Name ____

68th Annual Tax Institute

July 23-24, 2018

Denver Tax Institute

A tax-exempt organization

720-389-5900

www.denvertaxinstitute.org

Monday, July 23, 2018

8:30 a.m. **Registration**

9:00 a.m. **Current Developments**
Professor Rex A. Logemann
Graduate Tax Program, University of Denver

Professor Logemann will present the significant legislative, judicial, and administrative changes from the past year, focusing on the corporate provisions of the Tax Cuts and Jobs Act.

10:50 a.m. **Break**

11:00 a.m. **What You Need to Do to Prepare for the New Centralized Partnership Audit Rules**
Richard B. Robinson
Robinson, Diss and Clowdus, P.C.
Denver, CO

Every partnership and LLC agreement must be amended to address the new centralized partnership audit rules. Partnerships with trusts, grantor trusts, limited liability companies, other partnerships, or disregarded entities as partners cannot elect out of these new rules. Every partnership must appoint a partnership representative for each tax year even if it elects out of these rules. The new rules make it easier for the Government to audit partnership tax returns; increase the likelihood that more taxes will be paid; and make it more likely that mistakes will be made. This program will provide an overview of the new centralized partnership audit rules and practical advice on how partnership agreements should be amended to address the issues.

12:30 p.m. **Lunch** (on your own)

1:30 p.m. **Navigating §199A: The 20% Pass-Through Deduction**
Anthony J. Nitti
WithumSmith+Brown
Aspen, CO

Section 199A was added to the Code as part of the Tax Cuts and Jobs Act. The new provision grants to owners of sole proprietorships, S corporations, and partnerships a deduction equal to 20% of the qualified business income generated by the business. A closer look at §199A reveals more questions than answers. What do we do with rental properties? Section 1231 gains? A qualified business loss? And of course, the question that every tax advisor will be struggling to answer for the foreseeable future: what exactly is a "specified service business" that is generally barred from generating qualified business income? In this session, Mr. Nitti will discuss the structure of §199A, who can and can't claim the deduction, and the many terms of art that are critical to understanding how to benefit from the 20% deduction. In addition, Mr. Nitti will dissect the many challenges practitioners face in applying §199A, while providing common-sense guidance that can be utilized until IRS authority is published.

3:20 p.m. **Break**

3:30 p.m. **Breakout Sessions:**

Breakout A: Evolving Impact of Cybersecurity
Ishita Sharma and Adam S. Wright
Ernst & Young LLP
Denver, CO

Ms. Sharma and Mr. Wright will discuss the marketplace response to the growing cybersecurity risk; stakeholder concerns; regulatory activities; financial audit and tax implications; the AICPA's cybersecurity initiative; evaluating and reporting on cybersecurity risk management programs; and what tax professionals should be doing to team with their internal audit or compliance teams to address cybersecurity risks.

Breakout B: Selected Issues in Tax Accounting Methods and Tax Reform
Caleb Cordonnier
Grant Thornton LLP
Washington, DC

Scott Vance
KPMG LLP
Denver, CO

Mr. Cordonnier and Mr. Vance will discuss significant tax accounting method issues arising from the Tax Cuts and Jobs Act. In some cases, new statutory provisions squarely address timing matters; in others, tax accounting methods may have a significant bearing on non-timing items under the new law (for example, the various international tax reform provisions and FASB Topic 606; see Rev. Proc. 2018-29). This presentation will also cover relevant administrative guidance issued to date as well as commonly encountered practical issues.

5:00 p.m. **Adjournment**

Tuesday, July 24, 2018

9:00 a.m. **Update: Ethics for Tax Professionals***

Val J. Albright	Victoria Sherlock
Foley & Lardner LLP, Dallas, TX	KPMG LLP, Houston, TX

This presentation will briefly cover the basic rules issued by the AICPA, ABA, and Circular 230 that impact ethical issues faced by tax professionals, with primary focus on common dilemmas facing tax professionals in both preparing and filing tax returns as well as representing taxpayers before the IRS. Also discussed will be penalties that can be asserted against tax professionals by the IRS and any recent examples of enforcement action.

***This program qualifies for 2 hours of ethics credit.**

10:45 a.m. **Break**

11:00 a.m. **Breakout Sessions:**

Breakout A: Current Developments in Corporate Taxation

David Strong
Morrison & Foerster LLP, Denver, CO

Mr. Strong will address a range of recent developments in corporate taxation, including the impact of the Tax Cuts and Jobs Act on corporate M&A, private equity and venture capital transactions, and intercompany planning; trends in corporate acquisition agreements; and issues affecting the potential qualification of certain stock in closely held corporations as "qualified small business stock" under §1202. He will also review selected judicial decisions, administrative rulings, and corporate transactions of interest that have occurred during the past year.

Breakout B: State Hot Topics - Tax Reform and Market Sourcing

Greg McClure and Scott Schiefelbein
Deloitte Tax LLP, Denver, CO and Portland, OR

The first half of 2018 has proven to be one of the most dynamic periods in recent memory in terms of changing state tax law and policy. This presentation will discuss the state tax implications of federal tax reform, states' legislative and administrative responses to tax reform, the move to market sourcing by Colorado and other states, and states' varying concepts for determining the "market" in applying market sourcing.

12:30 p.m. **Lunch** (on your own)

1:30 p.m. **Breakout Sessions:**

Breakout A: Real Estate Update

James R. Walker
Lewis Roca Rothgerber Christie LLP, Denver, CO

Mr. Walker will review the continued tax benefits of capital gain planning, including new favorable case law, and key changes in the Tax Cuts and Jobs Act impacting real estate (including 100% expensing). He will also address coordinating income and estate planning for real estate entrepreneurs and investors.

Breakout B: Inside, Outside, Upside Down: Balancing the Basics of Basis Adjustments at Death

Griffin H. Bridgers
Hutchins & Associates LLP, Denver, CO

Mr. Bridgers will examine the interplay of several tax code provisions which serve to adjust the basis of assets as a result of a taxpayer's death. Subtopics include outside basis adjustments for assets owned by a decedent (or treated as owned by a decedent) including interests in pass-through entities; inside basis adjustments for assets owned by pass-through entities; basis adjustments for upside-down loss property; and other relevant basis adjustments which often fly under the radar of tax professionals.

3:00 p.m. **Break**

3:15 p.m. **Breakout Sessions:**

Breakout A: Individual Tax Planning Workshop

Mark A. Vogel	Edward J. Roche, Jr.
Tax Education Services, LLC	Graduate Tax Program

In a reprise of their annual ITP presentation, Retired Professor Vogel and Professor Roche will focus this year on the legislative changes made by the Tax Cuts and Jobs Act, as well as the Bipartisan Budget Act, which affect individuals for 2018. Included will be a discussion of the 2018 COLAs, Small Employer Health Reimbursement Arrangements, depreciation changes including bonus depreciation with a §754 election, Form 8332 and alimony, the current status of fringe benefits and entertainment expenses, Head of Household filing status, the Child Tax Credit, and the effect of §461(l) on deductible losses. The session will also cover itemized deductions on Schedule A, including the new mortgage interest expense deduction as it affects the principal residence and a vacation home, the status of real estate taxes as a charitable contribution, and what to do now that miscellaneous itemized deductions are no longer deductible.

Breakout B: International Tax Potpourri

Mark M. Hrenya	John R. Wilson
Hrenya Senatore LLP	Holland & Hart LLP and Graduate Tax Program

Mr. Hrenya and Professor Wilson will address selected international tax developments of note, with an emphasis on the international provisions of the Tax Cuts and Jobs Act, including the transitional rules of §965 and the new Global Intangible Low Taxed Income (GILTI), Foreign Derived Intangible Income (FDII), and Base Erosion and Anti-abuse Tax (BEAT) regimes. They will also consider how other countries have responded to the Tax Cuts and Jobs Act and their progress with implementation of the OECD Base Erosion and Profit Shifting (BEPS) recommendations.

5:10 p.m. **Institute Adjourns**

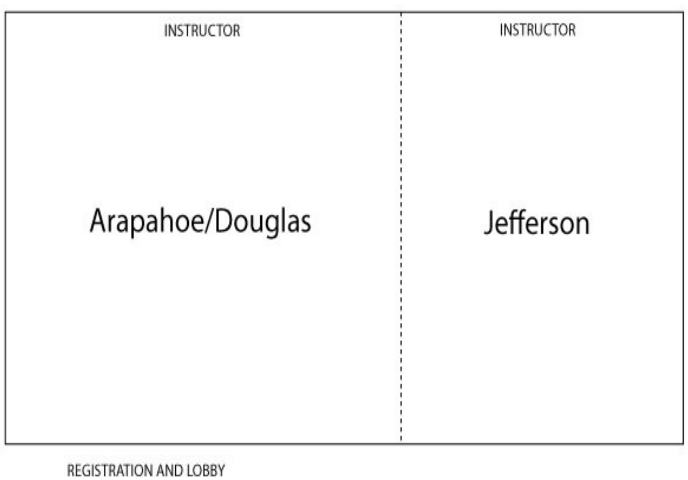
68th Annual Tax Institute Breakout Sessions

Monday, July 23

3:30 p.m.

Tax Accounting Methods
Arapahoe/Douglas

Cybersecurity
Jefferson



Tuesday, July 24

11:00 a.m.

Corporate Tax
Arapahoe/Douglas

State Hot Topics
Jefferson

1:30 p.m.

Real Estate Update
Arapahoe/Douglas

Basis Adjustment at Death
Jefferson

3:15 p.m.

Individual Tax Planning Workshop
Arapahoe/Douglas

International Tax Potpourri
Jefferson

PARTICIPANT EVALUATION

68th ANNUAL DENVER TAX INSTITUTE

To help us continually improve this program, please express your feelings by filling out the appropriate number in each scale below:

5=Excellent, 4=Very Good, 3=Good, 2=Fair, 1=Poor

1. EFFECTIVENESS OF THE DISCUSSION LEADERS:

Mon	**Rex A. Logemann (Current Developments)**	(5)	(4)	(3)	(2)	(1)	(NA)
	Richard B. Robinson (Partnership Audit)	(5)	(4)	(3)	(2)	(1)	(NA)
	Anthony J. Nitti (§ 199A)	(5)	(4)	(3)	(2)	(1)	(NA)
	Ishita Sharma / Adam Wright (Cybersecurity)	(5)	(4)	(3)	(2)	(1)	(NA)
	Caleb Cordonnier / Scott Vance (Tax Acctg)	(5)	(4)	(3)	(2)	(1)	(NA)
Tues	**Val Albright / Victoria Sherlock (Ethics)**	(5)	(4)	(3)	(2)	(1)	(NA)
	David Strong (Corporate)	(5)	(4)	(3)	(2)	(1)	(NA)
	Greg McClure / Scott Schiefelbein (SALT)	(5)	(4)	(3)	(2)	(1)	(NA)
	James R. Walker (Real Estate)	(5)	(4)	(3)	(2)	(1)	(NA)
	Griffin Bridgers (Basis Adjustment)	(5)	(4)	(3)	(2)	(1)	(NA)
	Mark A. Vogel / Edward J. Roche, Jr. (ITP)	(5)	(4)	(3)	(2)	(1)	(NA)
	Mark Hrenya /John Wilson (International)	(5)	(4)	(3)	(2)	(1)	(NA)

2. PLEASE EVALUATE THE AREAS LISTED BELOW:

Were the learning objectives met?	(5)	(4)	(3)	(2)	(1)
Were the prerequisites appropriate?	(5)	(4)	(3)	(2)	(1)
Were the program materials relevant?	(5)	(4)	(3)	(2)	(1)
Was the time allotted appropriate overall?	(5)	(4)	(3)	(2)	(1)

3. Which aspect of the Institute was most valuable? ______________________________

____

____

____

4. **Which aspect of the Institute was <u>least</u> valuable?** ________________________________

____

____

5. **Were there areas that should have been included which were not, or which should have been covered in more detail?**

   Yes __ No __ If yes, please list ____

____

____

____

6. **Do you feel the material will be helpful in your practice?**

   Very Helpful __ Somewhat Helpful __ Not Helpful __

7. **How would you rate this course compared to other continuing education courses you have attended?**

   Above Average ___ Average ___ Below Average ___

8. **Overall, was your investment of time and money worth it?**

   Yes ___ No ___

9. **Please add any additional comments you have on any aspect of the Institute, including content, materials, instructors, format, etc.**

____

____

____

____

____

10. **I am:**

___ an accountant ___ an attorney ___ a tax return preparer

___ in private practice ___ in public practice ___ in industry

___ with the IRS ___ other (please specify) ____________________________

PLEASE RETURN THIS EVALUATION FORM TO THE REGISTRATION TABLE AT THE END OF THE TAX INSTITUTE. THANK YOU!

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Phone 720-389-5900 | Fax 720-708-3246
www.aestax.com | www.cpe4ucolorado.com

PERSONAL RECORD OF ATTENDANCE

This letter serves as a personal record of attendance for the participant named below. **An official attendance certificate will be emailed to the participant following the program.** Attendance will be reported to the Internal Revenue Service if the participant has supplied his or her PTIN.

This program was designed to comply with the Statement on Standards for Formal Group Study Programs published by the American Institute of Certified Public Accountants.

NASBA Sponsor: Accountant's Education Services / CPE4U Colorado

Seminar Title: **68th Annual Denver Tax Institute**

Date: July 23-24, 2018

Location: Denver, CO

NASBA Delivery Method: Group-Live

NASBA Field of Study: Taxes - Technical

IRS Program #: MF2AY-U-00663-18-I (14 hours Federal Tax Law Updates)
MF2AY-E-00662-18-I (2 hours Ethics)

Credit Hours: ________ *(to be completed by participant)*
Full attendance would qualify for 16 hours credit (includes 2 ethics).

SIGNATURE ____

NAME ____

ADDRESS ____

____

I certify that I attended __________% of the above program, for a total of _____ hours.

(IF YOU MUST LEAVE EARLY, PLEASE CHECK OUT AT THE REGISTRATION TABLE.)

In accordance with the standards of the National Registry of CPE Sponsors, CPE credits are granted based on a 50-minute hour. NASBA #103295.

Instructions for Accountants: Please keep this letter for your personal record of attendance.

Instructions for Attorneys: The Colorado CLE affidavit is printed on the back of this page.

Instructions for EAs and Tax Return Preparers: Your attendance will be reported to the IRS if you supplied a valid PTIN. You may not receive IRS credit for the state tax breakout session.

Colorado Supreme Court
Office of Continuing Legal & Judicial Education
1300 Broadway, Suite 510
Denver, CO 80203
(303) 928-7771
www.coloradosupremecourt.us

NOTICE OF ACCREDITATION

The Board has accredited the following continuing legal education seminar under Rule 260:

NAME OF SEMINAR	LOCATION	DATE	SPONSOR	GENERAL CREDITS	ETHICS CREDITS
DENVER TAX INST: 68TH ANNL	AURORA CO	7/23/2018	CPE4U	16	2

Colorado attorneys and judges who attend the entire seminar may claim the credits indicated. If any Ethics Credits are indicated, they may be claimed by attending those parts of the seminar indicated below the seminar's name. Ethics credits are NOT IN ADDITION TO General Credits. General and Ethics Credits are NOT added to or subtracted from each other. This accreditation is awarded provided the sponsor permits the Board's staff to attend the seminar; gives every Colorado attorney and judge attending a copy of this combined notice/affidavit form; accepts at the seminar, this form after it is executed by attending Colorado attorneys and judges; and delivers the executed forms to the Board within 10 days after the seminar.

