh Circuit first reasoned that the phrase "determination of such assessment" in § 6751(b) is best interpreted not as a reference to communications to the taxpayer, but rather as a reference to the IRS's conclusion that it has the authority and duty to assess penalties and its resolution to do so. The court explained:

> The "initial" determination may differ depending on the process the IRS uses to assess a penalty. … But we are confident that the term "initial determination of such assessment" has nothing to do with communication and everything to do with the formal process of calculating and recording an obligation on the IRS's books.

The court then turned to the question of *when* a supervisor must approve a penalty in order to comply with § 6751(b). The court analyzed the language of § 6751(b) and concluded: "We likewise see nothing in the text that requires a supervisor to approve penalties at any particular time before assessment." Thus, according to the Eleventh Circuit, the IRS can comply with § 6751(b) by obtaining supervisory approval of a penalty at any time, even just before assessment.

Finally, the court reviewed the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), in which the court had interpreted § 6751(b) in light of Congress's purpose in enacting the provision, which, according to the Second Circuit, was to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. According to the Eleventh Circuit, the *Chai* decision did not take into account the full purpose of § 6751(b). The purpose of the statute, the court reasoned, was not only to prevent unjustified threats of penalties, but also to ensure that only accurate and appropriate penalties are imposed. There is no need for supervisory approval to occur at any specific time before the assessment of penalties, the court explained, to ensure that penalties are accurate and appropriate and therefore carry out this aspect of Congress's

purpose in enacting the statute. Further, the Eleventh Circuit concluded, there is no need for a pre-assessment deadline for supervisory approval to reduce the use of penalties as a bargaining chip by IRS agents. This is so, according to the court, because negotiations over penalties occur even after a penalty is assessed, such as in administrative proceedings after the IRS issues a notice of federal tax lien or a notice of levy. (This latter point by the court seems to us to be a stretch. Although it is possible to have penalties reduced or eliminated post-assessment, such post-assessment review does not meaningfully reduce the threat of penalties by IRS agents to encourage settlement at the examination stage.)

Concurring opinion by Judge Newsom. In a concurring opinion, Judge Newsom cautioned against interpreting statutes by reference to their legislative histories: "Without much effort, one can mine from § 6751(b)'s legislative history other—and sometimes conflicting—congressional 'purposes.'" The legislative history, according to Judge Newsom, is "utterly unenlightening." Statutes, in his view, should be interpreted by reference to their text.

c. Yes, the tide seems to be turning. The Tenth Circuit has held that, when the IRS must issue a notice of deficiency before assessing tax, the government can comply with the requirement of § 6751(b) that there be written supervisory approval of penalties by securing the approval no later than the date the IRS issues the notice of deficiency formally asserting a penalty. Minemyer v. Commissioner, 131 A.F.T.R.2d 2023-364 (10th Cir. 1/19/23), aff'g in part and rev'g in part T.C. Memo. 2020-99 (7/1/20). In an unpublished order and judgment by Judge Tymkovich, the U.S. Court of Appeals for the Tenth Circuit has held that, when the IRS must issue a notice of deficiency before assessing a penalty, the IRS can comply with the supervisory approval requirement of § 6751(b) by obtaining supervisory approval on or before the date on which the IRS issues a notice of deficiency.

The taxpayer in this case was indicted on two counts of tax evasion for the years 2000 and 2001. The taxpayer pleaded guilty with respect to the year 2000 and, in exchange, the government dismissed the count for 2001. Subsequently, the IRS asserted deficiencies for 2000 and 2001 and § 6663 civil fraud penalties for both years. In 2010, an IRS revenue agent visited the taxpayer in prison and obtained his signature on Form 4549, Income Tax Examination Changes, in which the IRS proposed the deficiencies and penalties for 2000 and 2001. At that time, the agent's supervisor had not approved the penalties. The taxpayer later requested that his agreement to the deficiencies and penalties be withdrawn. The IRS agreed to the withdrawal and later issued a 30-day letter (Letter 950) asserting the same deficiencies and penalties. The 30-day letter was signed by the revenue agent's supervisor. The IRS later issued a notice of deficiency asserting the deficiencies and penalties for both years.

Tax Court's Analysis. The taxpayer challenged the notice of deficiency by filing a petition in the U.S. Tax Court. The Tax Court (Judge Kerrigan) granted summary judgment in favor of the IRS as to the deficiencies for both years and as to the fraud penalty for 2000. Following a trial, the Tax Court held that the IRS was precluded from asserting the fraud penalty for 2001 by § 6751(b)(1). (The court also held that conviction for tax evasion on the 2000 count collaterally estopped the taxpayer from challenging the civil fraud penalty for 2000.) Section 6751(b)(1) provides:

> No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.

The Tax Court's prior decisions have focused on what constitutes the *initial determination* of the penalty in question. These decisions have concluded that the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See, e.g.*, *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021). Accordingly, if the IRS notifies the taxpayer that it intends to assert penalties in a document

such as a revenue agent's report, and if the IRS fails to secure the required supervisory approval before that notification occurs, then § 6751(b)(1) precludes the IRS from asserting the penalty. In this case, the Tax Court held, the IRS had failed to comply with § 6751(b)(1) because the Form 4549 the revenue agent presented to the taxpayer in prison was the initial determination of the penalties, and the IRS had not secured the required supervisory approval before the agent presented the form to the taxpayer.

Tenth Circuit's Analysis. On appeal, the U.S. Court of Appeals for the Tenth Circuit affirmed the Tax Court's grant of summary judgment to the government as to the deficiencies for both years and as to the fraud penalty for 2000 but reversed the Tax Court's decision as to the penalty for 2001. The court observed that the U.S. Courts of Appeal for the Ninth and Eleventh Circuits have disagreed with the Tax Court's position that the supervisory approval before the IRS first communicates to the taxpayer that it intends to assert penalties. See *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 3/25/22); *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 9/13/22). The court agreed with the Ninth and Eleventh Circuits:

> We agree with these assessments of § 6751(b)(1) and hold that its plain language does not require approval before proposed penalties are communicated to a taxpayer.

The Tenth Circuit then addressed the question of what timing requirement, if any, § 6751(b)(1) imposes on the government to obtain the necessary supervisory approval. The court analyzed the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), and agreed with the Second Circuit's analysis:

> We are persuaded by the Second Circuit's reasoning and hold that with respect to civil penalties, the requirements of § 6751(b)(1) are met so long as written supervisory approval of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

Because the revenue agent's supervisor had approved the 2001 civil fraud penalty before the IRS issued the notice of deficiency, the Tenth Circuit reversed the Tax Court's decision as to the 2001 penalty and remanded a determination of whether the taxpayer was liable for the penalty.

d. The turning tide now seems to have washed over the Tax Court--at least in this case appealable to the Ninth Circuit. Kraske v. Commissioner, 161 T.C. No. 7 (10/26/23). This Tax Court decision presents an opportunity to synthesize for our readers the case law developments over the last few years (as detailed above) concerning the supervisory approval requirement of § 6751(b)(1). Readers will recall that § 6751(b)(1) requires the "initial determination" of the assessment of certain (but not all) federal income tax penalties be "personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." The bare language of the poorly drafted statute is ambiguous, leaving room for various interpretations as evidenced by numerous recent court decisions. For a thorough discussion and analysis of the "hundreds of cases" that have been decided under § 6751(b)(1), see Gianni, *Supervisory Approval of Penalties: The Opening of a Graev Pandora's Box*, 76 Tax Lawyer 41 (2022). Professor Gianni ultimately concludes that § 6751(b)(1) should be retroactively repealed and replaced as proposed (but never passed) in H.R. 5376, 117th Cong. §§ 138404(a), 138404(c)(1). Professor Gianna also details in her article the many penalties that are and are not subject to the supervisory approval requirement of § 6751(b)(1).

The Tax Court. The Tax Court has taken an expansive view of § 6751(b)(1) regarding what constitutes the *initial determination* of the penalty in question. In a series of cases beginning with *Graev v. Commissioner*, 149 T.C. 485 (2017), the Tax Court reversed its earlier position that supervisory approval need only occur before assessment of the penalties subject to § 6751(b)(1). Instead, the Tax Court in *Graev* accepted the Second Circuit's interpretation of § 6751(b)(1) as set forth in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017): "that § 6751(b)(1) requires written

approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Then, in subsequent cases, the Tax Court has gone further, generally holding that:

- The supervisory approval requirement of § 6751(b)(1) applies to both "assessable penalties" (i.e., penalties not subject to deficiency procedures, like § 6707A concerning failure to disclose a reportable transaction) and to penalties that are subject to deficiency procedures (like the § 6662(a) and (b)(2) accuracy-related penalties); and
- Supervisory approval must be obtained under § 6751(b)(1) on or before the date of the *initial determination* of the penalty in question, which is the earlier of (1) the date on which the IRS issues the notice of deficiency or (2) the date on which the IRS "formally communicates" (such as in a Revenue Agent's Report) to the taxpayer the assertion of a penalty or penalties subject to § 6751(b)(1).

See, e.g., *Clay v. Commissioner*, 152 T.C. 23 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021); *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021).

The Circuit Courts. The Circuit Court interpretations of § 6751(b)(1) have not been as expansive as the Tax Court's, but they have not been consistent either.

- As mentioned above, the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part and rev'g in part*, T.C. Memo 2015-42, held that, for penalties subject to deficiency procedures (like the § 6662 accuracy-related penalties) "§ 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty."
- The Ninth Circuit in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), held that for an "assessable penalty" not requiring a deficiency procedure (like the penalty imposed by § 6707A for failure to disclose a reportable transaction) the § 6751(b)(1) supervisory approval requirement applies "before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment."
- The Eleventh Circuit in *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 2022), *rev'g*, T.C. Memo. 2020-73, held that, for penalties subject to deficiency procedures, the IRS may comply with § 6751(b)(1) by obtaining supervisory approval at any time, even just before assessment. Writing in reversal of the Tax Court, the Eleventh Circuit stated: "The 'initial' determination may differ depending on the process the IRS uses to assess a penalty…But we are confident that the term 'initial determination of such assessment' has nothing to do with communication and everything to do with the formal process of calculating and recording an obligation on the IRS's books."
- The Tenth Circuit, in an unpublished opinion, *Minemyer v. Commissioner*, 131 A.F.T.R.2d 2023-364 (10th Cir. 2023), *aff'g in part and rev'g in part*, T.C. Memo. 2020-99 (2020), aligned itself with the Second Circuit by holding in a case concerning penalties subject to deficiency procedures that "the requirements of § 6751(b)(1) are met so long as written supervisory of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

The Facts in Kraske. The Tax Court in *Kraske v. Commissioner*, 161 T.C. No. 7 (10/26/23), a case appealable to the Ninth Circuit, signaled that it may be reconsidering its expansive interpretation of § 6751(b)(1) and backing off its view that supervisory approval must come on or before the IRS "formally communicates" proposed penalties to a taxpayer. On June 2, 2014, the examining agent within the IRS's Small Business and Self-Employed Division sent the taxpayer in *Kraske* a Letter 692 (15-day letter) proposing in part the imposition of accuracy-related penalties

under § 6662. The 15-day letter further advised that if the taxpayer did not respond within 15 days, a notice of deficiency would be issued. Almost a month after the deadline passed for responding to the 15-day letter, the taxpayer on July 16, 2014, mailed the IRS examining agent a letter disagreeing with the examining agent's proposed tax adjustments and penalties. Coincidentally, on that same day, July 16, 2024, the examining agent, not having received a response to the 15-day letter from the taxpayer after having been promised it several times, closed the case as unagreed and forwarded it to the agent's group manager, who was the agent's immediate supervisor. On July 21, 2014, the group manager reviewed the case, signed approval forms regarding the agent's assertion of accuracy-related penalties under § 6662, and approved the case for closure. The case was then forwarded to Appeals on July 24, 2014, immediately after the IRS received on that date the taxpayer's July 16, 2014, letter objecting to the proposed tax adjustments and penalties. IRS Appeals received the case on August 12, 2014, and after the taxpayer and Appeals were unable to settle matters, a notice of deficiency was issued to the taxpayer on July 28, 2015. Before the Tax Court, the taxpayer argued that imposition of any accuracy-related penalty under § 6662 was improper because the IRS had not timely obtained supervisory approval under § 6751(b)(1).

The Tax Court's Opinion in Kraske. In an opinion written by Judge Gale, the Tax Court acknowledged that under the court's holding in *Clay v. Commissioner*, 152 T.C. 23 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021), the supervisory approval obtained in *Kraske* would be considered untimely under § 6751(b)(1) because it came after a "formal communication" (i.e., the 15-day letter) of the proposed penalties was sent to the taxpayer. Judge Gale noted, however, that because the case was appealable to the Ninth Circuit, the Ninth Circuit's decision in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), must be considered. As noted above, *Laidlaw's Harely Davidson Sales, Inc.* concerned an "assessable penalty," not a penalty subject to deficiency procedures as in *Kraske*. Arguably, then, *Laidlaw's Harley Davidson Sales, Inc.* was distinguishable, and the Tax Court was not necessarily bound to follow it under a strict application of *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (holding that "better judicial administration...requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone)." Judge Gale also noted, though, that the so-called *Golson* doctrine allows the Tax Court to examine not just the narrow holding of a binding Circuit Court decision, but also the underlying rationale of the decision. On this basis, Judge Gale determined that the *Golson* doctrine should apply in *Kraske*, resulting in the Tax Court ruling in favor of the government and against the taxpayer. Judge Gale wrote:

> The rationale of the Ninth Circuit's holding in *Laidlaw's Harley Davidson* is clear regarding the timing of supervisory approval. The Ninth Circuit rejected outright our position in *Clay* that the supervisory approval required by section 6751(b)(1) is timely only if it is obtained before a formal communication to the taxpayer that penalties would be proposed, finding that our interpretation "has no basis in the text of the statute." [Citation omitted.] Instead, the Ninth Circuit opined that approval is timely at any time before assessment, provided the supervisor retains discretion to give or withhold approval.

Judge Gale then ruled that the timeline for supervisory approval under § 6751(b)(1) in *Kraske* was "well within the parameters . . . found timely by the Ninth Circuit in *Laidlaw's Harley Davidson*," explaining further:

> When the supervisor approved the penalties on July 21, 2014, it was more than a month past the deadline for [the taxpayer] to respond to the 15-day letter, and the [examining agent] had not received a written request for Appeals' consideration from him. Although [the taxpayer] had mailed such a request on July 16, 2014, it was not received by the [examining agent] until July 24, 2014--three days after written supervisory approval had been given. The case was not received by Appeals

until August 12, 2014--over three weeks after supervisory approval had been given. Thus, the [examining agent's] immediate supervisor retained discretion to approve or to withhold approval of the penalties when she did so on July 21 because the case had not yet been transferred to Appeals (at which time the Small Business and Self-Employed Division's jurisdiction over the case, and the supervisor's discretion, may have terminated).

2. What's the point of a penalty if the IRS is precluded from collecting it? The Tax Court has held that there is no statutory authority for the IRS to assess penalties imposed by § 6038(b) for failure to file information returns with respect to foreign business entities and that the IRS therefore cannot proceed to collect the penalties through a levy. Farhy v. Commissioner, 160 T.C. No. 6 (4/3/23). Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls (defined in § 6038(e)(2) as owning more than 50 percent of all classes of stock, measure by vote or value). The form prescribed for providing this information is Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Section 6038(b)(1) imposes a penalty of $10,000 for each annual accounting period for which a person fails to provide the required information. In addition, § 6038(b)(2) imposes a continuation penalty of $10,000 for each 30-day period that the failure continues up to a maximum continuation penalty of $50,000 per annual accounting period. In this case, the taxpayer was required to file Form 5471 for several years with respect to two wholly-owned corporations organized in Belize but failed to do so. The IRS assessed a penalty under § 6038(b)(1) of $10,000 and a continuation penalty of $50,000 for each of the years in issue. In response to a notice of levy, the taxpayer requested a collection due process (CDP) hearing. In the CDP hearing, the taxpayer argued that the IRS had no legal authority to assess § 6038 penalties. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action and the taxpayer changed this determination by filing a petition in the Tax Court. The Tax Court (Judge Marvel) agreed with the taxpayer and held that there is no statutory authority for the IRS to assess § 6038 penalties. The IRS argued that § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title" authorizes assessment of penalties imposed by § 6038. The court disagreed, however, and reasoned that the term "assessable penalties" in § 6201(a) does not automatically apply to all penalties in the Code. The court observed that (1) §§ 6671(a) and 6665(a)(1) provide that penalties imposed by specified Code sections shall be assessed and collected in the same manner as taxes and (2) Code sections other than those specified by §§ 6671(a) and 6665(a)(1) commonly provide that the penalty is a tax or assessable penalty for purposes of collection or are expressly covered by (or contain a cross-reference to) one of the specified Code sections. In contrast, the court explained, § 6038 is not one of the Code sections specified by §§ 6671(a) and 6665(a)(1) and contains only a cross-reference to a criminal penalty provision. The court also rejected the IRS's argument that § 6038 penalties are "taxes" within the meaning of § 6201(a) and therefore subject to assessment. In short the court held, although § 6038(b) provides penalties for failure to provide the information required by § 6038(a), there is no statutory authority for assessment of those penalties and the IRS therefore is unable to collect those penalties through a levy.

- The court's holding that there is no authority for assessment of § 6038 penalties suggests that (1) the IRS would be precluded from exercising its other administrative collection powers, such as a lien or a refund offset, and (2) the mechanism for the IRS to collect § 6038 penalties is a civil action under 28 U.S.C. § 2461(a).

a. The Tax Court got it wrong, says the D.C. Circuit. Despite the absence of explicit language authorizing the assessment of penalties imposed by § 6038(b), the text, structure, and function of § 6038(b) indicate that the penalties it imposes are assessable. Farhy v. Commissioner, 100 F.4th 223 (D.C. Cir. 5/3/24), *rev'g* 160 T.C. No. 6 (4/3/23). In an opinion by Judge Pillard, the U.S. Court of Appeals for the D.C. Circuit has reversed the Tax Court and held that statutory authority exists for the assessment of penalties imposed by § 6038(b) and

that the IRS therefore is able to collect those penalties through its administrative collection powers, such as a levy. The court first rejected the parties' competing readings of § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title." The IRS argued that § 6201(a) authorizes the assessment of all taxes and penalties unless the Code expressly requires a different process for a given exaction. The taxpayer argued that § 6201(a) authorizes the assessment of a penalty only if the penalty is explicitly characterized as a "tax" or designated as assessable. The court declined to adopt either interpretation of § 6201(a) and instead based its holding on the text, structure, and function of the specific provision at issue, § 6038(b). The court placed primary emphasis on the history and legislative purpose underlying § 6038(b). Congress enacted § 6038 in 1960. As originally enacted, the penalty for failure to file the required informational return regarding a foreign corporation was a 10-percent reduction in the U.S. taxpayer's foreign tax credit. Congress amended § 6038 in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III, § 338, 96 Stat. 324, 631, commonly known as TEFRA. The 1982 amendments moved the 10-percent reduction of a taxpayer's foreign tax credit to current § 6038(c) and amended § 6038(b) to impose a new, fixed-dollar penalty for failure to file the required informational return. Amended § 6038(c)(3) coordinates the two penalties by providing that the § 6038(c) reduction of a taxpayer's foreign tax credit is reduced by any fixed-dollar penalty imposed by § 6038(b). These changes, the court observed, were intended to bolster and streamline enforcement of the penalty. The parties in this case agreed that the penalty imposed by § 6038(c) is assessable because a reduction of a taxpayer's foreign tax credit has the effect of increasing a taxpayer's tax liability, and § 6201(a) authorizes the assessment of all taxes imposed by the Internal Revenue Code. The remaining question was whether authority exists for the IRS to assess the penalty imposed by § 6038(b). The court emphasized that Congress's purpose in amending § 6038 in 1982 to add the fixed-dollar penalty currently provided by § 6038(b) was to streamline collection of the penalty. Under the interpretation of § 6038 advanced by the taxpayer, the IRS can assess and therefore collect through its administrative collection powers the penalty imposed by § 6038(c) (the 10-percent reduction in a taxpayer's foreign tax credit) but must instead enforce the fixed-dollar penalty imposed by § 6038(b) by bringing legal action against the taxpayer in a United States District Court. Such an interpretation, the court concluded, does not make sense:

> It would be "highly anomalous" for Congress to have responded to the identified problem of the underuse of subsection (c) penalties by promulgating a penalty that, while simpler to calculate, is much harder to enforce. … That view is contradicted by the clear congressional purpose behind the enactment of subsection (b).

The court also reasoned that the availability of a reasonable cause defense to the penalty imposed by § 6038(b) suggests that the penalty is assessable. A taxpayer can avoid the penalty imposed by § 6038(b) by showing reasonable cause for the noncompliance. See I.R.C. § 6038(c)(4); Reg. § 1.6038-2(k)(3)(ii). Section 6038(c)(4)(B), the court reasoned, "expressly treats the reasonable cause showing for failure to file the relevant informational returns as within the purview of the Service." Further, the court observed, "[i]f the subsection (b) penalty were not assessable, there would be no post-assessment administrative process in which the taxpayer could make a reasonable cause showing to the Secretary." The express contemplation of § 6038 that the Secretary of the Treasury will determine the availability of a reasonable cause defense to the penalties imposed by § 6038 supports treating the penalties imposed by both § 6038(b) and § 6038(c) as assessable. Finally, the court, observed, interpreting the § 6038(b) as not being assessable and therefore collectible only through an action in U.S. District Court and the § 6038(c) penalty as being assessable and collectible through the IRS's administrative collection powers with judicial review of the collection process (following a collection due process hearing) in the Tax Court could lead to inconsistent holdings in the two courts for the same taxpayer and would raise other potential issues:

> We decline to adopt a reading of section 6038(b) that attributes to Congress the intent to respond to the problem it identifies in a manner that is not only ineffective, but counterproductive.

3. Trustee learns that frivolity can be costly when it comes to filing and signing his trust's tax returns. Stanojevich v. Commissioner, 160 T.C. No. 7 (4/10/23). In a case of first impression, the Tax Court, in an opinion by Chief Judge Kerrigan, has determined that the $5,000 per taxable year frivolous return penalty of § 6702(a) can be imposed personally (apparently not limited to the trust's assets) against a trustee filing and signing an IRS Form 1041 (U.S. Income Tax Return for Estates and Trusts) as an "authorized representative." The case arose out of a collection due process hearing after the IRS sent the taxpayer a notice of federal tax lien relating to the assertion of the § 6702(a) frivolous return penalty across multiple years. The taxpayer was the trustee of, in Judge Kerrigan's words, a "grantor-type trust." (The opinion does not elaborate on the precise federal income tax status of the trust—i.e., disregarded grantor trust within the meaning of Reg. § 1.671-4 or another type trust—except to state in a footnote that the IRS disputed the validity of the trust, but the Tax Court assumed it was valid for purposes of the opinion.) The trust in question reported gross income across multiple years but simultaneously reported tax withheld for those years equal to or exceeding the amount of reported gross income. The returns reported that the trust had no tax liability and that it had made overpayments equal to the tax withheld. The IRS previously announced in Section III(22) of Notice 2010-33, 2010-17 I.R.B. 609, 611, its position that such facially incorrect returns are considered frivolous within the meaning of § 6702. The trustee argued that the § 6702(a) frivolous return penalty should not apply to him personally, even if he filed and signed the multi-year returns as an "authorized representative of the trust, because the frivolous returns were returns of the trust, not the trustee as an individual. Judge Kerrigan disagreed, relying on the plain terms of § 6702(a) which states that a "person shall pay a penalty of $5,000 if (1) such person files [a frivolous return, as defined]." Judge Kerrigan reasoned further that nothing in the statute conditions the imposition of the penalty on a person's filing of his or her personal return and that Congress, because it did not provide otherwise, must have considered it appropriate to impose the § 6702(a) penalty personally on a trustee who files a return on behalf of a trust.

4. Tax Court holds IRS does not need written supervisory approval to apply the 6% excise tax of § 4973 to excess contributions to an IRA. Couturier v. Commissioner, T.C. Memo. 2024-6 (1/17/24). In general, under § 7491(c), the IRS has the burden of production with respect to "any penalty, addition to tax, or additional amount." To satisfy this burden, § 6751(b)(1) requires the IRS to prove that "the initial determination of [the] assessment … [of any penalty was] personally approved (in writing) by the immediate supervisor of the individual making such determination." *See, e.g.*, *Frost v. Commissioner*, 154 T.C. 23, 34-35 (2020). Pursuant to § 6751(c), the term "penalties" as used in § 6571 includes "any addition to tax or any additional amount."

In this case, the taxpayer, a corporate executive, participated in several deferred compensation arrangements. These included shares in an employee stock ownership plan (ESOP) (a qualified retirement plan) and several compensatory plans, none of which was a qualified plan. In 2004, as part of a corporate reorganization, the taxpayer accepted a $26 million buyout from his company, which took the form of a $12 million cash payment to the taxpayer's IRA and a $14 million promissory note payable to his IRA, which the company satisfied in 2005. On his 2004 federal income tax return, he characterized the $26 million as a tax-free "rollover contribution" to his IRA. He left blank line 59, "Additional tax on IRAs, other qualified retirement plans, etc." Similarly, he filed his tax returns for 2005 through 2014 leaving blank line 59. He also did not attach to any of his returns Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."

The IRS audited the taxpayer and ultimately issued two notices of deficiency, one for 2004 through 2008 and another for 2019 through 2014. The IRS asserted that, of the $26 million contributed to the taxpayer's IRA, $25.1 million was attributable to his relinquishment of his rights in the non-

ESOP deferred compensation plans, which were not eligible for treatment as a tax-free rollover. The IRS's position in the notices of deficiency was that this $25.1 million was an "excess contribution" subject to the 6% excise tax of § 4973(a). Further, under § 4973(b)(2), the excise tax continues to apply for future years until the original excess contribution is distributed to the taxpayer and included in income. Therefore, according to the IRS, the taxpayer owed for the years involved an excise tax in the aggregate amount of approximately $8.5 million. In response to the notices of deficiency, the taxpayer petitioned the Tax Court. He subsequently filed an amended petition in which he argued that the 6% excise tax imposed by § 4973(a) is a penalty subject to the supervisory approval requirement of § 6751(b)(1) and that the IRS was precluded from assessing the penalty because it had failed to comply with the supervisory approval requirement. In the Tax Court, the IRS moved for partial summary judgment and argued that the exaction imposed by § 4973(a) is a "tax" and not a "penalty" and that the supervisory approval requirement of § 6751(b)(1) therefore did not apply.

The Tax Court (Judge Lauber) held that the § 4973(a) exaction is a "tax" and not a "penalty." Because it is a "tax," the court held, it is not subject to the § 6751(b)(1) written supervisory approval requirement. In reaching this conclusion, Judge Lauber relied primarily on the language of § 4973. He noted that the flush language of § 4973(a) refers to the exaction four times and describes it in each case as a "tax." The term "penalty," Judge Lauber observed, "appears nowhere in section 4973(a) or in any of the provision's other six subsections." The court further relied on the placement of § 4973 in the Code. Congress placed § 4973 in Subtitle D, chapter 43 of the Code. Subtitle D, the court pointed out, is captioned "Miscellaneous Excise Taxes" and chapter 43, captioned "Qualified Pension, Etc., Plans," contains 18 Code sections that impose excise taxes on various actions. The court emphasized that, in several prior decisions, it had "held that an exaction constitutes a tax where Congress used the term 'tax' in the Code provision imposing it and situated that provision in a chapter of the Code that provides for 'taxes.' *See, e.g.*, *Grajales v. Commissioner*, 156 T.C. 55 (2021) (holding that the 'additional tax' imposed by section 72(t) is a 'tax' and not a 'penalty' for section 6751(b) purposes), *aff'd*, 47 F.4th 58 (2d Cir. 2022)." In contrast, the court noted, Congress has generally situated penalties in Subtitle F of the Code, captioned "Procedure and Administration." The court also reviewed the legislative history of § 4973 and prior judicial decisions in which a taxpayer's failure file Form 5329 to report the exaction imposed by § 4973 had resulted in an "addition to tax" under § 6651(a)(1) for failure to timely file a return or under § 6651(a)(2) for failure to timely pay tax. "These precedents show that the exaction imposed by section 4973 is "a tax"; otherwise, no "additions to the tax" could have been sustained. No provision of the Code authorizes the imposition of "additions to the tax" with respect to penalties." Finally, the court emphasized that interpreting the exaction imposed by § 4973(a) as a tax is supported by common sense. Congress's purpose in enacting § 6751(b), the court stated, was to help ensure that IRS revenue agents did not threaten penalties to induce taxpayers to settle. A revenue agent, the court observed, could not plausibly assert an excise tax under § 4973(a) at the conclusion of an income tax audit to induce settlement. The court rejected the taxpayer's arguments that (1) in determining whether an exaction is a penalty, the court should look past the statutory text and engage in a functional analysis that treats as penalties all exactions that function as penalties, i.e., that are punitive in nature, (2) the placement of provisions such as § 4973 in the Code is irrelevant in determining whether they impose a penalty because § 7806(b) provides that "[n]o inference, implication, or presumption of legislative construction shall be...made by reason of the location...of any particular [Code] section," and (3) the exaction imposed by § 4973 is an "additional amount" within the meaning of § 6751(c) and therefore a penalty within the meaning of § 6751(b)(1). Accordingly, the court granted the IRS's motion for summary judgment on the issue of whether the supervisory approval requirement of § 6751(b)(1) applied.

B. Discovery: Summonses and FOIA

C. Litigation Costs

1. Saved by the *Boechler*: Dilatory taxpayer secures full IRS concession for tax year 2014 after SCOTUS decision in 2022, but does not succeed in recovering almost $130,000 in litigation costs. Castillo v. Commissioner, 160 T.C. No. 15 (6/5/23). Another apt headline for this case might be that "Sometimes for taxpayers it is better to be lucky than good."

Facts. The case began in November of 2016, when the IRS sent the taxpayer a notice of deficiency for unreported income relating to 2014. The taxpayer either never received or never responded to the notice of deficiency, and on April 17, 2017, the IRS assessed back taxes, interest, and penalties against the taxpayer for 2014. Next, in February of 2018 the IRS sent to the taxpayer a Notice of Federal Tax Lien Filing and Your Right to a Hearing Under Section 6320 ("NFTL"). In response, the taxpayer filed a request for a collection due process ("CDP") hearing on March 2, 2018. At the CDP hearing, the taxpayer argued that the deficiency the IRS assessed for 2014 was not attributable to her income, but instead to income realized by a business the taxpayer sold in 2009. The IRS officer conducting the CDP hearing informed the taxpayer that she could not contest the underlying and assessed tax liability because the notice of deficiency was properly mailed and the taxpayer did not petition the Tax Court. The IRS then sent the taxpayer a notice of determination under § 6330(d) sustaining the NFTL for 2014. The notice of determination was mailed to the taxpayer's last known address on December 11, 2018. Under § 6330(d)(1), the taxpayer then had 30 days within which to file a petition in the Tax Court challenging the IRS's determination. This 30-day period expired on January 10, 2019. Nevertheless, almost nine months later, on October 8, 2019, the taxpayer filed a petition in the Tax Court challenging the notice of determination that upheld the NFTL. The taxpayer asserted (as she had in the CDP hearing) that the back taxes, interest, and penalties sought by the IRS were not attributable to her but to the business she sold in 2009. Regardless, on March 25, 2020, the Tax Court, upon a motion made by the IRS, dismissed the taxpayer's petition as untimely. The Tax Court held that the 30-day time period prescribed by § 6330(d)(1) was jurisdictional, and because the taxpayer missed the deadline, the court had no jurisdiction to hear the taxpayer's case regardless of the underlying merits. The taxpayer appealed to the U.S. Court of Appeals for the Second Circuit.

Second Circuit Appeal. The Second Circuit held the taxpayer's appeal in abeyance pending the U.S. Supreme Court's issuance of a decision in *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22). In *Boechler*, the Court held that the 30-day period specified in § 6330(d)(1) for requesting review in the Tax Court of a notice of determination following a CDP hearing is *not* jurisdictional and *is* subject to equitable tolling. After *Boechler* was decided, the Second Circuit vacated the Tax Court's earlier decision dismissing the taxpayer's petition as untimely and remanded the case for further proceedings.

Back in Tax Court. Upon remand to the Tax Court, the IRS and the taxpayer filed a stipulation of settled issues on November 8, 2022, wherein the IRS completely conceded the case in favor of the taxpayer. (The opinion does not explain why the IRS conceded the case.) The taxpayer, perhaps justifiably miffed but also incredibly lucky given her past delays in responding to the IRS, filed a motion in the Tax Court pursuant to § 7430 on January 5, 2023, for an award of administrative ($5,601) and litigation ($129,750) costs. Along with other requirements and limitations, § 7430 allows a prevailing party to recover reasonable administrative and litigation costs in connection with the determination, collection, or refund of any tax, interest, or penalty if the government's position was not substantially justified. The taxpayer thus argued that (i) she was the prevailing party, (ii) she had met the other requirements and limitations of § 7430 (which the IRS conceded), and (iii) under *Boechler* and unspecified provisions of the Internal Revenue Manual, the IRS's litigating position was not substantially justified. The IRS (for reasons that are not clear in the Tax Court's opinion) conceded the taxpayer's claim to $5,601 in administrative costs, but the IRS contested whether the taxpayer was the prevailing party for purposes of a § 7430 award of litigation costs. Under § 7430(c)(4)(A)(i)(II), a taxpayer is not considered a prevailing

party if the government establishes that its position was substantially justified. The IRS thus argued that its pre-*Boechler* litigating position concerning the jurisdictional nature of the 30-day period prescribed by § 6330(d)(1) was substantially justified.

Tax Court Opinion. The Tax Court (Judge Kerrigan) agreed with the IRS and rejected the taxpayer's § 7430 claim for $129,750 in litigation costs. Judge Kerrigan first pointed out that IRS's eventual concession of the case was not determinative of an award of litigation costs for the taxpayer under § 7430. Second, Judge Kerrigan noted that the question of whether the IRS's litigating position was substantially justified must be determined as of early 2020, when the IRS filed its motion to dismiss the taxpayer's untimely Tax Court petition. Third, emphasizing that *Boechler* was a case of first impression decided in 2022, Judge Kerrigan reasoned that "it was well established [prior to *Boechler*] that the 30-day period to file a petition for review of a collection due process determination was jurisdictional." Lastly, Judge Kerrigan rejected the taxpayer's additional argument that the IRS's litigating position was not substantially justified because the IRS did not follow unspecified provisions of the Internal Revenue Manual. The Internal Revenue Manual, Judge Kerrigan wrote, is not "applicable published guidance" within the meaning of § 7430(c)(4)(B)(ii). Accordingly, Judge Kerrigan concluded that the taxpayer was not entitled to an award of litigation costs under § 7430.

D. Statutory Notice of Deficiency

1. Ever heard of a 424-day letter? Well, now you have in this case of first impression from the Tax Court. Dodson v. Commissioner, 162 T.C. No. 1 (1/3/24). The taxpayers in this case received a notice of deficiency dated October 7, *2021* ("first 90-day letter"). The first 90-day letter specified December 5, *2022*, as the last day for filing a petition in the Tax Court. (FYI, December 5, 2022, is 424 days after October 7, 2021.) Promptly realizing its mistake, on October 8, 2021, the IRS sent the taxpayers a "corrected" notice of deficiency ("second 90-day letter") substantially the same as the first 90-day letter but specifying January 6, *2022*, as the last day for filing a petition in the Tax Court. A cover sheet to the second 90-day letter stated: "PREVIOUS NOTICE SENT WITH INCORRECT DATE. CORRECTED NOTICE WITH CORRECT DATES." The taxpayers stated that they did not receive the second 90-day letter. The taxpayers also produced tracking information from the USPS indicating that the second 90-day letter left a distribution center near the taxpayers' address but did not show delivery. On March 3, 2022, 147 days after October 7, 2021, the taxpayers filed a petition in the Tax Court disputing the adjustments proposed by the IRS in the first 90-day letter. The IRS moved to dismiss the taxpayers' petition on the grounds that it was untimely because it was filed beyond the 90-day period specified in § 6213(a) (which was the date reflected in the IRS's corrected, second 90-day letter). The taxpayers, however, argued that their petition in response to the IRS's first 90-day letter was timely because, as the last sentence of § 6213(a) states: "Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed." In a case of first impression, the Tax Court (Judge Marvel) agreed with the taxpayers. Judge Marvel reasoned that the above-quoted last sentence of § 6213(a) controlled in this case, especially because the IRS did not rescind the first 90-day letter as permitted by § 6212(d). Section 6212(d) permits the IRS to rescind a notice of deficiency mailed to a taxpayer if the taxpayer consents on a properly executed Form 8626 (Agreement to Rescind Notice of Deficiency) or other acceptable document reflecting an agreement to rescind between the IRS and the taxpayer. *See also* Rev. Proc. 98-54, 1998-2 C.B. 529 at 530 (§ 5.07). Judge Marvel further determined that the second 90-day letter sent by the IRS was insufficient to unilaterally rescind the first 90-day letter. Moreover, the Tenth Circuit, to which an appeal from the Tax Court would lie in this case, has stated: "[I]f a notice indicates a petition date that is more than 90 days after the date of mailing, that date controls." *Smith v. Commissioner*, 275 F.3rd 912 at 916 (10th Cir. 2001). Judge Marvel rejected the IRS's argument that the 90-day period set forth in § 6213(a) nevertheless should apply because the date in the first 90-day letter was an "obvious mistake." The IRS's argument relied in part upon two prior decisions in which the 90-day period in § 6213(a) was enforced even though the notice of deficiency completely omitted a date by which a petition in the

Tax Court was required to be filed. *See Smith v. Commissioner*, 114 T.C. 489 (2000), *aff'd* 275 F.3rd 912 (10th Cir. 2001) (notice of deficiency was valid despite failure to specify last date to file a petition in Tax Court); *Rochelle v. Commissioner*, 116 T.C. 356 (2001) (petition filed 143 days after mailing of notice of deficiency was untimely despite failure of notice to specify last date to file a petition in Tax Court). Judge Marvel distinguished *Smith* and *Rochelle* because those cases dealt with circumstances where no filing date for a Tax Court petition was specified, not a situation like the present case in which the specified filing date incorrectly extended beyond the 90-day period of § 6213(a). Judge Marvel reasoned that the IRS's argument "attempts to create uncertainty about the meaning of the last sentence of section 6213(a) where there is none." Anticipating a future case, perhaps, Judge Marvel also wrote: "This is not a case where a taxpayer petitions us for redetermination of a deficiency in a notice that purports to correct a prior notice of deficiency, a circumstance for which we express no view on the application of the last sentence of section 6213(a)."

E. Statute of Limitations

1. If you're on "island time," or think you might be, here's why you might want to "meticulously" and "intentionally" file a U.S. federal income return even if you think you have $0 U.S. gross income and $0 U.S. tax liability. Tice v. Commissioner, 160 T.C. No. 8 (4/10/23). In a case with extremely narrow application, the Tax Court (Judge Pugh), in a unanimous, reviewed opinion, has held that filing a return solely with the U.S. Virgin Islands Bureau of Internal Revenue ("VIBIR") does not trigger the limitations period under § 6501 for the IRS to assess tax. The taxpayer in this case claimed to be a bona fide resident of the U.S. Virgin Islands (USVI) for tax years 2002 and 2003. Accordingly, pursuant to § 932(c) (coordination of U.S. and USVI income taxes), the taxpayer filed his Form 1040 for those years only with the VIBIR (the USVI's IRS counterpart). The IRS audited the taxpayer and challenged his status as a bona fide resident of the USVI but did not issue a notice of deficiency until 2015. The taxpayer petitioned the Tax Court and moved for summary judgment on the grounds that the IRS's notice of deficiency was time-barred under § 6501(a), which generally provides that the IRS can assess tax within three years after a return is filed. Nevertheless, the Tax Court held that the IRS's notice of deficiency was timely and that the § 6501 limitations period had not begun to run against the IRS because the taxpayer did not show "meticulous compliance" by *intentionally* filing a return with the IRS. In so holding, the Tax Court aligned itself with decisions of the Eighth and Eleventh Circuits. *See Coffey v. Commissioner*, 987 F.3d 808 (8th Cir. 2021), *reversing and remanding Hulett v. Commissioner*, 150 T.C. 60 (2018), and *Commissioner v. Estate of Sanders*, 834 F.3d 1269 (11th Cir. 2016).

Appleton and Hulett distinguished. The Tax Court distinguished its holding in *Tice* from its seemingly contrary holding in *Appleton v. Commissioner*, 140 T.C. 273 (2013). The taxpayer in *Appleton* also filed returns for 2002-2004 with the VIBIR only; however, the IRS had subsequently received copies of the taxpayer's USVI returns from the VIBIR. The IRS had received the *Appleton* taxpayer's USVI returns through the so-called "cover-over" process whereby the VIBIR requests that taxes paid to the U.S. by USVI residents be remitted (i.e., "covered over") to the USVI. The VIBIR invokes the cover-over process by sending critical portions of a taxpayer's return information to the IRS. A cover-over request typically includes a partial or complete copy of a taxpayer's USVI return. The IRS conceded in *Appleton* that "the taxpayer's subjective intent has no role to play" in determining whether a return has been properly filed. The taxpayer and the IRS in *Appleton* also stipulated that the taxpayer was a bona fide resident of the USVI for the years in issue. Thus, the taxpayer contended, and the Tax Court in *Appleton* agreed, that the copies of the taxpayer's USVI returns for years 2002-2004 transmitted to the IRS started the § 6501 limitations period vis-à-vis the IRS. The *Hulett* taxpayer made an argument similar to that made by the taxpayer in *Appleton* about the cover-over process triggering the § 6501 limitations period, and the lead Tax Court opinion in *Hulett* adopted this argument to hold for the taxpayer regarding the § 6501 limitations period. As noted above, however, the Eighth Circuit reversed the Tax Court's decision in *Hulett*, holding that the VIBIR-IRS cover-over process is not sufficient to

"meticulously comply with the requirements to file with the IRS." *See Coffey v. Commissioner*, 987 F.3d 808 (8th Cir. 2021). Similarly, the Eleventh Circuit in *Commissioner v. Estate of Sanders*, 834 F.3d 1269 (11th Cir. 2016), also rejected the cover-over argument, holding that "a taxpayer who files a return only with the VIBIR does not trigger the statute of limitations unless he actually is a bona fide resident of the USVI." The taxpayer in *Tice* reserved making a similar argument as the taxpayer in *Appleton* (i.e., that VIBIR return copies sent to the IRS start the statute of limitations against the IRS under § 6501), so expect another Tax Court decision on this issue soon.

Reading between the lines and clarifying. It appears that, if in addition to the taxpayer's USVI return filed with the VIBIR, the taxpayer had *meticulously* and *intentionally* filed a Form 1040 with the IRS for 2002 and 2003—even if the return so filed listed $0 gross income, $0 deductions, and $0 tax—the statute of limitations of § 6501 would have run against the IRS. Further, for USVI returns filed for 2006 and later tax years, Reg. § 1.932-1(c)(2)(ii) expressly provides that the § 6501 limitations period begins running against the IRS based solely upon filing a return with the VIBIR in which the taxpayer takes the position that he or she is a bona fide resident of the USVI.

a. Wow! That was fast. Estate of Tanner v. Commissioner, T.C. Memo 2023-54 (5/1/23). In a case appealable to the Eleventh Circuit and with facts virtually identical to *Tice*, the Tax Court (Judge Buch), in a memorandum decision, refused to grant summary judgment to a taxpayer who argued that the cover-over process between the VIBIR and IRS triggers the § 6501 limitations period on assessment of tax for the IRS. Instead, Judge Buch ruled that a genuine issue of material fact remained to be determined: whether the taxpayer "intended the VIBIR's transmission of the cover-over requests to be the filing of his returns." In both *Tice* and *Estate of Tanner*, the IRS neither (i) conceded that the taxpayer's subjective intent has no role to play in determining whether a return has been properly filed, nor (ii) stipulated that the taxpayer was a bona fide resident of the USVI. Thus, Judge Buch's opinion noted that both *Appleton* and *Hulett* are distinguishable. Judge Buch further noted that the *Estate of Tanner* case is appealable to the Eleventh Circuit and governed by the *Estate of Sanders* decision mentioned above. Therefore, the Tax Court's decision in *Estate of Tanner* also supports the conclusion that, if a taxpayer wishes to ensure the running of the § 6501 statute of limitations against the IRS, the taxpayer would be well advised to file a return in the U.S. even if that return shows $0 gross income, $0 deductions, and $0 tax. Again, with respect to USVI returns filed for 2006 and later tax years, Reg. § 1.932-1(c)(2)(ii) expressly provides that the § 6501 limitations period begins running against the IRS based solely upon filing a return with the VIBIR in which the taxpayer takes the position that he or she is a bona fide resident of the USVI.

2. The 90-day period specified in § 6213(a) for filing a petition in the U.S. Tax Court is jurisdictional and is not subject to equitable tolling, according to the Tax Court. Hallmark Research Collective v. Commissioner, 159 T.C. No. 6 (11/29/22). In a unanimous, reviewed opinion by Judge Gustafson, the Tax Court has held that the 90-day period specified by § 6213(a) within which taxpayers can challenge a notice of deficiency by filing a petition in the Tax Court is jurisdictional and is not subject to equitable tolling. In this case, the IRS sent a notice of deficiency to the taxpayer. Pursuant to § 6213(a), the taxpayer then had 90 days within which to challenge the notice of deficiency by filing a petition in the U.S. Tax Court. The last day of this 90-day period was September 1, 2021. The taxpayer electronically filed its petition on September 2, 2021, which was one day late. In the petition, the taxpayer stated: "My CPA . . . contracted COVID/DELTA over the last 40 days and kindly requests additional time to respond." In other words, it appears that the taxpayer was requesting an extension of the § 6213(a) 90-day period.

Procedural history. The Tax Court issued an order to show cause in which it ordered the parties to respond as to why the court should not, on its own motion, dismiss the action for lack of jurisdiction. The taxpayer requested that the court defer ruling on the matter until the U.S. Supreme Court issued its opinion in *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22), which was pending in the Supreme Court. The Tax Court declined to defer ruling and dismissed the taxpayer's action. After the U.S. Supreme Court issued its opinion in *Boechler*, the taxpayer moved to vacate

the court's order of dismissal. After receiving briefing, the court issued a unanimous, reviewed opinion denying the motion to vacate its prior order of dismissal.

Tax Court's holding. In a lengthy (57 pages) and extraordinarily thorough opinion, the Tax Court examined the text and history of § 6213(a) and concluded that Congress had clearly indicated that the 90-day period specified in the statute is jurisdictional. The court observed that the Tax Court is a court of limited jurisdiction and has only whatever jurisdiction it has been granted by Congress. Accordingly, because the 90-day period is jurisdictional, in the court's view, the court must dismiss cases, such as this one, in which the taxpayer's petition is filed late. And because the statute is jurisdictional, the court concluded, it is not subject to equitable tolling, i.e., taxpayers cannot argue for exceptions on the basis that they had good cause for failing to meet the deadline. The court also concluded rather briefly that its view on the jurisdictional nature of § 6213(a) was not affected by the U.S. Supreme Court's decision in *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22). In *Boechler*, the Court held that the 30-day period specified in § 6330(d)(1) for requesting review in the Tax Court of a notice of determination following a collection due process hearing is *not* jurisdictional and *is* subject to equitable tolling. According to the Tax Court, *Boechler* "emphatically teaches that" § 6213(a) and § 6330(d)(1) "are different sections" that "[e]ach must be analyzed in light of its own text, context, and history." The fact that, in *Boechler*, the Supreme Court concluded that the 30-day period specified in § 6330(d)(1) is *not* jurisdictional did not change the Tax Court's view that the 90-day period specified in § 6213(a) *is* jurisdictional. Accordingly, the Tax Court dismissed the taxpayer's action.

a. The Third Circuit disagrees. The 90-day period specified in § 6213(a) for filing a petition in the U.S. Tax Court is *not* jurisdictional and *is* subject to equitable tolling. Culp v. Commissioner, 75 F.4th 196 (3d Cir. 7/19/23). In an opinion by Judge Ambro, the U.S. Court of Appeals for the Third Circuit has held that the 90-day period specified by § 6213(a) within which taxpayers can challenge a notice of deficiency by filing a petition in the Tax Court is *not* jurisdictional and *is* subject to equitable tolling. Although the Third Circuit's opinion does not provide specific dates, it states that the IRS mailed a notice of deficiency to the taxpayers, a married couple, as well as a second notice of deficiency, both with respect to the taxable year 2015. The taxpayers filed a petition in the Tax Court seeking redetermination of the deficiency well outside the 90-day period specified in § 6213(a) for doing so. In an unpublished order, the Tax Court dismissed the taxpayers' petition for lack of jurisdiction. On appeal, the taxpayers, backed by amicus curiae represented by the Legal Services Center of Harvard Law School, argued that the 90-day period provided by § 6213(a) is not jurisdictional and is subject to equitable tolling in appropriate circumstances. The court framed the issue in this way:

> The central question in this appeal is whether the Culps' late filing deprives the Tax Court of jurisdiction to consider their petition. Put another way, is § 6213(a)'s 90-day requirement jurisdictional or is it a claims-processing rule?

The court first analyzed the text of § 6213(a), which provides in part:

> Within 90 days … after the notice of deficiency authorized in section 6212 is mailed …, the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. … The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition.

The court concluded that the provision's text did not indicate that the 90-day period specified in § 6213(a) is jurisdictional. The language Congress used, the court reasoned, does not link the 90-day deadline to the Tax Court's jurisdiction. The statute provides that the Tax Court has no jurisdiction to enjoin actions or order a refund if the taxpayer's petition is not timely filed, which indicates that "Congress knew how to limit the scope of the Tax Court's jurisdiction." But the

provision does not similarly limit the Tax Court's jurisdiction to review petitions that are not timely filed. Further, according to the court, neither the context of the statute nor the court's own precedent interpreting § 6213(a) indicates that the 90-day period is jurisdictional.

After holding that the 90-day period specified in § 6213(a) is not jurisdictional, the court considered whether the period is subject to equitable tolling. According to the court, neither the text nor the context of the statute suggests that Congress intended the period not to be subject to equitable tolling. Accordingly, the court remanded the case to the Tax Court with instructions for the Tax Court to consider whether the taxpayers could demonstrate sufficient grounds for the 90-day period to be equitably tolled.

b. In a reviewed opinion, the Tax Court has held that it will not follow the Third Circuit's decision in *Culp* in cases appealable to other Circuits. Sanders v. Commissioner, 161 T.C. No. 8 (11/2/23). In a reviewed opinion (10-1-2) by JudgeNega, the Tax Court has reaffirmed its position that the 90-day period specified in § 6213(a) for filing a petition in the Tax Court in response to a notice of deficiency is jurisdictional and therefore not subject to equitable exceptions. In this case, the IRS issued a notice of deficiency that stated the last day to file a petition in the Tax Court to challenge the notice of deficiency was June 21, 2022. The taxpayer mailed her petition to the Tax Court using the U.S. Postal Service's Priority Mail service and the envelope she mailed bore a postmark of June 23, 2022. The IRS moved to dismiss for lack of jurisdiction on the ground that the taxpayer had filed the petition outside the permitted 90-day period and that this time period is jurisdictional. The court reviewed its prior decision in *Hallmark Research Collective v. Commissioner*, 159 T.C. No. 6 (11/29/22), and the Third Circuit's conflicting decision in *Culp v. Commissioner*, 75 F.4th 196 (3d Cir. 7/19/23). Under the rule of *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), the Tax Court follows the precedent of the U.S. Court of Appeals that will hear the appeal of a case from the Tax Court. Therefore, in decisions appealable to the Third Circuit, the Tax Court will follow the holding of *Culp* that the 90-day period of § 6213(a) is not jurisdictional and therefore is subject to equitable exceptions. The present case, however, was appealable to the Fourth Circuit, which has not issued a precedential opinion on point, and therefore the Tax Court was not constrained by the *Golsen* rule. The court reaffirmd its view that the 90-day period of § 6213(a) is jurisdictional:

> After thoroughly considering the Third Circuit's reasoning in *Culp*, we reaffirm *Hallmark* and will continue to treat the 90-day deficiency deadline as jurisdictional in cases appealable outside the Third Circuit, including in cases appealable to the First and Fourth Circuits. … Nothing in the Third Circuit's reasoning in *Culp* causes us to abandon or otherwise modify our application of the traditional tools of statutory construction or our holding as to the jurisdictional nature of the 90-day deficiency deadline.

Accordingly, the court granted the government's motion to dismiss for lack of jurisdiction.

Concurring opinion of Judge Buch. In a very thorough concurring opinion, Judge Buch (joined by Judges Kerrigan, Nega, Pugh, Ashford, Urda, Copeland, Toro, Greaves, and Marshall) reviewed both the statutory text and the context of § 6213(a) as well as the historical treatment of the provision and concluded that the 90-day period specified in the statute is jurisdictional.

Dissenting opinion of Judge Foley. In a dissenting opinion, Judge Foley (joined by Judge Weiler) reasoned that a limitations period is jurisdictional only if Congress has clearly stated that it is, and that Congress did not make such a clear statement in § 6213(a). In Judge Foley's view, the 90-day period of § 6213(a) is analogous to the 30-day period for filing a petition in the Tax Court in response to a notice of determination following a collection due process (CDP) hearing, which the U.S. Supreme Court held is not jurisdictional and therefore is subject to equitable exceptions. *Boechler, P.C. v. Commissioner,* 142 S. Ct. 1493 (4/21/22).

c. The Tax Court will not follow the Third Circuit's decision in *Culp* in cases appealable to the Tenth Circuit. Nguyen v. Commissioner, T.C. Memo 2023-151

(12/20/23). In a case decided after the Third Circuit issued its decision in *Culp v. Commissioner*, 75 F.4th 196 (3d Cir. 7/19/23), the Tax Court refused to apply equitable tolling in a case appealable to the Tenth Circuit. Briefly, the taxpayer's Tax Court petition arrived one day after the 90-day period of § 6213(a) had expired. Moreover, the "timely-mailed, timely-filed" rule of § 7502 did not apply because the taxpayer used FedEx Ground instead of one of the other FedEx delivery services permitted under § 7502 pursuant to Notice 2016-30, 2016-18 I.R.B. 676. The Tax Court (Judge Lauber) refused to apply equitable tolling principles and dismissed the taxpayer's petition for lack of jurisdiction, stating in footnote 2 of the opinion:

> Absent stipulation to the contrary this case is appealable to the Tenth Circuit, and we thus follow its precedent, which is squarely on point. See *Golsen v. Commissioner*, 54 T.C. 742, 756–57 (1970), aff'd, 445 F.2d 985 [27 AFTR 2d 71-1583] (10th Cir. 1971). The Tenth Circuit has long agreed with this Court's holdings that the statutory period prescribed by section 6213(a) is a jurisdictional requirement. See *Armstrong v. Commissioner*, 15 F.3d at 973 n.2; *Foster v. Commissioner*, 445 F.2d 799, 800 [28 AFTR 2d 71-5210] (10th Cir. 1971). Thus, we need not address a recent ruling by the U.S. Court of Appeals for the Third Circuit that the statutory filing deadline in deficiency cases is a non-jurisdictional "claims-processing" rule. *See Culp v. Commissioner*, 75 F.4th 196, 205 [132 AFTR 2d 2023-5198] (3d Cir. 2023).

3. Do you know the difference between a "postponement" and an "extension"? The IRS explains and announces slightly longer look-back periods under § 6511 for filing claims for credit or refund relating to COVID-year postponed returns and payments of taxes. Notice 2023-21, 2023-11 I.R.B. 563 (2/27/23). Appreciating this IRS Notice requires some knowledge of recent history as well as an understanding of § 6511 relating to claims for credit or refund of federal taxes paid. The bottom line, though, is good news for taxpayers. *Note to self*: You may want to mark May 17, 2024, on your calendar for individual clients who filed their 2020 federal income tax returns by the COVID-year postponed due date of May 17, 2021.

Background. As a result of the COVID pandemic, the IRS exercised its authority under § 7508A to postpone the filing and payment deadlines for numerous types of federal tax returns and taxes due in 2020 and 2021. *See* Notice 2020-23, 2020-18 I.R.B. 742 (4/9/20) (normal April 15, 2020, filing and payment obligations postponed to July 15, 2020, for Form 1040 series returns (individuals), Form 1120 series returns (corporations), Form 1065 (partnerships), Form 1041 (income tax return of trusts and estates), Form 706 (estate and generation-skipping transfer tax return), Form 709 (gift and generation-skipping transfer tax return), and Form 990-T (unrelated business income of tax-exempt organizations); Notice 2021-21, 2021-15 I.R.B. 986 (4/12/21) (normal April 15, 2021, filing and payment obligations postponed to May 17, 2021, for Form 1040 series returns (individuals)). Although Notice 2020-23 and Notice 2021-21 *postponed* certain return filing and payment due dates, those notices did not *extend* the time for filing the returns because a postponement is not an extension. *See* Reg. § 301.7508A-1(b)(4). As a result, the postponements did not lengthen the so-called "lookback period" of § 6511(b), which limits a taxpayer to recovering only taxes paid within a specified look-back period.

Limitations periods of § 6511. Section 6511(a) generally requires claims for credit or refund of federal taxes paid to be filed by the *later of* (i) three years from the time the taxpayer's return was filed or (ii) two years from the time the tax was paid. If the taxpayer fails to file the claim within one of these periods, then § 651l(b)(l) prohibits the Service from making the refund. Even if a taxpayer files a claim for refund within one of the periods prescribed by § 6511(a), the amount of tax that the taxpayer can recover may be limited by § 6511(b)(2). If the taxpayer files the claim within the three-year period of § 6511(a), then under § 651l(b)(2)(A) the taxpayer can recover only the portion of the tax paid during the period preceding the filing of the refund claim equal to three years *plus any extension of time the taxpayer may have obtained for filing the return*. If the

taxpayer files the refund claim more than three years after the taxpayer filed the return, but within two years after the taxpayer paid the tax (so that the two-year period of § 6511(a) is satisfied), then under § 6511(b)(2)(B) the taxpayer can recover only the portion of the tax paid during the two years preceding the filing of the refund claim. Furthermore, for a calendar-year taxpayer, withheld and estimated income taxes are deemed paid on the due date of the tax return, generally April 15 of each year. *See* § 6513(b)(1)-(2). The three-year lookback period of § 6511(b)(2)(A), particularly the deemed April 15 payment date for withheld and estimated taxes, is the subject of Notice 2023-21.

Notice 2023-21. Under the general rule of § 6511(b)(2)(A) described above, taxpayers who did not extend the time for filing their 2019 or 2020 federal returns must file a claim for credit or refund within three years of the normal due date for their returns (generally April 15, 2020, or April 15, 2021, respectively). Yet, Notice 2020-23 *postponed* until July 15, 2020, the due date for most 2019 federal tax returns, and Notice 2021-21 *postponed* until May 17, 2021, the due date for 2020 individual federal income tax returns. Technically, these "postponements" are not "extensions." Therefore, absent relief, the three-year lookback period for filing claims for credit or refund of 2019 or 2020 taxes paid (or deemed paid) with returns timely-filed according to the postponed 2020 or 2021 filing dates would expire earlier than the full three years otherwise allowed by § 6511(b)(2)(A). Consequently, pursuant to § 7508A the IRS has announced relief for any person (i) with a federal tax return filing or payment obligation that was postponed by Notice 2020-23 to July 15, 2020, or (ii) with a federal income tax return in the Form 1040 series that was postponed by Notice 2021-21 to May 17, 2021. Notice 2023-21 provides that, for taxpayers affected by Notice 2020-23, the period beginning on April 15, 2020, and ending on July 15, 2020, will be disregarded in determining the beginning of the lookback period for the purpose of determining the amount of a credit or refund under § 6511(b)(2)(A). Similarly, for taxpayers affected by Notice 2021-21 the period beginning on April 15, 2021, and ending on May 17, 2021, will be disregarded in determining the beginning of the lookback period for the purpose of determining the amount of a credit or refund under § 6511(b)(2)(A). The relief provided under § 7508A and announced in Notice 2023-21 is automatic. Affected taxpayers do not have to call the IRS, file any form, or send letters or other documents to receive this relief.

Example. Taxpayer is a calendar-year filer with a 2019 federal income tax return due date of April 15, 2020. Taxpayer's employer withheld income taxes from Taxpayer's wages throughout 2019 and remitted the withheld income taxes to the IRS. Pursuant to § 6513(b), these withheld income taxes are deemed paid on April 15, 2020. The due date for Taxpayer's 2019 federal income tax return was postponed by Notice 2020-23 to July 15, 2020. Pursuant to the postponed due date, Taxpayer timely filed their return on June 22, 2020. Under § 6511(a), Taxpayer may timely file a claim for credit or refund until three years from the return filing date, or June 22, 2023. But if Taxpayer files a claim for credit or refund on June 22, 2023, absent the relief granted in Notice 2023-21, the amount of Taxpayer's credit or refund would be limited to tax paid during the period beginning three years before the filing of the claim, or June 22, 2020. As a result, a credit or refund of Taxpayer's withheld income taxes would be barred because they were deemed paid on April 15, 2020, outside of the lookback period in § 6511(b)(2)(A). This notice provides relief by disregarding the period beginning on April 15, 2020, and ending on July 15, 2020, in determining the beginning of the lookback period. Accordingly, under the relief provided by this notice, if Taxpayer files a claim for credit or refund on or before June 22, 2023, the lookback period extends three years back from the date of the claim, disregarding the period beginning on April 15, 2020, and ending on July 15, 2020. As a result, the limit to the amount of the credit or refund would include Taxpayer's withheld income taxes deemed paid on April 15, 2020.

4. IRS bait and switch? Partnership's 2001 tax year remains open until 2010 because no original return was filed and neither a copy faxed to an IRS agent in 2005 nor a second copy mailed to an IRS attorney in 2007 started the three-year limitations period on assessment of tax. Seaview Trading, LLC v. Commissioner, 62 F.4th 1131 (9th Cir. 3/10/23) (en banc), *vacating* 34 F.4th 666 (9th Cir. 2022), *and aff'g* T.C. Memo. 2019-122 (2019). As evidenced

by the citation above, the procedural history of this case demonstrates the Tax Court's and the Ninth Circuit's struggles to determine the proper outcome. First, the Tax Court held for the IRS. Then, a three-judge panel of the Ninth Circuit (by a two to one vote) reversed the Tax Court and held for the taxpayer. Finally, an *en banc* panel of the Ninth Circuit (by a ten to one vote) vacated the three-judge panel's prior decision and held for the IRS, affirming the Tax Court. Notwithstanding the procedural complexities, the facts of the case are relatively straightforward. Seaview Trading, LLC, a TEFRA partnership, mistakenly failed to file its original 2001 Form 1065 even though the return apparently had been timely prepared and signed. (Seaview's return preparer may have mailed a related entity's original tax return in the envelope that was meant to contain Seaview's 2001 Form 1065.) In July of 2005, an IRS agent in South Dakota notified the tax matters partner that there was no record of Seaview having filed a return for 2001. Next, in September of 2005, Seaview faxed a copy of its original return to the IRS agent; however, the agent did not forward the faxed return to the IRS Service Center in Ogden, Utah, which was the proper place for filing Seaview's 2001 return. Subsequently, in July of 2007 while an IRS audit was ongoing, Seaview mailed a copy of its original 2001 return to an IRS attorney in Minnesota; but again, the attorney did not forward the copy to the Ogden Service Center. Lastly, in October of 2010, the IRS issued a notice of final partnership administrative adjustment ("FPAA") to Seaview disallowing a $35.5 million claimed loss for 2001. Seaview responded by filing a petition in the Tax Court contending that the IRS's proposed adjustment was untimely. Seaview asserted that, under § 6229(a)(1), the IRS has only three years from the time the partnership return is filed to assess tax, and that this period had expired no later than July 2010 (three years after the copy of the taxpayer's return was mailed to the IRS attorney in Minnesota and before the FPAA was received). The IRS, of course, argued that the statute of limitations never began to run because Seaview did not properly file an original return with the Ogden Service Center. As the case wound its way through the Tax Court up to the Ninth Circuit, the record established that Seaview's original 2001 Form 1065 (nor a copy thereof) was ever sent to or received by the Ogden Service Center. Thus, the only question before the Ninth Circuit was whether the IRS's FPAA, issued in October 2010, was issued before the three-year limitations period on assessment of tax had expired.

The Arguments. The IRS argued that a return is properly "filed" for statute of limitation purposes only when it is submitted to, or eventually received by, the proper IRS Service Center, which in this case was in Ogden, Utah. The IRS relied upon then-applicable regulations (Reg. § 1.6031(a)-1(e)) and instructions to the 2001 Form 1065, which designated the Ogden Service Center as the proper place for filing Seaview's return. Seaview countered that the then-applicable regulations and instructions to the 2001 Form 1065 should be read to apply to returns filed on time, not late-filed returns or copies thereof delivered to an IRS agent or attorney. For delinquent returns, Seaview argued, there is no specific instruction regarding where such returns should be filed in the Code, applicable regulations, or the instructions for Form 1065. Therefore, Seaview urged the Ninth Circuit to hold that its delinquent 2001 return on Form 1065 was "filed" no later than July 2007, when it was mailed to the IRS attorney in Minnesota. In support of its position, Seaview cited IRS documents (a 1999 advice memorandum, the 2005 Internal Revenue Manual, and a 2006 policy statement) which permitted IRS personnel to receive and "accept" delinquent returns during an examination. The 2005 Internal Revenue Manual went further to state that such accepted but delinquent returns should be forwarded "to the appropriate campus." Seaview also cited as support for its position the Tax Court's decision in *Dingman v. Commissioner*, T.C. Memo 2011-116. In *Dingman*, the Tax Court held that delinquent, original returns delivered to IRS investigators, not an IRS Service Center, were considered properly "filed" when checks accompanying the delinquent returns were credited to the taxpayer's account.

Ninth Circuit Majority. The Ninth Circuit majority was not persuaded by Seaview's arguments. Judge Waterford, writing on behalf of the ten-judge majority, reasoned that, although the Code, regulations, and instructions for Form 1065 did not dictate where delinquent tax returns (or copies thereof) should be filed, limitation statutes barring the collection of taxes are strictly construed in favor of the government. Thus, a taxpayer's "meticulous compliance" with return filing

requirements is necessary to start the statute of limitations running against the IRS. The court reasoned that the failure of the IRS agent and attorney to forward copies of Seaview's 2001 Form 1065 to the Ogden Service Center according to IRS policy did not relieve Seaview of its return filing obligations. Judge Waterford concluded:

> Because Seaview did not meticulously comply with the regulation's place-for-filing requirement, it is not entitled to claim the benefit of the three-year limitations period. Having never properly filed its return, Seaview is instead subject to the provision allowing taxes attributable to partnership items to be assessed "at any time."

Dissenting opinion of Judge Bumatay. Judge Bumatay dissented, arguing that the majority's decision "throws our tax system into disarray" by allowing "bureaucrats," not law, to control when a return filing starts the statute of limitations running against the IRS. Judge Bumatay reasoned that, in the absence of clear regulations or other published guidance, the IRS should be bound by its stated policy directing IRS personnel to forward "accepted" but delinquent returns to the appropriate IRS Service Center. Therefore, in Judge Bumatay's view, a late partnership return should be considered "filed" for statute-of-limitations purposes

> when (1) an IRS representative authorized to obtain and receive delinquent returns informs a partnership that a tax return is missing and requests that tax return, (2) the partnership responds by giving the IRS representative the tax return in the manner requested, and (3) the IRS representative receives the tax return.

5. Better be aware of your time zone when you e-file your Tax Court petition, says the Tax Court. A petition e-filed at 11:05 p.m. central time, which is 12:05 a.m. eastern time, was late and the Tax Court therefore had no jurisdiction to hear the matter. Nutt v. Commissioner, 160 T.C. No. 10 (5/2/23). The taxpayers in this case received a notice of deficiency with respect to tax year 2019. The last day of the 90-day period specified by § 6213(a) within which the taxpayers could challenge the notice of deficiency by filing a petition in the U.S. Tax Court was July 18, 2022. The taxpayers, who resided in Alabama, e-filed their petition at 11:05 p.m. central time on July 18. The IRS moved to dismiss for lack of jurisdiction on the basis that the taxpayers had not filed their petition by the last day of the 90-day period specified by § 6213(a). The Tax Court (Judge Buch) agreed with the government and granted the motion to dismiss. The court reasoned that "a petition is ordinarily 'filed' when it is received by the Tax Court in Washington, D.C." In this case, the court observed, the Tax Court, which is in the Eastern time zone, had received the taxpayers' petition at 12:05 a.m. on July 19, which was one day late. Further, the court observed, the "timely mailing" rule of § 7502(a) does not apply to petitions filed electronically:

> Under section 7502(a), a document that is mailed before it is due but received after it is due is deemed to have been received when mailed. But that rule applies only to documents that are delivered by U.S. mail or a designated delivery service. I.R.C. § 7502(a)(1), (f). Because an electronically filed petition is not delivered by U.S. mail or a designated delivery service, the exception of section 7502 does not apply.

If the timely mailing rule does not apply, the court stated, then a taxpayer's petition is filed when it is received by the Tax Court. In this case, the court reasoned, although it was still July 18 where the taxpayers resided and where they e-filed their petition, it was July 19 in the Eastern time zone and their petition therefore was filed one day late. Accordingly, the court granted the government's motion to dismiss for lack of jurisdiction.

- *Observation*: the court's holding could work to the advantage of a taxpayer who resides abroad. (Keep in mind that taxpayers residing abroad normally have 150 days (rather than 90) to file their petitions.) If a U.S. citizen resides, say, in England, and the last day to file the petition is July 18, then, assuming a 5-hour time difference, the taxpayers presumably would have

until 4:59 a.m. on July 19 to e-file their petition because the petition would be received by the Tax Court in the eastern time zone at 11:59 p.m. on July 18.

6. This promoter was SOL because there is no SOL for promoter penalties. Crim v. Commissioner, 66 F.4th 999 (D.C. Cir. 5/2/23) *aff'g* T.C. Memo. 2021-117. The taxpayer-promoter in this case was convicted of certain tax crimes in 2008 and sentenced to prison, where he remained until his release in 2014. In 2010 and within the three-year limitations period on assessment provided by § 6501, the IRS assessed penalties against the taxpayer under IRC § 6700 (promoting abusive tax shelters). Then, in 2011, the IRS recorded a Notice of Federal Tax Lien ("NFTL") against the taxpayer's California property and delivered to the taxpayer a Letter 3172, Notice of Federal Tax Lien Filing and Your Right to a Hearing ("lien notice"). The letter instructed the taxpayer to submit his request for a collection due process ("CDP") hearing by December 30, 2011. The taxpayer did not respond to the lien notice and did not request a CDP hearing. The IRS then suspended collection activities against the taxpayer while he was incarcerated. Next, in 2017, approximately three years after the taxpayer was released from prison but within the ten-year collection period of § 6502, the IRS issued a notice of determination to the taxpayer sustaining the collection action and delivered a Letter 1058, Notice of Intent to Levy and Your Right to a Hearing ("levy notice") relating to the § 6700 penalties. Through his representative, the taxpayer requested a CDP hearing. In the CDP hearing, the IRS Settlement Officer issued a notice of determination upholding the proposed collection action. The taxpayer challenged this determination by filing a petition in the Tax Court. The taxpayer first filed a motion to recuse and disqualify all Tax Court judges on separation of powers grounds. The Tax Court denied that motion in July 2019. Next, in December 2019, the IRS filed a motion for summary judgment, and the taxpayer filed a cross-motion for summary judgment arguing alternatively that the statute of limitations had run against the IRS under both § 6501 (three-year limit on assessment) and § 6502 (ten-year limit on collection). The Tax Court (Judge Lauber) decided in favor of the IRS and issued its opinion sustaining the IRS's collection actions in October 2021. The taxpayer appealed to the D.C. Circuit.

Appeal: On appeal to the D.C. Circuit, the taxpayer again made his separation of powers and statute of limitations arguments. The D.C. Circuit, in an opinion by Judge Rogers, ruled two-to-one against the taxpayer on both arguments. We omit discussion of the taxpayer's separation of powers argument. Concerning the taxpayer's statute of limitations argument, Judge Rogers held for the IRS noting that the D.C. Circuit is joining the Second, Fifth, and Eighth Circuits in holding that § 6501 does not apply to the assessment of promoter penalties under § 6700. *See Barrister Assocs. v. United States*, 989 F.2d 1290, 1296-97 n.1 (2d Cir. 1993); *Sage v. United States*, 908 F.2d 18, 24-25 (5th Cir. 1990); *Lamb v. United States*, 977 F.2d 1296, 1296-97 (8th Cir. 1992). According to Judge Rogers, the primary reason that the three-year limitation on *assessment* under § 6501 does not apply is because the § 6700 penalty turns on the promoter's conduct, *not the filing of a return by the promoter's client*. The taxpayer also made a statute of limitations argument under 28 U.S.C. 2462 which imposes a five-year limitation period on any action to enforce a "civil fine, penalty, or forfeiture." With regard to this argument, Judge Rogers agreed with the Second and Eighth Circuits that 28 U.S.C. 2462 does not apply to § 6700 penalties because Congress "otherwise provided" for the ten-year limitation on *collection* in § 6502. *See Capozzi v. United States*, 980 F.2d 872, 874-75 (2d Cir. 1992); *Lamb v. United States*, 977 F.2d 1296 at 1297 (8th Cir. 1992). The D.C. Circuit thus upheld the Tax Court's summary judgment in favor of the IRS and against the taxpayer.

Dissenting opinion of Judge Walker. In a dissenting opinion, Judge Walker indicated that he would remand the case to the Tax Court for further proceedings because he believed that the taxpayer's statute-of-limitations argument "has some merit." Judge Walker wrote: "Rather than deciding, as the majority does, that no return can ever trigger § 6501(a)'s statute of limitations in a tax-shelter-promotion case, I would let the Tax Court determine, on a case-by-case basis, whether a tax return has triggered the limitations clock."

7. The common-law mailbox rule has been displaced by regulations, says the Fourth Circuit, but the taxpayer nevertheless plausibly alleged that his claim for refund was

physically delivered to the IRS. Pond v. United States, 69 F.4th 155 (4th Cir. 5/26/23). The IRS audited the taxpayer's 2012 return. The audit revealed that the taxpayer was entitled to a refund but the IRS mistakenly sent the taxpayer a letter stating that he owed additional tax and interest, which he paid. After the taxpayer's accountant discovered the error, the taxpayer mailed a claim for refund for 2012 and, in the same envelope, mailed an amended return for 2013 claiming a refund for 2013 as a result of certain adjustments to his 2012 return. The taxpayer mailed the envelope containing the claims for refund for 2012 and 2013 by first class mail. After a great deal of effort on the taxpayer's part, the IRS issued the refund for 2012. But the IRS took the position that it had never received the taxpayer's claim for refund for 2013. The taxpayer brought this action for a refund in the U.S. District Court. Under § 7422(a), the jurisdiction of both U.S. District Courts and the U.S. Court of Federal Claims to hear tax refund actions is limited to those cases in which the taxpayer has "duly filed" a claim for refund with the IRS. The issue in this case was how the taxpayer could prove that he had filed the necessary timely refund claim for 2013.

The taxpayer argued that he could rely on the so-called common-law mailbox rule developed and applied by some courts. Under the narrow version of this rule, if a taxpayer can show that a document was actually delivered, but can't prove precisely when delivery occurred, a court can presume that physical delivery occurred within the ordinary time after mailing. Under a broader version of this rule adopted by some courts, proof of proper mailing (including by testimonial or circumstantial evidence) gives rise to a rebuttable presumption that the document was physically delivered to the addressee in the time the mailing would ordinarily take to arrive. In other words, the narrow version requires the taxpayer to prove delivery and assists the taxpayer only in establishing the time of delivery. The broader version of the rule requires the taxpayer only to prove timely mailing and, if timely mailing occurred, gives rise to a rebuttable presumption that the document was delivered.

The government moved to dismiss the taxpayer's refund action for lack of jurisdiction and argued that the common-law mailbox rule, the court held, has been displaced by § 7502. Under § 7502(a) (which reflects the narrower version of the common-law mailbox rule), the postmark stamped on the cover in which a return or claim is mailed is deemed to be the date of delivery if the return or claim (1) is deposited in the mail in the United States within the time prescribed for filing in a properly addressed, postage prepaid envelope or other appropriate wrapper and bears a postmark date that falls within the time prescribed for filing, and (2) is delivered by United States mail after the prescribed time for filing to the agency with which it is required to be filed. In § 7502(c)(1), the statute also reflects the broader version of the common law mailbox rule and provides that, if the return or claim is mailed by United States registered mail, the date of registration is treated as the postmark date and the registration is prima facie evidence that the return or claim was delivered to the agency to which it was addressed. Section 7502(c)(2) authorizes the Secretary of the Treasury to issue regulations providing the same treatment of returns or claims sent by certified mail, which Treasury and the IRS have done. *See* Reg. § 301.7502-1(c)(2). Section 301.7502-1(e)(2)(i) of the regulations further provides that, except for direct proof of actual delivery, proof of proper use of registered or certified mail (or a designated private delivery service) is the *exclusive means* to establish prima facie evidence of delivery and that "[n]o other evidence of a postmark or of mailing will be prima facie evidence of delivery or raise a presumption that the document was delivered."

The Fourth Circuit agreed with the IRS that the common-law mailbox rule has been displaced by § 7502. Because the taxpayer had not sent his claims for refund by registered or certified mail, he could not rely on the presumption of delivery provided by § 7502(c). In reaching this conclusion, the court did *not* give deference to Reg. § 301.7502-1(e)(2)(i) under the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded that the statute was not ambiguous on this question (*Chevron* step one) and that giving deference to the regulation was therefore unnecessary.

According to the Fourth Circuit, however, this did not end the inquiry:

> Is Pond out of luck just because he cannot rely on a *presumption* of delivery? No. He can still proceed if he has plausibly alleged that his claim was physically delivered to the IRS.

The court concluded that the taxpayer had plausibly alleged that his claim was physically delivered to the IRS and had supported his claim with three factual allegations. The taxpayer had alleged: (1) that the envelope containing the 2013 claim was postmarked on a specific date, which suggests that the document made it to its destination; (2)that his 2012 and 2013 claims were sent in a single envelope, and the IRS paid his 2012 claim; and (3) that the letter he received from the IRS denying his 2013 claim listed the "date of claims received" as a specific date.

Therefore, according to the Fourth Circuit, the District Court, in ruling on the government's motion to dismiss, should have drawn all reasonable inferences in the light most favorable to the taxpayer. The District Court had not done so and therefore erred in granting the government's motion. The court remanded for further proceedings.

- *Use separate envelopes, and for God's sake, use registered or certified mail when a deadline is approaching!* This decision provides two valuable lessons to those filing documents with the IRS when a deadline is approaching. First, although it might be easier to send multiple filings in a single envelope, doing so runs the risk that the IRS will perceive the envelope as containing only one item. It is much better practice to mail one item per envelope. Second, if a deadline is approaching, it is imperative to send the document to the IRS using registered or certified mail. Doing so will provide prima facie evidence of mailing and will give rise to a statutory presumption that the document was delivered.

8. Better mind the clock too! A petition e-filed *eleven seconds* after midnight is late, so the Tax Court lacks jurisdiction to hear the case. Sanders v. Commissioner, 160 T.C. No. 16 (6/20/23). The 90-day deadline under § 6213 for this pro se taxpayer to file a petition in the Tax Court was midnight on December 12, 2022. The Tax Court's DAWSON e-filing system was available and fully operational at all relevant times on December 12, 2022, during which the taxpayer sought to e-file his petition. The taxpayer initially attempted to use his mobile telephone to e-file his petition on the evening of December 12, 2022; however, the taxpayer encountered technological problems using his mobile telephone. Next, after gaining access to a computer shortly before midnight, the taxpayer logged into the Tax Court's DAWSON e-filing system at 11:57 p.m. on December 12, 2022, and began the e-filing process. Several steps must be completed under the DAWSON system to e-file, and the taxpayer did not complete those steps prior to midnight. In fact, due to no fault of the DAWSON system, the upload process for the taxpayer's e-filed petition did not begin until 12:00:09 am on December 13, 2022, and the petition was not electronically received by the Tax Court until 12:00:11 am on December 13, 2022, eleven seconds late. Because the taxpayer's petition was filed eleven seconds late, the IRS filed a motion to dismiss for lack of subject matter jurisdiction. The taxpayer objected, arguing that the Tax Court should treat his petition as timely filed when the taxpayer logged into the DAWSON system at 11:57 pm and began the filing process. Essentially, the taxpayer argued that logging into the DAWSON e-filing system at 11:57 p.m. on December 12, 2022, to meet the 90-day deadline under § 6213 was equivalent to timely mailing a petition prior to midnight on December 12, 2022, under the special mailbox rule of § 7502. The Center for Taxpayer Rights, represented by the Tax Clinic at the Legal Services Center of Harvard Law School, filed an amicus brief supporting the taxpayer's position. The Tax Court (Judge Buch) nonetheless ruled that e-filing a petition to meet the 90-day deadline under § 6213 is not equivalent to mailing a petition under § 7502 prior to the 90-day deadline. Judge Buch reasoned that the mailbox rule of § 7502 is a limited exception to the general rule that a Tax Court petition is not filed until it is received, citing *Nutt v. Commissioner*, 160 T.C. No. 10 (5/2/23), discussed above in this outline. Furthermore, Judge Buch determined that another special rule under § 7451(b) that tolls the deadline for filing a Tax Court petition when "a filing location is inaccessible or otherwise unavailable to the general public" did not apply because the DAWSON system was functioning normally at all relevant times on December 12, 2022. According to Judge Buch, the courts have consistently held that "inaccessibility" under § 7451(b) does not extend to

"user error or technical difficulties on the user's side." Finally, Judge Buch noted that equitable tolling does not apply to the filing of a Tax Court petition in a deficiency case. The filing deadline under § 6213 is jurisdictional, and the Tax Court must enforce it "regardless of equitable considerations."

9. If I'm high on cannabis and forget the 30-day deadline, will "equitable tolling" get me a few extra days to file my collection due process hearing request with IRS Appeals? Maybe. Organic Cannabis Foundation, LLC v. Commissioner, 161 T.C. No. 4 (9/27/23). Ala *Boechler*, the Tax Court, in a reviewed opinion (14-0-3), introduces "equitable tolling" to the 30-day deadline under § 6320(a)(3)(B) for requesting a collection due process ("CDP") hearing with IRS Appeals, overruling *Kennedy v. Commissioner*, 116 T.C. 255 (2001). Recall that in *Boechler, P.C. v. Commissioner,* 596 U.S. 199, (2022), the Supreme Court of the United States held that the 30-day period specified in § 6330(d)(1) for requesting *judicial* review in the Tax Court of a notice of determination following a CDP hearing with IRS Appeals is *not* jurisdictional and *is* subject to equitable tolling. In this case, the taxpayer missed the 30-day deadline in another provision, § 6320(a)(3)(B), which permits a taxpayer to request an *administrative* hearing with IRS Appeals after receiving a notice of the filing of federal tax lien ("NFTL") under § 6323(a). More specifically, the taxpayer, a single-member LLC subsidiary that had elected subchapter C status, had unpaid tax for three years: 2010, 2011, and 2018. The IRS issued notices of federal tax lien filings to the taxpayer for all three years. For tax years 2010 and 2011, the taxpayer timely requested a CDP hearing with IRS Appeals within the 30-day period under § 6320(a)(3)(B). For some reason, however, the taxpayer's § 6320(a)(3)(B) request for a CDP hearing with IRS Appeals for 2018 was filed one day late. IRS Appeals determined that the taxpayer's hearing request for 2018 was untimely and provided an equivalent hearing under Treas. Reg. § 301.6320-1(i)(1). Ultimately, IRS Appeals issued an adverse notice of determination to the taxpayer for 2010 and 2011 and an adverse decision letter for 2018. The taxpayer then filed a petition in Tax Court seeking review for all three years. In response, the IRS moved to dismiss the taxpayer's Tax Court petition with respect to 2018 for lack of jurisdiction, arguing that IRS Appeals did not make a "determination" for the Tax Court to review under § 6330(d)(1). See *Kennedy v. Commissioner*, 116 T.C. 255 (2001). The taxpayer argued that the 30-day period for requesting a CDP *administrative* hearing with IRS Appeals under § 6320(a)(3)(B) should be equitably tolled, similar to SCOTUS's ruling in *Boechler* under § 6330(d)(1) for a *judicial* hearing in Tax Court. The Tax Court, in a thirty-one-page opinion written by Judge Goeke reached the following holdings:

- IRS Appeals has authority under § 6320 to hold CDP hearings and issue a notice of determination even when a taxpayer files a request after the 30-day period of § 6320(a)(3)(B).
- The Regulations under § 6320 do not preclude the application of the doctrine of equitable tolling with respect to the 30-day period.
- The 30-day period is subject to equitable tolling where the circumstances so warrant.
- *Kennedy v. Commissioner*, 116 T.C. 255 (2001), is overruled to the extent that it holds that IRS Appeals is not authorized under § 6320(a)(3)(B) to waive the 30-day period and issue a notice of determination (instead of a decision letter after a CDP equivalent hearing) where circumstances warrant application of the doctrine of equitable tolling.

The Tax Court then remanded the case to IRS Appeals to determine if the taxpayer's circumstances warranted equitable tolling.

Concurring and dissenting opinion of Judge Jones. In a concurring and dissenting opinion by Judge Jones (joined by Judges Buch and Foley), Judge Jones dissented from the majority's holding that the Regulations under § 6320 do not preclude equitable tolling and would have held for the IRS and against the taxpayer on that basis.