Date Reviewed: 6/28/2018

AFFIDAVIT

INSTRUCTIONS: Colorado attorneys and judges may report CLE Credits earned at this seminar by logging into the Online CLE Transcript. You can access the online entry of Affidavits by visiting http://www.cletrack.com Click on CLE Transcripts, login and select Enter Online Affidavits. You can enter your affidavit using the Course ID located at the bottom of this page.

DO NOT CLAIM THESE CREDITS ON ANY OTHER AFFIDAVIT

CERTIFICATION OF ATTENDANCE: By signing below I certify that I am entitled to claim:

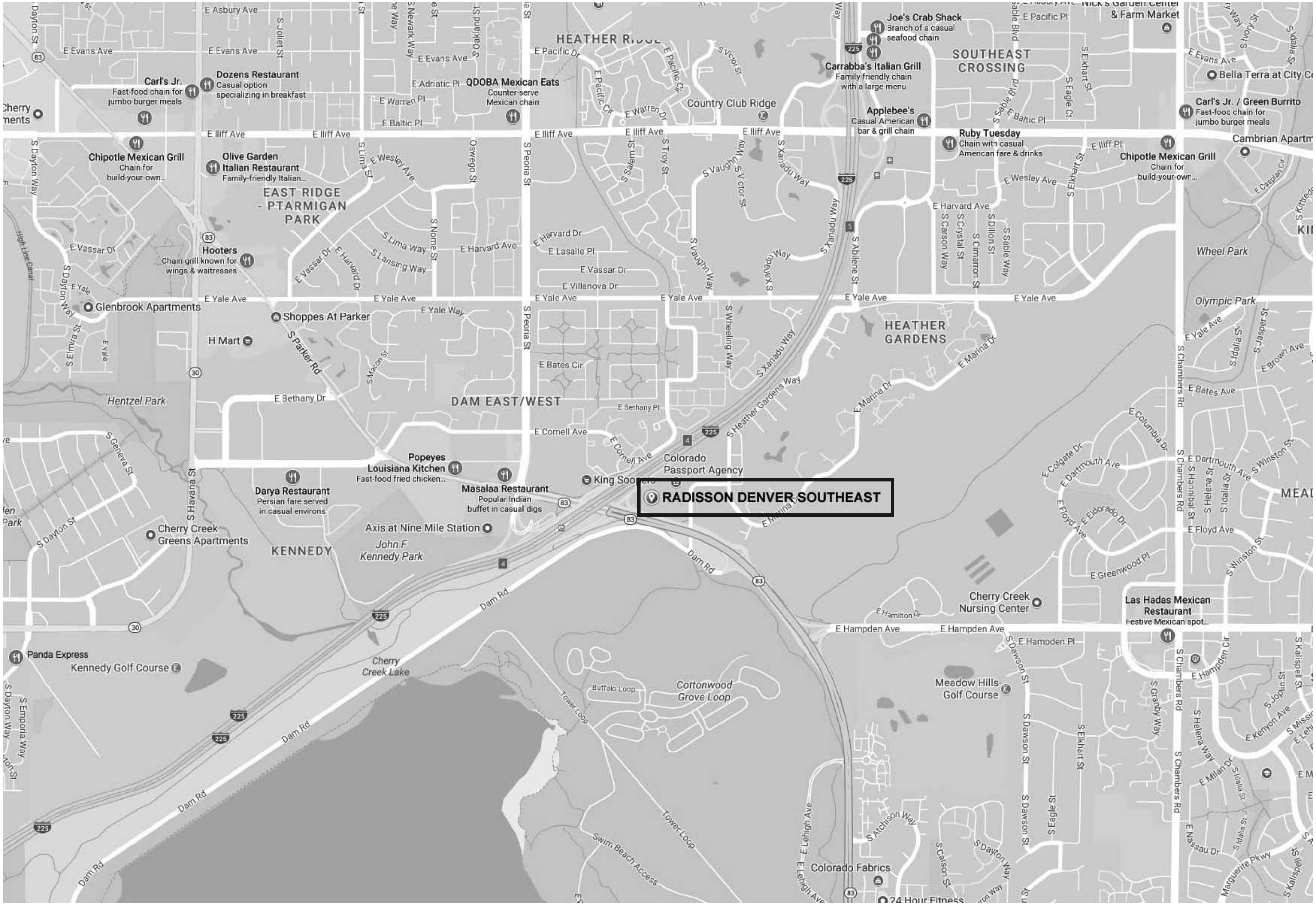
_______ General Credits _______ Ethics Credits

ATTY NUMBER ____________ LAST NAME (print) ______________________________

SIGNATURE ______________________________ DATE ________________

COURSE ID: 764622

Nearby Restaurants



IF YOU WANT TO WALK TO LUNCH:
Walk southwest from the Radisson and use the Cherry Creek Trail to cross safely under Parker Road and 225.

STRATEGIES FOR LEAVING THE RADISSON
(besides getting on 225):

GOING NORTH:
Turn left (north) when leaving the parking lot, and drive parallel to the highway until you get to Iliff.
Keep bearing to the left. The street name keeps changing:

- South Vaughn Way
- South Heather Gardens Way
- South Abiline Street
- East Harvard Avenue
- South Blackhawk Street

Turn left on Iliff and take the ramp (right) onto 225 north.

GOING SOUTH:
Turn right (south) when leaving the parking lot, and cross <u>under</u> Parker Road. Turn right onto the Dam Road.
After crossing Cherry Creek Dam, continue on East Union Avenue which then becomes Temple Drive.
Turn right at DTC Boulevard, cross under the highway, and turn left to take the ramp onto 225 south.

Current Developments

Professor Rex A. Logemann
Graduate Tax Program
University of Denver

68th ANNUAL TAX INSTITUTE

RECENT DEVELOPMENTS

Speaker: Rex A. Logemann

Recent Developments – Slide Index

1. New Legislation and Guidance – Slide 3
2. Income & Capital Gains, Exclusions & Deferrals – Slide 122
3. Business Expenses & Losses – Slide 179
4. Depreciation, Capitalization and Amortization – Slide 216
5. Personal Exemptions; Charitable Deductions – Slide 224
6. Travel and Entertainment – Slide 250
7. Marital Dissolutions – Slide 255
8. Employment and Self-Employment Taxes – Slide 278
9. Partnerships and LLCs – Slide 304
10. S Corporations and Shareholders – Slide 322
11. Tax Accounting – Slide 338
12. Tax Practice and Procedure – Slide 357
13. Transfer Taxes – Slide 421

NEW LEGISLATION

Guidance on Legislation

Status of the Budget Deficit

A. Budget deficit dropped through 2015 but increased thereafter:

1. 2010 and 2011: $1.3 trillion.
2. 2013: $681 billion.
3. 2014: $483 billion.
4. 2015: $439 billion (smallest deficit since 2007).
5. <u>2016: $588 billion</u> (about 3.2% of GDP).
6. <u>2017: $666 billion</u> (about 3.5% of GDP).
7. **<u>2018: $804 billion</u>** (OMB estimate; 4.2% of GDP).

Status of the Budget Deficit
Long-Term Projections by the CBO

A. In a June 26, 2018, report, the CBO projected:

1. The TCJA will increase deficits by about $1.85 trillion between 2018 and 2028, even after subtracting about $571 billion for estimated favorable macroeconomic effects.

2. The budget **deficit** will increase to 4.2% of GDP in 2018, up from 3.5% in 2017, and climb to 5.1% by 2022. After briefly stabilizing as a percentage of GDP, the deficit will rise to 9.5% of GDP by 2048.

3. **Federal debt** held by the public will approach 100% of GDP by 2028, and 152% by 2048. It is now 78% of GDP, the highest level since shortly after World War II.

Status of the Budget Deficit
Long-Term Projections by the CBO

A. In a June 26, 2018, report, the CBO projected:

1. Spending as a share of GDP will increase significantly over the next 30 years due to the aging population receiving benefits under Social Security and Medicare, and due to rising interest rates.

2. **Spending** excluding net interest costs will rise from the recent average of 18% of GDP (1968 to 2017) to 19% in 2018, 21% in 2028, and 23% in 2048.

3. **Net interest costs** have averaged 2% of GDP over the past 50 years (a high of 3.2% and a low of 1.2%). They are projected to be 1.6% in 2018, but will increase to 3.1% by 2028.

Status of the Budget Deficit
Long-Term Projections by the CBO

A. In a June 26, 2018 report, the CBO projected:

1. Over the past 50 years, revenues as a share of GDP have fluctuated between 15% and 20%.

2. **Revenues** are projected to remain near 16.6% of GDP from 2018 through 2021, rise to 17.5% by 2025, and then increase to 18.1% in 2026 if the individual tax cuts under the TCJA in fact expire.

3. Revenues would increase to 18.5% of GDP by 2028 under that scenario.

4. May 2018 CBO report: Trump budget will reduce revenue by $604 billion over next ten years due to extending TCJA.

Tax Regulations

A. Immediately after taking office on January 20, 2017, President Trump issued a series of Executive Orders that affected tax regulations.

1. On January 20, 2017, White House issued a general temporary stop order on regulations pending administrative review.

2. It also ordered agencies to immediately withdraw all regulations that had been sent to the Office of the Federal Register, but had not been published. The Treasury Department was not free from the freeze until June 2017. New partnership proposed audit regulations that had been issued in January were withdrawn and not reissued until June 2017.

Tax Regulations

A. On January 30, 2017, the White House issued an executive order that provides that whenever an agency publicly proposes for notice and comment a new regulation, it shall identify at least two existing regulations to be repealed."

1. The order is not clear as to precisely what regulations are covered, and how a regulation should be "counted" for purposes of the order. Such details are left to the OMB, which historically has not been involved in tax regulations.
2. The OMB has opined that the order applies only to regulations that are "significant regulatory actions" as determined by the OMB.

Tax Regulations

A. Executive Order 13789 was issued April 21, 2017:

1. Ordered Secretary of the Treasury to immediately review "all significant tax regulations" issued on or after January 1, 2016, and identify those that:
   a. Impose an undue financial burden on taxpayers;
   b. Add undue complexity to the federal tax laws; or
   c. Exceed the statutory authority of the IRS/Treasury.
2. The Secretary was required to recommend specific actions to mitigate the burden imposed by the identified regulations.

Tax Regulations

A. Executive Order 13789:

1. On July 7, 2017, the IRS issued Notice 2017-38 and identified eight tax regulations it found overly burdensome or unduly complex (out of 53 significant regulations issued between January 1, 2016, through April 21, 2017). It did not identify any regulations that were beyond the authority of Treasury. Included in the regulations identified were:
   a. Proposed valuation regulations under §2704 (REG-163113-02).
   b. Temporary regulations under §752 (T.D. 9788) relating to partnership debt allocations and "bottom-dollar" guarantees.
   d. Final and temporary regulations under §385 (T.D. 9790), the so-called "debt/equity" regulations.

Treasury Acts on Eight Identified Regulations

A. On October 4, 2017, Treasury issued its final "Report" on the eight regulations it had previously identified in Notice 2017-38.

1. Treasury also commented on its overall regulatory review:
   a. It is considering reforms of "several" recent regulations not identified in Notice 2017-38, including those relating to U.S. source dividends, and those implementing the Foreign Account Tax Compliance Act (FATCA).
   b. In addition, the IRS Chief Counsel's Office has identified "over 200" regulations for potential revocation because they are unnecessary, duplicative, obsolete, or force taxpayers to navigate unnecessarily complex or confusing rules.

Treasury Acts on Eight Identified Regulations

A. Final report on the eight identified regulations:

1. Regulations that will be withdrawn entirely.

   a. The proposed regulations under §2704. Section 2704 disregards restrictions on the ability to liquidate family-controlled entities in determining the FMV of an interest in an entity for transfer tax purposes. It also treats certain lapses of voting or liquidation rights as if they were transfers for those purposes.

   b. Treasury concluded that these regulations, "through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded." New requirements were "unclear," their effect on traditional valuation discounts "was uncertain," and they were "unworkable." Policy gains were uncertain.

Treasury Acts on Eight Identified Regulations

A. Final report on the eight identified regulations:

2. Regulations that will be revoked in part:

   a. Final regulations under §385, the "debt/equity" regulations. These regulations are primarily comprised of (1) "documentation regulations" as to showing an interest is debt rather than equity; and (2) "distribution regulations" relating to rules that treat as stock certain debt that is issued by a corporation to a controlling shareholder.

   b. Treasury recommends revocation of the documentation regulations due to compliance burdens and other concerns. It recommends that the distribution regulations be retained pending enactment of tax reform because revocation "could make existing problems worse."

Treasury Acts on Eight Identified Regulations

A. Final report on the eight identified regulations:

2. <u>Regulations that will be revoked in part</u>:

c. <u>Proposed and temporary regulations under §§707 and 752</u>. These regulations cover allocations of debt for purposes of disguised sale treatment and limit leveraged partnerships. They also eliminate so-called "bottom-dollar" guarantees.

d. <u>Treasury recommends that the revisions concerning debt allocations under disguised sale rules be revoked</u>, and prior regulations be reinstated, because the "far-reaching" change they cause requires further study. <u>Treasury recommends that the regulations eliminating bottom-dollar guarantees be retained</u>.

Proposed Regulation to Eliminate Regulations

A. In February 2018, the IRS issued proposed regulations (REG-132197-170) to <u>eliminate 300 regulations</u> that have "no current or future applicability under" the IRC.

1. Commentators likened this to "throwing out old junk from the attic," noting that this just "cleans things up" and will not affect enforcement of existing tax law because all of these regulations are obsolete.

B. It is not clear what effect this housekeeping will have on the "2 for 1" rule for new regulations. Should Treasury get credit?

OMB Review of Treasury Regulations

A. Another issue: OMB role in reviewing proposed tax regulations.

1. Historically, the OMB largely did not involve itself with tax regulations. Executive Orders issued by President Trump now require the OMB to review "significant regulatory actions."
2. In an April 11, 2018, memorandum of agreement (MOA), Treasury and the OMB agreed on the scope and timing of review by the OMB's Office of Information and Regulatory Affairs (OIRA).
   a. Generally a tax regulation will be subject to review by OIRA under Executive Order 12866 if it may result in a rule that may (1) interfere with actions of another agency; (2) raise novel legal or policy issues; or (3) "have an annual non-revenue effect on the economy of $100 million or more, measured against a no-action baseline." Timing limits apply.

Tax Regulations

A. Treasury and the IRS had ceased publishing substantive guidance after the Executive Orders described above, beginning in January 2017.

1. On May 25, 2017, officials stated that Treasury was in a position to begin publishing substantive guidance again.
2. On August 3, 2017, David J. Kautter was confirmed as Treasury Assistant Secretary for Tax Policy, and he also was appointed as Acting Commissioner of the IRS.
3. Charles Rettig, a tax lawyer, has been nominated to become the new permanent IRS Commissioner, and is expected to receive Senate approval in July 2018.

Prior Legislation Affecting 2018
New Guidance

A. In the past 30 months, Congress passed six bills with substantive and significant tax provisions:

1. The Tax Cuts and Jobs Act (the "TCJA" enacted 12/22/17).
2. The Bipartisan Budget Act of 2018 (H.R. 1892), along with the Consolidated Appropriations Act, 2018 (H.R. 1625).
3. The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015.
4. The Bipartisan Budget Act of 2015 (the "BBA 2015").
5. The Fixing America's Surface Transportation Act ("FAST Act").
6. The Protecting Americans From Tax Hikes Act of 2015 ("PATH Act").

Bipartisan Budget Act of 2015

A. "Simplifies" partnership audits after 2017:

1. Current rules provided three regimes for partnership audits:
   a. If 10 or fewer partners, IRS audits the partnership (P/S) and each partner separately.
   b. If more than 10 partners, TEFRA rules apply.
   c. If 100 or more partners and P/S elects to be an Electing Large Partnership (ELP), adjustments flow through for the year of adjustment rather than the year under audit.
2. Act: Repeal TEFRA and ELP rules and replace with centralized system for audit, adjustment, assessment and collection of tax. But opt-out allowed if 100 or fewer partners.

Bipartisan Budget Act of 2015

A. "Simplifies" partnership audits for partnership years beginning after December 31, 2017:

1. Proposed regulations were issued but retracted in January 2017 due to the regulation "freeze," and reissued in June 2017. Additional proposed regulations are pending concerning key issues. See details in partnership slides below and separate Tax Institute session.

2. Key for many: final regulations on the opt-out provisions for partnerships with 100 or less partners (determined by how many Forms K-1 the partnership and any S Corp. partners issue), and which have only "eligible partners" (partnerships, trusts and disregarded entities are not "eligible partners).

Fixing America's Surface Transportation Act
The "FAST Act"

A. Extends expenditure authority for the Highway Trust Fund through 9/30/2020 and certain excise taxes through September 2022 or 2023.

B. Tax offsets:

1. Revocation or denial of passport for certain unpaid taxes.

2. Requires the IRS to enter into qualified tax collection contracts for the collection of inactive tax receivables, and thus resumes private debt collection. The new program was launched in April 2017.

Fixing America's Surface Transportation Act The "FAST Act"

A. Passport provisions (Section 7345):

1. Secretary of State is required to deny a passport or renewal of one to a "seriously delinquent" taxpayer, and may revoke any passport previously issued to such person. IRS certifies.
2. May also deny an application for a passport if the applicant fails to provide a social security number, or provides an incorrect or invalid number willfully, intentionally, recklessly or negligently.
3. Exception: emergencies or humanitarian circumstances, including issuance of a passport for short-term use by the delinquent taxpayer to return to the U.S.

Fixing America's Surface Transportation Act The "FAST Act"

A. Passport provisions (Section 7345):

4. "Seriously delinquent tax debt" includes federal tax liability (including interest and any penalties) in excess of $51,000, for which a notice of lien or a notice of levy has been filed.
5. When a notice of lien has been filed, the debt is "seriously delinquent" only if T's administrative review rights have been exhausted or lapsed.
6. Debt is not seriously delinquent if it is being timely paid under an installment agreement or OIC, or collection action is suspended due to a CDP hearing, or innocent spouse relief has been requested or is pending.

Fixing America's Surface Transportation Act The "FAST Act"

A. Passport provisions:

7. Taxpayer safeguards ensure that the IRS corrects erroneous certifications, and considers actions taken by a T to remove the debt from the category of delinquent debt.
   a. See Notice 2018-1 and IRM 5.1.12.27.7 , which provide that the State Department will hold open passport applications of a certified taxpayer for 90 days to resolve any certification issues.
   b. The IRS began to certify taxpayers in January 2018, but only with respect to new passport applicants or renewals. It has not begun to certify taxpayers to revoke a previously issued passport.
   c. Taxpayer Advocate has concerns about the program with respect to lower-income taxpayers with cases pending before her office.

Fixing America's Surface Transportation Act The "FAST Act"

A. Private Debt Collection Provisions:

1. Requires the IRS to enter into qualified tax collection contracts for the collection of inactive tax receivables, defined as receivables:
   a. Removed from the active inventory for lack of resources or inability to locate the T;
   b. For which more than 1/3 of the applicable limitations period has lapsed and no IRS employee has been assigned to collect; or
   c. Which have been assigned for collection but more than 365 days have passed without interaction with the T or a third party.
2. IRS has released a sample CP40 notice letter and Pub. 4518.

Fixing America's Surface Transportation Act The "FAST Act"

A. Private Debt Collection start:

1. As of mid-May 2017, about 9,600 cases had been turned over to four participating private collection companies. Now more than 70,000 cases have been assigned.
2. Concerns that private companies were not complying with taxpayer protections and negotiating installment agreements longer than allowed have caused introduction of the Taxpayer Protection Act of 2017 (H.R. 2171) to abolish the program.
3. The Taxpayer Advocate opposes the private program as an infringement on an "inherently governmental function" of collecting taxes. She claims over 25% of cases assigned involve taxpayers with income not greater than the Federal Poverty Line.

Extenders PATH Act of 2015

A. Enacted 12/18/2015: The Protecting Americans from Tax Hikes (PATH) Act of 2015:

1. Permanently extended 22 provisions.
2. Extended four provisions through 2019.
3. <u>Extended 30 provisions through 2016</u> (The Bipartisan Budget Act of 2018 extended most of those provisions through 2017).
4. Added provisions on REITs.
5. Provided rules on conduct of IRS employees and on fraud with respect to the EITC, CTC, and education credits.

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018, signed into law in February 2018 after a brief government shutdown, was used to extend certain energy provisions for five years with phase-outs, and provided for a one-year retroactive extension (through 2017) for most of the provisions that the PATH Act only extended through 2016.

1. Extensions through 2017:

   a. Exclusion from GI for discharge of qualified principal residence debt.

   b. Mortgage insurance premiums treated as qualified residence interest.

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

1. Extensions through 2017:

   c. Above-the-line deduction for qualified tuition and related expenses.

   d. Railroad track maintenance credit.

   e. Mine rescue team training credit.

   f. Three-year recovery period for race horses.

   g. Seven-year recovery period for motorsports entertainment complexes.

   h. Election to expense mine safety equipment.

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

1. Extensions through 2017:
   - i. Expensing for qualified film and television productions.
   - j. Deduction for domestic production activities in Puerto Rico.
   - k. <u>Tax rate of 23.8% for qualified timber gain</u>.
   - l. <u>Empowerment zone tax incentives</u>.
   - m. Section 25C credit for nonbusiness energy property.
   - n. Credit for two-wheeled plug-in electric vehicles.
   - o. Credit for new qualified fuel cell motor vehicles.

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

1. Extensions through 2017:
   - p. Credit for alternative fuel vehicle refueling property.
   - q. Second generation biofuel producer credit.
   - r. Biodiesel and renewable diesel incentives.
   - s. Credits with respect to facilities producing energy from renewable resources.
   - t. Credit for energy-efficient new homes.
   - u. Deduction for energy-efficient commercial buildings.
   - v. Excise tax credits relating to alternative fuels.

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

2. Other extensions:

a. Credit for residential energy property through 2021 with a phase-out.

b. Benefits for solar and thermal energy property to 2022 or 2024 with phase-outs relating to fiber-optic solar, qualified fuel cell, and qualified small wind energy property.

3. Other tax provisions in the BBA 2018:

a. Hold-harmless provision for improper levy on retirement plans (can re-contribute levied amounts without penalty).

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

3. Other tax provisions in the BBA 2018:

b. Freezes user fee for installment agreements.

c. Provides simplified Form 1040SR for seniors.

d. Clarifies rules on whistleblower awards and related attorneys' fees.

e. Clarifies that the TCJA 1.4% excise tax on investment income of private colleges applies only to institutions that have at least 500 tuition-paying students and have more than 50% of their tuition-paying students located in the U.S. (directed at Berea College in Kentucky, which charges no tuition, thereby exempting it from the tax).

Extenders
The Bipartisan Budget Act of 2018

A. The BBA 2018.

3. Other tax provision in the BBA 2018:

   f. Requires IRS to allow employees taking hardship distributions from a retirement plan to continue making contributions to the plan. Also allows hardship distributions from retirement plans to include account earnings and employer contributions.

   g. Allows a U.S. citizen or resident who serves in support of the U.S. Armed Forces and has a foreign tax home located in a designated combat zone to qualify for the foreign earned income exclusion, even if that person has a U.S. abode.

   h. Provides updated tax relief for victims of the California wildfires and Hurricanes Harvey, Irma, and Maria.

Status of Proposed Healthcare Legislation

A. The Affordable Care Act (ACA): Repeal and replace?

1. On May 4, 2017, the House passed (217-213) H.R. 1628, the American Health Care Act of 2017 (AHCA).

   a. The AHCA repealed most taxes under the ACA retroactive to January 1, 2017, including the 3.8% tax on net investment income and the medical device excise tax.

2. The Senate drafted its own bill, the Better Care Reconciliation Act of 2017 (BCRA), which was similar to the AHCA, but with differences on the effective dates for repeal of ACA taxes.

   a. The BCRA was pulled from a Senate floor vote shortly before the July 2017 congressional recess, for lack of Republican support.

Status of Proposed Healthcare Legislation

A. The Affordable Care Act (ACA): Repeal and replace?

3. Later in July 2017, Senate Republican leaders offered the "Health Care Freedom Act" as an amendment to the AHCA, with several versions being offered.

4. On July 28, 2017, the Health Care Freedom Act failed by a Senate vote of 51-49, with three Republicans crossing the aisle to vote with Democrats in a dramatic late-night vote.

5. Therefore the attempt to repeal the ACA failed, and Republicans and the President turned their attention to tax reform.

Congress and the President Turn to Tax Reform

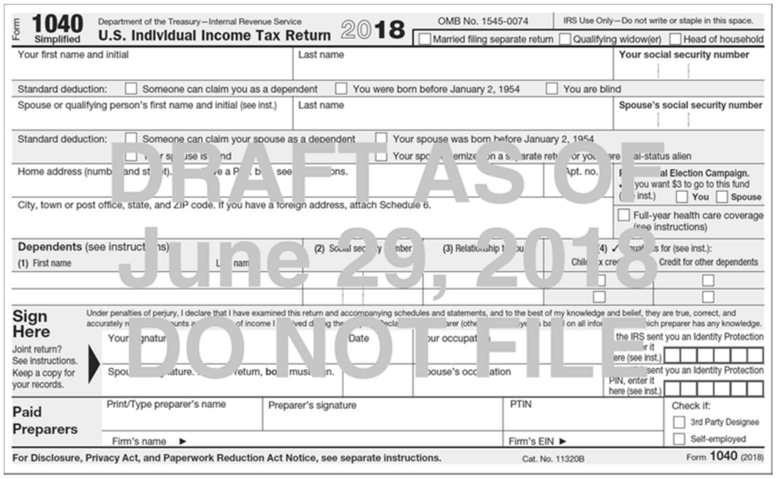
A. Here is what they promised:

SIMPLE, FAIR "POSTCARD" TAX FILING

1	Wage and compensation income	1	
2	Add 1/2 of investment income	2	
3	Subtract contributions to specified savings plans	3	
4	Subtract standard deduction OR	4	
5	Subtract mortgage interest deduction	5	
6	Subtract charitable contribution deduction	6	
7	Taxable income	7	
8	Preliminary tax (from tax table)	8	
9	Subtract child credit	9	
10	Subtract earned income credit	10	
11	Subtract higher education credit	11	
12	Total tax	12	
13	Subtract taxes withheld	13	
14	**Refund due / taxes owed**	14	

Congress and the President Turn to Tax Reform

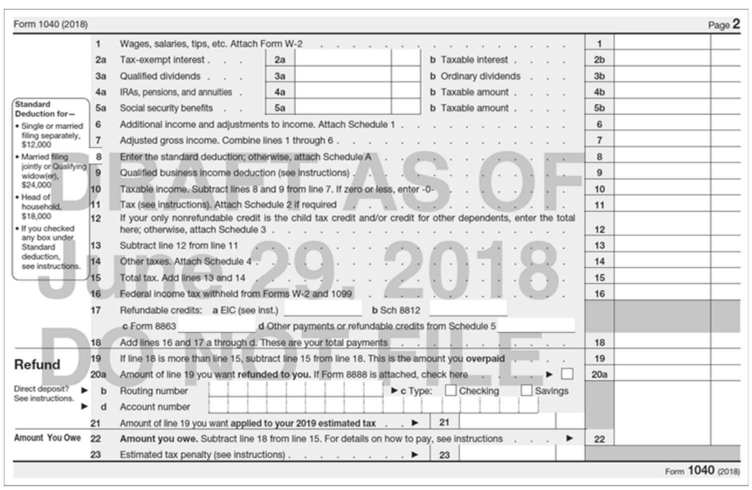
A. Here is what you got (page 1):



Form 1040 Simplified
Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2018
OMB No. 1545-0074
IRS Use Only—Do not write or staple in this space.
Married filing separate return | Qualifying widow(er) | Head of household
Your first name and initial | Last name | Your social security number
Standard deduction: Someone can claim you as a dependent | You were born before January 2, 1954 | You are blind
Spouse or qualifying person's first name and initial (see inst.) | Last name | Spouse's social security number
Standard deduction: Someone can claim your spouse as a dependent | Your spouse was born before January 2, 1954
Your spouse is blind | Your spouse itemizes on a separate return or you were dual-status alien
Home address (number and street). If you have a P.O. box, see instructions. | Apt. no.
Presidential Election Campaign. Do you want $3 to go to this fund (see inst.) You | Spouse
City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.
Full-year health care coverage (see instructions)
Dependents (see instructions)
(1) First name | Last name | (2) Social security number | (3) Relationship to you | (4) ✓ if qualifies for (see inst.): Child tax credit | Credit for other dependents
Sign Here
Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and accurately ... of income I received during the tax year. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Joint return? See instructions. Keep a copy for your records.
Your signature | Date | Your occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, both must sign. | Spouse's occupation | If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Paid Preparers
Print/Type preparer's name | Preparer's signature | PTIN | Check if: 3rd Party Designee | Self-employed
Firm's name ► | Firm's EIN ►
For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.
Cat. No. 11320B
Form 1040 (2018)
DRAFT AS OF June 29, 2018 DO NOT FILE

Congress and the President Turn to Tax Reform

A. Here is what you got (page 2):



Form 1040 (2018) | Page 2
1 Wages, salaries, tips, etc. Attach Form W-2 | 1
2a Tax-exempt interest | 2a | b Taxable interest | 2b
3a Qualified dividends | 3a | b Ordinary dividends | 3b
4a IRAs, pensions, and annuities | 4a | b Taxable amount | 4b
5a Social security benefits | 5a | b Taxable amount | 5b
6 Additional income and adjustments to income. Attach Schedule 1 | 6
7 Adjusted gross income. Combine lines 1 through 6 | 7
8 Enter the standard deduction; otherwise, attach Schedule A | 8
9 Qualified business income deduction (see instructions) | 9
10 Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0- | 10
11 Tax (see instructions). Attach Schedule 2 if required | 11
12 If your only nonrefundable credit is the child tax credit and/or credit for other dependents, enter the total here; otherwise, attach Schedule 3 | 12
13 Subtract line 12 from line 11 | 13
14 Other taxes. Attach Schedule 4 | 14
15 Total tax. Add lines 13 and 14 | 15
16 Federal income tax withheld from Forms W-2 and 1099 | 16
17 Refundable credits: a EIC (see inst.) | b Sch 8812 | c Form 8863 | d Other payments or refundable credits from Schedule 5
18 Add lines 16 and 17 a through d. These are your total payments | 18
Standard Deduction for— • Single or married filing separately, $12,000 • Married filing jointly or Qualifying widow(er), $24,000 • Head of household, $18,000 • If you checked any box under Standard deduction, see instructions.
Refund
19 If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you overpaid | 19
20a Amount of line 19 you want refunded to you. If Form 8888 is attached, check here ► | 20a
Direct deposit? See instructions. ► b Routing number | ► c Type: Checking | Savings
► d Account number
21 Amount of line 19 you want applied to your 2019 estimated tax ► | 21
Amount You Owe 22 Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions ► | 22
23 Estimated tax penalty (see instructions) ► | 23
Form 1040 (2018)
DRAFT AS OF June 29, 2018 DO NOT FILE

The Tax Cuts and Jobs Act
Introduction

B. The Tax Cuts and Jobs Act (TCJA) first was released by the Ways and Means Committee of the House on **November 2, 2017**, and approved with modifications a week later.