10. Despite the availability of electronic filing, if the office of the clerk of the Tax Court is inaccessible on the last day for filing a Tax Court petition, then under § 7451(b), the 90-day period for filing the petition is tolled for the number of days of inaccessibility plus an additional 14 days. Sall v. Commissioner, 161 T.C. No. 13 (11/30/23). The taxpayer received a notice of deficiency that stated the last day to file a petition with the Tax Court was Friday, November 25, 2022, which was the day after Thanksgiving. The Tax Court was administratively closed on that day. The taxpayer, who resided in Colorado, mailed his petition to the court on Monday, November 28, 2022. The court received the petition on December 1, 2022. The IRS filed a motion to dismiss for lack of jurisdiction on the basis that the taxpayer had filed the petition late. The Tax Court (Judge Buch) held that the taxpayer had timely filed the petition and denied the IRS's motion. Section 7451(b), added to the Code in 2021 by the Infrastructure Investments and Jobs Act, tolls the period for filing a Tax Court petition if a filing location is inaccessible. Section 7451(b)(1) provides:

> Notwithstanding any other provision of this title, in any case (including by reason of a lapse in appropriations) in which a filing location is inaccessible or otherwise unavailable to the general public on the date a petition is due, the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days.

Section 7451(b)(2) defines the term "filing location" as either "(A) the office of the clerk of the Tax Court, or (B) any on-line portal made available by the Tax Court for electronic filing of petitions." The court reasoned that, because the office of the clerk of the Tax Court, which is a filing location, was inaccessible on November 25, 2022 (the date the petition was due), § 7451(b) tolled the period for filing the taxpayer's petition by one day (the period of inaccessibility) plus an additional 14 days. Accordingly, the taxpayer had until December 10, 2022, to file the petition. Further, because December 10, 2022, was a Saturday, under § 7503, the taxpayer had until Monday, December 12, 2022, to file the petition. The taxpayer's petition was filed on December 1, 2022, the date on which it was received by the Tax Court, and therefore was timely. Although the taxpayer could have filed the petition at any time through Dawson, the court's electronic filing system, the court concluded that, because "a fling location" was inaccessible on November 25, 2022, "the availability of the Court's electronic filing system is immaterial."

11. The limitations period for the IRS to assess the 6% excise tax imposed by § 4973(a) on excess contributions to an IRA is six years if the taxpayer does not file Form 5329, but only for returns filed on or after December 29, 2022. For returns filed before that date without Form 5329, the limitations period never begins to run. Couturier v. Commissioner, 162 T.C. No. 4 (2/28/24) (reviewed). In this case, the taxpayer, a corporate executive, participated in several deferred compensation arrangements. These included shares in an employee stock ownership plan (ESOP) (a qualified retirement plan) and several compensatory plans, none of which was a qualified plan. In 2004, as part of a corporate reorganization, the taxpayer accepted a $26 million buyout from his company, which took the form of a $12 million cash payment to the taxpayer's IRA and a $14 million promissory note payable to his IRA, which the company satisfied in 2005. On his 2004 federal income tax return, he characterized the $26 million as a tax-free "rollover contribution" to his IRA. He left blank line 59, "Additional tax on IRAs, other qualified retirement plans, etc." Similarly, he filed his tax returns for 2005 through 2014 leaving blank line 59. He also did not attach to any of his returns Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts."

The IRS audited the taxpayer and ultimately issued two notices of deficiency, one for 2004 through 2008 and another for 2019 through 2014. The IRS asserted that, of the $26 million contributed to the taxpayer's IRA, $25.1 million was attributable to his relinquishment of his rights in the non-ESOP deferred compensation plans, which were not eligible for treatment as a tax-free rollover. The IRS's position in the notices of deficiency was that this $25.1 million was an "excess contribution" subject to the 6% excise tax of § 4973(a). Further, under § 4973(b)(2), the excise tax continues to apply for future years until the original excess contribution is distributed to the

taxpayer and included in income. Therefore, according to the IRS, the taxpayer owed for the years involved an excise tax in the aggregate amount of approximately $8.5 million. The IRS issued the two notices of deficiency on June 16, 2016. In response to the notices of deficiency, the taxpayer petitioned the Tax Court.

The taxpayer filed a motion for summary judgment in which he argued that the period of limitations during which the IRS could assess the excise tax imposed by § 4973(a) had expired for the years 2004-2008 before the IRS issued the notice of deficiency for those years on June 16, 2016. (The taxpayer did not challenge the timeliness of the notice of deficiency for the years 2009-2014.)

Section 6501(a) provides that, subject to various exceptions, any tax imposed must be assessed within three years after the return was filed. For this purpose, § 6501(a) provides that "the term 'return' means the return required to be filed by the taxpayer." If the taxpayer does not file a return, then pursuant to § 6501(c)(3), the tax may be assessed at any time, i.e., there is no limitations period on the IRS's assessment of the tax. In prior decisions, the Tax Court had held that the limitations period for the IRS to assess the excise tax imposed by § 4973(a) begins to run only if the taxpayer files a return that includes sufficient information for the IRS to determine the taxpayer's liability for the excise tax. Specifically, the Tax Court previously had held that a taxpayer's filing of a return on Form 1040 does not start the running of the limitations period for the IRS to assess the § 4973(a) excise tax unless the taxpayer files Form 5329, "Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts," or provides the required information elsewhere on Form 1040. *Paschall v. Commissioner*, 137 T.C. 8, 16 (2011); *Mazzei v. Commissioner*, 150 T.C. 138, 149 n.15 (2018), *rev'd on other grounds*, 998 F.3d 1041 (9th Cir. 2021).

Section 6501(*l*)(4), enacted in 2022 as part of the Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, provides:

> (A) For purposes of any tax imposed by section 4973 or 4974 in connection with an individual retirement plan, the return referred to in this section shall include the income tax return filed by the person on whom the tax under such section is imposed for the year in which the act (or failure to act) giving rise to the liability for such tax occurred.
>
> …
>
> (C) In any case in which the return with respect to a tax imposed by section 4973 is the individual's income tax return for purposes of this section, subsection (a) shall be applied by substituting a 6-year period in lieu of the 3-year period otherwise referred to in such subsection.

The effect of § 6501(*l*)(4) is that a three-year limitations period applies if the taxpayer files Form 5329, but a six-year limitations period will apply if the taxpayer files a return on Form 1040 but fails to attach Form 5329. When Congress enacted § 6501(*l*)(4), it specified that the amendment "shall take effect on the date of the enactment of this Act," which was December 29, 2022.

The question before the court was whether § 6501(*l*)(4) applied retroactively. The taxpayer filed timely returns on Form 1040 for the years 2004-2008 but, as discussed earlier, failed to attach Form 5329 to any of the returns. If § 6501(*l*)(4) applied retroactively, then the IRS had six years from the date of filing within which to assess the § 4973(a) excise tax and the notice of deficiency for 2004-2008, issued on June 16, 2016, was untimely.

In a reviewed opinion (7-5-2) by Judge Lauber (joined by Judges Kerrigan, Nega, Pugh, Ashford, Copeland, and Weller), the Tax Court held that § 6501(*l*)(4) applies prospectively only and therefore did not bar the IRS's assessment of the § 4973(a) excise tax for the taxpayer's 2004-2008 taxable years. In reaching this conclusion, the court rejected the taxpayer's argument that Congress intended § 6501(*l*)(4) to apply to all disputes pending with the IRS as of the date of enactment.

When Congress had previously amended § 6501 to apply to returns filed before the date of enactment, the court observed, it had said so explicitly in the relevant effective date provision. Congress failed to do so in this instance. The most natural reading of the effective date provision for § 6501(*l*)(4), the court held, was that the new rule applies to returns filed on or after the effective date of December 29, 2022:

> In short, section 6501(*l*)(4) specifies the consequences of filing tax returns. Because Congress provided that this amendment "shall take effect on the date of the enactment," we think the amendment is logically read to apply to tax returns filed on or after the date of enactment.

Nevertheless, the court assumed for the sake of argument that the effective date provision was ambiguous and considered whether application of § 6501(*l*)(4) as the taxpayer proposed would have a retroactive effect. A statute has retroactive effect, the court stated, "if it 'would impair rights a party possessed when he acted.'" 162 T.C. No. 4, at 11 (quoting *Landgraf v. USI Film Products*, 511 U.S. 244, 280 (1994)). If a statute would have retroactive effect, the court observed, a court must determine whether "clear congressional intent" militates in favor of retroactive application. In making this determination, a court must apply a presumption that Congress did not intend for a statute to apply retroactively if the statute affects substantive rights because doing so "would contravene principles of fair notice, reasonable reliance, and settled expectations." In this case, the court held, the taxpayer's interpretation of § 6501(*l*)(4) would have retroactive effect and the presumption against retroactivity applied because applying the statute retroactively would alter the IRS's substantive rights to assess tax. When the IRS issued the notice of deficiency for 2004-2008 on June 16, 2016, the court noted, the notice was timely because, under the Tax Court's existing interpretation of § 6501, the taxpayer's failure to file Form 5329 meant that the limitations period on assessment never began to run. Further, pursuant to § 6503, the taxpayer's filing of a Tax Court petition suspended the running of the limitations period on assessment until 60 days after the Tax Court's decision became final. Applying § 6501(*l*)(4) as the taxpayer proposed, the court concluded, would contravene principles of fair notice, reasonable reliance, and settled expectations.

In summary, the court held that § 6501(*l*)(4) applies prospectively only and therefore did not bar the IRS's assessment of the § 4973(a) excise tax for the taxpayer's 2004-2008 taxable years.

Concurring opinion of Judge Toro. In a very lengthy concurring opinion, Judge Toro (joined by Judge Greaves and joined in part by Judges Buch and Urda) concurred in the result but heavily criticized the court's opinion. In Judge Toro's view, § 6501(*l*)(4) focuses on assessment of tax and can apply to returns filed before December 29, 2022, the date of enactment. Judge Toro concluded:

> Under my reading of section 313(b) of the Act, the Commissioner no longer possesses the authority to assess any taxes imposed by section 4973 if the taxpayer filed an income tax return more than six years ago (or was not required to file such a return, as provided in section 6501(l)(4)(B)) and a notice of deficiency with respect to those taxes is not issued within the six-year period (or the three-year period, for a taxpayer who was not required to file an income tax return). As relevant here, the only exception to this rule is for taxpayers (like Mr. Couturier) to whom notices of deficiency were already issued before December 29, 2022, and whose circumstances are governed by section 6503(a)(1).

Dissenting opinion of Judge Foley. In a brief dissenting opinion, Judge Foley (joined by Judge Marshall) argued that, because § 6501(*l*)(4) became effective on December 29, 2022, the IRS was required to send a notice of deficiency within six years after the taxpayer filed his returns for 2004-2008. Because the IRS failed to do so, he argued, the court should grant the taxpayer's motion for summary judgment.

F. Liens and Collections

G. Innocent Spouse

1. Better clean up those social media posts featuring sailboats or ski vacations before filing a petition in the Tax Court seeking innocent spouse relief. Such posts are "newly discovered evidence" within the meaning of § 6015(e)(7) and therefore admissible even if they existed before the taxpayer requested innocent spouse relief. Thomas v. Commissioner, 160 T.C. No. 4 (2/13/23). The Taxpayer First Act, Pub. L. No. 116-25, § 1203, enacted in 2019, amended Code § 6015 to clarify the scope and standard of review in the Tax Court of any determination with respect to a claim for innocent spouse relief, i.e., any claim for relief under § 6015 from joint and several liability for tax liability arising from a joint return. Among other changes, the legislation added § 6015(e)(7), which provides:

> Any review of a determination made under this section shall be reviewed de novo by the Tax Court and shall be based upon—
>
> A. the administrative record established at the time of the determination, and
>
> B. any additional newly discovered or previously unavailable evidence.

The amendment was generally consistent with the Tax Court's holding in *Porter v. Commissioner*, 132 T.C. 203 (2009), but resolved conflicting decisions in cases in which the taxpayer sought equitable innocent spouse relief under § 6015(f), some of which had held that the Tax Court's review was limited to the administrative record and that the Tax Court's standard of review was for abuse of discretion.

Procedural history. In this case, the taxpayer filed joint returns with her husband for the years 2012, 2013, and 2014 but some of the tax liability reported on those returns remained unpaid. Her husband died in 2016. The taxpayer submitted to the IRS a request for innocent spouse relief for those years, which the IRS denied. The taxpayer responded by filing a petition in the Tax Court seeking review pursuant to § 6015(e) and asking the court to determine that she was entitled to innocent spouse relief under § 6015(f). At trial, the IRS sought to introduce into evidence Exhibit 13-R, which consisted of a series of blog posts from the taxpayer's personal blog. These posts ranged in date from November 2, 2016, to January 5, 2022. The taxpayer moved to strike all blog posts that existed before September 8, 2020, the date on which the taxpayer submitted her administrative request for innocent spouse relief, on the ground that the posts had not been in the administrative record and were not "newly discovered evidence" within the meaning of § 6015(e)(7).

Tax Court's analysis. In a unanimous, reviewed opinion by Judge Toro, the Tax Court concluded that the blog posts were "newly discovered evidence" within the meaning of § 6015(e)(7). The court began with the language of the statute and concluded that § 6015 does not define the term "newly discovered evidence." Accordingly, the court reasoned, "[w]e must therefore discern the ordinary meaning of that phrase in 2019." The court turned to the dictionary definition of the phrase "*newly discovered*" and concluded that the ordinary meaning of the phrase as of 2019 "was 'recently obtained sight or knowledge of for the first time.'" The court concluded that the blog posts the IRS sought to introduce into evidence were "newly discovered evidence" because the IRS had first discovered them by searching the internet after the taxpayer had filed her petition in the Tax Court. In reaching this conclusion, the court rejected the taxpayer's argument that § 6015(e)(7)(B) should be read to incorporate an additional limitation similar to that in Federal Rule of Civil Procedure (FRCP) 60(b)(2). Rule 60(b)(2) provides that a court can relieve a party from a final judgement, order, or proceeding on the basis of "newly discovered evidence *that, with reasonable diligence, could not have been discovered in time to move for a new trial.*" (emphasis added). The taxpayer argued that the IRS could have discovered the blog posts that existed before September 8, 2020, once she had submitted her administrative request for innocent spouse relief on that date and that they therefore should not be considered "newly discovered evidence." The court rejected this argument. The court reasoned that Congress had not included a reasonable

diligence standard in the language of § 6015(e)(7)(B) and, in fact, the statute's use of the phrase "*any* additional newly discovered evidence" counseled against reading such a limitation into the statute. The court also observed that the statute's specification that the Tax Court's standard of review of an IRS determination concerning innocent spouse relief is de novo (rather than an abuse-of-discretion standard) supported "the conclusion that evidence unknown to a participant in the innocent spouse administrative proceeding should be admissible if that participant (now a party in our Court) offers it in the proceedings before us." Finally, the court noted that § 6015(e)(7) applies in a context entirely different from that of FRCP 60(b)(2). When a party moves for relief from a judgment under FRCP 60(b)(2), both parties have had an opportunity to conduct discovery and introduce evidence at trial. In contrast, "in the context of section 6015(e)(7), the Court considers a case for the first time following a relatively limited administrative proceeding." Accordingly, the court concluded that the blog posts offered into evidence by the IRS were admissible.

- *Concurring opinion of Judge Buch.* In a concurring opinion joined by Judges Ashford and Copeland, Judge Buch emphasized that, although the court's holding was faithful to the language of § 6015(e)(7), that language "may not have captured what Congress intended." Specifically, Judge Buch reasoned that the statute's language permitting the introduction of "newly discovered or previously unavailable evidence" might be a one-way street that benefits only the government. Judge Buch gave an example of a spouse who is abused by her husband, posts about the abuse on social media, and submits an administrative request for innocent spouse relief that does not mention the social media posts. Such a spouse might be precluded from introducing the social media posts at trial in a subsequent Tax Court proceeding because she created the posts and therefore it might be difficult for her to establish that the posts were "newly discovered or previously unavailable" to her. This problem, he observed, is not limited to social media posts but could apply to "a vast array of evidence" that could be helpful to a requesting spouse to prove entitlement to innocent spouse relief.

a. When the court's findings of fact refer to trips to New York for a birthday celebration, trips to Rome, Paris, and Florence, a trip to Napa for wine tastings, purses from Dior and Kate Spade, a 5-carat diamond ring, a home in an affluent suburb of San Francisco, and a vacation home in Lake Tahoe, you don't need to read further to know that the court denied the taxpayer's request for innocent spouse relief. Thomas v. Commissioner, 162 T.C. No. 2 (1/30/24). As discussed above, the taxpayer filed joint returns with her husband for the years 2012, 2013, and 2014 but some of the tax liability reported on those returns remained unpaid. Her husband died in 2016. The taxpayer submitted to the IRS a request for innocent spouse relief for those years, which the IRS denied. The taxpayer responded by filing a petition in the Tax Court seeking review pursuant to § 6015(e) and asking the court to determine that she was entitled to innocent spouse relief under § 6015(f). Following a trial, the Tax Court (Judge Toro) issued this opinion, which addresses two basic issues: (1) whether certain letters from third parties that the taxpayer submitted to the IRS as part of her administrative request for innocent spouse relief had to be excluded from evidence as inadmissible hearsay, and (2) whether the taxpayer was entitled to innocent spouse relief under § 6015(f).

Whether portions of the administrative record were excluded as hearsay. With respect to the first issue, the court held that the letters the taxpayer had submitted to the IRS with her administrative request for innocent spouse relief were admissible and rejected the Service's argument that the letters were inadmissible hearsay. The letters the taxpayer submitted had been written by two of her friends. The court began with the proposition that "[t]he rule against hearsay applies only when it is not supplanted by federal statute, other rules of the Federal Rules of Evidence, or any rules prescribed by the Supreme Court." In this case, the court reasoned, a federal statute, § 6015(e)(7), supplanted the rule against hearsay. Section 6015(e)(7) provides:

> Any review of a determination made under this section shall be reviewed de novo by the Tax Court and shall be based upon—
>
> A. the administrative record established at the time of the determination, and

B. any additional newly discovered or previously unavailable evidence.

Because § 6015(e)(7) directs the court to base its determination on the administrative record, and because the administrative record included the letters the taxpayer had submitted, the court concluded, "[t]o apply the rule against hearsay to exclude these documents from our consideration would undermine Congress's clear direction as articulated in section 6015(e)(7)." The court reviewed analogous situations in which statutes override the rule against hearsay and in which courts reviewing administrative records to determine whether there was an abuse of discretion have admitted evidence that otherwise would have been inadmissible hearsay. Nevertheless, the court cautioned that, "as in a case we review for abuse of discretion, here (where we review de novo) there may be questions as to whether evidence in the administrative record is probative and reliable" and that, in determining the probative value and reliability of evidence, it would "consider indicia of reliability such as whether a document is or contains hearsay."

Eligibility for innocent spouse relief under § 6015(f). Section 4.01 of Rev. Proc. 2013-34, 2013-2 C.B. 297, sets forth seven threshold requirements that apply to all requests for equitable relief under § 6015(f). The parties agreed that the taxpayer satisfied the threshold requirements. Section 4.02 of Rev. Proc. 2013-34 sets forth the conditions under which the IRS will make streamlined determinations granting equitable relief under § 6015(f). A streamlined determination is available if (1) the requesting spouse is no longer married to the non-requesting spouse, (2) the requesting spouse would suffer economic hardship if relief were not granted, and (3) in underpayment cases such as this one, the requesting spouse "did not know or have reason to know that the non-requesting spouse would not or could not pay the underpayment of tax reported on the joint income tax return." The IRS asserted that the taxpayer had not established that she would suffer economic hardship if relief were not granted, and the court agreed. The court reviewed her sources of income and her assets, including a house in an affluent suburb of San Francisco and a vacation home near ski resorts in Lake Tahoe, and concluded that she had not established that she would suffer economic hardship if relief were not granted. Accordingly, the court concluded that she was not eligible for a streamlined determination without reaching the question of whether she knew or had reason to know that the non-requesting spouse would not pay the underpayment of tax. Section 4.03 of Rev. Proc. 2013-34 provides a nonexclusive list of factors for consideration in determining whether a spouse who does not qualify for streamlined relief is nevertheless relieved under § 6015(f) of federal income tax liability resulting from the filing of a joint return. Although Rev. Proc. 2013-34 lists seven equitable factors, the only factors in dispute were whether the taxpayer would suffer economic hardship absent relief, whether she knew or had reason to know that her former husband would not or could not pay the income tax liabilities, and whether she significantly benefited from the underpayment of tax. The court concluded that the taxpayer had not established that she would suffer economic hardship if relief were not granted and that, even if the taxpayer knew or had reason to know that her former husband would not or could not pay the income tax liabilities, this factor was outweighed by the significant benefit to her of the unpaid tax liabilities. In reaching the conclusion that the taxpayer had significantly benefitted from the underpayment of tax, the court took into account her purchase of a luxury vehicle (a 2013 Land Rover), several vacations she took with her daughters to New York, Europe, and Napa Valley, and her blog posts about a green Dior bag she purchased for her daughter's 18th birthday as well as several designer bags she owned herself and about paying a business coach $220 an hour for private sessions.

H. Miscellaneous

1. Surely, it's not constitutional for the government to revoke or refuse to issue an individual's passport just for having a seriously delinquent tax debt? Isn't there some sort of fundamental right to travel? Don't pack your bags just yet. Franklin v. United States, 49 F.4th 429 (5th Cir. 9/15/22). Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015) (FAST Act). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such a certification may petition the Tax Court or bring an action in a U.S. District Court to determine if the certification was made erroneously. § 7345(e)(1). If the Tax Court or U.S. District Court concludes the certification was either made in error or that the IRS has since reversed its certification, the court may order the Secretary of the Treasury to notify the State Department that the certification was erroneous. § 7345(e)(2).

The IRS assessed $421,766 in penalties for the plaintiff's failure to file accurate tax returns and failure to report a foreign trust of which he was the beneficial owner. The IRS began collection efforts in 2018. These included issuing a notice of federal tax lien and levying on his Social Security benefits. Pursuant to § 7345, the IRS issued a notice of certification of a "seriously delinquent tax debt" and notified the Secretary of State that his passport should be revoked. The State Department then revoked his passport. The plaintiff attempted to eliminate his liability by submitting two separate offers-in-compromise for doubt as to liability, both of which were rejected by the IRS. He then brought an action in the U.S. District Court for the Northern District of Texas. Among other claims, he asserted various claims related to the IRS's alleged failure to obtain supervisory approval of the penalties as required by § 6751(b). He also challenged the constitutionality of the State Department's revocation of his passport and argued that the revocation violated his rights under the Fifth Amendment. The District Court dismissed the plaintiff's claims under § 6751(b) for lack of subject matter jurisdiction and concluded that, although it had subject matter jurisdiction over his constitutional claim, that claim did not have merit because the passport-revocation scheme of the FAST Act was constitutional under a rational-basis review.

Section 6751(b) claims. Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Fifth Circuit concluded that the District Court had correctly dismissed the plaintiff's claims for lack of subject matter jurisdiction. Subject to certain exceptions, the full payment rule established by *Flora v. United States*, 362 U.S. 145 (1960), requires that a taxpayer pay the full amount of tax that the IRS seeks to collect and then seek a refund. A federal district court lacks jurisdiction to hear the claims of a taxpayer who seeks a refund of tax but who has not complied with the full-payment rule (or qualified under an exception to it). Further, the Anti-Injunction Act, 26 U.S.C. §7421(a) (AIA), bars lawsuits filed "for the purpose of restraining the assessment or collection of any tax" by the IRS. The Fifth Circuit concluded that each of the plaintiff's claims under § 6751(b) implicitly challenged the validity of the penalties the IRS had assessed and therefore violated the AIA. The court recognized that, in *CIC Services, LLC v. IRS*, 141 S. Ct. 1582 (2021), the U.S. Supreme Court had held that a challenge to a reporting requirement could proceed even if failure to comply with the reporting requirement resulted in penalties. But the Court in *CIC Services*, the Fifth Circuit observed, had reaffirmed that a challenge to the assessment or collection of a tax or penalty is still barred by the AIA. The plaintiff's claims in this case based on the IRS's alleged failure to obtain supervisory approval of the penalties as required by § 6751(b), the court concluded, implicitly challenged the validity of the penalties and were therefore barred by the AIA.

Constitutional claims. The Fifth Circuit also affirmed the District Court's dismissal of the plaintiff's constitutional challenge for failure to state a claim on which relief can be granted. The plaintiff argued that the State Department's revocation of his passport violated his rights under the Due Process Clause of the Fifth Amendment. Specifically, the court concluded that international travel is not a fundamental right that must be reviewed under so-called strict scrutiny. If the court's standard of review were strict scrutiny, then any legislative infringement of a fundamental right must be narrowly tailored to serve a compelling government interest. Instead, the court held, because international travel is not a fundamental right, the constitutionality of § 7345 must be determined under either a rational basis standard of review or under so-called intermediate scrutiny. Under a rational basis standard, the court observed, "the restriction at issue survives as long as it is 'rationally related to a legitimate government interest.'" *Reyes v. N. Tex. Tollway Auth.*, 861 F.3d 558 (5th Cir. 2017); *see also FCC v. Beach Comm'cns, Inc.*, 508 U.S. 307, 313 (1993). Under an intermediate-scrutiny standard, "the challenged restriction 'must serve important governmental objectives and must be substantially related to achievement of those objectives.'" *Craig v. Boren*, 429 U.S. 190 (1976). The Fifth Circuit declined to decide whether the passport-revocation scheme must be judged under rational-basis review or instead intermediate scrutiny because, the court held, even under the higher standard of intermediate scrutiny, the statute is constitutional. The federal government's interest in collecting taxes, the court concluded, "is undoubtedly an important one." The passport-revocation scheme, the court held, is substantially related to achieving the government's objective:

> The passport-revocation scheme is also clearly connected to that goal: delinquent taxpayers will be well-incentivized to pay the government what it is owed to secure return of their passports, and those same taxpayers will find it much more difficult to squirrel away assets in other countries if they are effectively not allowed to legally leave the country.

a. This taxpayer apparently didn't get the memo about *Franklin* or *Ruesch* (see above and below), but regardless, the Tax Court determines that its jurisdiction under § 7345 is limited to deciding whether the IRS's certification is erroneous and does not extend to hearing substantive challenges to assessed taxes or constitutional claims. Adams v. Commissioner, 160 T.C. No. 1 (1/24/23). The taxpayer in this case owed more than $1.2 million in federal income taxes, penalties, and interest accumulated across eight taxable years. The taxpayer failed to file federal income tax returns for the relevant years, and the IRS prepared substitute returns for each year under § 6020(b). The IRS also filed a notice of federal tax lien for each year under § 6323(f) and had notified the taxpayer of his right to a collection due process (CDP) hearing under § 6320. The taxpayer did not request a CDP hearing for any of the years in issue and the time for doing so had passed. The IRS's subsequent collection efforts against the taxpayer failed, so the IRS issued the certification (via the Treasury Department) under § 7345(a) to the Secretary of State for purposes of denying, revoking, or limiting the taxpayer's passport. Later, the taxpayer apparently lost his passport and applied to the State Department for a replacement. The Secretary of State refused to issue a replacement passport due to the outstanding § 7345 certification of the taxpayer's "seriously delinquent tax debt" and so notified the taxpayer. Thereafter, the taxpayer petitioned the Tax Court, as permitted under § 7345(e)(1), to determine if the IRS's certification was erroneous. The taxpayer made two arguments that the IRS's § 7345 certification was erroneous. The taxpayer's first argument was that he did not have a "seriously delinquent tax debt" because "as a matter of law [the IRS] has failed to prove that any of the taxes [for the relevant years] were *properly assessed*." (Emphasis added.) Giving the *pro se* taxpayer the benefit of the doubt, the Tax Court liberally construed the taxpayer's first argument to raise two alternative positions: (1) that he should be allowed to substantively challenge his tax liabilities underlying the § 7345(a) certification in Tax Court or (2) that § 7345 requires the underlying tax liabilities to be "properly assessed," not merely "assessed," before the IRS certification can be issued. The Tax Court (Judge Toro) held that, as determined in ***Ruesch v. Commissioner***, 154 T.C. 289 (6/25/20), *aff'd in part but vacated and remanded in part on other grounds* 25 F.4th 67 (2d Cir. 1/27/22), the Tax Court lacks jurisdiction under § 7345(e)(1) to review the tax liabilities

underlying the certification of a "seriously delinquent tax debt." Moreover, Judge Toro noted that plain language of § 7345(e)(1), which allows the taxpayer to petition the Tax Court, only requires that the tax liability be "assessed" by the IRS. Here, the IRS clearly had "assessed" the tax liabilities against the taxpayer. Furthermore, the taxpayer had ample prior opportunity (either via a deficiency proceeding or a collection due process hearing) to substantively challenge the IRS's assessment. The taxpayer's second argument was identical to the taxpayer's argument in *Franklin v. United States*, 49 F.4th 429 (5th Cir. 9/15/22), but again Judge Toro relied upon the plain language of § 7345(e)(1). Judge Toro reasoned that § 7345(e)(1) does not grant the Tax Court jurisdiction to hear constitutional challenges relating to the refusal of the Department of State to issue a passport. Given its limited jurisdiction, the Tax Court does not have authority over the Secretary of State. Only a federal district court potentially has jurisdiction to hear the taxpayer's constitutional arguments against § 7345 and possibly compel the Department of State to issue a passport notwithstanding the IRS certification. Instead, the Tax Court's jurisdiction is limited, as § 7345(e)(1) provides, to correcting an erroneous IRS certification of a "seriously delinquent tax debt." Judge Toro did note, though, that a constitutional challenge to § 7345 was unsuccessful in *Franklin v. United States*, 49 F.4th 429 (5th Cir. 9/15/22).

b. ♪♫"Let's call the whole thing off."♫♪ Yet another Tax Court reviewed decision concerning IRC § 7345. Pugh v. Commissioner, 161 T.C. No. 2 (8/14/23). In this case under § 7345, the taxpayer applied for renewal of her passport after the IRS had certified (via the Treasury Department) to the Secretary of State that she had a "seriously delinquent tax debt." Accordingly, the Department of State declined to renew the taxpayer's passport. Thereafter, the *pro se* taxpayer petitioned the Tax Court under § 7345(e)(1). After clearing some procedural hurdles, the IRS moved for summary judgment against the taxpayer. The taxpayer never responded to the IRS's motion, even after two separate Tax Court orders were issued for her to do so. Eventually, the taxpayer filed a motion to dismiss her case, but failed to indicate whether the requested dismissal was with or without prejudice. The IRS initially objected to the taxpayer's motion to dismiss, but then consented. The Tax Court (Judge Copeland) construed the taxpayer's motion as one to dismiss without prejudice; however, the court then had to determine whether, as a matter of first impression, a taxpayer is permitted to withdraw without prejudice a petition filed under § 7345(e)(1). On the one hand, Judge Copeland noted that, in deficiency proceedings under § 6213, the Tax Court cannot grant taxpayer motions to dismiss without prejudice. *See Estate of Ming v. Commissioner*, 62 T.C. 519 (1974). On the other hand, Judge Copeland reasoned that, where the Tax Court's jurisdiction has been expanded, taxpayer motions to dismiss without prejudice have been allowed. See, e.g., *Wagner v. Commissioner*, 118 T.C. 330 (2002) (collection due process); *Davidson v. Commissioner*, 144 T.C. 273 (2015) (innocent spouse relief); *Jacobson v. Commissioner*, 148 T.C. 68 (2017) (whistleblower claim). Judge Copeland then looked to the Federal Rules of Civil Procedure for further guidance. The Federal Rules of Civil Procedure generally allow courts to grant motions to dismiss without prejudice unless dismissal would inflict "clear legal prejudice" on the non-moving party. Because the IRS consented to the dismissal, Judge Copeland determined that the IRS would not be harmed, and therefore granted the taxpayer's § 7345(e)(1) motion to dismiss without prejudice. Finally, Judge Copeland ruled that the IRS's prior summary judgment motion was moot and should be dismissed as well.

2. As grandpa said, "The more things change, the more they stay the same." Ann. 2023-11, 2023-17 I.R.B. 798 (4/10/23). The IRS begrudgingly announces Treasury's issuance of proposed regulations, REG–109309–22, Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest, 88 F.R. 21547 (4/11/23), "re-identifying" certain micro-captive insurance arrangements as "listed transactions" under §§ 6111 and 6112. For background, see below.

Background. Previously, both the Sixth Circuit and the Tax Court invalidated certain IRS notices that identified specific transactions as "listed transaction" under §§ 6111 and 6112. Both courts held that the IRS failed to comply with the Administrative Procedures Act ("APA") when issuing the notices in dispute. The Sixth Circuit, in Mann Construction, Inc. v. United States, 27

F.4th 1138 (6th Cir. 3/3/22), invalidated Notice 2007-83, 2007-2 C.B. 960, relating to cash value life insurance trust arrangements. The Tax Court, in Green Valley Investors, LLC v. Commissioner, 159 T.C. No. 5 (11/9/22), invalidated Notice 2017-10, 2017-4 I.R.B. 544, relating to syndicated conservation easements. *Green Valley Investors* was particularly troublesome for the IRS because it was a Tax Court decision and undercut the IRS's longstanding battle against syndicated conservation easement transactions. In response to the Tax Court's holding in *Green Valley Investors*, Treasury issued proposed regulations (complying with the APA) to "re-identify" syndicated conservation easement transactions as "listed transactions." *See* REG-106134-22, Syndicated Conservation Easements as Listed Transactions, 87 F.R. 75185 (12/8/2022). For further discussion, see Bruce A. McGovern and Cassady V. ("Cass") Brewer, *Recent Developments in Federal Income Taxation: The Year 2022*, 76 Tax Law. 645 (2023).

The impetus for Ann. 2023-11. Meanwhile, in *CIC Services, LLC v. IRS*, 592 F.Supp.3d 677 (E.D. Tenn 3/21/22), a federal district court within the Sixth Circuit invalidated Notice 2016-66, 2016-47 I.R.B. 745, relating to the identification of certain micro-captive insurance arrangements as "listed transactions." Consequently, as announced in Ann. 2023-11, Treasury has responded to the district court's holding in *CIC Services*, LLC by issuing proposed regulations "re-identifying" certain micro-captive insurance arrangements as "listed transactions." *See* REG–109309–22, Micro-Captive Listed Transactions and Micro-Captive Transactions of Interest, 88 F.R. 21547 (4/11/2023). Ann. 2023-11 also states, though, that Treasury and the IRS continue to "disagree with the recent court decisions holding that listed transactions cannot be identified by notice or other subregulatory guidance." Thus, we likely have not heard the last of this dispute concerning APA requirements and IRS "listed transaction" notices.

3. By a five-to-four vote, SCOTUS demonstrates yet again that the FBAR penalty statute is totally FUBAR, but at least we think we know the law until Congress says otherwise: $10,000 max penalty per year for non-willful violations, but the greater of $100,000 or 50 percent of each foreign account for willful violations. Bittner v. United States, 598 U.S. ___, 142 S. Ct. 2833 (6/21/23). The Bank Secrecy Act provides in part that U.S. persons owning an interest in foreign accounts with an aggregate balance of more than $10,000 in deposits must file an annual disclosure report. *See* 31 U.S.C. 5314; 31 C.F.R. § 1010.306 (2021). The annual disclosure is filed on the Financial Crimes Enforcement Network's ("FinCEN") Form 114 — Report of Foreign Bank and Financial Accounts ("FBAR"). Failure to properly file FinCEN Form 114 may result in varying penalties under 31 U.S.C. 5321(a)(5) depending upon whether the failure was willful or non-willful. We have reported below on the numerous cases decided under 31 U.S.C. 5321(a)(5) regarding the controversy surrounding the FBAR penalty for *willful* violations of 31 U.S.C. 5314. Generally, however, the United States Courts of Appeal addressing the issue agree that the FBAR penalty for willful violations is the greater of $100,000 or 50 percent of each offending account. With regard to non-willful FBAR violations, there has been a split between the Ninth and Fifth Circuits. In *United States v. Boyd*, 991 F.3d 1077 (9th Cir. 3/24/2021), the Ninth Circuit held for the taxpayer that the FBAR penalty for non-willful violations of 31 U.S.C. 5314 should be limited to $10,000 per annual filing of FinCen Form 114 regardless of the number of foreign accounts the taxpayer failed to properly report. In *United States v. Bittner*, 19 F.4th 734 (5th Cir. 11/30/2021), the Fifth Circuit disagreed and held for the government that the FBAR penalty for non-willful violations is determined on a per-offending-account basis, similar to the FBAR penalty for willful violations. SCOTUS granted certiorari in *United States v. Bittner*, 19 F.4th 734 (5th Cir. 11/30/2021) to resolve the split between the circuits.

The taxpayer in *Bittner v. United States*, 598 U.S. ___, 142 S. Ct. 2833 (6/21/23), had 61 foreign bank accounts in 2007, 51 in 2008, 53 in 2009 and 2010, and 54 in 2011. The government acknowledged that the taxpayer's failure to properly file FinCEN Forms 114 for the numerous accounts held over the five-year period was non-willful. Nevertheless, the government sought to impose an FBAR penalty of $2.72 million on the taxpayer due to the number of offending accounts over the five-year period. Therefore, the question before the U.S. Supreme Court was whether the taxpayer owed $2.72 million in FBAR penalties or only $50,000 ($10,000 per year). Justice

Gorsuch wrote the opinion for the majority (Gorsuch, Roberts, Alito, Kavanaugh, and Jackson), holding that the FBAR penalty under 31 U.S.C. 5321(a)(5) should be limited to $10,000 per year for non-willful violations of 31 U.S.C. 5314. Justice Gorsuch reasoned that 31 U.S.C. 5314 "does not speak of accounts or their number," but instead refers to a duty to file annual "reports." Justice Gorsuch was not persuaded by the government's argument that because the penalty for *willful* violations of 31 U.S.C. 5321(a)(5) is determined on a per-offending-account basis, so should the lower penalty for non-willful violations. Instead, applying the *expressio unius est exclusio alterius* maxim of statutory construction (i.e., the use of different terms within a single statute implies a different meaning), Justice Gorsuch concluded that Mr. Bittner's maximum FBAR penalty for non-willfully violating 31 U.S.C. 5314 over five years should be only $50,000 ($10,000 per year). Justice Barret wrote for the dissenters (Barrett, Thomas, Sotomayor, and Kagan), arguing that although *expressio unius est exclusio alterius* is a general rule of statutory interpretation, it gives way where context suggests otherwise. In Justice Barrett's view, the FBAR penalties permitted under 31 U.S.C. 5321(a)(5), whether for willful or non-willful violations, only make sense if they are determined on a per-account basis. Otherwise, dissenting Justice Barrett wrote, the maximum annual penalty that the government may impose for a non-willful violation of 31 U.S.C. 5314 is $10,000 whether the taxpayer has one offending foreign bank account or one hundred such accounts.

4. Misinformation in your W-2 information returns can result in civil liability for damages, especially if you have a puzzling STD—*not what you think*—plan. Doherty v. Turner Broadcasting Systems, Inc., 72 F.4th 324 (D.C. Cir. 6/30/23). The plaintiff in this case, a photojournalist, was an employee of the defendant, Turner Broadcasting Systems, Inc. (TBS) when the plaintiff injured his back in late 2012 loading camera equipment while at work. Thereafter, the plaintiff remained on the TBS's payroll and was paid certain amounts under the defendant's short-term disability ("STD") plan. Puzzlingly, though, TBS's STD plan consisted of two distinct policies. The first policy, J.A. 388, was for "job-related" injuries or illnesses and paid an injured employee a predetermined amount (*or such greater amount as required by applicable workers' compensation law*) over the 26-week period following the injury. After the 26-week period, TBS's workers' compensation insurance carrier funds any payments to an injured or ill employee. The second policy, J.A. 383, was for employees "absent from work due to [their] own medical needs." The predetermined payments to be made to injured or ill employees under either J.A. 388 or J.A. 383 were largely the same, except that J.A. 383 did not provide for increased payments due to workers' compensation law). (The court's opinion does not indicate whether payments under J.A. 383 continued beyond the 26-week period following injury.) TBS apparently considered all disability-related payments made to the plaintiff as falling under its J.A. 383 policy (non-workers' compensation portion of its STD plan), while the plaintiff believed that the disability-related payments he received fell under J.A. 388 (workers' compensation portion of STD plan). The distinction was important because any workers' compensation payments made to the plaintiff would be excludable from gross income under § 104(a)(1); however, employer-funded disability payments to an employee that are not workers' compensation are not excludable from gross income by the employee. TBS apparently believing that the payments to the plaintiff were not workers' compensation payments, reported all amounts paid to the plaintiff during the years in issue as gross income on the Forms W-2 issued to the plaintiff. The plaintiff alerted TBS to the alleged error, but TBS either did not agree with the plaintiff or did not fully appreciate the significance of issuing inaccurate Forms W-2. Subsequently, the plaintiff sued TBS in federal district court under § 7434, which authorizes a private civil action for damages against "any person [who] willfully files a fraudulent information return with respect to payments purported to be made to any other person." Section 7434 applies to information returns listed in § 6724(d)(1)(A), including Forms W-2, 1099-MISC, 1099-INT, and 1099-DIV among others. The district court had granted TBS's motion for summary judgment, ruling that the Forms W-2 issued to the plaintiff were not fraudulent under any of three theories: (i) that the Forms W-2 filed by the defendant had the accurate gross amount of payments to the plaintiff, even if some portion of the payments should have been designated as excludable from gross income; (ii) that no reasonable jury could conclude

that the plaintiff's payments were workers' compensation; or (iii) that the defendant's error was not intentional and thus lacked the specific intent to deceive required for willfulness under § 7434. The U.S. Court of Appeals for the D.C. Circuit reversed and remanded the case for further proceedings, concluding that the District Court had erred under all three of its theories for granting summary judgment to TBS. In an opinion by Judge Wilkins, the D.C. Circuit held (i) that an information return may be false under § 7434 even if the gross amount of the payment is correct; (ii) that the confusion surrounding TBS's STD plan, consisting of a workers' compensation policy (J.A. 388) and non-workers' compensation policy (J.A. 383), could lead a reasonable jury to find that the payments the plaintiff received were workers' compensation; and (iii) that a knowing or reckless action, as opposed to specific intent to deceive, is sufficient to meet the willfulness requirement of § 7434. Of course, because the case was remanded to the federal district court for further proceedings, we do not know if the plaintiff ultimately will prevail in his § 7434 action for damages against the defendant. Nevertheless, the case is instructive regarding the care an employer (or its agent) should take in preparing and filing information returns subject to § 7434.

5. A return was a joint return despite the fact that one spouse did not personally sign it, says the Second Circuit. Soni v. Commissioner, 76 F.4th 49 (2d Cir. 7/27/23), *aff'g Soni v. Commissioner*, T.C. Memo. 2021-37 (12/1/21). The taxpayers in this case were a married couple. The husband, Om, was experienced in business and established several businesses with large accounting and finance departments. His wife, Anjali, took care of the home and relied on her husband to handle all financial and tax matters. According to the opinion of the Tax Court (Judge Copeland), Anjali was reluctant to sign documents because a family member had forged her father's signature to steal money, and she therefore was "leary of signing documents and made it an ordeal to get her signature on any document." Again according to the Tax Court's opinion, she

> chose to not take part in the financial matters of the home, including tax matters. Since the time of their marriage, Anjali has never signed a tax return or asked anyone to sign a tax return for her. She did not pay attention to tax issues.

The 2004 return and proceedings in the Tax Court. The taxpayers' tax returns were prepared by an accounting firm. The returns for the years 1999-2003 and for 2005-2015 were joint returns. For the year in question, 2004, the firm prepared a joint return, which Om signed. Although their son often signed his mother's name on documents, including tax-related documents, the record was unclear as to who signed Anjali's name on the 2004 return. The parties stipulated on appeal, however, that Anjali did not personally sign the 2004 return. On the 2004 return, the taxpayers deducted a loss of over $1.7 million from a subchapter S corporation in which Om held an ownership interest. Following an audit, the IRS disallowed the loss deduction because, according to the IRS, the taxpayers had failed to provide documentation to establish their basis in the S corporation's stock. The IRS issued a notice of deficiency asserting that the taxpayers were jointly and severally liable for additional tax of $642,629 and a late-filing penalty under § 6651(a)(1) of $28,835. The taxpayers filed a petition in the Tax Court, where they argued that the return filed for 2004 was not a valid joint return. In an amended answer, the IRS asserted that the taxpayers also were liable for an accuracy-related penalty under § 6662 of $128,526. The Tax Court concluded that, although Anjali had not personally signed the return, it was nevertheless a valid joint return. Judge Copeland concluded that Anjali had tacitly consented to filing a joint return for 2004 because she had "approved or at least acquiesced in the joint filing of their 2004 return."

Second Circuit's Analysis. In an opinion by Judge Cabranes, the U.S. Court of Appeals for the Second Circuit affirmed the Tax Court's decision. The court relied on its prior decision in *O'Connor v. Commissioner*, 412 F.2d 304 (2d Cir. 1969), in which the court had provided guidance on the determination of whether a return is a joint return. According to *O'Connor*, a determination that a return is a joint return "is a factual issue of the intention of the parties and must be affirmed unless clearly erroneous." *Id.* at 309. Although normally a presumption of correctness attaches to the IRS's determination that a return is a joint return, that presumption does not apply if one spouse has not signed a purported joint return. *Id*. When one spouse has not signed,

the IRS bears the burden of proving that the intent of the parties was to file jointly. *Id*. The court in this case observed that four circumstances present in *O'Connor*, in which the court had concluded that the return was a joint return, were also present here. *First*, the non-signing spouse knew that a return had to be filed because the evidence showed that Anjali was aware that a return had to be filed and simply chose not to engage. *Second,* the non-signing spouse knew of the signing spouse's expert knowledge concerning preparing and filing tax returns because Anjali knew of Om's expert knowledge and relied on him to handle the family's finances, including the filing of tax returns. *Third*, the parties filed a joint petition in the Tax Court. Fourth, the taxpayers asserted only a delayed challenge to the return's characterization as a joint return because they had not disavowed its joint status until trial. The court also noted that the taxpayers had filed joint returns for every other year from 1999 through 2003 and from 2005 through 2014. Accordingly, the court concluded that the Tax Court had not clearly erred in in finding that the taxpayers intended to file a joint return.

Other issues. The taxpayers also argued that the three-year limitations period on assessment of tax provided by § 6501(a) had expired before the IRS issued the notice of deficiency. The notice of deficiency for the year in question, 2004, was issued on March 12, 2015. The IRS received a total of eight consents to extend the limitations period on assessment on Form 872, which ostensibly had been signed by the taxpayers or by their CPA, Mr. Grossman. The taxpayers argued that the consents were invalid for a variety of reasons, such as their contention that they had not signed a power of attorney on Form 2848 authorizing Grossman to act on their behalf and that he had forged Om's signature on the power of attorney, and therefore any consents executed by him on their behalf were invalid. The Second Circuit affirmed the Tax Court's decision that the period of limitations on assessment had not expired before the notice of deficiency was issued. The court affirmed the Tax Court's finding that Om had signed the power of attorney on Form 2848 and its conclusion that both Om and Anjali had authorized Grossman to act on their behalf in consenting to extend the limitations period on assessment. Finally, the court affirmed the IRS's imposition of the late-filing penalty and the accuracy-related penalty because the taxpayers had not established a reasonable cause defense to the penalties.

6. Anti-abuse judicial doctrines create confusion and headaches for everybody. GSS Holdings (Liberty) Inc. v. United States, 81 F.4th 1378 (Fed. Cir. 9/21/23), vacating and remanding 154 Fed. Cl. 481 (2021). This somewhat esoteric 2-1 opinion from the Court of Appeals for the Federal Circuit vacating a decision by the Claims Court and remanding the case for further proceedings is not, in our opinion, a "must read" for tax advisors. In fact, we are unsure whether a firm conclusion can be drawn from the court's opinion. The case concerns whether the Claims Court conflated and therefore misapplied the judicially created economic substance and step-transaction anti-abuse doctrines. If we count Judge Bruggink's Claims Court's opinion and the dissenting opinion of Judge Newman against the two-judge majority opinion of the Court of Appeals for the Federal Circuit, we have a tie. Perhaps, though, the case offers some lessons: one practical and one academic, as explained further below.

Facts: The background of the case is complicated, involving multiple parties entering numerous contracts and related financial transactions across tax years 2006 through 2011. The essential facts, though, concern 2011 and are as follows. The taxpayer, GSS Holdings (Liberty) Inc. was a member of a limited liability company treated as a partnership for federal income tax purposes. Under a contract originally executed by the LLC-partnership in 2006 but amended and closed in 2011, the LLC-partnership was compelled for financial and regulatory reasons to dispose of certain assets. The assets consisted of (i) a promissory note with a par value and basis higher than the note's fair market value plus (ii) cash that the LLC-partnership had to "rebate" to compensate the buyer for acquiring the devalued promissory note at its par value (instead of its fair market value). The total loss suffered by the LLC-partnership from the transaction with the buyer was approximately $22.5 million. The loss was allocated entirely to the taxpayer via the LLC-partnership. On the one hand, in the view of the IRS (and as originally reported by the LLC-partnership on its 2011 Form 1065), the loss derived from a § 165 sale or exchange of a capital

asset (the promissory note, coupled with the rebate of cash) and because the loss arose from a sale or exchange with a related party, the loss must be disallowed under § 707(b)(1). On the other hand, in the view of the taxpayer (and as subsequently reported on an amended return and refund claim filed in 2013), the loss was ordinary and stemmed solely from the cash that the LLC-partnership had to "rebate" to the buyer in a transaction separate and distinct from the disposition of the promissory note. Thus, the fundamental dispute was whether the transaction with the buyer consisted of one sale of assets (a promissory note and the cash rebate) resulting in a disallowed capital loss or, instead, two separate transactions: a sale of the promissory note at par value (no gain or loss) and a separate, independent § 165 ordinary loss "rebate" of cash to the buyer. (Again, we could spend pages explaining the entire factual background and the reasons that the promissory note was acquired from the LLC-partnership by the buyer at its par value along with cash "rebated" to the buyer, but suffice it to say that the case involves complex financial transactions and relationships that are not critical to the appeals court's reversal of the lower court.)

Claims Court Decision: The Claims Court (Judge Bruggink) found for the IRS, denying the taxpayer's refund claim on the basis that the disposition of the promissory note and cash late in 2011 was a single sale or exchange transaction. Judge Bruggink reasoned that the disposition of the promissory note and the rebate of the cash were inextricably linked. Therefore, economic substance as well as the step transaction doctrine mandated sale or exchange treatment as argued by the IRS.

Federal Circuit Decision: The majority of the three-judge panel of the Court of Appeals for the Federal Circuit (Judges Cunningham and Reyna) disagreed, holding that Judge Bruggink of the Claims Court "erred by applying a hybrid legal standard that improperly conflated the step transaction doctrine and the economic substance doctrine." 81 F.4th at 1381. In the opinion of the majority, Judge Bruggink should not have mixed the economic substance and step transaction doctrines in his analysis. Instead, Judge Bruggink should have applied the so-called "end result" test (examining and collapsing a multi-step transaction from the outset based upon the intent of the taxpayer) of the step transaction doctrine by determining which was the first step of the transaction: 2006 (the date the contract originally was executed) or 2011 (when the contract was amended and the transaction closed)? Although the majority vacated Judge Bruggink's decision and remanded the case for further proceedings, Judge Cunningham's majority opinion also stated, "We are not suggesting any particular outcome; we are simply instructing the Claims Court to apply the correct legal standard." 81 F.4th at 1383.

Dissenting Opinion: The dissent, written by Judge Newman, would have upheld the Claims Court's decision. In Judge Newman's opinion, the economic substance and step transaction doctrines are subsumed by longstanding "substance over form" principles, so Judge Bruggink's analysis did not improperly conflate the two doctrines.

Practical Lesson—File Consistently: Yet again we see a case where a taxpayer took a position on an originally filed return followed by a different position taken on a subsequently filed amended return. An IRS audit and ensuing litigation almost seem certain when this happens.

Academic Lesson—What's the Law?: The traditional anti-abuse judicial doctrines (substance over form, economic substance, and step transaction) employed by the courts in some federal income tax cases do not have clear boundaries, and the decisions applying these doctrines are confusing. Predicting whether and how such doctrines apply to particular circumstances is all but impossible. To wit, the majority and dissenting opinions in *GSS Holdings (Liberty) Inc. v. United States* cited the same precedent as support for their differing analyses: *Falconwood Corp. v. United States*, 422 F.3d 1339 at 1349 (Fed. Cir. 2005) which, quoting an earlier case, states:

> The step transaction doctrine is a judicial manifestation of the more general tax law ideal that effect should be given to the substance, rather than the form, of a transaction, "by ignoring for tax purposes, steps of an integrated transaction that separately are without substance."

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

1. "Sticks and stones may break my bones but …" calling someone a limited partner in a state-law limited partnership does not necessarily exempt that person from self-employment tax on their distributive share of partnership income. Soroban Capital Partners LP v. Commissioner, 161 T.C. No. 12 (11/28/23). The petitioner in this case, Soroban Capital Partners LP (Soroban), is a limited partnership that, for the years in question, was subject to the former TEFRA unified audit and litigation procedures. Soroban had one general partner (a limited liability company) and three individual limited partners, Messrs. Mandelblatt, Kapadia, and Friedman. On its partnership tax returns for 2016 and 2017, Soroban included in net earnings from self-employment the guaranteed payments received by the three limited partners and the general partner's distributive share of the partnership's ordinary business income. On the other hand, Soroban excluded from net earnings from self-employment the limited partners' distributive shares of the partnership's ordinary business income. Following an audit, the IRS issued Notices of Final Partnership Administrative Adjustment for 2016 and 2017 in which the IRS proposed increasing net earnings from self-employment by the limited partners' distributive shares of the partnership's ordinary business income. On behalf of the partnership, the general partner filed a petition in the Tax Court challenging this adjustment. In the Tax Court, Soroban filed a motion for summary judgment asking the court to determine as a matter of law that the limited partners' shares of the partnership's ordinary business income were excluded from net earnings from self-employment or, alternatively, that any inquiry into the roles of the limited partners in the partnership's business did not concern a partnership matter and therefore could not be resolved in this TEFRA partnership-level proceeding. The government filed a motion for partial summary judgment asking the court to determine as a matter of law that an inquiry into the limited partners' roles could be determined in this partnership-level proceeding. The Tax Court (Judge Buch) denied Soroban's motion and granted the government's motion. Under § 1402(a), a partner's distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment "the distributive share of any item of income or loss of a limited partner, as such …" (other than guaranteed payments for services). The court reviewed the legislative history of § 1402(a)(13) and the government's issuance of proposed regulations in 1997 that sought to define the scope of this limited partner exception and that led to a congressional moratorium on the issuance of regulations. The court also reviewed prior judicial interpretation of the limited partner exception in § 1402(a)(13), including the court's prior decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). In *Renkemeyer*, the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive shares of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore "they were not acting as investors in the law firm." The Tax Court had not previously addressed whether a limited partner in a state law limited partnership is automatically a "limited partner, as such" within the meaning of § 1402(a)(13) or instead must satisfy a functional analysis test like the one applied in *Renkemeyer* to be entitled to the limited partner exception. The partnership, Soroban, argued that, because Soroban was a state law limited partnership and its Limited Partnership Agreement identified Messrs. Mandelblatt, Kapadia, and Friedman as limited partners, § 1402(a)(13) was satisfied. The court, however, disagreed and concluded that "[a] functional analysis test should be applied when determining whether the limited partner exception under section 1402(a)(13) applies to limited partners in state law limited partnerships." Because this test requires analysis of the functions and roles of the limited partners, which are factual determinations, the court denied the partnership's motion for summary judgment. The court also held that this examination of the roles of the limited partners is a partnership item that the court had jurisdiction to determine in this TEFRA partnership-level proceeding.

C. Excise Taxes

XII. TAX LEGISLATION

A. Enacted

1. The Inflation Reduction Act enacts a corporate AMT, imposes a 1 percent excise tax on redemptions of corporate stock by publicly traded corporations, and makes certain other changes. The Inflation Reduction Act, Pub. L. No. 117-169, signed by the President on August 16, 2022, imposes a 15 percent alternative minimum tax (AMT) on corporations with "applicable financial statement income" over $1 billion, imposes an excise tax of 1 percent on redemptions of stock by publicly traded corporations, extends through 2025 certain favorable changes to the premium tax credit of § 36B, and extends through 2028 the § 461(*l*) disallowance of "excess business losses" for noncorporate taxpayers.

2. The SECURE 2.0 Act increases the age at which required minimum distributions must begin, modifies the rules regarding catch-up contributions, and makes many other significant changes that affect retirement plans. The Consolidated Appropriations Act, 2023, Pub. L. No. 117-328, signed by the President on December 29, 2022, includes the SECURE 2.0 Act of 2022, which increases the age at which required minimum distributions (RMDs) must begin to age 73, reduces the penalty for failure to take RMDs, modifies the rules for catch-up contributions to qualified retirement plans, and makes many other significant changes that affect retirement plans.

XIII. TRUSTS, ESTATES & GIFTS

A. Gross Estate

1. Case results in a clear split between Eighth and Eleventh Circuits concerning inclusion of corporate-owned life insurance proceeds in estate tax value of closely-held stock. Connelly v. United States, 70 F.4th 412 (8th Cir. 6/2/23). In this federal estate tax case, the U.S. Court of Appeals for the Eighth Circuit had to decide whether corporate-owned life insurance proceeds were includable in the estate tax value of a deceased shareholder's redeemed shares or should be excluded from such value as the Eleventh Circuit had held in *Estate of Blount v. Commissioner*, 428 F.3rd 1338 (11th Cir. 2005). Two brothers owned all 500 outstanding shares of stock of Crown C Corporation ("Crown"), a building-materials company located in St. Louis. One brother owned a majority (385.9 shares or 77.18%) of Crown's outstanding stock, while the other brother owned a minority (114.1 shares or 22.82%) of Crown's outstanding stock. Crown and the two brothers had entered into a stock purchase agreement that would take effect upon the death of either brother. Under the agreement, the surviving brother had an option to purchase the deceased brother's shares, or if the surviving brother declined the option, the corporation, Crown, was obligated to redeem the deceased brother's shares. The agreement set the price for the decedent's shares via either (i) a contemporaneous "Certificate of Agreed Value" executed between the brothers each year or (ii) an appraisal process if the brothers failed to execute a "Certificate of Agreed Value" for the relevant year. Furthermore, Crown owned separate $3.5 million insurance policies on the life of each brother to facilitate a redemption of stock upon the death of either brother. When the brother owning the majority of Crown's shares died in 2013, the surviving brother's and Crown's rights under the stock purchase agreement were triggered. No "Certificate of Agreed Value" had been executed between the brothers for 2013 (or, for that matter, ever), and the surviving brother declined to exercise his purchase option. Therefore, Crown proceeded to redeem the deceased brother's shares (385.9 shares or 77.18%) for $3 million, funded by the $3.5 million corporate-owned life insurance policy on the decedent's life, with Crown retaining the $500,000 excess of life insurance proceeds over the redemption price. Rather than the redemption price being set by the agreement itself, however, the deceased brother's son and the surviving brother, as executor of the deceased brother's estate, had agreed to the $3 million value for the deceased brother's shares as part of an "amicable and expeditious" settlement of several estate-administrative matters. Not surprisingly, the decedent's estate reported the value of the redeemed stock at $3 million for federal estate tax purposes. On audit, the IRS challenged the reported $3 million estate tax value of the decedent's shares, arguing that Crown's overall fair

market value, including the $3.5 million in life insurance proceeds, was $6.86 million ($3.36 million exclusive of the $3.5 million in life insurance proceeds). The IRS further argued that the higher company-level value informs the estate tax value of the decedent's stock, not merely the $3 million redemption price agreed to by the decedent's son and the surviving brother. The IRS (supported by expert testimony) thus set the value of the deceased brother's shares at about $5.3 million (77.17% x $6.86 million) and assessed a $1 million estate tax deficiency against the decedent's estate. The estate paid the deficiency and filed a refund suit in U.S. District Court, where the lower court held for the IRS. The estate then appealed to the Eighth Circuit.

The Estate's Arguments. The estate of the deceased brother made two arguments that the $3 million redemption price for the decedent's shares was proper for estate tax purposes. The estate's first argument was that the stock purchase agreement complied with § 2703(b) and therefore sets the value of the deceased brother's shares for estate tax purposes. Section 2703(a) generally provides that the estate tax value of property is determined without regard to any agreement restricting the property's sale or setting the property's price at less than fair market value. Section 2703(b), though, provides an exception, thereby potentially allowing an agreement to set the estate tax value of property via agreement if three requirements are met: (i) it is a bona fide business arrangement; (ii) it is not a device to transfer property among family members for less than full and adequate consideration; and (iii) its terms are comparable to arms' length transactions entered into by unrelated persons. The estate's second argument was that the $3 million price set for the deceased bother's shares reflected the stock's fair market value exclusive of the $3.5 million of life insurance proceeds, which is the proper result under *Estate of Blount v. Commissioner*, 428 F.3d 1338 (11th Cir. 2005). The Eleventh Circuit in *Blount* held under similar circumstances that the estate tax value of a decedent's shares subject to a stock purchase agreement at death should not include corporate-owned life insurance proceeds used to redeem the decedent's shares. The Eighth Circuit reasoned that any such life insurance proceeds have no net effect on the value of the redeemed shares because the proceeds received by the corporation are offset by a concomitant liability to purchase the decedent's stock. The Eighth Circuit stated in *Blount*, "To suggest that a reasonably competent business person, interested in acquiring a company, would ignore a $3 million liability strains credulity and defies any sensible construct of fair market value." 428 F.3rd at 1346. *See also Estate of Cartwright v. Commissioner*, 183 F.3rd 1034 (9th Cir. 1999).

The Eighth Circuit's Opinion. The Eighth Circuit rejected both arguments by the estate and accepted the IRS's position that Crown's overall fair market value upon the decedent's death was $6.86 million, resulting in the deceased brother's shares being valued at approximately $5.3 million for estate tax purposes, inclusive of the $3.5 million of corporate-owned life insurance proceeds. In an opinion by Chief Judge Smith, the Eighth Circuit reasoned that the estate's first argument concerning § 2703 was flawed because the stock purchase agreement did not contain a fixed price or formula to set the value of the deceased brother's shares for estate tax purposes. Courts, including the Eleventh Circuit in *Blount*, have recognized that, under Reg. § 20.2031-2(h), a stock purchase agreement must contain a fixed or determinable price if it is to be binding for estate tax valuation purposes. Reg. § 20.2031-1(h) provides in part that "[l]ittle weight will be accorded a price" in an agreement where the decedent was "free to dispose of" stock at any price during the decedent's lifetime. Section 2703 was enacted against the backdrop of Reg. § 20-2031-2(h), and thus the courts have applied the two in tandem to control the determination of value for estate tax purposes. Chief Judge Smith thus concluded that the stock purchase agreement at issue in Connelly v. United States could not establish the estate tax value of the decedent's shares under § 2703 or Reg. § 20.2023-2(h) because, in the absence of a pre-determined and binding "Certificate of Agreed Value" or a compulsory appraisal, the agreement had no fixed or determinable method for setting the stock's redemption price as of the decedent's death. The Eighth Circuit also declined to adopt the estate's second argument that *Blount* controlled to exclude the $3.5 million of corporate-owned life insurance proceeds from the determination of the estate tax value of the deceased brother's shares. Chief Judge Smith cited as support both the general willing buyer/willing seller rule of Reg. § 20.2031-2(a) and the more specific rule of Reg. § 20.2031-2(f)(2), which states that in valuing shares of a closely-held corporation for estate tax

purposes "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company." Chief Judge Smith emphasized this latter point by noting that the $500,000 of excess life insurance proceeds not used to redeem the decedent's shares benefitted Crown and augmented its overall fair market value. Chief Judge Smith wrote further:

> The IRS has the better argument. *Blount*'s flaw lies in its premise. An obligation to redeem shares is not a liability in the ordinary business sense . . . A buyer of Crown would therefore pay up to $6.86 million [for all of Crown's outstanding stock], having "taken into account" the life insurance proceeds, and extinguish [the stock purchase agreement] or redeem [the deceased brother's shares] as desired. *See* 26 C.F.R. § 20.2031-2(f)(2). On the flip side, a hypothetical willing seller of Crown holding all 500 shares would not accept only $3.86 million knowing that the company was about to receive $3 million in life insurance proceeds, even if those proceeds were intended to redeem a portion of *the seller's own shares*. To accept $3.86 million would be to ignore, instead of "take[ ] into account," the anticipated life insurance proceeds. (Emphasis in original.)

Chief Judge Smith also wrote of the estate's argument and the court's decision not to follow *Blount*:

> To further see the illogic of the estate's position, consider the resulting windfall to [the surviving brother]. If we accept the estate's view and look to Crown's value exclusive of the life insurance proceeds intended for redemption, then upon [the deceased brother's] death, each share was worth $7,720 before redemption. After redemption, [the deceased brother's] interest is extinguished, but [the surviving brother] still has 114.1 shares giving him full control of Crown's $3.86 million value. Those shares are now worth about $33,800 each. Overnight and without any material change to the company, [the surviving brother's] shares would have quadrupled in value. This view of the world contradicts the estate's position that the proceeds were offset dollar-by-dollar by a "liability." A true offset would leave the value of [the surviving brother's] shares undisturbed.

Comment. Never leave it to clients to mutually agree to the value stock on an annual basis as part of a stock purchase agreement triggered by a stockholder's death, especially if they are related. Moreover, consider having any life insurance policies that are intended to fund the purchase of a deceased shareholder's stock being held outside the corporation, such as in a trust or a partnership that is a party to the stock purchase agreement.

a. The U.S. Supreme Court will resolve the conflict between the Eleventh Circuit's decision in *Connelly* and that of the Eighth Circuit in *Estate of Blount*. Connelly v. United States, No. 23-146 (U.S. 12/13/23). The U.S. Supreme Court has granted the taxpayer's motion for a writ of certiorari in *Connelly v. United States*, 70 F.4th 412 (8th Cir. 6/2/23). Oral arguments were held on March 27, 2024.

B. Deductions

C. Gifts

1. If you're about to die and need to make some annual exclusion gifts, maybe try Zelle, CashApp, Venmo etc. Estate of DeMuth v. Commissioner, 132 A.F.T.R.2d 2023-5122, 2023 WL 4486739 (3rd Cir. 7/12/23), *aff'g* T.C. Memo. 2022-72. The taxpayer in this case, who resided in Pennsylvania, was diagnosed with "an enstage medical condition" in early September 2015. On September 6, 2015, the taxpayer's son, acting under a power of attorney, wrote eleven checks on the taxpayer and spouse's investment account. Ten of the eleven checks were intended as annual exclusion gifts to family members ($14,000 per donee in 2015 under § 2503, which allowed the taxpayer and his wife to pay $28,000 per donee), while one check for $240,000 was

payable to a "savings plan." (The opinion does not elaborate, but the authors assume the $240,000 check was payable to a § 529 college savings plan for the benefit of multiple family members). The eleven checks were either delivered personally or mailed to the payees by the taxpayer's son. The taxpayer died five days later, on September 11, 2015. Seven of the eleven checks, totaling $366,000, had not cleared the drawee bank before the taxpayer's death. Even though the seven checks totaling $366,000 had not cleared the drawee bank as of the taxpayer's death, the estate did not include the $366,000 represented by the seven uncleared checks in the taxpayer's federal gross estate under § 2031. On audit, the IRS asserted an estate tax deficiency based upon the estate's failure to include the $366,000 in the taxpayer's gross estate. The IRS's position was that the seven uncleared checks were incomplete gifts because the taxpayer retained the power under Pennsylvania law to stop payment on the checks until his death. *See* Reg. § 25.2511-2(c) (gift is "incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself"); *see also* Rev. Rul. 67-396, 1967-2 C.B. 351 *as modified by* Rev. Rul. 96-56, 1996-2 C.B. 161 (generally, a gift is not complete for estate and gift tax purposes until the check is paid, certified, or accepted by the drawee, or negotiated for value to a third party). The Tax Court (Judge Jones) agreed with the IRS that the $366,000 represented by the seven uncleared checks should have been included in the taxpayer's gross estate.[2] The estate appealed to the U.S. Court of Appeals for the Third Circuit and argued that the seven delivered but uncleared checks were made in contemplation of death and, therefore, under Pennsylvania's "in causa mortis" doctrine, were completed gifts excludable from the taxpayer's gross estate. The Third Circuit acknowledged that, under Pennsylvania law, donative transfers "prompted by the [donor's] belief ... that his death is impending, and made as a provision for the donee if death ensues" are considered gifts "in causa mortis" complete at the time of delivery even if the check does not clear the drawee bank until after the donor's death. Nevertheless, in an opinion written by Judge Shwartz, the Third Circuit affirmed the Tax Court's decision, determining that the taxpayer had not produced evidence to show that Pennsylvania's "in causa mortis" doctrine applied. Other than the circumstances surrounding the taxpayer's demise (i.e., the taxpayer's "enstage medical condition diagnosis" in early September 2015 followed shortly thereafter by the taxpayer's death on September 11, 2015) and the fact that annual gifts to family members generally were given in December rather than September, the estate had not provided specific evidence that the taxpayer's gifts made via his son's power of attorney were motivated by the taxpayer's anticipated death. The taxpayer had pre-authorized his son in the power of attorney to make annual exclusion gifts on the taxpayer's behalf, but the estate presented no evidence that the taxpayer actually had directed his son to make such gifts in September of 2015. Accordingly, the court ruled, the $366,000 represented by the seven uncleared checks should have been included in the taxpayer's gross estate.

D. <u>Trusts</u>

1. No, you IDGT! You don't get a basis step-up at the grantor's death. Rev. Rul. 2023-2, 2023-16 I.R.B. 658 (3/29/23). A relatively common estate-planning strategy involves the use of a so-called "intentionally defective grantor trust" ("IDGT"). An IDGT exploits the

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[2] Actually, ten of the checks totaling $436,000 had not cleared the drawee bank as of the taxpayer's death; however, only seven checks totaling $366,000 were in issue because of an IRS mistake in its brief as to the applicable law. The IRS mistakenly assumed in its Tax Court brief that three of the ten uncleared checks were completed gifts because the checks had been *deposited* by the payees, even though the three checks had not cleared the *drawee* bank. The proper test for a completed gift is whether a check has cleared the *drawee* bank, not merely deposited with the payee's bank. See the authorities cited above. Judge Jones, however, did not let the IRS off the hook for its mistake, writing: "Thus, although all ten checks at issue would otherwise apparently be includible in decedent's gross estate under a proper legal analysis, to ignore the concession respondent made in his brief sua sponte would be prejudicial to the petitioner. We will therefore hold respondent to his concession: checks Nos. 1215, 1219, and 1221, which total $70,000, will not be included in decedent's gross estate. The remaining seven checks at issue, which total $366,000, are included in the gross estate."

mismatch between subchapter J (income taxation of trusts and estates) of chapter 1 of the IRC and subtitle B (estate and gift taxes) of chapter 11 of the IRC. Through an IDGT, a grantor can make a completed gift of property for estate and gift tax purposes under subtitle B, chapter 11 of the IRC but still be taxed on the income from the property under subchapter J chapter 1 of the IRC. More specifically, Rev. Rul. 2023-2 postulates the following facts:

> In Year 1, A, an individual, established irrevocable trust, T, and funded T with Asset in a transfer that was a completed gift for gift tax purposes. A retained a power over T that causes A to be treated as the owner of T for income tax purposes under subpart E of part I of subchapter J of chapter 1 (subpart E). A did not hold a power over T that would result in the inclusion of T's assets in A's gross estate under the provisions of chapter 11. By the time of A's death in Year 7, the fair market value (FMV) of Asset had appreciated. At A's death, the liabilities of T did not exceed the basis of the assets in T, and neither T nor A held a note on which the other was the obligor.

Normally, of course, when property is acquired from a decedent via a bequest or devise, § 1014(a) allows a step-up in basis equal to the value of the property includable in the decedent's gross estate under chapter 11 of the IRC. *See also* Reg. § 1.1014-1(a). Apparently, some taxpayers have taken the position that property acquired from an IDGT after the grantor's death is entitled to a basis step-up under § 1014(a). Rev. Rul. 2023-2 asserts the contrary, reasoning that the "Asset" (see above) was not acquired or passed from A (the decedent) within the meaning of IRC § 1014(a) as elaborated in subsections (b)(1)-(10). Instead, Rev. Rul. 2023-2 holds that the "Asset" was acquired from the IDGT, which was not includable in A's estate under § 2031 or otherwise under chapter 11. Notably, Rev. Rul. 2023-2 distinguishes an older ruling, Rev. Rul. 84-139, 1984-2 C.B. 168, where a non-citizen, non-resident person devised non-U.S. real property to a U.S. citizen. The non-U.S. real property was not subject to chapter 11 (estate and gift taxation) because it was owned by a non-US person. Nevertheless, Rev. Rul. 84-139 held that the non-U.S. property was "acquired from a decedent" under § 1014(b)(1) and thereby entitled to a basis step-up under § 1014(a).

2. "The gain disappearing act the [taxpayers] attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or caselaw." Distributions from a CRAT were taxable and were ordinary income, says the Tax Court. Gerhardt v. Commissioner, 160 T.C. No. 9 (4/20/23). Four married couples (collectively, the Gerhardts) had their cases consolidated in the Tax Court. In each case, the taxpayers contributed real property with a high value and a low basis to a charitable remainder annuity trust (CRAT). Shortly after contribution, each CRAT sold the real property and used the sale proceeds to purchase a single-premium immediate annuity (SPIA) owned by the CRAT. Pursuant to the terms of the trust, each CRAT paid to the taxpayers the payments received from the SPIA. The taxpayers took the position that the distributions from the CRAT were not taxable except to the extent of a small amount of interest income earned by the CRAT. For example, one couple contributed real properties with a total adjusted basis of $97,517 to their CRAT and the CRAT sold the properties for approximately $1.7 million. Their CRAT purchased a SPIA that would make five annual payments to the couple of $311,708. The CRAT distributed $311,708 to the couple in 2016 and again in 2017, the years at issue in the Tax Court. The CRAT issued Schedules K-1 to the couple in each year reporting only interest income of $4,052 (2,026 per person). Following an audit, the IRS asserted that the gain the CRAT realized on the sale of the real property was ordinary income pursuant to § 1245. The IRS also asserted that the $311,708 distribution to the couple in each year was fully included in their gross income and was ordinary income. The IRS issued a notice of deficiency to each couple for 2016 and 2017 and each couple filed a petition in the Tax Court.

Background on CRATs. A CRAT is a common estate planning tool. Generally, to establish a CRAT, a grantor transfers cash or property to an irrevocable trust. The terms of the trust provide for specified payments, made at least annually, to the grantors or another noncharitable beneficiary for life or for a specified period of up to twenty years. Whatever remains in the trust is transferred

to or held for the benefit of one or more qualified charitable organizations. At the time of the contribution to the CRAT, the grantor is entitled to a charitable contribution deduction equal to the value of the contributed property less the present value of the annuity payments to be received (and limited to the present value of the trust's remainder interest). The grantor does not recognize gain from the transfer of appreciated property to the CRAT. The CRAT takes the same basis in the contributed property that the grantor had. The CRAT is tax-exempt and does not pay tax on any gain realized from its sale of contributed property. Nevertheless, gain realized by the CRAT on the sale of contributed property must be tracked and affects the tax treatment of distributions from the CRAT. Under § 664(b), distributions from the CRAT to its income beneficiaries are treated as distributed in the following order with the following character:

(1) as ordinary income, to the extent of the CRAT's current and previously undistributed ordinary income;

(2) as capital gain, to the extent of the CRAT's current and previously undistributed capital gain;

(3) as other income, to the extent of the CRAT's current and previously undistributed other income; and

(4) as a nontaxable distribution of trust corpus.

Tax Court's analysis. In the Tax Court, the taxpayers argued that any gain realized by a CRAT on the sale of contributed property effectively disappears and therefore does not make taxable any distributions by the CRAT that are funded with proceeds from the sale. The Tax Court (Judge Toro) rejected this argument. The court noted that it had considered and rejected this argument in *Furrer v. Commissioner*, T.C. Memo. 2022-100, and that the same advisers who advised the taxpayers in this case had been involved in *Furrer*. The court invited the Gerhardts to distinguish *Furrer* but, according to the court's opinion, their briefs failed to mention the case. The court summarized the taxpayers' argument as follows:

> As best we can tell, the Gerhardts maintain that the bases of assets donated to a CRAT are equal to their fair market values. … Section 1015 flatly contradicts their position. Section 1015(a) governs transfers by gift, and section 1015(b) governs transfers in trust (other than transfers in trust by gift). Under either provision, the basis in the property "shall be the same as it would be in the hands of the donor" under section 1015(a) or "in the hands of the grantor" under section 1015(b)

The court upheld the IRS's position that the CRATs involved had realized ordinary income from the sale of the contributed properties that resulted in the distributions from the CRATs to the Gerhardts being fully taxable and characterized as ordinary income. As the court put it, "[t]he gain disappearing act the Gerhardts attribute to the CRATs is worthy of a Penn and Teller magic show. But it finds no support in the Code, regulations, or caselaw."

Issue concerning gain recognition in like-kind exchange. In a separate transaction in 2017, one couple exchanged property (the Armstrong Site) for other property. The Armstrong site "comprised hog buildings and equipment as well as raw land." The couple treated this exchange as a like-kind exchange that qualified for nonrecognition of gain under § 1031. The IRS took the position that, although the exchange qualified under § 1031, the property exchanged was § 1245 property and § 1245 required the couple to recognize gain characterized as ordinary income on the exchange. The court agreed with the IRS. The flush language of § 1245(a)(1) provides that gain from the disposition of § 1245 property "shall be recognized notwithstanding any other provision of this subtitle." And Reg. 1.1245-6(b) explicitly provides that § 1245 overrides § 1031. Acordingly, the court held that the couple had to recognize the gain realized from the exchange and that the gain was ordinary income.

Recent Developments in Federal Income Taxation Individuals

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1

Current Tax Legislative Outlook *[Not in Outline]*

- **Tax Relief for American Families and Workers Act of 2024**
  - Approved January 19, 2024, by House Ways and Means Committee (40-3).
  - Passed on January 31, 2024, by House of Representatives (357-70).
  - Timing in the Senate is unclear.
  - Many Senators advocate the normal mark-up process by the Senate Finance Committee, which will result in amendments to the House version.
    - This would require a conference of the House and Senate to secure legislative approval.

2

2

Current Tax Legislative Outlook
[Not in Outline]

- **Tax Relief for American Families and Workers Act of 2024 (House version)**
- Would increase refundable portion of **child tax credit** to $1,800 (instead of current $1,600) for 2023, $1,900 for 2024, and $2,000 for 2025
- Would make domestic **research and experimental expenditures** (§ 174) deductible for 2022 through 2025.
- Would restore 100% **bonus depreciation** for 2023 through 2025
- Would slightly increase **§ 179 deduction** to $1.29 million for 2024 and future years (to be adjusted for inflation after 2024)
- Would increase **Form 1099-NEC reporting threshold** to $1,000 (for 2024)
- For purposes of **§ 163(j) limit on deducting business interest**, allows elective use of EBITDA (rather than EBIT) for 2022 and 2023 to determine adjusted taxable income.
- Would terminate period for making **employee retention credit** claims on January 31, 2024

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III. Investment Gain and Income

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Kim v. Commissioner
T.C. Memo. 2023-91 (7/20/23)
Outline: item A.1, page 16

- For 2013-2017, IRS received information reports from Coinbase, a virtual currency exchange, reporting taxpayer's transactions in virtual currencies.
  - These included Bitcoin, Litecoin, and Etherium.
- The taxpayer timely filed federal income tax returns for 2013-2016 but reported no gains or losses from the virtual currency transactions.
  - On his timely-filed 2017 income tax return, the taxpayer reported on Schedule D a net gain from virtual currency transactions of $42,069.
- Following an audit of 2013-2017, the IRS determined that the taxpayer had short-term capital gain of $75,400 for 2013, short-term capital gain of just over $4 million for 2017, and long-term capital gain of $74,565 for 2017.
- Taxpayer argued that his virtual currency assets had been wiped out with large losses in 2020 due to actions or inactions of the federal government.
- Issue: Is the government estopped from collecting tax on his 2013-2017 gains under the "clean hands" doctrine?
- Held: No. The clean hands principle is inapplicable because the government is not seeking equitable relief. The annual accounting principle makes taxpayer's 2020 losses irrelevant.

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IV. Compensation Issues

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Proposed Regulations on RMDS (2/24/22)
No More Stretch RMDs from Non-Spousal Inherited Retirement Accounts
Outline: item B.2, page 18

- A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(E)
- Modifies the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs).
- Requires all funds to be distributed by the end of the 10th calendar year following the year of death.
  - There appears to be no requirement to withdraw any minimum amount before that date.
- Current rules, which permit taking RMDs over many years, continue to apply to certain designated beneficiaries, including surviving spouses, children of the participant who have not reached the age of majority, and those not more than 10 years younger than the deceased individual.
- Applies to distributions with respect to those who die after 12/31/19.

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Proposed Regulations on RMDs (2/24/22)
87 F.R. 10504
Outline: item B.2, page 18

- These proposed regulations update existing regulations to address the changes made by the SECURE Act as well as several other statutory changes.
- The proposed regulations adopt an interpretation of the 10-year rule that appears to differ from the plain language of the statute and from the interpretation of the legislation by most advisors.
- "For example, if an employee died after the required beginning date with a designated beneficiary who is not an eligible designated beneficiary, then the designated beneficiary would continue to have required minimum distributions calculated using the beneficiary's life expectancy as under the existing regulations for up to nine calendar years after the employee's death. In the tenth year following the calendar year of the employee's death, a full distribution of the employee's remaining interest would be required."

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Notice 2022-53
2022-45 I.R.B. 437 (10/7/2022)
Outline: item B.2.a, page 19

- Provides relief to those required to take RMDs under the interpretation of the 10-year rule in the February 2022 proposed regulations.
- Generally, relief applies to beneficiaries who:
  - Are not eligible designated beneficiaries (i.e., are subject to the 10-year rule)
  - Inherited the account from an employee/IRA owner who died:
    - in 2020 or 2021, and
    - after the required beginning date for distributions, and
  - Were required to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations.
- The 50% (or 25%) excise tax of § 4974 for failure to take RMDs will not apply. Those who paid the excise tax can seek a refund.

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Notice 2023-54
2023-31 I.R.B. 382 (7/14/23)
Outline: item B.2.b, page 20

- Provides additional relief to those required to take RMDs under the interpretation of the 10-year rule in the February 2022 proposed regulations.
- Generally, relief applies to beneficiaries who:
  - Are not eligible designated beneficiaries (i.e., are subject to the 10-year rule)
  - Inherited the account from an employee/IRA owner who died:
    - in 2020, 2021, or 2022 and
    - after the required beginning date for distributions, and
  - Were required to take RMDs in 2021, 2022, or 2023 under the interpretation of the 10-year rule in the proposed regulations.
- The 50% (or 25%) excise tax of § 4974 for failure to take RMDs will not apply. Those who paid the excise tax can seek a refund.

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Notice 2024-35
2024-19 I.R.B. 1051 (4/16/24)
Outline: item B.2.c, page 21

- Provides additional relief to those required to take RMDs under the interpretation of the 10-year rule in the February 2022 proposed regulations.
- Generally, relief applies to beneficiaries who:
  - Are not eligible designated beneficiaries (i.e., are subject to the 10-year rule)
  - Inherited the account from an employee/IRA owner who died:
    - in 2020, 2021, 2022 or 2023, and
    - after the required beginning date for distributions, and
  - Were required to take RMDs in 2021, 2022, 2023 or 2024 under the interpretation of the 10-year rule in the proposed regulations.
- The 50% (or 25%) excise tax of § 4974 for failure to take RMDs will not apply. Those who paid the excise tax can seek a refund.

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Notice 2024-35
2024-19 I.R.B. 1051 (4/16/24)
Outline: item B.2.c, page 21

- Example:
  - Owner passed away in 2020
  - At the time of his death, Owner was the owner of a traditional IRA
  - Owner's death occurred after the required beginning date for distributions from the IRA.
  - Beneficiary is the sole beneficiary of the IRA and is not an eligible designated beneficiary (therefore is subject to the 10-year rule)
  - Under the proposed regulations, Beneficiary must take RMDs for 2020 through 2029, and any remaining funds in the account must be distributed by the end of 2030
  - Pursuant to Notices 2022-53, 2023-54, and 2024-35, no excise tax will be imposed for the missed RMDs in 2021, 2022, 2023, or 2024.
  - Query: how much must Beneficiary withdraw in 2025?

12

12

Legislative Developments SECURE 2.0 Act of 2022

- Consolidated Appropriations Act, 2023, Pub. L. No. 117-328
  - Signed by the President on December 29, 2022.
  - Division T of the legislation contains the SECURE 2.0 Act of 2022.
    - Makes significant changes that affect retirement plans.
- What's not in SECURE 2.0
  - No elimination of or restriction on back-door Roth IRAs
  - No restrictions on Roth conversions for high-income taxpayers
  - No increase in required minimum distributions (RMDs) for high-income taxpayers with large retirement account balances
  - No change to the age at which qualified charitable distributions from an IRA can be made (age 70-1/2)
  - No clarification of how the 10-year rule applies to a person who inherits a retirement account and is not an eligible designated beneficiary.

13

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Age at Which RMDs Must Begin *Outline: item B.3, page 21*

- SECURE 2.0 Act:
  - Increases the age at which RMDs must begin. In 2022, individuals who attained age 72 were required to begin taking RMDs. SECURE 2.0 increases the RMD age to age 73 in 2023 and to age 75 in 2033.
- Notice 2023-54 (7/14/23):
  - Automated payment systems must be updated to reflect the change in the age at which RMDs must begin and this may take time.
  - Therefore, those born in 1951 (who attain age 72 in 2023) might receive distributions in 2023 that are mischaracterized as RMDs (and therefore normally ineligible for rollover).
  - Individuals who receive such distributions from January 1 through July 31, 2023, had until September 30, 2023, to roll such mischaracterized distributions into an eligible retirement plan.
    - Applies to both employer-sponsored plans and IRAs.
    - The "one rollover every 12 months" rule for IRAs is not a bar.

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Reduced Penalties for Missed RMDs
Outline: item B.4, page 22

- SECURE 2.0 Act § 302:
  - Reduces the penalty for failure to take an RMD. Effective for 2023 and future years, SECURE 2.0 reduces the 50% penalty for an RMD shortfall to 25%. If the shortfall is corrected within a specified period, the penalty is further reduced to 10%.
  - Penalty is reduced to 10% if:
    1. An individual receives all past-due RMDs, and
    2. Files a tax return that reflects the excise tax on such RMDs before the earliest of three dates:
       a. The date of mailing of a notice of deficiency with respect to the excise tax,
       b. The date on which the excise tax is assessed, or
       c. The last day of the second tax year that begins after the close of the tax year in which the excise tax is imposed (apparently, the close of the second tax year after year of the missed RMD).