1. The Act generally follows in general the "Framework" issued by the "Big Six" Republican tax leaders in September 2017
2. The House passed the Act on a vote of 227-205 on **November 16**, and the Senate passed its version of the Act (with the same name) on a vote of 52-48 on **December 2**.
3. A Joint Conference Committee released the final version of the Act on Friday, **December 15**. The Senate voted 51-48, and the House voted 224-201, to approve the Act on **December 20**. The President signed the Act into law on **December 22, 2017**. Total process: 50 days.

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:
(details to be covered in ITP Workshop at 3:15 p.m. on Tuesday)

1. Rate Brackets – The Act keeps seven individual tax brackets. Rather than having the highest bracket begin at $500,000 of taxable income for single filers and $1,000,000 for joint filers with a top rate of either 38.5% or 39.6%, (as previously proposed), the final Act provides a top rate of 37% beginning at $500,000 for single filers and $600,00 for joint filers. Capital gain rates generally unchanged.
2. Individual AMT. The individual AMT is not repealed but the exemption amount is increased and phase-out threshold raised such that significantly fewer taxpayers will be subject to the AMT.
3. Deduction for Qualified Business Income – The Act provides a 20% (rather than 23%) deduction for qualified trade or business income of pass-through entities and sole proprietors that yields a maximum rate on such income of 29.6% *(details in Anthony Nitti session at 1:30 p.m. today).*

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

4. Standard Deduction and Personal Exemption. The Act increases the standard deduction to $24,000 for joint filers, $18,000 for heads of household, and $12,000 for single filers, and repeals the personal exemption deduction. Thereby reduces number of itemizers by more than 50%.

5. Child Tax Credit. Increases the child tax credit to $2,000 per child, with a phaseout for joint returns starting at AGI of $400,000 ($200,000 for singles). Retains the age limit, to children not age 17. Increases the refundable CTC to $1,400.

6. Charitable Contribution. The Act keeps the charitable contribution deduction with minor changes (limit of 60% of AGI rather than 50% of AGI for certain cash contributions).

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

7. SALT Deductions The Act allows a state and local tax ("SALT") deduction of up to $10,000 for any combination of income, property, or sales taxes. Prior bills repealed all SALT deductions except for real property taxes up to $10,000._ State trying to do "workarounds."

8. Mortgage Interest. The Act allows a deduction for mortgage interest on up to $750,000 of total acquisition debt for two homes, and repeals the deduction for home equity interest.

9. Medical Expenses. The Act keeps the medical expense deduction and provides for a 7.5% AGI threshold for 2017 and 2018.

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

10. Casualty Losses The Act limits casualty losses to those incurred in a presidentially declared disaster area.

11. Bonus Depreciation. The Act allows 100% additional first-year depreciation (bonus depreciation) for all qualified property placed in service after September 27, 2017, and before January 1, 2023. It also increases the §179 deduction and expands the definition of §179 property.

12. Alimony Deduction. The Act eliminates the deduction for alimony by the payor spouse and the inclusion of alimony in the income of the payee spouse for divorce or separation instruments executed on or after January 1, 2019.

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

13. Miscellaneous Itemized Deductions. The Act repeals the deduction for miscellaneous itemized deductions (which includes deductions for expenses for the production of income, tax preparation expenses, IRA custodian fees, investment advisory fees, and expenses on Form 2106, unreimbursed employee expenses).

14. Moving and Entertainment Expenses. The Act denies a deduction for all entertainment-related expenses under §274, and disallows a deduction for all moving expenses except for members of the Armed Forces.

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

15. Kiddie Tax Modified. Taxable income due to net unearned income now will be taxed according to brackets and rates applicable to trusts and estates, rather then being taxed at rates "on top" of the parent's income. Taxable income due to earned income will continue to be taxed according to a single taxpayer's brackets and rates.

16. Estate Tax Repeal. The Act doubles the estate and gift tax exclusion amount through 2025 (to $11,180,000 in 2018), but does not repeal the estate and GST tax prospectively as proposed in the prior House version of the Act.

The Tax Cuts and Jobs Act
Introduction

C. Top Individual Highlights of Final Act:

17. Repeal of Individual Mandate. The Act repeals the individual mandate to have essential minimum health insurance coverage under the Affordable Care Act (ACA) in 2019.

18. Reminder: All individual provisions in the Tax Cuts and Jobs Act sunset at the end of 2025, except for repeal of the individual mandate under the ACA and the use of a new method ("chained CPI") to calculate inflation increases to various amounts under the Code.

19. See Rev. Proc. 2018-18 for revised inflation numbers for 2018 due to the change in calculating inflation and other changes in the TCJA. Original inflation numbers for 2018 were issued in Rev. Proc. 2017-58.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

1. Corporate Tax Rate.

   a. The corporate tax rate is reduced to a flat 21% and corporate AMT is repealed, effective for taxable years beginning after December 31, 2017.

   b. Corporations with a fiscal year that spans portions of 2017 and 2018 will have a blended tax rate under §15, and be subject to AMT for the part of the fiscal year that is in 2017. Section 15 provides for the calculation of tax for a year in which rates change during the course of a taxpayer's taxable year. See Notice 2018-38 for IRS guidance on this issue.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

1. Corporate Tax Rate.

   c. Generally, under §15(a), when rates change during the taxable year, taxpayers calculate tentative taxes on TI for the entire year under both the old rates and the new rates. The corporation then proportions each tax amount based on the number of days in the year when the different rates were in effect. The tax for the fiscal year is the sum of those two amounts.

   d. The tentative minimum tax to compute AMT is determined in the same manner, but due to repeal it does not need to be computed for the portion of the tax year beginning on and after January 1, 2018.

Compare Individual Tax Brackets
To the 21% C Corporation Flat Rate

Single Filers Income Range	Joint Filers Income Range	Head of Household Income Range	Tax Rate
$0 - $9,525	$0 - $19,050	$0 - $13,600	10.0%
$9,525 - $38,700	$19,050 - $77,400	$13,600 - $51,800	12.0%
$38,700 - $82,500	$77,400 - $165,000	$51,800 - $82,500	22.0%
$82,500 - $157,500	$165,000 - $315,000	$82,500 - $157,500	24.0%
$157,500 - $200,000	$315,000 - $400,000	$157,500 - $200,000	32.0%
$200,000 - $500,000	$400,000 - $600,000	$200,000 - $500,000	35.0%
Over $500,000	Over $600,000	Over $500,000	37%
Also compare the rate on certain business income (qualified business income, or "QBI") under new §199A. It permits a 20% deduction on QBI from pass-through entities and sole-proprietorships subject to limits. If that full deduction is allowed, the maximum tax rate on QBI is 29.6% (80% X high individual rate of 37%).			

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   a. Taxpayers may fully expense 100% of the cost of qualified property (as now defined for bonus depreciation purposes) acquired and placed in service after 9/27/2017 and before 1/1/2023. (Certain property with a longer production period receives an additional year.)

   b. "Qualified property" includes depreciable property to which §168 applies which has a recovery period of 20 years or less, and Congress intended that this cover "qualified improvement property" (QIP) as defined in §168(e)(6).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   c. The QIP definition was changed to consolidate into one term what previously was defined separately as qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property. The intent was that QIP be treated as 15-year property, and be eligible for bonus depreciation and expensing under §179(f).

   d. Problem: Due to a drafting error, the TCJA did not specify a 15-year recovery period for QIP. Thus no bonus depreciation applies. A technical corrections bill is needed to correct this glitch, even though congressional intent is clear.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   e. QIP is defined as "any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service." Excluded are any improvements due to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

   f. In addition to 100% bonus depreciation through 2022, the Act provides for 80% bonus depreciation in 2023, 60% bonus in 2024, 40% bonus in 2025, and 20% bonus in 2027.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   g. For a taxpayer's first tax year ending after 9/27/2017, the taxpayer may elect to apply 50% bonus depreciation rather than 100%.

   h. Property must be both acquired and placed in service after 9/27/2017 in order for the new rules to apply.

   i. The prior requirement that the original use of the property begins with the taxpayer is repealed. Property is eligible if it is the taxpayer's first use (means the purchase of used property is eligible for bonus depreciation).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   i. Used property only qualifies if all the following apply:

      (i) T did not use the property at any time before acquiring it;

      (ii) T did not acquire the property from a related party;

      (iii) T did not acquire the property from a member of a controlled group of corporations;

      (iv) T's basis in the used property is not computed by reference to the basis of the seller or transferor; and

      (v) T's basis is not computed under the rules to determine basis of property acquired from a decedent.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; 100% Bonus Depreciation.

   j. Qualified property includes specified plants planted or grafted after 9/27/2017.

   k. Qualified property also includes qualified film, television, and live theatrical productions for which a deduction otherwise would have been allowable under §181, without regard to dollar limits in that section.

   l. Qualified property does not include any property used in a T/B that has had floor plan financing indebtedness unless the taxpayer is exempt from interest deduction limits due to meeting the small business gross receipts test.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery; Bonus Depreciation and Automobile Limits.

   m. The election to accelerate AMT credits in lieu of bonus depreciation is repealed.

   n. The Act keeps the §280F increased amount of $8,000 bonus depreciation for passenger automobiles placed in service after 12/31/2017. The depreciation limitations under §280F for passenger automobiles are increased to $10,000 for the year the vehicle is placed in service (plus any allowed bonus); $16,000 for the second year; $9,600 for the third year; and $5,760 for the fourth and later years.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery.

o. Other provisions related to cost recovery include:

1) Computer or peripheral equipment is removed from the definition of listed property.

2) For a farming business, the depreciation recovery period is reduced from 7 to 5 years for any machinery or equipment (other than grain bins, cotton ginning assets, fences, or other land improvement) the original use of which commences with the taxpayer and is placed in service after 2017.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery.

o. Other provisions related to cost recovery include:

3) The Act repeals the required use of the 150% declining balance method of depreciation for property used in a farming business (i.e., for three, five, seven, and ten-year property). The 150% declining balance method continues to apply to any 15- or 20-year property to which the straight line method does not apply. A "farming business" means a business as defined in §263A(e)(4).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery.

o. Other provisions related to cost recovery include:

4) The Act requires a farming business electing out of the limitation of the deduction for interest to use the ADS to depreciate any property with a recovery period of 10 years or more (e.g., property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).

5) The Act modifies a special rule for recovering costs related to citrus plants lost or damaged due to casualty.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

2. Cost Recovery.

p. Recovery period for real property is not reduced.

1) The Senate bill reduced the recovery period for nonresidential and residential real property to 25 years, with the ADS recovery period reduced from 40 to 30 years.

2) The final Act maintains the present law MACRS recovery periods of 39 for nonresidential real property and 27.5 years for residential rental property, but the ADS period has been reduced from 40 years to 30 years for residential property.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

3. <u>Small Business Reforms</u>.

a. The deduction limitation under §179 is increased to \$1 million and the phase-out threshold increased to \$2.5 million, indexed for inflation (along with the \$25,000 SUV limitation).

1) Expands definition of qualified real property under §179(f) to include these improvements to nonresidential real property: <u>roofs, HVAC property, fire protection and alarm systems, security systems, and all QIP</u>.

2) Expands §179 to cover certain depreciable tangible personal property used to furnish lodging.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

3. <u>Small Business Reforms</u>.

b. The §448(c) annual average gross receipts threshold that allows corporations and partnerships with a corporate partner to use the cash method of accounting is increased from \$5 million to **\$25 million**. The requirement that such businesses satisfy the requirement for all prior years is repealed. New amount indexed to inflation.

c. New §471(c): Business with average annual gross receipts of \$25 million or less can use the cash method of accounting even if the business is required to maintain inventories, if it treats inventory as non-incidental materials and supplies, or conforms treatment to Ts method in applicable financial statement or books and records.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

3. Small Business Reforms.

   d. Section 263A(i): Any producer or reseller that meets the **$25 million** gross receipts test under §448(c) is exempt from the UNICAP rules under §263A.

   e. Section 460(e): For certain long-term contracts of not more than two years, the $10 million average gross receipts exception to the percentage-of-completion method is increased to **$25 million**, allowing more businesses to use the completed contract method.

   f. Rules for changes in method of accounting and §481(a) adjustments apply, but the long-term contract provision will be applied on a cutoff basis (so no adjustments for contracts entered into before 2018).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

3. Small Business Reforms.

   g. Treatment of S corporation conversions to a C corporation.

      1) If a change in method of accounting from the cash method to the accrual method results, the §481 adjustment is taken into account ratably during the six-taxable-year period beginning with the year of change.

      2) Applies to a terminated S corporation if it revokes its S election within two years after enactment of the TCJA and all owners remain the same in identical proportions.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

3. <u>Small Business Reforms</u>.

g. Treatment of S corporation conversions to a C corporation.

3) Also modifies rules on effect of a distribution of money from the accumulated adjustments account if converting to a C corporation. The AAA account may now be distributed during a two-year post-termination transition period, rather than one.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

4. <u>Other Business Reforms</u>.

a. <u>Advance Payments</u>. For accrual method taxpayers, the Act allows certain advance payments for goods and services to be deferred until the item is reported on an AFS, or if earlier, the taxable year following the year of receipt (codifies Rev. Proc. 2004-34 in §451(c)).

1) Notice 2018-35: IRS transitional guidance allowing taxpayers with or without an AFS to continue to rely on Rev. Proc. 2004-34 for the treatment of advance payments until further guidance.

Tax Cuts and Jobs Act Details

D. Business Tax Reform.

4. Other Business Reforms.

b. Loss Limitation Rules. For taxable years beginning after December 31, 2017, and before January 1, 2026, § 461(l) provides that "excess business losses" of a taxpayer other than a corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent taxable years.

1) Under the Act, NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 80% of taxable income determined without regard to the deduction for NOLs.

Tax Cuts and Jobs Act Details

D. Business Tax Reform.

4. Other Business Reforms.

b. Loss Limitation Rules.

2) An "excess business loss" for the taxable year is the excess (if any) of aggregate deductions of T attributable to T/Bs (determined without regard to the loss limit), minus the sum of aggregate gross income or gain of T from such T/Bs, plus $250,000 ($500,000 for joint returns). The threshold amounts are indexed for inflation.

3) In the case of a partnership or S corporation, the provision applies at the owner level. Each owner's share of items of income, gain, deduction, or loss of the entity are taken into account by the owner in applying the limitation for the taxable year of the owner with or within which the taxable year of the entity ends.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

4. Other Business Reforms.

b. Loss Limitation Rules.

4) Regulatory authority is provided to apply the provision to any other passthrough entity to the extent necessary to carry out the limitation, and to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the limitation.

5) The provision applies after the application of the passive loss rules.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

5. Interest Deductions.

a. Under §163(j), except for businesses with average annual gross receipts of $25 million or less, in the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of:

1) Business interest income (not investment interest);

2) 30% of the adjusted taxable income of the taxpayer for the year (but not less than zero); and

3) The "floor plan financing" interest of the taxpayer for the year.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

5. Interest Deductions.

   b. Any interest deduction not allowed may be carried forward indefinitely.

   c. Limitation applies at the entity level (e.g., at the partnership level instead of partner level).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

5. Interest Deductions.

   d. Adjusted taxable income means income computed without regard to:

      1) Any item of income, etc., not properly allocable to the T/B;

      2) Any business interest or business interest income; and

      3) The amount of any NOL deduction and any deduction allowed under §199A; and

      4) For years beginning before 1/1/2022, any deduction for depreciation, amortization, or depletion.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

5. Interest Deductions.

e. "Floor plan financing interest" is that paid on debt used to finance the acquisition of motor vehicles held for lease or sale and secured by the inventory so acquired.

1) A motor vehicle is any self-propelled vehicle designed for transporting persons or property on a public street or highway, as well as boats and farm machinery and equipment.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

5. Interest Deductions.

f. For partnerships, the limit is applied at the partnership level and special rules prevent double counting.

g. The T/B of performing services as an employee is not treated as a T/B for purposes of the limit. Thus wages of an employee are not counted in the adjusted taxable income for purposes of determining the limit.

h. The limit does not apply to an electing real property trade or business as defined in §469(c)(7)(C). Also excluded are electing farming businesses and water or electrical energy businesses.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

6. <u>Modification of NOL Deduction</u>.

   a. Taxpayers may deduct an NOL carryover or carryback only to the extent of 80% of taxable income of the year to which it is carried (determined without regard to the NOL deduction).

   b. Generally repeals all NOL carrybacks, but provides a special two-year carryback for small businesses and farms in the case of certain casualty and disaster losses. Carryforwards are indefinite.

   c. Need guidance: Where T has "old" 100% NOLs and "new" carryforwards subject to the 80% limit; how to calculate?

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

7. <u>Like-Kind Exchanges of Real Property</u>.

   a. Deferral of gain under §1031 is allowed only for like-kind exchanges of <u>real property</u>, effective for transfers after 2017.

   b. Applies to exchanges <u>completed</u> after 12/31/2017.

   c. A transition rule allows a like-kind exchange of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before 12/31/2017.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

8. Contributions to Capital.

a. The Act retains the general rule that gross income of a corporation does not include contributions to capital, but provides that the term "contributions to capital" does not include:

1) Any contribution in aid of construction or any other contribution as a customer or potential customer; and

2) Any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

b. Intent: State governments should not be able to lavish corporations with incentives without tax consequences. New rule applies to contributions made after date of enactment, unless made pursuant a prior plan approved by a government entity.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

9. The deduction for lobbying expenses with respect to local councils or similar government bodies is repealed for amounts paid or incurred after date of enactment.

10. Section 199 regarding a deduction for qualified production activities income is repealed (but deduction allowed for Puerto Rico).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

11. <u>Entertainment and Meal Expenses and §274 expenses</u>.

    a. No deduction is allowed with respect to:

        1) An activity generally considered to be entertainment, amusement, or recreation;

        2) Membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes; or

        3) A facility or portion thereof used in connection with any of the above items.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

11. <u>Entertainment and Meal Expenses and §274 expenses</u>.

    b. Repeals the present-law exception allowing a deduction for entertainment, amusement, or recreation that is "directly related to" (or in some cases "associated with") the active conduct of a T/B, and the related rule applying a 50% limit to such deductions.

    c. Disallows a deduction for costs of providing any qualified transportation fringe to employees (parking and bus or transit pass) as defined in §132(f).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

11. <u>Entertainment and Meal Expenses and §274 expenses</u>.

    d. Except as necessary for ensuring the safety of an employee, disallows a deduction for any expense incurred for providing transportation (or any payment or reimbursement) for commuting.

    e. Taxpayers generally may still deduct 50% of the food and beverage expenses associated with operating a T/B (e.g., meals consumed by employees on work travel), with no deduction allowed for other entertainment expenses.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

11. <u>Entertainment and Meal Expenses and §274 expenses</u>.

    f. For amounts paid after 12/31/2017, the Act expands the 50% limitation on expenses associated with providing food and beverages to employees through an eating facility that meets the requirements for *de minimis* fringes under §132, and for the convenience of the employer under §119.

    1) This means that a deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility, is subject to the 50% limit on the deduction. (See *Jacobs*.)

    2) Such amounts are not deductible at all if paid or incurred after 12/31/2025.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

11. Entertainment and Meal Expenses and §274 expenses.

    g. What about meals for clients?

        1) Are such meals "entertainment" where the deduction for any cost is no longer deductible?

        2) Or do they meet the requirements of §274(k) if not lavish or extravagant and T or an employee is present (with 50% limit)?

        3) Many practitioners: It is non-deductible entertainment. IRS guidance needed.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

12. Employee achievement awards.

    a. Amends §74 definition of "tangible personal property" that may be considered a deductible employee achievement award to exclude:

        1) Cash, cash equivalents, gift cards, or equivalents (other than arrangement conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer); or

        2) Vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and similar items.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

13. <u>Unrelated business taxable income of tax-exempt organization</u>.

    a. The Act provides that unrelated business taxable income includes any amounts paid or incurred by a tax exempt organization for any of the following expenses, provided such amounts are not deductible under §274:

        1) Qualified transportation fringe benefits as defined in §132(f), or a parking facility used in connection with qualified parking as defined in §132(f)(5)(C); or

        2) Any on-premises athletic facility as defined in §132(j)(4)(B).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

14. <u>Rollovers of publicly traded securities gain</u>.

    a. The Act repeals the rule permitting gains on the sale of publicly traded securities to be deferred if rolled over to investment in a specialized small business investment company.

15. <u>Self-created property and capital gain</u>.

    a. Excludes from the definition of a capital asset a self-created patent, invention, model, design, or secret formula or process. Note: Rule in §1235 (sale of patent prior to exploitation is capital transaction) is <u>not</u> repealed. Nor is the exception for music.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

16. Technical terminations of partnerships.

   a. The Act repeals the §708(b)(1)(B) rule providing for technical terminations of partnerships.

   b. It does not change the present-law rule in §708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners.

   c. The Act also limits the amount of a charitable contribution deduction and foreign tax deduction to the partner's basis in its partnership interest.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

17. Carried interest.

   a. The Act does not change the "carried interest" rules that allow some persons to receive a partnership interest in exchange for services, and then later receive capital gain.

      1) The Act does provide for a three-year holding period in the case of certain net long-term capital gains with respect to any "applicable partnership interest" held by the taxpayer.

      2) The three-year period applies notwithstanding the rules of §83 or any election in effect under §83(b). Glitch: could use S corps under statutory language to avoid the new rule!

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

18. Amortization of research and experimental expenses.

    a. For taxable years beginning after 12/31/2022, amounts paid or incurred for specified research or experimental expenditures ("R&D" expenses) will be required to be capitalized and amortized ratably over five years, beginning with the midpoint of the taxable year in which the expenses were paid or incurred.

    b. Such expenses attributable to research that is conducted outside the U.S. will be required to be capitalized and amortized ratably over 15 years. As part of the repeal of the corporate AMT, taxpayers may no longer elect to amortize R&D expenses over 10 years.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

19. Special rules for taxable year of inclusion.

    a. Amended §451(b) requires an accrual method taxpayer subject to the all events test for an item of gross income to recognize such income no later than the year in which such income is taken into account as revenue in an applicable financial statement (AFS) (or another financial statement specified by the Secretary). Effective for tax years beginning after 12/31/2017.

        1) Rule does not apply to taxpayers without an AFS or specified financial statement. An AFS is defined in a manner similar to the definition in the tangible property regulations.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

19. Special rules for taxable year of inclusion.

    b. The new provisions also require accrual method taxpayers with an AFS to apply the income recognition rules under §451 before applying the special rules in part V of subchapter P (the OID and related rules). Effective for tax years beginning after 12/31/2018.

    c. The Act also limits the current deferral method of accounting for advance payments for good, services, and specified items under Rev. Proc. 2004-34, but Notice 2018-35 has transitional relief that allows taxpayers to continue to rely on Rev. Proc. 2004-34 until further guidance is issued.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

20. Denial of deduction for certain fines and penalties.

    a. The Act denies a deduction for any otherwise deductible amount paid or incurred to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation in inquiry by such government or entity into the potential violation of any law.

    b. Exception: Payments that the taxpayer establishes are either restitution (including remediation of property), or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

20. Denial of deduction for certain fines and penalties.

c. In case of any amount of restitution for failure to pay any tax that is assessed as restitution under the Code, it is deductible only to the extent it would have been allowed as a deduction if it had been timely paid.

d. The IRS remains free to challenge the characterization of an amount identified under the above rules, but no deduction is allowed unless the identification is made.

e. Restitution or remediation does not include reimbursement of government investigative or litigation costs.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

20. Denial of deduction for certain fines and penalties.

f. The provision applies only where a government or other entity is a complainant or investigator with respect to the violation or potential violation of any law.

g. Government agencies or other entities treated as such must report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid is at least $600. The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

20. <u>Denial of deduction for certain fines and penalties</u>.

h. The new rules are effective for amounts paid or incurred on or after the date of enactment, except they do not apply to amounts paid or incurred under any binding order or agreement entered into before such date.

i. The exception does not apply to an order or agreement requiring court approval unless the approval was obtained before the date of enactment.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

21. <u>Sexual harassment or sexual abuse settlements</u>.

a. No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

   i. Pending legislation would broaden limitations on deducting amounts paid in such cases.

Tax Cuts and Jobs Act Details

D. Business Tax Reform.

22. Reform of Business Credits.

a. Reduces the §45C business tax credit for qualified clinical testing expenses incurred in testing certain drugs for rare diseases or conditions ("orphan drugs") from 50% to 25%.

b. Keeps the employer credit under §42F for qualified child care expenses and resource and referral services.

c. Repeals the 10% rehabilitation credit for pre-1936 buildings under §47, but keeps the 20% credit for qualified rehabilitation expenses for certified historic structures, with modifications and a transition rule.

Tax Cuts and Jobs Act Details

D. Business Tax Reform.

22. Reform of Business Credits.

d. Keeps the §51 work opportunity tax credit, which is scheduled in any event to expire as to wages paid to individuals who begin work for an employer after 12/31/2019.

e. Keeps the deduction under §196 for unused business credits due to death or an entity ceasing to exist.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

22. Reform of Business Credits.

    f. Keeps the new markets tax credit under §45D.

    g. Keeps the §44 credit for expenses to provide access to disabled individuals ("eligible access expenditures").

    h. Leaves unchanged the credit for FICA taxes an employer pays on tips under §45B.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

22. Reform of Business Credits.

    i. Provides in new §45S a new employer credit for paid family and medical leave.

        1) For 2018 and 2019, eligible employers may claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees for any period in which such employees are on family and medical leave, provided the rate of payment is at least 50% of normal wages of the employee.

        2) Credit is increased by 0.25% (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

22. Reform of Business Credits.

i. Provides in new §45S a new employer credit for paid family and medical leave.

3) Time period limit: May not take into account for any employee more than 12 weeks.

4) Employer must have a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave (and allows all employees who are not full-time a commensurate amount of leave on a pro rata basis).

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

22. Reform of Business Credits.

i. Provides in new §45S a new employer credit for paid family and medical leave.

5) A qualifying employee means one defined in the Fair Labor Standards Act who has been employed by the employer for one year or more, and who for the preceding year had compensation not in excess of 60% of the compensation threshold for highly compensated employees ($120,000 for 2017 under §414(g)(1)(B)).

6) Family and medical leave is defined as leave described in the Family and Medical Leave Act of 1993.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

22. Reform of Business Credits.

    i. Provides in new §45S a new employer credit for paid family and medical leave.

        7) Any leave which is paid for by a state or local government "or required by state or local law" shall not be taken into account to determine the amount of paid family and medical leave provided by the employer. (See CA, NY, NJ, RI.)

        8) The IRS issued FAQs on April 9, 2018. See Notice 2018-69.

Tax Cuts and Jobs Act
Details

D. Business Tax Reform.

23. Miscellaneous Business Reforms.

    a. Lowers the current 80% dividends received deduction (DRD) for corporate shareholders to 65%, and lowers the current 70% DRD to 50%. This is due to the lower corporate income tax rate.

    b. The Act has numerous changes concerning the special tax rules for insurance companies, including rules on NOLs, computing reserves, tax reporting for life settlement transactions, and clarification of the tax basis of life insurance contracts.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

1. Limitations on Deductions of Excessive Compensation.

   a. The exceptions to the current $1 million compensation deduction limitation under §162(m) for commissions and performance-based compensation are repealed. But compensation is exempt from the change if paid under a contract in effect on 11/2/2017 that is not later modified in any material respect.

   b. Definition of "covered employee" will be revised to include specified persons to mirror current SEC rules.

   c. Once an employee is a covered person, he or she will remain so as long as her or she is paid remuneration by the corporation.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

2. Excise tax on excess compensation paid by tax-exempt organizations.

   a. Employers are liable for a 21% excise tax on the sum of remuneration in excess of $1 million paid to a covered employee by an applicable tax-exempt organization. Covered employee: any of the five highest compensated employees of the organization.

   b. Applicable tax-exempt organization includes §501(a) organizations, exempt co-ops, a federal, state, or local governmental entity with excludable income (such as a utility), and political organizations.

   c. Disagreement: Does it apply to public universities and cover Alabama's Nick Saban, highest-paid college football coach? Best answer is probably yes.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

3. Provides that a nonresident alien individual may hold shares of stock in an S corporation through an ESBT.

   a. An ESBT may also take a charitable contribution deduction based on the same rules that apply to an individual rather than a trust.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

4. Qualified Equity Grants.

   a. The Act allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer.

   b. An election to defer income inclusion (“inclusion deferral election”) with respect to qualified stock must be made no later than 30 days after the first time the employee’s right to the stock is substantially vested or is transferable, whichever occurs earlier.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

4. Qualified Equity Grants.

   c. If an employee makes such an election, the income must be included in the employee's income for the taxable year that includes the earliest of:

      1) The first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;
      2) The date the employee first becomes an excluded employee (as described below);
      3) The first date on which any stock of the employer becomes readily tradable on an established securities market;
      4) The date five years after the first date the employee's right to the stock becomes substantially vested;
      5) The date on which the employee revokes her inclusion deferral election.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

4. Qualified Equity Grants.

   d. The deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock.

   e. The provision generally applies with respect to stock attributable to options exercised or RSUs (Restricted Stock Units) settled after December 31, 2017.