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No RMDs for Roth Accounts in Employer Plans
Outline: item B.5, page 22

- SECURE 2.0 Act § 325:
  - No RMDs for Roth accounts in employer retirement plans. Effective in 2024, Roth accounts in employer retirement plans are exempt from RMD requirements.
  - Effect:
    - Those already taking RMDs from Roth accounts in employer sponsored plans, and those who turn age 73 in 2023, must take an RMD for 2023 (no later than April 1, 2024).
    - For 2024 and later years, no RMDs are required from Roth accounts in employer sponsored plans.

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Surviving Spouses Can Defer RMDs
Outline: item B.6, page 22

- SECURE 2.0 Act § 327:
  - Deferral of RMDs for surviving spouses. If a participant dies before reaching the age at which RMDs must begin and has designated a spouse as the sole beneficiary, then the spouse may make an irrevocable election to be treated as the participant for purposes of receiving RMDs.
  - This will allow the surviving spouse to defer RMDs until the deceased spouse would have reached the RMD age.
  - This change is effective in 2024.
  - Example: H is age 62 and W is age 68. H passes away and W is sole beneficiary of his retirement account. W can elect to be treated as H to determine when RMDs must begin. W need not take RMDs until H would have turned 73.

17

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Changes to Employer Plan Catch-Up Contributions
Outline: item B.7, page 23

- SECURE 2.0 § 109:
  - Changes to employer plan catch-up contributions. Individuals age 50 and older can contribute an additional $7,500 (2023 and 2024) to an employer-sponsored retirement plan. SECURE 2.0:
    - Increased catch-up contributions for those ages 60-63. Effective in 2025, provides a special catch-up contribution for participants ages 60 to 63 equal to the greater of $10,000 (adjusted annually for inflation) or 150 percent of the regular catch-up contribution amount for 2024.
    - Note: 150% of the 2024 regular catch-up contribution amount ($7,500) is $11,250, i.e., more than $10,000.

18

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Expanded Penalty-Free Retirement Withdrawals
Outline: items B.11, B.12, and B.13, pages 25-26

- SECURE 2.0 Act:
  - Expanded penalty-free withdrawals. SECURE 2.0 modifies certain existing exceptions and adds additional exceptions to the normal 10% penalty on early withdrawals from qualified retirement plans, including exceptions for:
    - Emergency withdrawals: beginning in 2024, individuals can withdraw up to $1,000 without a penalty for "unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses." [S2.0 § 115]
    - Survivors of domestic abuse: beginning in 2024, no penalty applies to distributions up to $10,000 (or 50% of the account value, if less) that are "made to an individual during the 1-year period beginning on any date on which the individual is a victim of domestic abuse [as defined] by a spouse or domestic partner." [S2.0 § 314]
    - Those with a terminal illness: beginning in 2023, distributions are penalty-free if made to "an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification." [S2.0 § 326]
      - See Notice 2024-2 (12/20/23) section F (Q&A F1-F15)

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Notice 2023-27
2023-25 I.R.B. 634 (3/21/23)
Outline: item B.14, page 26

- Announces future guidance that will treat certain nonfungible tokens (NFTs) as "collectibles" for purposes of § 408(m).
- NFTs are akin to electronic works of art, such as digital images, animations, or videos, that are bought and sold via the internet.
- Future guidance will determine whether an NFT is a collectible by applying a look-through rule
  - Example: a gem is a § 408(m) collectible, and therefore an NFT that certifies ownership of a gem constitutes a § 408(m) collectible.
- Impact of treating NFTs as collectibles:
  - If an IRA or a self-directed qualified plan acquires an NFT, then the IRA or plan is treated as distributing the NFT to the account owner.
    - The distribution is taxable to the account owner
  - A taxpayer's gain on the sale of an NFT that is a capital asset will be collectibles gain taxed at a 28% rate
  - Treatment as a collectible also is relevant under other Code provisions

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Estate of Caan v. Commissioner, 161 T.C. No. 6 (10/18/23)
Outline: item D.3, page 30

- Facts
  - The actor James Caan passed away in 2022.
  - At the time of his death, he had two IRAs with UBS. One of the IRAs held a nontraditional asset, a partnership interest in a private hedge fund.
  - Caan failed to notify UBS of the value of the hedge fund interest for 2014, as required by the IRA custodial agreement.
  - UBS distributed the interest to him and issued Form 1099-R
  - Caan established a rollover IRA with Merrill Lynch, which directed the hedge fund to liquidate Caan's interest and and transfer the cash to the rollover IRA.
- Issues:
  1. Was the transfer of cash to Merrill Lynch a valid rollover?
  2. If not, what was the value of the distribution from UBS to Caan?
- Held:
  1. No. The transfer was outside the 60-day rollover window and was not the same property in the UBS IRA.
  2. $1.548 million

21

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Balint v. Commissioner T.C. Memo. 2023-118 (9/25/23)
Outline: item D.4, page 32

- While the taxpayer was incarcerated, he signed a broadly worded power of attorney.
  - It specifically authorized her to make gifts of his property and to engage in acts that otherwise would constitute prohibited self-dealing.
- Pursuant to the POA, his wife withdrew more than $150,000 from the taxpayer's IRAs and pension and annuity accounts.
  - She used the funds to move from Florida to Kentucky, renovate a house there, and to care for her ailing mother.
  - She filed for divorce. He later filed his own divorce action.
- Issues:
  1. Was the IRS bound by a state court order that his wife was liable for tax?
  2. Did the taxpayer have to include in income the amounts his wife withdrew?
- Held:
  1. No. The government was not a party to the divorce action.
  2. No. The taxpayer neither authorized nor benefitted from the withdrawals and therefore was not the "payee or distributee" under § 408(d)(1).

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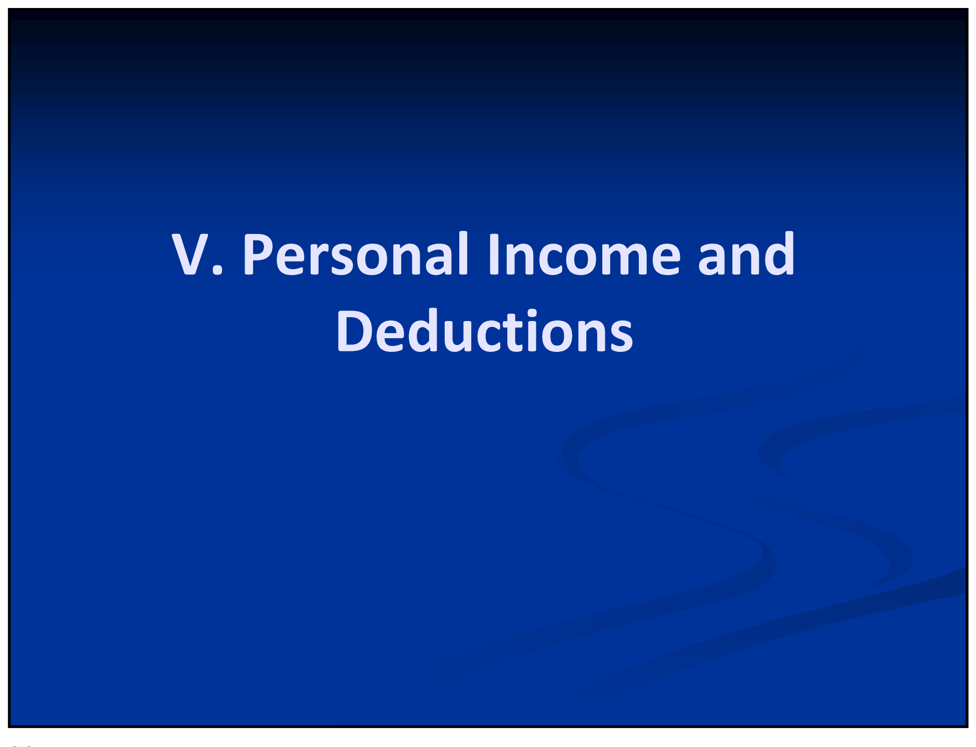

23

Gregory v. Commissioner, 69 F.4th 762 (11th Cir. 5/30/23)

Outline: item C.1.a, page 35

- Held: deductions allowed by § 183 (up to the amount fo income from activities not engaged in for profit) are below-the-line deductions and are miscellaneous itemized deductions subject to the 2% floor of (or denial by) § 67.

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Gomas v. United States, 132 A.F.T.R.2d 2023-5165 (M.D. Fla. 7/1723)

Outline: item D.5, page 39

- The taxpayers' daughter/stepdaughter defrauded the taxpayers of nearly $2 million.
- In 2017, the taxpayers withdrew nearly $1.2 million from an IRA and pension plan to pay her.
- Issue:
  1. Did the taxpayers have to include the $1.2 million in gross income?
  2. Could the taxpayers deduct the amount they paid as a business expense?
- Held:
  1. Yes. The taxpayers were the distributees.
  2. No. At the time the transfers were made, the taxpayers were retired and were no longer carrying on the trade or business.
- Query: could the taxpayers take a theft loss deduction in 2019 (the year they discovered the theft) under Rev. Rul. 2009-9 (Bernie Madoff Ponzi scheme)?

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Rollovers from 529 Plans to Roth IRAs

Outline: item F.1, page 40

- SECURE 2.0 Act § 126:
  - Rollovers from 529 plans to Roth IRAs. Beginning in 2024, beneficiaries of 529 college savings plans that have been open for more than 15 years can roll over up to $35,000 from the 529 plan to a Roth IRA during their lifetime (subject to annual Roth IRA contribution rules).
  - Requirements:
    - The § 529 account must have been maintained for the 15-year period ending on the date of the distribution,
    - The distribution does not exceed amount contributed to the § 529 plan (plus earnings) before the 5-year period ending on date of distribution,
    - The distribution is paid by direct trustee-to-trustee transfer to a Roth IRA maintained for benefit of designated beneficiary of the § 529 account,
    - Amount rolled over in current year cannot exceed annual limit on Roth IRA contributions ($6,500 for 2023) reduced by aggregate IRA contributions made during year for benefit of designated beneficiary,
    - Lifetime limit of $35,000.

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Bittner v. United States, 142 S. Ct. 2833 (6/21/23)

Outline: item H.2, page 88

- A 5-4 decision.
- Issue: are penalties for non-willful failure to file an FBAR determined $10,000 per offending account or just $10,000?
- Held: Just $10,000. The penalty is not determined per account.

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Estate of DeMuth v. Commissioner
132 A.F.T.R.2d 2023-5122 (3d Cir. 7/12/23)
Outline: item C.1, page 96

- Taxpayer was diagnosed with an “end-stage medical condition.”
- His son held a power of attorney authorizing him to act for his father
- The son wrote 11 checks for the taxpayer intended as annual exclusion gifts.
- Of the 11 checks, 7 had not cleared the drawee bank on the date of taxpayer’s death.
- Issue: were the funds represented by these 7 checks completed gifts and therefore excluded from the gross estate?
- Held: No. The checks had not cleared the drawee bank on the date of death.

30

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Recent Developments in Federal Income Taxation Business

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1

II. Business Income and Deductions

2

Hyatt Hotels Corp. v. Commissioner
T.C. Memo. 2023-122 (10/2/23)
Outline: item A.1, page 4

- Hyatt hotels were owned approximately 25% by Hyatt and 75% by third parties
- When a hotel guest earned rewards points by staying at a Hyatt-branded hotel, Hyatt required the hotel owner to pay a specified amount into an operating fund held by a Hyatt subsidiary.
- When a hotel guest used points to pay for a room at a Hyatt-branded hotel, Hyatt would make a compensating payment from the fund to the hotel owner.
- Hyatt also used the assets of the fund to pay administrative and advertising expenses that it determined were related to the rewards program.
- Held:
  1. Hyatt was required to include the fund's revenue in gross income. The trust fund doctrine did not apply because Hyatt benefitted from the fund.
  2. Hyatt did not experience a change of accounting method with a positive § 481 adjustment because Hyatt's exclusion of the revenue did not involve timing.
  3. The trading stamp method did not apply and therefore Hyatt could not reduce gross revenue from the fund by the estimated cost of future compensation payments to hotel owners.

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Clary Hood, Inc. v. Commissioner,
69 F.4th 168 (4th Cir. 5/31/23)
Outline: item C.1, page 9

- The taxpayer was a subchapter C corporation.
- Clary Hood served as CEO and he and his wife were the sole shareholders and members of the board of directors.
- The corporation operated a land excavation and grading business and averaged gross revenue of $21 million from 2000-2010, which grew to $44 million in 2015 and $69 million in 2016.
  - The corporation never paid any dividends.
  - Mr. Hood's annual salary ranged from $130,000 to $196,500.
- In part to make up for undercompensating Mr. Hood in prior years, the corporation paid him bonuses of $5 million in each of 2015 and 2016.
- Issue: could the corporation deduct the bonuses under § 162 as reasonable compensation?
- Held: No. Only $3.7 million is deductible for 2015 and $1.4 million for 2016.
  - Court approved of use of multi-factor test (rather than independent investor test)
  - Court reversed Tax Court on accuracy related penalties

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Notice 2024-8
2024-2 I.R.B. 356 (12/14/23)
Outline: item D.1, page 11

- Standard mileage rate for business miles in 2024 goes up to 67 cents per mile (from 65.5 cents in 2023).
- Medical/moving rate for 2024 is 21 cents per mile (*down* from 22 cents in 2023).
- Charitable mileage rate for 2024 remains fixed by § 170(i) at 14 cents.
- The portion of the business standard mileage rate treated as depreciation goes up to 30 cents per mile for 2024 (up from 28 cents in 2023).
- Reminders:
  - Unreimbursed employee business expenses are miscellaneous itemized deductions and therefore not deductible through 2025.
  - Moving expenses are not deductible through 2025 except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station.

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Notice 2024-8
2024-2 I.R.B. 356 (12/14/23)
Outline: item D.1, page 11

- Standard mileage rates for 2024 and the preceding two years:

Category	**2022**		**2023**	**2024**
	Jan.-Jun.	Jul.-Dec.		
Business mileage	58.5 cents	62.5 cents	65.5 cents	67 cents
Medical/ moving	18 cents	22 cents	22 cents	21 cents
Charitable mileage	14 cents	14 cents	14 cents	14 cents

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Prevailing Wage and Apprenticeship Requirements Proposed Regulations (8/30/23)

Outline: item D.2.b, page 12

- Inflation Reduction Act (Aug. 2022)
  - Amended several Code provisions and enacted others that authorize tax credits (or deductions)
  - Examples:
    - Deduction (§ 179D) for making commercial buildings energy efficient
    - Credit (§ 45L) for contractors building and selling energy-efficient homes
  - Generally, the credit or deduction is 5 times the normal amount if prevailing wage and apprenticeship requirements are satisfied
- Notice 2022-61 (11/30/22): provides initial guidance on PWA requirements
- Proposed regulations: 88 F.R. 60018 (8/30/23):
  - State that, generally, taxpayer satisfies prevailing wage requirement by ensuring laborers and mechanics employed are paid at rates not less than those set forth by Department of Labor
  - Permit taxpayers to cure failure to satisfy PWA with a penalty
  - Provide guidance on types of records needed to demonstrate compliance with PWA requirements

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Growmark, Inc. v. Commissioner 160 T.C. No. 11 (5/16/23)

Outline: item F.2, page 15

- Taxpayer, a Delaware corporation, is an agricultural cooperative that sells gasoline and diesel fuel, renewable fuels, alcohol fuel mixtures, and biodiesel mixtures.
- In connection with these activities, taxpayer paid a fuel excise tax under § 4081.
- The taxpayer was eligible for certain credits against its fuel excise tax liability.
- Issue: in determining its cost of goods sold (COGS), could the taxpayer take into account its gross fuel excise tax liability, or was it limited to taking into account its net fuel excise tax liability (gross fuel excise tax liability less available credits)?
- Held: the taxpayer's COGS includes its net fuel excise tax liability, not its gross fuel excise tax liability.

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Changes to Employer Plan Catch-Up Contributions
Outline: item B.8, page 23

- SECURE 2.0 § 603:
  - Changes to employer plan catch-up contributions. Individuals age 50 and older can contribute an additional $7,500 (2023 and 2024) to an employer-sponsored retirement plan. SECURE 2.0:
    - Catch-up contributions must be invested in Roth accounts for those with wages over $145,000. Provides that, beginning in 2024, if a participant has wages over $145,000 during the previous year, all catch-up contributions must be deposited into a Roth account. The $145,000 wage threshold will be adjusted annually for inflation.

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Changes to Employer Plan Catch-Up Contributions
Outline: item B.8.a, page 23

- Notice 2023-62, 2023-37 I.R.B. 817 (8/25/23):
  - IRS has announced a two-year "administrative transition period."
  - Specifically, until taxable years beginning after December 31, 2025:
    1. catch-up contributions will be treated as satisfying the requirements of section 414(v)(7)(A), even if the contributions are not designated as Roth contributions, and
    2. a plan that does not provide for designated Roth contributions will be treated as satisfying the requirements of section 414(v)(7)(B).
  - Notice 2023-62 also provides that future guidance will:
    - Provide that those who do not have wages are not subject to the Roth-only rule
    - Plan administrators and employers can treat employees who are subject to the Roth-only rule as having elected to make Roth contributions
    - Provide guidance on employer plans maintained by more than one employer

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Automatic Enrollment of Employees in New Plans
Outline: item B.9, page 24

- SECURE 2.0 Act § 101:
  - Automatic enrollment of employees in newly-created 401(k) and 403(b) plans. SECURE 2.0 provides that beginning in 2025, 401(k) and 403(b) plans established after December 29, 2022, must automatically enroll eligible participants.
  - Beginning in 2025, plans subject to this requirement must provide that:
    1. The percentage of compensation contributed by participants is at least 3% and not more than 10% in the first year of participation,
    2. Whatever the initial percentage of compensation contributed, the percentage is increased by 1 percentage point per year until the percentage contributed is at least 10% and not more than 15% of compensation.
  - Employees can opt out of participation or can elect to contribute a different amount.

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Automatic Enrollment of Employees in New Plans
Outline: item B.9, page 24

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  - Exceptions:
    1. § 401(k) and § 403(b) plans established before December 29, 2022, (See Notice 2024-2, sec. A (Q&A A1-A6))
    2. Plans maintained by employers that have been in existence fewer than 3 years,
    3. Plans maintained by employers that normally employ 10 or fewer employees, and
    4. Governmental plans (within the meaning of § 414(d)) and church plans (within the meaning of § 414(e)).

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Hoops, LP v. Commissioner, 77 F.4th 557 (7th Cir. 8/9/23)
Outline: item C.1.a, page 28

- In 2012, an accrual method partnership, Hoops, LP, which owned the NBA's Memphis Grizzlies, sold substantially all the assets to a buyer.
  - The buyer assumed substantially all the liabilities of Hoops, including the obligation to pay approximately $10.7 million in nonqualified deferred compensation to two players (Zach Randolph and Michael Conley).
- Hoops included the assumed liabilities in its amount realized from the sale.
- Hoops filed an amended partnership return for 2012 claiming a deduction for the deferred compensation.
- Issues:
  1. Could the partnership deduct the deferred compensation in 2012?
  2. [Did Hoops have to include the assumed liabilities in its amount realized?]
- Held:
  1. No. Section 404(a)(5) defers Hoops' deduction until the year in which the players include the compensation in gross income.
  2. [Yes, under the definition of amount realized in § 1001(b) and Reg. § 1.1001-2(a)(1).—argument not raised in 7th Circuit]

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Rev. Proc. 2023-26
2023-33 I.R.B. 486 (7/26/23)
Outline: item H.1, page 42

- IRS has made permanent its fast-track program for private letter rulings solely or primarily under the jurisdiction of the Associate Chief Counsel (Corporate).
  - Replaces, with minor changes, the pilot program established in Rev. Proc. 2022-10, 2022-6 I.R.B. 473
- If fast-track processing is available:
  - IRS will endeavor to complete the processing of the letter ruling request and, if appropriate, to issue the letter ruling within the time period specified by the branch representative or branch reviewer.
  - This period normally is 12 weeks.
- Pre-submission conference with IRS is required
- IRS strongly recommends that taxpayers submit fast-track requests as an encrypted e-mail attachment

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ES NPA Holding, LLC v. Commissioner, T.C. Memo. 2023-55 (5/3/23)
Outline: item G.1, page 46

- Background:
  - A person providing services to a partnership might receive either:
    - Capital Interest, or
    - Profits Interest
  - Under Rev. Proc. 93-27:
    - "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, then the IRS will not treat the receipt of such an interest as a taxable event for the partner or the partnership.“
    - Profits Interest: “[A] partnership interest other than a capital interest.” Rev. Proc. 93-27, § 2.01.
    - Capital Interest: “[A]n interest that would give the holder a share of the proceeds if the partnership assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” Rev. Proc. 93-27, § 2.01.

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    - Capital Interest: “[A]n interest that would give the holder a share of the proceeds if the partnership assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.” Rev. Proc. 93-27, § 2.01.

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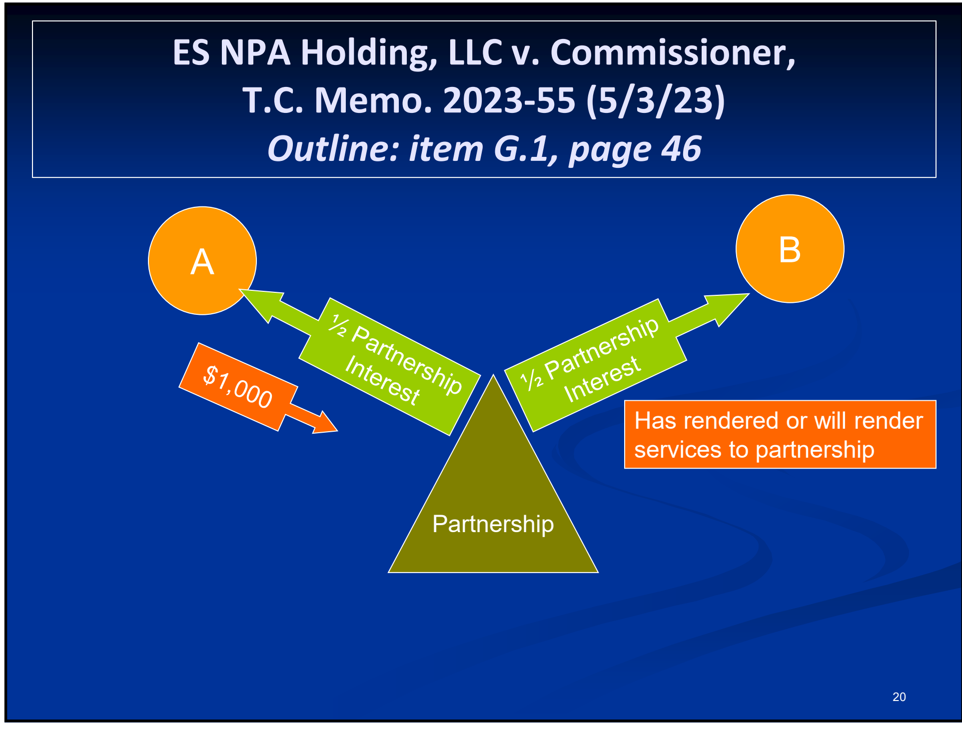

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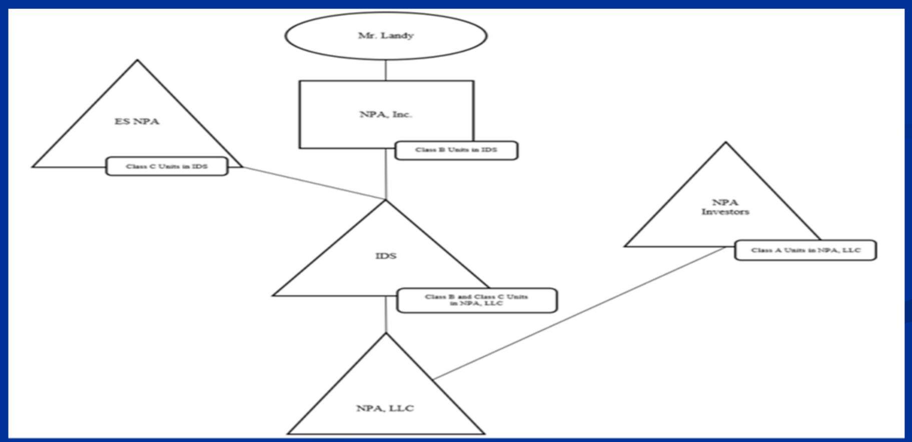
ES NPA Holding, LLC v. Commissioner, T.C. Memo. 2023-55 (5/3/23)

Outline: item G.1, page 46

- In a tiered partnership structure, ES NPA, LLC ("ES NPA") received a partnership interest in IDS (which was an indirect partnership interest in NPA, LLC) in exchange for services provided to NPA, Inc.



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ES NPA Holding, LLC v. Commissioner, T.C. Memo. 2023-55 (5/3/23)

Outline: item G.1, page 46

- Issues:
  1. Did Rev. Proc. 93-27 apply to ES NPA's receipt of a partnership interest in IDS (which was indirectly a partnership interest in NPA, LLC) in exchange for services that ES NPA had provided to NPA, Inc.?
  2. If Rev. Proc. 93-27 applies, was the partnership interest that ES NPA received a profits interest or a capital interest?
- Held:
  1. Yes, Rev. Proc. 93-27 applies.
     - Court rejects IRS's argument that Rev. Proc. 93-27 did not apply because ES NPA had not provided services to IDS, the partnership in which it received an interest.
  2. Yes, the partnership interest that ES NPA received was a profits interest.
     - Court rejects IRS's argument that assets of the underlying partnership had been undervalued and that the interest was really a capital interest.

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IX. Exempt Organizations and Charitable Giving

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Estate of Hoenscheid v. Commissioner, T.C. Memo. 2023-34 (3/15/23)

Outline: item B.2, page 51

- Facts
  - Taxpayer and his two brothers held appreciated shares of stock in a corporation originally formed in 1927
  - Taxpayer donated some of his shares to a charitable organization two days before the planned sale of all of the stock in the corporation (including the shares held by the charitable organization).
- Main Issues:
  1. Did the anticipatory assignment of income doctrine require the taxpayer to recognize capital gain with respect to the shares sold by the charitable organization?
  2. Was the appraisal of the shares a qualified appraisal?
- Held:
  1. Yes, taxpayer must recognize the capital gain on the shares sold by the charitable organization.
  2. No, it was not a qualified appraisal. Taxpayer's charitable contribution deduction denied.

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Farhy v. Commissioner, 100 F.4th 223 (D.C. Cir. 5/3/24)

Outline: item A.2.a, page 61

- Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls
  - Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.
- Section 6038(b)(1) imposes a penalty of $10,000 for each annual accounting period for which a person fails to provide the required information.
  - In addition, § 6038(b)(2) imposes a continuation penalty of $10,000 for each 30-day period that the failure continues up to a maximum continuation penalty of $50,000 per annual accounting period.
- Issue: can the IRS levy to collect the penalties imposed by § 6038(b)?
- Held: Yes. There is statutory authority for the IRS to assess theses penalties. Because they cant be assessed, the IRS can exercise its administrative collection powers to collect them.
- **Note:** case reverses the U.S. Tax Court on this issue.

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Dodson v. Commissioner, 162 T.C. No. 1 (1/3/24)

Outline: item D.1, page 66

- IRS sent a notice of deficiency ("first notice of deficiency") dated October 7, 2021, and specifying that December 5, 2022 (424 days later) was the last day to file a petition in the Tax Court.
- IRS sent a corrected notice of deficiency ("second notice of deficiency") dated October 8, 2021, and specifying that January 6, 2022, was the last day to file a petition in the Tax Court.
  - The taxpayers asserted they never received the second notice of deficiency.
- Taxpayers filed a petition in the Tax Court on March 3, 2022, 147 days after the first notice of deficiency.
- Issue: was their petition timely filed?
- Held: Yes. The first notice of deficiency was never rescinded.
  - Section 6213(a): "Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed."

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Hallmark Research Collective v. Commissioner, 159 T.C. No. 6 (11/29/22)

Outline: item E.2, page 68

- A unanimous, reviewed decision of the U.S. Tax Court.
- Issue: is the 90-day period specified in § 6213(a) for filing a Tax Court petition in response to a notice of deficiency jurisdictional, and is it subject to equitable tolling?
- Held: Yes, the 90-day period is jurisdictional. The period is not subject to equitable tolling.
  - U.S. Supreme Court's decision in *Boechler, P.C. v. Commissioner*, __ U.S. __ (4/21/22), does not dictate a contrary result.

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Culp v. Commissioner, 75 F.4th 196 (3d Cir. 7/19/23)
Outline: item E.2.a, page 69

- Issue: is the 90-day period specified in § 6213(a) for filing a Tax Court petition in response to a notice of deficiency jurisdictional, and is it subject to equitable tolling?
- Held: No, the 90-day period is not jurisdictional. The period is subject to equitable tolling.
  - Section 6213(a): "Within 90 days … after the notice of deficiency authorized in section 6212 is mailed …, the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. … The Tax Court shall have no jurisdiction to enjoin any action or proceeding or order any refund under this subsection unless a timely petition for a redetermination of the deficiency has been filed and then only in respect of the deficiency that is the subject of such petition."
- Note: in *Nguyen v. Commissioner*, T.C. Memo. 2023-151 (12/20/23), court declined to apply *Culp* in decision appealable to the 10th Circuit.

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Sanders v. Commissioner, 161 T.C. No. 8 (11/2/23)
Outline: item E.1.b, page 70

- In response to a notice of deficiency, taxpayer filed her Tax Court petition late.
- Issue: is the 90-day period specified in § 6213(a) for filing a Tax Court petition in response to a notice of deficiency jurisdictional?
- Held: Yes, the 90-day period is jurisdictional. The period is not subject to equitable exceptions.
  - Reviewed opinion (10-1-2).
- The Tax Court follows the precedent of the U.S. Court of Appeals to which the case is appealable. *Golsen v. Commissioner*, 54 T.C. 742 (1970).
- The taxpayer resided in the Fourth Circuit, and therefore any appeal of the Tax Court's decision would be decided by the Fourth Circuit.
  - The Fourth Circuit has not issued a precedential opinion on the issue of whether the 90-day period of § 6213(a) is jurisdictional.
- Tax Court will adhere to its prior decision in *Hallmark* and will not follow the Third Circuit's decision in *Culp* in cases appealable to other Circuits.
- Government's motion to dismiss for lack of jurisdiction granted.
- Dissenting opinion of Judge Foley joined by Judge Weiler.

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Sanders v. Commissioner, 160 T.C. No. 16 (6/20/23)
Outline: item E.8, page 77

- Taxpayers received a notice of deficiency.
  - Section 6213(a) provides a 90-day period
  - During this period, taxpayer can file a Tax Court petition to challenge the notice of deficiency
- The last day to file a Tax Court petition was December 12, 2022.
- Taxpayer had trouble logging into the Tax Court's system (DAWSON) on his mobile phone and switched to his computer.
- The upload of his petition began at 12:00:09 a.m. on December 13, 2022, and the court received the petition at 12:00:11 a.m.
- Issue: was the taxpayer's petition timely filed?
- Held: No. When the "timely mailing" rule does not apply, a Tax Court petition is filed when received by the court.
  - The petition was received 11 seconds late.

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Organic Cannabis Foundation, LLC, v. Comm'r, 161 T.C. No. 4 (9/7/23)
Outline: item E.9, page 78

- IRS filed a notice of federal tax lien for three years.
  - Under section 6320(a)(3)(b), taxpayer had 30-days to request a collection due process (CDP) hearing with IRS Appeals.
- The taxpayer timely requested a CDP hearing for two of the years.
- For 2018, the taxpayer filed a request for a CDP hearing one day late.
- Because the CDP request for 2018 was late, the IRS held an equivalent hearing for that year, from which the taxpayer normally has no right of judicial review in the Tax Court.
- IRS Appeals issued an adverse notice of determination for all three years and taxpayer filed a petition in the Tax Court.
- Issue: is the 30-day period in section 6320(a)(3)(b) for requesting an administrative CDP hearing subject to equitable tolling?
- Held: Yes. Case remanded to IRS Appeals to determine whether equitable tolling was warranted.

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Sall v. Commissioner
161 T.C. No. 13 (11/30/23)
Outline: item E.10, page 79

- The taxpayer received a notice of deficiency stating the last day to file a petition with the Tax Court was Friday, November 25, 2022, the day after Thanksgiving.
- The Tax Court was administratively closed on that day.
- The taxpayer mailed his petition to the court on Monday, November 28, 2022. The court received the petition on December 1, 2022.
- Issue: Did the taxpayer timely file his Tax Court petition?
- Held: Yes. Section 7451(b)(1) (added in 2021) provides:
  - "Notwithstanding any other provision of this title, in any case (including by reason of a lapse in appropriations) in which a filing location is inaccessible or otherwise unavailable to the general public on the date a petition is due, the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days."
  - The office of the clerk of the Tax Court, which is a filing location, was inaccessible on November 25, 2022 (the date the petition was due).
  - Therefore, the taxpayer had until December 10, 2022, to file the petition. Because December 10, 2022, was a Saturday, under § 7503, the taxpayer had until Monday, December 12, 2022, to file the petition.

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Soroban Capital Partners v. Commissioner, 161 T.C. No. 12 (11/28/23)

Outline: item B.1, page 93

- Facts
  - The petitioner, Soroban Capital Partners LP (Soroban), is a limited partnership subject to the former TEFRA unified audit and litigation procedures.
  - Soroban had one general partner (a limited liability company) and three individual limited partners.
  - On its partnership tax returns for 2016 and 2017, Soroban included in net earnings from self-employment the guaranteed payments received by the three limited partners and the general partner's distributive share of the partnership's ordinary business income.
  - Soroban excluded from net earnings from self-employment the limited partners' distributive shares of the partnership's ordinary business income.
- Issue: were the limited partners' shares of the partnership's ordinary business income automatically excluded from net earnings from self-employment?
- Held: No. Although § 1402(a)(13) excludes from net earnings from self-employment "the distributive share of any item of income or loss of a limited partner, as such …," an analysis of the limited partners' functions and roles is required.

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XIII. Trusts, Gifts, and Estates

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Connelly v. United States
70 F.4th 412 (8th Cir. 6/2/23)
Outline: item A.1, page 94

- Two brothers owned all the shares of stock of a corporation.
- Under a stock purchase agreement, upon the death of either brother:
  - The surviving brother had the right to purchase the deceased brother's shares and,
  - If the surviving brother declined to purchase the shares, the corporation was obligated to redeem the shares.
- Value of stock was established either by brothers' agreement or by appraisal.
- The corporation owned life insurance with a death benefit of $3.5 million on each brother's life to allow the corporation to redeem shares.
- One brother passed away and the corporation redeemed the shares for $3 million. Value established by agreement of surviving brother and decedent's son.
- Issue: in determining the value of the deceased brother's shares for estate tax purposes, is the value increased by the $3.5 million of life insurance proceeds?
- Held: Yes. The corporation's obligation to redeem the shares is not a liability that offsets this $3.5 million. Estate of Blount (11th Cir. 2005) rejected.
- Note: U.S. Supreme Court granted certiorari. Arguments held Mar. 27.

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Session Description

This presentation will first discuss the treatment of partners as W-2 employees, IRS self-employment tax examinations, and recent IRS SECA court cases, and examine risks and next steps. It will then explore IRS, DOL and Virginia independent contractors issues, including a discussion of the rules (especially DOL updates), and steps to consider in determining status.

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RSM

Common Types of Partnership Awards

Recipient Becomes a Partner at some point	Award does not confer ownership
Profits Interest	Unit Appreciation Rights
Capital Interest	Phantom Equity
Option to acquire an interest In a Partnership (upon exercise)	

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Capital Interests

RSM

Capital Interests Granted for Services

- Recipient has compensation income
  - How reported?
  - Did recipient provide service as an employee? Contractor?
- Partnership gets a tax deduction equal to the recipient's compensation.
- IRC Section 83 - The amount of compensation and corresponding deduction are equal to Fair Market Value of the grant.
- Timing of compensation and deduction?

Compensation on Initial Grant of Interest: Guaranteed Payments vs. Form W-2

Employee ≠ Partner Rev. Rul. 69-184

Reg. section 1.707-1(c) provides that guaranteed payments for services rendered by a partner are not gross income.

Compensatory event occurs either on:

- Grant (if an 83(b) election is filed or if grant is fully vested); or,
- Vesting (if no 83(b) election is filed).

Post-transfer treatment

- Reporting the taxation of the compensatory transfer
- Once the compensatory event occurs, compensation treatment shifts from being reported on Form W-2, subject to FICA and federal income tax withholding (as an employee) to reported on a Schedule K-1, subject to SECA and estimated taxes.
- What about the limited partner SECA exemption?

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RSM

Profits Interests: Rev. Proc. 93-27

- Special valuation rule - the receipt of a safe-harbor profits interest is not treated as taxable compensation when awarded for services.
  - Value?
  - GAAP?

- Rev. Proc. 93-27 does not apply when the profits interest:
  - relates to a substantially certain/predictable stream of income;
  - Is disposed of within two years of grant; or,
  - Is a limited partnership interest in a public partnership.

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Profits Interests: Rev. Proc. 2001-43

- Built on 93-27 and applies when a profits interest is subject to a vesting schedule.
- A profits interest recipient holds an unvested profits interest on the grant date IF:
    1) The PI holder is *treated as a partner from the grant date.*
    2) There are no deductions taken for the transfer of the profits interest, AND
    3) All other conditions of Rev. Proc. 93-27 are met.

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Profits Interests: Use of Thresholds

- Profits interest recipients are entitled to a share of FUTURE profits but do not share in profits/value accrued prior to the grant date.

- Since the interest does not share in prior value, a profits interest holder would receive $0 if the partnership liquidated soon after the profits interest was granted.

- Section 83(b) election?

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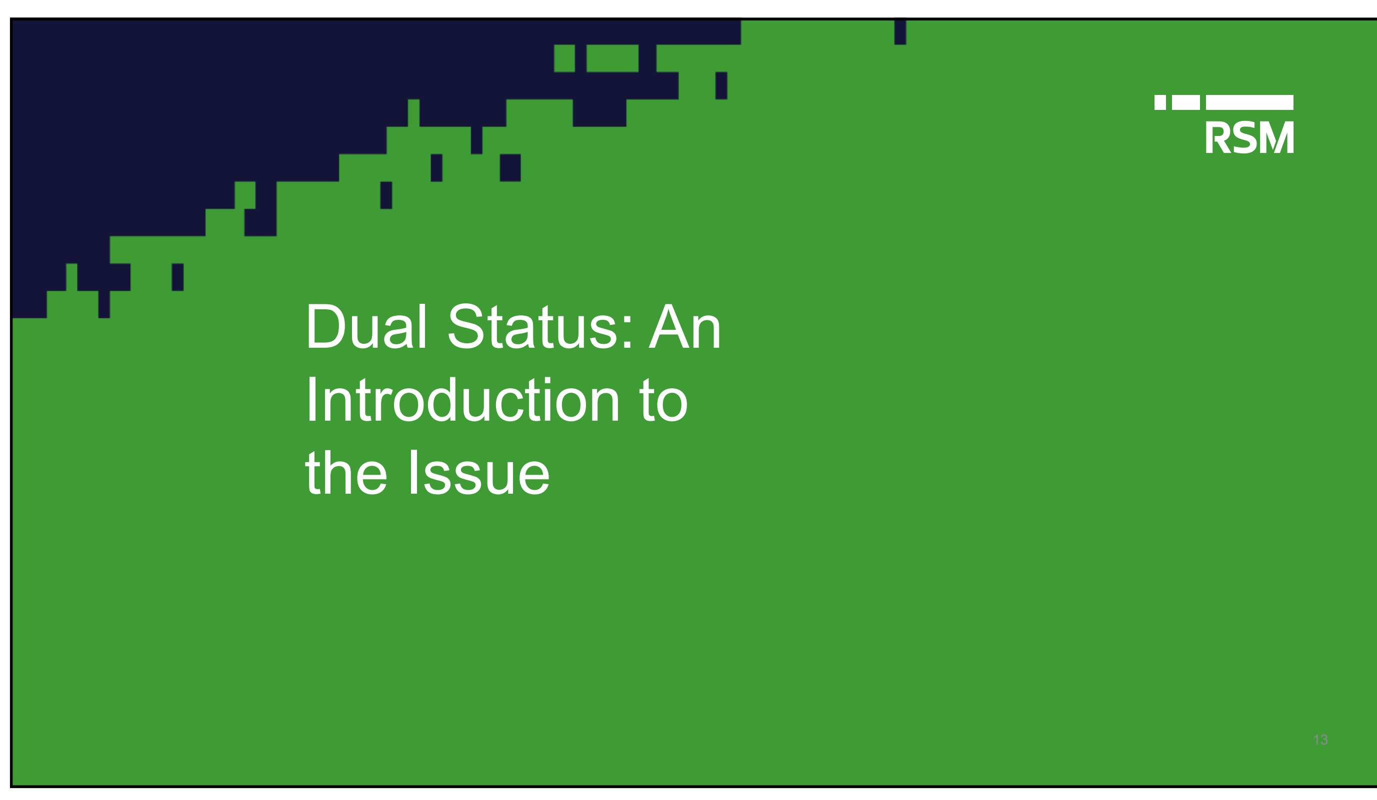

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What is “Dual Status” in the partnership/service provider context?

Partnerships may issue compensatory equity to current employees

Do these service providers have “dual status” as partners and employees or are they treated as partners for all tax purposes?

- Partner:
  - Compensation reported on Schedule K-1 as a guaranteed payment. No W-2.
    - Partner responsible for own SECA filings.
  - Distributive share of partnership items reported on Schedule K-1.
  - Certain employee benefits not available or taxed differently
- Dual Status:
  - Treated as a partner with respect to their distributive share of partnership items.
  - Treated as an employee with respect to benefits and wages (Form W-2).

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Exposure - FICA v SECA

FICA tax and SECA tax

- Employees:
  - Employer withholds FICA taxes from an employee's wages
  - Employer pays its share of FICA taxes
- Partners
  - Partner pays SECA tax (aggregate Employer and employee share of FICA)
  - No withholding – partner makes estimated tax payments
- If treated as an employee instead of a partner:
  - Over withholding and overpayment of FICA taxes by the employer
  - Underpayment of SECA tax by the partner
- Schedule K-1 may be inaccurate

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Exposure- Employee Benefits – Statutory differences

Cafeteria plans (Sec. 125):

- Allows an employee election between a taxable benefit (e.g., cash) and certain nontaxable benefits, for example
  - Health insurance premiums
  - Health flexible spending arrangements
  - Dependent care spending arrangements
- Only employees may participate
- Participation by a partner may technically disqualify the plan for all participants

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Benefits (Continued)

Retirement plans (e.g., Sec. 401(k) plans)
- Plan must be designed to allow partners to participate (using the partnership compensation definition)
- Participation by partners without design considerations can cause a plan failure
- Contributions to plan if participant does not have enough SECA income

Health care benefits
- Employee: Employee health care costs (e.g., health insurance premiums) paid by the employer are excludible from income
- Partner: Costs paid by the partnership are included in income as guaranteed payments

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Fringe Benefits for Partners

- Section 132 – "working condition fringe benefits" and other standard tax-free fringe benefits.
- Each type of fringe benefit is different, but most 132 fringe benefits can be provided tax free to service partners (and receive same treatment as employees)
- **Exception – qualified parking and transportation (partners are not eligible to participate)**

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Fringe Benefits for Partners (cont'd)

Section 74 – Achievement awards, partner treated as employee

Section 79 – Group Term Life, partner is not an employee under section 79, see Reg. 1.79-0, but partner is an employee under ERISA so they can participate (but do not get the exclusion for the first $50k of coverage)

Section 119 – Meals, Lodging for Employer's Convenience, partner treated as employee? Maybe?

- Phinney case vs Wilson case and others are contrary

Section 129 – Dependent Care Assistance (not an FSA), partner treated as employee

- Discrimination rules apply

Fringe Benefits for Partners (cont'd)

- Section 105 – HRA, Medical Expense Reimbursement Program (MERP)
  - Partner not treated as an employee
- Section 223 – HSA, partner not treated as employee, but partner can receive employer contribution as distribution or guaranteed payment
  - Taxable,
  - Subject to SECA
  - Generally tax deductible on Form 1040

- Discrimination rules apply to all above

Exposure-Additional Risks

State income taxes
- Employee: Pay income tax based on where services are provided to earn compensation, except where states agree to allow taxation based on state of residence
  - Apportionment issues also possible

- Partner: Filing may be required in multiple states

- Qualified business income deduction (Sec. 199A)

- Is the grant really an ownership grant?
  - Is a promise to pay “profits” ONLY at sale of the partnership actually ownership?

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Dual Status Planning Arrangements

What we see in practice

- Tiering up – Transfer / grant profits interests to employees in a *regarded* upper tier entity (all profits interests held by one LLC which is owned by several individuals who are separately employees in the lower-tier Opco
- Intermediate Holdco – Add an intermediate company above Opco, below/separate from major owner partnership
- Other similar structures – corporation? S-corporations?

- Issue to consider – does the partnership have a business purpose?

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Self-Employment Tax and Partnership Concerns

- Section 1401 – Imposes tax on self-employment “SE” income (FICA equivalent)
  - Generally, ordinary partnership distributions are expected to be included as SECA income for most types of partnerships
- Sec. 1402(a) - SE income includes an individual’s distributive share of income or loss described in Sec. 702(a)(8) from any trade/business carried on by a partnership of which the individual is a member
- Various exclusions, including a retirement payment distribution exclusion under IRC 1402(a)(10)

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Self Employment Tax (continued)

- Reg. §1.1402(a)-1(a) – Guaranteed payments from a partnership engaged in a trade or business are included in SE income.

- Sec. 1402(a)(13) - Excludes the distributive share of any item of income or loss of a limited partner (other than guaranteed payments for services in Sec. 707(c)) from net earnings from self-employment subject to SE tax.
  - Original purpose for enactment of Sec. 1402(a)(13)?
    - Keeping investors out of Social Security

  - **What is a limited partner in this context?**
    - **Currently being litigated**

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1997 Proposed Regulations on SECA exclusions

- Currently there are no final regulations on a Sec. 1402(a)(13) limited partner
- Proposed regs (can be relied upon if strictly followed).
  - A service partner in a service partnership cannot use proposed regulations.

General Three-Prong Test Under Proposed Sec. 1402(a)(13) Regulations

- An individual generally is treated as a limited partner unless the individual:

1. Has personal liability for the debts or claims against the partnership due to being a partner; **or**
2. Has authority (under the law of the jurisdiction in which the partnership is formed) to contract on behalf of the partnership; **or**
3. Participates in the partnership's trades or businesses for more than 500 hours during the partnership's taxable year.

Note: regulations provide that one class of income could be subject to SECA while another class of income might not be SECA income (such as Class A and Class B shares with different ownership rights, etc.)

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Case Law on Sec. 1402(a)(13)

Earlier cases raised questions on whether (a)(13) applied to LLPs or LLCs – newer forms of partnerships)

Renkemeyer, Campbell, Weaver, LLP v. Commissioner, 136 T.C. 137 (2011)

- The Tax Court examined the legislative history of the statute to interpret the meaning of a limited partner for the purposes of Sec. 1402(a)(13)
  - ➢ Intent – to ensure that individuals who merely invested in a partnership and were not actively participating in the partnership's business operations would not receive credit toward Social Security coverage.
- Holding: revenue was derived from services performed by partners in their capacity as partners; the partners were not acting as investors of the partnership, and thus, the partners were liable for SE tax.

- Primary characteristics of a limited partner:
  - ✓ Limited Liability, **AND**
  - ✓ **Lack of Control over Business**

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Case Law on Sec. 1402(a)(13) (cont'd)

Castigliola v. Commissioner, T.C. Memo. 2017-62

Taxpayers were three lawyers who practiced law through a professional limited liability company (the "PLLC"), classified as a partnership for tax purposes

- PLLC did not have a written operating agreement; Lawyers collectively made decisions about the PLLC
- Guaranteed payments –
  - Compensation agreement required each of the lawyers to receive a guaranteed payment for services rendered to the PLLC; amount was commensurate with local legal salaries
  - Lawyers also receive distributive share of net profits of the PLLC

Tax Return reporting treatment under the partnership:

- Guaranteed payment – subject to SE tax
- Distributive Share – not subject to SE tax
- Conclusion: Lawyers participated in control of the PLLC; thus, were not limited partners under Sec. 1402(a)(13)
  - ➢ **Appears to apply all or nothing approach – no carve out for reasonable compensation**
  - See also **CCA 201640014** and **CCA 201436049**

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Case Law on Sec. 1402(a)(13) (cont'd)

Hardy v. Commissioner, T.C. Memo. 2017-16

- Taxpayer was a plastic surgeon who performed surgeries at various surgical centers, including "MBJ", a center in which he owned a 12.5% interest
- MBJ was an LLC classified as a partnership for U.S. tax purposes
  - Question is whether distributive share from MBJ is subject to SE tax
- Dr. Hardy received distributions from MBJ whether or not he performed surgeries there
- Main issue: Were his activities passive?

Tax Court Conclusion (on SECA treatment)

- Dr. Hardy's distributive share of income from MBJ was not subject to SE tax; Dr. Hardy received share of MBJ income *in his capacity as an investor*
  - Patients paid Dr. Hardy directly for fees as surgeon; separately paid surgical centers for use of facility
  - MBJ was professionally managed and Dr. Hardy did not have day-to-day management responsibility; not involved in management decisions

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Soroban & Limited Partner Self-Employment Tax

Background – statutory limited partner exception of section 1402(a)(13) exempts from SE tax a limited partner's distributive share of ordinary business income

Soroban Capital Partners LP – investment firm based in New York and organized as a Delaware limited partnership (one general partner, three limited partners)

- Limited partners received guaranteed payments in exchange for performance of services rendered to Soroban
- Limited partners received distributive share of partnership's ordinary business income
- Soroban reported the net earnings from self-employment to the limited partner's (equal to their guaranteed payments), but did *not report* limited partner's distributive share of partnership's ordinary business income as earnings from self-employment taking the position that the statutory limited partner exception of section 1402(a)(13) applied to such earnings

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Soroban & Sirius & Limited Partner Self-Employment Tax (cont'd)

Soroban Tax Court agreed with IRS and granted summary judgment holding that

"…determining whether a partner is a limited partner in name only requires an inquiry into the functions and roles of the limited partner… (and) the limited partner exception applies only to a limited partner who is functioning as a limited partner."

Takeaways - there has been almost no guidance regarding the definition of 'limited partner' for purposes of the 1402(a)(13) exception, at least for state law limited partnerships/pass through entities.

- Soroban is the first decision to suggest that a state law limited partner may not be a limited partner for SE tax purposes.
- Decision may create an additional test for taxpayers to navigate when determining whether the section 1402(a)(13) self-employment exception applies to state law limited partners in a state law limited partnership
- Tax Court has not yet ruled on whether the limited partners in Soroban were limited partners under the 'functional analysis test'

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Sec. 1402(a)(10)

- Sec. 1402(a)(10) excludes certain partnership retirement payments from the retiree partner's self-employment earnings where they do not provide any services to the partnership during the taxable year of the payments.
  - (1) Retiree does not perform services during the partnership's taxable year; and
  - (2) No obligation from other partner to retiree other than retirement payments; and
  - (3) Partner's share of capital has been paid out by close of partnership's taxable year

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Partner vs Contractor

- A partner cannot be an employee in the same firm but can a partner also separately be a contractor?
  - Unusual but it can happen! Section 707 actually acknowledges this dual capacity
  - Can occasionally be useful
    - Regular partner, providing normal services
      - For a unique project, a partner that has separate skills or expertise can be separately “hired” separately as a contractor – providing services in a different capacity. This separate amount can be reported on Form 1099 NEC.

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Brief Update on Contractor vs Employee Issues

- Three levels of testing
  - Federal IRS Employee vs Contractor Classification
  - Federal Department of Labor (DOL) rules
  - State Rules
- Questions coming up on new DOL rules vs IRS rules
- Issues coming up on Merger & Acquisition Due Diligence
- Risks to employee benefit plans if employees kept out of plans (less of an issue with most 401(k) plans because of protective language).
- Possible risks if “contractors” contribute to their own plans (SEPs, solo (k) plans) based on what should be employee compensation

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IRS vs DOL

- DOL - LABOR rules – overtime/wage and hour rules, workplace safety,
  - Nature of the work – Is normal work done part of company's "core business"?
  - Control and degree of control – Who sets hours, who provides training and equipment, can the company tell the employee HOW to do the work (step by step)?
  - Does the worker have much financial risk/ability to make profit specific to the worker's skill?
  - Does the employee own/invest in their own tools, place of work, etc.?
  - Does worker expect long-term, ongoing working relationship with this specific company or does the worker expect to work for several unrelated companies

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IRS

IRS rules – focus on compensation, reporting and related benefits issues

- Three-part test (compilation of older 20 factor tests)
  - Behavioral Control
  - Financial Control
  - Relationship (rights, benefits, long-term service expectations)

- IRS and DOL acknowledge that their rules are different
  - TECHNICALLY POSSIBLE to treat an individual as a contractor for IRS purposes and an employee for DOL, but new rules make it harder and invite scrutiny!

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Watch State rules!

- State may expect payment of unemployment compensation even if otherwise a contractor for federal purposes
- State may have different standards – CA – might have to do W-2 on state side even if doing 1099 NEC on federal side..
- Virginia – essentially uses old IRS 20 factor test – make your arguments, but the assumption leans towards treating people as employees.
  - Employee/contractor can sue…
  - $1,000 per misclassified employee, can go up higher

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Steps for determining Contractor vs Employee

- What does the contract say?
  - However, the contract does not control if the facts are contrary
- Did or does the employer give a “choice” between contractor or employment status?
- Check to determine what the company provides
  - Equipment?
  - Benefits?
  - Supplies?
  - Training?

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Steps (Continued)

- Nature of the work
  - Specific projects?
- How is project timeframe developed?
- Are there employees doing the same, or similar job?

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Inflation Reduction Act Update
Scott Bragg, CPA
Jeff Barbour, CPA
BROWNEDWARDS
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Agenda
TOPICS TO COVER
• Background
• New and Enhanced Credits
• Elective Pay and Credit Transfers
• Recent Guidance
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Background

- Signed into law on August 16, 2022
- Allocated $369B to programs focusing on climate issues and use of renewable energy over fossil fuels
- Contains tax incentives designed to promote U.S. production of electric vehicles, renewable energy technologies, and critical minerals
- Provisions that subsidize energy resources that do not emit carbon (solar, wind, nuclear)

Key Tax Provisions

- Introduced new credits and structures
- Extended or enhanced many previously existing energy-related credits
- Provides credits for domestic manufacturing of clean energy components
- Creates options for monetization of tax credits for taxable and tax-exempt entities

Tax Credits

Production Credits

- Section 45 – Renewable Electricity Production Tax Credit (Extended / Modified)
- 45Q – Credit for Carbon Oxide Sequestration (Extended / Modified)
- 45U – Nuclear Power Production Tax Credit (New)
- 45V – Clean Hydrogen Production Tax Credit (New)
- 45X – Advanced Manufacturing Production Credit (New)
- 45Y – Clean Energy Production Credit (New)
- 45Z – Clean Fuel Production Credit (New)

Tax Credits

Investment Credits

- Section 48 – Energy Credit (Extended / Modified)
- 45L – New Energy Efficient Home Credit (Extended / Modified)
- 30C – Alternative Fuel Vehicle Refueling Property Credit (Extended)
- 48C – Qualified Advanced Energy Project Credit (Modified)
- 48E – Clean Electricity Investment Credit (New)

Tax Credits

Fuel Tax Credits

- 40A – Biodiesel and Renewable Diesel Credit (Extended)
- 40A – Second Generation Biofuel Producer Credit (Extended)
- 40B – Sustainable Aviation Fuel Credit (New)

Tax Credits

Residential Tax Credits

- 25C – Energy Efficient Home Improvement Credit (Extended / Modified)
- 25D – Residential Clean Energy Credit (Extended / Modified)

Tax Credits

Clean Vehicle Credits

- 30D – New Clean Vehicle Credit (Modified)
- 25E – Credit for Previously-Owned Clean Vehicles (New)
- 45W – Credit for Qualified Commercial Clean Vehicles

Elective Pay & Transferability

- The IRA provides two new mechanisms to facilitate use of certain credits
- Elective Pay (Section 6417) – Allows certain tax-exempt entities to monetize tax credits by treating them as a direct cash payment of income tax
- Transferability (Section 6418) – Allows tax-paying entities the ability to sell their clean energy credits to other tax-paying entities
- Proposed Regs released on June 14, 2023
- Final Regs released on March 5, 2024 for Elective Pay and April 25, 2024 for credit transfers

- Pre-IRA law:
  - Not available for projects that began construction after 12/31/21
  - Credit was 26% of eligible basis
- IRA changes:
  - Extends the credit for construction that begins prior to 1/1/2025
  - Credit is 6% of basis of qualified property placed in service
  - 5x bonus if prevailing wage and apprenticeship requirements met, or project less than 1 MW
  - 2% bonus for Domestic Content (eligible for 5x)
  - 2% bonus if located in Energy Community (eligible for 5x)
  - Transferable

Section 48 Energy Credit

- Eligible property:
  - Equipment using solar energy to generate electricity (i.e. solar panels)
  - Equipment using solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight
  - Electrochromic glass
  - Equipment used to produce, distribute, or use energy from a geothermal deposit
  - Qualified fuel cell or microturbine property
  - Qualified small wind energy property
  - Waste energy recovery property (in-service after 12/31/22)
  - Energy storage property (in-service after 12/31/22)
  - Qualified biogas property (in-service after 12/31/22)
  - Microgrid controllers (in-service after 12/31/22)

Section 48 Energy Credit

- Requirements:
  - Must be tangible, depreciable property
  - Taxpayer must be original user
  - Construction must begin prior to 1/1/2025
- Bonus Credit:
  - Credit goes from 6% to 30% if
    - Maximum output is less than 1 megawatt
    - Prevailing wage requirements are met, or
    - Construction began prior to 1/29/2023

Section 48 Energy Credit

- Energy Community Bonus:
  - 2% in the case of 6% credit
  - 10% in the case of 30% credit
  - "Energy Community" defined as:
    - Brownfield site
    - Metro or non-metro area which
      - Has 17% or more of its direct employment or 25% of local tax revenues related to fossil fuels AND
      - Has unemployment rate at or above the national average for the previous year
    - Census tract which
      - Had a coal mine close after 12/31/1999
      - Had a coal-fired electric generating unit retired after 12/31/1999, OR
      - A directly adjoining census tract

Section 48 Energy Credit

Section 48 Energy Credit

- Domestic Content Bonus:
  - 2% in the case of 6% credit
  - 10% in the case of 30% credit
  - 100% of steel must be manufactured in the U.S.
  - 40% of manufactured products must be made in the U.S.
  - Notice 2023-28
    - Manufactured Component Test based on cost
    - Only direct costs are included

Section 48 Energy Credit

- Calculation of credit:
  - Based on all costs
  - Includes applicable indirect costs, supports, etc.
  - Basis reduced by 50% of credit
  - Remaining basis depreciated as 5-year property, eligible for bonus
  - Subject to recapture under Sec. 50
  - Subject to passive limitations

- Example
  - Installation of $425,000 in solar panels
  - Steel supports costing $25,000
  - Electrical connections costing $25,000
  - Installation, overhead, and design $25,000
  - Total installed cost = $500,000
  - Project located in WV and all components manufactured in the U.S.

Section 48 Energy Credit

- Example:
  - Credit calculated on $500,000
  - Credit equal to 50% of project cost
    - Credit of $250,000 = Basis reduction of $125,00
    - Remaining depreciable basis $375,000
    - Bonus depreciation of $225,00 (60% in 2024)
    - Standard depreciation of $30,000 on remaining basis at 5-year class life
  - Assuming 30% tax rate, total first year savings of $224,500

Section 48 Energy Credit

Qualified Commercial Clean Vehicle Credit (Section 45W)

- Newly established by the IRA
- For vehicles acquired before 12/31/2032
- Credit is the lesser of:
  - 15% of the vehicle's cost (30% for vehicles not powered by a gasoline or diesel internal combustion engine) OR
  - Incremental cost of the vehicle relative to a comparable vehicle
- Max credit:
  - $7,500 if less than 14,000 lbs
  - $40,000 for vehicles over 14,000 lbs
- Battery capacity of 7kw hours (less than 14,000 lbs) or 15kw hours (more than 14,000 lbs), charged by an external source of electricity
- Manufacturer must have a written agreement with the IRS
- Tax-exempt entities have option to receive elective payment
- Cannot be a lease
- Must be for business-use

Alternative Fuel Vehicle Refueling Property (Section 30C)

- For installation of property used for storage or dispensing of clean-burning fuel, including electricity.
- Similar in structure to the Section 48 credit (6% base with opportunity for 30% for projects meeting prevailing wage and apprenticeship requirements)
- Property must be placed in service in a non-urban or low-income community. (Requirement, not a bonus)
- Maximum credit per charging station for depreciable property is $100,000
- Eligible for Elective Pay – opportunity for municipalities, college campuses

Qualified Advanced Energy Project (Section 48C)

- Time sensitive opportunity!
- Application based
- Concept paper submitted to DOE, followed by full application to IRS
- IRS allocates based on DOE recommendation
- $10B allocated overall. $4B allocated in 2023, leaving $6B for allocation in 2024.
- Credit up to 30% of qualified investment
- Similar to Sec. 48 credit, but with a broader view
- Notice 2024-36 provides a timeline with Portal opening no later than May 28, 2024.
  - 30-day submission window

Prevailing Wage

- Applies to any laborers and mechanics employed by the taxpayer or any other contractor / subcontractor
- Shall be paid wages at rates not less than the prevailing rates for construction, alteration or repair of a similar character in the locality in which the facility is located
- Correction and penalty provisions apply if credit is claimed at increased rate and less than prevailing rates are paid
  - Must pay shortfall to laborers plus interest
  - Must pay penalty to the Secretary based on number of laborers paid below the prevailing wage
  - Penalty is increased if determined that failure to pay a prevailing wage was due to intentional disregard

Apprenticeship

- Certain percentages of the work must be performed by qualified apprentices
  - 10% if construction began before 1/1/23
  - 12.5% for construction beginning during 2023
  - 15% for construction beginning after 2023
  - Any taxpayer that employs more than four individuals to perform construction / alteration / repair must employ one or more apprentices
- Relief if apprentices are requested, but denied
- Certain hours excluded from the apprenticeship requirement:
  - Foreman
  - Superintendent
  - Owners
  - Executive, administrative, professional roles

Elective Pay

- Allows "applicable entities" to benefit from certain credits
- Applicable Entities:
  - Tax-exempt organizations
  - State and political subdivisions
  - U.S. territories and other political subdivisions
  - Agencies and instrumentalities of state, local, tribal and U.S. territorial governements
  - Alaska Native corporations
  - Tennessee Valley Authority
  - Rural electric cooperatives

Elective Pay

- How to receive Elective Payment:
  - Identify the project or activity to be pursued and satisfy all requirements for the applicable credit
  - Determine the correct tax year, which determines the due date of the return
  - Complete the pre-filing registration process with the IRS (More information coming later this year)
  - Make election on a timely filed (including extensions) annual tax return, which will include any form required to claim the relevant credit

Elective Pay

- Eligible credits:
  - Alternative Fuel Vehicle Refueling Property (30C)
  - Production Tax Credit (Sec 45)
  - Carbon Capture & Sequestration (45Q)
  - Zero-Emission Nuclear Power Production (45U)
  - Clean Hydrogen Production (45V)
  - Clean Commercial Vehicles (45W)
  - Advanced Manufacturing Production (45X)
  - Technology-Neutral Production Credit (45Y)
  - Clean Fuel Production Credit (45Z)
  - Investment Tax Credit (Sec 48)
  - Advanced Energy Project Credit (48C)
  - Clean Electricity Investment Credit (48E)

Elective Pay

- Final Regs
  - Issued March 5, 2024
  - Rejected comments that mixed partnerships be included as eligible entities
    - However, do allow an entity to make a valid election out of Subchapter K – complex, burdensome
  - Tax-exempt grants and loans allowed to the extent of "no excess benefit"
  - Non-filing entities may adopt a calendar or fiscal year for filing of 990-T

Tax Credit Transfers

- Section 6418 allows certain taxpayers to transfer credits to unrelated parties for cash
- Eligible taxpayers are those that are NOT applicable entities under Section 6417 (Elective Pay)
- Transfer can be in whole or in part
- Project must be in-service prior to transfer
- Credits may only be transferred once
  - Three-year carryback, 22-year carryforward
- Transfers by passthrough entity made at entity level
- Basis of property related to credit subject to reduction of 50% of the credit amount (Seller)
- Cash received is not taxable income. Cash paid is not deductible.
- Election to transfer must be made by extended due date of **transferor's** tax return
- Pre-filing registration

Tax Credit Transfers

- Recapture rules:
  - Buyers are the liable party for any recaptured credits
  - Seller required to notify buyer of any recapture events
- Possible recapture events:
  - Failure to meet prevailing wage and apprenticeship requirements
  - Disposal of property
- Other risks:
  - Structure
  - Qualification
  - Valuation
  - Timing
- Consider indemnification clauses, tax credit insurance, requiring seller to insure

Tax Credit Transfers

- Eligible credits:
  - Alternative Fuel Vehicle Refueling Property (30C)
  - Production Tax Credit (Sec 45)
  - Carbon Capture & Sequestration (45Q)
  - Zero-Emission Nuclear Power Production (45U)
  - Clean Hydrogen Production (45V)
  - Advanced Manufacturing Production (45X)
  - Technology-Neutral Production Credit (45Y)
  - Clean Fuel Production Credit (45Z)
  - Investment Tax Credit (Sec 48)
  - Advanced Energy Project Credit (48C)
  - Clean Electricity Investment Credit (48E)
- Same list as Elective Pay option, with exception of 45W Clean Commercial Vehicle Credit

- Final Regs
  - Issued April 25, 2024
  - No exemption from PAL rules
  - Clarification that partnerships qualify even if owned by tax-exempt entities, subject to limitations or reductions
  - Confirmed the "one credit" concept. Bonus credit cannot be transferred separately from base credit
  - Confirmed advance payment is not allowed
  - Confirmed one-time only transfer
  - Election must be made on original return, but revisions for numerical errors can be made on amended returns
  - Partnerships can revise operating agreements for distributive share of credits up until due date of return

Tax Credit Transfers

TRANSFER EXAMPLE

DESCRIPTION	CREDIT CALCULATION
Eligible Project Costs	$500,000
Sec. 48 ITC Rate	50%
Tax Credit	$250,000
Market Discount	$0.93 per $1.00
Buyer's Net Purchase Price	$232,500
Buyer's Net Cash / Tax Savings	$17,500

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Pre-Filing Registration

Information Required:

- Name, address, TIN
- Tax year, type of entity, tax form number
- Type of eligible credits
- Amount to be transferred / used for elective pay
- Date construction commenced and facility was placed in service
- Name of contact authorized to bind taxpayer

A registration number will be provided, which is required to be included on your tax return

INDIVIDUAL CREDITS

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- Pre-IRA law:
  - 30% credit through 2019, decreased to 26% through 2022, scheduled to reduce to 22% in 2023, then expire
  - New solar electric, solar water heating, fuel cells, geothermal heat pumps, small wind energy, and biomass fuel property
- IRA changes:
  - Credit extended through 2034
  - 30% credit restored for tax years 2023 – 2032
  - Credit decreases to 26% in 2033 and 22% in 2034
  - Qualified battery storage technology added to the list of eligible property
  - For improvements made to your "main home" – can be owner or renter, but taxpayer must live in the home
  - Excluding fuel cell property, can claim for improvements made to a second home if lived in part-time and not rented

Residential Clean Energy Credit

- Additional info:
  - Claimed on Form 5695
  - Nonrefundable, but can be carried forward
  - No annual or lifetime dollar limit (except on fuel cells)
    - Fuel cell property limited to $500 per each half kilowatt of capacity

Residential Clean Energy Credit

Energy Efficient Home Improvement Credit

- Pre-IRA law:
  - Known as the Nonbusiness Energy Property Credit
  - 10% credit for qualified improvements of residential energy property to a primary residence (insulation, doors, windows, roofing, etc.)
  - 100% credit for installation of certain water heaters, heat pumps, HVAC
  - Lifetime limit of $500; Limited to $200 for windows
- IRA changes:
  - As of 1/1/2023
  - 30% credit for eligible home improvements
  - Lifetime limit is eliminated
  - New annual limit: $1,200 for building envelope (doors, windows, insulation), $2,000 for qualified heat pumps, biomass stoves / boilers. Total potential credit of $3,200
  - Further limits apply based on type of property

Energy Efficient Home Improvement Credit

IRA changes (cont'd):
  - Per property annual limits:
    - $250 per exterior door; $500 for all exterior doors
    - $600 for all windows / skylights
    - $150 for home energy audits
  - Insulation and air sealing materials remain eligible, but roofing is no longer included
  - Improvements / replacements of panelboards, branch circuits, or feeders used with qualifying property are credit-eligible costs
  - Beginning in 2025, manufacturer must provide a product ID number and taxpayer must provide that number on their tax return
- Additional Info:
  - Claim on Form 5695
  - Nonrefundable
  - https://www.ahrinet.org/certification/cee-directory

New Clean Vehicle Credit

- Pre-IRA law:
  - Known as the Plug-In Electric Drive Motor Vehicles Credit
  - $2,500, plus $417 if vehicle draws propulsion energy from a battery with at least 5kw hours of capacity, plus $417 for each kilowatt hour in excess of 5, not to exceed a total of $7,500
  - Phased out over a one-year period after the manufacturer sold 200,000 qualifying vehicles
- IRA changes:
  - 200,000 vehicles per manufacturer limit eliminated
  - $3,750 if critical minerals requirements met
  - $3,750 if battery components requirements met
  - Total maximum credit per vehicle $7,500

New Clean Vehicle Credit

- Available to individuals and their businesses
- Modified AGI may not exceed:
  - $300,000 MFJ
  - $225,000 HOH
  - $150,000 all other
- MAGI is the lower of the year delivery is taken or the previous year
- Nonrefundable
- Vehicles placed in service prior to April 17, 2023 follow the old law
- Qualified vehicles:
  - Battery capacity of at least 7kw hours
  - GVWR of less than 14,000 pounds
  - Made by a qualified manufacturer
  - Final assembly in North America
  - Meet critical mineral and battery component requirements
  - New vehicles only

New Clean Vehicle Credit

- Qualified vehicles (cont'd):
  - Seller must report buyer's name and TIN to the IRS
  - MSRP cannot exceed $80,000 for vans, SUVs, and pickups; $55,000 for all other vehicles
  - If placed in service after 2023, cannot include battery components that were manufactured or assembled in a "foreign entity of concern" (China, Russia, North Korea, Iran)
  - If placed in service after 2024, cannot include critical minerals in the battery from a foreign entity of concern
  - Information regarding weight, battery capacity, final assembly point should be available on window sticker, and can also be found at fueleconomy.gov
- Claimed on Form 8936
- Starting in 2024, taxpayers purchasing eligible vehicles can elect to transfer the credit to the dealer in exchange for a reduction in purchase price.

Credit for Previously Owned Clean Vehicle

- Newly established by the IRA
- Credit of up to $4,000, limited to 30% of purchase price
- Modified AGI may not exceed:
  - $150,000 MFJ
  - $112,500 HOH
  - $ 75,000 all other
- MAGI is lower of year delivery is taken or previous year
- Vehicle price of $25,000 or less and have a model year at least two years earlier than the year of purchase
- Must be purchased from a dealer
- Must be the first transfer since the Act to a buyer other than the original buyer
- Can only be claimed by the same individual once during a three year period
- Starting in 2024, taxpayers purchasing eligible vehicles can elect to transfer the credit to the dealer in exchange for a reduction in purchase price.

Questions?
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Pass Through Entity Tax: *The Adventure Continues . . .*

1

Presenter:

Lori Roberts, CPA, MSBA, CGMA
Director

FAIRFAX, VA

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Course Objectives:

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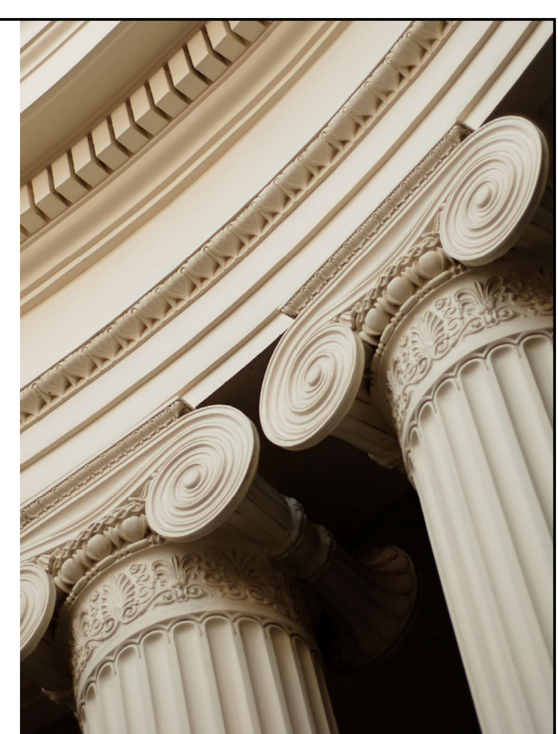
- Overview Refresher of Pass Through Entity Tax – PTET
- Virginia
  - 2021 PTET
- Refunds
- Other states, considerations
- Opportunities, traps, clarity?
- What may be ahead?
- Border states

4

PTET Overview

- PTE's elect into PTET
  - Exceptions, CT, DC, TX Franchise, NH B.A.T.
  - Some states have restricted PTE eligibility
    - Investment partnerships
    - Non-individual owners
- Tax calculated, paid, deducted at entity level
- Reduced federal income passes through K-1 to owners
- State provides for either income reduction or credit against state tax for owners' returns.



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History of PTET

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- 2017 Tax Cuts & Jobs Act created the $10,000 SALT CAP limitation
  - Significant impact on individuals, particularly high tax, high income states
- 2018 States began searching for work-around
  - Charitable Contributions in exchange for tax credits
    - IRS notice 2018-54; Rev Proc. 2019-12;
      - SCOTUS throws case out
  - Pass Through Entity Taxes
    - Notice 2020-75

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IRS: Notice 2020-75

- Acknowledged income taxes imposed by a state or locality on a PTE which are deducted from PTE owners' distributive income will continue to reduce such pro-rata income under present law.
  - Effectively makes SALT deductible as "Specified Income Tax Payments"
- ***Intent to issue proposed Regulations to provide certainty.***
  - ***Over 3 years later, no sign of regulations!***
- Specified income tax payments:
  - Not subject to SALT limitation.
  - Non-separately stated income or Loss
    - Page 1 or, Form 8825, OR . . .

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IRS: Notice 2020-75

Uncertainties

- What about separately stated income?
- Investment entities?
- Where to deduct tax related to separately stated income?
  - **Schedule A – other tax?**
- Special allocations – Federal return
  - Permissible for Partnerships, not for S-Corps

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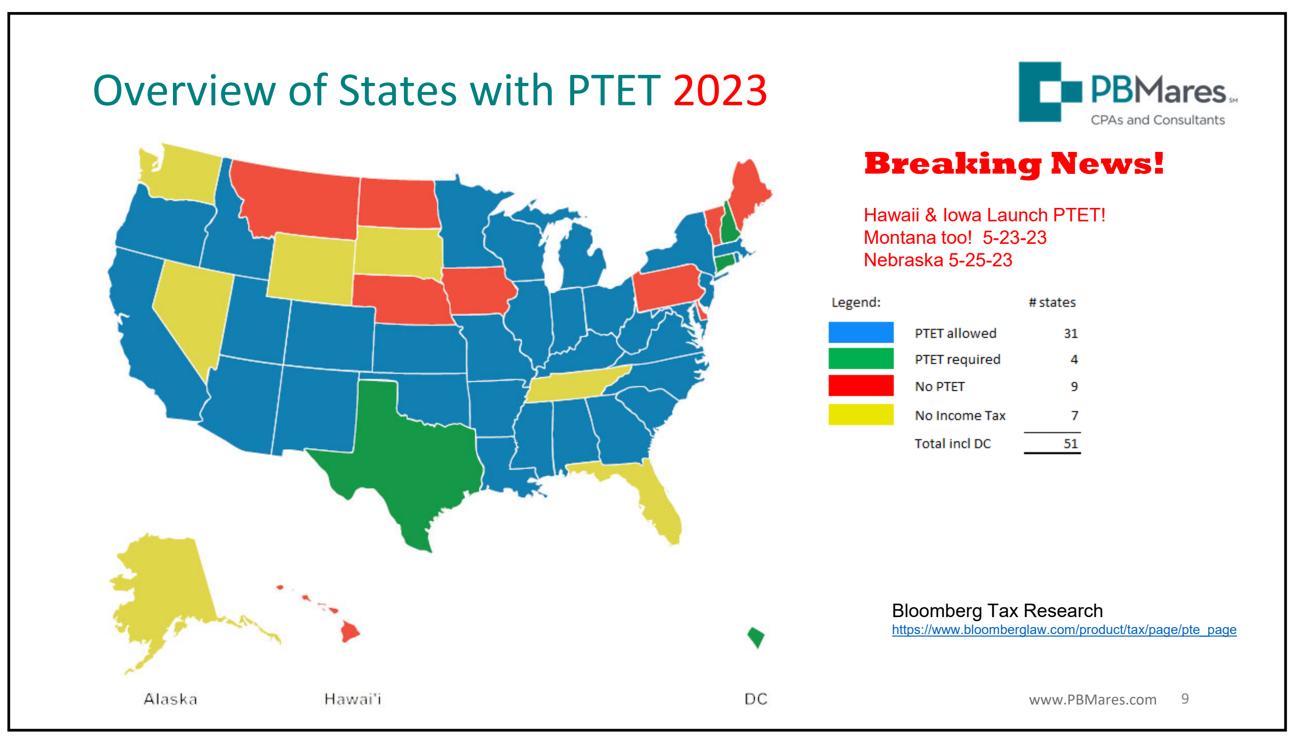

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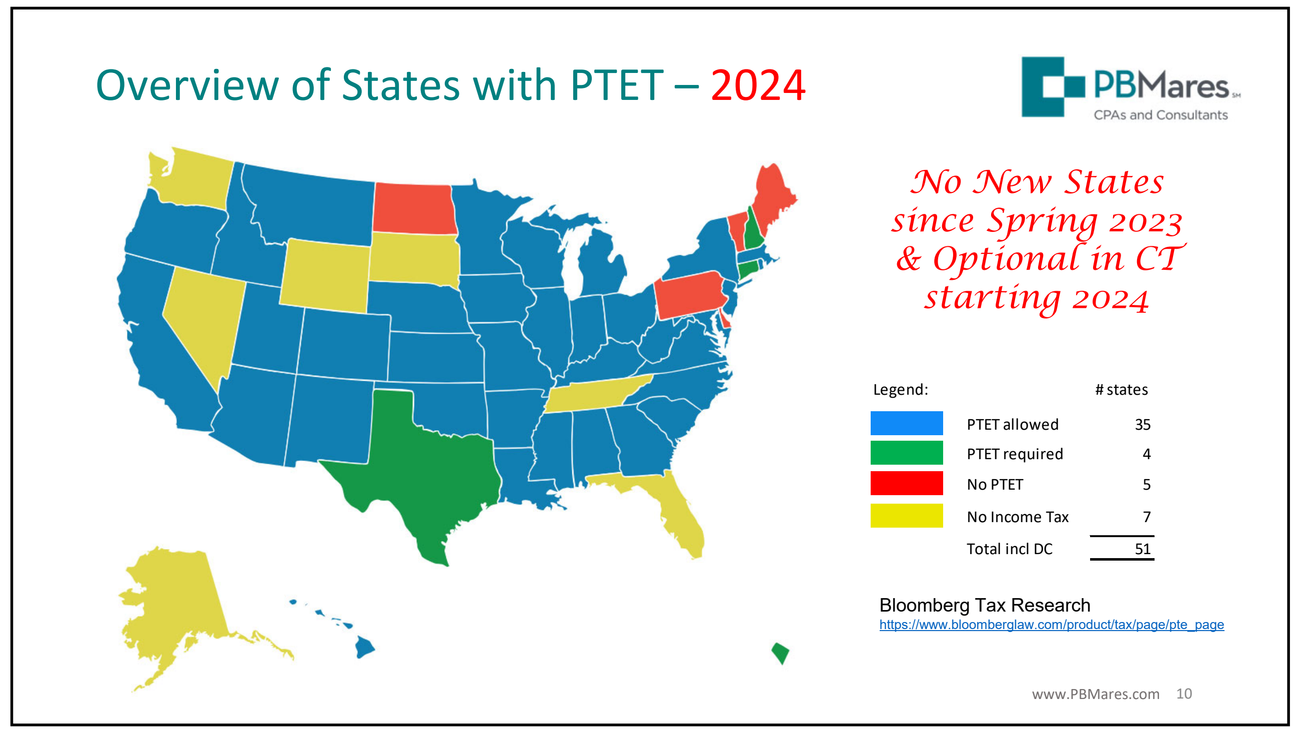

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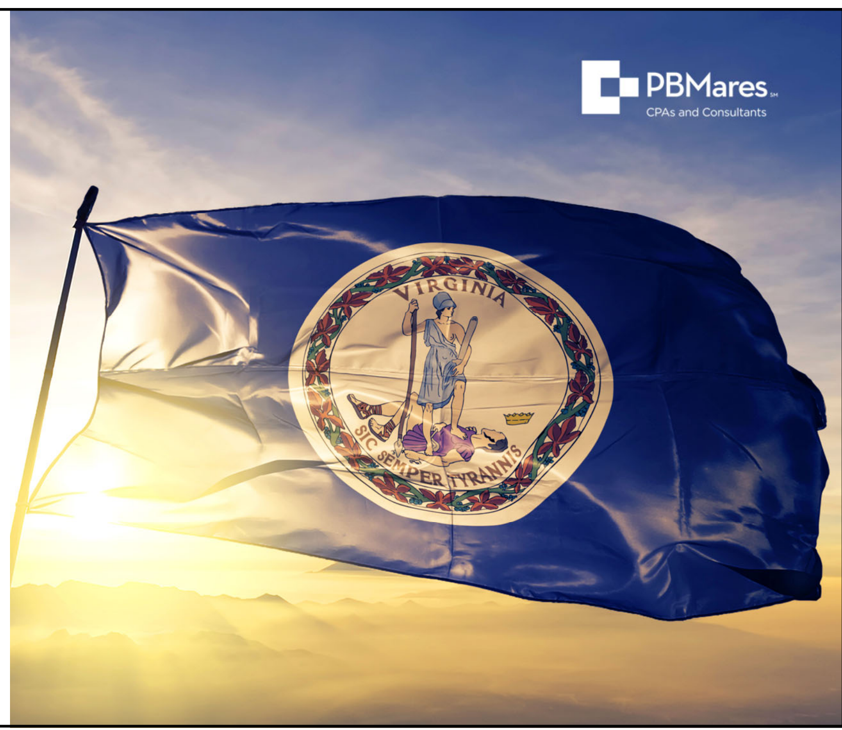
Virginia



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Virginia Pass-Through Entity Tax – VA 58.1-390.3

Enacted 2022 legislative session, Revised 2023 session

- Tax years beginning on or after 1/1/2021 and before 1/1/2022
  - **Process released February 2024.**
- Tax years 1/1/2022 and before 1/1/2026:
  - Available to pass-through entities with "Eligible owners." VA 58.1-390.1
  - Election on or before due date of return including extensions
  - Tax rate 5.75%
  - Federal deduction for SALT based on income must be added back to VA taxable income
  - PTE owner entitled to credit equal to pro-rata share of tax paid
  - Credit is refundable to owner
  - PTE subject to tax, penalties and interest as if a corporate taxpayer
  - Non-resident owners not required to file non-resident VA return.

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Virginia Pass Through Entity Tax

- Tax is calculated only for Eligible Owners, as described in 2022 legislation.
  - Resident Owners taxed on 100% of allocated income.
  - Non-resident owners taxed on VA apportioned income only.
  - **S-Corps! May elect to tax apportioned income for all eligible owners.**
- All taxable trusts can be included.
  - Does not pass credit through to beneficiaries, stays at trust level, refundable.
- No tax calculated for ineligible owners:
  - Other Partnerships
  - Corporations

Virginia – Credit for Taxes Paid to Other States

- VA Sec 58.1-332
  - Amended to allow for credit for taxes paid by a PTE under a law of another state similar to VA 58.1-390.3
  - Previously such credits were allowed for S-corp owners, but not for partnership owners.
  - Provision only applies to tax years beginning on or after 1/1/2021 and before 1/1/2026.

Virginia Credits

Credits on Entity Returns:

- Credits granted to a PTE are generally passed through to owners through VK-1.
  - They are not applied to the calculated PTET liability.
  - Except for: R&D Expense & Motion Picture Production only if the PTE elects to receive and claim at the entity level.
- Will generally require duplicate outlay of cash to receive credit benefit:
  - Cash outlay for PTET
  - Cash outlay for Credit purchase; ex. Land Preservation credits.

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Virginia Credits

Ordering of Credits on Individual Returns

- Credits claimed in accordance with Public Document 95-240:
  1. Credits that are structural in nature and considered to be a reduction in tax liability, therefore, limited to current year tax liability with no carryforward allowed, such as **other state tax credit**
  2. Any credit which does not have a statutory carryforward or refundable feature
  3. Credit carryforwards to the taxable year, in order of expiration.
  4. Current year credits based on order of those with shortest carryforward period first
  5. Refundable Credits last such as VA PTET credits

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Virginia Credits

Ordering of Credits on Individual Returns

- Taxable refund consideration
  - Refer to FAQ's issued 5-8-24.
  - Virginia's system applies all refundable credits simultaneously following application of current year credits. Therefore, no prescribed order or tracking as to what is applied first.
  - https://www.tax.virginia.gov/sites/default/files/inline-files/elective-pass-through-entity-faqs-may-8-2024.pdf

Virginia 2021 PTET Election *in 2024*

2021 Virginia PTET Election

Overview

- History
  - Included in 2022 legislation. Aka 2021 filing season!
  - Implementation in 2022 not possible, instead set for AFTER 2022 filings
- Payment provisions established in late 2023
  - No specifics on filing requirements released
- Actual filing requirements released 2/19/24
  - "Guidelines for the Retroactive Taxable Year 2021 Pass-Through Entity Tax"
  - *https://townhall.virginia.gov/L/GetFile.cfm?File=C:\TownHall\docroot\GuidanceDocs_Proposed\161\GDoc_TAX_6981_20240220.pdf*

2021 Virginia PTET Election

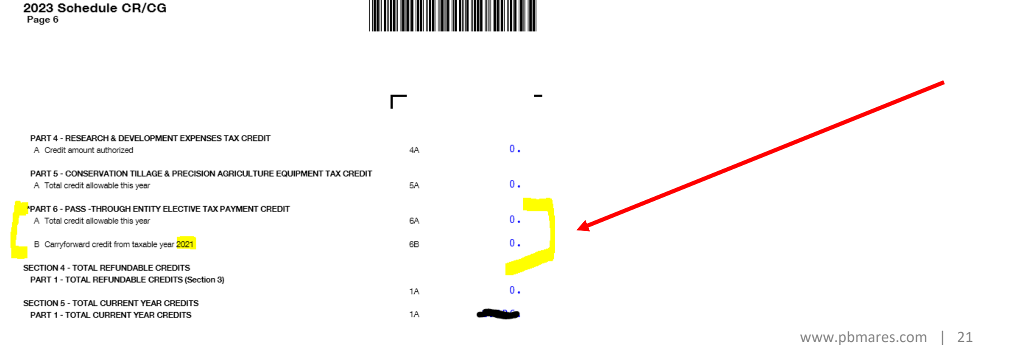
Process – High Level

- This is NOT a mandatory filing, entirely elective
- Requires outlay of cash to cover PTET due
- VA 502PTET filed on-line at Virginia Tax Website
  - NOT available through practitioner software
  - Tax MUST be paid at time of filing.
  - **No 2021 Virginia PTET filings allowed after September 16, 2024**
- Entity takes deduction for state taxes paid on 2024 return
  - Or 2023 if appropriate

2021 Virginia PTET Election

Process – High Level

- Entity owners claim credit on 2023 individual return
  - Ok to amend if already filed.
- Benefit is through federal deduction/ federal tax savings to owners.



2023 Schedule CR/CG
Page 6

PART 4 - RESEARCH & DEVELOPMENT EXPENSES TAX CREDIT		
A Credit amount authorized	4A	0.
PART 5 - CONSERVATION TILLAGE & PRECISION AGRICULTURE EQUIPMENT TAX CREDIT		
A Total credit allowable this year	5A	0.
*PART 6 - PASS -THROUGH ENTITY ELECTIVE TAX PAYMENT CREDIT		
A Total credit allowable this year	6A	0.
B Carryforward credit from taxable year 2021	6B	0.
SECTION 4 - TOTAL REFUNDABLE CREDITS		
PART 1 - TOTAL REFUNDABLE CREDITS (Section 3)	1A	0.
SECTION 5 - TOTAL CURRENT YEAR CREDITS		
PART 1 - TOTAL CURRENT YEAR CREDITS	1A	

2021 Virginia PTET Election

Before you begin . . .

- Consider:
  - Ultimate benefit to client
  - “Human Factors” will all owners ultimately receive fair outcome?
  - Benefit to your firm (fees, client goodwill)
  - Process should be net positive for client!

2021 Virginia PTET Election

Firm-level considerations

- How will this process integrate w/ existing processes?
  - Direct on-line filing matter
- Engagement letters
- Client communications
- Documentation
- Short-term duration
- Staffing / Training

2021 Virginia PTET Election

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Client considerations

- Optimal Situation
  - High level of 2021 Virginia taxable income
  - Few owners
  - Virginia Residents
  - Client understands/appreciates process
  - No or minimal ownership changes since 2021
  - Higher individual tax rates for owners

2021 Virginia PTET Election

Client considerations

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- Maybe not such a great idea?
  - Low 2021 Virginia taxable income
  - Many owners
  - Non-resident owners/ low Virginia apportionment
  - Client "personality"
  - Significant ownership changes since 2021
  - Low owner individual tax rates, taxable income
    - Utilizing NOL's on personal returns

2021 Virginia PTET Election

More options to consider

- Allocation of credit can be based on
  - 2021 ownership OR
  - 2023 ownership
  - Each partner gets their appropriate share of credit based on taxed income and consideration of non-resident withholding.
    - Non-resident owners have already received credit for withholding on their behalf
    - Resident owner credit should not be diluted
- S-Corporations may calculate tax for resident owners based upon Virginia apportionment factor
  - This to maintain S-Corp one-class of stock requirements

2021 Virginia PTET Election

More options to consider

- Non-resident Composite Filing in 2021:
  - If elected, income taxed on composite return is subtracted from non-resident taxable income on 502PTET.
- May NOT amend 2021 return for PTET claim !!!
- No interest will be paid on refunds related to 2021 PTET.
  - Part of reason for including credit on 2023 return

2021 Virginia PTET Election

Into the details . .

- Get your ducks in a row:
  - Set up individual “preparer” account:
  - Tax calculation, payment to be made, projected benefit to client
  - Have 2021 return w/ VK-1 at-hand
  - Have most recent VA income tax return filed at-hand
  - Does client have a Virginia tax on-line account?

2021 Virginia PTET Election

Into the details . .

- Set up a preparer account here:
  - https://www.business.tax.virginia.gov/VTOL/tax/Login.xhtml

Virginia Tax Online Services for Businesses

New Users	iFile Login	Other Online Services
Enroll in Business iFile to establish your User ID and Password Are you a new Business? Register Here Register as a Household Employer Register as a Tax Preparer Register with VEC Only	Account Type TAX VEC Account # Forgot my TAX Account # Forgot my VEC Account # User ID Forgot my User ID Password Forgot my Password Log In	eForms Web Upload Pay a bill - QuickPay Tax Preparer Login Sign up for email updates FIPS Code Lookup Apply for a Nonprofit Exemption

- Note that this is a “personal” account, not a firm registration
  - Personal information to be provided
  - Your “unique identifier” is designed to be shared with others/clients

LJR1

2021 Virginia PTET Election

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Into the details . .

- Set up an entity account here: https://www.business.tax.virginia.gov/VTOL/tax/SignUp.xhtml

- Watch for:

TAX Validation Criteria

Tax Account Number

Tax Return Amount OR A return has not yet been filed

Primary Address Zip Code

Tax Account number is Virginia, incorporates FEIN Example: 3054-1234567F001

Tax Return Amount is tax due on most recent income tax return filed for this entity

Primary zip: Based on what is in Virginia Tax database!

…. *Address change box???*

Slide 30

LJR1 Lori Roberts, 5/23/2024

2021 Virginia PTET Election

Return Filing

- Form 502PTET Entry:
  - Complete information for header, taxable income.
  - Calculation at top of screen: "Validate Requirements"
    - Gray areas will populate
  - Match calculations to your expectations

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2021 Virginia PTET Election

Return Filing – Con't.

- Schedule VK-1:
  - Enter Owner Details
  - Enter allocated PTET credit
    - Total of allocated credit MUST agree to total PTET credit calculated on 502PTET
    - More than 50 K-1's? MUST use Web-upload.
- Review Preview & Draft Transcript of Return
  - Draft may be printed

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2021 Virginia PTET Election

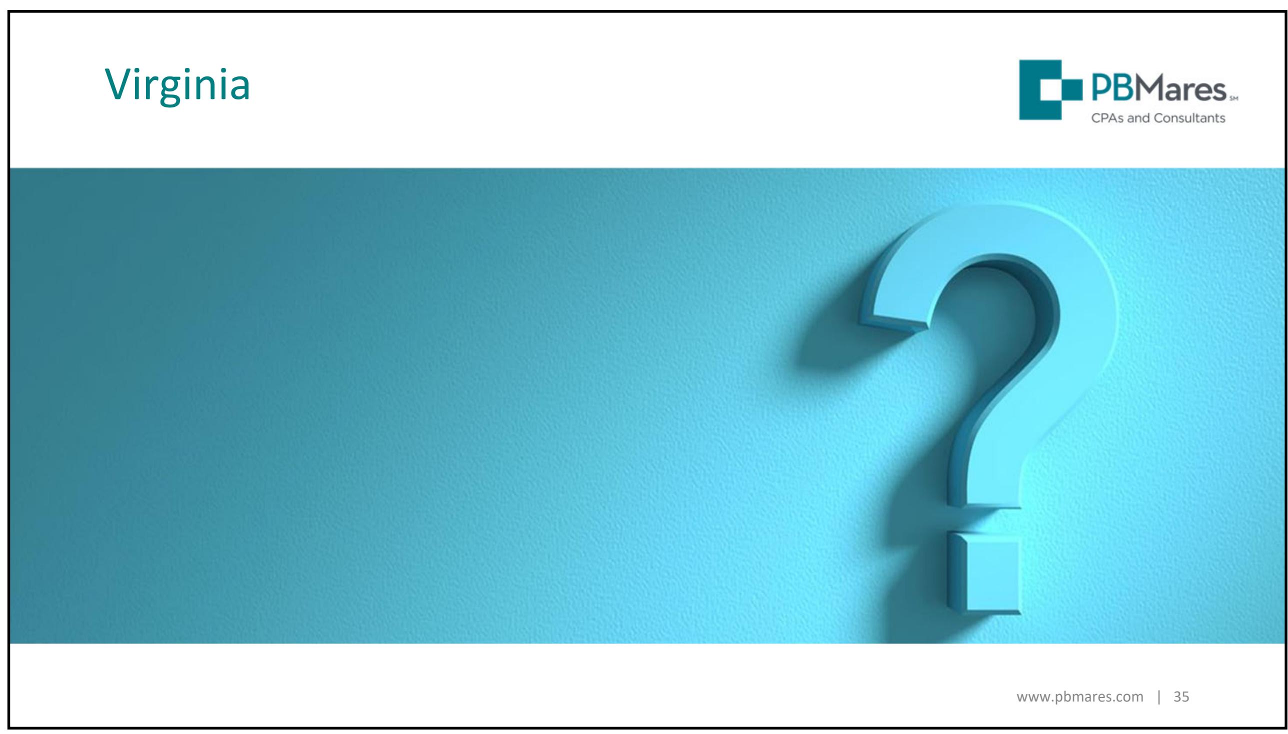
Return Filing – Con't.

- Provide payment information, OR
  - Make payment at PTET payment website https://www.business.tax.virginia.gov/tax-eforms/ptetpmt.php#
  - Apply payment to return
- **Payment MUST be made when return is filed!**
- Enter Continue to finalize return – Submit return
- Print Final Copy
- Distribute VK-1 information to client (to forward to owners)

2021 Virginia PTET Election

Good News!

- VK-1's generated from 2021 PTET filing do not need to be attached to 2023 return when filed.
  - Data will be in readily available to match in Credit Department, hence payment REQUIRED upon filing.



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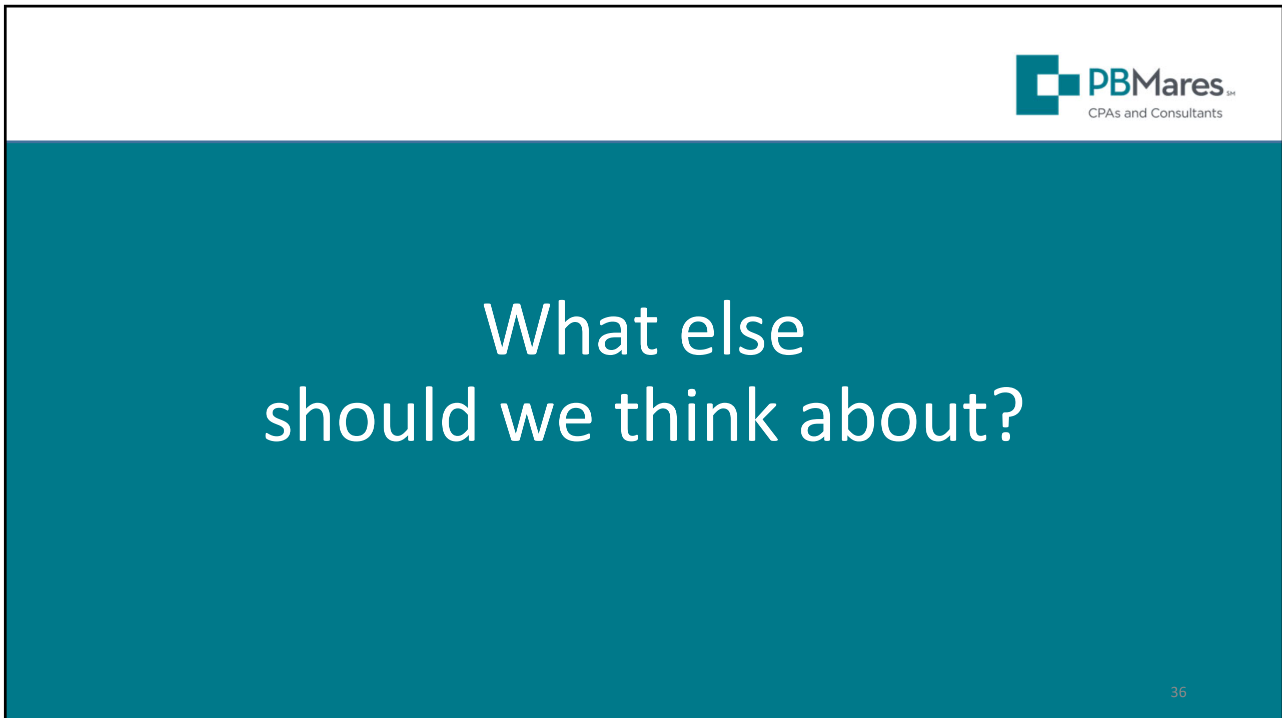

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State Tax Refunds – When PTET is in play

- Refund taxable if tax benefit received
  - Benefit comes through reduced income from PTE.
- 1040 Instructions –
  - no description, discussion, identification RE: PTET impact
  - Continue to focus on Schedule A activity
- Impact of SALT Cap on Schedule A SALT deductions

State Tax Refunds – Cont.

- Think "Basis"
- Other sources of tax payments not deductible on Schedule A?
  - Withholding
  - Estimated taxes
- Standard Deduction used?
  - Generally, refund would not be taxable
- No "Basis"
  - No other tax payments w/o benefit to offset?
  - Consider reporting refund as taxable income

For refunds attributable to 2021 PTET; consider "basis" in 2021 tax payments

State Tax Refunds – Con't

Example:

State tax refund	**30,000**	**30,000**
State income tax	53,000	53,000
SALT Itemized deduction claimed	(10,000)	(10,000)
Real estate tax	7,000	15,000
Personal property tax	2,000	2,000
Available SALT Cap	(1,000)	-
State income tax withholding	15,000	-
Estimated state income tax payments	20,000	-
transferable credits redeemed	20,000	20,000
Basis in state and local taxes	**54,000**	**20,000**
Taxable Portion of refund	**-**	**10,000**

Strategy to Avoid State Tax Refunds

- If no refund, no taxability to consider
- Reduce Estimated payments
- Consider reduction of Withholding taxes
- Think twice about purchasing credits to offset tax liability

- It may be worth potential payment of estimate penalties to avoid tax on refund.

Other State Considerations:

- Early election required?
  - CA: First payment due by June 15
  - NY: Must make on-line election by March 15
- Refundable credit? CA no, MA limited-
- Is credit available to resident in their home state?
  - Issue is to avoid paying tax twice.
- No tax state?
  - Owners will get benefit through federal deduction, reduced income. Should realize savings through non-resident filings.

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Uncertainties?

- Notice 2020-75 & Separately stated income:
  - Investment income?
  - LTCG?
  - Separately stated deductions?
- Accounting Method
  - Recurring item, fixed and determinable, when to deduct?
- S-Corps; resident vs. non-resident owners? S-Election blown?
  - Federal return allocates benefit of deduction per share/per day, unless closing of books elected.
- Deduction won't happen if you don't take it.
  - Discuss with Client, Document discussion
  - Firm Policies – Higher level review?

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Other Considerations:

- NOL's?
  - Owners will have reduced income flowing from PTE, slows burn of NOL
- Multi-state PTE's – where resident owners taxed 100%, non resident on apportioned %.
  - Potential for more than 100% income taxed at state level, resulting deduction, ultimately benefits PTE owner when PTET credits fully "refundable". Note refund risks.

Allocations to Owners:

- Be mindful of owner agreements!
  - Including cash flow / distributions
- Federal deduction
  - Partnerships, profits can be specially allocated
  - S-Corps, no! per share per day.
- Credit allocated at state level
  - Based on owner share of tax, may need special allocation
    - Does not violate S-corp, outside of federal return.
- Add-back for state tax deduction
  - Add-back to state income should be based on deduction on federal return, allocated share of tax deduction from federal included in K-1

Unequal Situations

- Resident vs. non resident owners, taxed based on 100% of income vs. apportioned income
  - Partnerships - True-up through distributions
    - Be mindful of partnership agreements
  - S-corps – W-2 compensation?
    - Consider cost vs. benefit, not everybody wins.

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Create Eligibility

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- Single member LLC's,
- Schedules C, E, F
- Form a partnership,
  - Spouse, children, trust
- Make S Election?

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What's next?

- Post TCJA – 12/31/2025
  - Most states: PTET set to expire w/ SALT Cap or 12/25/25.
  - Efforts to adjust/remove SALT Cap, unsuccessful to date.
  - Anticipate PTET will continue. Strong impact on business owners.
- Will IRS Issue Regs. Related to PTET?
  - Focus on treatment of tax deduction, when, where, how permitted. Source of income issues.
  - Treatment of refunds when PTET deductions are involved.

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Maryland

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Maryland PTET

Basic features

- Established w/ Tax year 2020.
- Credit allowed on individual return for taxes paid
- All types of PTE's and their owners eligible to participate, including layered partnerships and fiduciaries
  - PTET credit passed through MD K-1 to owners
- Taxed income: MD apportioned income for all owners

Maryland PTET

Recent changes

- **Effective for tax years after December 31, 2022, first estimated payment "elects" type of return to be filed. Irrevocable!**
  - Maryland Tax Alert 4-11-2023
- **MD Law update 5-8-2023:**
  - Defines "member" and "pass-through entity"
  - Requires add back to MD income of specified credit "claimed" against state income tax for taxes paid by the PTE to another state.
  - Clarification on credits allowed for taxes paid by PTE's to other states
  - Applies to taxable years after 12/31/22

North Carolina

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North Carolina – PTET Highlights

Basic features

- PTE makes "Taxed Partnership Election" (timely filed return including extension)
- Pays state income tax on PTE's taxable income at individual rates.
- Taxable income, generally:
  - Residents: 100% of income or loss
  - Non-residents: income or loss attributable to NC
  - Not including separately stated K-1 deductions
- Each PTE Owner *deducts* the Owner's share of the PTE's *income* on the Owner's North Carolina individual tax return
  - No *credits* are passed through to Owners
- Effective for tax years beginning on or after January 1, 2022

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North Carolina – PTET Highlights

Eligibility

- S Corporations
- Partnerships whose partners are:
    - Individuals
    - Estates
    - Certain trusts
    - Certain nonprofit organizations
    - S-Corporations
    - Partnerships
    - Corporation - *added October 2023*

"Pass-Through Partner" (S-Corporations, Partnerships)

- Rental real estate partnerships are specifically *included*.
- Investment partnerships are specifically *excluded*.

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North Carolina PTET

Individual filing requirements

- NC residents
    - File the normal NC individual return
    - Include all normal adjustments to income to federal income, including decoupling adjustments to PTE income
    - Deduct from income the income taxed at the PTE level (which includes the decoupling adjustments)
- NC nonresidents
    - Not required to file NC individual return if only income is from a PTE that pays taxes on the income (whether through PTET or nonresident withholding)

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North Carolina PTET

PTET Eligibility – Partnerships with S Corps and Partnerships as Partners

- The Pass-Through Partner does not participate in the PTET. Instead, it's business as usual for them.
- Resident Pass-Through Partners
  - PTE reports the income, but does not calculate any tax.
- Nonresident Pass-Through Partners
  - Still subject to Nonresident Withholding as if PTET were not elected.
  - PTE can file NC-NPA (Nonresident Partner Affirmation) to bypass NR WH.
- NCDOR has issued revisions to Partnership (Form D-403) instructions.

North Carolina PTET

Individual partner's Other State Credit

- Previously, the shareholder of an S Corp could claim an Other State Credit on their individual NC return for taxes paid at the entity level.
- New 4-3-23 law allows partners in a partnership to claim the Other State Credit.
  - Must be an entity-level tax levied by the other state (or D.C.) on the PTE's aggregate share of income allocable to its owners
  - Applies only to shareholders / partners whose PTE did not make the PTET election in North Carolina
  - No Need for PTET electors to have it. The entity takes the Credit.

Kentucky

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Kentucky

- Had PTET provision, killed it, created a new one in 2023!
- Form 740 - PTET
- "Authorized person" binds all members of entity to PTET
  - Election is binding once made
- Election for 2022 to be made after March 31, 2023 and before **August 31, 2024.** No late payment or filing penalties to be imposed.
- Election for years beginning with 2023 tax year:
  - Due date of return, including extension.

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Kentucky – Con't

- Tax is credited on the owner tax return. Refundable.
- Credit allowed to owner for taxes paid by partnership to other states.
- Composite returns no longer permitted after 2021 tax year.
- Non-resident PTE owners required to file KY return.
- Composite returns no longer allowed.

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West Virginia

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West Virginia

- Election for years beginning with 2022 tax year; Form EPT-100 by due date of return, incl. extension.
- Tiered partnerships eligible.
- Tax is a credit on the owner tax return. Non-refundable.
- Credit allowed on EPT-100 for taxes paid by PTE to other states.
- Non-resident PTE owners NOT required to file WV return.

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Questions

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Wealth Transfer Planning Ahead of the Sunset

Farhad Aghdami

WILLIAMS MULLEN

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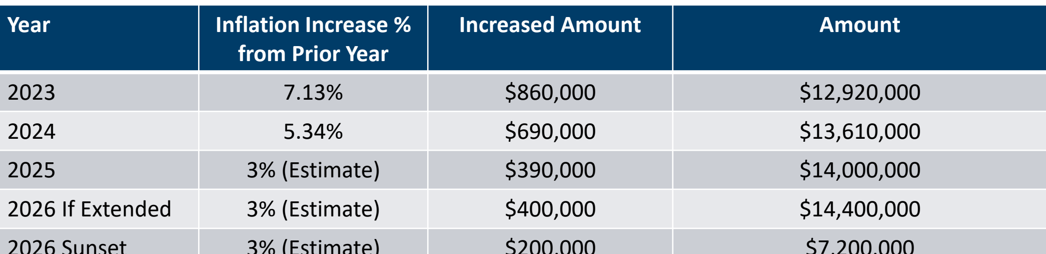
Increase of Exemptions in 2018 and Sunset in 2026

- The Tax Cuts and Jobs Act of 2017 increased the estate, gift, and GST tax exemption amounts from $5,000,000 to $10,000,000, each as adjusted for inflation
  - In 2017, the inflation adjusted exemption amount was $5.49 million and it jumped to $11.18 million in 2018
  - The top marginal tax rate remains at 40%
  - With substantial increases in inflation, the exemption is $13.61 million in 2024
- This provision is scheduled to sunset at the end of 2025 and will return to $5 million (as adjusted for inflation) in 2026

2 WILLIAMS MULLEN finding yes

2

Estate, Gift and GST Increases and Sunset



Year	Inflation Increase % from Prior Year	Increased Amount	Amount
2023	7.13%	$860,000	$12,920,000
2024	5.34%	$690,000	$13,610,000
2025	3% (Estimate)	$390,000	$14,000,000
2026 If Extended	3% (Estimate)	$400,000	$14,400,000
2026 Sunset	3% (Estimate)	$200,000	$7,200,000

Estate/Gift Tax Value of Reduced Exemption is 40% of $7,200,000 or $2,880,000

Planning Ahead of the Sunset

> Clients who have substantial assets are considering whether to gift or otherwise use the larger exemption amount before the end of 2025.

> By gifting before 2026, they hope to lock in the larger exemption amount

> If the exemption is reduced, in most cases, the amount gifted when the exemption was larger cannot be "clawed back" if it is later reduced

– Prop. Treas. Reg. § 20.2010-1(c)(3) would generally foreclose application of the "anti-clawback" rule to completed gifts that aren't adjusted taxable gifts but, rather, are gifts whose value is includable in the donor's gross estate under IRC §§ 2035, 2036, 2037, 2038 or 2042.

Planning Ahead of the Sunset

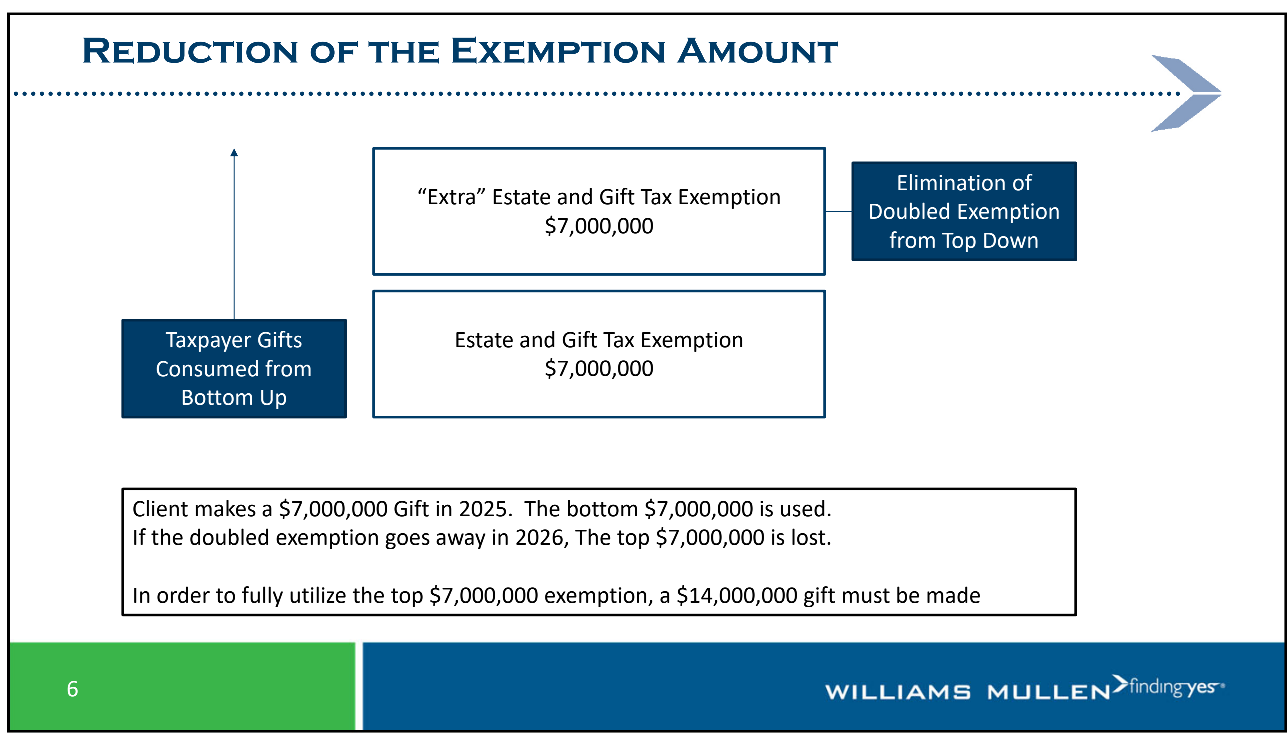
> Many clients, however, are reluctant to make large gifts because they are afraid that they may want or need the assets gifted for future needs.
  - Future health care expenses
  - Economic reversals
  - Geopolitical risks
  - Concerns about transferring too much money to their kids and creating "trust fund babies"

> "There are worse things than paying taxes; one of them is running out of money"

5 WILLIAMS MULLEN finding yes

5

Reduction of the Exemption Amount



6 WILLIAMS MULLEN finding yes

6

7

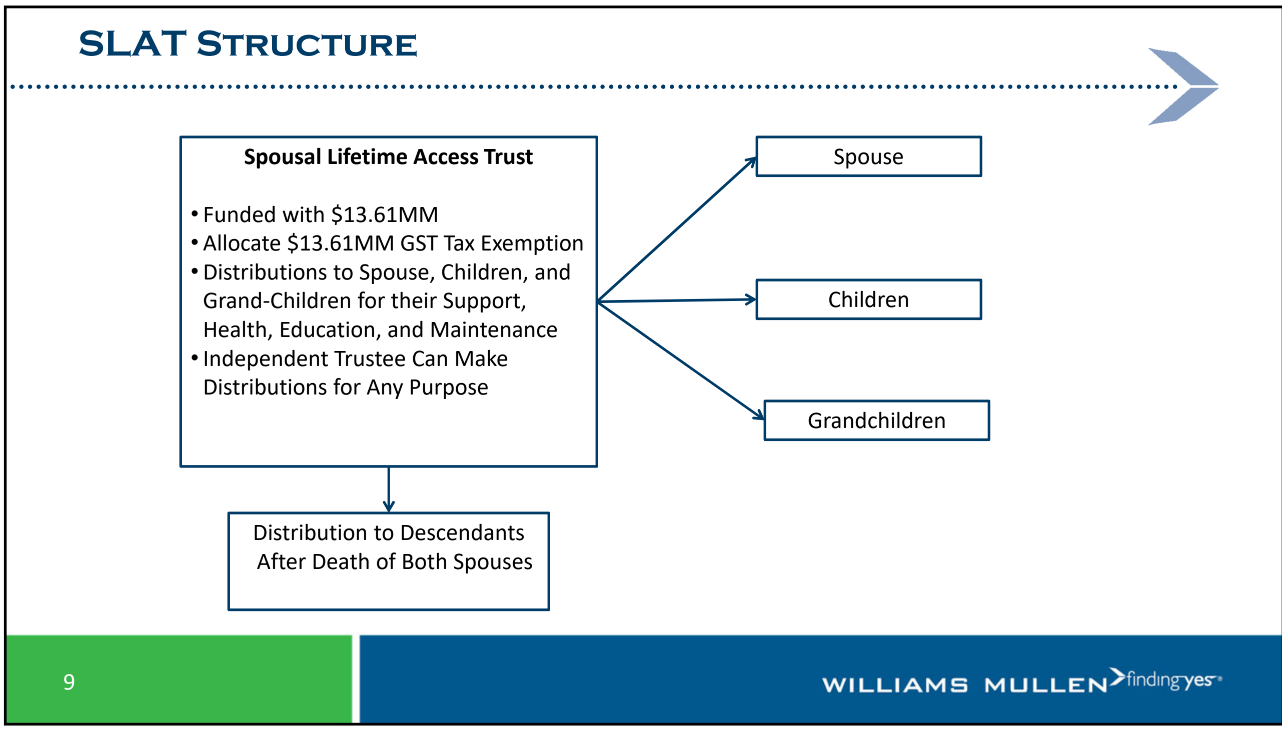
Planning opportunities – 2024 and 2025

> SLATs

- As clients look ahead to the sunset of the doubled basic exclusion amount, a popular planning technique is the creation of a spousal lifetime access trust or “SLAT”
- A SLAT operates much like a credit-shelter trust funded with a decedent’s estate tax exemption amount, but rather than waiting until death, it is funded during a client’s lifetime
- The benefit is that a client can make a gift (before 2026) that uses their remaining gift tax exemption, but since the client’s spouse is a beneficiary (and often a Trustee), the wealth transferred to the SLAT provides access to those in the marital household

8 WILLIAMS MULLEN finding yes

8



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Designing the SLAT

- Almost Always a Grantor Trust for Income Tax Purposes
  - Code Section 677(a)(1) power to distribute income to spouse
- Spousal Lifetime Access Trust - What Access Does the Spouse Have?
  - Income
  - Principal for support, health, education, and maintenance
  - Independent Trustee distributions for any purpose
  - Spouse May Have a Lifetime Power of Withdrawal
  - Spouse May Have a Limited Power of Appointment
    - Flexibility to Address Future Change in Circumstances

10 WILLIAMS MULLEN finding yes

10

Principal Distributions - Ascertainable Standards

> Distributions Subject to an Ascertainable Standard – "HEMS"

- Health
- Education
- Maintenance
- Support

> Why is an Ascertainable Standard So Important?

- Distribution Does Not Cause Trustee or Beneficiary to Hold a General Power of Appointment Over Trust Assets
  - Avoids Estate Tax Inclusion

WILLIAMS MULLEN finding yes

Principal Distributions - Ascertainable Standards

> Treas. Regs. § 20.2041-1(c)(2):

- A power to consume, invade, or appropriate income or corpus, or both, for the benefit of the decedent which is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is, by reason of section 2041(b)(1)(A), not a general power of appointment.
- A power is limited by such a standard if the extent of the holder's duty to exercise and not to exercise the power is reasonably measurable in terms of his needs for health, education, or support (or any combination of them).
- As used in this subparagraph, the words "support" and "maintenance" are synonymous and their meaning is not limited to the bare necessities of life.

WILLIAMS MULLEN finding yes

Distributions to Discharge Obligation of Support

> If A Beneficiary Who Is Serving As Trustee Can Make A Distribution That Discharges Their Legal Obligation Of Support, They May Be Deemed To Hold A General Power Of Appointment
  – Parent Has Legal Duty to Support Child Until Age 18
  – If Parent Uses Trust to Support Child (Instead of Personal Assets), They May Be Deemed to Hold a General Power of Appointment Over Trust
  – See, Va. Code 64.-2-776.B.2

> A Sample Clause to Address This Concern Might Look Like This:
  – *No person serving as Trustee shall participate as the Trustee in any discretionary decision to distribute income or principal of any trust (1) for the pecuniary benefit of such person unless necessary for the health, education, maintenance, or support of such person as a beneficiary of the trust, or (2) to discharge a legal obligation of such person.*

13 WILLIAMS MULLEN finding yes

13

Broader Distribution Powers

> A Trustee Can Make Distributions Broader than Health, Education, Maintenance, and Support
  – Comfort, Welfare, Happiness
  – Any Purpose

> If Power Held By Beneficiary
  – General Power of Appointment (Causes Estate Tax Inclusion)
  – State Law Protections Under Uniform Trust Code
    - Va. Code §64.2-776.B.1 provides that “A person other than a settlor who is a beneficiary and trustee of a trust that confers on the trustee a power to make discretionary distributions to or for the trustee's personal benefit may exercise the power only in accordance with an ascertainable standard.”

> Later Discussion of Independent Trustees

14 WILLIAMS MULLEN finding yes

14

Broader Distribution Powers

- Can Be Useful to Provide Access to Assets In Trust for Needs or Desires in Excess of What Might Be Permitted Under an Ascertainable Standard
  - Safety Valve for Access to Trust Assets (Some Clients Like This)
- If Interests of Beneficiaries are Adverse, Need to Be Careful When Using Broad Distribution Powers
  - Potentially Drain Trust and Divert Assets from Remainder Beneficiaries
- Identity of Trustee is Important
  - Later Discussion

Designing the SLAT

- Can the Client Be a Beneficiary of the SLAT
  - The general answer is no, as a retained interest will likely cause the asset to be included in the client/donor’s estate
- Some potential options to add the Client as a beneficiary
  - The Spouse could be given a broad limited power of appointment. The Spouse could appoint the assets to a second trust for the benefit of the Client
  - In certain states, including Virginia, with self-settled spendthrift trust statutes, the Client could take advantage of the statute and be included as a beneficiary. See, Virginia Code Section 64.2-745.1, et seq.
  - May be safer to not include the Client at the outset, but have a Trust Protector add the Client at a future date

Death and Divorce

> One of the biggest risks with a SLAT is death and divorce

> “Musical Spouse Clause” - definition of “Spouse” is person to whom Settlor was married at the time or married to at the time of death

> “Hard Wired” Spouse

> Ethical Issues with Joint Representation
– Who Is Your Client
– Joint or Separate Representation

Death and Divorce – Repeal of Section 682

> Under Code Section 677(a)(1), a grantor is treated as the owner of any portion of a trust if income may be distributed to the grantor or the grantor’s spouse.

> Under Code Section 672(e)(1)(A)—often referred to as the “spousal unity rule”—a grantor is treated as holding any power or interest held by an individual who was the grantor’s spouse at the time the power or interest was created.

> It is not clear whether such a trust should continue to be a grantor trust even after a divorce or legal separation.

> Prior to 2019, Code Section 682 prevented such a result by providing that income distributed to an ex-spouse after a divorce is taxable to the recipient spouse and not the grantor spouse.

> That protection ended with the repeal of Code Section 682 by the Tax Cuts and Jobs Act of 2017 (P.L. 115-97, enacted December 22, 2017) for divorce or separation agreements executed after December 31, 2018.

19

Interested Trustee

> Interested Trustee
- Often a Family Member
- Likely a Beneficiary
- Often the Spouse and then the Children
  - Typically Serve Without Compensation
- Can Make Distributions Subject to Ascertainable Standard
- Can't Make Distributions Broader Than Ascertainable Standard
- May Not Be Able to Make Advancements

20 WILLIAMS MULLEN finding yes

20

Independent Trustees

> Independent Trustee
  - Often a Professional Fiduciary
    - Bank or Trust Company
    - Professional Fiduciary - Lawyer or CPA
    - Could Be Next Door Neighbor, Golf Buddy, or Worse…
    - Compensated for Services
  - Can Make Distributions Not Limited By Ascertainable Standard
    - Facilitate Large Gifts for Gifting
    - Facilitate Decanting

Power to Remove and Replace Independent Trustee

> If an Independent Trustee can hold powers to make distribution that are not limited by an ascertainable standard, does a grantor's right to remove and replace the Trustee cause estate inclusion.
  - If Grantor can remove the Trustee, then he can keep firing and replacing the Trustee until he finds someone who will take the action that he wants to be taken and control trust income
  - Code Section 2036 and 2038 Concerns

> Rev. Rul. 79-353 provided that the reservation by a decedent-settlor of the unrestricted power to remove a corporate trustee and appoint a successor corporate trustee is equivalent to the decedent-settlor's reservation of the trustee's discretionary powers.

Power to Remove and Replace Independent Trustee

- In Estate of Wall, 101 T.C. 300 (1993), the decedent created a trust and designated an independent corporate fiduciary as trustee. The trustee possessed broad discretionary powers of distribution. The decedent reserved the right to remove and replace the corporate trustee with another independent corporate trustee.
  - The court concluded that the decedent's retained power was not equivalent to a power to affect the beneficial enjoyment of the trust property.
- In response to the Wall decision, the IRS issued Rev. Rul. 95-58; 1995-2 C.B. 191 and revoked Rev. Rul. 79-353.

23 WILLIAMS MULLEN finding yes

23

Power to Remove and Replace Independent Trustee

- In Estate of Wall, 101 T.C. 300 (1993), the decedent created a trust and designated an independent corporate fiduciary as trustee. The trustee possessed broad discretionary powers of distribution. The decedent reserved the right to remove and replace the corporate trustee with another independent corporate trustee.
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24 WILLIAMS MULLEN finding yes

24

Power to Remove and Replace Independent Trustee

> Rev. Rul. 95-58 provides that where a decedent possesses the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of section 672(c)), the decedent would not have retained a trustee's discretionary control over trust income.

– *Any Trustee appointed in or under this agreement shall have the right to serve as an Independent Trustee, provided such Trustee satisfies the qualifications set forth in this paragraph. An Independent Trustee is any Trustee who (1) is not a beneficiary of any trust under this agreement and (2) is not related or subordinate to me, my wife, any currently serving Trustee, or any beneficiary of any trust under this agreement within the meaning of Code § 672(c). Neither I, nor my wife, nor any beneficiary of any trust under this agreement may be an Independent Trustee. An Independent Trustee shall not be required to serve under this Agreement, but the powers and discretions reserved to the Independent Trustee may only be exercised by an Independent Trustee.*

25 WILLIAMS MULLEN finding yes

25

Code Section 672(c)

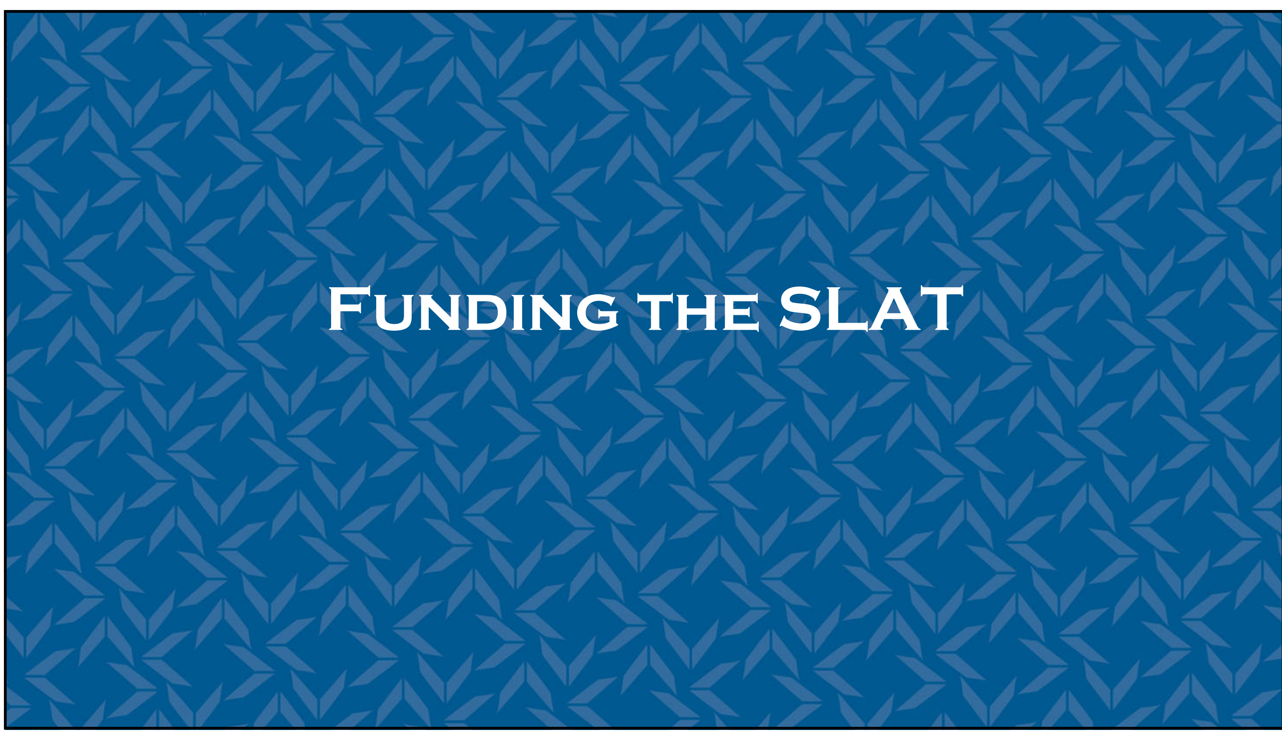
> For purposes of this subpart, the term "related or subordinate party" means any nonadverse party who is—

– the grantor's spouse if living with the grantor;

– any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

26 WILLIAMS MULLEN finding yes

26



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Gift Splitting

> Gift Splitting
  - Assets gifted to a SLAT are likely ineligible for gifting splitting because the beneficiary spouse cannot elect to split a gift to a trust in which they have a beneficial interest
  - It is important to be certain exactly how much gift tax exemption the donor spouse has available and can gift to a SLAT
  - Review prior gift tax returns and consider any other gifts made during the year

28

28

Gift Splitting

> Assume Husband previously made a $6 million gift.
> Wife has made no taxable gifts
> Husband now wants to gift $14 million to a SLAT for Wife and have Wife "split" gift and treat ½ of gift as being made by her
  – Husband hopes to make a $7 million gift and for Wife to make a $7 million gift (with the split gift election)
  – However, because Wife is a beneficiary of the SLAT, gift splitting is unavailable
  – Husband will be deemed to make the full $14 million gift (resulting in a total of $20 million in lifetime gifts causing the payment of gift tax)

Positioning Assets Now

> Positioning Assets Now Prior to Sunset
  – Now is a good time to start thinking about what assets client might want to gift to a SLAT and re-title those assets so they will be available to fund a SLAT
  – Account opening at year end may present a challenge
  – Consider opening an account in the name of a SLAT and nominally funding it now, so that a transfer to the SLAT will be a mere journal entry and will avoid a tedious new account opening process
  – If assets are jointly titled by spouses, consider splitting ownership now to avoid challenges around gift splitting and step transaction arguments

Step Transaction

> Example 1 - Assume Wife has $26MM and Husband has $0
- Wife gives Husband $13MM and Husband immediately gifts $13MM into SLAT for benefit of Wife
- *Concern that Step Transaction doctrine may apply and may treat the gift as being made by Wife and subject to estate tax inclusion*

> Example 2 - Assume Wife has $26MM and Husband has $0
- Wife gifts $13MM to SLAT and gift $13MM to Husband
- Husband immediately gifts $13MM to Trust for Wife's children
- *Concern that Step Transaction doctrine may apply and may treat Wife as having made a $26MM Gift*
- See, *Smaldino v. Commissioner, T.C. Memo. 2021-127*

31 WILLIAMS MULLEN finding yes

31

32

What and How to Gift?

> Gift Easy to Value Assets
  – Cash/Securities
  – Later Substitution in Grantor Trust
> Carefully Gift Hard to Value Assets
  – Defined Value Clause
  – *Wandry* Type Formula
  – Adequately Disclose Gifts and Non-Gifts
> Assets Over Which Control May Be Retained
  – Non-Voting Interests in Business Entities
  – Control with Buy-Sell Agreements

33 WILLIAMS MULLEN findingyes

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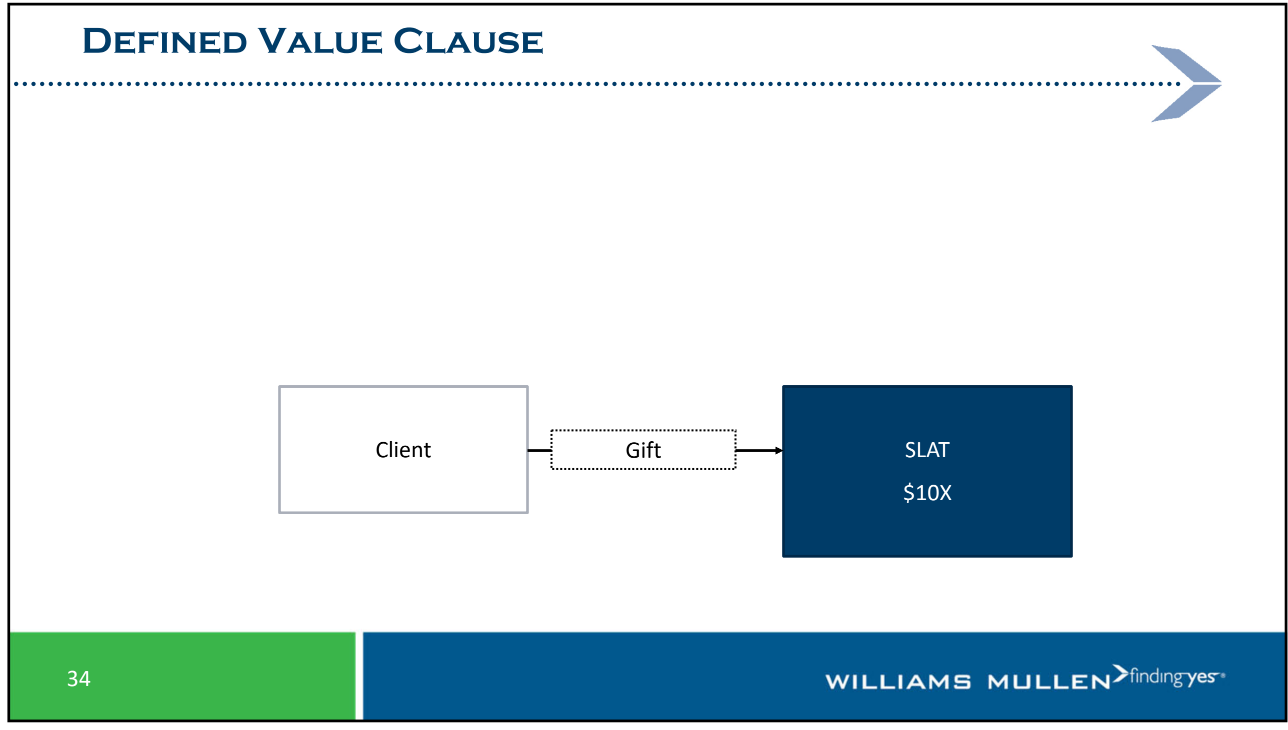

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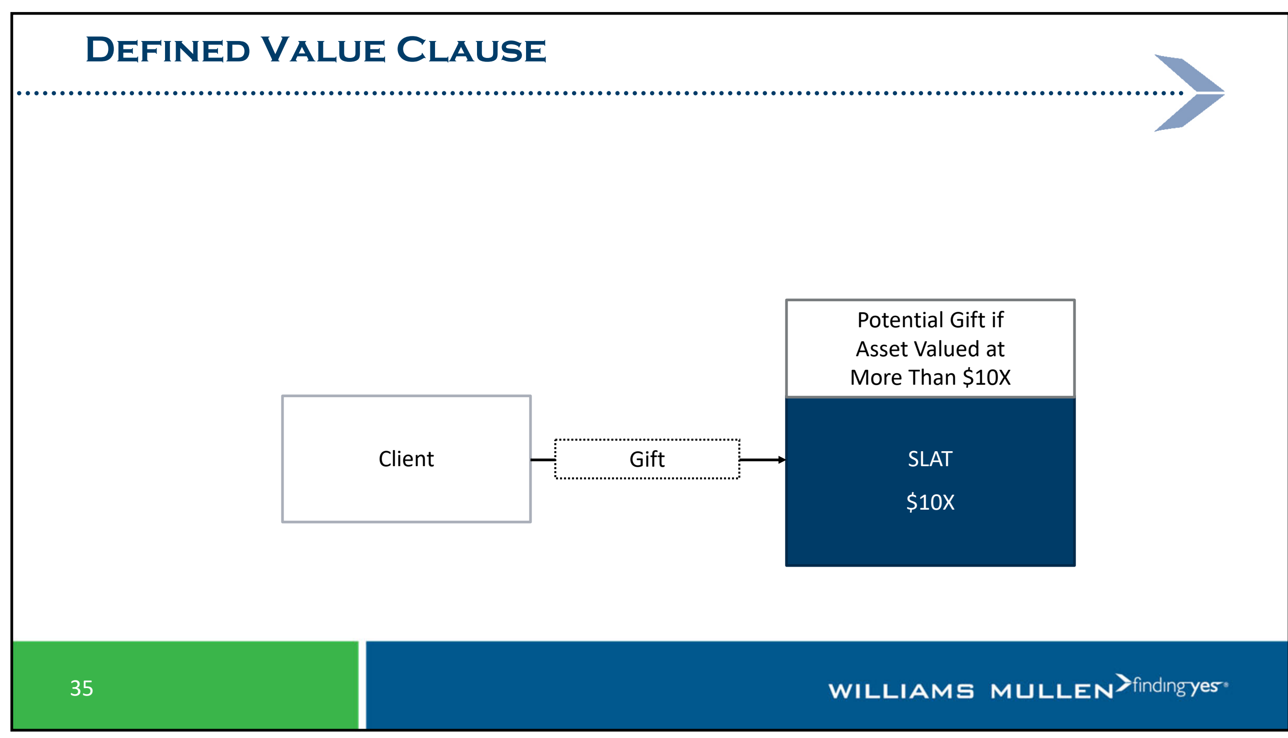

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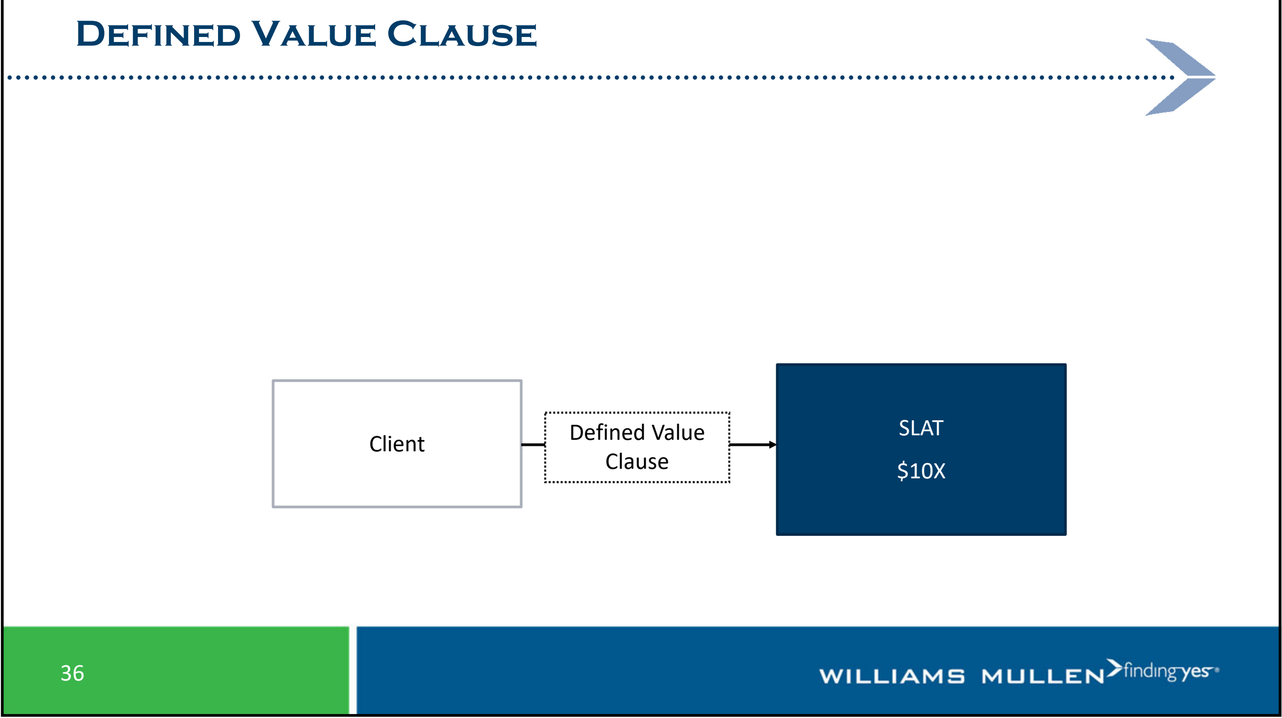

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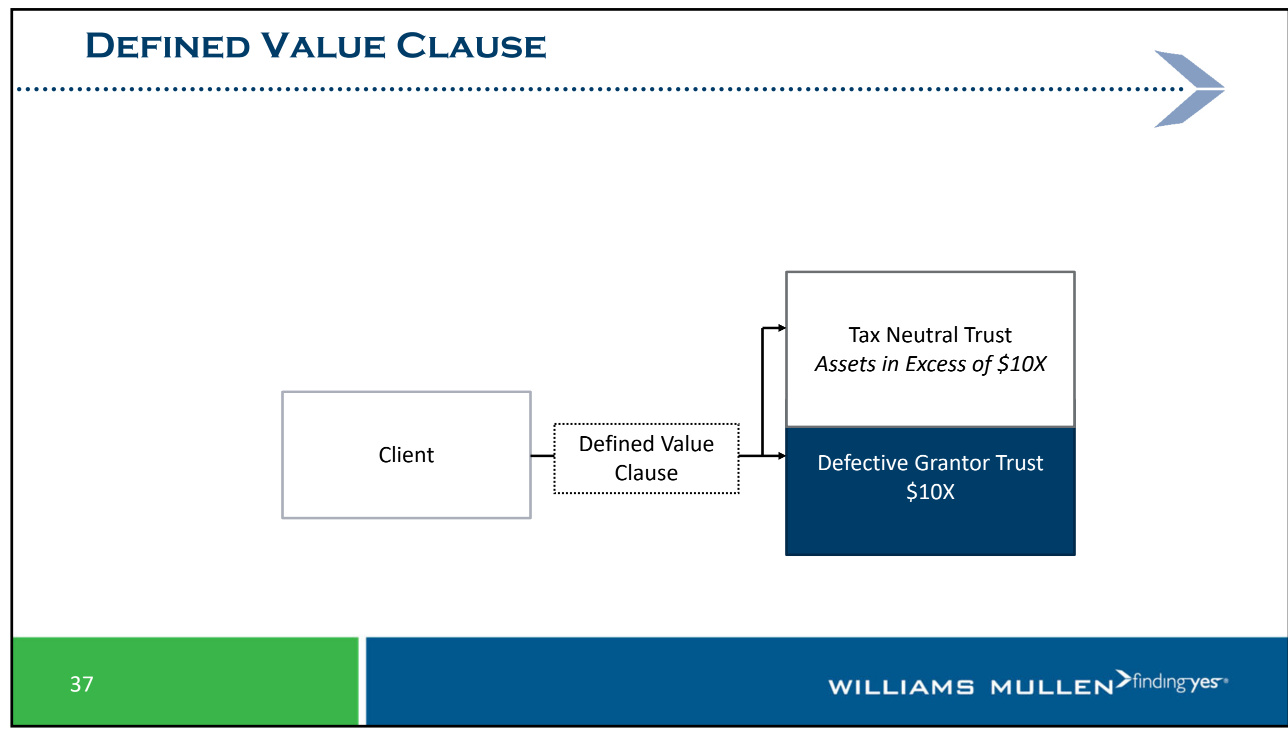

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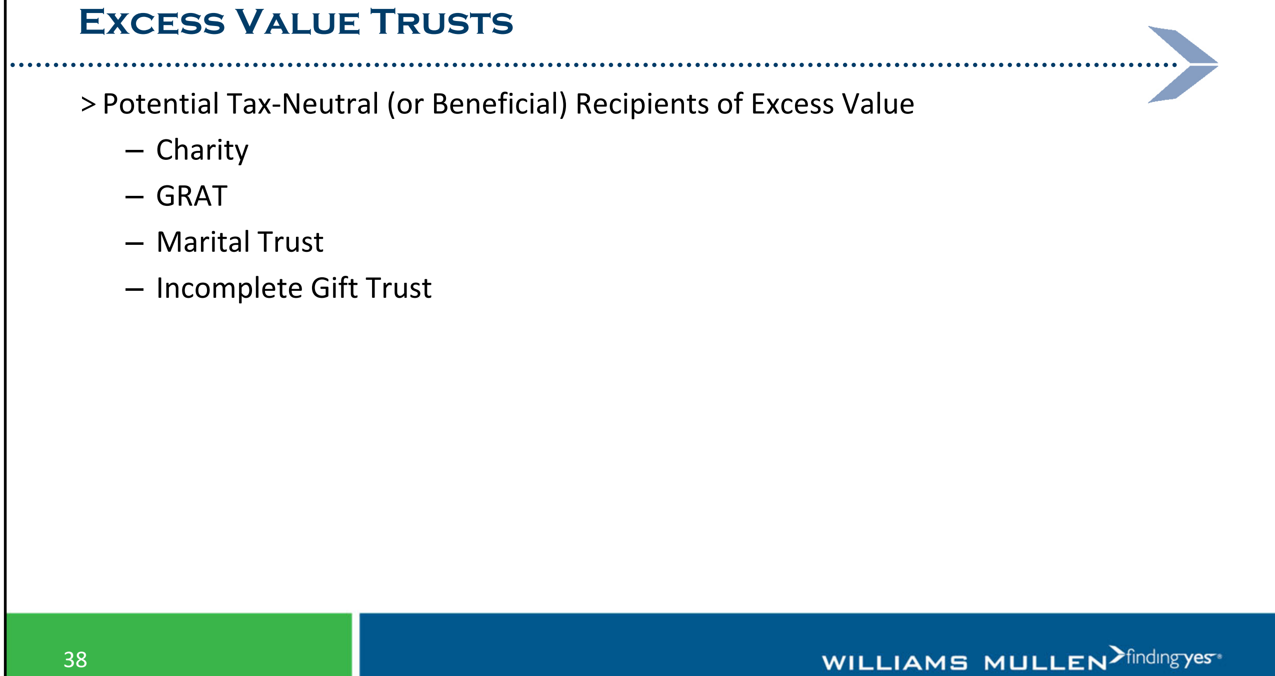

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Applicable Case Law

- *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944)
- *King v. United States*, 545 F.2d 700 (10th Cir. 1976)
- *Succession of McCord v. Commissioner*, 120 T.C. No. 13 (2003), rev'd, 461 F.3d 614 (5th Cir. 2006)
- Defined Value Clause
- *Christiansen v. Commissioner,* 130 T.C. No. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009)
- *Petter v. Commissioner*, T.C. Memo. 2009-820, *aff'd* 653 F.3d 1012 (9th Cir. 2011)
- *Hendrix v. Commissioner*, T.C. Memo. 2011-133

Procter

- Adjustment Clause
  - Initial transfer is partially unwound
  - Identity of the transferee does not change
  - Transferee pays an additional amount for the asset.
- Against public policy
  - If such clauses were effective, the result of an audit of the gift tax return could never result in a deficiency.

King

> Price-adjustment clause
  – In the case of IRS revaluation of the transferred stock, the stock purchase would be similarly adjusted, thereby ensuring that there was full and adequate consideration for the sale
> Court Focused on Arms-Length Nature
  – Independent appraiser used
  – Transfer terms were negotiated by the taxpayer's attorney and the trustee of the children's trusts

McCord and Progeny

> Gift of Assets Having Fixed Dollar Amount to Family
> Assets In Excess of Fixed Dollar Amount Passing to Charity
  – Revenue Incentive
  – Charity's Interest Enforceable
  – State Attorney General

Wandry Type Clause

> "Give me $10 worth of gas"
- Gas is $1/gallon = 10 gallons
- Gas is $2/gallon = 5 gallons
- Gas is $5/gallon = 2 gallons
- Only Transferring $10 – no more; no less

> "I give LLC units worth $15,000 to Donee"

Donor → $10 gas → Donee

WILLIAMS MULLEN finding yes

Finality on Gift Tax Return

> Adequate Disclosure of Gift on Gift Tax Return
- 3 Year Statute of Limitations

> What Constitutes Adequate Disclosure
- A description of the transferred property and any consideration received by the donor
- Identity and relationship of donor and donee
- Copy of the trust and EIN
- Method used to determine FMV of property or a qualified appraisal
- Statement describing any position that is contrary to any Treasury regulation or revenue ruling

WILLIAMS MULLEN finding yes

Sorensen v. Commissioner

- The parties settle a *Wandry* clause gift tax case in Tax Court.
- T.C. Docket Nos. 24797-18, 24798-18, 20284-19 and 20285-19
- On December 31, 2014, Brothers who then owned Firehouse Subs gifted nonvoting shares at a value of $5MM as finally determined for federal gift tax purposes per Irrevocable Stock Powers including *Wandry* language, to grantor trusts at a value of $532.79 per share
- Each then sold additional shares to the trusts in March 2015 using the same valuation
- Seven years later, Firehouse was sold at a value of more than $10,000 per share
- IRS contested the values per share in both transactions, and further argued that the defined value clause held no meaning because the shares transferred could not be adjusted (all shares were sold to a third party on the basis of ownership of the shares on the books based on their initial valuation)

Sorensen v. Commissioner

- Parties settled on a valuation of $1,640 per share for the gift and $1,722 per share for the sale
- IRS distinguished this case (and *Wandry*) from *McCord*, *Petter* and *Hendrix*, in which the quantity transferred was fixed, and only the allocation of that quantity between noncharitable and charitable recipients was dependent on the fair market value as finally determined

Sorensen Takeaways

> Include a footnote on stock ledgers and tax returns regarding future adjustment of number of shares transferred

> Document in company and trust records that distributions are based on initial determination of value and may be adjusted based on finally determined gift tax values

> Donees should countersign the stock powers to acknowledge the conditions

> If subsequent sale of company occurs, have buyer acknowledge the defined value formula transfers and fact that there may be a future adjustment of sale proceeds

> The huge appreciation in this case between the trust transfers and third-party sale is a reminder of what can happen if a defined value clause does work

> Transfers were still quite successful, for settled gift tax of $6.5MM, each brother transferred $150MM, reflecting an effective gift tax rate of less than 5%

Questions

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Tax Policy, Proposals & Prospects: A Washington Update

Jeff Kummer
Deloitte Tax LLP
June 7, 2024

Political dynamics of the 118th Congress

Divided government with narrow margins has impacted the policymaking agenda

US SENATE: 51 Democrats* | 49 Republicans

*Includes 2 Independents who caucus with Democrats and 1 Independent who takes committee assignments from Democrats

US HOUSE: 213 Democrats | 217 Republicans

Possible Impacts

- House: Focus on congressional oversight and investigations
- Senate: Focus on confirming judges and other presidential nominees (requires simple majority and no House action)
- Legislation:
  - Only bipartisan legislation can pass
  - Not expecting major tax increases or major new spending bills
  - Agenda likely to focus on "must do" items, such as government funding and program reauthorizations
- Active regulatory agenda expected

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The New Math on Capitol Hill – Why 2/3 can sometimes be equal to 3/5

- **In the Senate**, most major legislation is subject to a filibuster, and 60 votes (3/5 of the Senate) are needed to end a filibuster. The filibuster rules don't apply in certain situations, such as privileged motions, confirmations, and budget reconciliation.
- **In the House**, passing legislation under a "rule" requires a simple majority (50% + 1) of members who are present and voting. However, a 2/3 majority is required to pass legislation under expedited procedures often reserved for less controversial measures. This process, known as "suspension of the rules," features limited debate and no amendments.
  - With an extremely narrow majority and substantial intra-party disagreements on both process and substance, Republicans are having an increasingly hard time passing key bills on their own, especially those providing for government funding. As a result, House Leadership is increasingly relying on the votes of Democrats to pass legislation, often using the suspension process to avoid amendments and other procedural votes.
- Thus, as a practical matter, sometimes 2/3 = 3/5. Both define the margins that may be needed to pass some of the most important legislation in the U.S. Congress in 2024.

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Tax Policy in 2024

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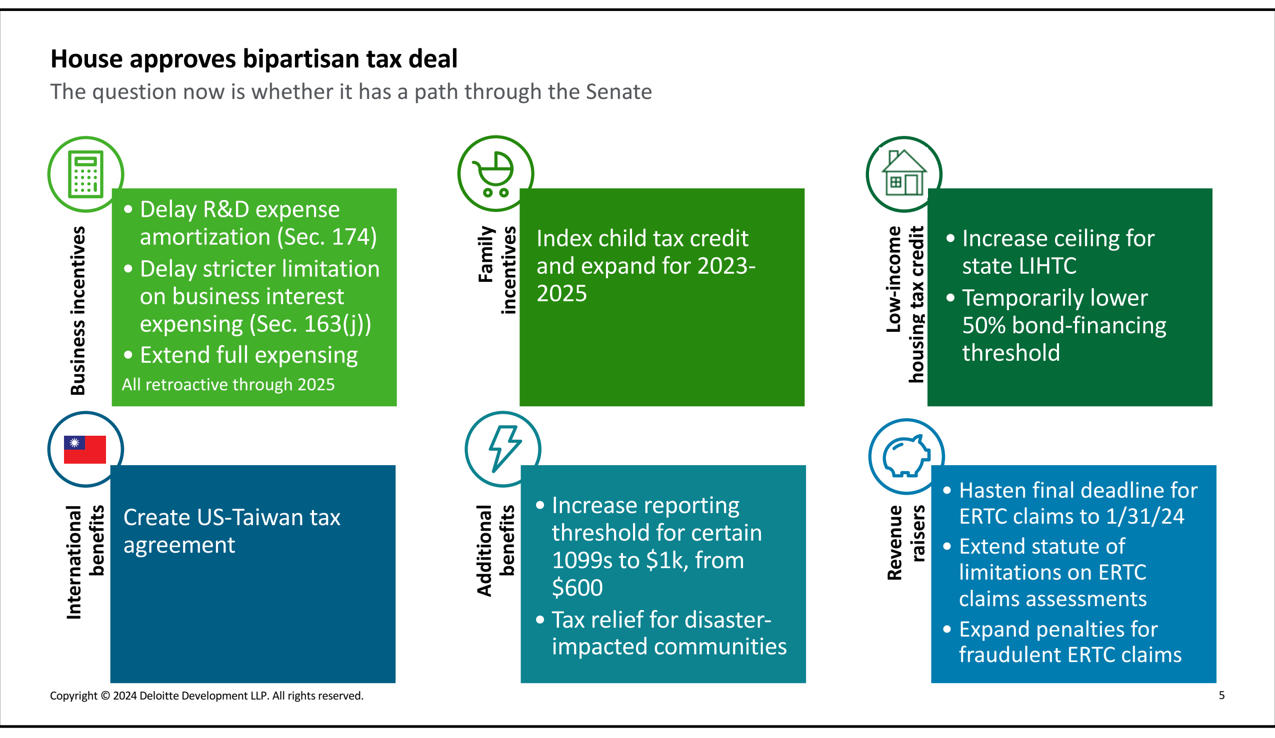

Pillar Two: Political dynamics of U.S. implementation

GOP-led House is making global tax agreement more challenging

- Both Republicans and Democrats have raised concerns that P2 provides for more favorable treatment of refundable tax credits over the nonrefundable credits more prevalent in the U.S.
  - *E.g.,* the UK's refundable R&D tax credit is treated as income, while the U.S.' nonrefundable version is treated as a reduction in tax payments that can drop a company's effective tax rate < 15% and trigger a top-up tax
  - Treasury has acknowledged the concerns and said they will work with the OECD, but the reality is that Congress is unlikely to change the format of U.S. credits, and OECD negotiators are not willing to reopen the topic
- House GOP legislative efforts include:
  - Calling for a policy rider as part of the FY2024 appropriations process that would prohibit US funding for the OECD
  - Imposing retaliatory taxes – subject to annual increases – on the US income of foreign entities and individuals from countries implementing a UTPR or similar measure
  - Tightening the U.S. base erosion and anti-avoidance tax (BEAT) rules for companies based in jurisdictions that impose a UTPR or other exterritorial tax on U.S. multinationals

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IRS strategic operating plan, updated

- The Inflation Reduction Act provided the Internal Revenue Service with about **$80B in additional appropriations** over 10 years, with about **$20B then rescinded** in March 2023 to cover other spending priorities
- An updated strategic plan released May 2 lays out the agency's plans to enhance enforcement and compliance activities, modernize its foundational technology, and improve tools available to IRS employees assisting taxpayers
- More than half of the total amount is allocated to enforcement, with a **focus on large corporate returns, complex passthrough entities, and high-net-worth individuals**, including plans to:
  - Nearly triple the audit rates on large corporations with assets greater than $250M to 22.6% in tax year 2026, up from 8.8% in tax year 2019
  - Increase audit rates by nearly 10-fold on large, complex partnerships with assets greater than $10M, going from 0.1% in 2019 to 1% in tax year 2026
  - Increase audit rates by more than 50% on wealthy individual taxpayers with total positive income greater than $10M, with audit rates going from an 11% coverage rate in 2019 to 16.5% in tax year 2026
- The IRS looks to **build its workforce** to 102,500 full-time equivalent employees by FY2029, up from roughly 83,000
- The plan makes the distinction that **no funds are to be used to increase the audit share of small businesses or households earning less than $400k** relative to historic levels, but expect continued political debate over allocation of funds to the IRS

Source: *IRA Strategic Operating Plan Annual Update*, Internal Revenue Service, May 2, 2024

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The President's FY2025 budget request

Key business tax proposals

Proposed changes	Revenue estimate (2025-34)
Increase corporate income tax rate to 28%	$1,350B
Increase GILTI, revise BEAT, adopt P2-conforming Undertaxed Profits Rule	$510B
Extend current $1M exec comp deduction limits to all C-corp employees	**$272B**
Increase stock buyback excise tax to 4%	$166B
Repeal FDII, replace with to-be-determined research benefit	$158B/-$158B (revenue neutral)
Increase corporate AMT rate to 21%	**$137B**
Strengthen limitation on losses for non-corporate taxpayers	$76B
Provide tax benefits for onshoring jobs, repeal tax benefits for offshoring jobs	-$71B/$71B (revenue neutral)
End tax preferences for fossil fuel activities	$45B

Note: New proposals in **bold**
Source: "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals," Treasury Department, March 11, 2024

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The President's FY2025 budget request

Key individual tax proposals (intended to apply only to those with incomes >$400k)

Proposed changes	Revenue estimate (2025-34)
25% minimum income tax for those with total income >$100M (including unrealized capital gains)	$503B
Increase NII tax and additional Medicare tax to 5% for those with income >$400k	$404B
Apply NII tax to passthrough income of business taxpayers earning >$400k	$393B
Tax capital gains as ordinary income for those with income >$1M	$289B
Increase top marginal income tax rate to 39.6%	$246B
Estate and gift changes	$97B
Prevent mega-IRAs	$24B
Repeal like-kind exchanges	$20B
Treat carried interest as ordinary income	$7B
Limit tax benefits of private placement life insurance	**$7B**

Note: New proposals in **bold**
Source: "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals," Treasury Department, March 11, 2024

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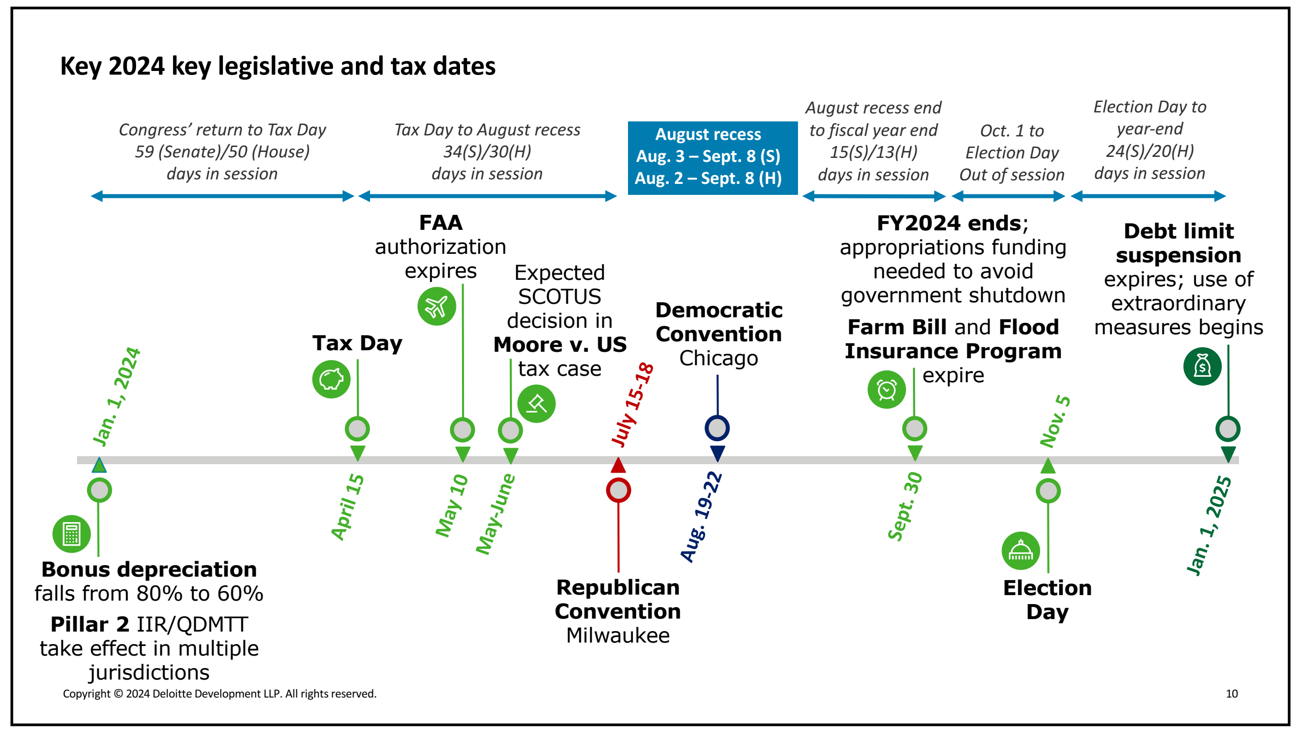

Budget Deficits, 2024 Elections and Future Tax Policy Decisions

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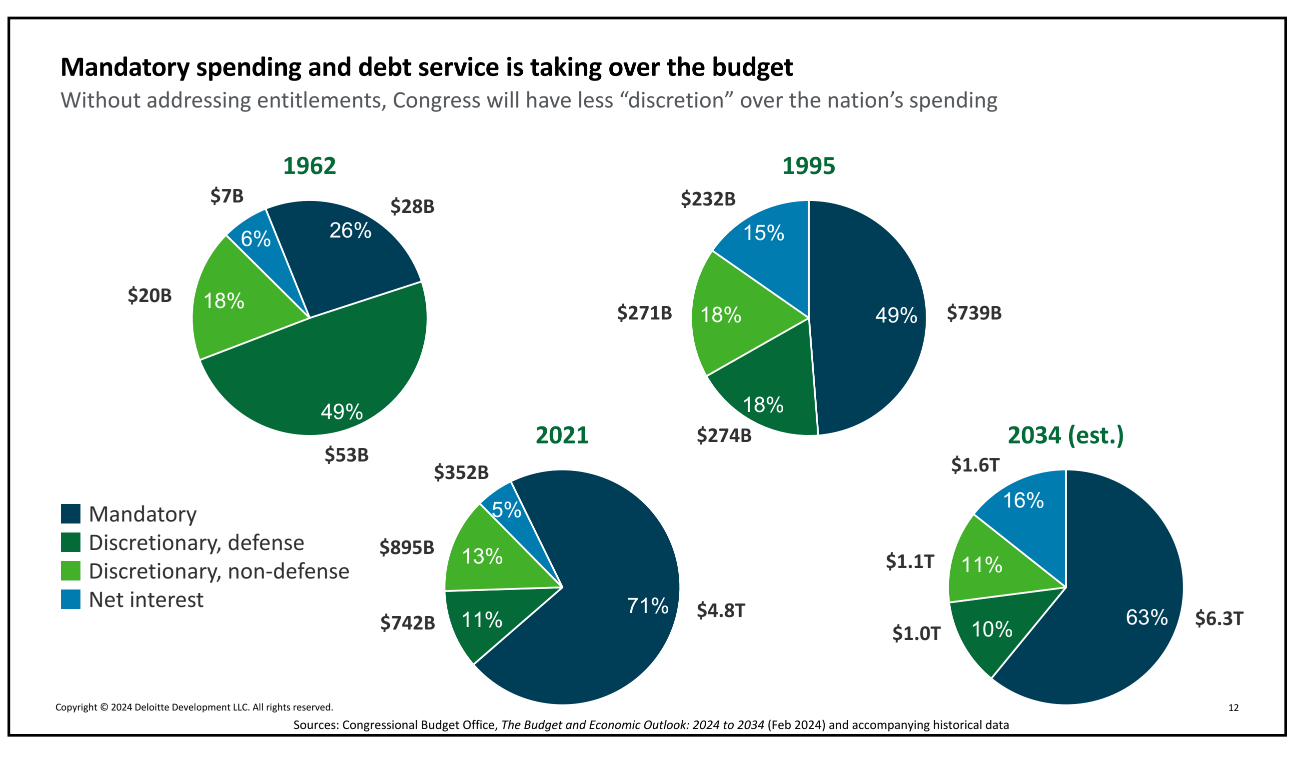
Mandatory spending and debt service is taking over the budget

Without addressing entitlements, Congress will have less “discretion” over the nation’s spending



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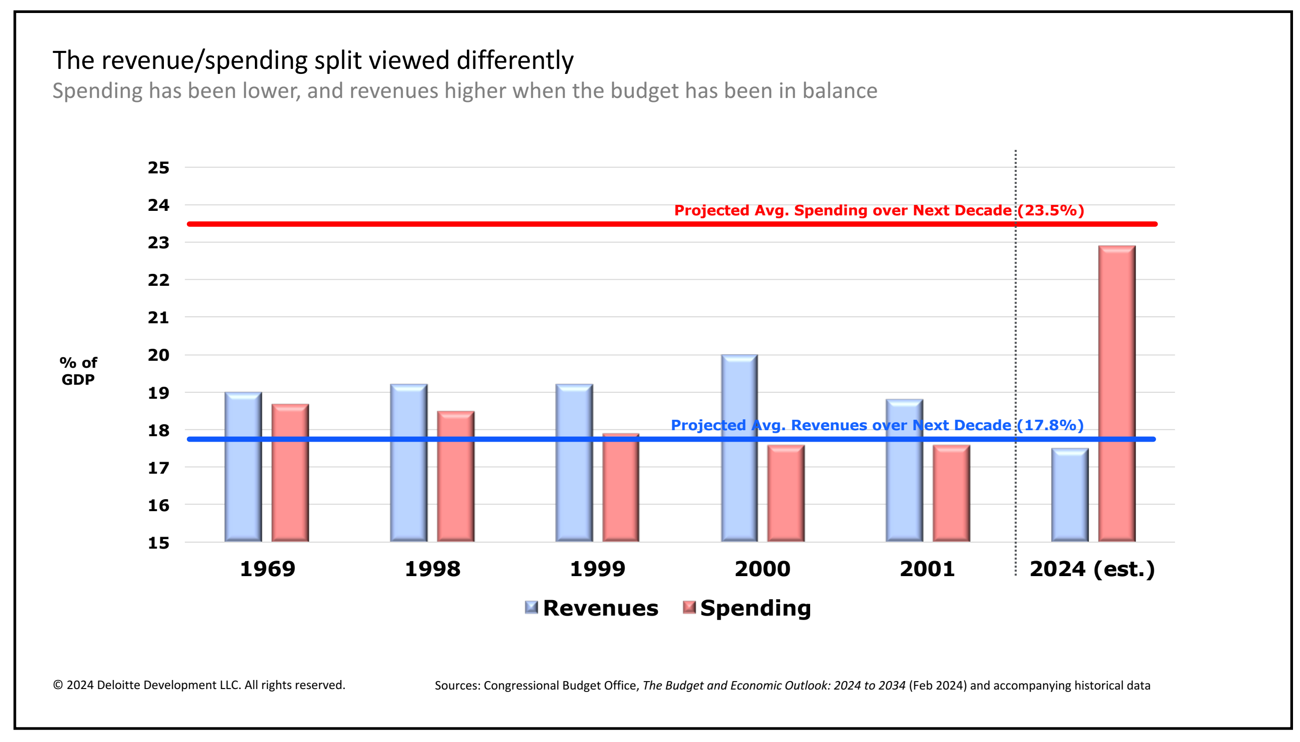
Sources: Congressional Budget Office, *The Budget and Economic Outlook: 2024 to 2034* (Feb 2024) and accompanying historical data


The revenue/spending split viewed differently
Spending has been lower, and revenues higher when the budget has been in balance
% of GDP
25
24
23
22
21
20
19
18
17
16
15
Projected Avg. Spending over Next Decade (23.5%)
Projected Avg. Revenues over Next Decade (17.8%)
1969
1998
1999
2000
2001
2024 (est.)
Revenues
Spending
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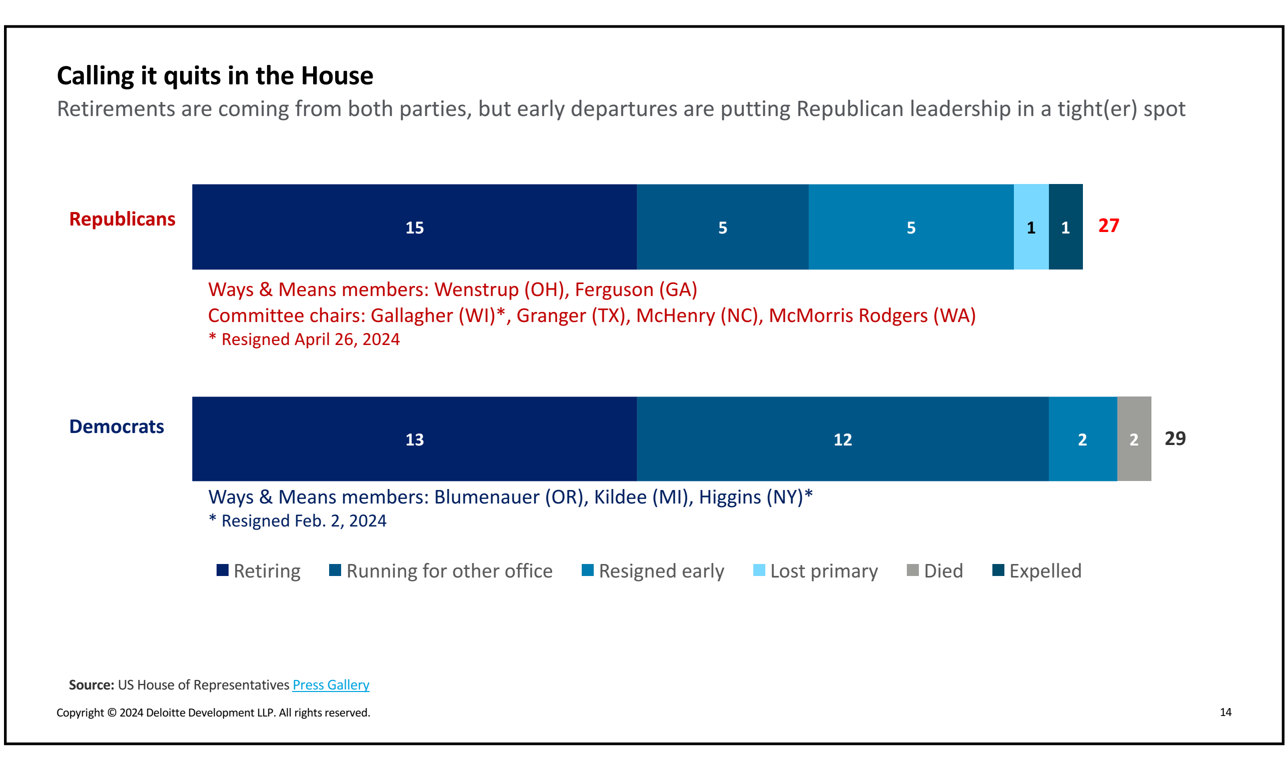
Sources: Congressional Budget Office, The Budget and Economic Outlook: 2024 to 2034 (Feb 2024) and accompanying historical data