Tax Cuts and Jobs Act
Details

E. Other Reforms.

5. Imposes 1.4% excise tax on net investment income of applicable educational institutions.

   a. Such institutions are ones that have at least 500 tuition-paying students, are state colleges and universities or described in §25A of the Code, and have aggregate assets not used directly in carrying out their tax-exempt purpose of at least $500,000 per student. Applies only to private colleges/universities.

   b. Note that after the House passed the Act, the Senate parliamentarian ruled that aspects of the standards used to define applicable educational institutions were not in compliance with the Senate reconciliation rules. The provision was changed from "500 tuition-paying students" to "500 students." Congress changed the language back to the original in subsequent legislation.

Tax Cuts and Jobs Act
Details

F. International Reforms.
(details in International Potpourri at 3:15 p.m. on Tuesday)

1. Taxation of foreign subsidiaries' earnings and profits (E&P) that have not previously been subject to U.S. tax (i.e., never have been repatriated):

   a. Include such E&P in income for the foreign subsidiary's last tax year beginning before 2018. Is deemed repatriation, period.

   b. Classify as either E&P that has been retained in the form of cash or cash equivalents, or E&P that has been reinvested in the foreign subsidiary's business.

   c. <u>Tax at rate of 15.5% for cash or cash equivalents, and at 8% for the balance</u>. Can elect to pay the tax over 8 years (8% of total due in each of first five years, 15% in year 6, 20% in year 7, and 25% in year 8).

Tax Cuts and Jobs Act
Who Benefits the Most?

G. JCT Report on April 23, 2018:

1. About 400,000 taxpayers with incomes of $500,000 or more will benefit the most from §199A and receive an estimated $21.4 billion in tax benefits in 2018, and $36.9 billion in 2024.

   a. About 5 million returns in the $50,000-$100,000 income range will receive an estimated $2.2 billion in tax benefits from the §199A deduction in 2018. Six years later that group will grow to 5.2 million returns and the tax benefit will rise to $2.8 billion.

   b. Supporters of TCJA: These numbers do not show how benefits are actually distributed throughout the economy.

Tax Cuts and Jobs Act
Who Benefits the Most?

G. JCT Report on April 23, 2018:

2. Distribution of benefit of SALT deductions: In 2017 taxpayers (mostly in $75,000-$200,000 income range) received a tax benefit of $109.5 billion, and that will drop to $20.2 billion in 2018 before rising to $173 billion in 2026, after the limits on the deduction expire.

   a. Number of itemizers will decrease from 46.5 million in 2017 to 18 million in 2018 and rebound to 54.2 million in 2026. Charitable contributions will drop by about $17.2 billion in 2018.

   b. CBO in April 2018: Corporations will pay $54 billion less in federal income taxes in 2018. Will pay $243 billion in taxes, about 7.3% of total federal revenue. Individual income tax receipts will be about 49% of revenue for 2018.

Subsequent Legislation
Fixing Glitches

A. Consolidated Appropriations Act, 2018 (H.R. 1625).

1. Is a $1.3 trillion spending bill enacted March 23, 2018, to prevent government shutdown and fund the government through September 2018.

   a. Fixes the "grain glitch" in the TCJA involving grain coops and uneven treatment under §199A.

   b. Contains pre-TCJA technical corrections including corrections to the partnership audit rules.

Proposed Legislation

A. The Strengthening the Tenth Amendment Through Entrusting States (STATES) Act:

1. Allows states, territories, and tribes to decide for themselves how to regulate marijuana without federal interference, according to bipartisan sponsors Senator Cory Gardner (R-Co.) and Senator Elizabeth Warren (D-Mass.).

   a. Forty-six states, the District of Columbia, two territories, and several Native American tribes have legalized marijuana in some form (medical or recreational).

   b. Meanwhile a state court in Indiana shot down the right of the First Church of Cannabis to use marijuana at services under the Indiana Religious Freedom Restoration Act.

Miscellaneous Items
TRP Issues Post-*Loving*

A. In *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014): Treasury lacks the authority to regulate persons who only prepare returns.

B. In *Ridgely v. Lew*, 2014 U.S. Dist. LEXIS 96447 (D. D.C. 2014): IRS does not have authority under Circular 230 to prohibit a CPA from charging a contingent fee for preparing a refund claim.

C. In *Sexton v. Hawkins*, 2017-1 U.S.T.C. (CCH) ¶50,181 (D. Nev. 2017): Under *Loving*, a disbarred lawyer who prepares returns is not subject to IRS regulatory authority.

D. In *Steele v. U.S.*, 2017-1 U.S.T.C. (CCH) ¶50,238 (D. D.C. 2017): The IRS may require a TRP to have and use a PTIN, but it cannot charge fees for PTINs. They are not a service or thing of value provided to TRPs by the IRS. Appeal is pending.

Miscellaneous Items
The IRS Budget

A. IRS budget has been cut about 10% since 2010, or nearly 20% indexed for inflation.

   1. The Consolidated Appropriations Act of 2017, passed by Congress in May 2017 to fund the government through September 30, 2017, provided for an IRS budget of $11.25 billion.

      a. Currently Congress is on track to provide an IRS budget of about $11.3 to $11.6 billion for fiscal 2018. Note that the IRS requested about $400 million extra to fund implementation of the TCJA.

      b. President Trump's 2018 budget only allows about $11.1 billion for the IRS, and allocated more dollars to enforcement and less to service. Service employees would be cut by 11%.

Miscellaneous Items
Supreme Court Reverses *Quill*

A. In *South Dakota v. Wayfair, Inc*., 2018 U.S. LEXIS 3825:

1. In a 5-4 decision the Supreme Court overruled the "physical presence" standard in the old *Quill* case, freeing states to require sellers to collect sales tax on internet and other remote sales even if they lack a physical presence in the state.

   a. The old rule "imposes the sort of arbitrary, formalistic distinction that the Court's modern Commerce Clause precedents disavow," according to the majority Justices Alito, Gorsuch, Ginsburg, Thomas, and Kennedy.

   b. With each passing year, the "physical presence rule becomes further removed from economic reality," resulting in significant losses to states. In response, Congress may act to regulate collection of taxes on remote sales to potentially lessen the burden on small sellers.

INCOME & CAPITAL GAINS EXCLUSIONS, DEFERRALS AND CREDITS

Stock Options Are Not Railroad Wages

A. In *Wisconsin Central Ltd. v. U.S.*, 2018-1 U.S.T.C. (CCH) ¶50,291 (S. Ct. 2018):

1. Resolving a conflict among the Circuits, the Supreme Court in a 5-4 decision held that employee stock options are not taxable compensation under the Railroad Retirement Tax Act because Congress limited the taxing of railroad employee compensation to "any form of money remuneration."
   a. Stock options at the time Congress enacted the relevant statute in 1937 did not fall within the definition of "money" ("currency issued … as a medium of exchange").
   b. More recent IRS interpretations treating such benefits as being the same as FICA wages were not entitled to *Chevron* deference.

Minister Housing Allowance Unconstitutional

A. In *Gaylor v. Mnuchin*, 278 F.Supp.3d 1081 (W.D. Wis. 2017):

1. Held: §107(2), which excludes from gross income of a minister of the gospel (or similar religious leader) any "rental allowance paid to him as part of his compensation," is unconstitutional.
   a. Previously the same court also so held, but on appeal the Seventh Circuit reversed on the procedural grounds that the plaintiffs lacked standing. See *Freedom from Religion Foundation, Inc. v. Lew*, 773 F.3d 815 (7^{th} Cir. 2014).
   b. The Court now found the plaintiffs had standing, and adhered to its prior conclusion that the provision violates the establishment clause because it provides a benefit to religious persons and to no one else, and alleviates no special burden on religious exercise. An appeal will follow.

Insolvency Test for COD

A. In *Hamilton v. Comm'r*, T.C. Memo. 2018-62:

1. Held: A couple was not insolvent for purposes of determining if they had cancellation of indebtedness income when they transferred funds to a son as a nominee.
   a. The Hamiltons had an adult son, Andrew, for whom Mr. Hamilton (H) obtained college student loans. H later injured his back, and the loans in the amount of $158,000 were discharged in 2011 due to his resulting disability.
   b. At the same time, H received about $308,000 in nontaxable cash distributions from an interest in a LLC.

Insolvency Test for COD

A. In *Hamilton v. Comm'r*:

1. Due to H's subsequent "erratic spending," Mrs. Hamilton (W) began to manage the couple's finances and transferred $323,000 to Andrew's savings account.
   a. W had access to Andrew's account, and his permission to transfer funds from that account. Throughout 2011, W regularly transferred money from Andrew's account to the Hamiltons' joint account, from which she paid most household bills.
   b. For 2011, the Hamiltons' TRP treated their liabilities as exceeding their assets by $165,000, and therefore excluded from GI the $158,000 of cancellation of debt (COD) income. The IRS disagreed, as there was no insolvency if the money in Andrew's account was included in the insolvency calculation under §108.

Insolvency Test for COD

A. In *Hamilton v. Comm'r*:

1. Court:

   a. If Andrew held the funds in his savings account as the Hamiltons' nominee, the funds were included in the insolvency calculation and the Hamiltons had to include the COD income in GI.

   b. Applying controlling Utah law, Andrew held the funds solely as a nominee because W had the ability to freely transfer funds to the Hamiltons' joint account as she chose. W continued to enjoy dominion and control over the funds, and Andrew was a nominee.

   c. Therefore the insolvency exception in §108 did not apply and the Hamiltons had to recognize the COD income in 2011.

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*, 150 T.C. No. 8 (2018):

1. Held: A couple's short sale of a home and resulting cancellation of debt was a single transaction for which they recognized neither a gain nor a loss.

   a. The Simonsens (together "T") bought a home in 2005 for $695,000, obtaining a nonrecourse $556,000 mortgage from a lender. The recession hit, and in 2010 when it was worth $495,000 T moved out and converted the home to a rental.

   b. In 2011 T did a short sale to a third party with the approval of the lender, receiving only $363,000, all of which went to the lender to pay down the mortgage and cover closing costs.

   c. The lender forgave the remaining loan balance of $219,000.

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*:

1. T reported the transaction as having sold the home for $363,000 in 2011, and having COD income of $219,000 in the same year. That resulted in a loss of $216,000 for a rental property and an exclusion of the COD income because it was for forgiveness of qualified principal residence debt.
2. Court: The tax result depends on whether
   a. The short sale was a single transaction, OR
   b. T was right that there were two separate transactions, a sale followed by the lender's cancellation of the debt remaining after the sale.

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*:

1. Court: Prior cases support the rule that a short sale with lender approval is a single transaction. The lender cancelled the debt in exchange for the proceeds of the sale, and the lender could dictate the terms of the sale.
   a. Here the "key point" is that the lender was willing to cancel the debt only if T turned over the sale proceeds. The lender had to re-convey the deed of trust for the sale to close.
   b. Therefore there was only one transaction.

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*:

1. Court: To compute the gain or loss on the one transaction:
    a. Amount realized from a sale of property includes the amount of liabilities from which the transferor is discharged, and the sale of property that secures nonrecourse liability discharges the transferor from the liability.
    b. In short, if a T sells property encumbered by a nonrecourse obligation, T must include the outstanding amount of the obligation in amount realized.
    c. Therefore amount realized was $555,960, the amount of the debt on the home at the time of the sale.

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*:

1. Court: As to basis, <u>T converted the property to a rental and Reg. §1.165-9(b)(2) provides that to compute a loss, a taxpayer must use an adjusted basis that is the **lesser** of existing basis or the property's FMV at time of conversion</u>.
2. Here FMV at time of conversion was $495,000, less than the existing basis at that time (which was the $695,000 purchase price less depreciation and plus any capital improvements).
3. Problem: Amount realized of $555,960 falls between the basis to use to calculate a loss ($495,000) and the basis to use to calculate a gain (assume $695,000). Thus the regulation gives T an "in-betweener."

No Gain or Loss on Short Sale

A. In *Simonsen v. Comm'r*:

1. Court: There is no precedent on this conundrum.
   a. So look to the basis rules for gifts, which provide for a carryover basis, but if FMV is less than the donor's basis, the donee uses the lower FMV to compute a loss. The carryover basis is used to compute any gain.
   b. For gifts, if a donee sells the property received for an amount between her "loss basis" and "gain basis," there is no gain or loss. This odd result should also apply to transactions covered by Reg. §1.165-9(b)(2).
   c. Therefore T realized neither a gain nor a loss on the short sale!

Nice Try Award
"Love Offerings" From Church Were Income

A. In *Jackson v. Comm'r*, T.C. Summ. Op. 2016-69:

1. The pastor of a small church informed the church's board that he did not want to be paid a salary for his services, but would not be opposed to receiving "love offerings," gifts, or loans.
   a. The pastor and his wife managed the church checking account and in 2012 she signed numerous checks to husband with notations such as "love offering" or "gift." Church's bookkeeper sent the pastor a Form 1099-MISC for 2012 reporting nonemployee compensation of $4,815.
   b. Taxpayers did not report that amount as gross income.

Nice Try Award
"Love Offerings" From Church Were Income

A. In *Jackson v. Comm'r*, T.C. Summ. Op. 2016-69:

2. Court:

a. Gross income is broadly defined and pastor had income under *Comm'r v. Duberstein*, 363 U.S. 278 (1960) (to distinguish a gift from income, transferor's intent is the critical issue; objective facts and circumstances control).

b. Here the "love offerings" were a substitute for a salary, and the bookkeeper intended that the payments be compensation. No church members testified to the contrary.

c. See *Goodwin v. U.S.*, 67 F.3d 149 (8th Cir. 1995): Cash payments collected from congregation and transferred to pastor as "special occasion gifts" were taxable income.

2017 Foreign Earned Income Exclusion

A. Section 911 foreign earned income exclusion for 2018 is **$103,900**, up from $102,100 in 2017.

B. The maximum exclusion for housing costs in 2018 is:

$31,170 (30% X $103,900, the reasonable housing cost cap)

- 16,624 (16% X $103,900, the base housing cost)

$14,546 Maximum exclusion for full-year resident

C. Notice 2018-44: List of localities where an increased reasonable housing cost cap applies. Highest is Hong Kong at $114,300, followed by Moscow at $108,000.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162, the Tax Court held that a commercial airline pilot was not a "qualified individual" for purposes of §911, finding that his abode was within the U.S. and he was not a bona fide resident of South Korea.

1. Acone is a pilot who worked for Korean Air Lines (KAL) from 2006 to 2013, stationed at Incheon International Airport in Seoul, South Korea. All his flights were in or out of Incheon.