Calling it quits in the House
Retirements are coming from both parties, but early departures are putting Republican leadership in a tight(er) spot
Republicans
15
5
5
1
1
27
Ways & Means members: Wenstrup (OH), Ferguson (GA)
Committee chairs: Gallagher (WI)*, Granger (TX), McHenry (NC), McMorris Rodgers (WA)
* Resigned April 26, 2024
Democrats
13
12
2
2
29
Ways & Means members: Blumenauer (OR), Kildee (MI), Higgins (NY)*
* Resigned Feb. 2, 2024
Retiring
Running for other office
Resigned early
Lost primary
Died
Expelled
Source: US House of Representatives Press Gallery
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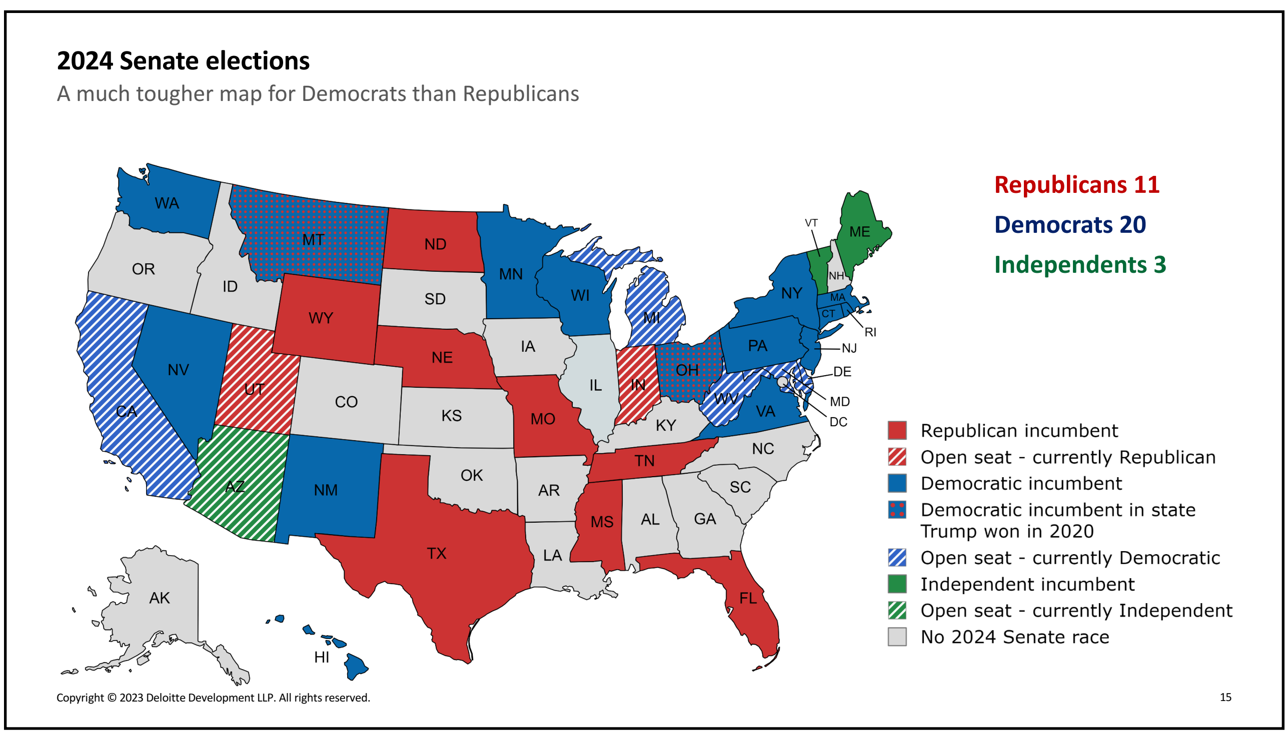
2024 Senate elections
A much tougher map for Democrats than Republicans
Republicans 11
Democrats 20
Independents 3
WA
OR
ID
MT
ND
SD
WY
NE
MN
WI
MI
IA
IL
IN
OH
PA
NY
VT
NH
ME
MA
CT
RI
NJ
DE
MD
DC
CA
NV
UT
CO
KS
MO
KY
WV
VA
NC
TN
SC
AZ
NM
OK
AR
MS
AL
GA
TX
LA
FL
AK
HI
Republican incumbent
Open seat - currently Republican
Democratic incumbent
Democratic incumbent in state Trump won in 2020
Open seat - currently Democratic
Independent incumbent
Open seat - currently Independent
No 2024 Senate race
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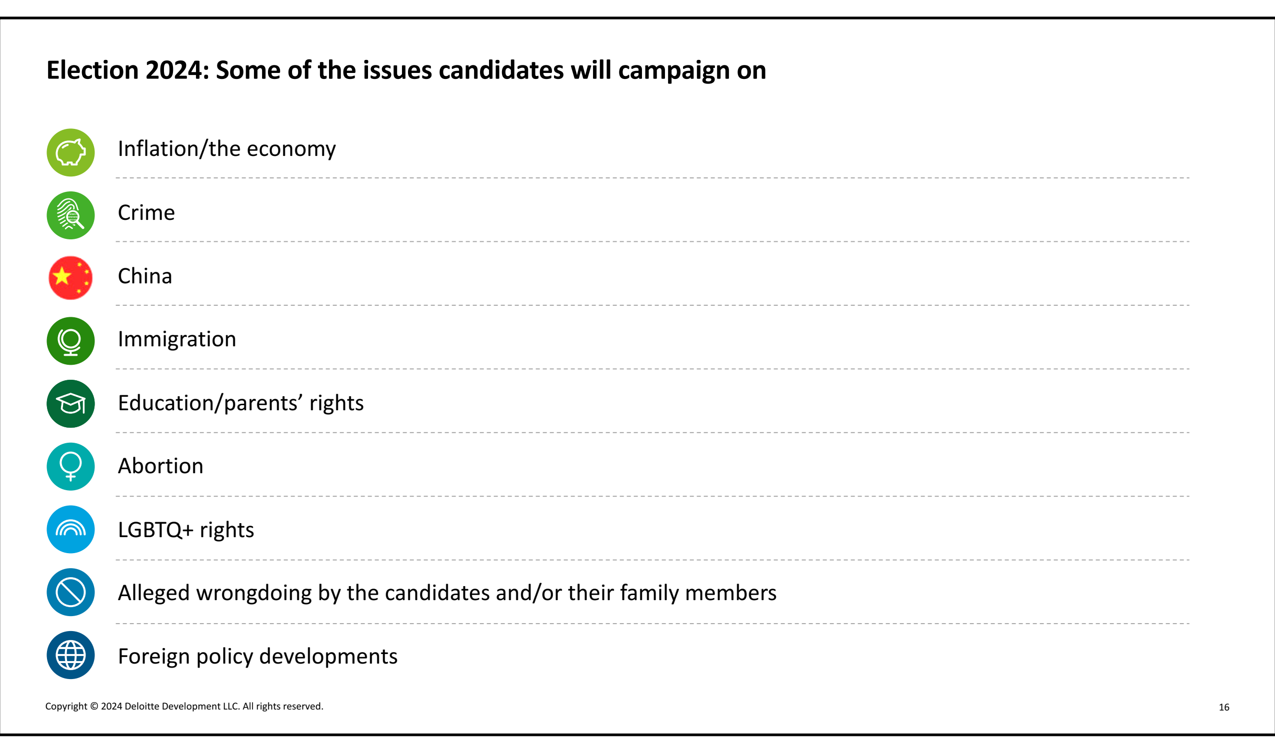
Election 2024: Some of the issues candidates will campaign on
Inflation/the economy
Crime
China
Immigration
Education/parents' rights
Abortion
LGBTQ+ rights
Alleged wrongdoing by the candidates and/or their family members
Foreign policy developments
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Governing 2025 – Taxes will take center stage

Lapsed and lapsing provisions will ensure tax system remains fluid

Effective January 1, 2022

- Adjusted taxable income base used in section 163(j) calculation changes from earnings before interest, taxes, depreciation and amortization (EBITDA) to earnings before interest and taxes (EBIT)
- Requirement to amortize research and experimentation expenditures begins

Effective January 1, 2023

- 100% expensing of new and used business property begins phases out

Expiring December 31, 2025

- New Markets Tax Credit (NMTC)
- Work Opportunity Tax Credit (WOTC)
- Look-through treatment of payments between related CFCs for purposes of Subpart F
- Exclusion for cancellation of debt income on a principal residence
- Empowerment zone tax incentives
- Seven-year recovery period for motorsports entertainment complexes
- Expensing of certain qualified film and live theater productions
- Employer credit for paid family and medical leave

Effective January 1, 2026

- Enhanced Affordable Care Act (ACA) premium assistance credits expire
- 10% base erosion and anti-abuse tax (BEAT) rate increases to 12.5%
- Deduction for GILTI falls from 50% to 37.5%
- Deduction for foreign derived intangible income (FDII) falls from 37.5% to 21.875%
- Reduced individual rates and nearly all other changes to personal tax rules – including SALT deduction cap, PEASE limitation, and estate tax changes – expire
- 20% deduction under section 199A on qualified business income expires

Effective January 1, 2029

- Limitation on deduction for pass-through owners' "excess business losses" expires

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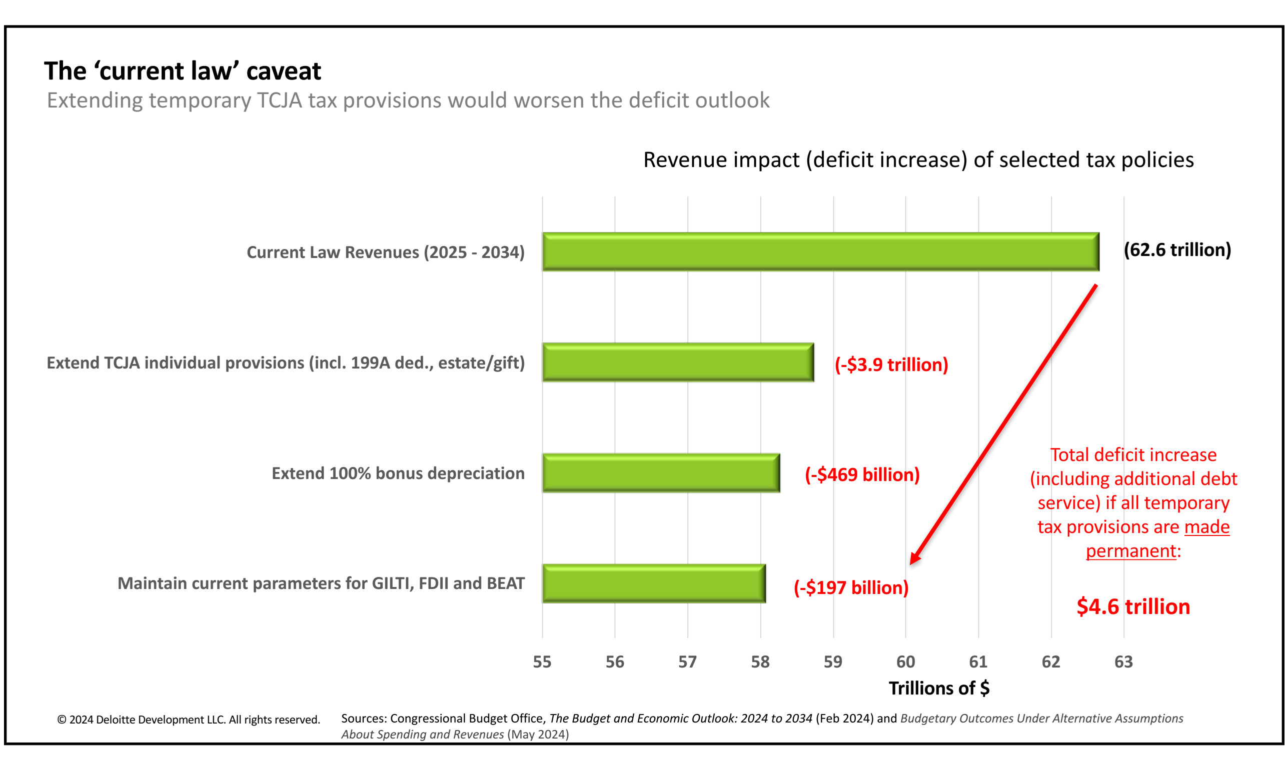

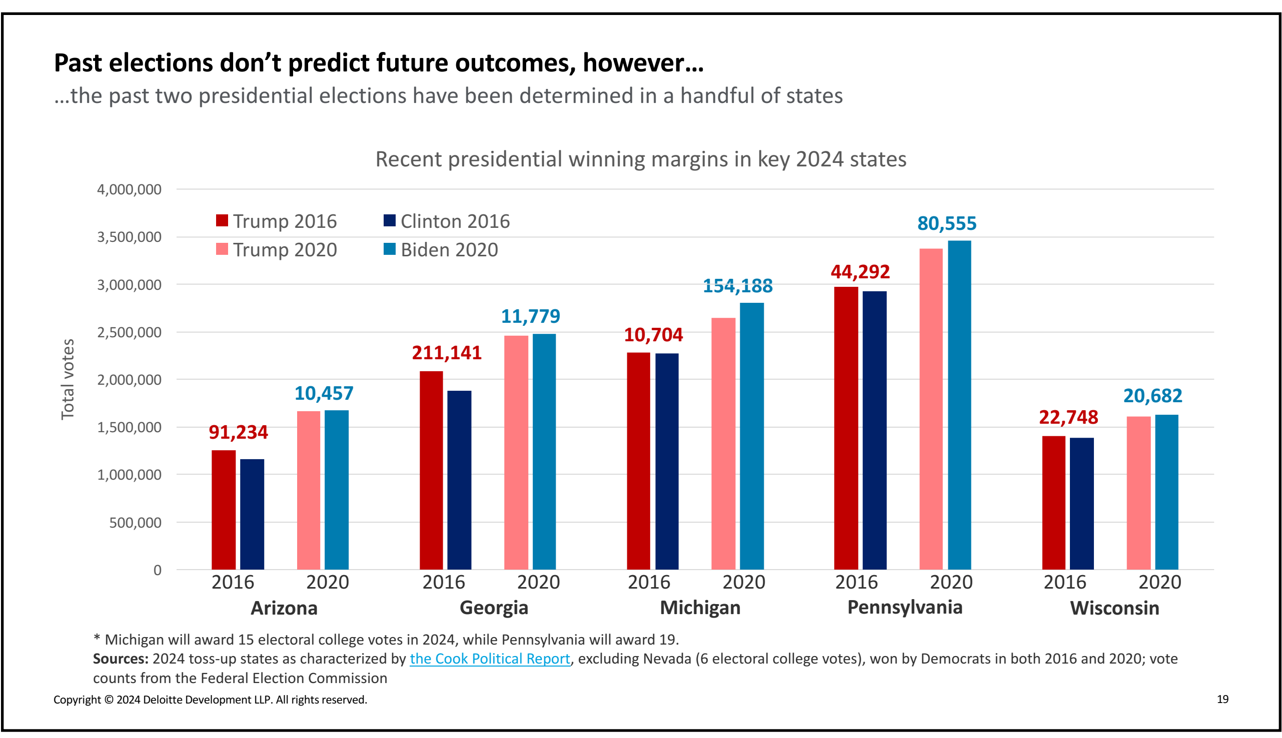

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Transaction Structures Involving S Corporations

Virginia Conference of Federal Taxation

June 7, 2024

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Basics – What is an S Corporation?

- An S corporation is an eligible corporation that elects to be taxed under a special pass-through regime.
- An S corporation generally does not pay corporate level income taxes.
- A shareholder's adjusted basis is increased for income and contributions and decreased by losses and distributions.
- Losses are limited to a shareholder's outside basis.
- Entity-level debt does not increase a shareholder's adjusted basis.
- There are no special allocations.
- Each share represents an equal right to current and liquidating distributions.

1

BASICS – Eligibility Requirements

A corporation must not:

- have more than 100 shareholders,
- have as a shareholder a person (other than an estate, an eligible trust, or a tax-exempt organization) who is not an individual,
- have a nonresident alien as a shareholder, and
- have more than 1 class of stock.

A timely election to be taxed as an S corporation must be made.

SOI Statistics for 2015

Type of Return	1120	1120-S	1065
Number of Returns	1,611,236	4,487,336	3,715,187
Total Receipts	$22,842,599,306	$7,504,357,192	$5,295,334,204
Net Income (less deficit)	$1,154,967,740	$457,048,244	$780,504,367

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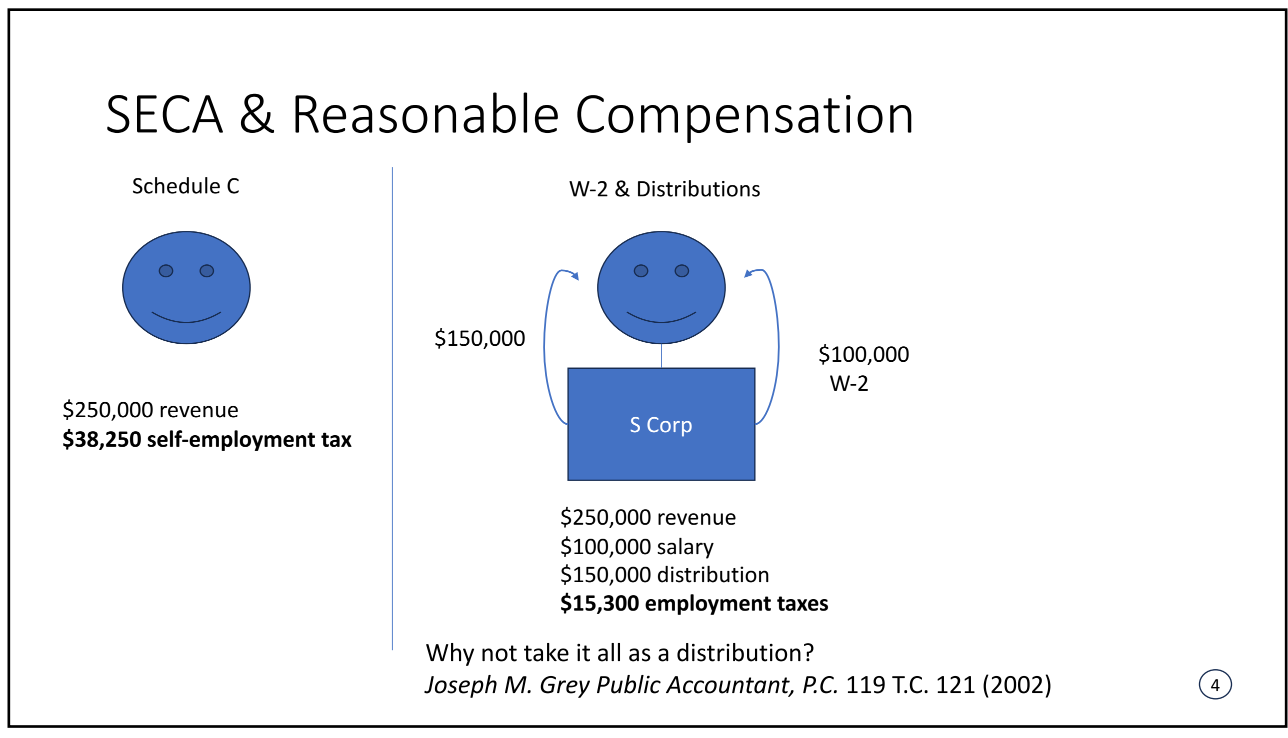
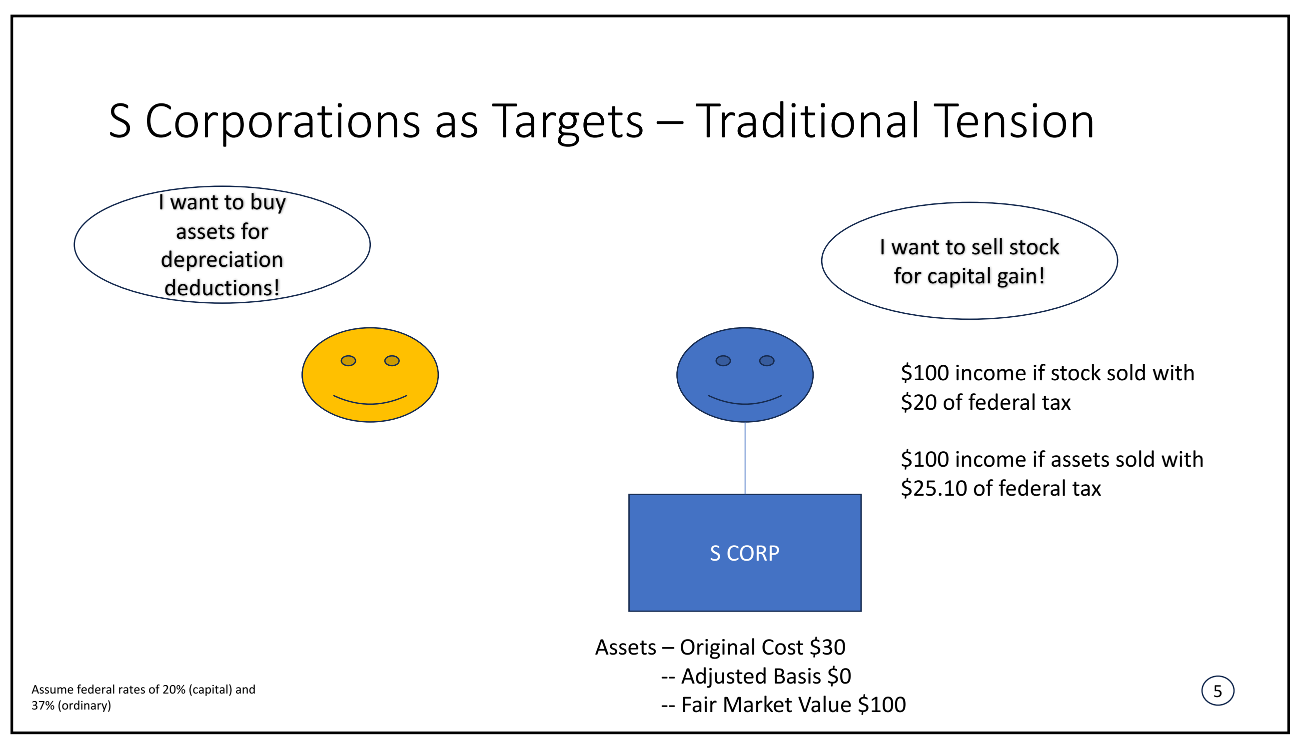
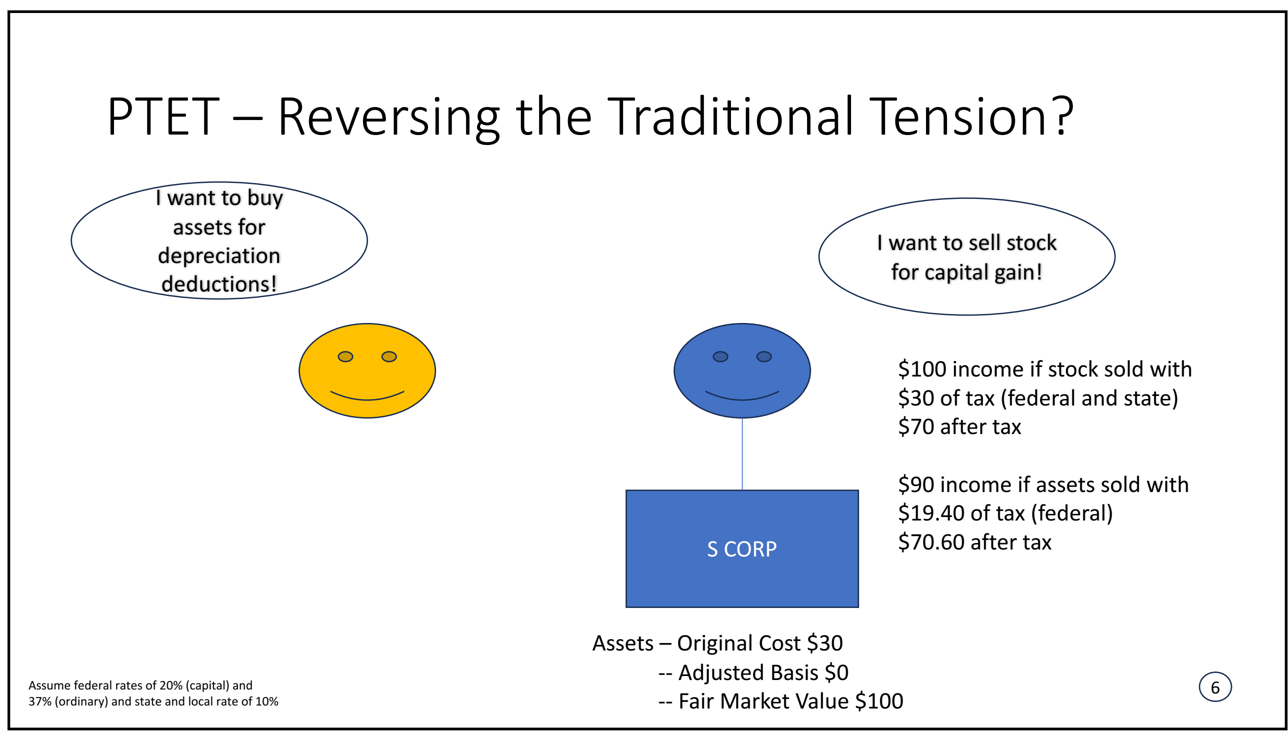
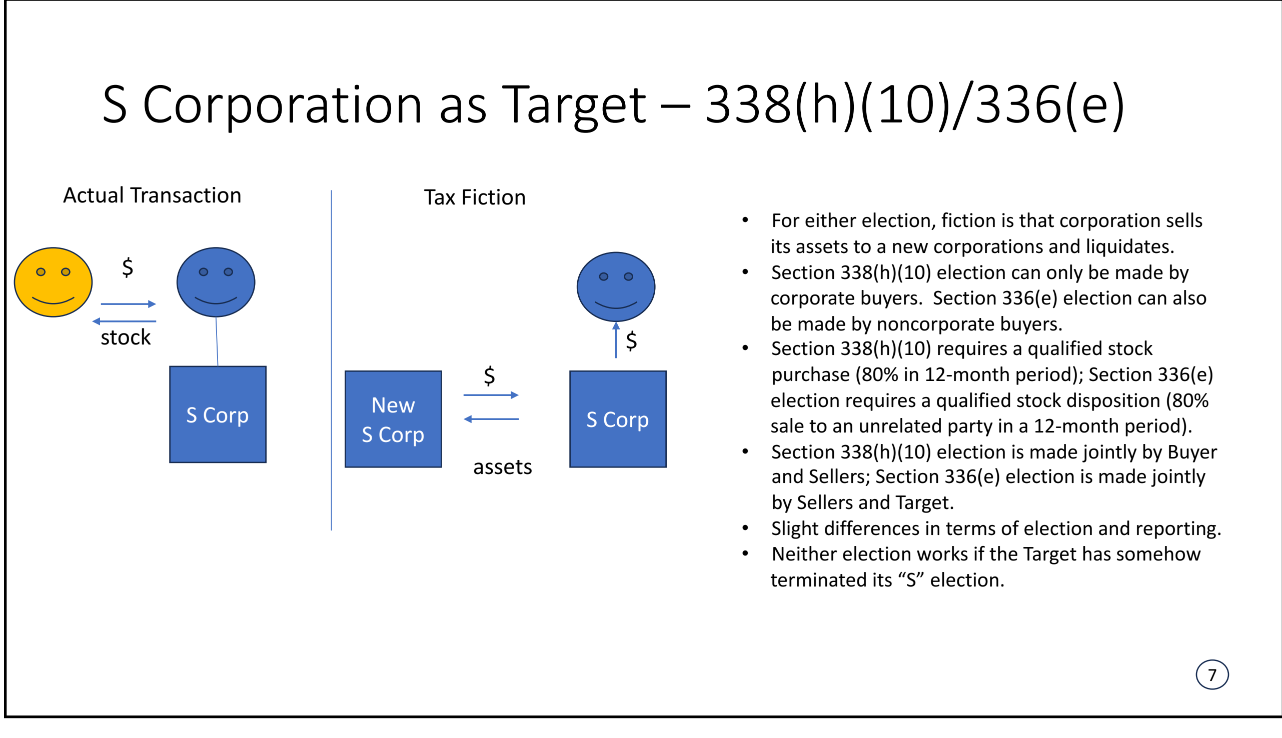
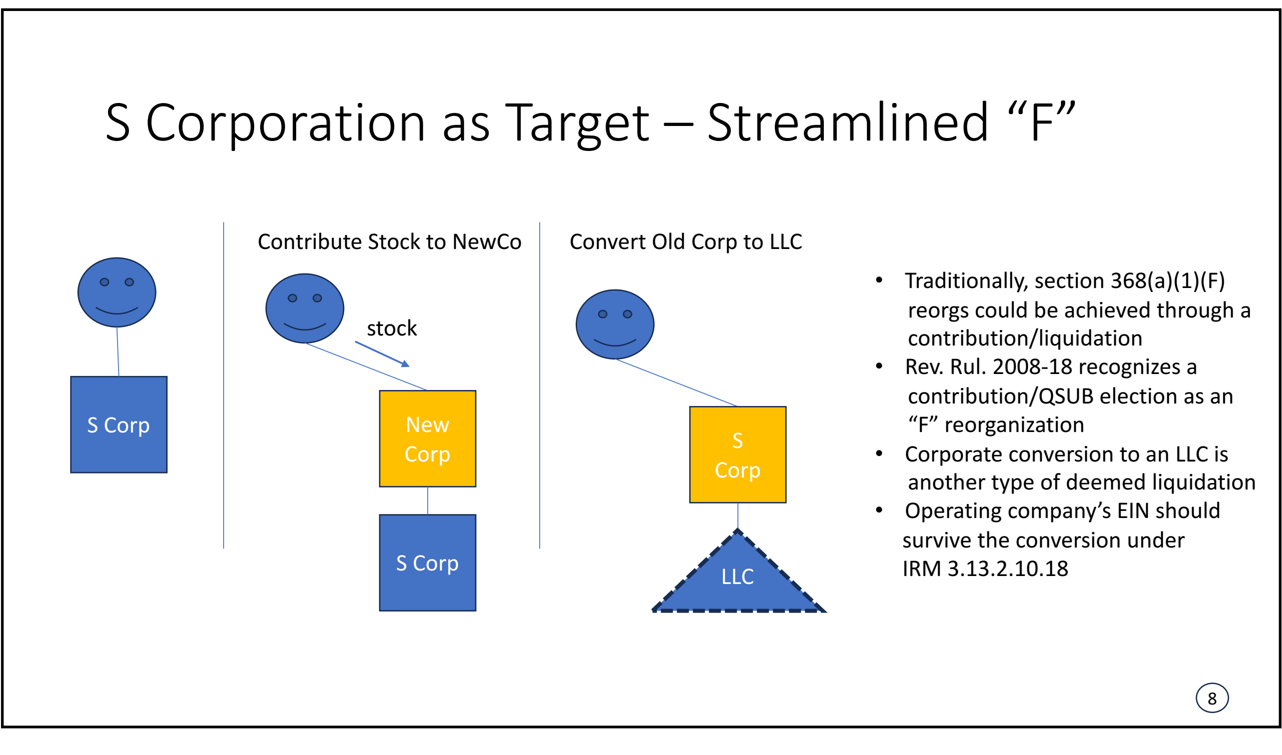
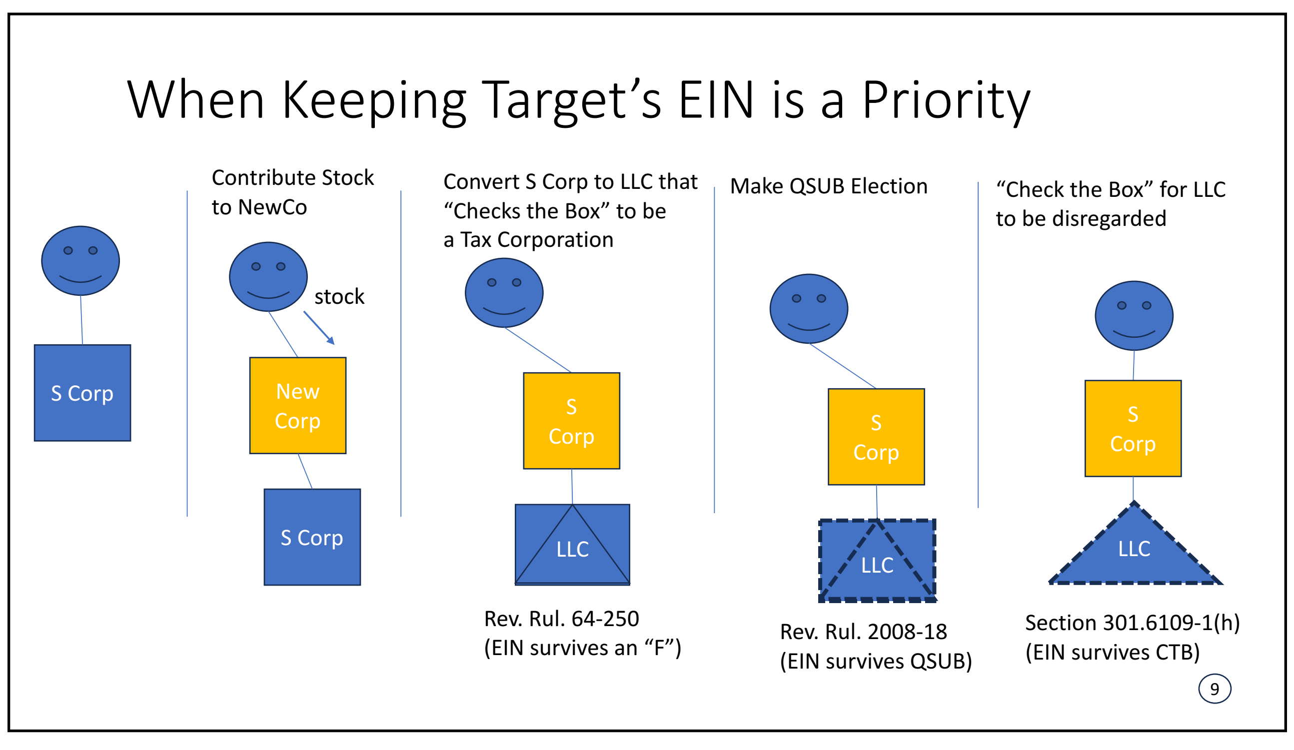

SECA & Reasonable Compensation
Schedule C
$250,000 revenue
$38,250 self-employment tax
W-2 & Distributions
$150,000
$100,000
W-2
S Corp
$250,000 revenue
$100,000 salary
$150,000 distribution
$15,300 employment taxes
Why not take it all as a distribution?
Joseph M. Grey Public Accountant, P.C. 119 T.C. 121 (2002)
4


S Corporations as Targets – Traditional Tension
I want to buy assets for depreciation deductions!
I want to sell stock for capital gain!
$100 income if stock sold with $20 of federal tax
$100 income if assets sold with $25.10 of federal tax
S CORP
Assets – Original Cost $30
-- Adjusted Basis $0
-- Fair Market Value $100
Assume federal rates of 20% (capital) and 37% (ordinary)
5


PTET – Reversing the Traditional Tension?
I want to buy assets for depreciation deductions!
I want to sell stock for capital gain!
$100 income if stock sold with
$30 of tax (federal and state)
$70 after tax
$90 income if assets sold with
$19.40 of tax (federal)
$70.60 after tax
S CORP
Assets – Original Cost $30
-- Adjusted Basis $0
-- Fair Market Value $100
Assume federal rates of 20% (capital) and 37% (ordinary) and state and local rate of 10%
6


S Corporation as Target – 338(h)(10)/336(e)
Actual Transaction
$
stock
S Corp
Tax Fiction
New S Corp
$
assets
S Corp
$
For either election, fiction is that corporation sells its assets to a new corporations and liquidates.
Section 338(h)(10) election can only be made by corporate buyers. Section 336(e) election can also be made by noncorporate buyers.
Section 338(h)(10) requires a qualified stock purchase (80% in 12-month period); Section 336(e) election requires a qualified stock disposition (80% sale to an unrelated party in a 12-month period).
Section 338(h)(10) election is made jointly by Buyer and Sellers; Section 336(e) election is made jointly by Sellers and Target.
Slight differences in terms of election and reporting.
Neither election works if the Target has somehow terminated its “S” election.
7


S Corporation as Target – Streamlined "F"
Contribute Stock to NewCo
Convert Old Corp to LLC
S Corp
stock
New Corp
S Corp
S Corp
LLC
• Traditionally, section 368(a)(1)(F) reorgs could be achieved through a contribution/liquidation
• Rev. Rul. 2008-18 recognizes a contribution/QSUB election as an "F" reorganization
• Corporate conversion to an LLC is another type of deemed liquidation
• Operating company's EIN should survive the conversion under IRM 3.13.2.10.18
8


When Keeping Target's EIN is a Priority
Contribute Stock to NewCo
Convert S Corp to LLC that "Checks the Box" to be a Tax Corporation
Make QSUB Election
"Check the Box" for LLC to be disregarded
S Corp
stock
New Corp
S Corp
S Corp
LLC
S Corp
LLC
S Corp
LLC
Rev. Rul. 64-250 (EIN survives an "F")
Rev. Rul. 2008-18 (EIN survives QSUB)
Section 301.6109-1(h) (EIN survives CTB)
9

S Corporation as Target – Residual Tax Liability

January 1, 2024

S Corp

June 15, 2024

New Corp

LLC

July 1, 2024

New Corp

Buyer

LLC

- If S Corp has somehow terminated its "S" election, there could be unpaid corporate tax liability.
- Unpaid corporate tax liability remains with LLC. Section 301.7701-2(c)(2)(iii)

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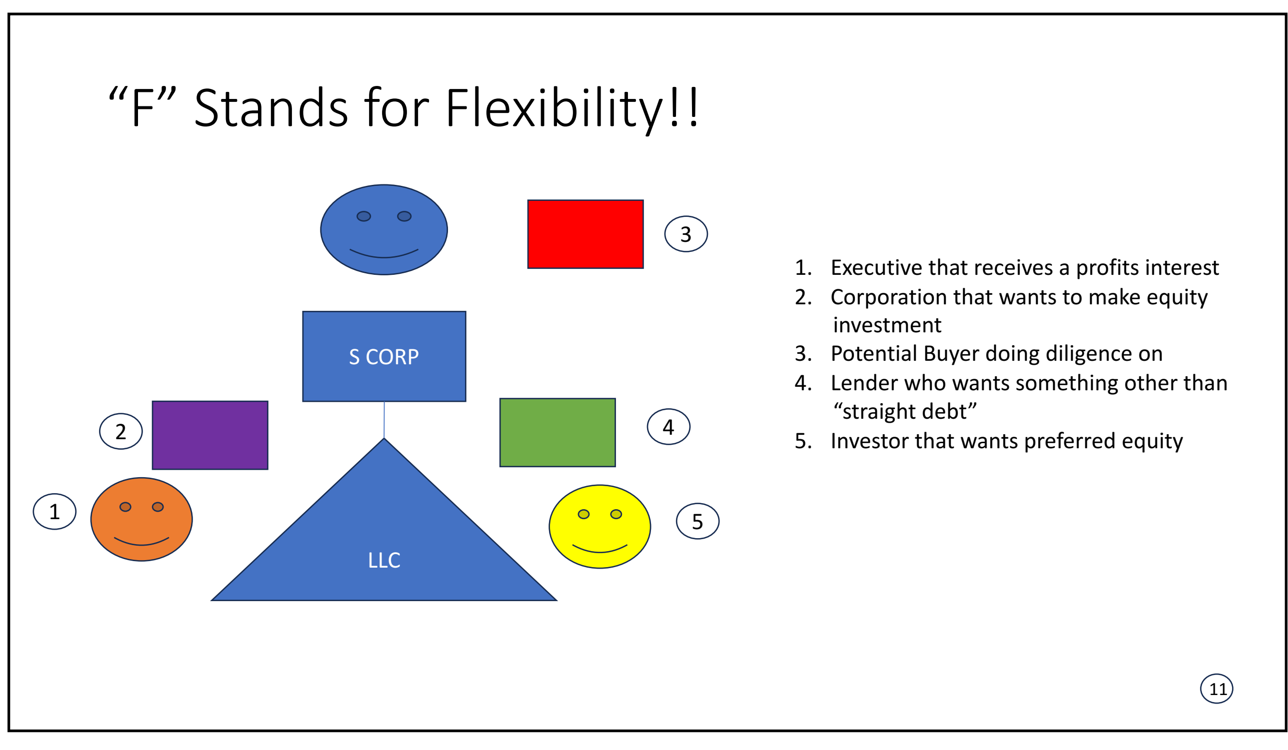
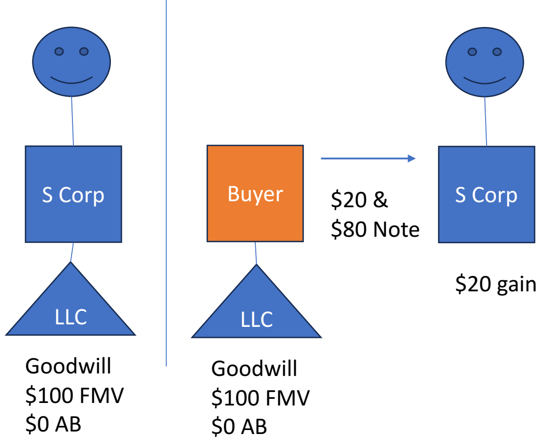


Installment Sales and the One-Day Note



When S Corp liquidates, 453B(h) says no gain triggered on note, but $20 of basis is allocated between cash (for $16 of gain) and the note. 1.453-11(a)(3).

$20 cash
$36 of gain
$80 note with $16 AB

What if the note was for $100 with the first $20 payment 5 days after sale?

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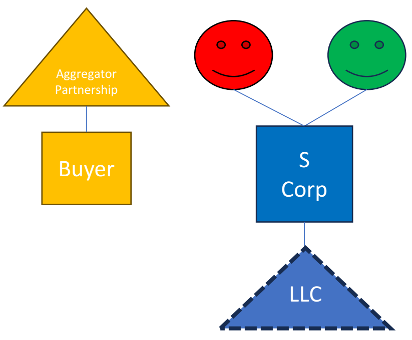
Part Sale/Part Roll



- Buyer wants S Corp assets and will either pay cash or accept a rollover.
- Red wants to rollover, but Green wants cash.
- What if Buyer sent two notes? One equal to Red's equity value and one equal to Green's equity value.
- Assuming no recapture or inventory, no gain is triggered at the S Corp level. If the S Corp immediately liquidates, Red and Green can take their notes without immediate gain recognition.
- Presumably Red could contribute its note to the Aggregator Partnership at some point in the future.
- Step transaction concerns?

Thanks to Sloan and Jennings, "Disproportionate S Corporation Rollovers: Lindsey Buckingham Was Right" *Tax Notes Today* November 14, 2023

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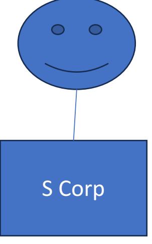
Post-Sale Liquidations Made Easy

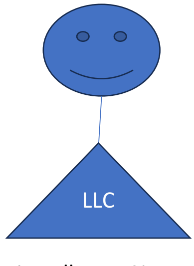
Problem



Installment Note

Shareholder wants to liquidate S Corp to take advantage of one-day note strategy, but Buyer wants S CORP to stay in existence and it is not clear how long corporate formalities will take.

Solution – Convert S Corp to an LLC



Installment Note

QSBS Basics

- Section 1202 was enacted in 1993 and generally provides non-corporate taxpayers with an exemption from federal income tax for eligible gains from the sale of qualified small business stock ("QSBS") held for more than five years.
- The gain exclusion is 100% for QSBS acquired after September 27, 2010, 75% for QSBS acquired after February 17, 2009, and before September 28, 2010, and 50% for QSBS acquired on or before February 17, 2009 (but before 1993).
- For the exemption, during substantially all of the taxpayer's holding period for such stock, the corporation must: (1) be a S corporation; and (2) satisfy the active trade or business requirement.
- Certain types of trades or businesses are excluded.
- The 1202 exemption only applies with respect to originally issued stock of the corporation, and stock purchased from a prior holder does not qualify for the exemption.
- The corporation must not have more than $50 million in aggregate gross assets before and immediately after the issuance of the 1202 stock, and subsequent increases in corporate assets do not disqualify previously issued stock.
- The 1202 exemption generally is limited to the greater of $10 million per taxpayer or 10 times the taxpayer's original adjusted tax basis in the QSBS.

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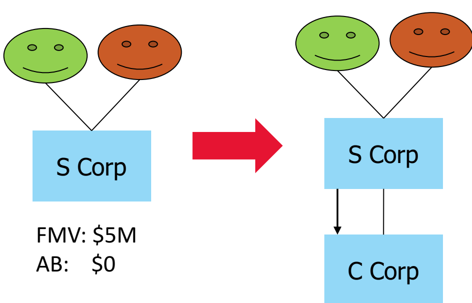
QSBS – What if you have an S Corporation?

- Shares must have been issued by a C corporation, and corporation must be a C corporation for "substantially all" of the shareholder's holding period.
- Was the corporation a C corporation when the shares were issued?
- If so, what percentage of the holding period was the corporation a C corporation?
- In other areas, authorities can treat a something as low as 60% as "substantially all."
- Remember, you revocation elections are effective at the beginning of the tax year, but transferring a single share to an ineligible corporation will terminate S status immediately.

QSBS – What if you have an S Corporation?



- An S Corp cannot qualify for QSB status.
- An S Corp as a shareholder can qualify for the QSBS exclusion
- S Corp can form a C Corp subsidiary for possible QSBS benefit on disposition
- Structure may be less marketable because of Buyer's inability to push step-up to operating assets
- Consider "Packing" benefit – each shareholder can now take advantage of the 10X and potentially exclude $25M of gain each
- Consider "Stacking" benefit – planning at shareholder level before formation of subsidiary

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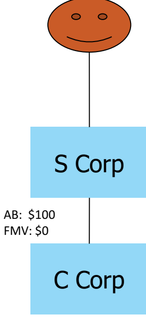
Section 165(g)(3) – Stock in a Worthless Affiliate?



- Under section 165(g)(3), a corporation can claim an ordinary loss if stock of an affiliate becomes worthless.
- Under section 1371(a), except as otherwise provided or to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders.
- Under section 1363(b), the taxable income of an S corporation is generally computed in the same manner as in the case of an individual.
- Consider *Rath*, 103 T.C. 196 (1993) – S corporation treated like a corporation for purposes of section 1244.

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Automatic Relief Provisions

- Rev. Proc. 2013-30: Expedited relief for late elections.
  - Applies to S corporation elections, electing small business trust (ESBT) elections, qualified subchapter S trust (QSST) elections, qualified subchapter S subsidiary (QSUB) elections, and corporate classification elections intended to take effect on the same date as the S corporation election.
  - Election cannot be more than 3 years and 75 days late.
  - Returns must have been filed consistently with election.
- Rev. Proc. 2022-19: Forgiveness of missteps.
  - Non-identical governing provisions.
  - Certain disproportionate distributions.
  - Missing acceptance letters.
  - Inconsistent filings.

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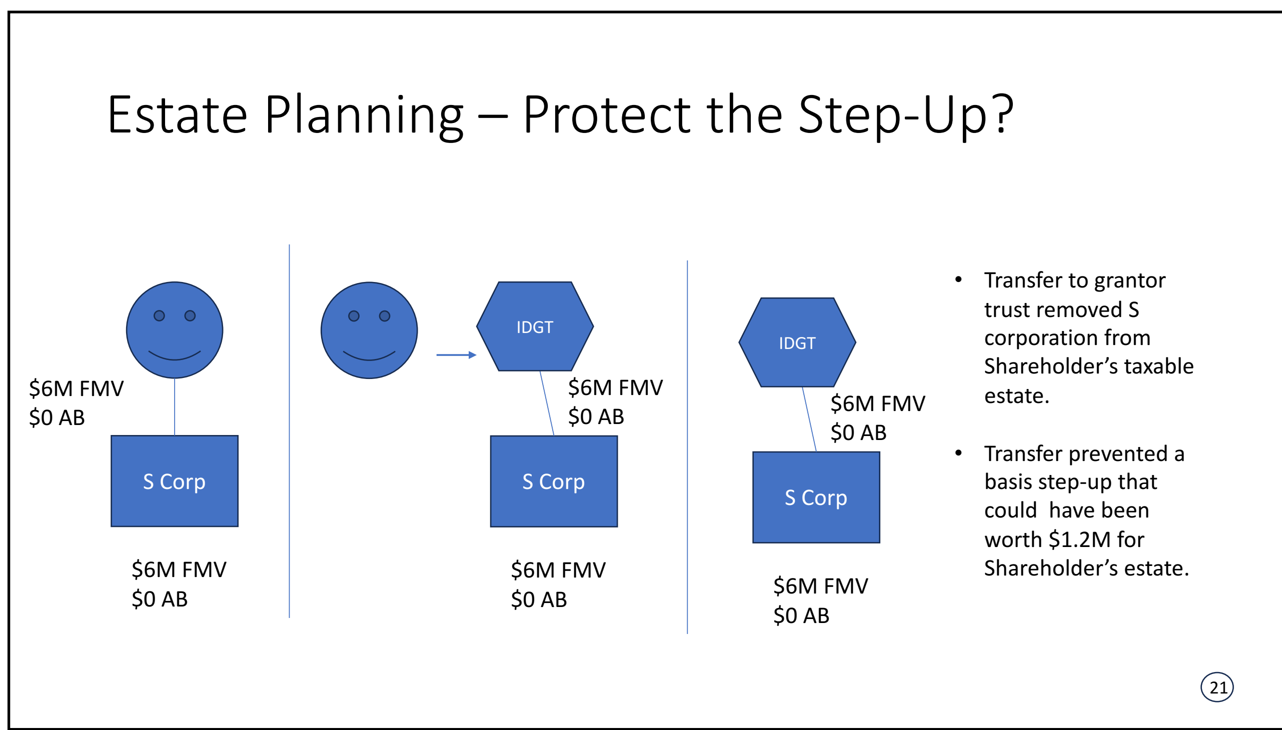
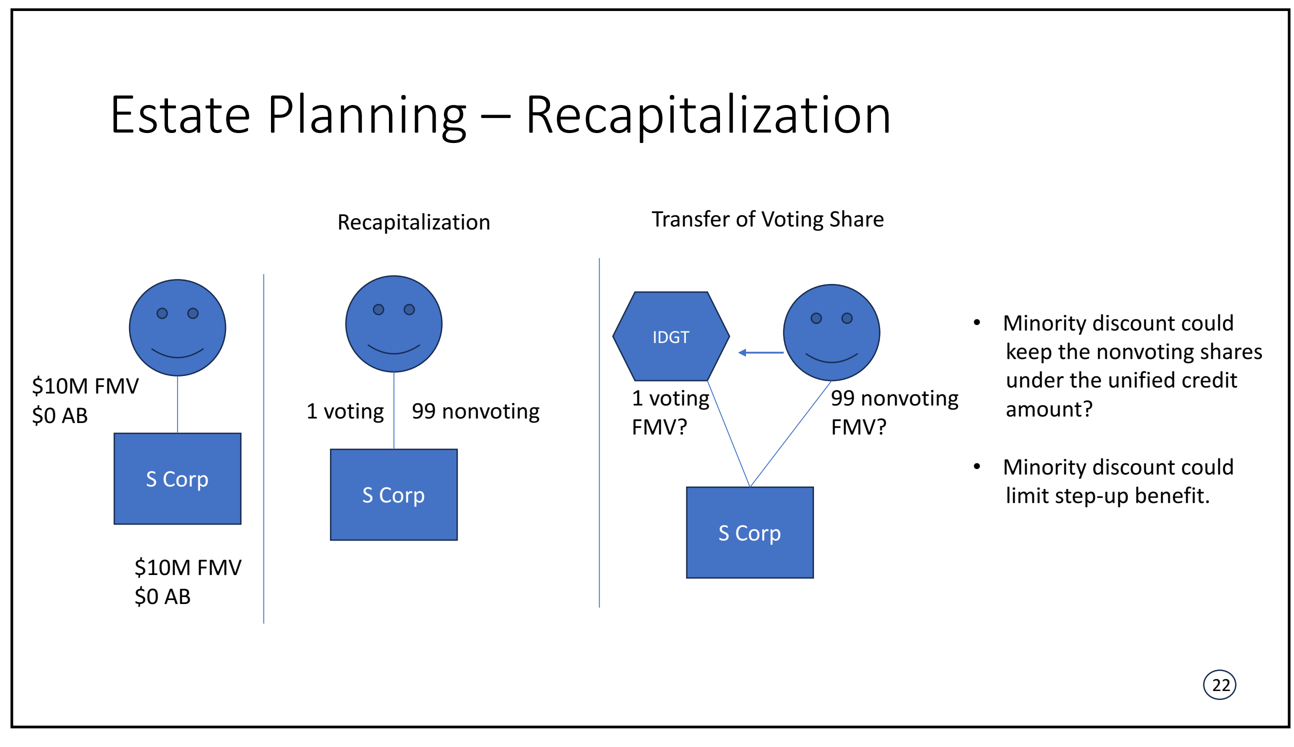
Charitable Contributions of S Corporation Stock

- Charitable contribution deduction at FMV if donated to public charity (assuming long-term holding period and qualified appraisal rules apply).
- Charitable contribution deduction for donation to private foundation may be limited to basis.
- Charity subject to UBTI on K-1 income and disposition gain.
- Charities more open to contributions if a sale or redemption is expected (beware of assignment of income rules).
- Private foundation may be subject to excise taxes.

Estate Planning – Protect the Step-Up?





Estate Planning – Recapitalization
Recapitalization
Transfer of Voting Share
$10M FMV
$0 AB
S Corp
$10M FMV
$0 AB
1 voting
99 nonvoting
S Corp
IDGT
1 voting
FMV?
99 nonvoting
FMV?
S Corp
• Minority discount could keep the nonvoting shares under the unified credit amount?
• Minority discount could limit step-up benefit.
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1

Agenda

1
Current Landscape

2
BBA Overview

3
BBA Audit Process

4
BBA Audit Process Is Long and Complex

5
Bringing the BBA Audit to Closure Sooner

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Partnership Returns Filed and Audits Closed

Partnership Forms 1065 Filed (Fiscal Year)				
2023	**2022**	**2021**	**2020**	**2019**
5,117,987	4,582,871	4,710,457	4,470,095	3,946,342

Partnership Audits Completed (Fiscal Year)				
2023	**2022**	**2021**	**2020**	**2019***
3,111	3,645	4,141	4,969	N/A

Source: IRS Data Book, 2019-2023

*Nontaxable returns are filed for entities that generally do not have a tax liability but pass through any profits and losses to the underlying owners, who include these profits or losses on their income tax returns. The examination of partnership, S corporation, andother nontaxable returns affects the amount of recommended additional tax for these associated income tax returns.

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IRS Steps Up Enforcement Using IRA funds

- A new Passthrough Entities Practice Area established in LB&I
- The IRS using AI in Large Partnership Compliance (LPC) audits
  - Fall 2023 75 partnerships selected for LPC audit
  - The types of partnerships included hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms and other industries with >$10 bil in assets on average
- Also fall of 2023, the IRS sent approximately 500 compliance letters to LB&I partnerships with beginning and ending year balance sheet discrepancies
- In the beginning of 2024, the IRS announced that it had conducted 80 audits under the partnership self-employment tax initiative, leaning into its win in *Soroban Capital Partners LP v. Commissioner* in November 2023 finding a limited partnership subject to SECA tax
  - Other LB&I partnership campaigns include distribution in excess of basis, sale of partnership interest

See IR 2023-166 (Sept. 8, 2024) & IR 2024-09 (Jan. 12, 2024)

BBA Overview

Overview of BBA

- Generally, for tax years beginning on or after January 1, 2018, BBA replaced the partnership audit procedures under TEFRA and the electing large partnership regime
- Under section 6221(a), adjustments are done at the partnership level and the partnership is liable for a tax computed on those adjustments u
  - Under section 6226, the partnership can elect to push adjustments out to partners
  - Under section 6226(c)(2)(C), there is an additional 2% interest if push out of audit adjustments
- A partnership subject to BBA cannot file an amended return and instead may file an administrative adjustment request (AAR)
- Under section 6223, partners must file their returns consistent with the partnership return
  - An inconsistent position on a partner's return can be adjusted under math error procedures unless the partner provides a notice of inconsistent treatment

Election Out of BBA (Section 6221(b))

- Partnerships with 100 or fewer eligible partners can elect out of BBA on their timely filed return
- Partnerships that elects out of BBA generally are not subject to the BBA rules and can still filed amended returns and amended Schedules K-1
- If the partnership elects out of BBA, the IRS exams the partners rather than the partnership

Partnership Representative (Section 6223)

- A PR designation is made each tax year is made on the partnership return
- The PR is the person with sole responsibility to bind the partnership and partners under BBA
- A PR can be any person (doesn't have to be a partner) with a substantial presence in the US (US TIN, US phone and street address, and is able to meet with IRS as mutually convenient time)
  - If PR is an entity, there must be a designated individual (DI) who also has a substantial presence in the US (Treas. Reg. § 301.6223-1(b)(3))

Scope of BBA (Section 6241)

- Partnership-related item (PRI)
  - Any item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return and including an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of, the partnership) which is relevant (determined without regard to this subchapter) in determining the tax liability of any person under chapter 1, and
  - Any partner's distributive share of any such item or amount
- Chapter 1 taxes only
  - For rules for coordination with taxes under chapter 2, 2A, 3, and 4, see section 6241(9) and IRM 4.31.9.6)

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Special Terms

- Imputed Underpayment (IU) (I.R.C. § 6225): Partnership-level tax calculated on adjustments to PRIs
  - Generally, adjustments are appropriately netted, multiplied by the highest tax rate, and the product is increased (sometimes reduced) by changes in credits
- Passthrough partner (Treas. Reg. § 301.6241-1(5)): A partner that is a partnership, an S corporation, a trust other than a grantor trust, or a decedent's estate
- Nonpassthrough partner: A partner that is not a passthrough partner

Relevant Years

- Reviewed year (I.R.C. § 6225(d)(1)): Partnership taxable year under audit
- Adjustment year (I.R.C. § 6225(d)(2)): Partnership taxable year of a final determination by a court or if timely petition not filed, partnership taxable year when the FPA is mailed; partnership taxable year an AAR is filed
- Reporting year (Treas. Reg. § 301.6226-3(a)): Partner's tax year that includes the year that the audited partnership sent the push out statement
- Intervening year (Treas. Reg. § 301.6226-3(b)(3)): Year between the reporting year and the reviewed year

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BBA Audit Process

BBA Audit Process – Audit Selection Phase

- Similar to a traditional audit, a BBA partnership will receive a notice of selection for examination
  - This notice is not sent to the PR, providing the partnership with an opportunity to change the PR without them knowing about the audit
  - Form 8979, *Partnership Representative Revocation, Designation, and Resignation,* used to change the PR
- At least 30 days after sending the notice of selection for examination, the IRS will send the partnership and the PR a statutorily required Notice of Administrative Proceeding (NAP) under section 6231(a)(1)
- This phase is usually when a Form 2848, *Power of Attorney*, is submitted to appoint a tax professional to represent the taxpayer before the IRS

BBA Audit Process – Examination Phase

- During this phase, the revenue agent will set expectations for the audit, request information to conduct the audit, generally through information document requests (IDRs), and discuss potential issues and adjustments
- If the revenue agent decides that no adjustments are warranted, the revenue agent will close the case and the audit process will end here
- If there are adjustments, the case will go to the Preliminary Adjustment phase

BBA Audit Process – Preliminary Adjustment Phase

- The revenue agent will provide the PR with the preliminary adjustments and explanations of each adjustment, along with a proposed imputed underpayment computation in the Preliminary Partnership Examination Changes and Imputed Underpayment (also referred to as a summary report package) sent to the PR
- If the taxpayer disagrees with the summary report package, a 30-day letter will be issued to provide the taxpayer with an opportunity to file a protest and have their case heard by the Independent Office of Appeals ("Appeals")

BBA Audit Process – NOPPA Phase

- The statutorily required Notice of Proposed Partnership Adjustment (NOPPA) under section 6231(a)(2) will be issued to the partnership and the PR during this phase
- Under section 6225(c)(7), the PR has 270 days from the date the NOPPA is issued to submit a request for modification
- Under section 6231(2)(A), the FPA cannot be mailed earlier than 270 days after the date the NOPPA is mailed, unless the waiting period is waived by the PR

BBA Audit Process – Modification Phase

- There are 8 types of modification

1. Amended return or alternative procedure (pull-in)
2. Rate modifications
3. Tax-exempt partners
4. Number and composition of IUs
5. Passive losses of publicly traded partnership
6. Partnerships with qualified investment entity (RIC/REIT) partners
7. Closing agreements
8. Tax treaty modification

BBA Audit Process – Modification Phase

- IRS has complete discretion to grant or deny a request for modification
- There is a second opportunity to go to Appeals if the IRS denies all or part of the modification request, but Appeals will not reconsider issues that Appeals previously considered (IRM 8.19.14.2.6)
- Each modification has its own criteria, forms and information that must be submitted
  - Detailed information (like allocations) is required to be submitted for the audited partnership and potentially upper tier partners and partnerships

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BBA Audit Process – Modification Phase

- The modification phase is eliminated if the PR chooses not to request a modification, for example when the PR:
  - Has determined that a push out election will be made in all events if adjustments are sustained
  - Agrees with the adjustments and intends to pay the imputed underpayment set forth in the NOPPA
  - Wants to expedite an end to the administrative proceeding and move straight to litigation

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BBA Audit Process – Final Adjustment Phase

- If unagreed issues remain after the NOPPA is issued, the IRS will issue the statutorily required final partnership adjustment (FPA) under section 6231(a)(3) to the partnership and the PR
- Under section 6226(a)(1), the partnership has 45 days from the date the FPA is mailed to make a push out election
- Under section 6234(a), the partnership has 90 days from the date the FPA is mailed to file a petition in court.

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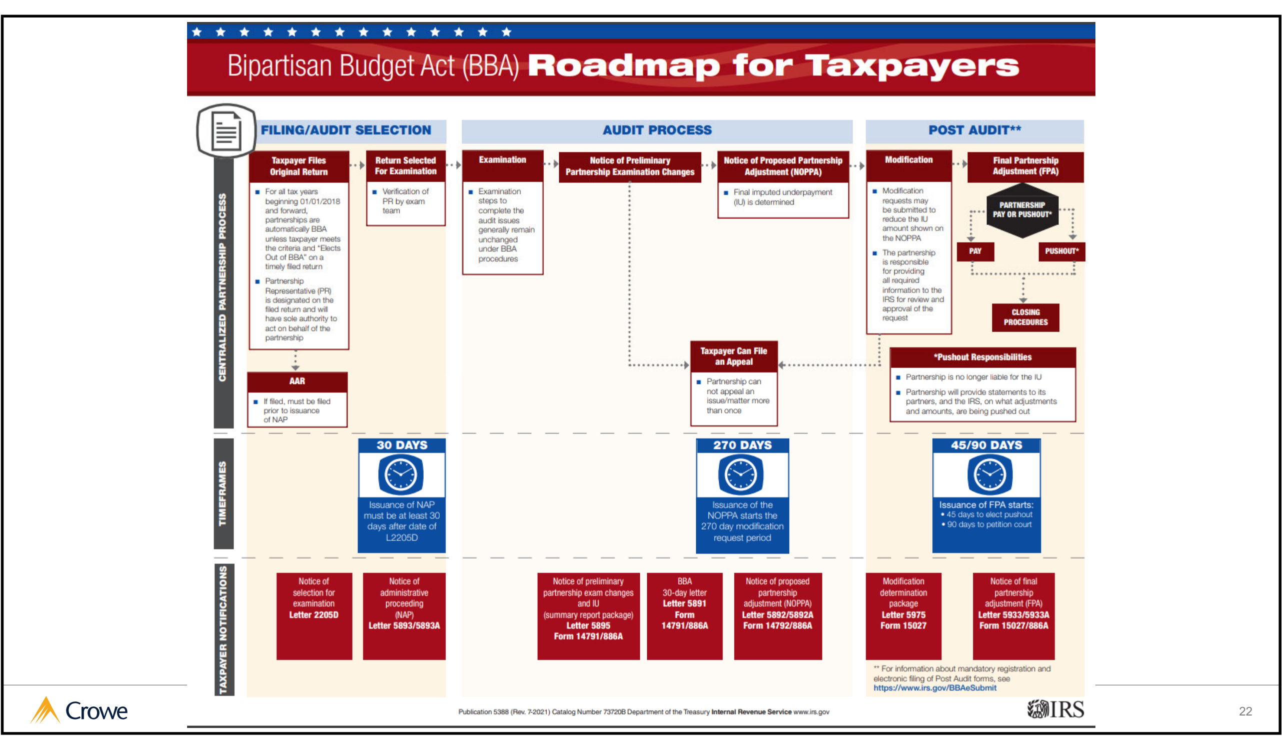

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BBA Audit Process is Long and Complex

BBA Audit Process is Long

- The BBA audit process can be quite long, often longer than a traditional audit.
- Two of the reasons for the length of the BBA audit process are:
  - There is a 270-day period to request modification (which corresponds with the 270-day waiting period for before the IRS can send the FPA)
  - There are two opportunities to go to Appeals
    - One opportunity after issuance of the Summary Report, the other opportunity if a modification request is denied
    - There must be 365 days on the statute of limitations to make adjustments under section 6235 when the case goes to Appeals (IRM 8.19.14.2.3)

The BBA Audit Process is Complex

- Reasons why the BBA audit process is complex :
  - The flow through nature of partnerships
  - The fact that the BBA upends the fundamental underpinnings of subchapter K of the Code by treating the partnership as a tax paying entity
  - Choices the IRS has made to implement the regime, such as requiring electronic submission of certain information

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BBA Web Portal Adds Complexity

- The IRS created a unique web portal for electronic submission of certain BBA-related documents
- To access to the BBA web portal, the taxpayer must register for ID.me, create a PIN and request a unique TCC
  - It takes considerable time and effort to complete this process
- Document formatting requirements, signature requirements, and the unique rules and features of the BBA web portal make the system is clunky and not very user-friendly
- The following forms are required to be submitted through the BBA web portal:
  - Forms related to modification
  - Push out forms
  - The form allowing the 270-day modification period to expire and waiving the 270-day FPA waiting period
  - The form waiving the FPA

Complexity at the Start of the Audit: Changing PR/DI

- Change PR/DI using Form 8979, *Partnership Representative Revocation, Designation, and Resignation*
  - Two forms required if PR/DI resigns: one signed by the resigning PR/DI, one signed by a partner for the reviewed year appointing new PR/DI
  - Same form for partnership to revoke and designate a new PR/DI
  - IRM 4.31.9.7.10 requires a new POA required if PR/DI that signed the form is revoked or resigns
  - But see Treas. Reg. § 301.6223-2(b) (stating that actions prior to termination remain in effect, including example of statute extension)

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Complexity at Start of Audit: Validate POA (IRM 4.31.9.7.10)

For Individual Partnership Representative:

John Tiger as partnership representative for
ABC Partnership
1111 Maple Street
Anywhere, USA 00000-0000

1 **Taxpayer information.** Taxpayer must sign and date this form on page 2, line 7.		
Taxpayer name and address	Taxpayer identification number(s) **TIN of BBA Partnership**	
John Tiger as Partnership Representative for ABC Partnership 1111 Maple St, Anywhere, USA 00000-0000	Daytime telephone number	Plan number (if applicable)

For Entity Partnership Representative and Designated Individual:

DEF, LLC as partnership representative for
ABC Partnership
1111 Maple Street
Anywhere, USA 00000-0000

1 **Taxpayer information.** Taxpayer must sign and date this form on page 2, line 7.		
Taxpayer name and address	Taxpayer identification number(s) **TIN of BBA Partnership**	
DEF, LLC as Partnership Representative for ABC Partnership 1111 Maple St, Anywhere, USA 00000-0000	Daytime telephone number	Plan number (if applicable)

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Bringing the BBA Audit to Closure Sooner

Agreed Cases

- Agree to the proposed adjustments – No push out
  - Sign the Offer section of the NOPPA
    - Waives modification and the FPA
    - agrees to immediate assessment of the IU and penalties
  - IRS view that an FPA is a prerequisite to the push out election (see FY25 Green Book)
    - Section 6226(a)(1) provides that the push out election must be made "*no later than* 45 days after the date of the notice of final partnership adjustment."
- Agreeing if adjustments will be pushed out
  - Sign Form 8981 to waive modification and the 270-day FPA waiting period
  - Must file Form 8981 and push out form electronically through BBA web portal

Agreed NOPPA Language

Offer of Agreement to Partnership Imputed Underpayments and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts & Waiver of Restrictions on Assessment for Imputed Underpayment, Penalties, Additions to Tax and Additional Amounts

By signing offer of agreement it is understood that the partnership and the partnership representative agree to the following:

- The partnership accepts the adjustments and other amounts on this form;
- The partnership will not be able to contest any of the amounts in any court;
- The partnership representative is binding the partners to the amounts;
- Neither the partnership nor the partnership representative will be able to exercise appeal rights with the Internal Revenue Service with respect to the amounts; and
- Neither the partnership nor any of the partners may file claims for refund, credit or any request for change to the amounts.
- The partnership will take into account adjustments that do not result in an imputed underpayment in the adjustment year in accordance with section 6225 (a)(2) of the Internal Revenue Code (IRC) unless an election is made under section 6226.

By signing this agreement, the partnership also waives modification of the imputed underpayment under section 6225(c), notice of final partnership adjustment under section 6231(a)(3), the limitations under section 6232(b) and consents to the assessment and collection of any imputed underpayment, penalty, addition to tax, or additional amounts plus additional interest as provided by law.

This agreement is conditional and will not become effective or final until this agreement form is returned to the Commissioner and is signed on his or her behalf. If this agreement is not signed by a representative of the Commissioner, a notice of final partnership adjustment (FPA) will be mailed under the provisions of section 6231 of the Internal Revenue Code (IRC).

From Form 14792, *Partnership Examination Changes, Imputed Underpayment Computation and Partnership Level Determinations as to Penalties, Additions to Tax and Additional Amounts*

Unagreed Cases – Modification Requested

- Options if modification request granted
  - Go to court on the adjustments
    - Consider filing push out election as a protective measure; election can't be made late but it can be revoked
  - Don't go to court on the adjustments
    - Pay the modified IU and penalties and consider filing Form 14726 to waive the FPA
    - If ultimately decide to push out (even though modifications granted) do not waive the FPA
- Options if modification request not granted
  - Go to Appeals – modification only, not adjustments
    - Settle at Appeals on modification, see prior slide for options for unagreed adjustments
    - No settlement at Appeals on modification, make go to court/don't go to court decision on both modification and adjustments

Crowe

Unagreed Cases – No Modification Requested

- File Form 8981 to have modification period expire and waive 270-day waiting period before the IRS can issue the FPA to accelerate issuance of the FPA
  - Don't waive the FPA if the taxpayer wants to go to court
  - Even if the taxpayer decides not to go to court, don't waive the FPA if the taxpayer wants to push out adjustments
- Deposit under section 6603 to stop running of interest
  - Rules for application unclear
  - IRS BBA website has instructions for "terminal partners" - Who is a terminal partner?
  - No rules have been released for how the partnership can make a deposit to stop the accrual of interest on the imputed underpayment as anticipated under section 6233(c)

Thank you

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Agenda

International Tax: FAQs when Advising Cross-Border Individuals and Companies.

What you need to know for cross-border individuals:

- U.S. employees working remotely overseas
- Keeping employees that move overseas
- Foreign nationals moving to the US: Pre-immigration planning.
- Foreign ownership of U.S. Real Property

Incentives and traps for cross-border companies:

- Paying foreign vendors
- Foreign partners in U.S. partnership
- U.S. companies expanding overseas
- Controlled Foreign Corporation (CFCs)
- Subpart F income
- GILTI – IRC 951A
- Income tax treaties
- Transfer pricing
- Export tax incentives

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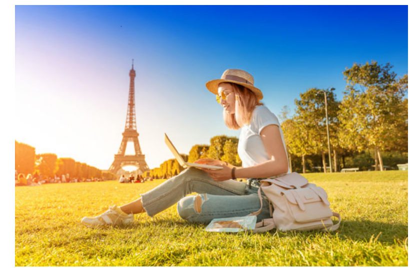
Cross-Border Individuals: Employees Working Remotely Overseas



I work remotely. Why does it matter where I live?

Employer Responsibilities:

- Foreign payroll tax and social insurance requirements.
- Foreign employee may create a requirement for company to file income taxes in-country.
- Registration and licensing considerations
- Cyber security issues.
- Immigration and employment law

Employees Moving Overseas

My key employee has to move overseas due to spouse job transfer.

How do I comply with foreign employment laws?

Options:

1. Shift employee to independent contractor - if eligible
2. Existing foreign company (i.e. client) hires your employee and bills your company.
3. Global Professional Employment Organization

Pre-immigration Planning

I am a UK citizen/resident moving to the U.S.
Is there anything I should do before the move?

- Accelerating sales of appreciated assets when foreign country tax rates are lower
- Divesting certain assets that have unfavorable U.S. tax regimes
  - Passive foreign investment companies (PFICs) i.e. foreign mutual funds
  - Controlled Foreign Corporations (CFCs) may be subject to GILTI and SubPart F U.S. income inclusions.
- Understanding retirement plan implications in the U.S. and home country.

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Foreign Ownership of U.S. Real Property

Any issues with nonresident aliens owning U.S. real estate?

FIRPTA (Foreign Investment in Real Property Act of 1980)

- When a foreign person sells U.S. real estate the buyer must withhold 15%/10% federal income tax on <u>gross</u> sell price.

U.S. Estate and Gift Tax Concerns

- Nonresident/non-domicile individuals are subject to federal estate/gift tax on their U.S. real property interests.
- Estate/gift exemption for nonresidents is only $60,000
- Ways to mitigate:
  - U.S. Transfer Tax Treaties
  - Qualified domestic trusts
  - Foreign person owns U.S. real estate through a foreign corporation.

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Cross-Border Company Activities: Paying Foreign Vendors

Any special IRS reporting requirements when paying foreign vendors?

- Default is to withhold 30% federal tax on payments to foreign persons for U.S. source income.
- Performing services while physically located in a foreign country is generally NOT U.S. source income. Therefore NO 30% withholding required.

Paying Foreign Vendors

How do I know if the vendor is performing services while in a foreign country and therefore 30% does not apply?

W-8BEN or W-8BEN-E – foreign vendor completes
(Similar to W-9s completed by U.S. citizens/residents.)

Purpose:
- Establish foreign status
- Claim treaty benefits for reduced withholding

Form1042 - file with the IRS
(Similar to 1099-NEC filed for payments to U.S. citizens/residents.)

Purpose:
- Report payments of U.S. sourced income to foreign persons
- Documents that withholding requirements are met

Withholding on Foreign Partner’s Earnings.

What are the withholding requirements for foreign partner earnings?

ECI – Income effectively connected with a U.S. trade or business
- Forms **8804/8805** are filed with the 1065 .
- Typically the foreign partner will need an ITIN and has to file a U.S. tax return.

  Withholding rates:
  - Individual partner – **37%**
  - Corporate partner – **21%**
  - Capital gain tax rate, if applicable

FDAP – Fixed determinable annual periodic income (i.e. dividends, interest, royalties)
- Forms **1042** – separate filing.
- Foreign partner generally does not need to file a U.S. tax return and does not need an ITIN.

  Withholding rates:
  - Default **30%** on gross income. No deductions
  - Lower treaty rate, if applicable.

Foreign Partner Sale of U.S. Partnership Interest

What changed with TCJA?

Effective 1/1/2018, TCJA initiated 1446(f) which generally requires that if any portion of the gain on a disposition of an interest in a partnership would be treated as effectively connected with the conduct of a U.S. trade or business, the transferee purchasing the interest from a foreign transferor must withhold tax of 10% of the amount realized on the disposition unless an exception to withholding applies.

Foreign Partner Sale of U.S. Partnership Interest

- For 1446(f) withholding to apply the partnership must be engaged in a U.S. trade or business. Must have U.S. ECI.
- The 10% withholding is on the gross sell price.
- Compliance is similar to FIRPTA rules when a foreign person sells U.S. real estate.
- If the buyer does not satisfy the 10% withholding rules then the liability falls on the partnership.
- Partnership needs to obtain certifications from both buyer and seller when any interest is transferred.

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U.S. Companies Expanding Overseas

My company is expanding overseas. How do we get started?

Foreign Expansion Structures:

1. Independent agent
2. Overseas distributor
3. Foreign branch
4. Foreign subsidiary

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Foreign Expansion

Independent Agents.

Using an independent agent generally means:

- No foreign corporate income tax, and
- No foreign employee payroll tax

Permanent Establishment (PE): ***Want to avoid having a PE!***

- U.S. company will likely avoid foreign corporate tax filings if it does not have a PE. The PE is defined in the treaty.
- Generally, a company has a PE if:
  - Office, factory in foreign country
  - Employee in country for 183 days – (if employee is not income generating or mgt likely no PE)
  - Independent agent that "habitually exercises an authority to conclude contracts in the foreign country that are binding on the U.S. company."

    Avoid allowing an independent contractors to sign contracts on your company's behalf while overseas!

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Foreign Expansion

Overseas Distributor

- A foreign distributor buys the goods from the U.S. company and takes full responsibility for selling overseas.
- The distributor is the customer.
- While this is low risk and provides simplicity, this structure will generally reduce profits and may cause the US corporation to lose control of the marketing and pricing of products.

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Foreign Expansion

Foreign Branch

- The branch is division of the US company and <u>not a separate legal entity</u> .
- Generally, the U.S. will tax all earnings of the foreign branch as if it is a pass through. The branch <u>may also be taxed in the foreign country</u>. As such, the U.S. will allow a foreign <u>tax credit</u> to relieve double taxation.

Foreign Expansion

Foreign Subsidiary

- A foreign subsidiary is a <u>separate legal entity</u> created in the foreign jurisdiction.
- In general, the separate legal subsidiary will only be taxed in the foreign country.
- However, when the subsidiary is a Controlled Foreign Corporation (CFC) the U.S. may tax certain foreign income before dividends are sent back to U.S. shareholders. These “anti-deferral” regimes include:
    - Subpart F income
    - GILTI income

Controlled Foreign Corporation

What is a Controlled Foreign Corporation (CFC)?

CFC defined:

A CFC is any foreign corporation of which more than 50% of the vote or value is owned by U.S. shareholders when only considering shareholders that own at least 10%.

For example:

- a foreign corp that is owned by 11 U.S. shareholders equally at 9.09% each is **NOT** a CFC.
- a foreign corp that is owned by 6 U.S shareholders equally at 10% each and 1 foreign shareholder at 40% **is a CFC**.

Generally speaking, a CFC is a U.S. controlled closely held foreign corp.
The IRS picks on CFCs!

Subpart F Income

What is Subpart F income?

- U.S. generally does not tax foreign business profits earned through a foreign subsidiary until funds are repatriated. The subsidiary is only taxed in the foreign country. The **GILTI** tax effective in **2018** is an exception to this rule as is **Subpart F** income that has been in place since the **1960s.**
- Subpart F taints certain foreign income earned by a **CFC** which causes this foreign income to be taxed in the current year by the U.S. shareholders even if no cash has been distributed to these shareholders.

Subpart F Income

What is Subpart F income?

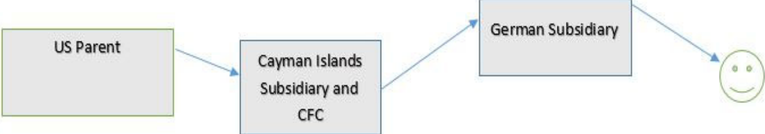
The main type of Subpart F income prevents US multinational corporations from artificially shifting profits to low-tax countries where there is no true business reason to be located in the tax haven.

Typical tax havens are the Cayman Islands, Malta, British Virgin Islands, Singapore, Isle of Man where there are low or no taxes.

Subpart F Income

What is Subpart F income?

- For example, without the Subpart F rules, a US parent corp could shift income to a subsidiary in the Cayman Islands by selling goods at an artificially low price.
- The Cayman subsidiary can then resell the goods at a higher price to another related corporation in Germany for resale to the ultimate German customer.
- The **net profit in the Cayman Islands is Subpart F** and **taxed currently to the US** parent corp.
- If there is otherwise a reason to be in the Cayman Islands (goods are manufactured in-country or sold to in-country customers) then Subpart F does not apply.



Subpart F Income – Other Examples

- Certain income earned by CFCs related to participation in unsanctioned international boycotts.
- Illegal bribes or kickbacks paid on behalf of the CFC to a government employee or official.
- Income derived by a CFC from certain disfavored foreign countries. These include foreign countries whose governments the US does not recognize; does not conduct diplomatic relations with; or has designated as governments that repeatedly support acts of terrorist. This list currently includes Cuba, Iran, N Korea, Bhutan to name a few.

GILTI - IRC 951A

What is GILTI – Global Low Taxed Intangible Income?

Background:

- TCJA added GILTI in 2018 to strengthen and expand previously existing laws, **Subpart F,** that pulls certain mobile types of foreign income into the U.S. tax base. This income is taxed **even before any cash dividends are sent home to the U.S. to pay the tax.**
- The goal of the new GILTI tax is to discourage U.S. corporations from moving profitable intangibles overseas.
- For companies that profit primarily from highly mobile income sources like intangible property, offshoring income to lower tax jurisdictions is not hard to accomplish. The rights to intellectual property can "reside" almost anywhere. Some firms that pre-TCJA stashed large amounts of intangible profits abroad were Apple, Microsoft, Cisco Systems, and Alphabet (Google).
- However, GILTI may apply to any industry and size of company. The calculation of the GILTI foreign "intangible income" starts with most all income of the CFCs (both tangible and intangible). Then 10% of the net foreign tangible depreciable assets is subtracted. The result is deemed to be "intangible income".

GILTI – IRC 951A

Who may be subject to GILTI?

- GILTI only applies to **10% or more shareholders of CFCs**.
  - **Not a 10% shareholder - GILTI does not apply.**
  - **Not a CFC - GILTI does not apply.**
- GILTI deemed foreign intangible income is taxed by a U.S. C corp shareholder at an effective rate of 10.5%. The code allows for a foreign tax credit of up to 80% against this GILTI tax. An 80% credit on a 13.125% foreign tax rate yields 10.5% that will completely offset the 10.5% GILTI tax.

  In other words, a U.S. C Corp shareholder of a CFC is not likely to be subject to GILTI tax if the CFC pays tax in the foreign home country at a rate of 13.125% or higher. The code is penalizing foreign income earned in low taxed jurisdictions.

- U.S. Individual shareholders are hit harder by GILTI then C Corp shareholders. There are various elections that may mitigate the GILTI burden on individuals including:
  - **IRC 962 election**
  - **High tax exception**

GILTI – IRC 951A

Are there differences in the GILTI tax calculation for C Corps vs. Individuals?

U.S. Individual shareholders are hit harder by GILTI then C Corp shareholders.

- **C Corps** can claim a FTC and the GILTI income tax rate is 10.5%
- **Individuals** do NOT get the FTC and are taxed at individual marginal rates of up to 37%. **PAINFUL!**

Individuals have options to mitigate the GILTI burden including:

- **IRC 962 election**
  - Individual can elect to be treated as a C Corp for GILTI purposes only. There are various pros and cons to this strategy. Modeling is recommended.
- **GILTI high tax exception**
  - If the CFC is taxed in the foreign country at 18.9% or higher (90% of current corp rate of 21%) then the individual can elect to exclude this CFC from the GILTI calculation.

Income Tax Treaties

What do I need to know about income tax treaties?

The US has more than 60 income tax treaties with its trading partners.

The main purpose is to lower tax barriers to the international flow of goods and services.

Treaties clarify the rules as to which treaty partner taxes certain income and at what rate.

Treaties generally reduce the tax liabilities, not increase**.**

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Income Tax Treaties

What are some typical treaty provisions?

- **Reduce tax on Investment Income.**
  - In absence of a treaty, dividend, interest, capital gains, royalties from sources in the U.S. are generally subject to a 30% withholding tax on the gross amount. The treaties generally reduce or eliminate this tax on a reciprocal basis with the treaty country.
- **Alleviate double taxation.**
  - If a resident of a treaty country is taxed on the same income in both treaty partner jurisdictions, the resident country must relieve any double taxation through a foreign tax credit.
  - This credit is calculated based on the resident country tax rate. For example, if the wages of a U.S. resident are taxed in both Sweden at 30% and the U.S. at 25%, the U.S. will only credit the tax calculated on the wages at the U.S. tax rate of 25%. Therefore, the taxpayer's overall tax rate will be the higher of the two countries.
- **Resolve treaty disputes.**
  - Mutual agreement procedures are included in treaties to resolve disputes as to the proper interpretation and application of specific treaty provisions.
- **Prevent tax evasion.**
  - Treaty partners exchange tax related information, with certain constraints, to enable enforcement of the laws.

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Income Tax Treaties

What is the Permanent Establishment treaty article?

Most income tax treaties define Permanent Establishment (PE).

- A U.S. company's business profits in a treaty country is subject to foreign income tax only if the U.S. company has a PE in that country. And the reciprocal is true.
- For example, a German company regularly sells inventory in the U.S. from its factory in Germany. The German company does not have a PE in the U.S. Profits from these sales, generally, are not taxed in the U.S.

  (No PE in the U.S. – No tax in the U.S.)

- Permanent establishment as defined in the model treaty takes two forms:

  (1) Physical PE or (2) Agency PE
- **(1) Physical PE** refers to a fixed place of business (factory, office) through which the business is carried on. There is an exception in that a facility merely used to store goods (warehouse) does not rise to the level of a PE.
- **(2) Agency PE** occurs when a dependent agent (employee) has the authority to execute contracts in the name of the company and habitually exercises such authority while in the treaty country. This dependent agent may not have a fixed place of business in the treaty country, but will create a PE.

  (PE in country then taxed in foreign country)

The general advice for a U.S. corporation just starting to expand overseas is to hire independent sales agents in the foreign country and do not give them authority to execute contracts. This reduces the foreign income tax exposure for company profits, and also removes the need to deal with foreign payroll taxes.

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Transfer Pricing

Why is transfer pricing important?

Transfer pricing is **related party pricing**. It can be abused to **shift taxable income outside the U.S. to low tax jurisdictions.**

- How is profit shifted outside of the US?
  - U.S. subsidiary of a foreign parent could purposely pay its parent too much for product.
  - U.S. parent could purposely invoice its foreign offices too little for overhead support.
- Does this happen?
  - IRS thinks it is a **HUGE** issue. IRS international agents and economists analyze patterns of shifting income overseas.
- Does this really happen?
  - Even with the best intentions transfer pricing can be challenged in an audit. It is an art, not a science.

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Transfer Pricing

What are the rules for transfer pricing?

IRC 482 and OECD

- Transfer pricing is addressed by the U.S. in the IRC 482 and in much of the rest of the world through the adoption of OECD transfer pricing guidelines. The Organization for Economic Co-operation and Development (OECD) is an intergovernmental economic organization with 36 member countries founded in 1961 to stimulate economic progress and world trade.
- The IRC 482 and OECD guidelines are similar. Both strive to ensure that transactions between related taxpayers are at "arm's length" consistent with the transactions between independent parties.

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Transfer Pricing

What are the rules for transfer pricing?

Related party transactions are subject to transfer pricing rules.

- IRC 482 refers to related parties as "controlled" taxpayers and for this purpose the meaning of control is very broad. Control does **not** require ownership of more than 50%. Instead, the courts have pointed to whether one party exercises actual authority over the business affairs of the other company.
- OECD definition of control is even broader. Under the model tax convention, the arm's length standard applies when an enterprise of one country participates directly or indirectly in the management, control, or capital of an enterprise in the other country.

Transaction pricing methods:

- IRC 482 regulations emphasize the search for the "best method" to determine the arm's length range. There are two main approaches:
  - (1) Transaction-based methods require the identification of prices or margins of transactions involving related entities and comparing these results to similar transactions with independent third parties.
  - (2) Profit-based methods seek to benchmark the profits earned by related entities and unrelated entities performing similar functions and incurring similar risks.

Clear documentation of following the guidelines mitigates risk of unfavorable audit adjustments.

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Export Incentives

Are there any tax incentive for exporting?

- IC-DISC –
  Interest Charge Domestic International Sales Corp
- FDII - Foreign Derived Income Deduction
- Virginia Export Incentives

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Export Incentives

IC-DISC

- The IC-DISC is a special purpose tax exempt corporate entity defined and regulated under IRC 991 - 994.
- The IC-DISC allows certain U.S. exporters to convert export income taxed at ordinary rates (up to 29.6% for pass-through entities) to qualified dividend rates (up to 23.8%). **29.6% tax rate to 23.8%**
- IC-DISC is more commonly used with S Corporation or Partnerships.
- Generally applies to income from exports of
  - **tangible** products, and
  - **only certain services –**
    architectural, engineering, construction.

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Export Incentives

FDII- Foreign Derived Income Deduction

The FDII deduction under IRC 250 is available for

- **Only U.S. C corps**
- The FDII deduction results in an effective tax rate of 13.125% on the FDII income as opposed to the regular corporate rate of 21%.

  21% tax rate to 13.125%

- Must have net positive taxable income to benefit.
- Applies to income from sales, licenses, or leases of tangible or intangible property to foreign persons for foreign use. Includes:
  - sales of products and services for foreign use
  - digital content delivered electronically to overseas market.
  - military sales made to US gov't for resale to foreign gov't.
  - may include sales to certain foreign related parties

Export Incentives

Virginia Export Incentives

The VALET (VA Leaders in Export Trade) program under the VEDP is particularly robust and provides support for VA companies that are expanding overseas:

- subsidies for travel to trade shows, trade missions
- grants for contract translation and foreign market studies
- two year export accelerator program that involves personalized coaching
  - (PBMares is a volunteer partner with this accelerator program.)

Visit **www.Export Virginia.org** for all resources and events

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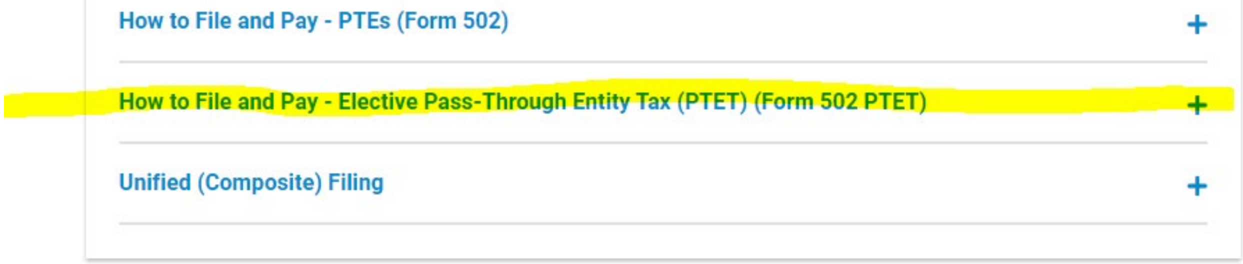
Virginia Website Links to Navigate Pass Through Entity Tax

"Home Page:
https://www.tax.virginia.gov/pass-through-entities

See drop-down box at bottom of page:



Set-up on-line Business Account:
https://www.business.tax.virginia.gov/VTOL/tax/SignUp.xhtml

Entity-level registration
Preparer registration – to enable PBMares practitioner to enter data.

On-line Business Account:
https://www.business.tax.virginia.gov/VTOL/tax/Login.xhtml

Where tax 2021 PTET tax return is entered

Guidelines:

https://www.tax.virginia.gov/elective-pass-through-entity-tax-guidelines

Page contains links to multiple other documents.

Legislative and Other Documents

House Bill 1121 (2022)

- HB 1121 Fiscal Impact Statement

Senate Bill 692 (2022)

- SB 692 Fiscal Impact Statement

Tax Bulletin 22-6 Virginia's New Elective Pass-Through Entity Tax

Guideline Development Documents

Elective Pass-Through Entity Tax FAQ - May 8, 2024 (PDF)

Retroactive Taxable Year 2021 Pass-through Entity Tax Guidelines (PDF)

Final Elective Pass-through Entity Tax Guidelines (PDF)

Elective Pass-through Entity Tax Guidance Document Interested Parties Notice (PDF)

Draft Pass-through Entity Tax Guidelines (PDF)

Pass-through Entity Tax FAQ (PDF)

Instructions 502PTET – 2023

While these instructions apply to the 2023 502PTET, technical concepts apply to 2021 filing, but know that filing process is different.

It has been noted that the instructions are not clear as to income taxed to resident vs. non-resident owners:

- Resident owners – 100% of allocated income to VK-1
- Non-resident owners – Virginia apportioned income only.

https://www.tax.virginia.gov/sites/default/files/taxforms/corporation-and-pass-through-entity-tax/2023/502ptet-instruction-package-2023.pdf

Guidelines for the Pass-through Entity Tax

During the 2022 Session, the Virginia General Assembly enacted House Bill 1121 (2022 *Acts of Assembly*, Chapter 690) and Senate Bill 692 (2022 *Acts of Assembly*, Chapter 689), which permit a qualifying pass-through entity ("PTE") to make an annual election to pay an elective income tax ("PTET") at a rate of 5.75 percent at the entity level. The legislation also allows a corresponding refundable income tax credit to certain PTE owners for income tax paid by a PTE if such PTE makes the election and pays the elective income tax imposed at the entity level.

The legislation allows an individual to claim a credit for taxes paid to other states under laws that are substantially similar to the pass-through entity income tax. Effective for taxable years beginning on and after January 1, 2021, but before January 1, 2026, this overrules Public Document 21-156 (December 29, 2021), which generally denied a credit for a tax paid to Maryland under that state's elective pass-through entity income tax. This provision only applies to taxes paid by a PTE under the law of another state that is substantially similar to *Va. Code* § 58.1-390.3. Therefore, it does not apply to any other entity-level taxes, such as any franchise, privilege, business, license, or occupation taxes described in *Va. Code* § 58.1-332.2.

During the 2023 Session, the Virginia General Assembly enacted House Bill 1456 (2023 *Acts of Assembly*, Chapter 686) and Senate Bill 1476 (2023 *Acts of Assembly*, Chapter 687), which removed the requirement that a PTE be 100 percent owned by natural persons or persons eligible to be shareholders of an S corporation in order to make the election to pay the PTET. This legislation also defines an "eligible owner" as a direct owner of a pass-through entity who is a natural person or an estate or trust, and states that only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners are subject to the PTET. These changes are effective for taxable years beginning on and after January 1, 2021.

These guidelines are published by the Department of Taxation ("the Department") to provide guidance to taxpayers regarding the elective income tax and corresponding refundable credit as required by *Va. Code* § 58.1-390.3 (F). These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner's general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information regarding these procedures will be published and posted on the Department's website, www.tax.virginia.gov.

These guidelines complement the Department's existing General Provisions Applicable to All Taxes Administered by the Department of Taxation Regulation (23 Virginia Administrative Code ("VAC") 23 VAC 10-20-10 et seq.), Individual Income Tax

Regulation (23 VAC 10-110-20 et seq.), and Corporation Income Tax Regulation (23 VAC 10-120-10 et seq.). To the extent that there is a conflict between the Department's existing guidance and the relevant laws (2022 *Acts of Assembly*, Chapters 689 and 690 as modified by 2023 *Acts of Assembly*, Chapters 686 and 687), the provisions of those laws, as interpreted by these guidelines, supersede existing guidance.

These guidelines represent the Department's interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845.

These guidelines address how to make the pass-through entity tax election for Taxable Year 2022 and after. Please note that the ability to make the pass-through entity tax election is currently set to sunset after Taxable Year 2025. Please also note that these guidelines do not address the method by which a return must be filed, and a pass-through entity tax must be paid for Taxable Year 2021. As a result, those seeking to make the election for Taxable Year 2021 should continue to follow Tax Bulletin 22-6. Subsequent guidance will be published by the Department regarding how to make the election for Taxable Year 2021.

Definitions

As used in these guidelines, unless the context requires otherwise:

"Credit for taxes paid other states" or "out-of-state credit" means the nonrefundable individual income tax credit allowed by *Va. Code* § 58.1-332.

"Electing pass-through entity" or "electing PTE" means a pass-through entity that has made the election allowed by *Va. Code* § 58.1-390.3.

"Eligible owner" means a direct owner of a pass-through entity who is a natural person or an estate or trust. For this purpose, a natural person also includes entities disregarded for federal tax purposes such as grantor trusts and single member limited liability companies, so long as that disregarded entity or grantor trust is 100 percent owned by a human being.

"Owner" means any individual or entity who is treated as a partner, member, or shareholder of a pass-through entity for federal income tax purposes.

"Pass-through entity" or "PTE" means any entity, including a limited partnership, a limited liability partnership, a general partnership, a limited liability company, a

professional limited liability company, a business trust, or a Subchapter S corporation, that is recognized as a separate entity for federal income tax purposes, in which the partners, members, or shareholders report their share of the income, gains, losses, deductions, and credits from the entity on their federal income tax returns or make the election and pay the tax levied pursuant to *Va. Code* § 58.1-390.3.

"Pass-through entity tax" or "PTET" means the elective income tax imposed by *Va. Code* § 58.1-390.3.

"Pass-through entity tax credit" or "PTET credit" means the refundable individual and fiduciary income tax credit allowed by subsection D of *Va. Code* § 58.1-390.3.

Making the Election

A PTE has the option to make the election to pay PTET for the taxable year. Such election can be made by:

- Making an estimated payment of PTET for the taxable year,
- Making an extension payment of PTET for the taxable year, or
- Filing a PTET return ("Form 502PTET") on or before the extended due date for the taxable year.

Please see the Department's website, www.tax.virginia.gov, for methods by which the estimated and extension payments may be made, as well as the methods by which the PTET return may be filed.

If a Form 502PTET has not been filed for the taxable year, the PTET election can be revoked by filing the Form 502. Once Form 502PTET is filed, the election is binding for that taxable year.

A PTET election for one taxable year may require the filing of Form 502PTET returns and Schedule VK-1s for more than one taxable year if estimated, extension, and final payments are made, and related state tax deductions are claimed, over two taxable years.

Each electing pass-through entity decides how to obtain consent from its eligible owners; provided, however, the election is binding on all the eligible owners once the election is made. For S corporations, this includes the choice whether to take advantage of the special option on how to compute their PTET, described below. An eligible owner does not have the option to "opt out" of an entity's election with the Department. An owner, officer, or employee of the PTE who is authorized to act on behalf of the PTE in

tax matters must sign the PTET return. By signing the return, the signer is declaring that they are the authorized representative of the PTE. Because the PTET return must be filed electronically, the return must be signed using the electronic signature procedures established by the Department. Please see the Department's website for more information.

Which PTEs Qualify to Make the Election

Any PTE can make the PTET election. However, only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners is subject to the PTET.

Pass-through Entity Taxable Income and Tax

Allocation and Apportionment

The first step in computing the PTET is determining the allocation and apportionment of the PTE's income. Please see the Form 502 Instructions for information regarding how to determine the PTE's allocation and apportionment.

Classifying Owners

The second step is determining whether each eligible owner should be classified as a resident or nonresident of Virginia.

With respect to individual owners, they are residents if they meet the definition of "resident" in *Va. Code* § 58.1-302, for the taxable year. All other individual owners should be treated as nonresidents. For the purposes of the PTET computation, eligible owners may not be classified as part-year residents.

With respect to estate or trust owners, they are residents if they meet the definition of "resident estate or trust" in *Va. Code* § 58.1-302, for the taxable year. Any estate or trust partner that does not meet this definition is a nonresident owner.

With respect to eligible owners that are disregarded entities, the classification should be based upon the individual, estate, or trust that owns the disregarded entity.

Effect of Classification on Allocation and Apportionment: General Principles

Once that classification is made, the Virginia taxable income of an electing PTE is determined by adding the following:

- Each resident eligible owner's share of the electing PTE's income or loss, subject to the modifications to the PTE's income as described in *Va. Code* §§ 58.1-

322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04. This is because Virginia residents are taxable on all of their PTE income regardless of the PTE's allocation and apportionment.

- Each nonresident eligible owner's share of the PTE's income or loss, subject to the modifications to the PTE's income as described in *Va. Code* §§ 58.1-322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04, that is attributable to Virginia.

In determining the share of such income or loss that is attributable to Virginia, the electing PTE adds:

- Each nonresident eligible owner's share of such income or loss other than dividend income ("apportionable income") multiplied by the PTE's apportionment percentage; and

- Each nonresident eligible owner's share of dividend income ("allocable income") if the PTE is commercially domiciled in Virginia.

An electing PTE's calculation of its PTE taxable income must include all items of income, gain, loss, or deduction, to the extent they would flow through and be included in the income of eligible owners that are taxable under *Va. Code* §§ 58.1-320 and 58.1-360, as applicable, including guaranteed payments. However, the electing PTE can exclude income from the calculation of PTE taxable income to the extent that the PTE can establish that the amount is properly allocable to an eligible owner who is not subject to tax on such amount under *Va. Code* §§ 58.1-320 and 58.1-360, as applicable. Two examples are (1) income that is not U.S. sourced and is allocable to nonresident alien partners and, therefore, not included in federal adjusted gross income under the Internal Revenue Code, and (2) retirement income of former partners that is exempt from nonresident state taxation under 4 U.S.C § 114.

Separately stated items of deduction are generally included when calculating each eligible owner's share of the PTE's taxable income. However, any deduction that is subject to a federal limitation, such as the deduction for charitable contributions and the Section 179 deduction, will be limited to what is allowed under federal law for a C corporation.

Electing PTEs must make an addition for any state and local income taxes paid or incurred during the taxable year to the extent that the electing entity deducted such taxes in determining its federal taxable income. The addition should occur in the same taxable year as the federal deduction, even if such taxable year is different from that in which the PTET credit is distributed to the PTE owners.

Example

Partnership ABC is a calendar year, cash-basis taxpayer. It makes a PTET election for Taxable Year 2023. It determines that it owes PTET in the amount $50,000, of which $40,000 has been paid as estimated tax payments throughout Taxable Year 2023, and $10,000 when it files its PTET return in the spring of 2024. The partners would claim their pro rata share of the $50,000 PTET credit on their Taxable Year 2023 returns. Partnership ABC would take the $40,000 federal deduction on its Taxable Year 2023 federal return and the corresponding addition, also in the amount of $40,000, on its Taxable Year 2023 Virginia PTET return. The remaining deduction and associated addition would be claimed on its Taxable Year 2024 return.

Effect of Classification on Allocation and Apportionment: Special Option for Certain S Corporations

If the electing PTE is an S corporation and has both resident and nonresident eligible owners, the electing S corporation has the option to compute its Virginia taxable income as if all of its owners are nonresidents. Therefore, as an alternative to the above, the Virginia taxable income of an electing S corporation with both nonresident and resident owners may be determined by adding the following:

- Each resident eligible owner's share of the electing S corporation's income or loss, subject to the modifications to the S corporation's income as described in *Va. Code* §§ 58.1-322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04 that is attributable to Virginia.

- Each nonresident eligible owner's share of the S corporation's income or loss, subject to the modifications to the S corporation's income as described in *Va. Code* §§ 58.1-322.01, 58.1-322.02, 58.1-322.03, and 58.1-322.04, that is attributable to Virginia.

In determining the share of such income or loss that is attributable to Virginia, the electing S corporation adds:

- Each eligible owner's share of such income or loss other than dividend income ("apportionable income") multiplied by the PTE's apportionment percentage; and

- Each eligible owner's share of dividend income ("allocable income") if the PTE is commercially domiciled in Virginia.

All the other principles described the "Effect of Classification on Allocation and Apportionment: General Principles" section above remain the same for S corporations choosing to take advantage of this optional approach.

Computing the Tax

An electing PTE calculates its Virginia income tax by multiplying its Virginia taxable income by 5.75 percent. Credits are generally passed through to the eligible owners and are not applied against the PTET. However, the following may be used to reduce the amount due with the PTET return or, if applicable, generate a refund to the electing PTE:

- Any payments that have formerly been made for the taxable year, including estimated and extension payments, and

- Any credit that permits the PTE to elect to receive and claim the credit at the entity level rather than passing through the credit to the owner, such as the Research and Development Expenses Tax Credit and the Motion Picture Production Tax Credit, but only if the PTE so elects to receive and claim the credit at the entity level.

This PTET is in addition to any other taxes imposed on the entity, including sales and use taxes, withholding taxes with respect to employees, and minimum taxes in lieu of income taxes.

Filing the Annual PTET Return

Electing PTEs are required to file their returns and the accompanying schedules and make any tax payments electronically. Please see the Department's PTET return instructions for more information regarding how to make payments and file returns electronically. No hardship exemptions are available for electronically filing PTET returns.

PTET returns ("Form 502PTET") are due by the 15th day of the 4th month following the close of the taxable year. For calendar year filers, that means April 15. Virginia allows an automatic 6-month filing extension for PTEs. No application for extension is required. For calendar year filers, that means that they have until October 15 to file their return on extension. However, this six-month extension is only for filing the return and does not extend the due date for payment of taxes. As a result, an electing PTE must pay at least 90 percent of its PTET due by the original due date for filing the return. If Form 502PTET is filed within the automatic extension period, but less than 90 percent of the tax liability was paid by the original due date, an extension penalty will apply. The extension penalty is imposed at the rate of 2 percent per month or part of a month from

the original due date through the date of full payment, the date the return is filed, or the extended due date, whichever is earlier. The maximum penalty is 12 percent of the tax due with the return.

When an electing PTE files an annual Virginia income tax return reflecting an overpayment, the Department will refund the overpayment of PTET to the electing PTE. Only the electing PTE is entitled to request a refund of an overpayment of PTET; the individual owners cannot request a refund.

An electing PTE must notify its owners that the election has been made and indicate whether they are an eligible owner entitled to receive the information and benefits of the election. In addition, an electing PTE must provide a Schedule VK-1 to each of its owners, including both eligible and ineligible owners, with information regarding the pass-through of income and related deductions and credits so that the owners can complete their own Virginia tax returns.

On its return, an electing entity must report its total PTET. The total amount of PTET credits reported by an electing entity shall not exceed the total PTET paid by the electing PTE.

The electing PTE must provide sufficient information on the Schedule VK-1s in its return to identify all PTET credit-eligible taxpayers and their credit amounts. If such identifying information is not provided, the otherwise eligible owners will not be entitled to utilize the PTET credit on their Virginia income tax returns.

In no case may the PTET credit be distributed to ineligible owners. The amount of PTET credit that is distributed to each eligible owner is equal to the amount of PTET paid by the PTE on the income distributed to each of them. Therefore, the credit must be allocated to nonresident eligible owners based on only their distributive or pro rata share of income attributable to Virginia. If the electing PTE's total PTE taxable income is zero or less, its eligible owners are not entitled to any PTET credits. Instead, the electing PTE may file Form 502PTET to request a refund of any PTET estimated tax payments it made.

Example

Partnership XYZ makes the PTET election for the taxable year and has $100,000 in income upon which it pays PTET in the amount of $5,750. It has three partners, all of whom are Virginia residents: Partner X receives a 50 percent share of the income, Partner Y receives 40 percent, and Partner Y receives 10 percent. Accordingly, the amount of credit that each partners receives is:

Partner X: $5,750 x 50% = $2,875

Partner Y: $5,750 x 40% = $2,300
Partner Z: $5,750 x 10% = $575

Example

Partnership XYZ makes the PTET election for the taxable year and has $100,000 in income upon which it pays PTET in the amount of $5,750. It has three partners: Partner X is a resident and receives a 50 percent share of the income, Partner Y is a resident and receives 40 percent of the income, and Partner Z is a nonresident and receives 10 percent of the income. Partnership XYZ's apportionment percentage is 75 percent, and it receives no dividend income. Accordingly, the amount of credit that each partner receives is:

Partner X: $50,000 x 100% x 5.75 % = $2,875
Partner Y: $40,000 x 100% x 5.75 % = $2,300
Partner Z: $10,000 x 75 % x 5.75 % = $431.25

Estimated Tax Payments

For Taxable Year 2022, an electing PTE is not required to make estimated payments of PTET and will not be subject to an addition to tax charge for not making estimated payments. If a PTE wishes to make a payment during Taxable Year 2022, it may do so. However, such payment is not required, and taxpayers may wait to make payments until the original due date of the return, when they should either make a return payment or, if filing on extension, an extension payment.

For taxable years after Taxable Year 2022, an electing PTE is required to make estimated payments if its PTET for the taxable year can reasonably be expected to exceed $1,000. Estimated payments for electing PTEs will be based upon the rules set forth in Article 20 (*Va. Code* § 58.1-500 et seq.). As a result, for calendar year filers required to make four quarterly installments, estimated payments must be made to the Department as follows: 25 percent by April 15, 25 percent by June 15, 25 percent by September 15, and 25 percent by December 15. For non-calendar year filers required to make four quarterly installments, the electing PTE is required to pay 25 percent of the amount due to the Department by the 15th day of the 4th month following the beginning of its fiscal year. Subsequent installments are payable by the 15th day of the 6th month, the 15th day of the 9th month, and the 15th day of the 12th month following the beginning of its fiscal year. In case of any underpayment of estimated payments by a PTE, an addition to tax will apply at the established interest rate for underpayments unless one of the following exceptions in *Va. Code* § 58.1-504 applies:

- Prior Year's Tax Exception: Generally, this exception applies if the PTE paid an amount that was equal to or more than the PTET shown on its previous

year return. However, the PTE must have filed a PTET return showing a tax liability for the preceding taxable year and that taxable year must have consisted of 12 months. Therefore, PTEs that did not make the PTET election for the preceding taxable year may not avail themselves of this exception.

- Tax on Prior Year's Income Using Current Year's Rates Exception: Generally, this exception applies if the amount the PTE paid is equal to or greater than the PTET figured by using the current year's rates but based on the facts shown on the prior year's PTET return and the law that applies to the prior year. A PTET return must have been filed for the prior year. Therefore, PTEs that did not make the PTET election for the preceding taxable year may not avail themselves of this exception.

- Tax on Annualized Income Exception: Please see *Va. Code* § 58.1-504(D)(3) and the Form 500C Instructions for more information on how this exception applies.

Nonresident Withholding Payments and Composite Payments

Electing PTEs must make nonresident withholding payments on behalf of its nonresident ineligible owners. However, electing PTEs should not make nonresident withholding payments or payments associated with composite returns ("composite payments") on behalf of its nonresident eligible owners. If nonresident withholding payments on behalf of its nonresident eligible owners were made before the PTE made the PTET election, the PTE should claim the withholding payment on Form PTET. If composite payments on behalf of its nonresident eligible owners were made before the PTE made the PTET election, the PTE should request a refund of any such payments made. Please see the Department's website for guidance on this. If the PTE would prefer to request reallocation of composite payments to its PTET return, it may do so by submitting a written request to the Virginia Department of Taxation, Customer Services, P.O. Box 1115, Richmond, VA 23218-1115. The request should be made as far in advance of filing the PTET return as possible.

Filing Requirements for Nonresident Eligible Owners of an Electing PTE

An electing PTE may not file a composite return on behalf of its nonresident eligible owners. If a nonresident eligible owner's only Virginia-source income is through an electing PTE that fully pays the PTET, such nonresident eligible owner is permitted, but not required, to file a Virginia nonresident return.

Penalties

Pursuant to *Va. Code* § 58.1-390.3(F), the penalties for electing PTEs are based upon the corporate penalties in Article 14 (*Va. Code* § 58.1-450 et seq.) instead of the penalties in Article 9 (*Va. Code* § 58.1-390.1 et seq.).

If the PTET return is filed within the 6-month extension, but the electing PTE failed to pay 90 percent of the tax due by the original due date, then the PTE is subject to an extension penalty of 2 percent per month or fraction of a month thereof from the original due date through the date of filing of the return, the date of full payment, or the extended due date, whichever is earlier. The maximum extension penalty is 12 percent of the tax due. If the full amount is not paid when the return is filed, the late payment penalty will be assessed at the rate of 6 percent per month up to a maximum of 30 percent of the tax due:

- In the case of a Form 502PTET filed within the extension period, from the date of filing through the date of payment, or

- In the case of a Form 502PTET filed on or before the original due date of the return, from the date of the original return due date through the date of payment.

If the PTET return is filed after the extended due date or is not filed at all, the extension provisions do not apply, and the PTE is subject to the late filing penalty (*Va. Code* § 58.1-455) equal to 30 percent of the tax due. In no case will the penalty for failure to file timely be less than $100, and this minimum $100 penalty applies whether or not tax is due for the period covered by the return. The late payment penalty does not apply to the extent that the taxpayer is already subject to the late filing penalty.

Civil and criminal penalties may be imposed for filing a fraudulent return. The criminal penalty for filing a fraudulent return is a Class 6 felony (*Va. Code* §§ 58.1-451 and 58.1-452). Interest on the unpaid balance of any tax and penalty is charged at the underpayment rate established by IRC § 6621, plus 2 percent, from the due date until paid.

Filing a Return by an Eligible Owner

An eligible owner may claim a refundable PTET credit against their Virginia individual income tax or fiduciary income tax. An estate or trust, other than a trust that is disregarded for income tax purposes, that is an eligible owner of an electing PTE is allowed to claim the full PTET credit that it receives on its fiduciary income tax return, but it is not permitted to distribute any portion of the credit to its beneficiaries.

Eligible owners must wait until the electing PTE issues the Schedule VK-1 before claiming the PTET credit. If the electing PTE does not issue the Schedule VK-1 until after the due date for the owner's return, the eligible owner may (1) make any necessary extension payments and file the return during the extension period or (2) file the original return without claiming the credit and then file an amended tax return once the Schedule VK-1 showing a PTET credit is received. Eligible owners of an electing PTE who claim the PTET credit on their individual or fiduciary income tax return must make an addition equal to the eligible owner's proportionate share of any deduction for state and local income taxes paid or incurred by the pass-through entity during the same taxable year.

Example

Partnership ABCD is a calendar year, cash-basis taxpayer. It makes a PTET election for Taxable Year 2023. It has four partners, all of whom are Virginia residents. Each partner receives an equal share of the income. Partnership ABCD determines that it owes PTET in the amount $50,000, of which $40,000 was paid as estimated tax payments throughout Taxable Year 2023, and $10,000 was paid when it files its PTET return in 2024.

Partnership ABCD should claim the $40,000 federal deduction on its Taxable Year 2023 federal return and the corresponding addition, also in the amount of $40,000, on its Taxable Year 2023 Virginia PTET return. The partners should claim their pro rata share of the $50,000 PTET credit on their Taxable Year 2023 individual returns: each partner would claim a PTET credit in the amount of $12,500 and would be required to make an addition of $10,000, equal to their share of the $40,000 federal deduction that must be claimed as an addition on the Virginia return. The remaining $10,000 deduction and the associated $10,000 addition would be claimed on Partnership ABCD's Taxable Year 2024 return. On their Taxable Year 2024 individual returns, the partners would claim their pro rata share of the remaining $10,000 Taxable Year 2023 PTET addition ($2,500).

Credits are claimed on an eligible owner's return in accordance with Public Document 95-240 (September 22, 1995). As a result, the following ordering rules apply:

1. Credits that are structural in nature and are considered by the Department to be a reduction in tax liability, rather than a credit against the tax. An example is the nonrefundable credit for taxes paid to other states (discussed below).
2. Credits that do not have a statutory carryforward or refundable feature. Where there are multiple credits of equal priority, taxpayers may claim them in the order in which they receive the maximum benefit.
3. Credit carryforwards to the taxable year, in the order of those carryforwards which are scheduled to expired first. Where there are multiple credits with

carryforwards of equal length, taxpayers may claim them in the order in which they receive the maximum benefit.

4. Current year credits, based on the order of those with the shortest carryforward period first. Where there are multiple credits with carryforwards of equal priority, taxpayers may claim them in the order in which they receive the maximum benefit.
5. Refundable credits. The net excess over remaining tax liability is refunded. The PTET credit is a refundable credit.

Where a credit is calculated as, or limited to, a percentage of the tax, the "tax" for this purpose is the gross tax, less any structural credits. A double benefit for any credit claimed or to be claimed, in one or more taxable years, is not permitted.

Credit for Taxes Paid to Other States

For Taxable Years 2021 through Taxable Year 2025, taxpayers may claim Virginia's nonrefundable credit for taxes paid to other states ("out-of-state credit") on their individual income tax return for certain taxes paid by a PTE under another state's substantially similar PTE tax structure. As explained in Tax Bulletin 22-6, this provision of the legislation overrules Public Document 21-156 (December 29, 2021), which generally denied a credit for a tax paid to Maryland under that state's elective PTET. This provision only applies to taxes paid by a PTE under the law of another state that is substantially similar to *Va. Code* § 58.1-390.3. Therefore, it does not apply to any other entity taxes, such as any non-elective franchise, privilege, business, license, occupation, excise, or unincorporated business taxes described in *Va. Code* §§ 58.1-332 and 58.1-332.2. The credit also does not apply to PTET imposed by any city, county, regional, or other local taxing jurisdiction, regardless of the fact that such local PTET may be collected by a state. For the purposes of determining the out-of-state credit, the other state's PTET should be distributed to each of the PTE's owners in the same proportion as it is distributed pursuant to the other state's PTET law, whether by credit, subtraction, or some other mechanism.

However, even if PTET is allocated by the PTE to its eligible owners, the eligible owners cannot necessarily claim full out-of-state credits for the allocated PTET. Instead, the credit for PTET may not exceed the limitation specified in *Va. Code* §§ 58.1-332(A)(3), which is based upon a ratio comparing the income upon which the other state's tax was computed with the Virginia taxable income upon which the Virginia individual income tax was computed. Generally, the income upon which the other state's tax was computed will be the amount of income reported on the nonresident individual income tax return, after sourcing and apportionment. However, in the case of a state using a subtraction or deduction-based PTET rather than a credit-based PTET, the income upon which the other state's tax was computed will be the sum of (1) the amount of taxable income reported on the nonresident individual income tax return, after sourcing and

apportionment and (2) the amount of taxable income on which the PTE paid PTET to the other state on the individual’s behalf, after sourcing and apportionment, which will typically equal the amount of subtraction or deduction that they are receiving from the PTE.

The out-of-state credit may also be claimed on fiduciary income tax returns pursuant to *Va. Code* § 58.1-371. Except as noted below regarding reverse credit states, the out-of-state credit is limited to Virginia resident returns only.

Reverse Credit States

When a state practices reciprocity with Virginia pursuant to *Va. Code* § 58.1-332(B), a Virginia resident receiving income from that state may typically claim an out-of-state credit on that state's nonresident income tax return and is prohibited from claiming a credit on his or her Virginia resident income tax return. Similarly, a resident of one of these states receiving income from Virginia may typically claim an out-of-state credit on Virginia’s nonresident income tax return but not on the other state’s resident income tax return. States that practice this kind of reciprocity are referred to as “reverse credit states” because they reverse the normal rule that out-of-state credits are claimed only on resident returns.

Currently, there are three reverse credit states with a substantially similar PTET: Arizona, California, and Oregon. Virginia is required to follow subsection B of *Va. Code* § 58.1-332 with respect to its PTET and the PTET of these reverse credit states. As a result, a Virginia resident may not claim an out-of-state credit for PTET paid to one of these reverse credit states on the Virginia return and should instead claim a credit on the other states’ nonresident income tax return for PTET paid to Virginia. However, if a reverse credit state does not allow an out-of-state credit for PTET paid to Virginia, Virginia residents may then claim a credit on the Virginia return, provided that documentation is attached to the Virginia return to verify that the other state disallows the out-of-state credit to Virginia residents. Similarly, a resident of a reverse credit state may claim an out-of-state credit for PTET paid to such reverse credit state on his or her Virginia return, provided that no out-of-state credit has been claimed on his or her return filed with the other state.

The credit may not exceed the limitation specified in *Va. Code* §§ 58.1-332(B), which is based upon a ratio comparing the income subject to Virginia individual income tax to the entire income upon which the other state’s tax was imposed. Generally, the income upon which the other state’s tax was computed will be the amount of income reported on the resident individual income tax return. However, in the case of a state using a subtraction or deduction-based PTET rather than a credit-based PTET, the income upon which the other state’s tax was computed will be the sum of (1) the amount of taxable income reported on the resident individual income tax return and (2) the amount

of taxable income on which the PTE paid PTET to the other state on the individual's behalf, which will generally equal the amount of subtraction or deduction that they are receiving from the PTE.

Additional Information

These guidelines are available online in the Laws, Rules & Decisions section of the Department's website, located at www.tax.virginia.gov. For additional information, please contact the Department at (804) 367-8037.

Approved:

Craig M. Burns
Tax Commissioner

Guidelines for the Retroactive Taxable Year 2021 Pass-through Entity Tax

During the 2022 Session, the Virginia General Assembly enacted House Bill 1121 (2022 *Acts of Assembly*, Chapter 690) and Senate Bill 692 (2022 *Acts of Assembly*, Chapter 689), which permit a qualifying pass-through entity ("PTE") to make an annual election to pay an elective income tax ("PTET") at a rate of 5.75 percent at the entity level. The legislation also allows a corresponding refundable income tax credit to certain PTE owners for income tax paid by a PTE if such PTE makes the election and pays the elective income tax imposed at the entity level.

The legislation allows an individual to claim a credit for taxes paid to other states under laws that are substantially similar to the pass-through entity income tax. Effective for taxable years beginning on and after January 1, 2021, but before January 1, 2026, this overrules Public Document 21-156 (December 29, 2021), which generally denied a credit for a tax paid to Maryland under that state's elective pass-through entity income tax. This provision only applies to taxes paid by a PTE under the law of another state that is substantially similar to *Va. Code* § 58.1-390.3. Therefore, it does not apply to any other entity-level taxes, such as any franchise, privilege, business, license, or occupation taxes described in *Va. Code* § 58.1-332.2.

During the 2023 Session, the Virginia General Assembly enacted House Bill 1456 (2023 *Acts of Assembly*, Chapter 686) and Senate Bill 1476 (2023 *Acts of Assembly*, Chapter 687), which removed the requirement that a PTE be 100 percent owned by natural persons or persons eligible to be shareholders of an S corporation in order to make the election to pay the PTET. This legislation also defined an "eligible owner" as a direct owner of a pass-through entity who is a natural person or an estate or trust and states that only the pro rata or distributive share of income, gain, loss, or deduction attributable to eligible owners are subject to the PTET. These changes are effective for taxable years beginning on and after January 1, 2021.

These guidelines are published by the Department of Taxation ("the Department") to provide guidance to taxpayers regarding the elective income tax and corresponding refundable credit as required by *Va. Code* § 58.1-390.3 (F). These guidelines are not rules or regulations subject to the provisions of the Administrative Process Act (*Va. Code* § 2.2-4000 et seq.) and are being published in accordance with the Tax Commissioner's general authority to supervise the administration of the tax laws of the Commonwealth pursuant to *Va. Code* § 58.1-202. As necessary, additional information regarding these procedures will be published and posted on the Department's website, www.tax.virginia.gov.

These guidelines complement the Department's existing General Provisions Applicable to All Taxes Administered by the Department of Taxation Regulation (23 Virginia Administrative Code ("VAC") 23 VAC 10-20-10 et seq.), Individual Income Tax

Regulation (23 VAC 10-110-20 et seq.), and Corporation Income Tax Regulation (23 VAC 10-120-10 et seq.). To the extent that there is a conflict between the Department's existing guidance and Va. Code §§ 58.1-332, 58.1-390.1, 58.1-390.2, and 58.1-390.3, as such laws were amended by 2022 *Acts of Assembly*, Chapters 689 and 690 and 2023 *Acts of Assembly*, Chapters 686 and 687, the provisions of such laws, as interpreted by these guidelines, supersede existing guidance.

These guidelines represent the Department's interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines is contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845.

These guidelines address how to make the pass-through entity tax election for Taxable Year 2021, file the Taxable Year 2021 PTET return, and claim a retroactive PTET credit. For information on definitions, eligibility requirements, the computation of pass-through entity tax, and the credit for taxes paid to other states, please refer to the Guidelines for the Pass-through Entity Tax.

Making the Election

For Taxable Year 2021, a PTE has the option to make a retroactive PTET election and pay PTET for the taxable year by:

- Submitting Taxable Year 2021 Form 502PTET, including all owner credit allocation information, using Business Online Services on or before September 16, 2024; and

- Making all payments electronically either prior to or at the time the Taxable Year 2021 Form 502PTET is submitted.

Taxable Year 2021 Form 502PTET will not be accepted after September 16, 2024, or without full payment of the 2021 PTET. Form 502 cannot be used to make the PTET election for Taxable Year 2021.

Each electing pass-through entity decides how to obtain consent from its eligible owners; provided, however, the election is binding on all the eligible owners once the election is made. For S corporations, this includes the choice whether to take advantage of the special option on how to compute their PTET, described in the Guidelines for the Pass-through Entity Tax. An eligible owner does not have the option to "opt out" of an entity's election with the Department. An owner, officer, or employee of the PTE who is authorized to act on behalf of the PTE in tax matters must sign the PTET return. By

signing the return, the signer is declaring that they are the authorized representative of the PTE. Because the PTET return must be filed electronically, the return must be signed using the electronic signature procedures established by the Department. Please see the Department's website for more information.

Filing the Retroactive Taxable Year 2021 PTET Return

Electing PTEs are required to file their retroactive Taxable Year 2021 PTET returns and the accompanying schedules and make any tax payments electronically. Please see the Department's PTET return instructions for more information regarding how to make payments and file returns electronically. No hardship exemptions are available for electronically filing PTET returns.

Electing PTEs are required to pay in full the PTET owed by the time they file their Taxable Year 2021 Form 502PTET and must file their Taxable Year 2021 Form 502PTET by September 16, 2024. No retroactive Taxable Year 2021 PTET returns will be accepted after that date. There are no extensions or late filing options.

An electing PTE must refer to its previously filed Taxable Year 2021 Form 502 to complete its Taxable Year 2021 Form 502PTET. If an electing PTET has not previously filed a Taxable Year 2021 Form 502, it would still be eligible for the retroactive Taxable Year 2021 PTET election; however, if it was required to file a Taxable Year 2021 Form 502 and it has not yet done so, it may be subject to a late filing penalty of up to $1,200.

An electing PTE must notify its owners (1) that the election has been made and (2) whether or not they are an eligible owner entitled to receive the information and benefits of the election. In addition, an electing PTE must provide a Schedule VK-1 to each of its owners, including its eligible and ineligible owners, with information regarding the pass-through of income and related deductions and credits so that the owners can complete their own Virginia tax returns.

On its return, an electing entity must report its total PTET. The total amount of PTET credits reported by an electing entity shall not exceed the total PTET paid by the electing PTE.

The electing PTE must provide sufficient information on the Schedule VK-1s in its return to identify all PTET credit-eligible taxpayers and their credit amounts. If such identifying information is not provided, the otherwise eligible owners will not be entitled to utilize the PTET credit on their Virginia income tax returns.

In no case may the PTET credit be distributed to ineligible owners. The amount of PTET credit that is distributed to each eligible owner is equal to the amount of PTET paid by the PTE on the income distributed to each of them. Therefore, the credit must be

allocated to nonresident eligible owners based on only their distributive or pro rata share of income attributable to Virginia. If the electing PTE's total PTE taxable income is zero or less, its eligible owners are not entitled to any PTET credits.

Estimated Tax Payments

Because the Taxable Year 2021 PTET election is retroactive, no estimated payments are required. However, full payment must be made on or before the earlier of (1) the date the return is filed or (2) September 16, 2024.

Previously Paid Nonresident Withholding

If nonresident withholding payments on behalf of nonresident eligible owners were made on a PTE return (Form 502), the PTE should claim the withholding payment on Form 502PTET. However, because eligible owners may have already received and claimed credit for any withholding payment made by the PTE, any withholding payments made must be subtracted from the total amount of retroactive PTET credits allocated to eligible owners.

Previously Filed Composite Returns

If a composite return (Form 765) has already been filed by the PTE, such PTE is still eligible to make the retroactive Taxable Year 2021 election, provided that it reports a subtraction on its PTET return for any income for which tax has been paid on a Form 765.

This appears to negate non-resident owners, but resident owners still eligible?

Penalties

Pursuant to *Va. Code* § 58.1-390.3 E, the penalties for electing PTEs are based [illegible] the corporate penalties in Article 14 (*Va. Code* § 58.1-450 et seq.) instead of the penalties in Article 9 (*Va. Code* § 58.1-390.1 et seq.). Civil and criminal penalties may be imposed for filing a fraudulent return. The criminal penalty for filing a fraudulent return is a Class 6 felony (*Va. Code* §§ 58.1-451 and 58.1-452).

Filing a Return by an Eligible Owner

An eligible owner may claim a refundable PTET credit against their Virginia individual income tax or fiduciary income tax. An estate or trust, other than a trust that is disregarded for income tax purposes, that is an eligible owner of an electing PTE is allowed to claim the full PTET credit that it receives on its fiduciary income tax return, but it is not permitted to distribute any portion of the credit to its beneficiaries.

this would be where refunds would be measured against.

Taxable Year 2021 Form 502PTET must be submitted and the PTET must be paid in full by September 16, 2024 before the Department will allow eligible owners to claim the PTET credit on their income tax returns as a retroactive 2021 PTET credit. Owners are not allowed to amend their Taxable Year 2021 owner returns to claim the retroactive 2021 PTET credit. Instead, as a filing convenience to taxpayers, the retroactive 2021 PTET credit will be reported exclusively on the owners' returns for Taxable Year 2023. While reported on a 2023 owner return and while no interest will generally be paid relating back to 2021, the retroactive 2021 PTET credit is based upon the owner's and the PTE's Taxable Year 2021 taxes, and any refunds issued on a Taxable Year 2023 return as a result of such credit are solely on account of the owner's and PTE's 2021 taxes.

Eligible owners must wait until the electing PTE issues the Schedule VK-1 before claiming the PTET credit. If the electing PTE does not issue the Schedule VK-1 until after the due date for the owner's return, the eligible owner may (1) make any necessary extension payments and file the return during the extension period or (2) file the original return without claiming the credit and then file an amended tax return once the Schedule VK-1 showing a PTET credit is received. Eligible owners of an electing PTE who claim the PTET credit on their individual or fiduciary income tax return must make an addition equal to the eligible owner's proportionate share of any deduction for state and local income taxes paid or incurred by the pass-through entity during the same taxable year.

Example

Partnership ABCD is a calendar year, cash-basis taxpayer. It makes the retroactive PTET election for Taxable Year 2021. It has four partners, all of whom are Virginia residents who receive an equal share of the income. Partnership ABCD determines that it owes PTET in the amount $50,000, of which $40,000 is paid on December 15, 2023, and $10,000 is paid when it files its 2021 PTET return in the spring of 2024. The partners would each claim their pro rata share of the $50,000 retroactive PTET credit on their Taxable Year 2023 returns.

Partnership ABCD would claim the $40,000 federal deduction on its Taxable Year 2023 federal return and the corresponding addition, also in the amount of $40,000, on its Taxable Year 2023 Virginia PTET return. The partners would each claim their pro rata share of the $40,000 federal deduction on their federal returns and the corresponding addition on their Taxable Year 2023 Virginia returns. The remaining federal deduction in the amount of $10,000 and the associated Virginia addition would be claimed on Partnership ABCD's Taxable Year 2024 returns. In addition, the partners would claim their pro rata share of the remaining $10,000 federal deduction and make a Virginia addition in the same amount on their Taxable Year 2024 returns.

Credits are claimed on an eligible owner's return in accordance with Public Document 95-240 (September 22, 1995). As a result, the following ordering rules apply:

1. Credits that are structural in nature, and are considered by the Department to be a reduction in tax liability, rather than a credit against the tax. An example is the nonrefundable credit for taxes paid to other states.
2. Credits which do not have a statutory carryforward or refundable feature. Where there are multiple credits of equal priority, taxpayers may claim them in the order in which they receive the maximum benefit.
3. Credit carryforwards to the taxable year, in the order of those carryforwards which are scheduled to expired first. Where there are multiple credits with carryforwards of equal length, taxpayers may claim them in the order in which they receive the maximum benefit.
4. Current year credit, based on the order of those with the shortest carryforward period first. Where there are multiple credits with carryforwards of equal priority taxpayers may claim them in the order in which they receive the maximum benefit.
5. Refundable credits. The net excess over remaining tax liability is refunded. The PTET credit is a refundable credit.

Where a credit is calculated as, or limited to, a percentage of the tax, the "tax" for this purpose is the gross tax, less any structural credits. A double benefit for any credit claimed or to be claimed, in one or more taxable years, is not permitted.

Additional Information

These guidelines are available online in the Laws, Rules & Decisions section of the Department's website, located at www.tax.virginia.gov. For additional information, please contact the Department at (804) 367-8037.

Approved:

Craig M. Burns
Tax Commissioner

Virginia Pass-Through Entity Tax (PTET) Frequently Asked Questions

Does Virginia Tax apply the PTET credit before or after income tax payments?

There is no prescribed order in which we apply the PTET credit and income tax payments. As explained in the Final Elective Pass-through Entity Tax Guidelines, the ordering rules for Virginia income tax credits are as follows:

1. Credits that are structural in nature.
2. Credits that do not have a statutory carryforward or refundable feature.
3. Credit carryforwards to the taxable year, in the order of those carryforwards which are scheduled to expire first.
4. Current year credits, based on the order of those with the shortest carryforward period first.
5. Refundable credits.

Among other things, refundable credits include:

- The PTET Credit,
- The Motion Picture Production Tax Credit,
- The Agricultural Best Management Practices Tax Credit,
- The Research and Development Tax Credit,
- The Conservation Tillage and Production Tax Credit,
- The refundable portion on the Earned Income Tax Credit,
- Estimated Tax Payments,
- Extension Tax Payments, and
- Income Tax Withholdings.

In computing an individual's Virginia income tax liability, our systems apply all of the refundable credits above together simultaneously following the application of current year credits. As a result, there is no prescribed order programmed into our systems that dictates which refundable credits are applied first.

A Pass-Through Entity (PTE) makes the PTET election and files a PTET return properly, showing no tax liability for Taxable Year 2023. When the entity files its Taxable Year 2024 return, will it qualify for the Tax (PTET) on prior year's income using current year's rates exception from the estimated payment addition to tax, assuming the other requirements of that exception are met?

Yes. Unlike the prior year's tax exception, the tax on prior year's income using current year's rate exception does not require that there was a tax liability for the prior year. Therefore, so long as the other requirements of the exception are met, the mere lack of a tax liability on the prior year return will not disqualify the PTE from availing itself of the exception.

Does an electing PTE need to make non-resident withholding payments on behalf of non-resident partners that are PTEs?

No, partners that are PTEs are exempt from withholding, regardless of whether a PTET election is made.

Can a non-Virginia PTE that does not have Virginia-source income nor any Virginia tax filing requirements make the election and pay the Virginia PTET on behalf of its partners, owners, or members that are Virginia residents?

Yes, PTEs with no Virginia-source income are permitted to make the PTET election.

When calculating the estimated payment addition to tax for individual owners, should PTET credits be included in income tax liability on Line 1 of the Form 760C?

Yes. The PTET credit should reduce the tax liability amount used to compute the addition to tax. Therefore, if the individual's tax liability before credits is $1,000 but the individual is eligible to claim a $100 PTET credit and a $400 land preservation credit, the amount on Line 1 of the Form 760C would be $500. The applicable PTET credit should similarly be included on Line 3 of the Form 760C.

When calculating the estimated payment addition to tax for individual owners, should the PTET be included as payment on Form 760C?

No. PTET payments are not considered payments of an owner's individual income tax liability. Instead, they are payments of the PTET liability of the PTE itself. Therefore, they should not be included as payments on the Form 760C.

However, as explained in the preceding question, the PTET credit can (like other income tax credits) reduce the tax liability reported on Lines 1 and 3 of Form 760C.

Virginia PTET Frequently Asked Questions Applicable to Taxable Year 2021 Only

Does a PTE making the retroactive 2021 PTET election have to issue amended 2021 VK-1s?

We are not providing a designated form for electing PTEs to provide information on the 2021 PTET credit to eligible owners. Instead, PTEs have discretion to use any format they choose as long as it includes the eligible owner's share of the retroactive credit and instructions for claiming the credit on their Taxable Year 2023 returns. The 2021 PTET credit information should not be added to 2023 Schedule VK-1s and in no case should eligible owners amend their 2021 return to claim the 2021 PTET credit.

What if there has been a change in ownership since Taxable Year 2021?

The Retroactive Taxable Year 2021 Pass-through Entity Tax Guidelines do not specify whether the 2021 PTET credit is distributed to the eligible owners as they existed in 2021 or 2023. Therefore, in lieu of distributing the

2021 PTET credit to eligible owners as they existed in 2021, the PTE has the option of distributing the 2021 PTET credit based on its ownership in Taxable Year 2023. As explained in the Retroactive Taxable Year 2021 Pass-through Entity Tax Guidelines, each electing pass-through entity decides how to obtain consent from its eligible owners; provided, however, the election is binding on all the eligible owners once the election is made. This includes the choice whether to distribute the 2021 PTET credit based on the entity's ownership in 2023.

Web Upload Guide

For Filing and Paying Returns Electronically with the
Virginia Department of Taxation and the Virginia Employment Commission

Rev. 11/2021

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What is Web Upload?

Web Upload is a free, secure and efficient online service which allows you to file/pay your returns electronically with the Virginia Department of Taxation (TAX) and with the Virginia Employment Commission (VEC). This Guide will help you with using this file-driven online system, including screenshots and step-by-stepinstructions to use Web Upload features.

The basic workflow for customers who use Web Upload system is to:

- **Sign Up** to use the system
- **Set Up** the *File Layout* and the *file* of data
- **Submit (or Schedule)** the data after successfully *Uploading* the file

IMPORTANT: Some customers may need to perform additional steps during the **Set Up** in order to create a file or match the file and File Layout to their filing/paying needs. Instructions to assist with this are provided later in the Guide.

Why Use Web Upload?

Web Upload is especially beneficial to tax professionals and payroll companies who want to submit return and payment information for a single client or even multiple clients at the same time. Using Web Upload does not require you to make changes to your computer system or existing computer settings. This service also eliminates the filing of the actual paper return.

Unsure if Web Upload is the most beneficial online system for your business returns? View the Online Service Options to compare using the Web Upload, eForms and Business iFile systems, based on your filing needs/requirements.

Supported Web Upload Forms

Withholding Tax

- VA-5 (Monthly/Quarterly) Withholding Return
- VA-15 Semi-Weekly Withholding Return
- VA-16 Quarterly Withholding Reconciliation
- VA-6 Annual Withholding Reconciliation

Income Tax Statements

- W-2 Wage and Tax Statement
- W-2C Corrected Wage and Tax Statements
- W-2G
- 1099-R Distributions from Pensions/Annuities/Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
- 1099-MISC Miscellaneous Income Form
- 1099-NEC Non-Employee Compensation Form
- 1099-K Payment Card and Third Party Network Transactions
- 770ES, 770IP

Sales Tax

- ST-8 Out of State Sales & Use Tax Return (with Schedule ST-6B) for Periods on or after 1/1/2020.
- ST-9 Sales & Use Tax Return for Periods on or after 1/1/2020.
- ST-9CO Consolidated Sales & Use Tax Return (with Schedule ST-9B) for Periods on or after 1/1/2020.

Schedule VK-1 – Partnership (PTE) Owner's Share of Income and Virginia Modifications and Credits

P2P – Peer-to-Peer Vehicle Sharing Tax Return

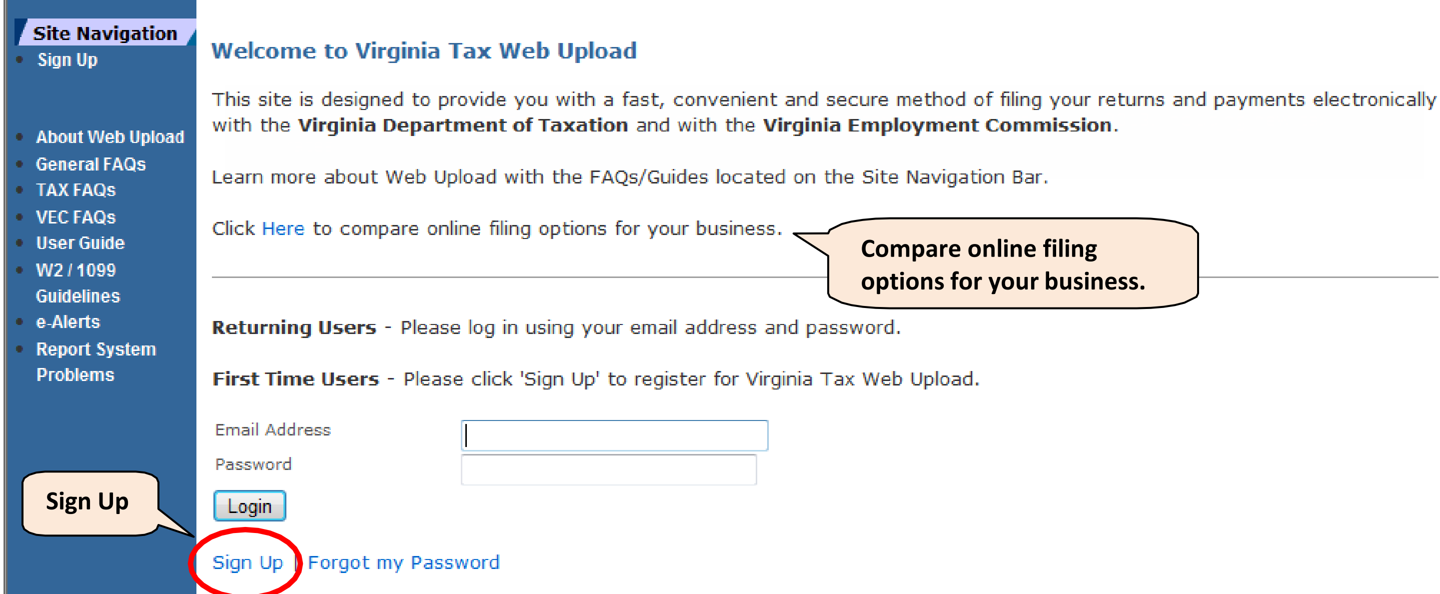
Unemployment Taxes – Forms FC-20 and FC-21 State Unemployment Insurance (SUI) Tax Reports
NOTE: VEC supports options of ICESA, EFW2/SSA, Excel and Delimited for SUI Tax Reports.

New User Registration

First time users of Web Upload are required to **Sign Up** prior to using the service. Your email address will be your user ID.

The email address you provide as your user ID also gives TAX and VEC permission to email registration confirmation, password changes, and confirmation of submitted files and notification of Web Upload changes/modifications to this address.
NOTE: Adding webupload@TAX.virginia.gov and webuploadVEC@VEC.virginia.gov to your list of safe email address will help ensure Web Upload emails reach your inbox.

1. Click 'Sign Up' on the Web Upload login page.
   NOTE: You only need to register for one Web Upload account to Submit for multiple files or for multiple companies.



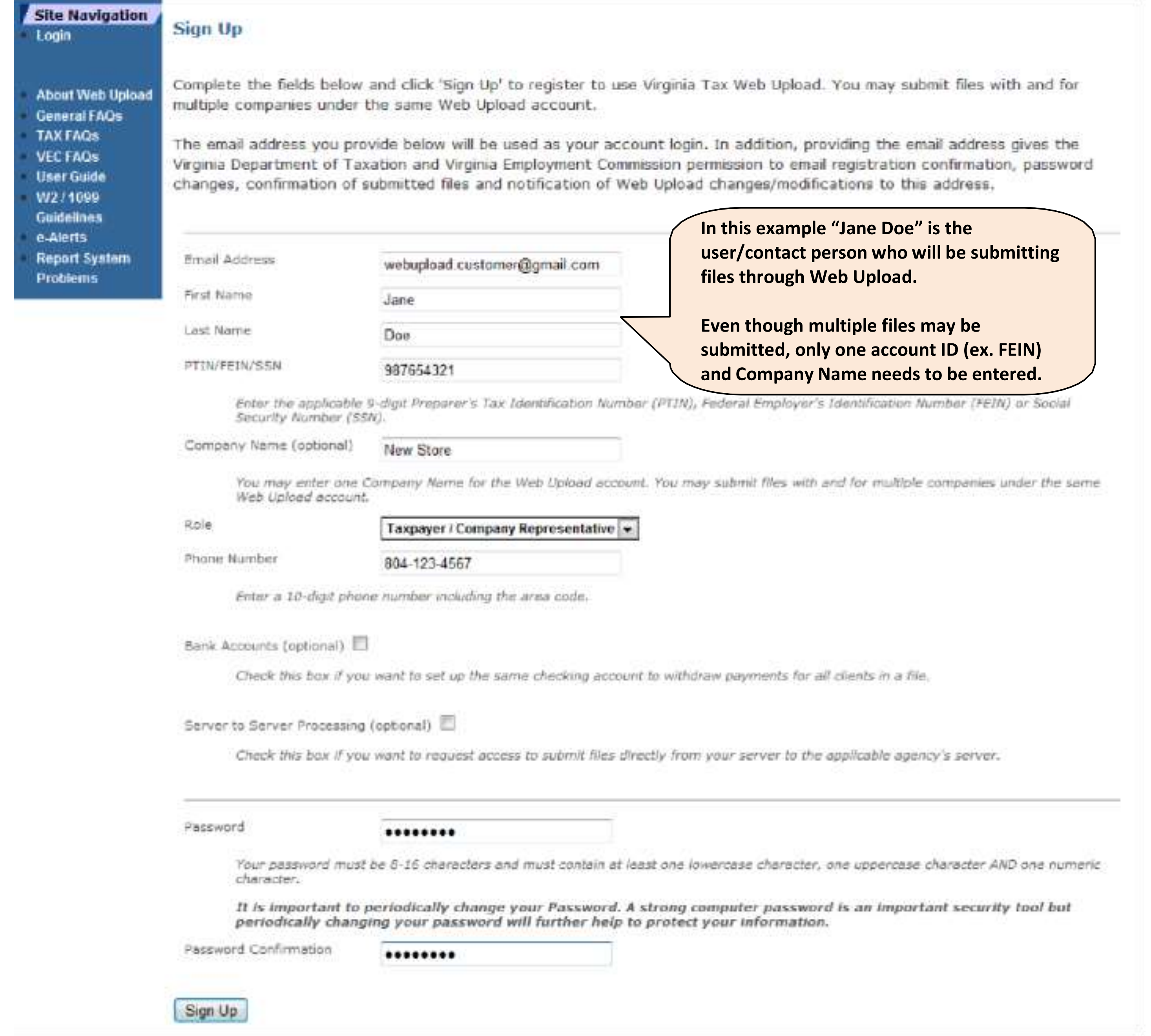
2. Complete the required fields.
   - Email Address – The valid address for all confirmations and your User ID to log into the system.
   - First Name – The first name of the contact person.
   - Last Name – The last name of the contact person.
   - PTIN/FEIN/SSN – The nine-digit PTIN, FEIN or SSN (of the preparer or company submitting files)
   - Role – Select your role:
     - Tax Preparer
     - Taxpayer / Representative
     - Payroll Provider
     - Other
   - Phone Number – Contact phone number (without space between the digits)
   - Password – Your password must be 8-16 characters and must contain at least one lowercase character, one uppercase character AND one numeric character.
     NOTE: It is important to periodically change your Password. A strong computer password is an important security tool, but periodically changing your password will further help to protect your information.

The Password field can be viewed on the following page.

3. Verify all the information entered in the required fields, especially your email address.

REMEMBER: The email address you provide as your account login ID also gives TAX and VEC permission to email registration confirmation, password changes, confirmation of submitted files and notification of Web Upload changes/modifications to this address.

Only **one** Web Upload account is needed to submit all of your files.



4. Complete the Optional fields as applicable.
   - Company Name – The Company's Name. (See the previous page for field location.)
   - Bank Accounts – To use one checking account for ALL of the returns in your file, mark this box. **NOTE**: The checking account and routing numbers are used to make your payment and the amount to be paid must be indicated in your file per the Payment Amount field. All payments with Web Upload are Debit EFT payments.
   - Server to Server Processing – Mark this box only if you are a payroll provider of a company with multiple clients to allow your server to send your TAX files directly to TAX's servers without having to log in through Web Upload. **DO NOT** mark this box if you are not sure about Server to Server Processing.
     - You will be asked to provide the external IP address of your server.
     - At the time of publishing this document VEC does not offer server to server processing.

Bank Accounts (optional) ☑

Check this box if you want to set up the same checking account to withdrew payments for all clients in a file.

Marking this check box causes the banking fields to display.

Account Name (optional)	Account Number	Routing Number

Enter the applicable Account and Routing Numbers for up to three separate checking accounts.
You must save the Payment Amount(s) in the File/File Layout and select the specific checking account prior to uploading your file.

John Smith
100 Main Street
Richmond, VA 23220
1234
Date
PAY TO THE ORDER OF
$
SAMPLE
Dollars
Routing # Account #
250250025 202020186 1234

Server to Server Processing (optional) ☑

Check this box if you want to request access to submit files directly from your server to the applicable agency's server.

This check box and IP Address field applies to large payroll providers/software providers with large volumes to file.

IP Address

Enter your external IP Address. This is required in order to provide server to server access to you.

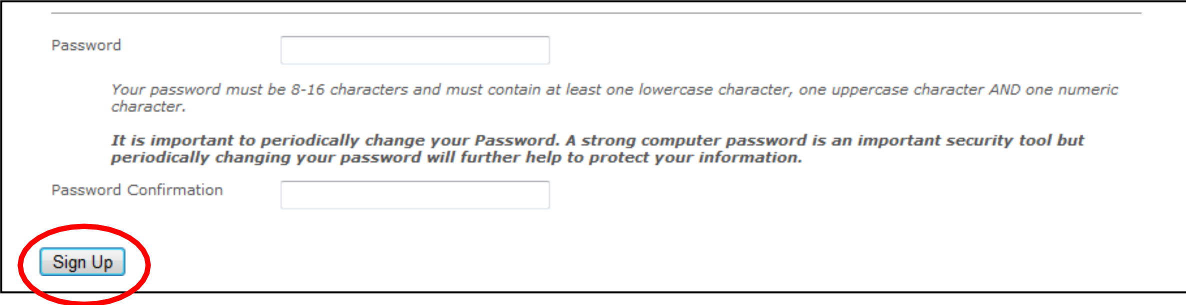
Password

Your password must be 8-16 characters and must contain at least one lowercase character, one uppercase character AND one numeric character.

It is important to periodically change your Password. A strong computer password is an important security tool but periodically changing your password will further help to protect your information.

Password Confirmation

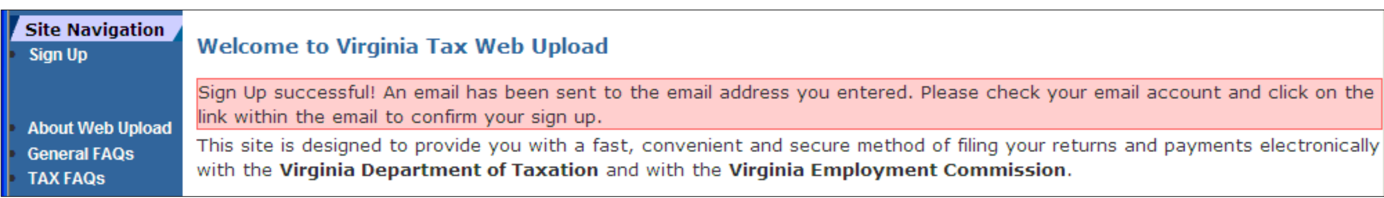
Sign Up



5. Click 'Sign Up' to complete your registration.

6. If error messages display at the top of the page,
   a. Correct your information according to the instructions in the error message.
      NOTE: The "Forgot My Password" option will help customers who receive a message advising the email address entered has already been registered.
   b. Click 'Sign Up' again to complete your registration.

Once you successfully complete the registration, the following message will display at the top of the page.



7. Access your email account and review the confirmation email from Web Upload.

   REMEMBER: Adding webupload@TAX.virginia.gov and webuploadVEC@VEC.virginia.gov to your list of safe email address will help ensure Web Upload emails reach your inbox.

8. If you do not receive a confirmation email within a few hours of registering, you may contact the Web Upload Administrators at webupload@TAX.virginia.gov or webuploadVEC@VEC.virginia.gov.
   NOTE: Your email filter may have blocked the confirmation email or the email address entered during Sign Up may have been not entered correctly.

9. Click the link 'Click Once Here' in the confirmation email to validate your request to sign up.
   NOTE: This activates your Web Upload account and will direct you to the Web Upload User Home Page.

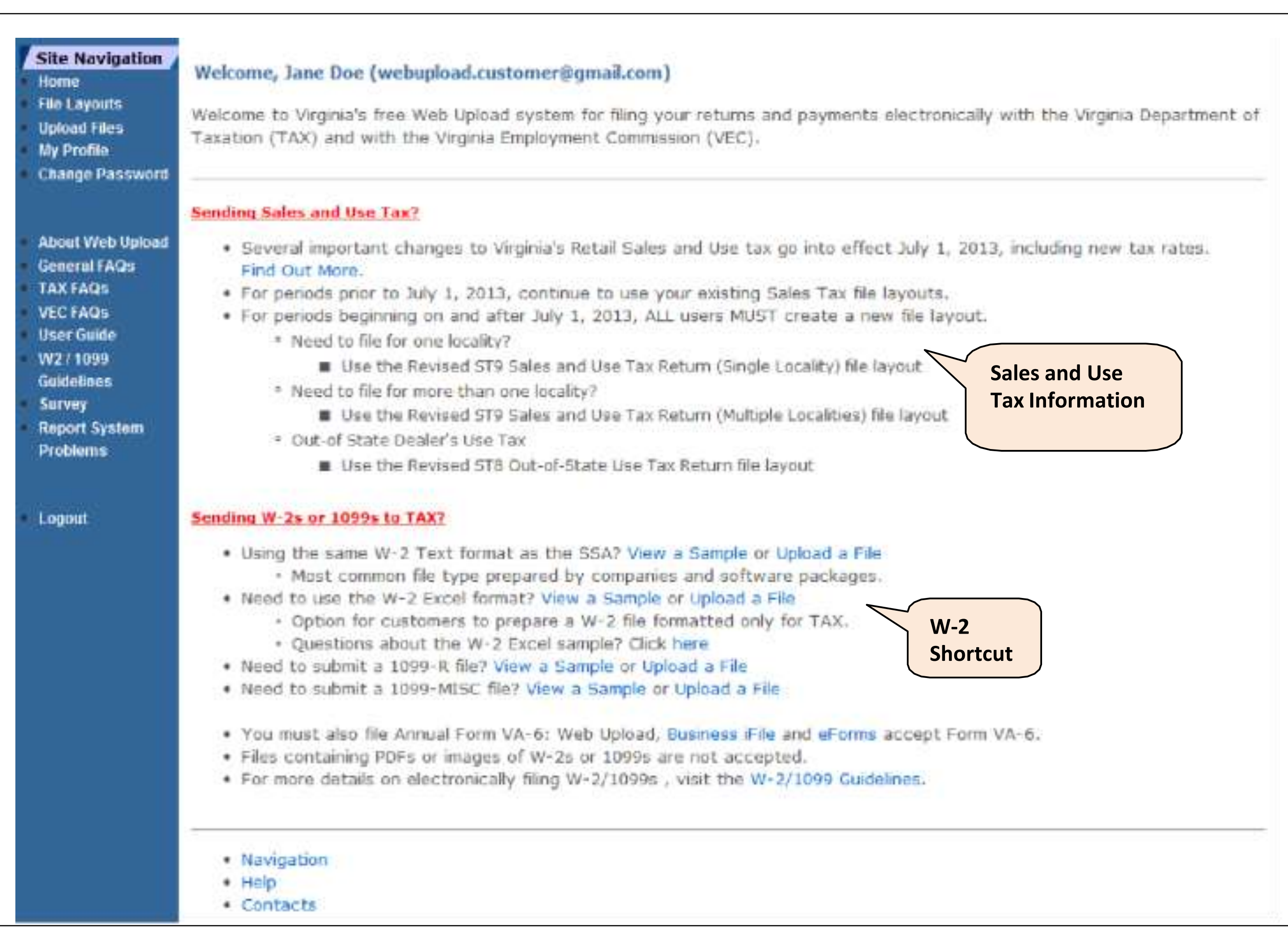
As a New User, you cannot access your Web Upload account until you click on the link.

Home Page

The Home Page is displayed after you validate your registration and when you log in as a returning user to upload and submit your files. It provides:

- System Announcements (when applicable)
- Site Navigation (including links to important Web Upload resources)
- Sales and Use Tax Information
- W-2 / 1099 Shortcut section
- Navigation Overview
- Description of each page in your Web Upload account
  NOTE: The links in the Site Navigation Bar will take you to each of the pages.

You will also find "Help" information per the described ⓘ icons and the contact information for the Web Upload Business Administrators for each agency.



Forgot Your Password

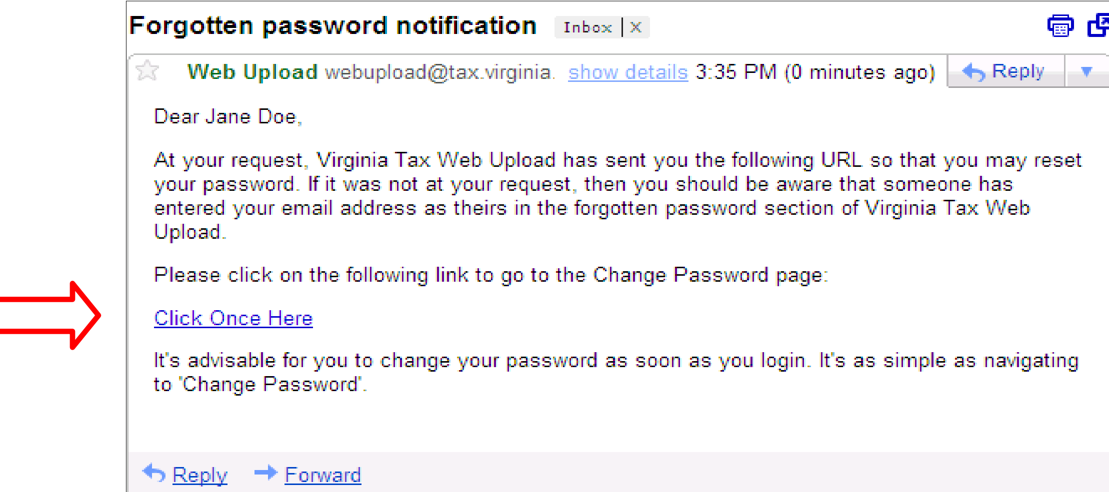
Web Upload Business Administrators cannot view or reset your password. If you forget your password, follow these steps:

1. Click 'Forgot my Password' located on the Login Page or Site Navigation Bar to open the "Forgotten Password" page.

2. Enter your email address.
   NOTE: This must be the same email address you saved in your Profile.

3. Click 'Reset Password'.
   NOTE: Instructions to finish resetting your password will be emailed to you.

4. Access your email account and review the "Forgotten Password Notification" email.

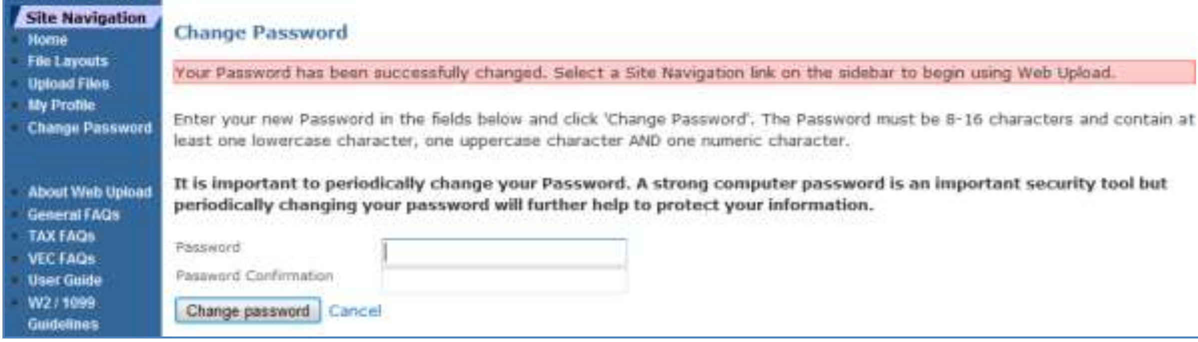


5. Click the link 'Click Once Here' to access the Change Password Page and complete resetting your password.

6. Enter your new password.

7. Enter the same password to confirm the new password choice.

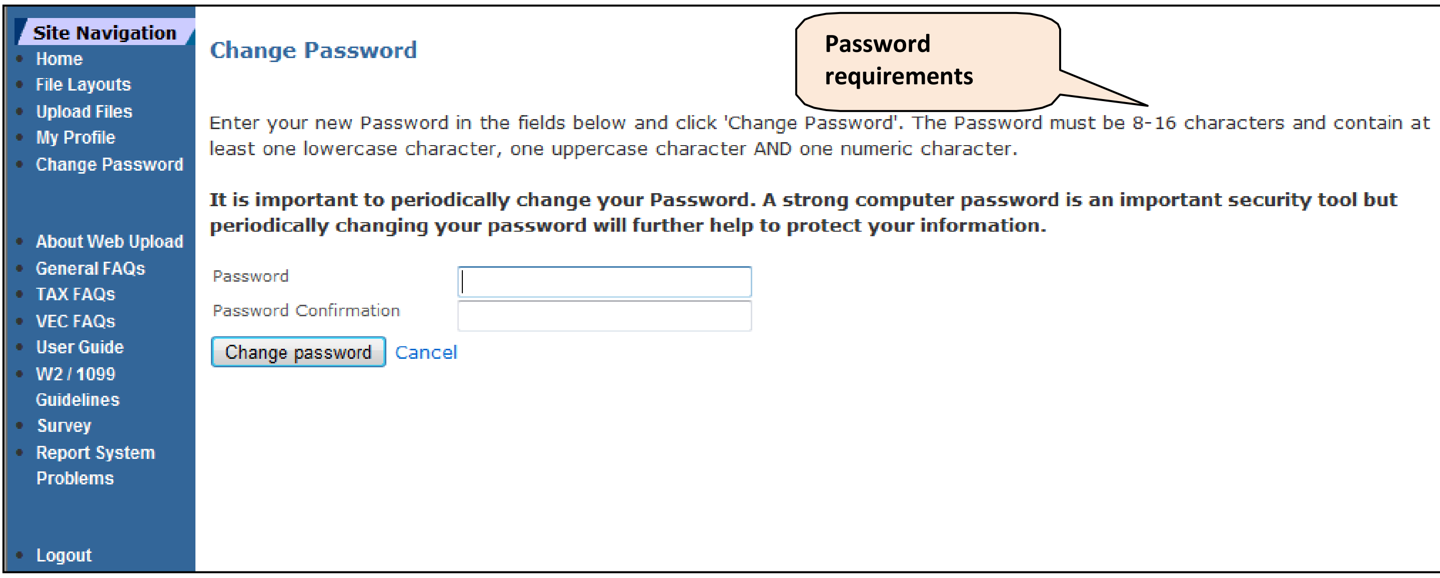
8. Click 'Change Password' to complete the password change.
   NOTE: You will see the message below when your new password matches in both fields. You can now navigate through Web Upload again.



Change Your Password

To change your password, you must already be logged in to Web Upload.

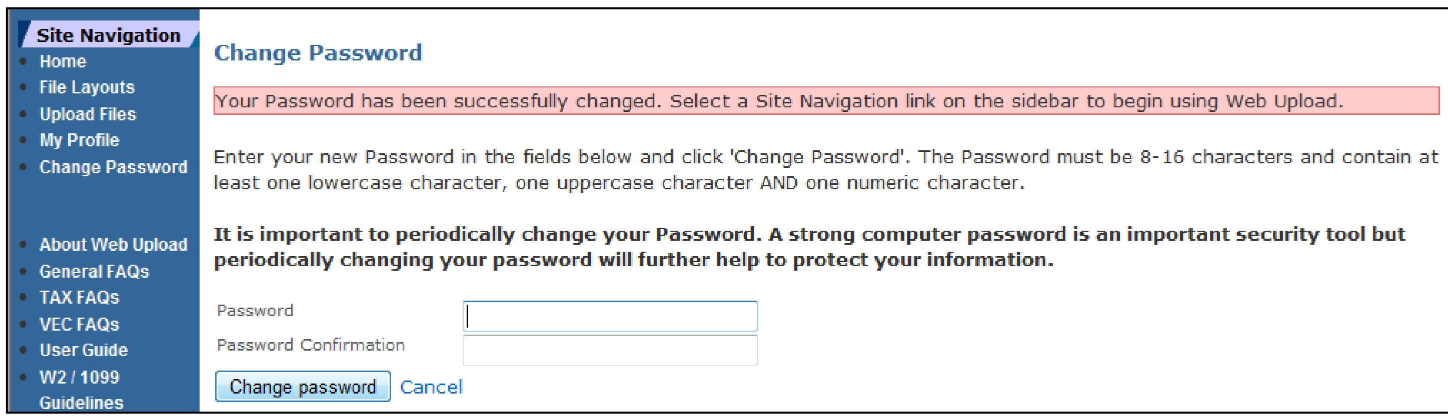
1. Click ‘Change Password’ located on the Site Navigation Bar.



2. Enter your new password.

3. Enter the same password to confirm the new password choice.

4. Click ‘Change Password’ to complete the password change.
   NOTE: You will see the following message, in red below, when your new password matches in both fields. You may continue navigating through Web Upload.



Change Your Profile

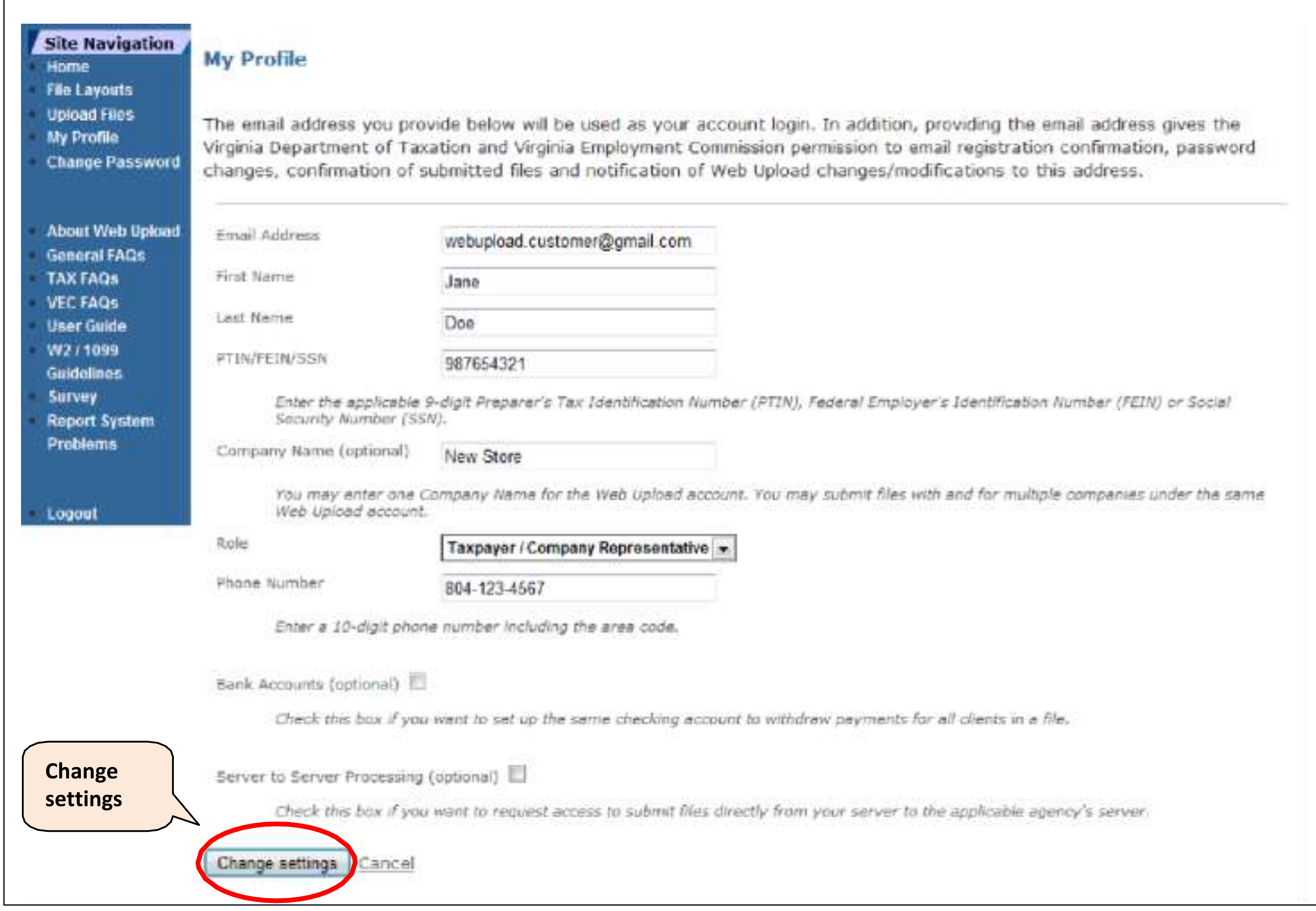
You may update your Profile only after the completion of the “Sign Up” process, by using the “My Profile” Page. Your name, email address, phone number and other information may be updated here.

If you change your email address, that new email address becomes part of your new login information.

1. Click ‘My Profile’ located on the Site Navigation Bar.

2. Make the necessary changes.

3. Click ‘Change Settings’ to save your updates **OR** if you do not want to save the updates, click ‘Cancel’.



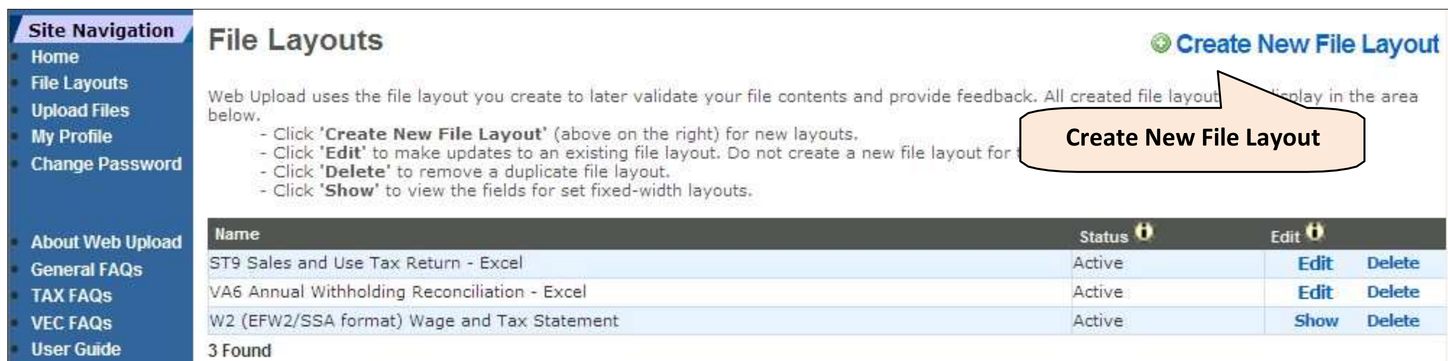
Create a File Layout

The first step to complete the **Set Up** for filing/paying with Web Upload is to create a File Layout.