2. Acone received nine days off per month, and usually spent that time in his New Hampshire home with his wife. When in Seoul, Acone stayed in a hotel owned by his employer.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162:

3. In 2011 and 2012, Acone retained his U.S. citizenship, maintained his New Hampshire home where he and his wife lived before and after his employment at KAL, had a U.S. driver's license, was registered to vote in New Hampshire, and retained his U.S. bank accounts, into which KAL deposited his wages.

    a. Acone's wife, a school teacher, stayed in the New Hampshire home when Acone was in Seoul. Acone spent about a third of 2011 and 2012 in Seoul, and more than 40% of his time in the U.S. He spent as much time as possible in the U.S. because his wife and three children were a "huge draw" for him.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162:

4. In 2011 and 2012 the Acones claimed the maximum allowable foreign earned income exclusion under §911. The IRS asserted tax deficiencies of about $32,000 for each year, claiming that Acone was not a "qualified individual" entitled to the exclusion because he failed to meet the two relevant requirements:

    a. The taxpayer's "tax home" for the relevant period must be "in a foreign country"; and

    b. The taxpayer must be a bona fide resident of a foreign country for an entire taxable year, or a U.S. citizen or resident who is present in a foreign country during at least 330 full days of a 12-month period.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162:

5. Acone did not meet the 330-day test, and therefore he had to prove that his "tax home" was in South Korea and that he was a "bona fide resident" of South Korea for an uninterrupted period including a full taxable year.

    a. A person is not treated as having a "tax home" in a foreign country for any period for which his "abode" is within the U.S.

    b. "Abode" is one's "home, habitation, residence, domicile, or place of dwelling." It does not mean one's principal place of business, has a "domestic rather than vocational" meaning, and stands in contrast to "tax home." The word connotes stability, not transience.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162 :

6. Factors considered by the Court as to "abode":

   a. Acone's housing in Seoul was his employer's hotel, where he stayed in whatever room happened to be vacant when he checked in. This was the "quintessence of transience." In contrast, his home in New Hampshire was stable.

   b. Even if a taxpayer may have some limited ties to a foreign country, if his ties to the U.S. "remain strong," his abode remains in the U.S.

   c. Acone chose to spend more time in the U.S. than in Korea, and spent over 80% of his off-duty days in the U.S. The mean length of his visits to the U.S. were more than twice that of Korea visits.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162:

6. Factors considered by the Court as to "abode":

   d. Acone also remained registered to vote in the U.S., never obtained a driver's license or car in Korea, and helped maintain his home in New Hampshire.

   e. Finally, because Acone did not pay for housing in Seoul or for plane fare to return to the U.S., his choice of where he spent his days was "fairly unencumbered economically." He chose the U.S. most often, and did not satisfy the "tax home" requirement.

Foreign Earned Income Exclusion
Pilot Did Not Qualify

A. In *Acone v. Comm'r*, T.C. Memo. 2017-162:

7. The Court also found that Acone was not a bona fide resident of South Korea because:

   a. Only 3 of 11 factors under *Sochurek v. Comm'r*, 300 F.2d 34 (7th Cir. 1962) favored Acone (he tried to assimilate in South Korea when there; he worked there for 7 years; and Acone acted in good faith in working out of Seoul).

   b. The other 8 factors were adverse to Acone: his intentions as to residence location, establishment of a home, physical presence, temporary absences, duplicate economic burdens, transience, employer's tax treatment, and family location.

   c. See also *Hudson v. Comm'r*, T.C. Memo. 2017-221 (same result for another South Korean pilot with similar facts).

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*, 2017 U.S. Tax Ct. Memo LEXIS 183:

1. Held: A government contractor who worked as a helicopter pilot in Iraq during three tax years had a tax home in Iraq and was a bona fide resident of that country, entitling him to the foreign earned income exclusion.

2. Linde was in the army 20 years and was a helicopter pilot.

   a. In 2009 Linde was hired by a government contractor to work in Iraq, where pilot jobs were more plentiful than in the U.S. His wife remained in Alabama.

   b. Linde worked in Iraq under one-year contracts and Iraq issued him a residency visa.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

3. Linde resided in Iraq for 248 days in 2010, 240 days in 2011, and 249 days in 2012.
    a. Linde's job was to fly U.S. officials "all over Iraq" to locations in support of the U.S. Ambassador to Iraq.
    b. Linde worked 60 straight days of 12-hour shifts followed by break periods of 30 days. His employer required him to leave Iraq every 60 days, and provided a round-trip plane ticket to Kuwait at the conclusion of each 60-day period. From there Linde flew to the U.S. or elsewhere at his own expense.
    c. Linde spent part of his break periods in Europe, and the rest in Alabama with family.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

4. In Iraq, Linde shared an employer-provided container housing unit (CHU), and no one else resided in Linde's bedroom when he was on break.
    a. Linde maintained an Iraqi bank account in 2010 and 2011, as well as an account at the Armed Forces Bank.
    b. Linde kept his vehicles in Alabama, where he was registered to vote and licensed to drive.
    c. Linde's employer prohibited employees from bringing relatives to Iraq due to dangerous conditions. Linde's wife and adult children could not join him elsewhere on his breaks, even in Europe, because of a severely disabled son-in-law.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

5. Linde did not pay taxes to Iraq through 2012, although he did in 2013 when his work schedule changed.
6. In each of 2010-2012, Linde's U.S. tax returns were prepared by an experienced preparer who advised him that he was eligible for the foreign earned income exclusion. Linde excluded between $62,000 and $88,700 of income in each of those years.
7. IRS: Linde was not a "qualified individual" entitled to the foreign earned income exclusion.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

8. To be a qualified individual, two requirements applied:
   a. His tax home had to be in Iraq; and
   b. He must either
      i. Be a "bona fide resident" of Iraq for an uninterrupted period which includes an entire taxable year, or
      ii. Be physically present in Iraq during at least 330 days in a 12-month period.
9. Linde did not satisfy the 330-day test, and therefore had to be a bona fide resident of Iraq to meet the second requirement.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

10. Tax home:

    a. Generally a person's tax home is the vicinity of his principal place of employment, but an individual shall not be treated as having a tax home in a foreign country for any period during which his "abode" is within the U.S.

    b. Temporary presence in the U.S. does not necessarily mean a person's abode is in the U.S.

    c. Maintenance of a dwelling in the U.S., whether or not used by a spouse and/or dependents, does not necessarily mean a person's abode is in the U.S.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

10. Tax home:

    d. Courts must examine and contrast a person's domestic ties (family, economic, and personal ties in the U.S.) to the person's ties to the foreign country.

    e. If the ties to the U.S. "remain strong," the Tax Court has held that the person's abode remained in the U.S., especially if the ties to the foreign country were "transitory or limited" during the relevant period.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

11. Court concluded Linde had stronger ties to Iraq than to the U.S. in 2010-2012 because:

    a. His economic and social life was centered in Iraq. It had become difficult in his mid-50s to be a pilot in the U.S., and he could be a pilot for the foreseeable future in Iraq.

    b. Linde spent 2/3 of his time in Iraq, and his economic ties to Iraq grew stronger each year with a promotion and social ties with other contractors.

    c. Linde's ties to the U.S. were more like "mere visits" and limited by convenience of breaks and flight schedules. His ties to Iraq were not merely transitory as in cases the IRS relied upon.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

11. Court concluded Linde had stronger ties to Iraq than to the U.S. in 2010-2012 because:

    d. Linde intended to continue working in Iraq indefinitely, and returned to visit the U.S. less frequently than taxpayers in prior cases cited by the IRS.

    e. Reg. §1.911-2(b): Temporary presence of an individual in the U.S. does not necessarily mean that the individual's "abode" is in the U.S.

    f. Overall, Linde had stronger ties to Iraq than to the U.S., and his abode and tax home were in Iraq.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

12. Bona fide residence:

    a. The issue of foreign residence is determined by applying principles of §871, and is a question of fact.

    b. Bona fide residence in a foreign country for an uninterrupted period may be established even if the taxpayer makes temporary visits during the period to the U.S. or elsewhere on vacation or business.

    c. In *Sochurek v. Comm'r*, 300 F.2d 34 (7^{th} Cir. 1962), the Court identified 11 factors that fall into four categories: (1) intent of T; (2) T's physical presence; (3) social, family, and professional relationships; and (4) T's representations.

Foreign Earned Income Exclusion
Helicopter Pilot in Iraq Did Qualify

A. In *Linde v. Comm'r*:

13. The following factors favored Linde and sustained his burden to prove he was a bona fide resident of Iraq:

    a. Intent to remain in Iraq indefinitely, or at least for a substantial period of time given employment opportunities.

    b. Sustained physical presence in Iraq for 2/3 of each year, with absences required by his employer.

    c. Although Linde had one-year contracts, they were expected to be and were renewed at the end of each year. The IRS argument that Linde did not intend to remain in Iraq after he retires was not persuasive as there was no evidence Linde intended to retire in the near future.

Stock Basis Calculated Using FIFO

A. In *Turan v. Comm'r*, T.C. Memo. 2017-141:

1. IRS properly calculated taxpayer T's basis in stock using the first-in, first-out method (FIFO).
   a. T, a real estate agent and tax return preparer, made numerous stock trades in 2013 through a brokerage account with Scottrade. In early 2013, T bought a total of 100,000 shares of Federal National Mortgage Association (FNMA) stock at different times at different prices.
   b. Later in 2013 T made a total of 16 sales of the FNMA stock.
   c. Scottrade sent T monthly statements and Forms 1099-B reporting the sales using the FIFO method to determine cost basis, its default method prominently disclosed in statements T received.

Stock Basis Calculated Using FIFO

A. In *Turan v. Comm'r*:

2. Reg. §1.1012-1(c):
   a. For Ts owning blocks of identical stock acquired on different dates or for different prices, the default method to determine stock basis is using the FIFO method.
   b. Ts, however, may opt to identify the specific shares of stock they wish to sell. Adequate identification for shares held by a broker requires the T at the time of sale to designate a particular lot of stock to be sold, and requires the broker to confirm such instructions in writing within a reasonable time.
   c. Generally, adequate identification must be no later than the settlement date.

Stock Basis Calculated Using FIFO

A. In *Turan v. Comm'r*:

3. T claimed the IRS and Scottrade erred in using the FIFO method to determine his basis in FNMA shares because he attempted to inform Scottrade of his desire to always use LIFO rather than FIFO, first through Scottrade's internet portal and later by phone, but such attempts failed due to Scottrade errors or misfeasance.

4. Court: Prove it. T offered no documentation or objective evidence to corroborate his claim of computer error and misfeasance by Scottrade. T lacked credibility and never proved adequate identification of FNMA shares to sell. Accuracy-related penalty of $9,091 applies.

Affirmed: Section 1234A Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. The taxpayer ("CRI"), a partnership engaged in the real estate business, acquired a hotel in Florida for $13.8 million in 2005, and operated the property in its trade or business.

   a. In 2006 CRI entered into a contract to sell the hotel to a third party ("RPS") for $39 million. RPS defaulted and the contract terminated in 2008. CRI was entitled to keep $9.7 million in deposits RPS had made.

   b. CRI reported the $9.7 million as net long-term capital gain. It stipulated that the hotel was §1231 property in its hands, and not property within the definition of a "capital asset" under §1221(a)(2) ("capital asset" does not include real property used in taxpayer's T/B).

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. CRI claimed that § 1234A applied. As relevant to the case, it provides that gain or loss attributable to the cancellation, lapse, or other termination of "a right or obligation with respect to property which is (or on acquisition would be) a **capital asset** in the hand of the taxpayer … shall be treated as gain or loss from the sale of a capital asset." (emphasis supplied).
   a. CRI: Had it sold the §1231 property it would have long-term capital gain, and the broad intention of Congress in enacting and amending § 1234A was to include §1231 property within the coverage of §1234A. Intent was to treat terminations like sales.
   b. IRS: §1234A refers to capital assets only, and its plain and unambiguous wording is controlling.

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. Court agreed with the IRS, stating that courts look beyond the plain meaning of words used in a statute only when their meaning is "inescapably ambiguous." When the will of Congress has been expressed in reasonably plain terms, that "language must ordinarily be regarded as conclusive."
2. Here, when a statute is clear on its face, courts require "unequivocal evidence" of legislative intent to override the plain meaning of words in the statute.
3. The Court was "unable to find anything in the legislative history" of §1234A to support CRI's claim that Congress intended to include §1231 property within its ambit.

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. The Court noted that Congress has had 35 years to amend the statute if it intended to include §1231 assets within the coverage of §1234A.
2. Congress knows how to use language that would have not limited coverage to capital assets. For example, similar to §1234(a) language, it could have referred to property that has the same character in the hands of the taxpayer as the property to which the termination of a right or obligation relates.
3. Therefore the "clarity of congressional purpose in restricting the reach of the statute to capital assets is ineluctable."

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. Some commentators disagree. The Court stated that it had not seen any references to the application of §1234A to §1231 property "outside of isolated mentions by some legal commentators." The Court did not cite those commentators, but was no doubt referring to the following argument.
2. A 1997 amendment expanded the reach of §1234A from certain personal property (to prevent abuses related to straddles, for example) to all property that is a capital asset. The Senate Committee Report to the 1997 amendment states that the change applied to interests in real property and non-actively traded personal property.

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. The Senate Report then states that an example of a real property interest that would be affected by the amendment is the tax treatment of amounts received to release a lessee from a requirement that it restore the leased premises at termination of the lease.

2. The Report then in a footnote cites two cases after this example. In both, a lessee paid a landlord to be released from the obligation to restore the leased premises to their original condition at the end of the lease. One of the cases clearly involved §1231 property, and the other probably did.

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. In *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016):

1. The commentators argue that because at least one of the cases cited in the Senate Report involved §1231 property, Congress expressly intended to cover §1231 property under §12324A.

2. There is, however, no specific reference to §1231 property in the Senate Report or other legislative history to §1234A.

3. It is not clear if the commentator's argument was made by CRI. If so, the Court apparently was not persuaded by it.

Section 1234A
Covers Only Capital Assets, Not §1231 Property

A. Affirmed: *CRI-Leslie LLC v. Comm'r*, 147 T.C. 217 (2016), *aff'd*, 882 F.3d 1026 (11^{th} Cir. 2018).

1. Court:

   a. The Code could not be clearer in the distinction between a "capital asset" and §1231 property.

   b. Section 1234A: Its clear language only applies when the underlying property is a "capital asset," and its special rule "simply doesn't apply. That's it. End of case."

   c. Even if a "purposes and objectives" argument is "not without foundation" (as scholars suggest), the "Code's plain language flatly forecloses it." If Congress intended otherwise, it can amend the Code.

IRS Explains Cure Period for Plan Loans

A. ILM 201736022:

1. Provides two situations where the cure period in Reg. §1.72(p)-1, Q&A-10, applies and prevents missed installment payments on a retirement plan loan from causing a deemed distribution.

2. Requirements of §72(p)(2) for the exception that a plan loan does not result in a deemed distribution:

   a. Repayment period of five years or less;

   b. Level amortization over the loan term (failure to make any installment payment violates this requirement); and

   c. At least quarterly payments.

IRS Explains Cure Period for Plan Loans

A. ILM 201736022:

3. Reg. §1.72(p)(1)-1, Q&A-10, permits plan to allow a cure period up to the last day of the calendar quarter following the calendar quarter in which the missed installment payment was due.
4. In both situations taxpayer T got a §401(k) plan loan with level payments due monthly over five years, starting in January 2018. The plan had a cure period as allowed in the regulation.
   a. Situation 1: T timely pays through 2/28/2019, and then misses the 3/31/2019 and 4/30/2019 payments. T then makes payments on 5/31/2019 and 6/30/2019, which are applied to the missed March and April payments. T makes three payments on 7/31/2019. which cover the missed May and June payments and the July payment.

IRS Explains Cure Period for Plan Loans

A. ILM 201736022:

1. Situation 1 Conclusion: The missed payments did not violate the level amortization requirement because they were cured within the applicable cure period, and no deemed distribution occurred.
   a. The missed payments in March and April have separate cure periods because they occur in separate calendar quarters. The missed March payment’s cure period ended on June 30, 2019, and the missed April payment’s cure period ended on September 30, 2019. The May and June payments cured the March and April missing payments. The July payments in turn cured the missing payments for May and June, which had a cure period ending in September.