This step identifies the form type, the file type and provides the return fields. The option to save a sample of the File Layout is also available.

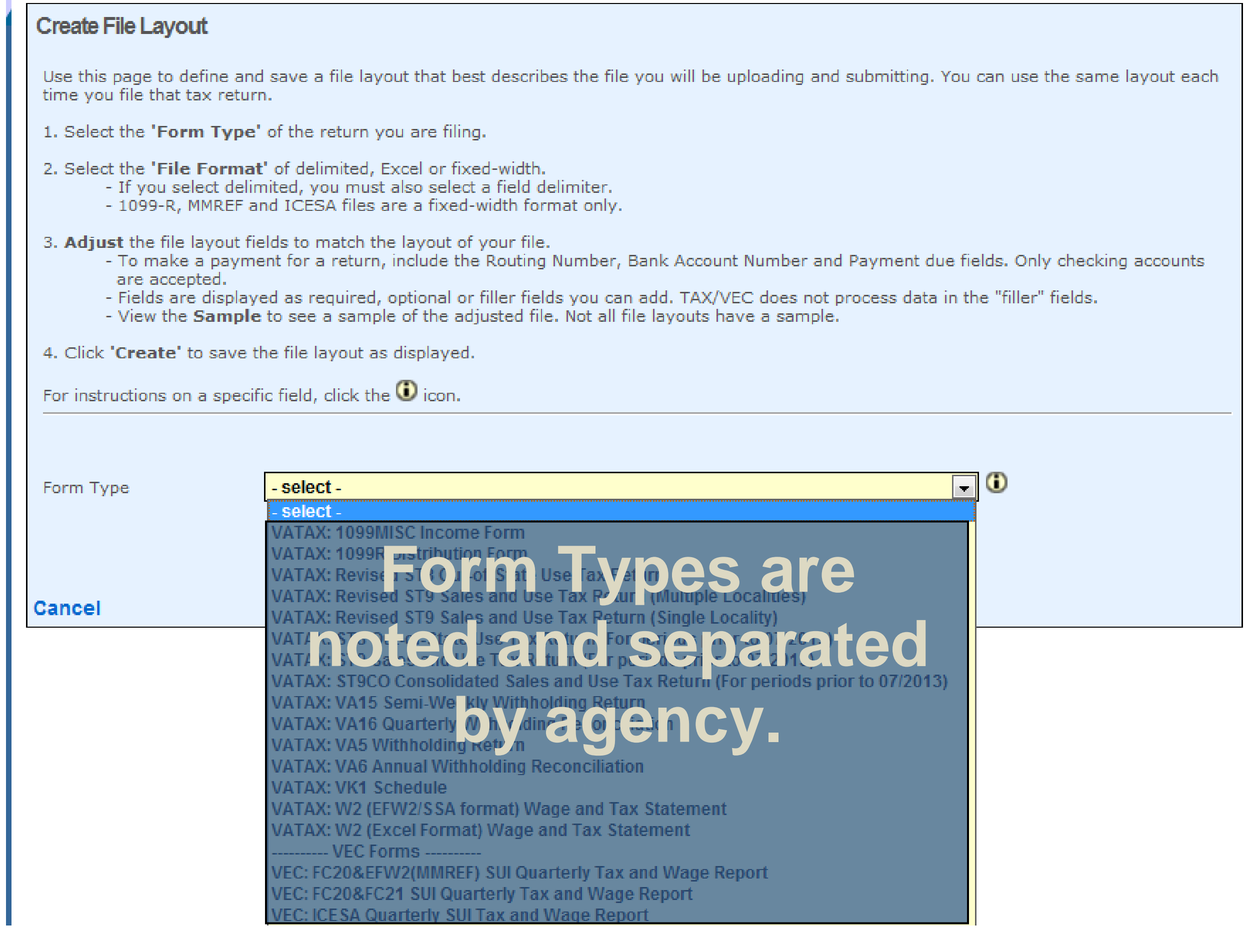
A File Layout for each return type only needs to be created once. It can be edited as long as no file using that File Layout is still being processed. You will also have the option to delete duplicate File Layouts, which is described later in the Guide.

1. Click ‘File Layouts’ located on the Site Navigation Bar.
   NOTE: Any created File Layouts will also be displayed on this page.



2. Click ‘Create New File Layout’.

3. Select a form type from the “Form Type” drop down box.

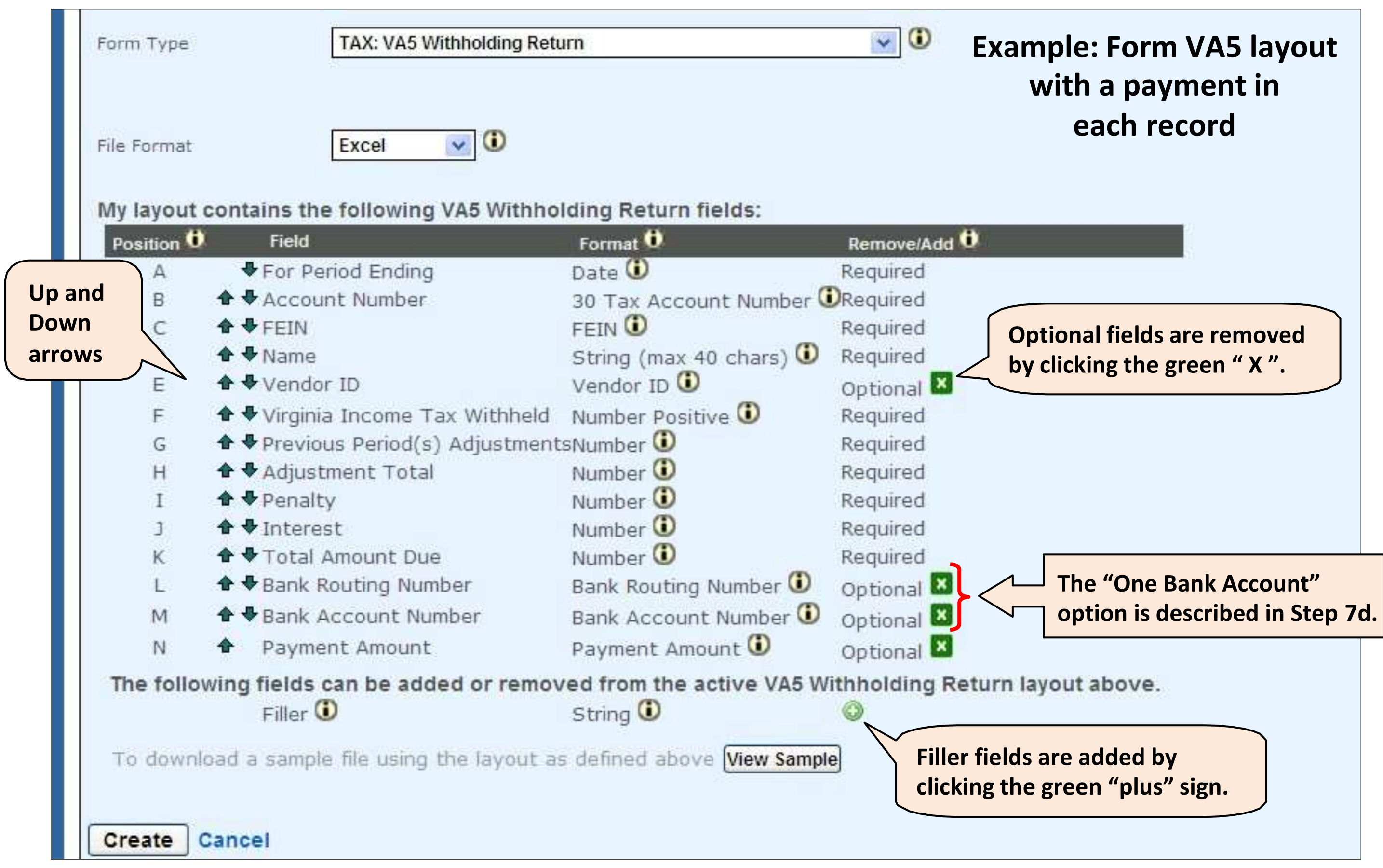


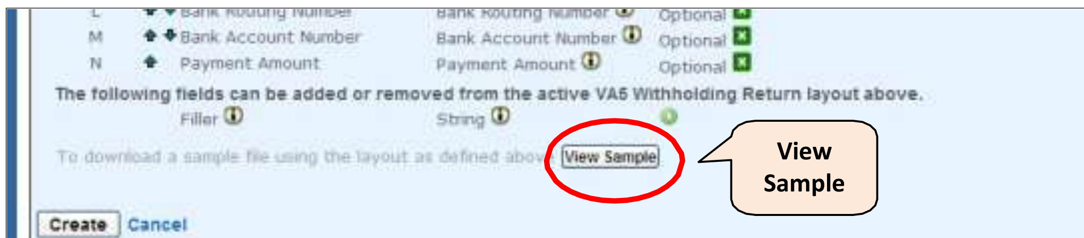
4. If you select any of these form types, skip ahead to Step 9.
   - TAX: 1099-MISC
   - TAX: 1099-R
   - TAX: 1099-NEC
   - TAX: 1099-K
   - TAX: W-2 (EFW2/SSA)
   - TAX: W-2C (EFW2C/SSA) Beginning Jan 2022
   - VEC: FC-20 EFW2/MMREF
   - VEC: ICESA Quarterly SUI

5. If you select the "TAX: W-2 (Excel)" form type, skip ahead to Step 8.
   NOTE: The Excel spreadsheet sample will be helpful in entering your W-2 data.

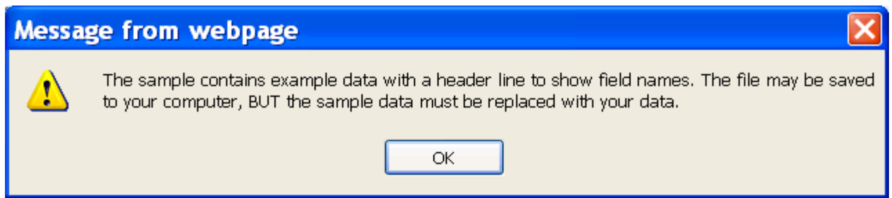
6. Select one file format from the "File Format" drop down box.
   - Delimited – all fields are separated by a specified character (tab, comma or semicolon)
   - Excel – a spreadsheet program from Microsoft
   - Fixed-Width – each field has a specified size than can be modified

7. Modify the File Layout, as applicable.
   NOTE: Customers using software will modify the File Layout based on the software provider's instructions.
   a. If you want to change the order of the fields, use the up and down arrows.
   b. If you want to remove an "Optional" field, click the green "**X**".
   c. If you want to add a filler field, click the green "plus" sign (+).
      NOTE: Filler fields are informational only. Data in these fields are ignored by Web Upload.
   d. If you want to include a payment with the return, modify your layout per **one** of these options.
      - ***List a Bank Account for Each Payment*** – Keep the Bank Routing Number, Bank Account Number and Payment Amount fields in the active section of the File Layout. (These fields must also be in the File you Submit through Web Upload.)
      - ***Use One Bank Account for All Payments***
        1. Remove the Bank Routing Number field and the Bank Account Number field from the File Layout by clicking the green " X ".
        2. Keep the Payment Amount field in the active section of the File Layout.
        3. Ensure the checking account information is saved in the My Profile page.
           NOTE: You may do this after creating the File Layout, if not done already.

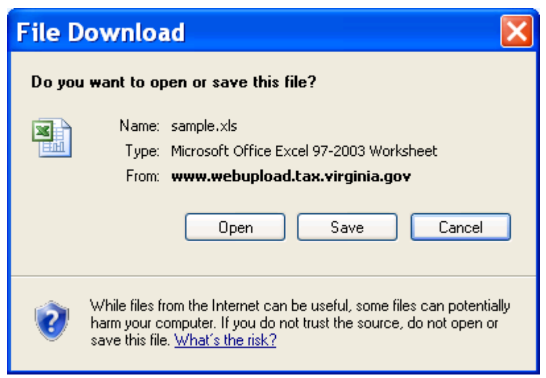

Form Type
TAX: VA5 Withholding Return
Example: Form VA5 layout with a payment in each record
File Format
Excel
My layout contains the following VA5 Withholding Return fields:
Position
Field
Format
Remove/Add
Up and Down arrows
A For Period Ending Date Required
B Account Number 30 Tax Account Number Required
C FEIN FEIN Required
D Name String (max 40 chars) Required
E Vendor ID Vendor ID Optional
Optional fields are removed by clicking the green " X ".
F Virginia Income Tax Withheld Number Positive Required
G Previous Period(s) Adjustments Number Required
H Adjustment Total Number Required
I Penalty Number Required
J Interest Number Required
K Total Amount Due Number Required
L Bank Routing Number Bank Routing Number Optional
M Bank Account Number Bank Account Number Optional
N Payment Amount Payment Amount Optional
The "One Bank Account" option is described in Step 7d.
The following fields can be added or removed from the active VA5 Withholding Return layout above.
Filler String
To download a sample file using the layout as defined above
View Sample
Filler fields are added by clicking the green "plus" sign.
Create
Cancel



8. If you want to view a **Sample** of your File Layout before creating it, click “View Sample”.
   NOTE: It is OK to use the sample as a template for your own file IF you use your own data in it. You must save the sample to your computer if you plan to use it as your file to Upload and Submit later.
   a. Click “OK” to open the sample.



   b. Click “Open” to finish opening the sample file.
   NOTE: The example message is for the Form VA-5 displayed on the prior page.



Are you using payroll software to prepare VEC files for Excel spreadsheets?

If so, you must download a VEC spreadsheet tool with Macros. This tool is required in order for calculations to process correctly.

   c. If you do not need to use a sample to make a file,
      - Close the Sample File after viewing it.
      - Go to Step 9.
   d. If you do need to use a sample to make a file,
      - Save the file to your computer in a location you can find later.
        NOTE: This is important because you need to remember where the file is located as part of the Upload process. Storing the files in a specific computer folder can help too.
      - Adjust your data accordingly.
        NOTE: Additional details are provided in the next section.

9. From the Web Upload screen, click ‘Create’ to save your File Layout.

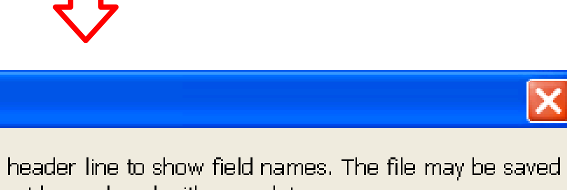
Your Web Upload File

To use Web Upload, your file must be saved on your computer.

The file is either saved from a software package or in-house programming. Or you created a file yourself, mostly likely with the Sample provided during the File Layout process.

When using a Web Upload Sample File, you must remember to:

- Replace the sample data with your own data.
- Delete any remaining rows of sample data.
- Save the updated file.



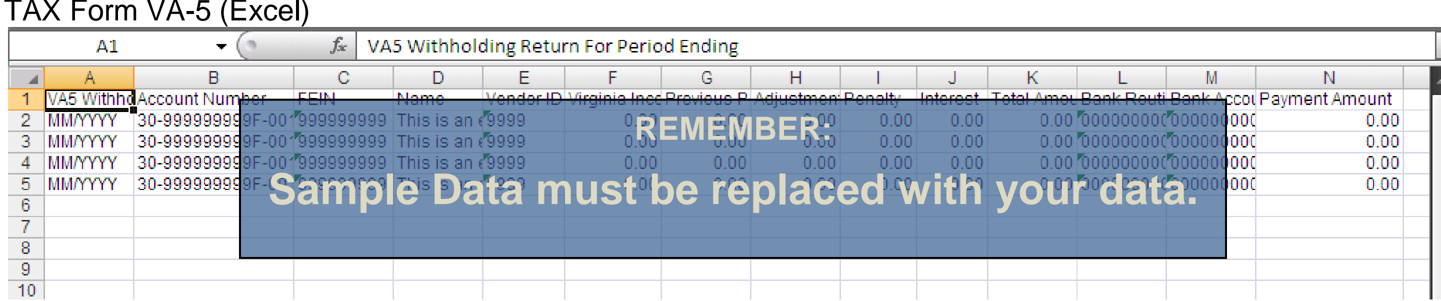
You must format your business tax return file according to the File Formatting specified for the File Layout. NOTE: It's important to pay attention

Each form, regardless of agency, will provide details in the File Formatting area of the File layout as described in the next section of this Guide.

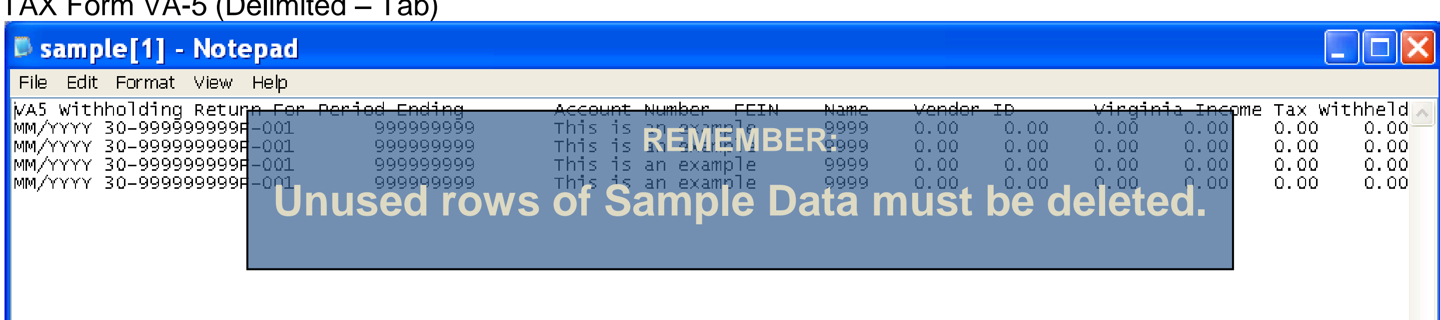
Examples of Form VA-5 Sample Files

REMEMBER: Most, but not all, forms supported by Web Upload will have Sample Files for you to view/use.

TAX Form VA-5 (Excel)



TAX Form VA-5 (Delimited – Tab)



Format a File

The File Layout for each format type has a list of Format details that you will need to review when creating your own file of return/payment information.

1. Click the help icon to display Format details.

2. Review the details for each field.

3. Use the formatting details to update/enter information in your file.
   NOTE: One example is to use these details to replace data in the Sample File on your computer with data for your company or clients' companies.

4. Click 'Close' (on the Format details box) when you are finished.

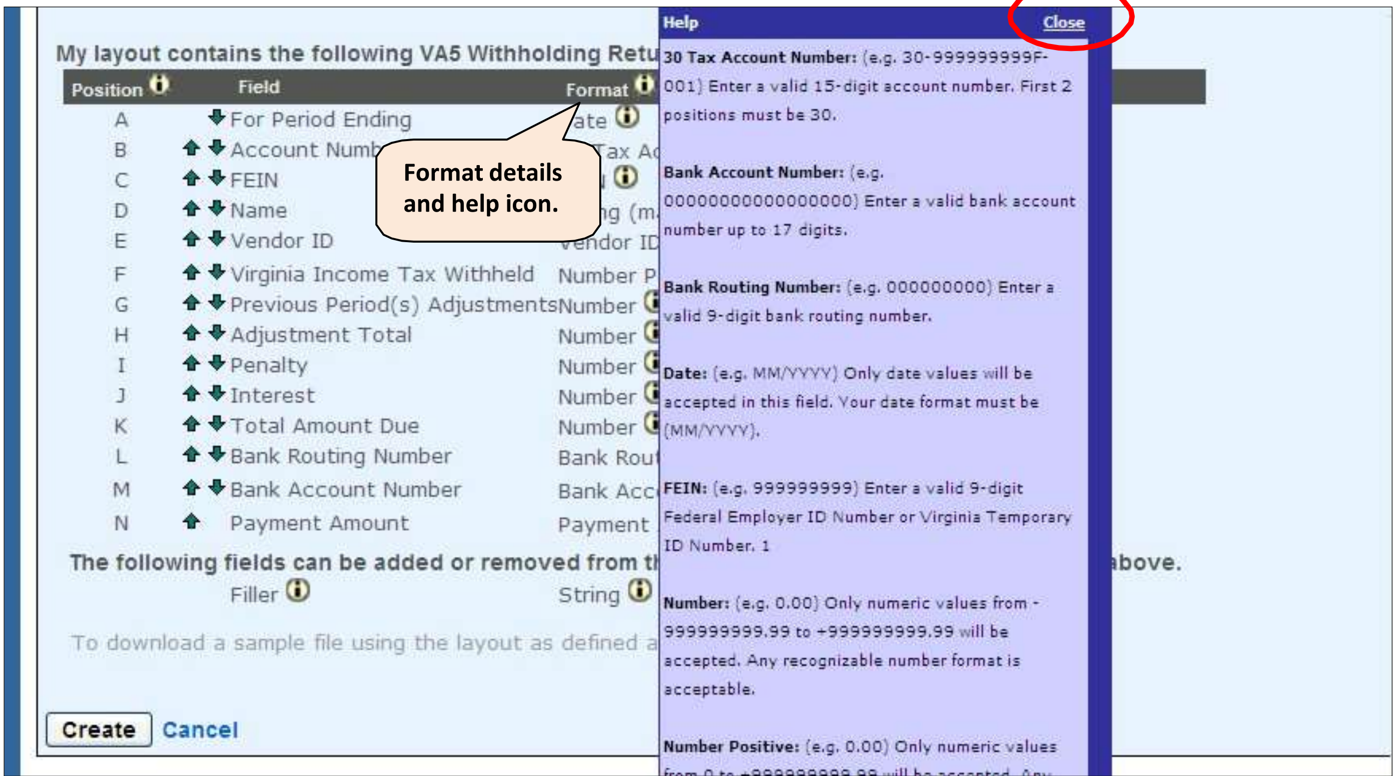
Special Notes:

- All files except, W-2 (EFW2), W2C, 1099-R, 1099-MISC and Schedule VK-1, must include the decimal place when reporting dollars and cents, regardless of the format. Web Upload does not assume decimal place for your return or payment information.

- Forgetting the decimal place when reporting dollars and cents causes inflated and incorrect amounts to be posted to you and/or your client's accounts.

- Files containing payments must be formatted one of two ways: (1) either with separate bank account and payment amount entries in each record or (2) with separate payment amount entries in each record and "One Bank Account" to debit each payment amount. (See Page 13 for additional details.)

This is an example of Form VA-5 with a partial list of Format details shown for a TAX form. Other TAX supported forms and VEC supported forms will display the same type of details.



Edit a File Layout

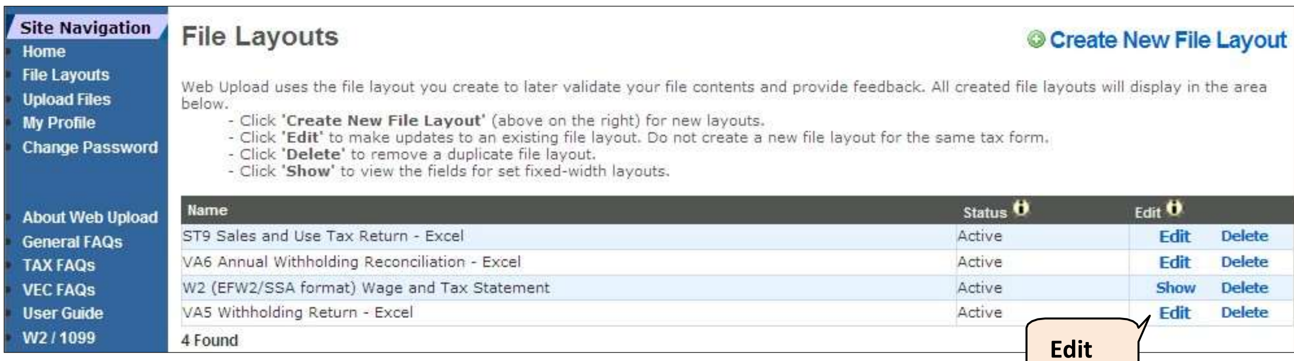
When you need to update your File Layout, edit an existing layout instead of creating a brand new one.

File Layouts can be edited when the status is "Active", meaning all files submitted with that Layout were processed. (Details for submitting files are described later in the Guide.)

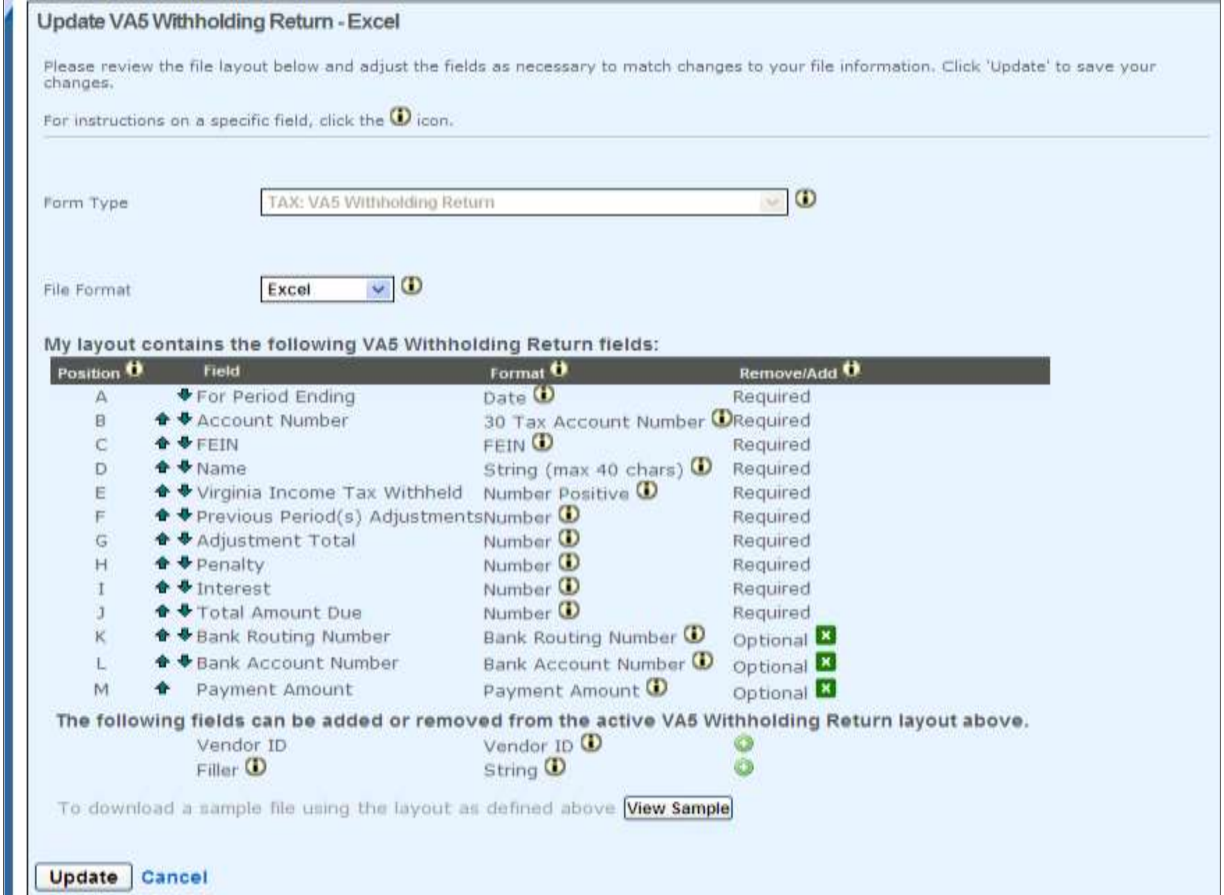
Certain File Layouts cannot be edited, so the option to 'Edit' does not display next to their File Layout:

- W-2 EFW2/SSA – the Layout must match the SSA's EFW2 guidelines
- W-2 Excel – the Layout must match the requirements set by TAX for Excel W-2s
- 1099-R and 1099-MISC – the Layouts must match the formatting set by the IRS's Publication 1220
- FC-20 EFW2/MMREF and ICESA Quarterly SUI – the layouts must match the requirements set by VEC

1. Click 'File Layouts' located on the Site Navigation Bar.
   NOTE: All saved File Layouts will appear on this page.

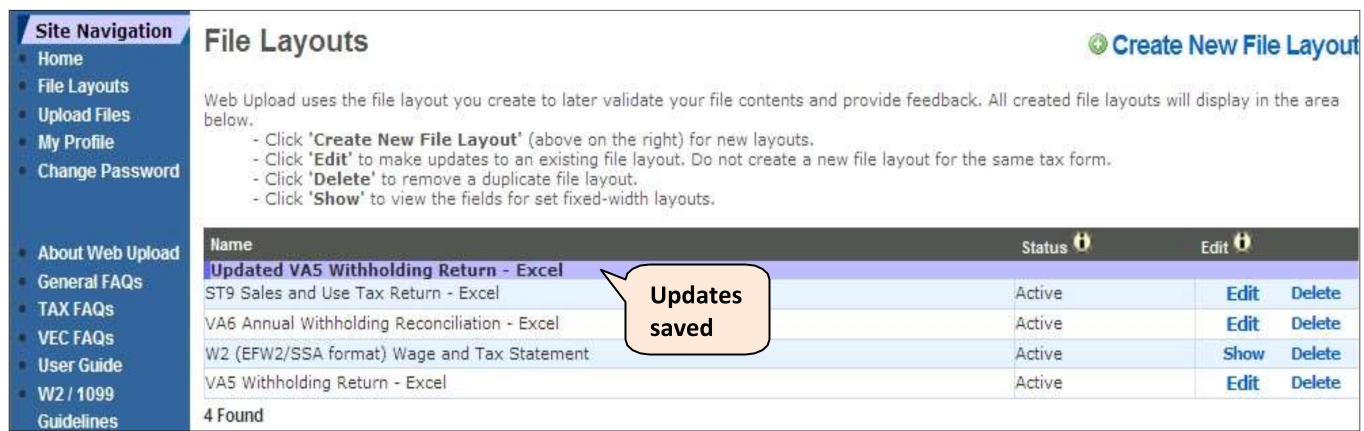


2. Click 'Edit' to make updates.
   NOTE: This page mimics the "Create File Layouts" Page, except for the page title and the 'Update' button.



3. Change your File Layout as needed.
   NOTE: You can edit the File Format (delimited/excel/fixed-width) and add/delete/re-order the form fields. Your file MUST also reflect the change(s) to made to the File Layout in Web Upload.

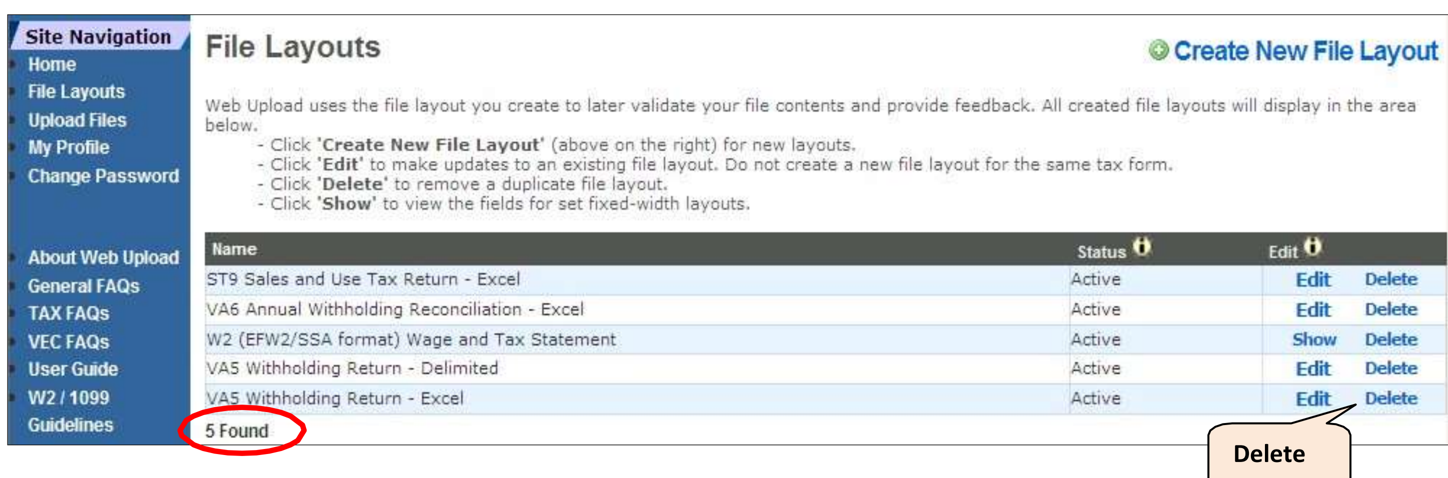
4. Click 'Update' to save your changes.



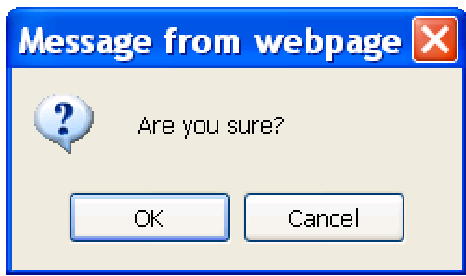
Delete a File Layout

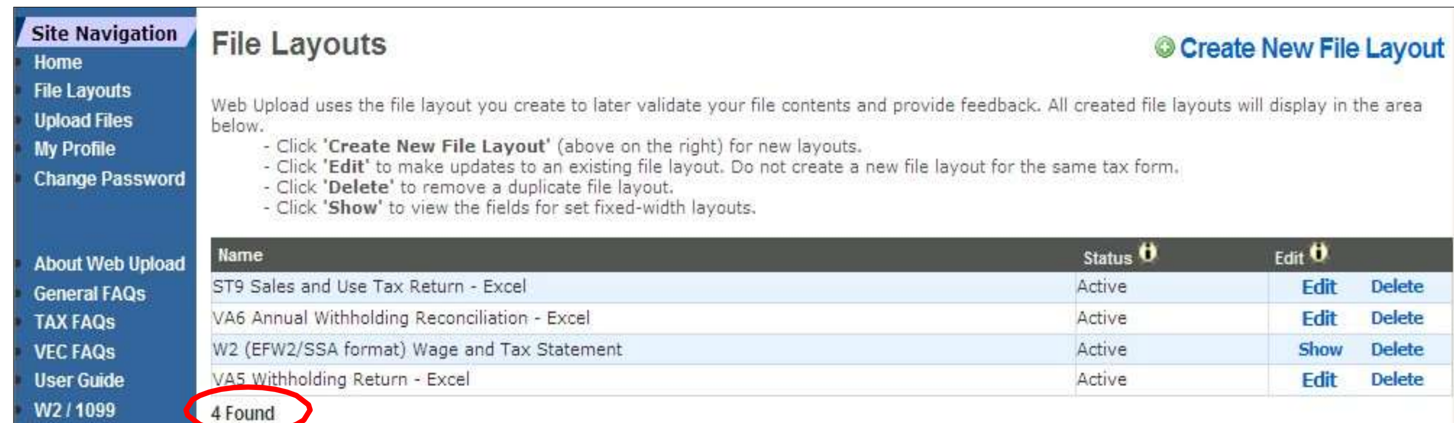
You can delete a duplicate File Layout, when all files using that Layout have been processed.

1. Click 'File Layouts' located on the Site Navigation Bar.
   NOTE: All saved File Layouts will appear on this page.



2. Click 'Delete' next to the File Layout.
   a. Click 'OK' if you want to delete the Layout.
   b. Click 'Cancel' if you do not want to delete the Layout.



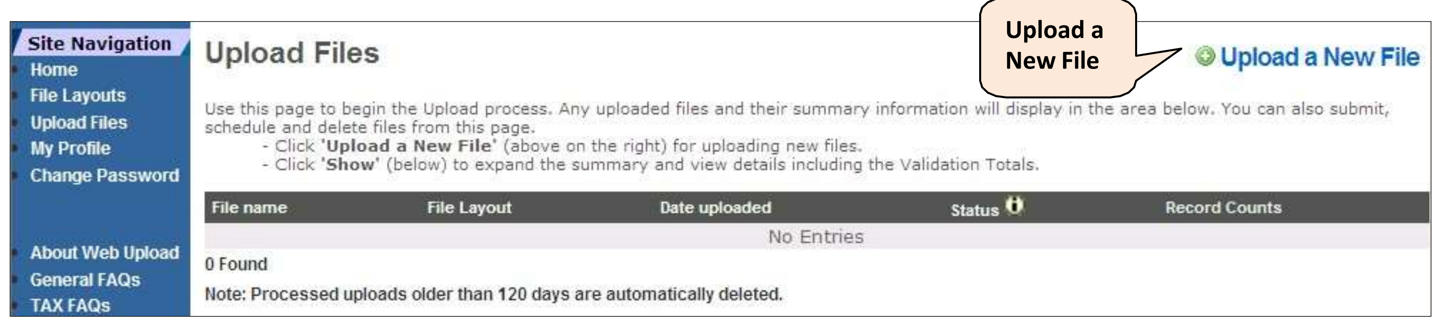


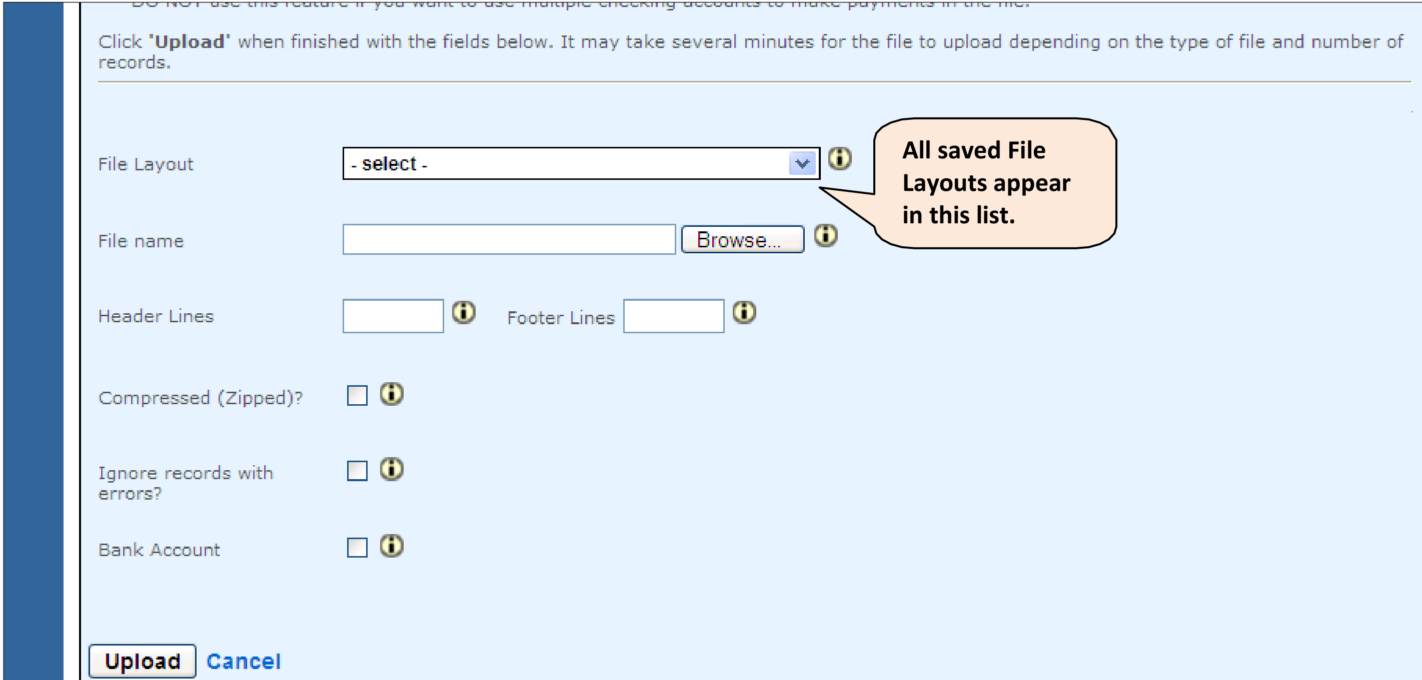
Upload a File

After creating your File Layout, the next step in Web Upload is to upload your file.

1. Click 'Upload Files' located on the Site Navigation Bar.

2. Click 'Upload a New File'.
   NOTE: If you try to upload a file before creating a File Layout, Web Upload will display a message stating you must create a File Layout and the system will not let you upload any files until you have created one.





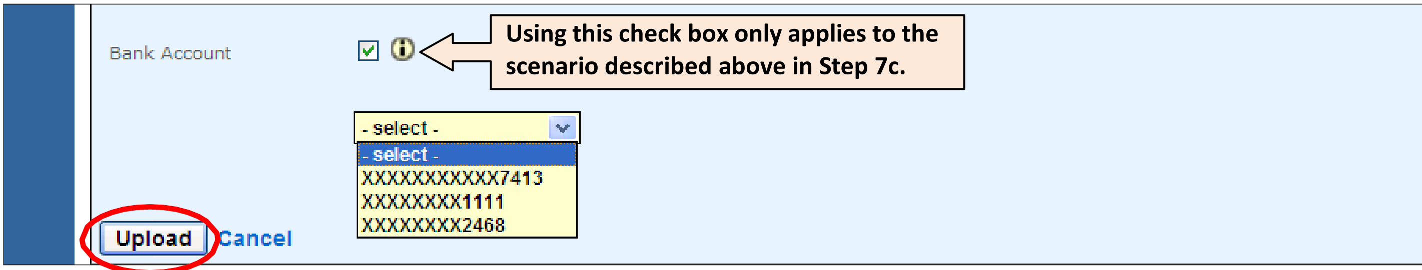
3. Select the File Layout you created from the "File Layout" drop down box.

4. Click 'Browse' to locate your file on your computer.
   NOTE: The file to be uploaded resides on your computer. You may have used a Sample File with your data saved in it, or you may have used a file created by in-house programming or software.

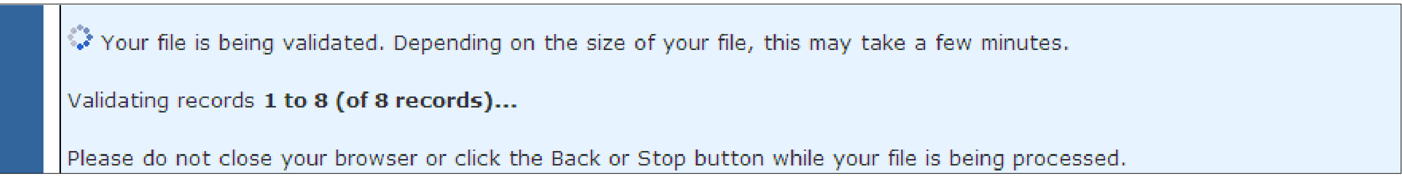
5. Select your file from the displayed list.
   NOTE: You may need to double click on the file to select it.

6. Enter the number of "Header" and/or "Footer" lines included in your file, as applicable.
   NOTE: This refers to ignoring rows of data in a file, like the names of the return fields instead of actual return/payment data. These fields are most commonly used when a Web Upload Sample File is used to create a file and with most files prepared by software packages.

7. Review the (conditional) Upload check boxes and mark as applicable.
    a. If your file has been compressed to zip-format using compression software, mark the box for "Compressed (Zipped)" files.
    b. If you want your valid records processed and your error records ignored, mark the "Ignore records with errors" check box.
       NOTE: It is recommended to leave this check box blank, in order to address correcting the errors.
    c. If you want to use the "(One) Bank Account" option to make payments for all records in the file,
        1. Mark the "Bank Account" check box.
        2. Select the checking account from the drop down box.
           NOTE: This option is only available when you save checking account information in your Profile and have the Payment Amount field in your File Layout. You must also have the Payment Amount field designated in your file with an amount for each record.



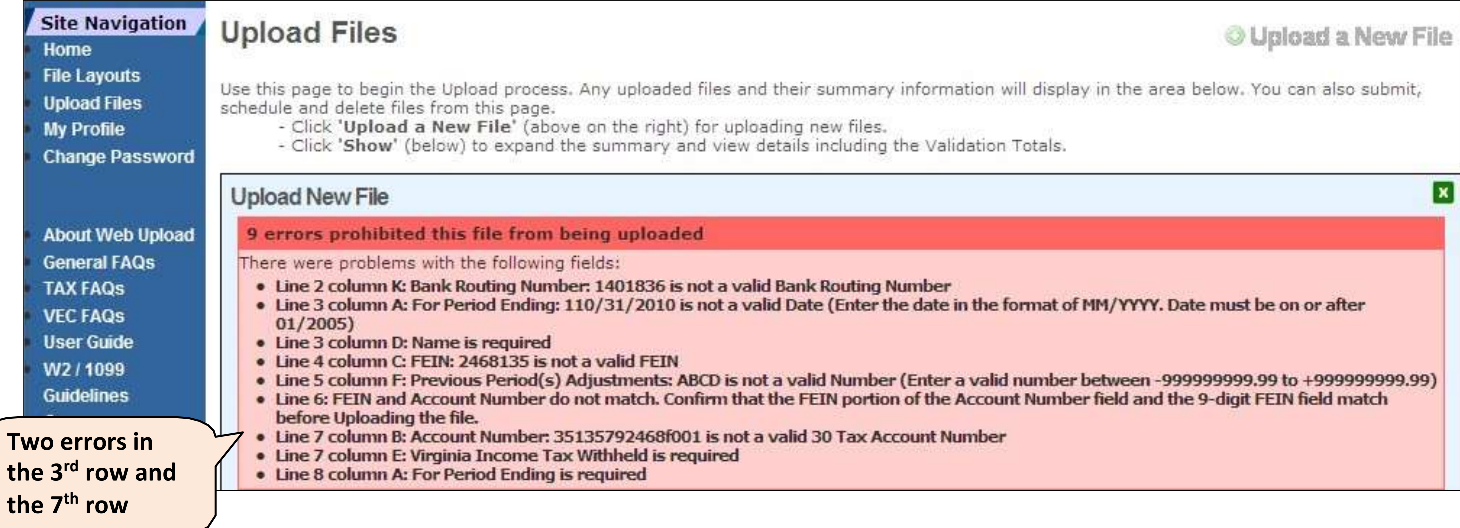
8. Click 'Upload' and wait until the file is fully uploaded before taking other actions.



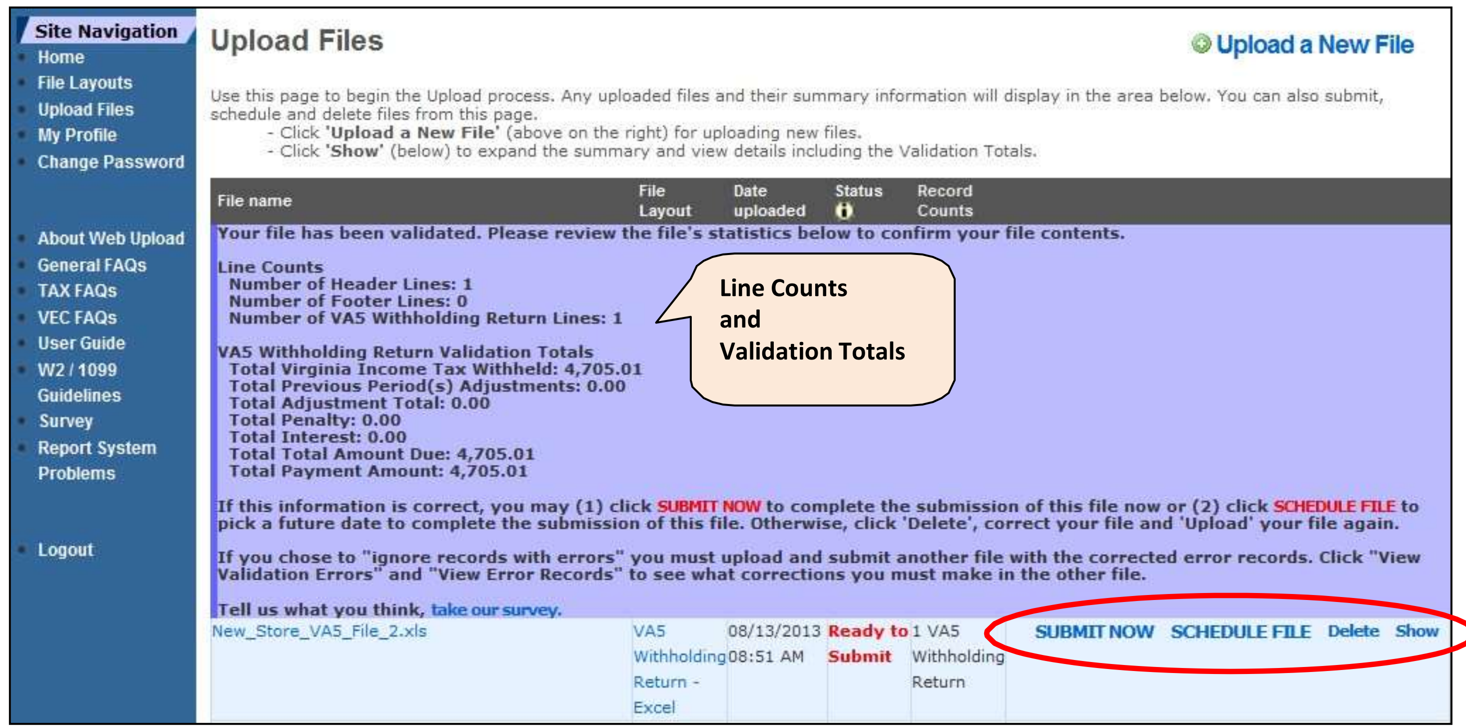
9. Review the results of your Upload at the top of the page:
    - Your file has been validated **OR**
    - Errors prohibited this file from being uploaded

10. If there are no errors reported, go to Step 12.

11. If there are errors in your file (as displayed in the red box below),
    a. Correct your records in your file according to the error message(s).
       NOTE: Web Upload lists each error separately by the line number. A record can have more than one error to correct.
    b. Repeat Steps 1 – 9 until no errors are reported.



12. Verify that the information in “Line Counts” and “Validation Totals” is correct.
    NOTE: The “Upload Files” page reflects statistics that enable you to confirm that the file contents were uploaded correctly. It is important to review these statistics before taking further action.



Submit Uploaded Files

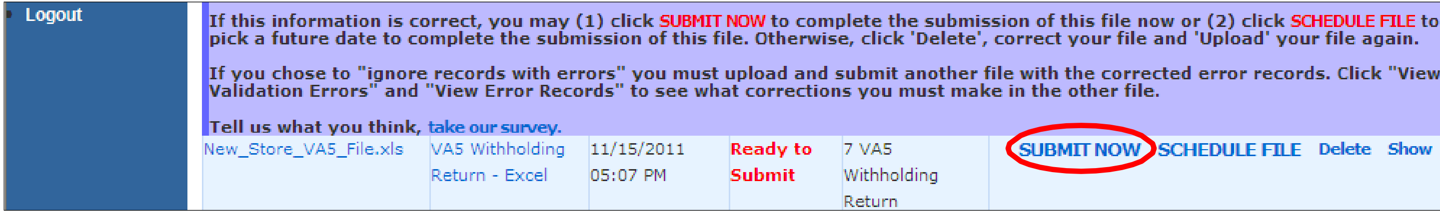
Once your file is validated as successfully uploaded, determine your next action. You have four options to choose from:

- **Submit Now** – submit the entire file immediately to the applicable agency
- **Schedule File** – select a future date to automatically submit the entire file to the applicable agency
- **Delete** – remove the unprocessed file from your Web Upload account
- **Show** – display and review contents of the file counts and totals

Instructions for each of these options are provided. Select your option and follow the process as defined.

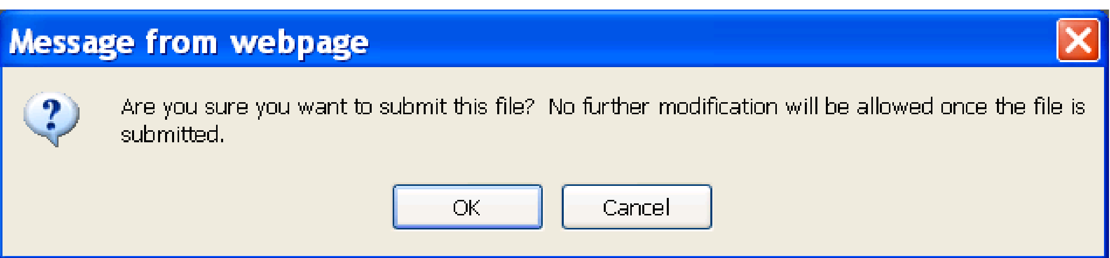
Submit a File

1. If you are ready for Web Upload to process your entire file (return and payment information) now, click 'Submit Now'.



2. If you want to Submit the Uploaded file, click 'OK'.

3. If you do not want to Submit the Uploaded file, click 'Cancel' to stop the process.

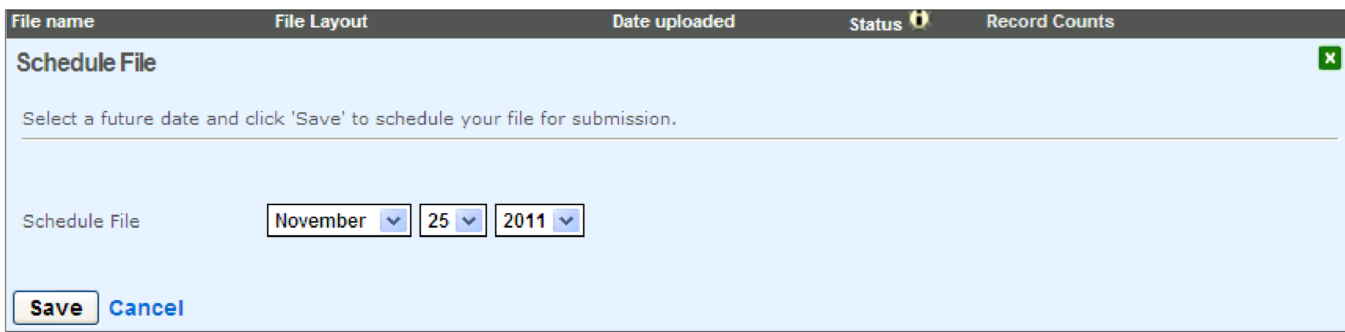


Your file status changes from "Ready to Submit" to "In Process" after you click 'OK'. It will change to "Processed" within 1 – 2 business days. An email confirmation will be sent to you once your file is processed.

4. If you discover incorrect information in your submitted file, submit a paper return to the applicable agency to amend that information.
   NOTE: Amended information is not allowed using Web Upload.

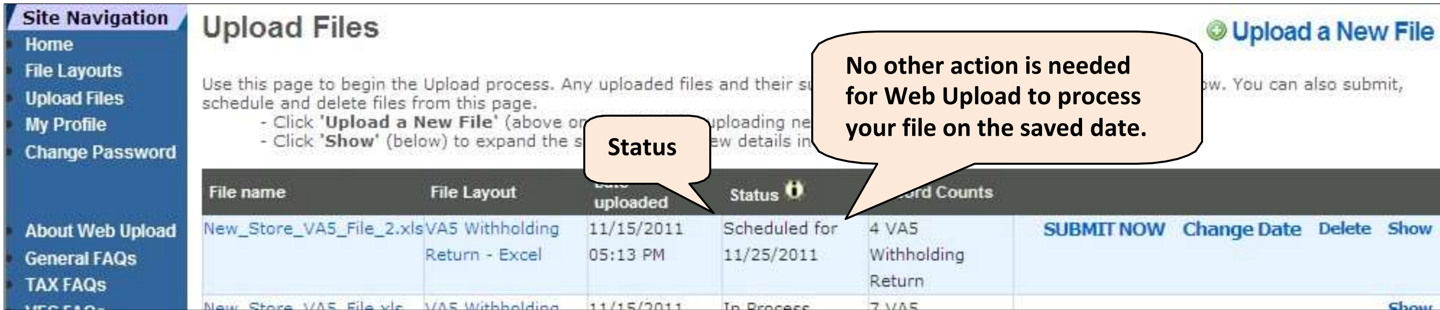
Schedule a File

1. If you want to Submit your file on a future date, click ‘Schedule File’.
   NOTE: This option Submits your **entire** file on the future date of your choosing.



2. Select the month, day and year (up to the due date) from the drop down boxes.

3. Click ‘Save’.
   NOTE: Your file status changes to “Scheduled for MM/DD/YYYY”. It will change to “In Process” on the date you selected. Like all other submitted files, the status will change to “Processed” within 1 – 2 business days and an email confirmation will be sent to you.



4. If you decide you want to Submit the Scheduled file immediately, click ‘Submit Now’.

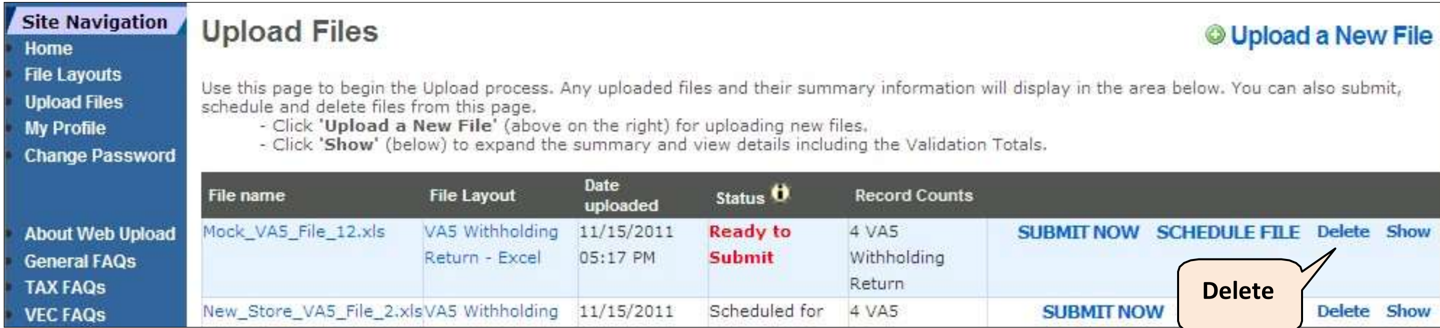
5. If you want to change the date of a Scheduled file,
   a. Click ‘Change Date’.
   b. Repeat Steps 2 and 3.

Delete a File

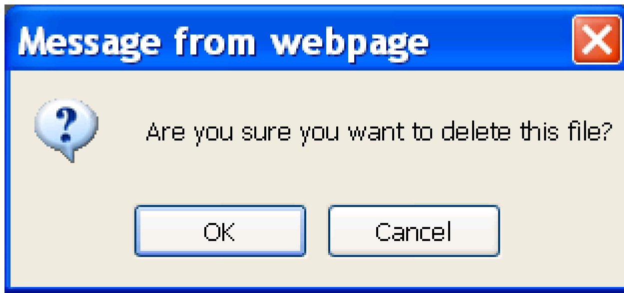
You cannot delete a Submitted file. However, Uploaded files can be deleted when the Status is as follows:

- “Ready to Submit”
- “Scheduled for MM/DD/YYYY”

1. Click ‘Upload Files’.



2. Click ‘Delete’.



3. If you want to delete the Uploaded file, click ‘OK’.
   NOTE: The file will be deleted and no longer appear on the Upload Files Page.

4. If you do not want to delete the Uploaded file, click ‘Cancel’.
   NOTE: Your file will remain in the “Ready to Submit” or “Scheduled for MM/DD/YYYY” status until you take action.

Show (a File entry)

The “Show” file function expands the “Upload Files” Page to display the overview for your file.

1. Click ‘Upload Files’.

2. Click ‘Show’.
   NOTE: You can click ‘Show’ for any file regardless of the status.

Site Navigation
- Home
- File Layouts
- Upload Files
- My Profile
- Change Password
- About Web Upload
- General FAQs
- TAX FAQs
- VEC FAQs
- User Guide
- W2 / 1099 Guidelines
- Survey
- Report System Problems
- Logout

Upload Files

Upload a New File

Use this page to begin the Upload process. Any uploaded files and their summary information will display in the area below. You can also submit, schedule and delete files from this page.
- Click **'Upload a New File'** (above on the right) for uploading new files.
- Click **'Show'** (below) to expand the summary and view details including the Validation Totals.

Show Upload File

File Layout	ST9 Sales and Use Tax Return (For periods prior to 07/2013) - Excel
File name	ST9_Mock_File11.xls
	View Validation Totals
Date uploaded	08/13/2013 08:36 AM
Date submitted	-
Status	Ready to Submit
Header Lines	1
Footer Lines	0
Record Counts	3 ST9 Sales and Use Tax Return
Ignored Records	0

Close

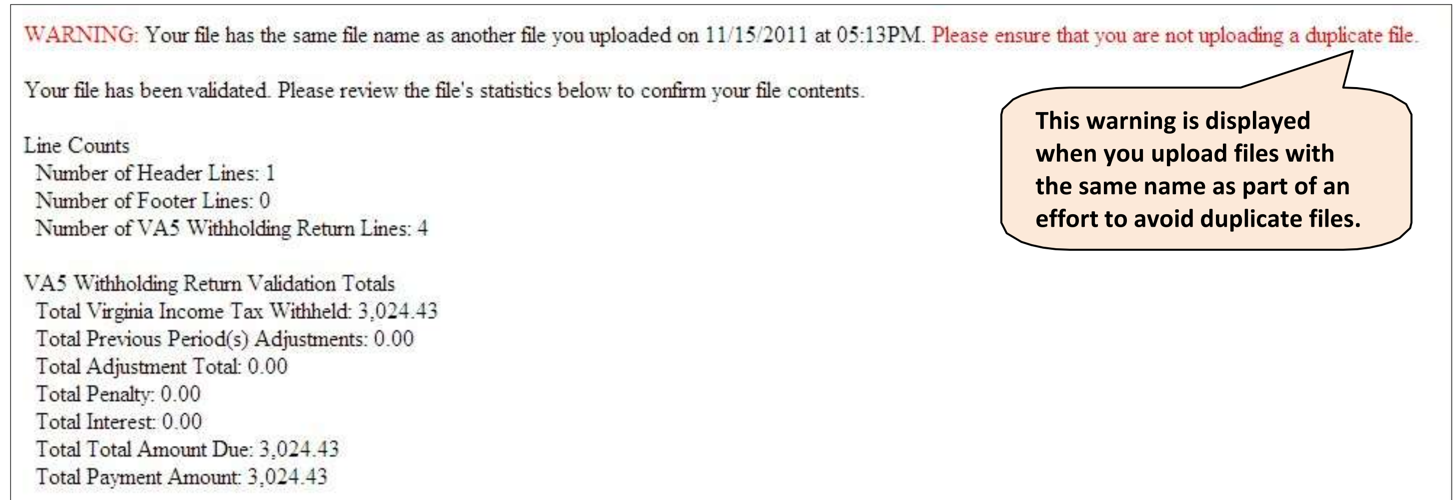
File name	File Layout	Date uploaded	Status	Record Counts				
Mock_VA5_File_12.xls	VA5 Withholding Return - Excel	08/13/2013 08:36 AM	Ready to Submit	1 VA5 Withholding Return	SUBMIT NOW	SCHEDULE FILE	Delete	Show
New_Store_VA5_File_2.xls	VA5 Withholding Return - Excel	08/13/2013 08:35 AM	Ready to Submit	1 VA5 Withholding Return	SUBMIT NOW	SCHEDULE FILE	Delete	Show

Validation Totals

The “ X “ Collapses the screen.

Show

3. If you want to view your file totals, click ‘View Validation Totals’ to open a separate window.

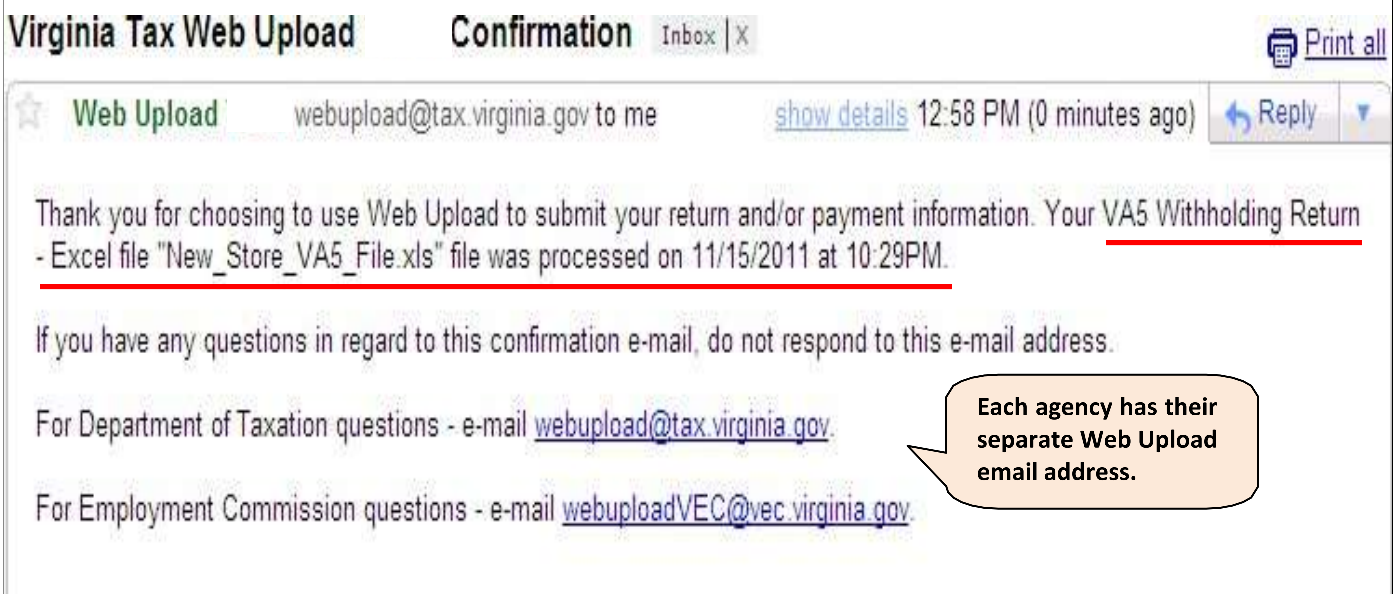


Confirmation Email

After you Submit a File and the status changes to “Processed”, Web Upload sends an automated confirmation email to the email address you use to log into the system.

Each submitted file will receive a corresponding confirmation email within 1 – 2 business days of submission. Confirmations are sent Monday morning for files submitted Friday evening/over the weekend.

The confirmation email will reference the Form Type and Date and Time, it was processed.

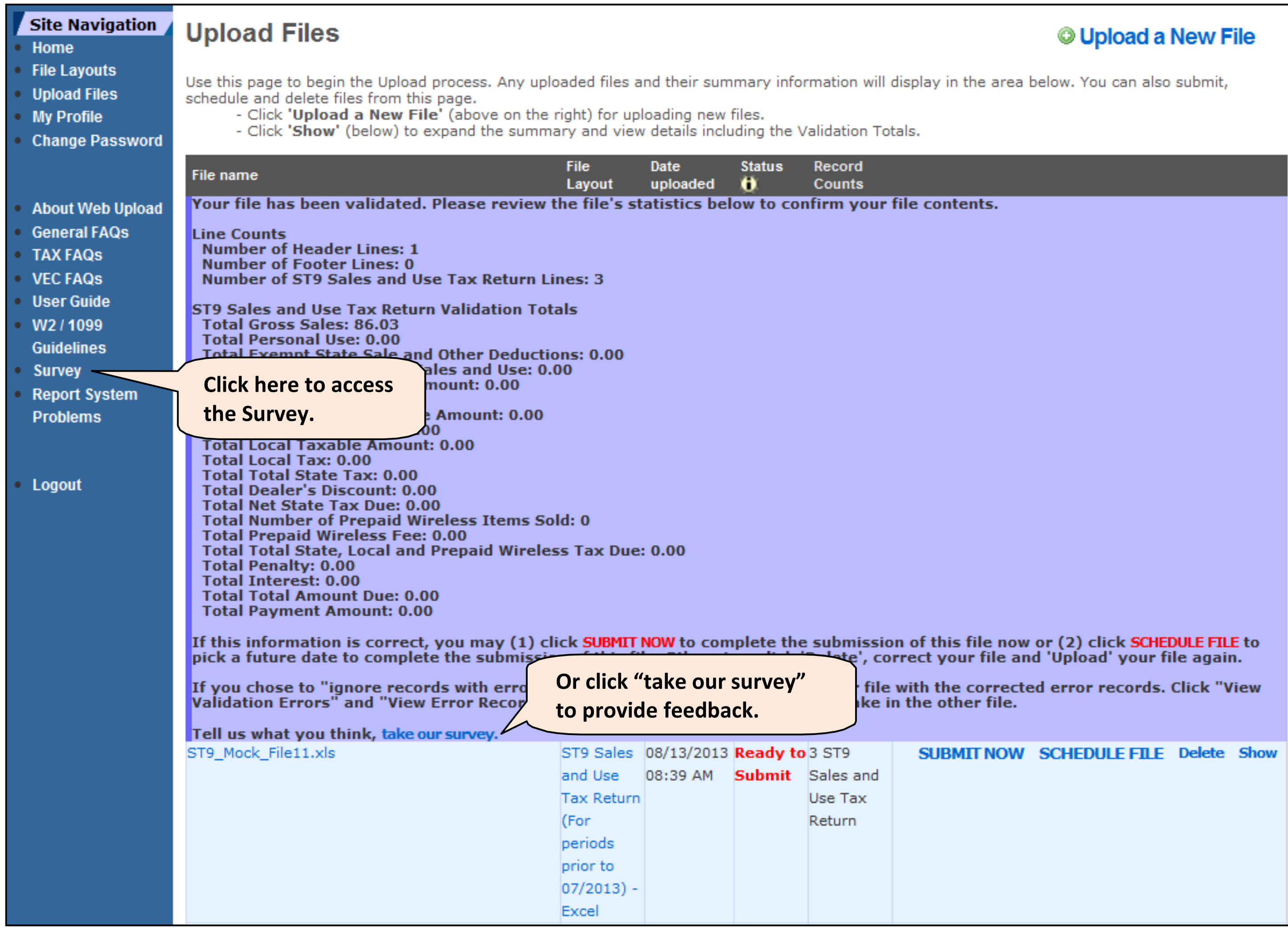


Web Upload Survey (Optional)

Once you finish uploading/submitting your files, please take a moment to complete the Web Upload Survey. TAX and VEC want to hear your feedback on the system.

The Survey can be accessed by clicking 'Survey' on the Site Navigation Bar or by clicking 'take our survey' as displayed below.

Your feedback is very important to us as it helps us in making the system more efficient and user friendly. You may leave your contact information with the Survey or remain anonymous if you prefer.



Questions and Support

If you have any questions while using Web Upload, you can click on the ⓘ icons located throughout the system. It will provide you with specific help and instructions.

These resources are also available for you online:

- Web Upload General Information Page
- Web Upload General FAQs
- Web Upload TAX FAQs
- Web Upload VEC FAQs
- Web Upload VEC Reporting Options Page

If you have additional questions or need more information regarding Web Upload, contact the applicable agency administrators.

- Virginia Department of Taxation – webupload@TAX.virginia.gov
- Virginia Employment Commission – webuploadVEC@VEC.virginia.gov

DO NOT attach your file or include customer information (SSN, FEIN, etc.) in your email as these email boxes are not secure for this confidential information.

For TAX return specific information, please visit www.TAX.virginia.gov.

For VEC report specific information, please visit www.VEC.virginia.gov.

DIRECTIVE

Subject: Changes That Allow Certain Trusts and Corporations to be Eligible Partners in a Taxed Partnership
Tax: Partnership Tax
Law: N.C. Gen. Stat. § 105-154.1
Issued By: Personal Taxes Division
Date: October 4, 2023
Revised: **May 16, 2024**
Number: TA-23-1

The following important information is addressed in this directive:

- An explanation of how a provision included in Session Law 2023-134 expanded the list of eligible partners for a partnership that is allowed to elect to be taxed for North Carolina income tax purposes at the partnership level ("Taxed Partnership Election").
- Information on a special provision included in **Session Law 2024-1** that allows an eligible partnership to amend its North Carolina Partnership Income Tax Return ("NC Partnership Tax Return") for tax year 2022 to make the Taxed Partnership Election.
- Important reminders for partnerships that are eligible to make the Taxed Partnership Election for tax year 2022.

Background

Session Law 2023-134 (House Bill 259) became law on October 3, 2023. This legislation included a provision that updates North Carolina's pass-through entity ("PTE") tax to allow certain trusts and corporations to be partners in a Taxed Partnership effective for taxable years beginning on or after January 1, 2022.[1] The purpose of this directive is to provide an overview of this important retroactive change.

Expanded Taxed Partnership Eligibility

Prior to the enactment of Session Law 2023-134, N.C. Gen. Stat. § 105-154.1(a)[2] did not allow a partnership to make the Taxed Partnership Election if it had, at any time during the taxable year, a partner who was not one of the following:

(1) An individual.
(2) An estate.
(3) A trust described in section 1361(c)(2) of the Code.
(4) An organization described in section 1361(c)(6) of the Code.
(5) A partnership including an entity that is classified as a partnership for federal income tax purposes, or an S Corporation as defined in N.C. Gen. Stat. § 105-131(b).

[1] For more information on North Carolina's pass-through entity tax, see the Department's Important Notice dated April 14, 2022. Terms defined in that notice will also be used in this Directive.
[2] *See* SB 174, s. 1.5.(b); S.L. 2023-12. *See also* the Department's Important Notice dated April 4, 2023.

Newly Qualifying Trust Partner

Session Law 2023-134 rewrote subdivision (3) of N.C. Gen. Stat. § 105-154.1(a) to read as follows:

> (3) Any of the following:
> a. A trust described in section 1361(c)(2) of the Code.
> **b. A trust if such trust does not have as a beneficiary any person other than an individual, an estate, a trust, or an organization described in section 1361(c)(6) of the Code.**
>
> *Emphasis added.*

Because of this modification, additional trusts now qualify as eligible partners for purposes of the Taxed Partnership Election. In particular, a partnership that includes a trust which is not described in Internal Revenue Code ("Code") § 1361(c)(2) is eligible to make the Taxed Partnership Election if the trust does not have as a beneficiary any person other than an individual, an estate, a trust, or an organization described in Code § 1361(c)(6) ("Qualifying Trust Partner").

Because the North Carolina taxable income of a Taxed Partnership is calculated based on the partners listed in N.C. Gen. Stat. §§ 105-154.1(a)(1) through 105-154.1(a)(4), a Taxed Partnership with a Qualifying Trust Partner will include that partner's distributive share in its calculation of North Carolina's PTE tax.[3]

Newly Qualifying Corporate Partner

Session Law 2023-134 also rewrote subdivision (5) of N.C. Gen. Stat. § 105-154.1(a) to read as follows:

> (5) A partnership, including an entity that is classified as a partnership for federal income tax purposes, **or an entity that is classified as a corporation for federal income tax purposes**.
>
> *Emphasis added.*

This modification allows **any** entity classified as a corporation for federal income tax purposes to be an eligible partner for purposes of the Taxed Partnership Election ("Qualifying Corporate Partner"). Under prior law, only an S Corporation was considered an eligible partner.[4]

As mentioned earlier, the taxable income of a Taxed Partnership is calculated based on the partners listed in N.C. Gen. Stat. §§ 105-154.1(a)(1) through 105-154.1(a)(4). Because a Qualifying Corporate Partner is listed under N.C. Gen. Stat. § 105-154.1(a)(5), a Taxed

[3] *See* SB 174, s. 1.5.(c); S.L. 2023-12. *See also* the Department's Important Notice dated April 4, 2023.
[4] *See* SB 174, s. 1.5.(b); S.L. 2023-12. *See also* the Department's Important Notice dated April 4, 2023.

Partnership with a Qualifying Corporate Partner **will NOT** include that partner's distributive share in its calculation of North Carolina's PTE tax.

Extension of Time to Make the Taxed Partnership Election for Tax Year 2022

A partnership that could not make the Taxed Partnership Election for tax year 2022 because the partnership had a partner not listed under subsection (a) of N.C. Gen. Stat. § 105-154.1 as originally enacted[5] can now make the Taxed Partnership Election if all of its partners are listed under N.C. Gen. Stat. § 105-154.1(a) as amended by Session Law 2023-134. Significantly, a partnership that previously filed a NC Partnership Tax Return ("Form D-403") for tax year 2022 can ***only*** make the Taxed Partnership Election if:

- The partnership filed Form D-403 on or before the due date of the return, including extensions, and
- The partnership files an amended return making the Taxed Partnership Election on or before **July 1, 2024**.[6] A Taxed Partnership Election made on an amended return for tax year 2022 filed after **July 1, 2024**, is **NOT** valid.

Important Reminders

The amended return for a Taxed Partnership with a Qualifying Trust Partner must be completed in accordance with the instructions provided in Form D-403A for tax year 2022. However, the amended return for a Taxed Partnership with a Qualifying Corporate Partner must be completed in accordance with the instructions provided in the Department's Important Notice dated April 4, 2023. Moreover, if a partnership files an amended Form D-403 to make the Taxed Partnership Election, the Taxed Partnership must furnish each partner with an updated Form NC K-1 for tax year 2022 if the information originally reported to the partner has changed.

In addition, a partnership that is eligible to make the Taxed Partnership Election for tax year 2022 but has not filed its NC Partnership Tax Return must make the election by the due date of the partnership's return, including extensions. A Taxed Partnership Election on a late-filed NC Partnership Tax Return is not valid.[7]

Future Impacts and Assistance

If you have any questions about this directive, you may call the North Carolina Department of Revenue Customer Service line at 1-877-252-3052 (7:00 am until 4:30 pm EDT, Monday through Friday), or write to Customer Service, PO Box 1168, Raleigh, NC 27602-1168.

To the extent there is any change to a statute or regulation, or new case law subsequent to the date of this directive, this directive may be superseded or voided. To the extent that any provisions in any other notice, directive, technical bulletin, or published guidance regarding the subject of this directive and issued prior to this directive conflict with this directive, the provisions contained in this directive supersede the previous guidance.

[5] *See* SB 105, s. 42.5.(h); S.L. 2021-180.
[6] *See* **SB 508**, s. 11.3.(a); S.L. 2024-1.
[7] *See* the Department's Important Notice dated April 14, 2022.

EQUITY INCENTIVE AND DEFERRED COMPENSATION – OVERVIEW OF STRUCTURE AND PLANNING OPPORTUNITIES

Taylor French
Robert Wynne

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Equity Incentives & Deferred Compensation

- Equity Incentives for Corporations
  - Restricted Stock
  - Nonqualified Stock Options
  - Incentive Stock Options
  - Employee Stock Purchase Plan
  - Qualified Equity Grants
  - Phantom Stock/Stock Appreciation Rights (SARs)
- Equity Incentives for Partnerships/LLCs
  - Nonqualified Stock Options
  - Restricted Capital Interests
  - Profits Interests
  - Phantom equity/SARs
- Deferred Compensation
  - Eligibility
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  - Limitations / Allocations / Variation
  - Hypothetical Investment of Plan Assets
  - Vesting
  - Distributions
  - Funding / Administration
  - Federal Tax Laws

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Equity Incentives for Corporations

Restricted Stock

Restricted Stock

- Involves the issuance of shares to, or purchase of shares by, an employee or other service provider.
- The service provider becomes a stockholder as of the date of grant/purchase.
- The stock received or purchased is nontransferable and subject to a substantial risk of forfeiture until applicable vesting conditions are met.
- Vesting may be conditioned on continued service or performance goal achievement.

Tax Consequences

- FMV of the stock over the price paid by the service provider (if any) is included in the service provider's income (ordinary income) in the first taxable year in which the stock is vested or becomes transferable.
- The service provider has the ability to make a special election (Section 83(b) election) to include the FMV of the stock at grant/purchase in income (ordinary income).
- Issuer has a compensation deduction at the same time and in the same amount.

Use as a Management Incentive

- Because restricted stock is subject to ordinary income tax at vesting (or at grant/purchase, if 83(b) election), when stock may still be illiquid, it is mostly used when the value of the stock at grant is low.
- Restricted stock can be purchased via a promissory note that can be paid back or forgiven over time.
- When coupled with an 83(b) election, the grant or purchase of restricted stock with a low fair market value can be a tax-efficient compensation tool.

Stock Options

Nonqualified Stock Options

- The service provider has a contractual right to purchase stock at a specified exercise price.
- The recipient is not a stockholder until exercise.
- The option's value is determined by the amount the stock's value increases over the exercise price.
- Vesting may be conditioned on continued service or performance goal achievement.
- Exercise price must not be less than the FMV of the underlying shares on the date of grant, using reasonable valuation method.
- Option must be granted on eligible stock – common stock of employer or direct/indirect parent of employer (but not of subsidiary of employer or brother sister).
- Generally cannot be modified or extended after grant date.

Tax Consequences

- Upon exercise, the service provider recognizes ordinary income equal to the difference between the FMV of the shares and the exercise price (the spread).
- Issuer has a compensation deduction at the same time and in the same amount.

Cons

- Although not tax efficient, and with some additional costs to obtain a valuation to set the exercise price, because they allow employees to defer tax until exercise upon a liquidity event, nonstatutory stock options are a very common way of incentivizing management in private corporations.

Stock Options

Incentive Stock Options

- Similar to nonqualified stock options, but qualify for favorable tax treatment if certain conditions are met, including:
  - Must be granted to employees only, under a plan approved by shareholders (the plan's term cannot exceed 10 years),
  - Have an exercise at least equal to FMV of the underlying stock as of grant (110% in the case of a 10% owners),
  - Have an exercise period of 10 years or less (5 years for 10% owners),
  - Must be exercised during or shortly after end of employment;
  - Cannot dispose of shares acquired within 2 years following the date of grant or 1 year following the date of exercise, and
  - Subject to $100,000 limitation.

Tax Consequences

- Employee recognizes no income at exercise – unless AMT applies.
- At sale after holding period ends, any gain over exercise price is capital gain.
- At sale before holding period ends (disqualifying disposition), compensation income equal to spread at exercise; any additional gain/loss is capital gain/loss.
- Employer does not get a compensation deduction unless there is a disqualifying disposition.

Use as a Management Incentive

- Because gain from exercise of incentive stock options is included for AMT purposes and because there is no deduction to the company (unless there is a disqualifying disposition), incentive stock options have fallen out of favor.
- However they can still provide a tax-efficient incentive for employees who are not expected to be subject to AMT.

Stock Options

Employee Stock Purchase Plan

- Similar to incentive stock options, but with certain differences including:
  - Cannot be granted to 5% of more shareholder.
  - Must be granted to all employees of the participating corporation (with certain limited exceptions).
  - All employees must have same rights and privileges.
  - Exercise price cannot be less than 85% of the FMV of the stock at the time the option is granted OR the time the option is exercised.
  - Limited terms (5 years or 27 months, depending on when exercise price is determined).
  - Subject to $25,000 limit.

Tax Consequences

- Similar to incentive stock options, except additional compensation income is recognized at time of sale where exercise price is between 85% and 100% of FMV of stock at grant.

Use as a Management Incentive

- Because an ESPP must be made available to substantially all employees, it is unusual for privately held companies to employ ESPPs as a management incentive.
- In certain cases (e.g., large privately held companies with procedures in place for regularly valuing their stock), an ESPP can provide a tax-efficient means of encouraging share ownership for all employees.

Phantom Stock / SARs

Phantom Stock / SARs

- Phantom stock (a/k/a restricted stock units (RSUs) = a contractual right to receive a payment in the form of stock or cash equal to the value of a share of stock in the future.
- Stock Appreciation Right (SAR) = a contractual right to receive a payment in the form of stock or cash equal to the appreciation in value of a share of stock in the future.
- Vesting may be conditioned on continued service or performance goal achievement.
- Vesting may occur before settlement (i.e., payment) without incurring an income tax liability.
- Must be structured to comply with (or be exempt from) nonqualified deferred compensation rules under Section 409A.

Tax Consequences

- The service provider is not taxed (for income tax purposes) until settlement, even though vesting may have occurred in a prior tax year; however FICA tax may apply at vesting.
- Income tax rate at settlement is ordinary income.
- Employer has a compensation deduction at the same time and in the same amount.

Use as a Management Incentive

- Though tax inefficient, phantom stock arrangements are common where employers wish to provide employees with the right to receive the full economic value of a share of stock (rather than just the appreciation in value), but are unable or unwilling to use restricted stock.
- Though less flexible than nonstatutory options, SARs may be used in circumstances where employees wish to grant an appreciation-only award but do not wish to obtain a Section 409A valuation or give the employee the right to acquire shares.

Qualified Equity Grants

- **New Section added to Code Section 83**: Aimed at privately held corporations (LLCs taxed as partnerships excluded).
- **Delays tax on exercise of options / RSUs to earliest of**:
  - Stock becoming transferable;
  - Becoming an excluded employee;
  - IPO;
  - 5 years after exercise / settlement; or
  - Date employee revokes deferral election.
- **Qualified Stock**:
  - Received in connection of exercise of option / settlement of RSU.
  - Award granted for services.
  - Cash settled awards excluded.
- **Eligible Corporation**:
  - Not publicly-traded.
  - Written plan grants awards to 80% of US employees each year.
  - Awards must have same rights & privileges.
- **Excluded Employees**:
  - 1% owners (currently or during 10 years prior).
  - Is or was CEO, CFO, one of 4 highest compensated officers (currently or during 10 years prior).
- **Tax Deferral Election**:
  - 30 days after rights in stock are transferable or not subject to a substantial risk of forfeiture (if earlier).
- **Use as a Management Incentive**
  - Because of the recent enactment of Section 83(i) and the absence of IRS regulations or other general guidance, and given the limitations on qualified employees and the requirement that at least 80% of employees be offered at least a de minimis amount of qualified stock, few employers have utilized Section 83(i) as a management incentive so far.

Equity Incentives for Partnerships/LLCs

Profits Interests

Profits Interests

- Partnerships only; includes LLCs taxed as partnerships.
- The recipient has an equity interest in a portion of company profits that exceed a specified threshold.
- Threshold must not be less than the liquidation value of the company on the date of grant.
- The recipient is a partner/member as of the date of grant.
- The profits interest's value is determined by the amount by which profits exceed the threshold.
- Vesting conditions may be attached to the profits interest award.

Tax Consequences

- The service provider is not taxed at grant or vesting of the profits interest and is taxed at capital gains rates on disposition.
- The service provider may incur taxable income in connection with his or her distributable share of the partnership's profits allocable to his or her interest (vested or nonvested).
- Service provider generally must be treated for purposes relating to compensation reporting, employment taxes, tax withholding and benefit plan participation as a self-employed individual rather than an employee.

Use as a Management Incentive

- Because of their tax efficiency, profits interest are a common way of incentivizing management of an LLC or partnership.
- However, because recipients of a profits interest may need to be treated as self-employed for tax and benefits purposes, profits interests are generally granted to more sophisticated members of management.

Deferred Compensation

Key Plan Design Terms & Features

Eligibility

- Employers have broad discretion to select individuals for plan participation.
  - No tax non-discrimination tests applicable (e.g., Code Section 401(a)(4) / 410(b)).
- However, participation must be limited to a "select group of management or highly compensated employees" to avoid becoming subject to key ERISA requirements.
  - This term is not defined by ERISA, though is generally considered to include C-Suite executives and the top 10% to 15% of an employer's personnel.
  - DOL looks at bargaining power / contends participation by one non-member taints entire plan.
  - Case law varied – relatively few employees / high level employees

Contributions

Defined Contribution Plans

- Employers may:
  - Allow participant elective deferrals from salary, cash bonuses, equity or derivative equity awards.
  - Provide matching contributions on participant deferrals.
  - Provide profit sharing or other employer contributions.
- Elections to contribute:
  - Generally must be made by participants in the year prior to the year in which the compensation is earned (e.g., deferral elections made in preceding calendar year for salary deferrals).
  - Performance-based compensation may be deferred 6 months before the end of the performance period.
- There are special opportunities to make deferral elections for the first year in which the plan is implemented.

Defined Benefit Plans

- Participants received a plan benefit derived from a formula.
- Benefit formulas based on years of service and final average pay are common.

Limitations / Allocations / Variation

- There are no limits on the amount of:
  - Participant elective deferrals;
  - Matching contributions; or
  - Profit sharing or other employer contributions.
- Employers have discretion to:
  - Vary contributions by participant; and
  - Increase or decrease contributions over time (subject to contractual promises to provide specified contributions).
  - No tax-related non-discrimination tests applicable (e.g., ADP / ACP tests).
- Employers may vary defined benefit formulas per participant.

Hypothetical Investment of Plan Assets

- Amounts deferred or contributed to the plan may:
  - Be invested by participants in hypothetical investment funds (e.g., similar to a 401(k) plan);
  - Receive a specified or fluctuating rate or return; or
  - Receive no interest.

Vesting

Employers may attach vesting conditions on:

- Matching contributions;
- Profit sharing or other discretionary contributions; and
- Defined benefit plan benefits.

Participants are generally always 100% vested in any elective deferrals.

Vesting conditions may be:

- Service-based (continued employment); or
- Performance-based (financial or other metrics).

Vesting schedules may:

- Vary by participant (less common); and
- Vary by contribution type (e.g., matching versus profit sharing or other employer contribution).

Vesting may be accelerated:

- By the employer at its discretion; or
- According to specified events (e.g., involuntary termination of employment, death, disability, change of control).

Distributions

Distribution Elections:

- Are made at the time of the deferral election or commencement of plan participation for defined benefit plans; and
- Can be changed, though tax rules require changes to be made at least 1 year prior to the payment date and the payment must be deferred at least 5 years from the original payment date.
  - The result of these re-deferral rules is that participants rarely make changes to their distribution elections.
- Multiple distribution events acceptable (e.g., "earlier of" formulation).
- "Toggle" Rule – Code Section 409A.

Distribution Forms:

- May vary by contribution or be hard-wired into plan terms.
- Lump sums, installments, annuities.

Distribution Events: Employers may allow distributions to occur upon some or all of the following events (many of which have specific definitions under federal tax laws):

- A specified date;
- Termination of employment;
- Death;
- Disability;
- Change of control; and
- Unforeseen emergencies (i.e., hardships).

➢ Distributions also available upon plan termination.

Funding / Administration

Funding: Employers may

- Fund elective deferrals and other contributions via a special type of trust, whose assets remain subject to the claims of the employers creditors (a “rabbi trust”); or
- Keep a bookkeeping account to track plan benefits.
- Plan assets cannot be held outside of the reach of the claims of an employer’s creditors or else participants will incur significant adverse tax consequences.
- Plan funding by non-U.S. entity generally triggers adverse tax consequences – Code Section 457A.

Administration:

- Plans are typically administered by the employer, the Board of Directors, or a selected committee of the Board of Directors.
- Complex plans and plans that provide for hypothetical investments often require third party assistance.

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Federal Tax Laws

Deferred compensation plans are governed by Section 409A of the Internal Revenue Code, which general provides:

- Rules regarding timing of deferral elections;
- Restrictions on payment triggering events;
- Restrictions on accelerating or delaying deferred amounts;
- Significant tax penalties for noncompliance on the plan participant in the form of:
  - A 20% excise tax;
  - Immediate income inclusion (irrespective of whether the deferred amount has been paid); and
  - Potential special interest payments.

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Payroll Taxes

- **FICA Tax – Special Timing Rule**: amounts payable taken into account upon the later of:
  - Date on which services that create the right to payment performed, or
  - Date on which the compensation is no longer subject to a substantial risk of forfeiture.
- **Non-Duplication**: Once taken into account for FICA, not subject to FICA at a later payment date – significant tax savings possible.
  - If Special Timing Rule not followed – amounts subject to FICA upon payment.

Questions or Comments?

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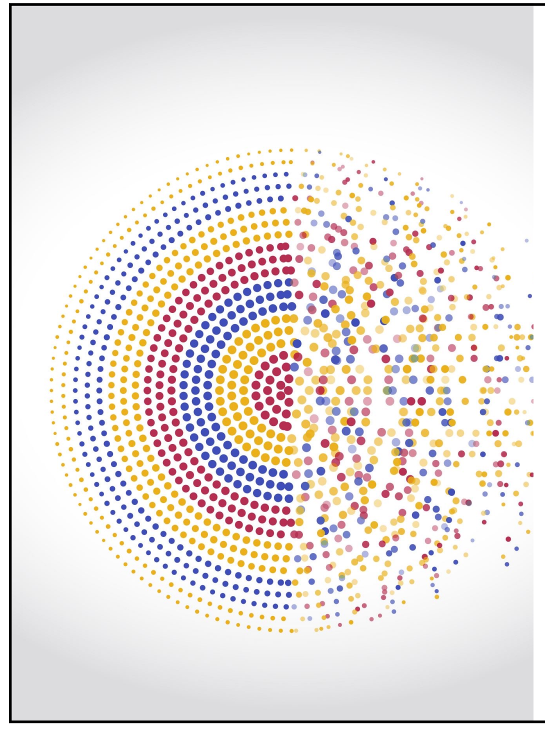

Hot Topics in Tax Practice Ethics

Tiffany L. Burton, Rees Broome, PC

Timothy M. Todd, Liberty University School of Law

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Outline

- Circular 230 Review
- AICPA SSTS Update
- Tax Return Mistakes
- Social Media and Tax Ethics
- Ethics and Technology
- Confidentiality Issues
- Tax Ethics in Times of Uncertainty

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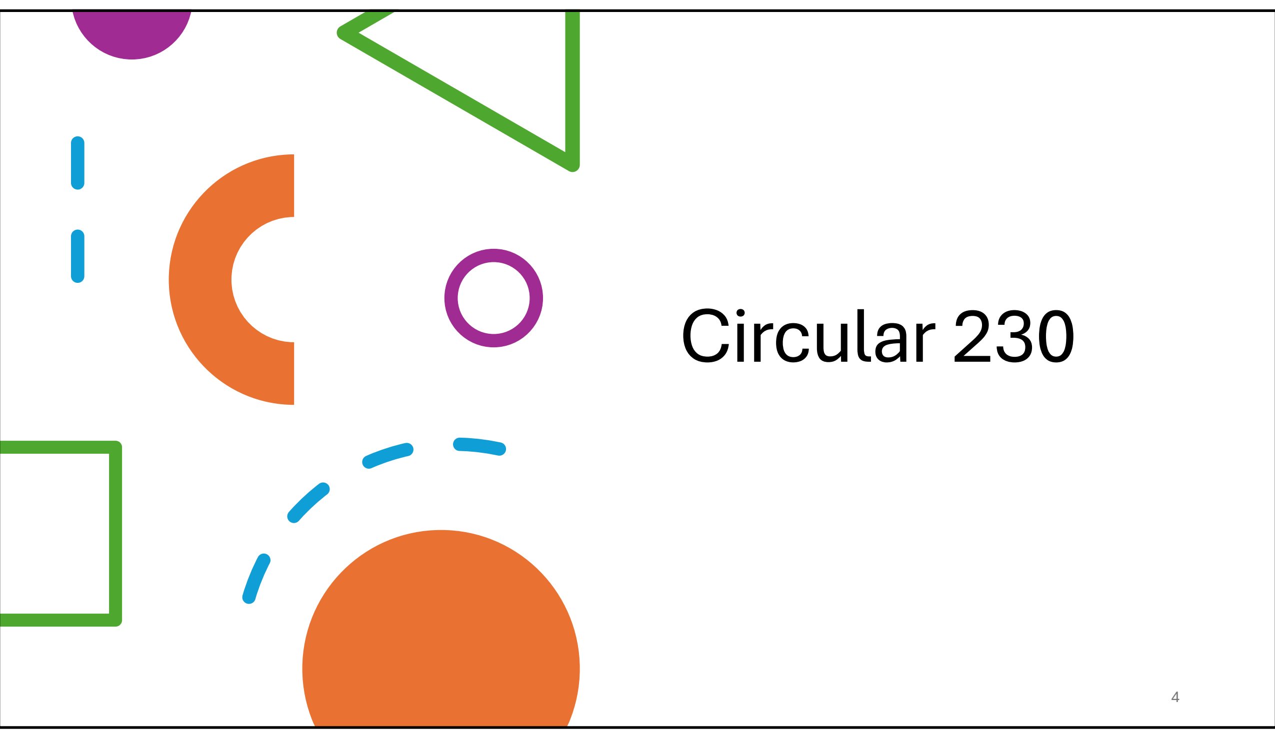

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OPR and Circular 230

- Office of Professional Responsibility
  - https://www.irs.gov/about-irs/the-office-of-professional-responsibility-opr-at-a-glance
  - Interprets and applies tax practice standards
  - Practitioner conduct and discipline standard oversight
- Statutory authority: 31 U.S.C. § 330 (1884)
  - Secretary of the Treasury may "regulate the ***practice*** of representatives of persons before the Department of the Treasury"
  - Allowed to suspend, disbar, and censure, § 330(c)

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"Practice before the IRS"

According to OPR, "practice before the IRS" means:

"'Practice before the IRS' comprehends all matters connected with a presentation to the IRS, or any of its officers or employees, relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to, preparing documents; filing documents; corresponding and communicating with the IRS; rendering oral and written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and representing a client at conferences, hearings and meetings."

https://www.irs.gov/tax-professionals/frequently-asked-questions#OPRQ3

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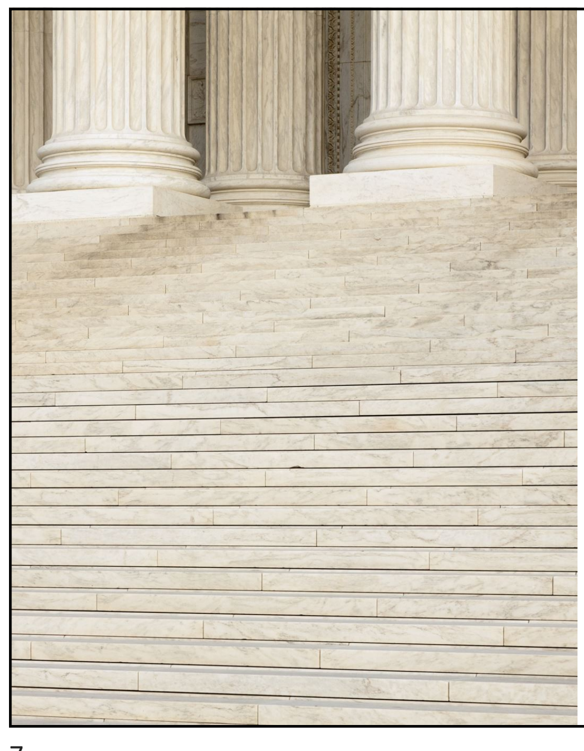

Loving and *Ridgely*

- Two cases decided in 2014 about the scope of *practice* under 31 § 330 (1884)
- *Loving v. IRS* (D.C. Cir., 2014): § 330 did not grant authority to regulate tax-return preparation industry (registered tax return preparer regulations issued in 2011).
- *Ridgely v. Lew* (D.D.C., 2014): § 330 did not provide Secretary authority to regulate “contingent fees” by CPAs in ordinary refund claims

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Circular 230 Highlights

- We will highlight:
  - Competence
  - Diligence
  - Tax return standards
  - Knowledge of error
  - Conflict of interest
  - Technology standards
  - Disreputable conduct

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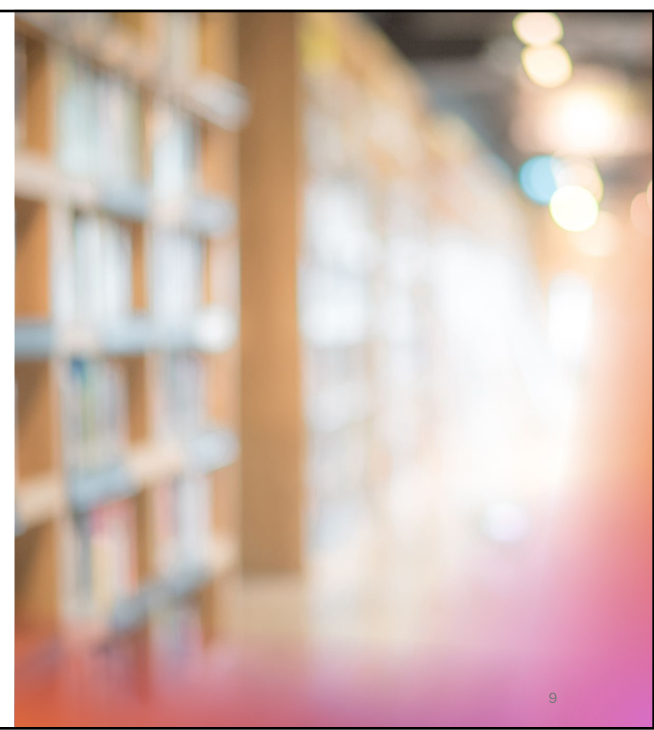
§ 10.35 Competence

(a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

(b) Effective/applicability date. This section is applicable beginning June 12, 2014.



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§ 10.22 Diligence

(a) In general. A practitioner must exercise due diligence —

  (1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

  (2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

  (3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others. Except as modified by §§10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

(c) Effective/applicability date. Paragraph (a) of this section is applicable on September 26, 2007. Paragraph (b) of this section is applicable beginning June 12, 2014.

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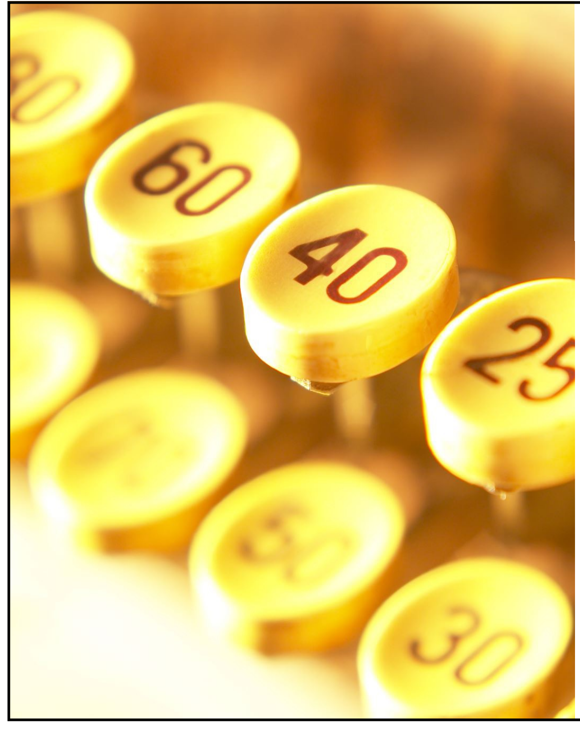

§ 10.34(a) Tax Return Standards

A practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund or advise a client to take a position that —

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in section 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance); or

(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

* * *

It further provides that "[a] pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence." § 10.34(a)(2).

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§ 10.34(b) Documents and Other Papers

(b) Documents, affidavits and other papers —

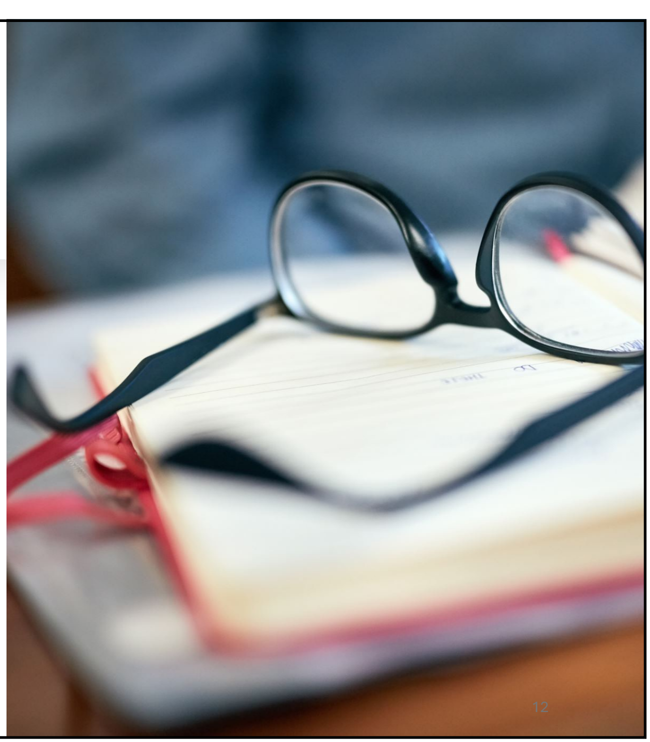
(1)A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2)A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —

(i)The purpose of which is to delay or impede the administration of the Federal tax laws;

(ii) That is frivolous; or

(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.



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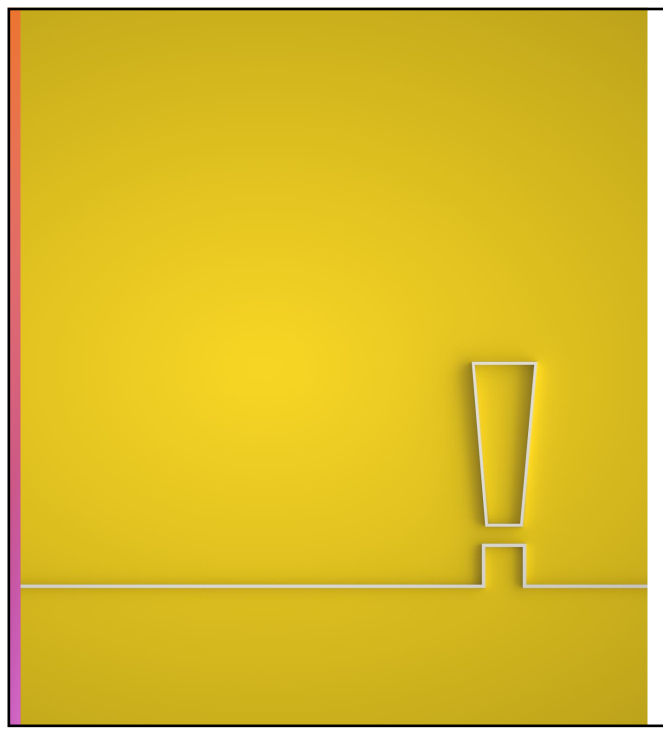

§ 10.34(c) Advise on Potential Penalties

(c) Advising clients on potential penalties —

(1)A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to —

- (i) A position taken on a tax return if —
- (A) The practitioner advised the client with respect to the position; or
- (B) The practitioner prepared or signed the tax return; and
- (ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.

(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

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§ 10.21 Knowledge of Error/Omission

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, **must advise the client promptly of the fact of such noncompliance, error, or omission.** *The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.*

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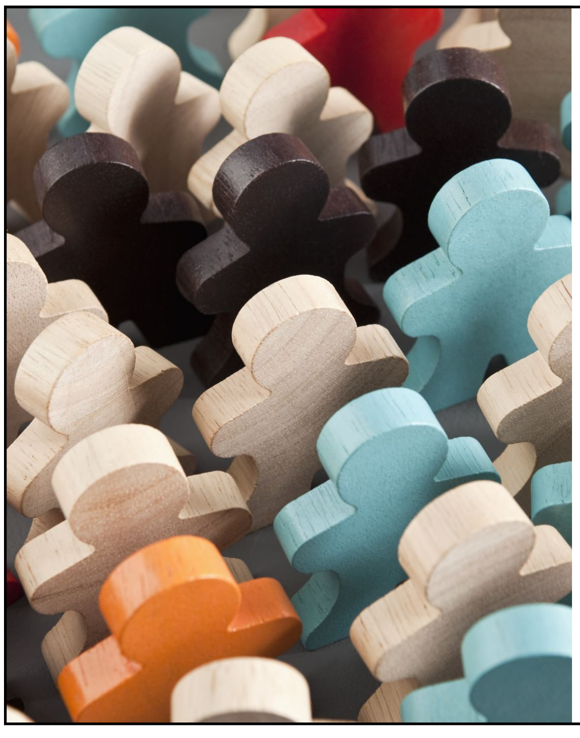

§ 10.29 Conflicting Interests

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

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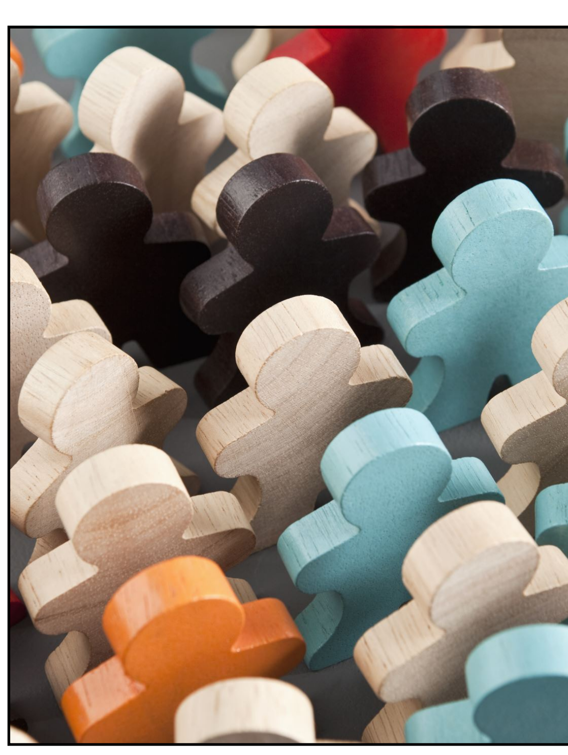

§ 10.29 cont'd

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if —

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law; and

(3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

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§ 10.36 Procedures to Ensure Compliance

(a) Any individual subject to the provisions of this part who has (or individuals who have or share) principal authority and responsibility for overseeing a firm's practice governed by this part, including the provision of advice concerning Federal tax matters and preparation of tax returns, claims for refund, or other documents for submission to the Internal Revenue Service, *must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with subparts A, B, and C of this part, as applicable . . . .*

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§ 10.51 Incompetence and Disreputable Conduct

- Conviction of federal tax law
- Conviction of any criminal offense involving dishonesty/breach of trust
- Conviction of a felony that renders the practitioner unfit
- Giving false or misleading information
- Disbarment or suspension as an attorney, CPA, etc.
- 18 subparagraphs of examples of incompetence and disreputable conduct

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Types of OPR Sanctions/Discipline

- "Soft letter"
- Private reprimand letter
- Censure (public reprimand)
- Suspension of practice
- Disbarment
- Monetary penalties

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SSTS Background

- Statements on Standards of Tax Practice first issued in 2000
  - Most recent update in 2023!
  - The 2023 revisions effective January 1, 2024
  - Apply to:
    - AICPA members who provide tax services and
    - Licensed CPAs in a state that has incorporated/adopted AICPA Code of Professional Conduct (***like Virginia***)
      - Virginia Code Ann. § 54.1-4413.3:

        Persons using the CPA title in Virginia and firms providing attest services, compilation services, or financial statement preparation services to persons or entities located in Virginia shall conform to the following standards of conduct and practice.

        . . .

        4. Follow the Code of Professional Conduct, and the related interpretive guidance, issued by the American Institute of Certified Public Accountants, or any successor standard-setting authorities.

        5. Follow the technical standards, and the related interpretive guidance, issued by committees and boards of the American Institute of Certified Public Accountants that are designated by the Council of the American Institute of Certified Public Accountants to promulgate technical standards, or that are issued by any successor standard-setting authorities.

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Past Standards (effective before Jan. 1, 2024)

- No. 1: Tax Return Positions
- No. 2: Answers to Questions on Returns
- No. 3: Certain Procedural Aspects of Preparing Returns
- No. 4: Use of Estimates
- No. 5: Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
- No. 6: Knowledge of Error: Return Preparation and Administrative Proceedings
- No. 7: Form and Content of Advice to Taxpayers

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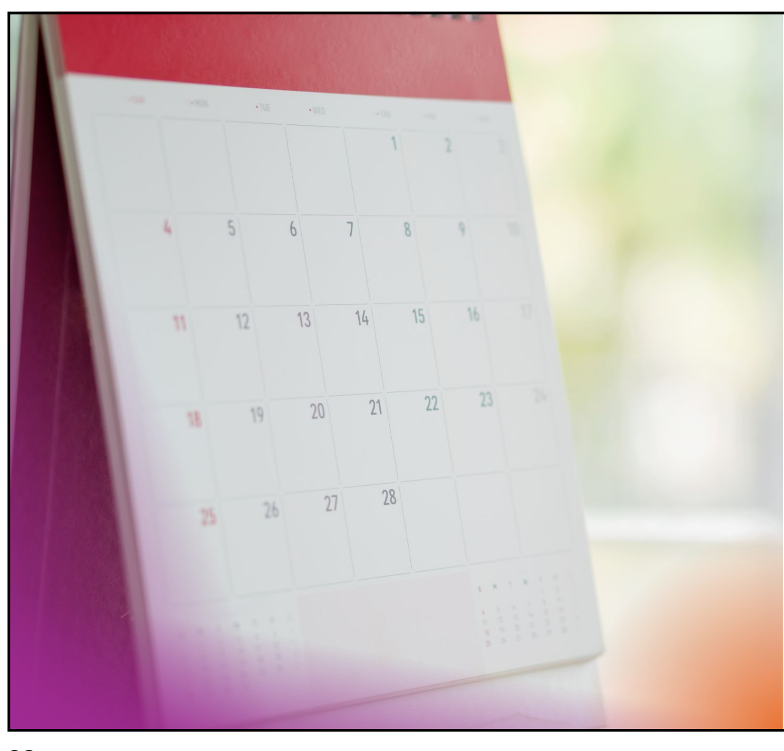

New Standards (eff. Jan. 1, 2024)

- No. 1: General Standards for Members Providing Tax Services
- No. 2: Standards for Members Providing Tax Compliance Services, Including Tax Return Positions
- No. 3: Standards for Members Providing Tax Consulting Services
- No. 4: Standards for Members Providing Tax Representation Services

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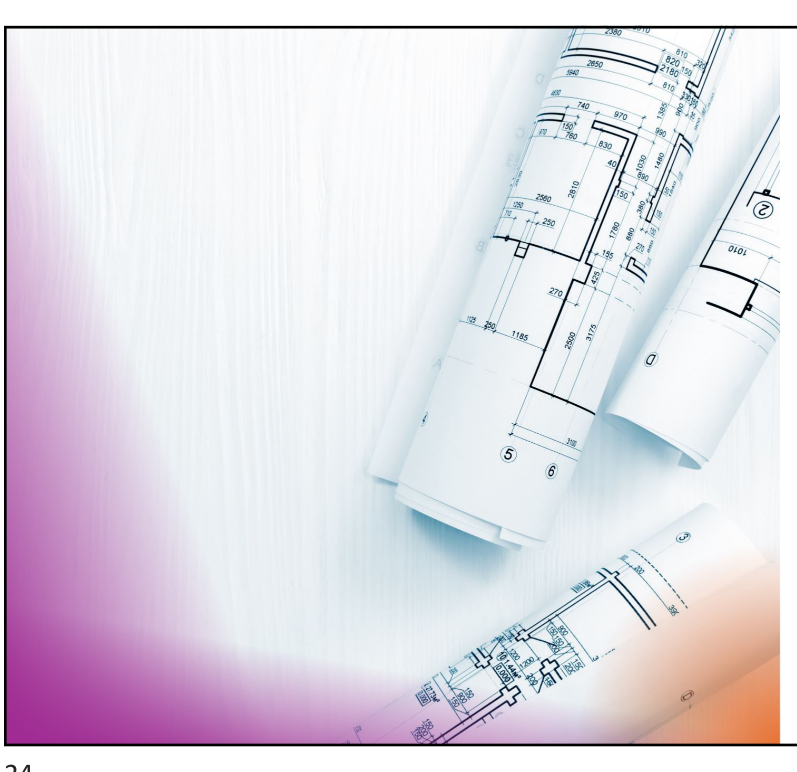

Overview of Revisions

- Reorganized the SSTSs by the nature of the work being performed
- Added three new standards that regard:
  - Data protection
  - Reliance on tools
  - Representation of clients before tax authorities

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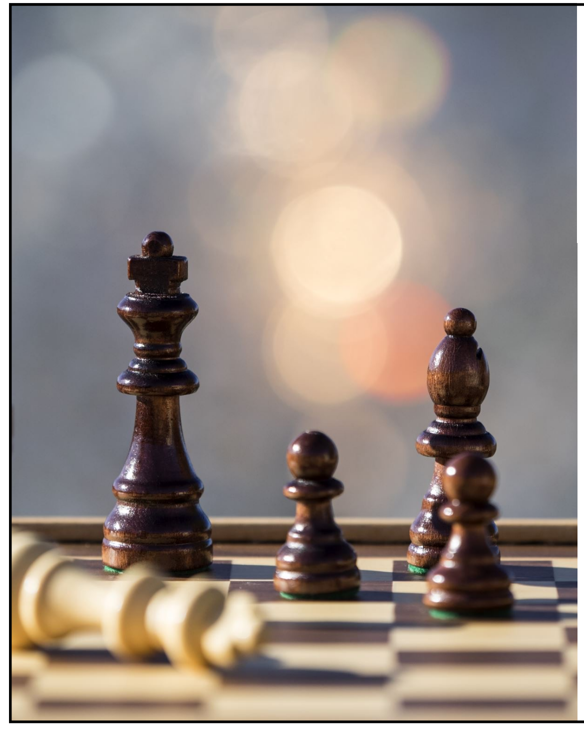

STSS 1.1 Advising on Tax Positions Highlights

- Should not advise a tax position unless "good-faith basis that the position has at least a realistic possibility of being sustained administratively or judicially on its merits, if challenged."
  - Applies if no specific tax authority standard on positions
- The member, may, if permitted by the tax authority, advise a position that the member concludes "there is a reasonable basis for the position" and has "appropriately disclose[d]" to the taxing authority

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STSS 1.2 Knowledge of Errors Highlights

- A member should promptly inform upon becoming aware of:
  - Taxpayer's failure to file a required return
  - An error in a previously filed return
  - Error in a return subject of an administrative filing
  - Error in a tax representation engagement
  - Error in advice provided
- Should also advise as to consequences of the error and corrective measures
- Advice my be oral
- Depending on situation, should also advise taxpayer to consult with attorney
- Error "does not include an item that has an *insignificant effect* on the taxpayer's liability"
  - This determination is left to the member's professional judgment based on all the facts and circumstances

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STSS 1.3 Data Protection Highlights

- Data protection is a "well-established professional responsibility"
- "A member should make reasonable efforts to safeguard taxpayer data, including data transmitted or stored electronically (1.3.4)
- "A member should consider applicable privacy laws when collecting and storing taxpayer data" (1.3.5)
- Explanations encourage members to consider:
  - Commercial security software
  - Encryption
  - Secure networks
  - Strong password policies
  - Firewalls
  - Secure data sharing and collaboration platforms
- Also notes Gramm-Leach-Bliley Act requirements (i.e., FTC Safeguards Rule)

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STSS 2.1 Tax Return Positions Highlights

- See earlier comment in 1.1
- Cannot take a position or sign a return that exploits audit selection or serves only as an arguing position to gain leverage

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STSS 2.2 Tax Return Questions Highlights

- Before signing a return, "a member should take reasonable steps to obtain from the taxpayer the information necessary to provide appropriate answers to all required questions on a tax return"
- Reasonable grounds could exist for omitting an answer; for example:
  - Information not readily available and answer is not significant
  - Genuine uncertainty exists as to meaning and application to taxpayer
  - Information is voluminous (but provide a statement that available upon request)
- Member should consider whether the omission will cause a return to be deemed incomplete or give rise to penalties
- If reasonable grounds for omission exist, not required to advise client to provide an explanation for omission on return

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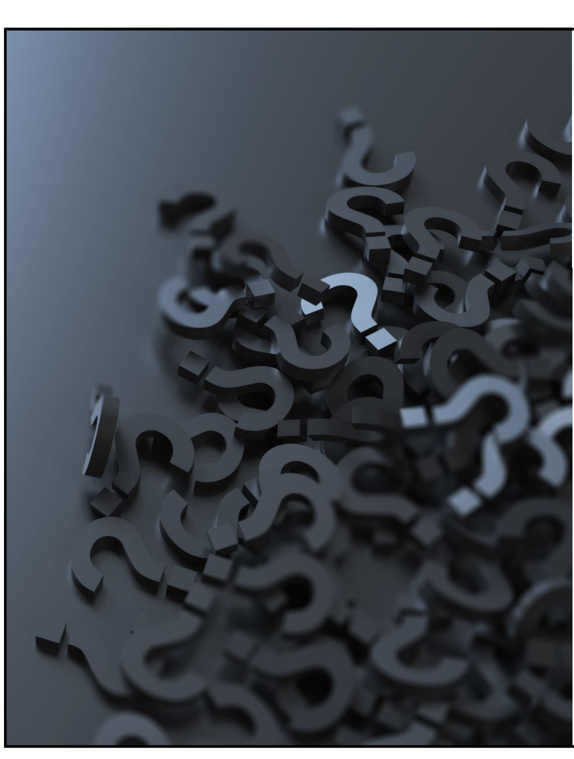

STSS 2.3 Reliance on Information from Others Highlights

- Can rely in good faith on information supplied by taxpayers or third-parties
- Should not ignore implications of information furnished
- Should make reasonable inquiries if information if incorrect, incomplete, or inconsistent
- Should consider relevant information actually known by the member

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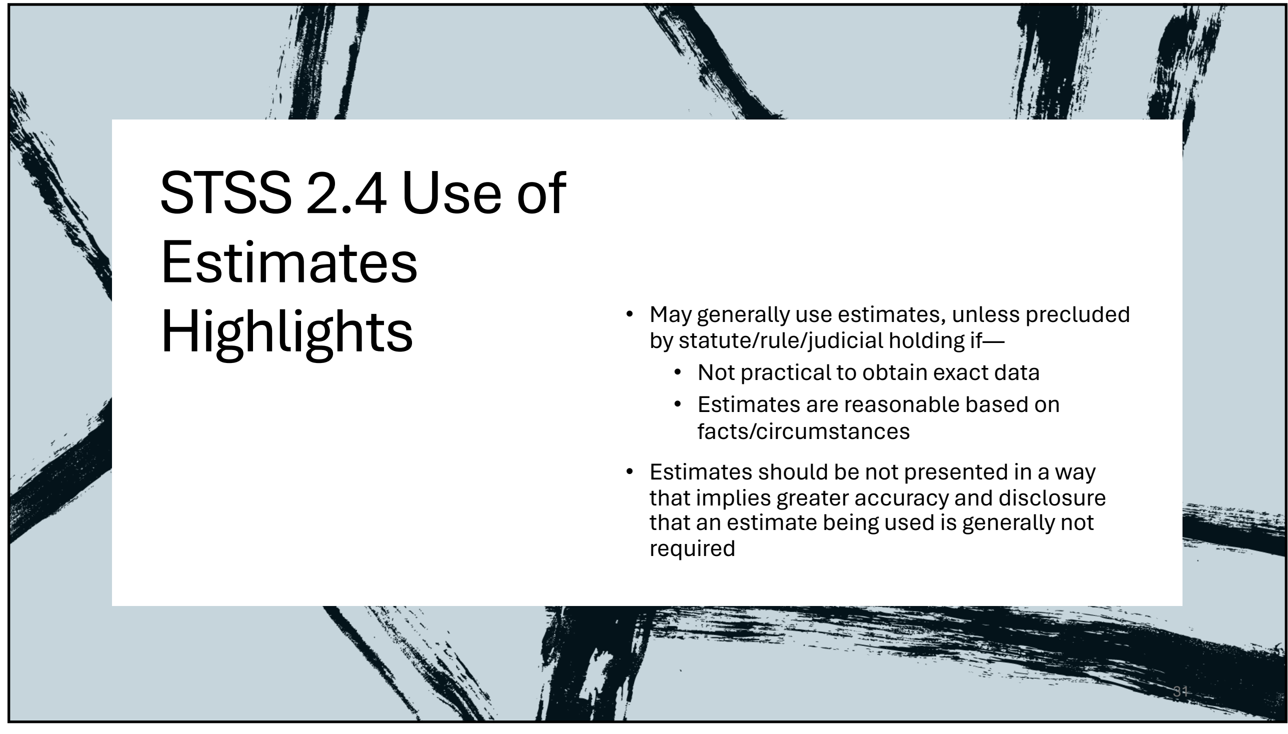

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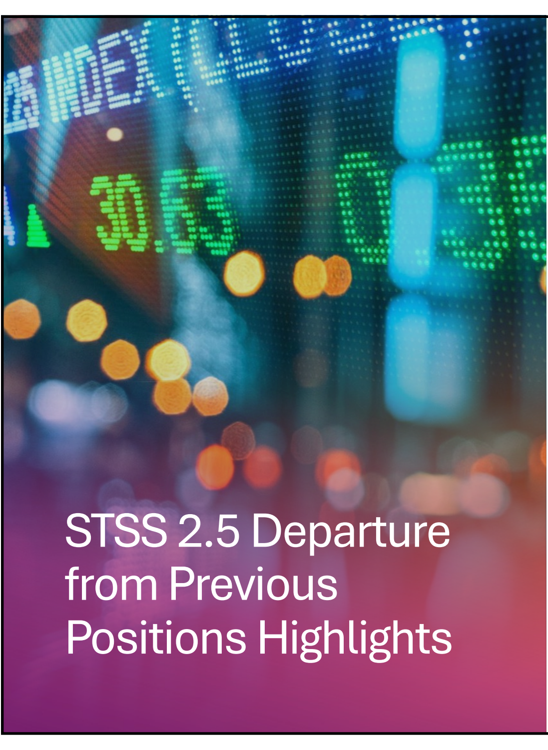

- Can generally depart from a position in previous return if not specifically bound
- Must still comply with § 2.1 Tax Return Positions

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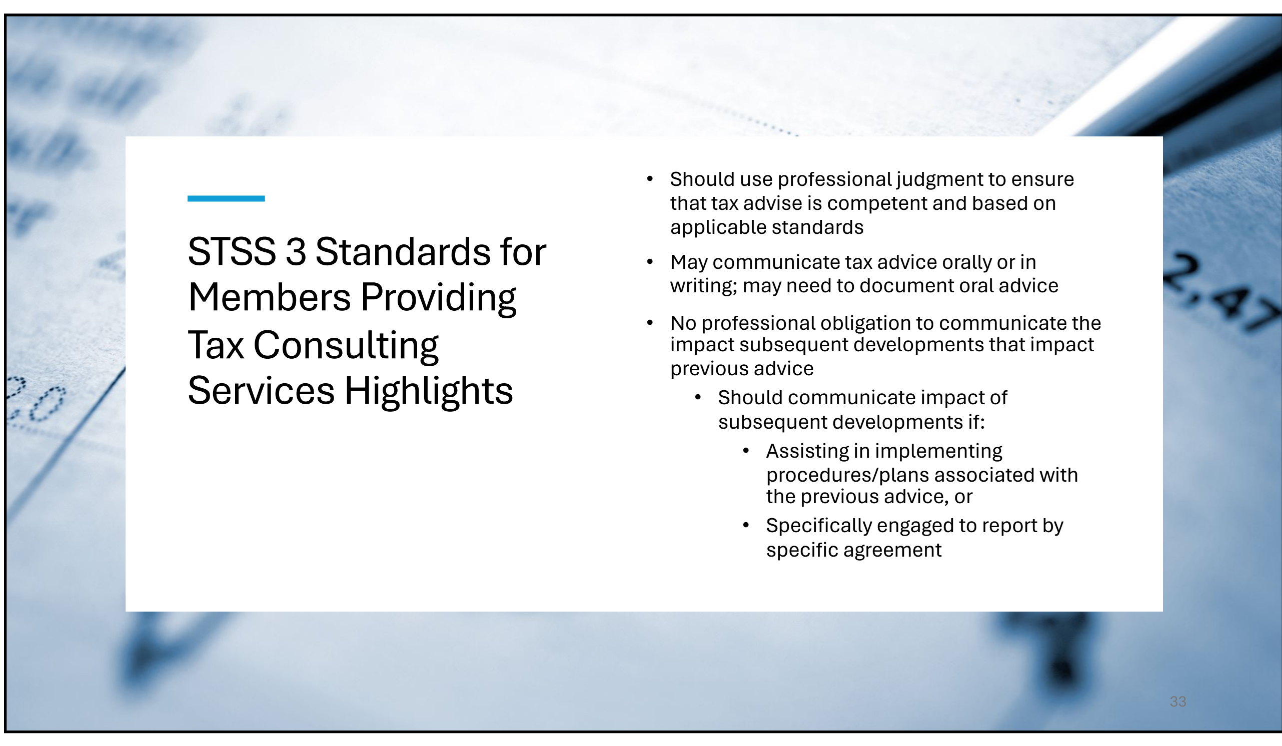

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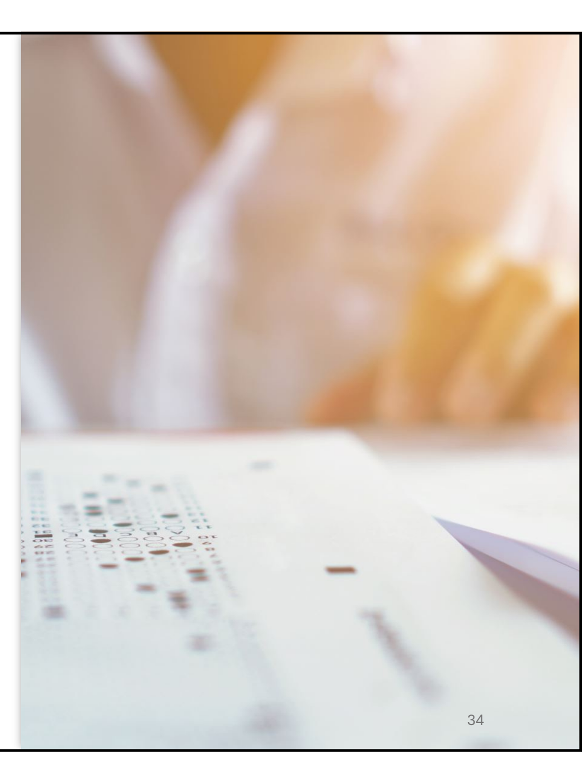
STSS 4 Standards for Members Providing Tax Representation Services Highlights

- "Should take steps to obtain technical competence in the subject matter involved as well as the tax practice and procedures of the taxing authority" (4.1.3)
- Comply with applicable professional and regulatory standards
- Act with integrity and professionalism, including timeliness
- Comply with confidentiality obligations
- Query whether can continue representation if become aware of fraudulent/criminal conduct; consider legal consultation
- In connection with completion of examination, review docs and computation for consistency and discuss consequences of agreeing to examination



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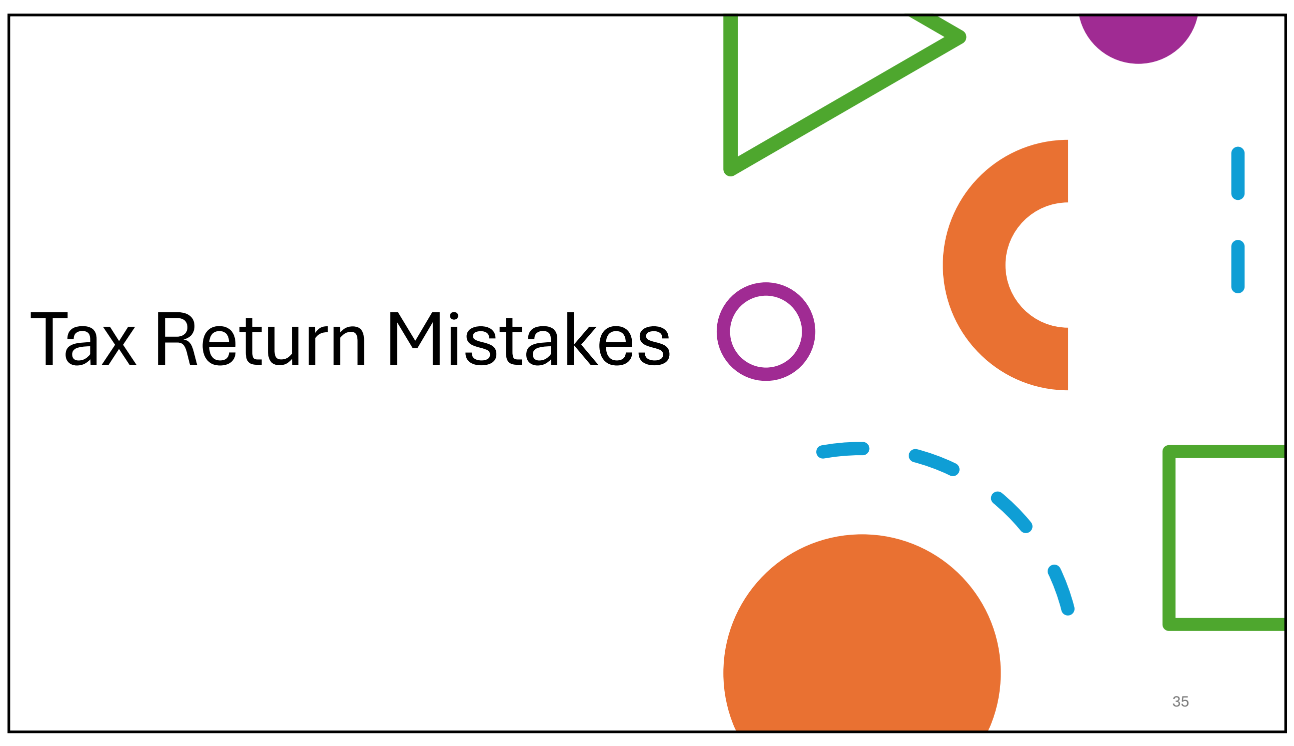

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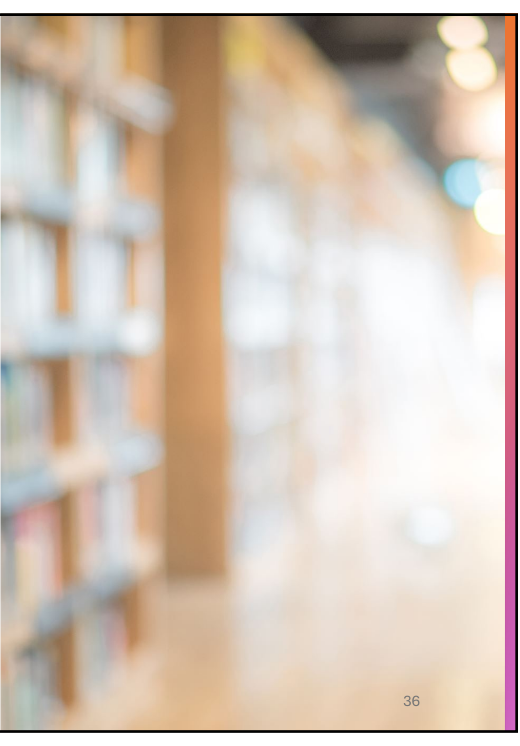
Applicable Professional Standards

- Recall ethical obligations imposed by:
  - Circular 230
  - AICPA STSS
  - ABA Model Rules (and state versions thereof)



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Circular 230: Errors and Mistakes

§ 10.21:

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, ***knows*** that the client has not complied with the revenue laws of the United States or has ***made an error*** in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, **must advise** the client promptly of the fact of such noncompliance, error, or omission.

Note there is NO express materiality requirement

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AICPA STSS

- Important caveat: § 1.2.2: "an error does not include an item that has an insignificant effect on the taxpayer's tax liability."
- Generally requires a member to promptly inform the taxpayer upon "becoming aware" of the error
- Must also advise as to potential consequences of the error
- Must also advise on the corrective measures to be taken
- Advice may be oral, but should consider documenting the advise
- If corrective measures not taken, query whether member should consider the engagement
- Not allowed to inform tax authority of error, unless allowed by client, except as required by law

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ABA Model Rule 1.6

"(a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b)."

Exceptions to confidentiality in subsection (b)

For example, to prevent reasonably certain death or substantial bodily harm

Under this rule, without client permission, lawyer likely cannot disclose an error to a taxing authority, unless the failure to disclose would continue/propound the fraud by the lawyer

Recall obligations under Model Rule 4.1

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Virginia Rule Professional Conduct 1.6

(a) A lawyer shall not reveal information protected by the attorney-client privilege under applicable law or other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraphs (b) and (c).

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ABA Model Rule 4.1

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of material fact or law to a third person; or

(b) fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6.

Thus, the lawyer cannot mislead the IRS

Virginia Rule of Professional Conduct 4.1

In the course of representing a client a lawyer shall not knowingly:

(a) make a false statement of fact or law; or

(b) fail to disclose a fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.

Comment 1:

[1] A lawyer is required to be truthful when dealing with others on a client's behalf, but generally has no affirmative duty to inform an opposing party of relevant facts. A misrepresentation can occur if the lawyer incorporates or affirms a statement of another person that the lawyer knows is false. Misrepresentations can also occur by failure to act or by knowingly failing to correct false statements made by the lawyer's client or someone acting on behalf of the client.

ABA Model Rule 3.1

A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law. A lawyer for the defendant in a criminal proceeding, or the respondent in a proceeding that could result in incarceration, may nevertheless so defend the proceeding as to require that every element of the case be established.

Can also apply in the tax context

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Virginia Rule of Professional Conduct 3.1

A lawyer shall not bring or defend a proceeding, or assert or controvert an issue therein, unless there is a basis for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law. A lawyer for the defendant in a criminal proceeding, or the respondent in a proceeding that could result in incarceration, may nevertheless so defend the proceeding as to require that every element of the case be established.

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ABA Model Rule 3.3(a)

(a) A lawyer shall not knowingly:

(1) make a false statement of fact or law to a tribunal or fail to correct a false statement of material fact or law previously made to the tribunal by the lawyer;

(2) fail to disclose to the tribunal legal authority in the controlling jurisdiction known to the lawyer to be directly adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer, the lawyer's client, or a witness called by the lawyer, has offered material evidence and the lawyer comes to know of its falsity, the lawyer shall take reasonable remedial measures, including, if necessary, disclosure to the tribunal. A lawyer may refuse to offer evidence, other than the testimony of a defendant in a criminal matter, that the lawyer reasonably believes is false.

Tribunal defined in Rule 1.0(m): “"Tribunal" denotes a court, an arbitrator in a binding arbitration proceeding or a legislative body, administrative agency or other body acting in an adjudicative capacity. A legislative body, administrative agency or other body acts in an adjudicative capacity when a neutral official, after the presentation of evidence or legal argument by a party or parties, will render a binding legal judgment directly affecting a party's interests in a particular matter.

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Virginia Rule of Professional Conduct 3.3(a)

A lawyer shall not knowingly: make a false statement of fact or law to a tribunal;

(1) fail to disclose a fact to a tribunal when disclosure is necessary to avoid assisting a criminal or fraudulent act by the client;

(2) fail to disclose to the tribunal controlling legal authority in the subject jurisdiction known to the lawyer to be adverse to the position of the client and not disclosed by opposing counsel; or

(3) offer evidence that the lawyer knows to be false. If a lawyer has offered material evidence and comes to know of its falsity, the lawyer shall take reasonable remedial measures.

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Background Principles

- Informing the ability to correct/fix a mistake is a background set of principles and doctrines, such as:
  - Annual accounting periods
  - Substance over form
  - Elections
  - Duty of consistency

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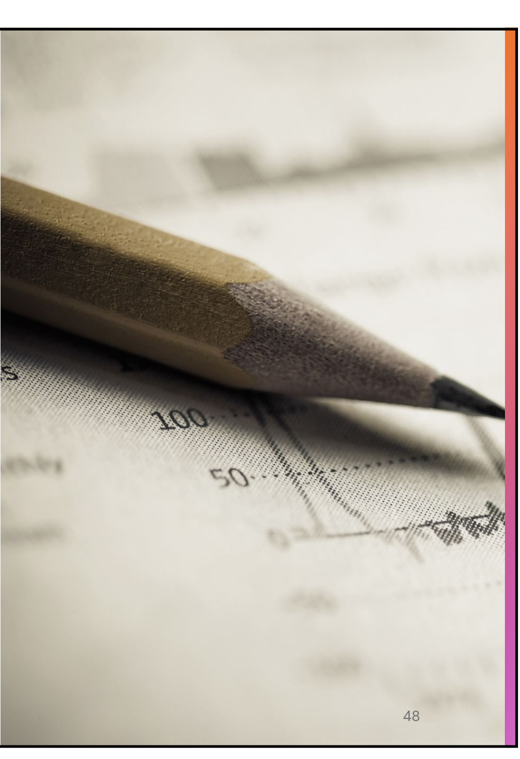
Annual Accounting

- Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931) sets forth annual accounting concept:
  - "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation."
- Claim of right doctrine
- Tax benefit rule



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Substance over Form

- "Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form." Weiss v. Stern, 265 U.S. 242, 254 (1924)

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Doctrine of Election

- Tax Court has described doctrine of election as having two elements:
  - "(1) There must be a free choice between two or more alternatives, and
  - (2) there must be an overt act by the taxpayer communicating the choice to the Commissioner, i.e., a manifestation of choice." Grynberg v. Commissioner, 83 T.C. 255, 261 (1984)
- "In short, once the taxpayer makes an elective choice, he is stuck with it." Roy H. Park Broadcasting, Inc. v. Comm'r, 78 T.C. 1093, 1134 (1982)

Duty of Consistency

Taxpayer has a duty of consistency when:

"(1) the taxpayer has made a representation or reported an item for tax purposes in one year, (2) the Commissioner has acquiesced in or relied on that fact for that year, and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year."

Beltzer v. United States, 495 F.2d 211, 212 (8th Cir. 1974).

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Timing Considerations

- Is the tax period still open?
  - Correcting documents? Backdating concerns?
  - Recission doctrine. See Rev. Rul. 80-58, 1980-1 C.B. 181.
- Original return not filed yet?
  - Be cautious of consistency obligations (e.g., with respect to partnership-related items). I.R.C. § 6662(a)
- Original return filed?
  - Superseding (correcting) return: defined by the IRM as "[a] second return submitted by a taxpayer before the due date which changes information on a return previously submitted" I.R.M. 3.5.61.1.8 (01-01-2024)
  - Updating estimates ("true-ups")
  - Amended return (and qualified amended returns)

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Timing Considerations, cont'd

- After an exam has commenced
- After statute of limitations has expired
  - If the year is closed, don't forget duty of consistency concerns
  - Don't conflate limitations on *assessment* and limitations for taxpayer claims
  - Consider the impact of accounting method changes, attribute redetermination, and mitigation provisions (e.g., §§ 1311 to 1314)
- For a fuller treatment of fixing federal tax return mistakes, see Tom Greenaway, "Fixing Federal Tax Return Mistakes: Taxpayer Options," 182 Tax Notes Federal 1379 (Feb. 19, 2024)

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Mistakes by the IRS/Government

- Interesting intersection of ethics and professional responsibility,
- Conflicting duties (i.e., duty to *client* and duty to *tax system*)

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ABA Standards of Tax Practice Statement 1991-1

- Issue: "[C]ounsel's responsibilities upon discovering a *computational error* made by the Service in the client's favor that is *unrelated to any affirmative representation or omission of either the client or counsel*." (emphasis added)
- Framework:
  - Rules 1.6 (confidentiality),
  - 4.1 (false statements to third parties),
  - 1.2(d) (assisting in crime/fraud),
  - 3.3(a) (false statements to tribunal)
  - 1.4 (keeping client informed)
  - 1.16 (withdrawal)
- Different types of errors: Computational (arithmetic mistake), Clerical (typographical mistake), or Conceptual (depends on application/interpretation of code section)

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ABA Standards of Tax Practice Statement 1991-1, Resolution

- In docketed cases:
  - If required to document the amount the the tax liability or overpayment, must disclose error to the court; even if not required to document the amount, "[d]isclosure is required and may be made without consulting the client." (Rooted in Rule 3.3, Duty to Tribunal)
- Settlement of Non-Docketed Case:
  - "A lawyer must disclose a clear arithmetic or clerical calculation error (but not a conceptual error), the amount of which is not de minimis to the Service, if there exists express or implied authority from the client to make the disclosure." Implied authority is a question of fact.
  - Importantly, it also notes that "[i]n refund situations, the cashing of an erroneous refund check can constitute a criminal violation for converting government property." And the potential crime is itself a client confidence.
  - "[I]f the client refuses to consent where there is no implied authorization, counsel must withdraw from the engagement because the failure to act would constitute a violation of Rule 8.4(c) and Rule 1.2(d).9"

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Application Example (based on Tax Practice Statement 1991-1)

- Consider the following hypothetical:
  - You and the Service have come to a agreement to settle a matter in a non-docketed case. In calculating the deficiency, the Service misplaces the decimal point, such that the the deficiency is noted as $30,450.20, instead of the proper amount of $304,502.
  - What do you do?

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Hypothetical 2

- You are in Appeals on a client matter. As part of the settlement, it is agreed that the client is entitled to a $150,000 deduction on his Schedule C.
- You, however, believe that the deduction likely is traceable to a passive activity, but this was not raised on appeal, and the settlement agreement treats it as a non-passive activity.
- If it was deemed passive, your client would not benefit from the deduction.
- What do you do?

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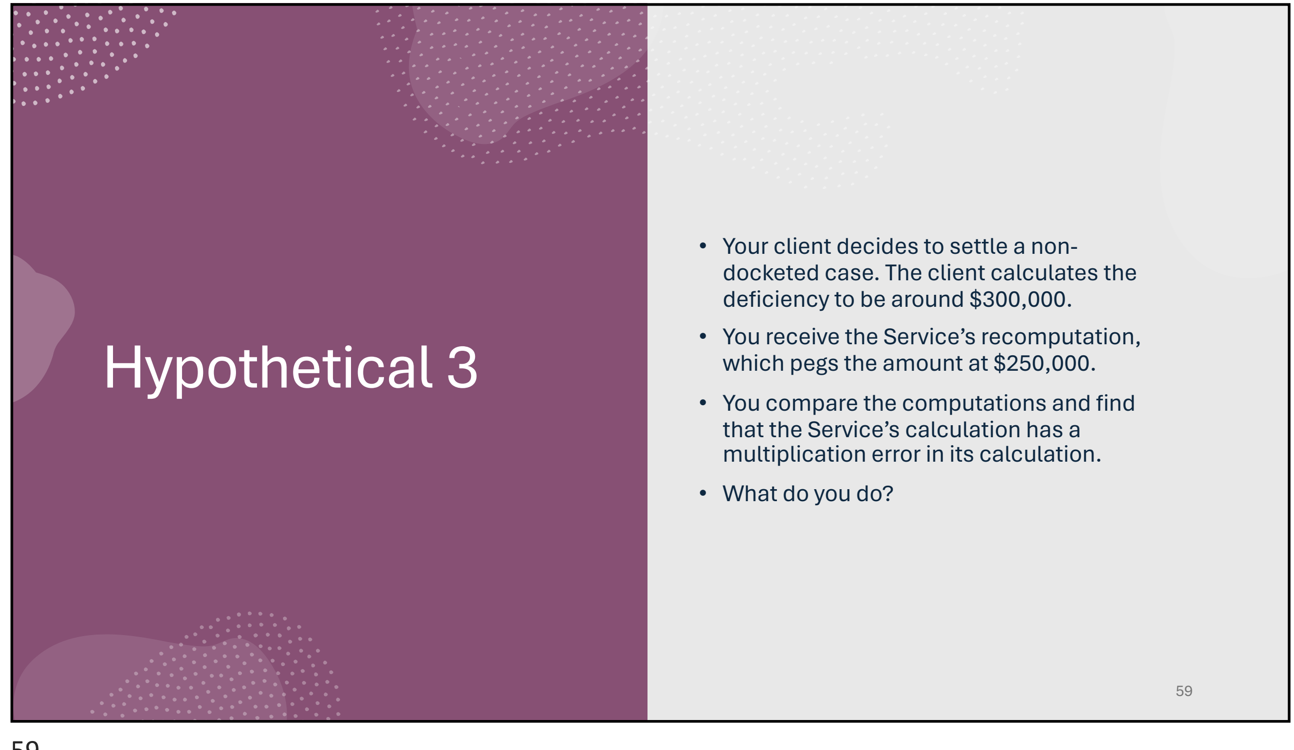

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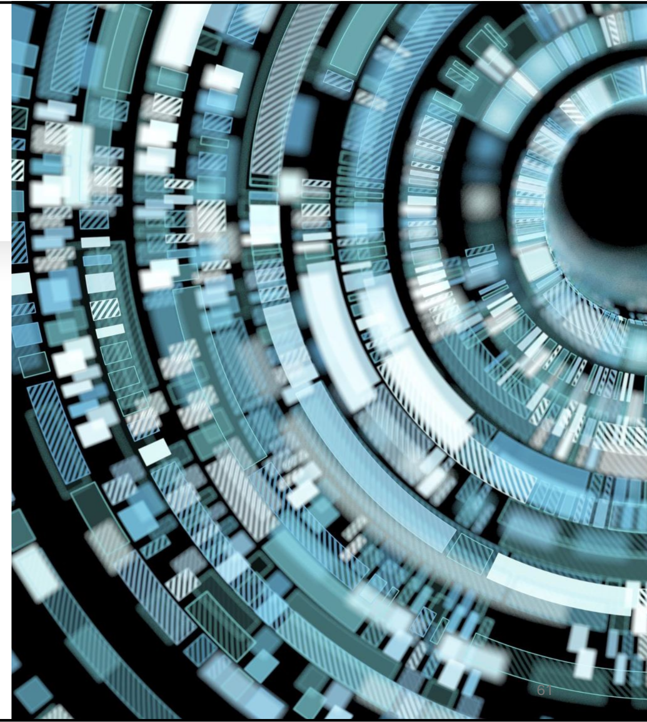
Social Media/Social Networks

- Diligence and competence require the lawyer to:
  - Understand if and how clients are using social networking;
  - Advise clients as to their further use of social networking to their best advantage; and
  - Use social networking sites as investigative tools (opposing party, witnesses, jurors).

VSB Website



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Advertising

- In 2018, the Virginia State Bar Standing Committee on Legal Ethics withdrew 12 Legal Advertising Opinions, which were superseded by amendments to the Rules of Professional Conduct or otherwise restated in whole or in part in LEO 1750. The only prior Legal Advertising Opinion that remains in effect is A-0114 (concerning communication involving lawyer recognition of listings in publications such as *The Best Lawyers in America*).

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Advertising

- "A lawyer shall not make a false or misleading communication about the lawyer or the lawyer's services. A communication is false or misleading if it contains a material misrepresentation of fact or law, or omits a fact necessary to make the statement considered as a whole not materially misleading." Rule 7.1, VA Rules of Professional Conduct.

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Advertising – LEO 1750

- Client endorsements published or posted by an attorney should be reviewed for compliance with applicable professional rules.
- "[T]here is no support in Virginia's Rules of Professional Conduct for affording greater leeway to advertising statements made by clients than those made by attorneys. The standard is the same in both instances."

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Advertising – Expertise/Specialization

- "A lawyer may communicate the fact that the lawyer does or does not practice in particular fields of law. A lawyer who is a specialist in a particular field of law by experience, specialized training, or education, or is certified by a named professional entity, may communicate such specialty or certification so long as the statement is not false or misleading." Rule 7.1, Comment 4, VA Rules of Professional Conduct.
- "The Committee opines that a lawyer's use of the words 'expert' or 'expertise' in public communications, if the claim cannot be factually sustained, amounts to misleading comparative statement and is therefore prohibited." LEO 1750.

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False or Misleading Communications

- "In communications about a lawyer's services, as in all other contexts, it is professional misconduct for a lawyer to engage in conduct involving dishonesty, fraud, deceit or misrepresentation which reflects adversely on the lawyer's fitness to practice law." Rule 7.1, Comment 3, VA Rules of Professional Conduct.

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- "A solicitation is a communication initiated by or on behalf of a lawyer that is directed to a specific person known to be in need of legal services in a particular matter and that offers to provide, or can reasonably be understood as offering to provide, legal services for that matter." Rule 7.3(a), VA Rules of Professional Conduct.
- "Every written, recorded or electronic solicitation from a lawyer shall conspicuously include the words "ADVERTISING MATERIAL" on the outside envelope, if any, and at the beginning and ending of any recorded or electronic solicitation, unless the recipient of the solicitation: (1) is a lawyer; or (2) has a familial, personal, or prior professional relationship with the lawyer; or (3) is one who has had prior contact with the lawyer; or (4) is contacted pursuant to court-ordered notification." Rule 7.3(c), VA Rules of Professional Conduct.

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Solicitation

- "A lawyer's communication typically does not constitute a solicitation if it is directed to the general public, such as through a billboard, an Internet banner advertisement, a website or a television commercial, or if it is in response to a request for information or is automatically generated in response to Internet searches." Rule 7.3, Comment 1, VA Rules of Professional Conduct

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Solicitations

- "A lawyer shall not compensate, give, or promise anything of value to a person who is not an employee or lawyer in the same law firm for recommending the lawyer's services except that a lawyer may pay the reasonable costs of advertisements or communications permitted by this Rule and Rule 7.1, including online group advertising..." Rule 7.3(d), VA Rules of Professional Conduct.
- "Paragraph (d)(1) allows a lawyer to pay for advertising and communications ... including the costs of print directory listings, on-line directory listings, newspaper ads, television and radio airtime, domain-name registrations, sponsorship fees, banner ads, and group advertising. A lawyer may compensate employees, agents, and vendors who are engaged to provide marketing or client-development services, such as publicists, public-relations personnel, business-development staff, and website designers, as long as the employees, agents, and vendors do not direct or control the lawyer's professional judgment in violation of Rule 5.4(c)." Rule 7.3, Comment 4, VA Rules of Professional Conduct.

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Answering Questions

- Despite the informality of social networking, the giving of legal advice to others including friends and acquaintances may create unintended client-lawyer relationships. At the very least, it can create confidentiality and conflicts issues. See LEO 1842 (communications with website visitors). See also ABA Formal Opinion 10-457 (August 5, 2010) (Lawyer Websites)
- Legal information of general application about a particular subject or issue is not "legal advice" and should not create any lawyer-client issues for the blogging or posting lawyer. Appropriate disclaimers will assure this conclusion.
- However, if a lawyer by online forms, email, chat room, social networking site, etc. elicits specific information about a person's particular legal problem and provides advice to that person, there is a risk that a lawyer-client relationship will have formed. See LEO 1842.

VSB Website

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Confidentiality

- "A lawyer shall not reveal information protected by the attorney-client privilege under applicable law or other information gained in the professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except" for certain exception set forth in the Rule. Rule 1.6(a), VA Rules of Professional Conduct.

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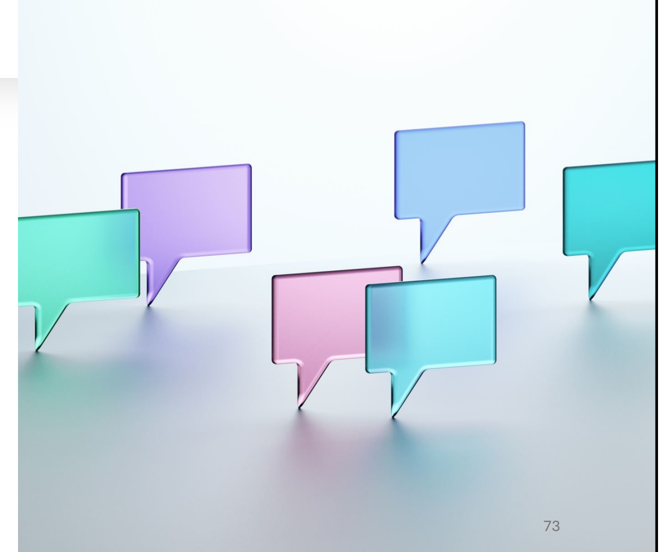
Messaging Technology

- Messages via Twitter or other social networks must be treated with the same degree of reasonable care as messages via email or other traditional communications.
- Discussion about pending legal matters raises problems, and generally should be left to traditional email format.

VSB Website



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Messaging Technology

- Rule 1.4, Communication, VA Rules of Professional Conduct
  a) A lawyer shall keep a client reasonably informed about the status of a matter and promptly comply with reasonable requests for information.
  b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.
  c) A lawyer shall inform the client of facts pertinent to the matter and of communications from another party that may significantly affect settlement or resolution of the matter
- "A lawyer may not simply upload information to an Internet portal and assume that her duty of communication is fulfilled without some confirmation from that client that he has received and understands the information provided." LEO 1872

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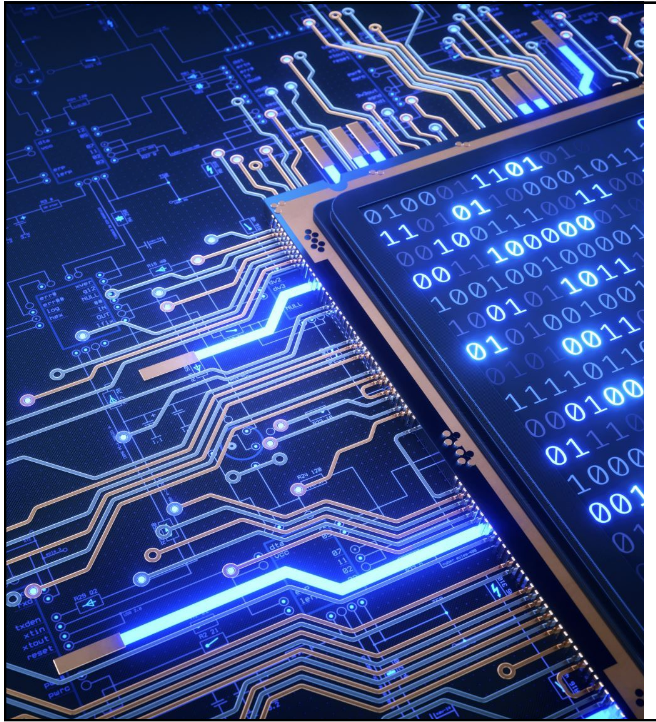

Metadata Issues

- "A lawyer who receives a document or electronically stored information relating to the representation of the lawyer's client and knows or reasonably should know that the document or electronically stored information is privileged and was inadvertently sent shall immediately terminate review or use of the document or electronically stored information, promptly notify the sender, and abide by the sender's instructions to return or destroy the document or electronically stored information." Rule 4.4(b), VA Rules of Professional Conduct

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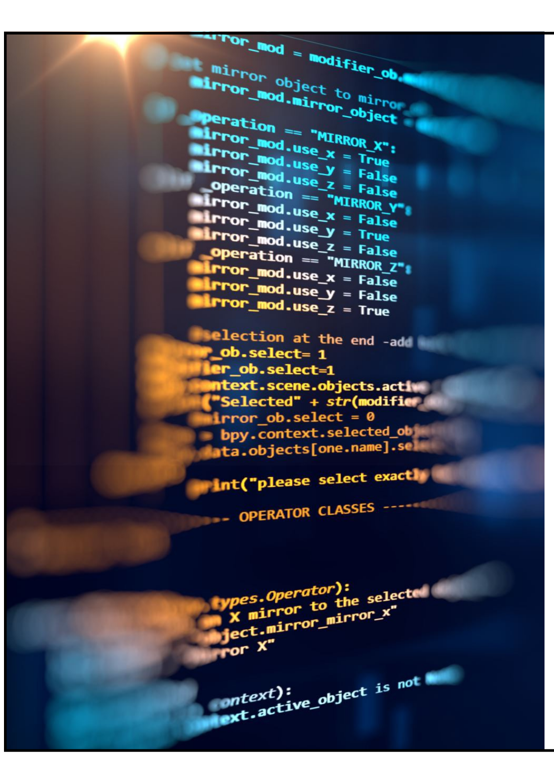

Metadata Issues

- "For purposes of this Rule, 'document or electronically stored information' includes, in addition to paper documents, email and other forms of electronically stored information, including embedded data (commonly referred to as "metadata"), that is subject to being read or put into readable form. Metadata in electronic documents creates an obligation under this Rule only if the receiving lawyer knows or reasonably should know that the metadata was inadvertently sent to the receiving lawyer and that it contains privileged information." Rule 4.4, Comment 2, VA Rules of Professional Conduct

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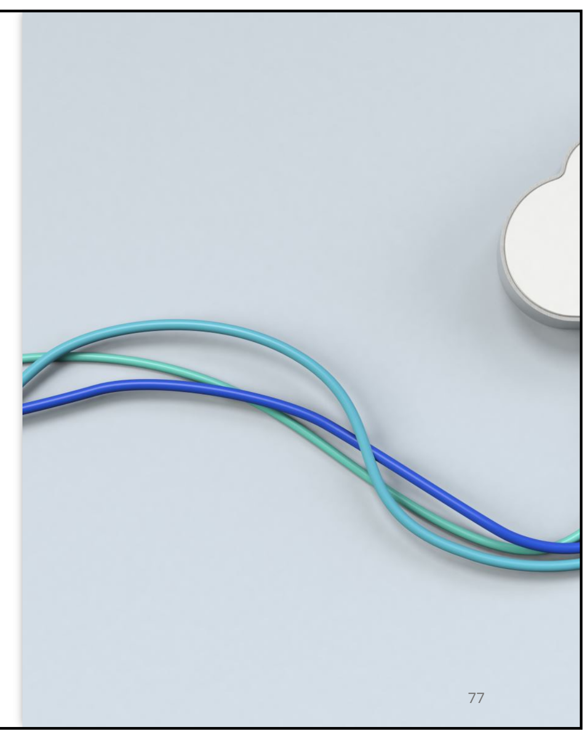
Cloud Computing

- "When a lawyer is using cloud computing or any other technology that involves the use of a third party for the storage or transmission of data, the lawyer must follow Rule 1.6(b)(6) and exercise care in the selection of the vendor, have a reasonable expectation that the vendor will keep the data confidential and inaccessible by other, and instruct the vendor to preserve the confidentiality of the information. The lawyer will have to examine the third party provider's use of technology and terms of service in order to know whether it adequately safeguards client information, and if the lawyer is not able to make this assessment on her own, she will have to consult with someone qualified to make that determination." LEO 1872



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Data Security Issues and Obligations

- "A lawyer shall make reasonable efforts to prevent the inadvertent or unauthorized disclosure of, or unauthorized access to, information protected under this Rule." Rule 1.6(d), VA Rules of Professional Conduct.
- This rule "requires a lawyer to act reasonably to safeguard information protected …against unauthorized access by third parties and against inadvertent or unauthorized disclosure … The unauthorized access to, or the inadvertent or unauthorized disclosure of, confidential information does not constitute a violation of this Rule if the lawyer has made reasonable efforts to prevent the access or disclosure. Factors to be considered in determining the reasonableness of the lawyer's efforts include… the likelihood of disclosure if additional safeguards are not employed, the employment or engagement of persons competent with technology, the cost of employing additional safeguards, the difficulty of implementing the safeguards, and the extent to which the safeguards adversely affect the lawyer's ability to represent clients (e.g., by making a device or important piece of software excessively difficult to use)." Rule 1.6(d), Comment 19, VA Rules of Professional Conduct.

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Data Security Issues and Obligations – Rule 1.6, Comment 20

- "[A] lawyer is not subject to discipline under [Rule 1.6] if the lawyer has made reasonable efforts to protect electronic data, even if there is a data breach, cyber-attack or other incident resulting in the loss, destruction, misdelivery or theft of confidential client information. Perfect online security and data protection is not attainable. Even large businesses and government organizations with sophisticated data security systems have suffered data breaches. Nevertheless, security and data breaches have become so prevalent that some security measures must be reasonably expected of all businesses, including lawyers and law firms. Lawyers have an ethical obligation to implement reasonable information security practices to protect the confidentiality of client data. What is "reasonable" will be determined in part by the size of the firm."

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Data Security Issues and Obligations – Rule 1.6, Comment 20

- To comply with Rule 1.6, "a lawyer does not need to have all the required technology competencies. The lawyer can and more likely must turn to the expertise of staff or an outside technology professional. Because threats and technology both change, lawyers should periodically review both and enhance their security as needed; steps that are reasonable measures when adopted may become outdated as well." Rule 1.6, Comment 20, VA Rules of Professional Conduct

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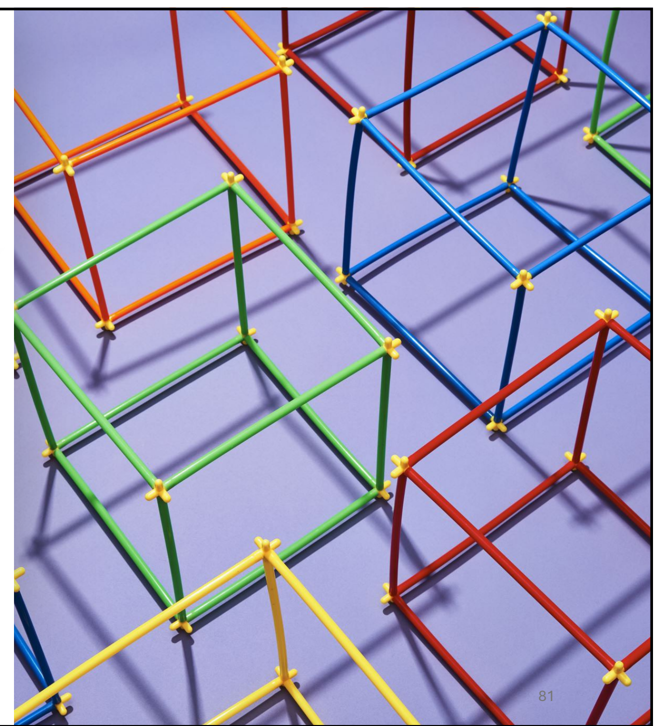
Data Security Issues and Obligations – Rule 1.6, Comment 21

- "Because of evolving technology, and associated evolving risks, law firms should keep abreast on an ongoing basis of reasonable methods for protecting client confidential information, addressing such practices as:
  - a) Periodic staff security training and evaluation programs, including precautions and procedures regarding data security;
  - b) Policies to address departing employee's future access to confidential firm data and return of electronically stored confidential data;
  - c) Procedures addressing security measures for access of third parties to stored information;
  - d) Procedures for both the backup and storage of firm data and steps to securely erase or wipe electronic data from computing devices before they are transferred, sold, or reused;
  - e) The use of strong passwords or other authentication measures to log on to their network, and the security of password and authentication measures; and
  - f) The use of hardware and/or software measures to prevent, detect and respond to malicious software and activity."



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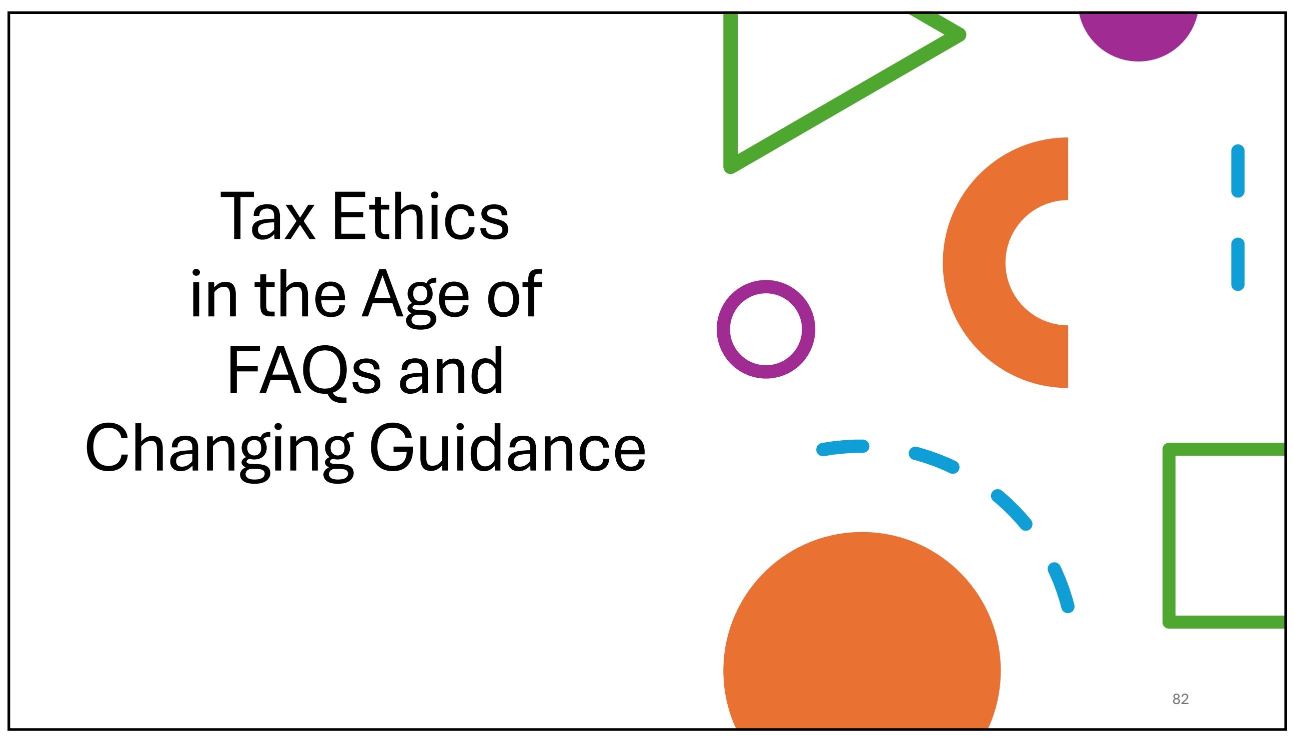

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Levels of Administrative Guidance

- Internal Revenue Code
- Treasury Regulations
  - See § 7805
  - Proposed regulations
  - Temporary regulations
- Internal Revenue Bulletin
  - Revenue Rulings
  - Revenue Procedures
  - Notices
  - Announcements
- Written Determinations
  - Private letter rulings
  - Technical advice memoranda
- Other IRS Publications
  - Forms and publications
  - News releases/fact sheets
  - FAQs

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Internal Revenue Bulletin

- This is the “authoritative instrument” of the Commissioner to announce official rulings and procedures
- “Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department regulations, but they may be used as precedents.”
- See https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs (last updated April 15, 2024)

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IRS Statement on FAQs

- "FAQs that have not been published in the Bulletin will not be relied on, used, or cited as precedents by Service personnel in the disposition of cases. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value."
- "[A] taxpayer's reasonable reliance on an FAQ (even one that is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply."
- "Taxpayers who show that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax."
- "In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return."
- See https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs (last updated April 15, 2024)

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Informal Guidance

- "If information included in informal guidance turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value."
- "a taxpayer's reasonable reliance on that informal guidance (even if the informal guidance is subsequently updated or modified) is relevant and will be considered in determining whether certain penalties apply."
- "Taxpayers who show that they relied in good faith on informal guidance and that their reliance was reasonable based on all the facts and circumstances will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax."
- See https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs (last updated April 15, 2024)

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Ethical Considerations

- When using subregulatory guidance, consider at least the following:
- ABA Model Rules:
  - 1.3: Diligence
  - 2.1: Advisor
  - 3.1: Meritorious claims

Circular 230:

§ 10.22: Diligence/accuracy

§ 10.34: Tax return standards

I.R.C. § 6664 and Treas. Reg. § 1.6664-4

Treas. Reg. § 1.6694-1 to -4

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Applicable Levels of Authority/Standards

- ***Will***: generally described as no material risk of being wrong
- ***Should***: generally described as a reasonably high level of confidence, but allows for a not insignificant risk of being incorrect
- ***More likely than not***: Greater than 50% chance
- ***Substantial authority***: "less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard" Treas. Reg. § 1.6662-4(d)(2).
- ***Realistic possibility of success***: "may advise the statement of positions most favorable to the client if the lawyer has a good faith belief that those positions are warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law" ABA Comm. on Ethics & Prof'l Responsibility, Formal Op. 352 (1985)
- ***Reasonable basis***: "significantly higher than not frivolous or not patently improper . . . is not satisfied by a return position that is merely arguable or that is merely a colorable claim." Treas. Reg. § 1.6662-3(b)(3)

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Ethical Considerations

Circular 230

§ 10.37 Requirements for written advice

. . .

(2) The practitioner must—

(i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

(ii) Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable

(v) Relate applicable law and authorities to facts; and

(vi) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

(3) Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent

Other sections/rules to be mindful of:

§ 10.22 (Diligence); § 10.34 (Tax return standards); ABA Model Rule 3.1 (Meritorious claims)