IRS Explains Cure Period for Plan Loans

A. ILM 201736022:

2. Situation 2: T made timely installment payments through 9/30/2019, but missed the payments due in October, November, and December 2019.

    a. On 1/15/2020, T refinanced the loan and replaced it with a new loan equal to the outstanding balance of the original loan, including the three missed payments.

    b. The replacement loan had to be repaid in level monthly installments at the end of each month through the end of the repayment term, which ended on 12/31/2022 (the same ending date as the original five-year loan). Assume the replacement loan meets the requirements of §72(p)(2) and the regulations.

IRS Explains Cure Period for Plan Loans

A. ILM 201736022:

2. Situation 2 Conclusion: The level amortization requirement was not violated because the missed payments were cured within the applicable cure period by refinancing the loan. There is no deemed distribution.

    a. Reg. §1.72(p)(1)-1, Q&A-20(a) provides that a T may refinance a plan loan if the loans collectively satisfy amount limitations and the original and replacement loan each satisfy the other requirements of §72(p)(2) and the regulations. Refinancing includes any situation where one loan replaces another loan.

    b. The cure period for the three missed payments ends 3/31/2020 and the replacement loan paid off the original loan on 1/15/2020, curing the missed payments. Therefore there was no distribution.

Default on Retirement Plan Loan
CPA Got Year of Deemed Distribution Wrong

A. In *Gowen v. Comm'r*, T.C. Summ. Op. 2017-57:

1. Taxpayer T, a CPA who holds a master's degree in taxation, borrowed $50,000 from his KPMG retirement plan in 2012.
    a. T was required to make 120 semimonthly payments of $451 beginning on March 30, 2012, and ending on March 15, 2017.
    b. T lost his job at KPMG and stopped making payments, beginning with the payment due on August 30, 2012.
    c. The plan administrator immediately notified T that his "cure period" for his default expired at the "end of the calendar quarter following the calendar quarter during which the payment was missed." Repeat notices were issued in November and December of 2012.

Default on Retirement Plan Loan
CPA Got Year of Deemed Distribution Wrong

A. In *Gowen v. Comm'r*:

1. Taxpayer T, a CPA who holds a master's degree in taxation, borrowed $50,000 from his KPMG retirement plan in 2012.
    d. T claimed he never received a Form 1099-R for 2012 (although the IRS did), but admitted he received a distribution statement for about $46,000 dated January 7, 2013.
    e. T treated the deemed distribution due to default on the plan loan as occurring in 2013, claiming that the plan administrator never told him it was deemed to occur on December 31, 2012.
    f. T did not report the distribution on his 2012 return.

Default on Retirement Plan Loan CPA Got Year of Deemed Distribution Wrong

A. In *Gowen v. Comm'r*:

2. Court:

a. Loans from a qualified retirement plan generally are treated as taxable distributions unless specific requirements are met under §72(p). That exception ceases to apply if the plan participant fails to make a loan payment either on the date due or within an allowed cure or grace period.

b. Reg. §1.72(p)-1, Q&A-10, provides that a plan administrator may allow a <u>cure or grace period which cannot continue beyond the last day of the calendar quarter following the calendar quarter in which the required payment was due</u>.

Default on Retirement Plan Loan CPA Got Year of Deemed Distribution Wrong

A. In *Gowen v. Comm'r*:

2. Court:

c. The Code and regulations are clear. If the non-payment date is in the third calendar quarter, the maximum cure period ends at the end of the fourth calendar quarter. Here the first non-payment date was in the third quarter of 2012, and the cure period ended on December 31, 2012. On that date the deemed distribution occurred.

d. T is wrong in arguing the non-payment date (here 8/30/2012) started a quarter running from August through October 2012, and then the cure period did not end until the end of January 2013. See the example in Reg. §1.72(p)-1, Q&A-10(c).

Reverse Like-Kind Exchange
Meets Requirements Even If No Safe Harbor

A. In *Estate of Bartell v. Comm'r*, 147 T.C. 140 (2016):

1. The Tax Court held that a reverse like-kind exchange qualified under §1031, even though the IRS claimed that:
   a. The accommodation party only held bare legal title to the replacement property until the relinquished property was sold; and the transactions was not completed within the safe harbor period of 180 days
2. On August 14, 2017, in AOD 2017-06, the IRS announced that it will not acquiesce in *Bartell*.
   a. The IRS did not state the reasons for that decision, but refused to acquiesce in the entire decision, not just the result.

Like-Kind Exchanges
Dual Use Property

A. ILM 201605017 addresses the issue of whether property used for both a T/B purpose and for personal purposes can qualify for like-kind exchange treatment.

1. T owned aircraft through a disregarded LLC, which provided business services to T's businesses and investments that were dispersed throughout the U.S. T had some business and investment need for the aircraft, but also used it for personal purposes.
2. The LLC exchanged the aircraft for a replacement aircraft. A revenue agent calculated that the percentage of the relinquished aircraft's flights for business/investment were "low" compared to the percentage for personal use.

Like-Kind Exchanges
Dual Use Property

A. ILM 201605017:

1. IRS: Because only a "low" percentage of the relinquished aircraft's flights were for business/investment use, the exchange did not meet §1031 requirements because it was not "held for productive use in a trade or business or investment."
2. Issue: Could the relinquished aircraft be treated as two assets (one T/B and investment, and one personal) for §1031 purposes?
3. IRS: No. Property is either held for productive use in a T/B or for investment (the "held for" requirement), or it is not. Treating dual-use properties as two properties would allow §1031 treatment where it was not intended.

Like-Kind Exchanges
Dual Use Property

A. ILM 201605017:

1. IRS: Here the relinquished aircraft is a single property that either meets or fails to meet the "held for" requirement. Additional facts were needed in the present case to determine the answer to that question.
2. If the examiner ultimately determines that more than 50% of the use of the aircraft was for personal purposes, the IRS would agree that the relinquished aircraft was not held for productive use in a T/B or for investment. There is, however, no general 50% use threshold for property to meet the "held by" requirement.
3. Analogous issue: safe harbor for like-kind exchange of vacation home, where limited personal use does not disqualify the exchange.

BUSINESS EXPENSES & LOSSES

Charitable Donation of Property by Trust Limited to Adjusted Basis

A. In *Green v. U.S.*, 880 F.3d 519 (10th Cir. 2018):

1. Held: Under §642(c)(1), a trust's charitable contribution deduction for property is limited to the adjusted basis in the donated property rather than the FMV of that property.
   a. The Greens set up a Dynasty Trust in 1993 for the benefit of their children, descendents, and charity. The trust held a 99% interest in a partnership that owns most of the "Hobby Lobby" retail stores located in the U.S. Each year the Trust received $29-$41 million in distributions from the partnership.
   b. The trust purchased parcels of real property, and in 2004 donated three parcels to charities when FMV of the properties exceeded the trust's adjusted basis in the properties by about $10 million.

Charitable Donation of Property by Trust Limited to Adjusted Basis

A. In *Green v. U.S.*:

1. The IRS challenged deductions by the trust for the FMV of the properties, and the district court held that the trust was entitled to deduct the FMV of the properties under §642(c)(1). The IRS disagreed.
2. Section 64(c)(1):
   a. For a trust there shall be allowed as a charitable deduction "any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is" paid for a charitable purpose.

Charitable Donation of Property by Trust Limited to Adjusted Basis

A. In *Green v. U.S.*:

1. Issue: What does the phrase "any amount of the gross income" mean?
   a. This term is ambiguous and the Court turned to Reg. §1,642(c)-1, which provides that "any amount of the gross income" means that a charitable donation must be made out of a trust's gross income. This construction is entitled to *Chevron* deference but does not solve the issue.
   b. Under this rule, real property purchased with gross income of a trust (as here) is treated as the equivalent of gross income, but is the amount of the deduction of such property limited to adjusted basis, or is the amount of the deduction FMV?

Charitable Donation of Property by Trust Limited to Adjusted Basis

A. In *Green v. U.S.*:

1. Court:
   a. Best construction is that for donated property purchased with gross income, the deduction is limited to adjusted basis.
   b. The Trust, after buying the properties, never was taxed on gains associated with an increase in the market value of the properties. To construe the deduction to extend to unrealized gains on property purchased by the Trust would be "inconsistent with the Code's general treatment of gross income." It is up to Congress to clearly express a different conclusion.

No Deduction for Legal Fees for Consulting T/B

A. In *Dulik v. Comm'r*, T.C. Summ. Op. 2017-51:

1. Dulik's long-standing employment at a generic pharmaceutical company (BG) was terminated in 2010.
   a. BG offered Dulik a severance agreement including pay for one year, but requiring he sign a "secrecy" agreement that included a non-compete covenant.
   b. Dulik hired lawyers to negotiate numerous issues concerning the severance agreement, including benefits, and paid them about $26,000. Dulik signed the agreement
   c. Later in 2010, Dulik formed an S corporation (AED), an entity through which he intended to engage in pharmaceutical consulting.

No Deduction for Legal Fees for Consulting T/B

A. In *Dulik v. Comm'r*:

2. Dulik filed a Form 1120S for 2010 reporting no gross receipts but claiming a $26,000 deduction for legal fees.
    a. The IRS disallowed the deduction, claiming that the legal fees were not part of Dulik's new consulting business that operated through AED, but rather expenses related to Dulik's employment that could be deducted only on Schedule A.
    b. Dulik claimed that the legal fees were business expenses of AED because he needed the attorneys to negotiate the severance agreement so that he could continue to conduct a pharmaceutical consulting business.

No Deduction for Legal Fees for Consulting T/B

A. In *Dulik v. Comm'r*:

3. Court:
    a. Legal fees are deductible as an ordinary and necessary business expense only if the matter with respect to which the fees were incurred "originated" in the taxpayer's trade or business, and only if the claim is sufficiently connected to that trade of business.
    b. The proper treatment does not depend on "the consequences that might result from a win or loss of a legal claim."
    c. Dulik may have been concerned that the secrecy provision in the severance agreement may affect whether he would be hired as a consultant, but that is not dispositive.

No Deduction for Legal Fees for Consulting T/B

A. In *Dulik v. Comm'r*:

3. Court:

   d. The "origin of the claim" for which he hired attorneys was the termination of his employment, and the potential consequences of the severance agreement did not make the legal fees an expense of the consulting business.

   e. AED was not even formed until after the legal services were performed and Dulik signed the severance agreement.

   f. Therefore Dulik was entitled only to a deduction on Schedule A.

Similar Case

A. In *Sas v. Comm'r*, T.C. Summ. Op. 2017-2:

1. Ellen Sas was terminated as president of a bank in 2010 and was given a "change of control" bonus of $612,000.

   a. She reported the bonus as wage income, but in late 2010 the bank sued Sas, alleging it was entitled to recover the bonus due to her breach of fiduciary duty.

   b. In 2011, the case was settled with mutual releases providing that neither party would pay the other any amount of money. In 2011 and 2012, Sas paid attorneys about $80,000 in fees.

   c. Sas and her husband filed a Schedule C in those years for an accounting and consulting business and deducted the attorneys' fees.

Similar Case

A. In *Sas v. Comm'r*, T.C. Summ. Op. 2017-2:

2. Court:
    a. The origin and character of the claim for which the legal fees were incurred controls, not the potential consequences upon the fortunes of the taxpayer.
    b. Sas argued not that the legal claim was rooted in the accounting business, but rather that the lawsuit would have an adverse effect on her professional reputation, which in turn could damage the reputation of the accounting business.
    c. Such an argument has been rejected in numerous cases. The origin of the claim related to Sas' employment. The consequences to the accounting business were irrelevant.

Gambling Losses
What If You Claim the Standard Deduction?

A. In *Bon Viso v. Comm'r*, T.C. Memo. 2017-154:

1. A couple was required to include the husband's gambling winnings in gross income, and they were not entitled to claim an itemized deduction for their gambling losses to offset their gambling winnings because they elected to claim the standard deduction on their joint return.
    a. In 2013 the husband received three Forms W-2G showing a total of $5,060 of gambling winnings from slot machines. The same year, husband had $6,983 in gambling losses.
    b. IRS: The couple must report all winnings and then claim a deduction for losses up to winnings, but may not claim an itemized deduction if the standard deduction is claimed.

Gambling Losses
What If You Claim the Standard Deduction?

A. In *Bon Viso v. Comm'r*:

2. Court:

   a. IRS wins. The taxpayers were not engaged in the trade or business of gambling, and would have to forgo the standard deduction in order to deduct their gambling losses as an itemized deductions. See §63(a)-(b) and *Torpie v. Comm'r*, T.C. Memo. 2000-168.

   b. The couple's standard deduction of $12,200 exceeded their potential itemized deduction for gambling losses ($5,060), and thus the election to claim the standard deduction resulted in a larger tax benefit.

The Hick from French Lick's Former Home
The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

1. Cooke is an attorney in Alaska. In 2007 he and his domestic partner formed Legend of French Lick, LLC (the LLC) to purchase for $787,500 the former home of NBA All-Star Larry Bird located in French Lick, Indiana.

   a. In 2007 and 2008, the LLC made improvements to the property to convert it into a bed and breakfast, which opened for business in June 2008.

   b. The LLC employed a series of managers between May 2008 and January 2010, when the last manager resigned and the business closed down. Gross receipts were $11,000 in 2008, $30,000 in 2009, and $497 in 2010.

The Hick from French Lick's Former Home The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

2. In September 2009 the LLC had listed the property for sale for $1,950,000.
    a. There were no lodgers at the property after 1/31/2010.
    b. In 2010 and 2011 a caretaker stayed on the property rent-free to oversee it and perform maintenance such as landscaping.
    c. In those years, the LLC kept records of all expenses associated with the property, including travel expenses of Cooke and his partner when they visited and stayed at the property.
    d. Cooke visited the property three times in 2010 (for a total of 26 days) and four times in 2012 (for a total of 33 days).

The Hick from French Lick's Former Home The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

3. The LLC, taxed as a partnership, claimed ordinary business non-passive losses of $134,273 in 2010 and $127,740 in 2011.
    a. Many of the expenses were for items such as advertising, utilities, phone and cable, linens, and lodging supplies, even though no lodgers stayed at the property after 1/31/2010.
    b. All the losses were put on the Form K-1 of Cooke, and none were attributed to his partner.
    c. The IRS disallowed the losses under §280A, or in the alternative, as passive losses.

The Hick from French Lick's Former Home The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

4. Court:

   a. Under §280A, no deduction is allowed with respect to any dwelling unit that the taxpayer uses as a residence.

   b. A dwelling unit is used as a residence if the taxpayer uses it for personal purposes for more than the greater of 14 days or 10% of the number of days during the year that the unit is rented at a fair rental value.

   c. If the taxpayer is engaged in repairs and maintenance of the dwelling unit substantially full time on any day, such use will not constitute personal use of the unit.

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The Hick from French Lick's Former Home The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

4. Court:

   d. Prop. Reg. §1.280A-1(e): A dwelling unit shall not be deemed to have been used for personal purposes on any day on which the "principal purpose" of the use is to perform repair or maintenance work on the unit.

   e. A facts and circumstances rule applies to determine principal purpose, including the amount of time devoted to repair and maintenance work, frequency of use for repair and maintenance, and presence and activity of companions.

   f. Congress did not want deductions to be claimed for expenses of a personal nature.

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The Hick from French Lick's Former Home The New Owners Forgot About §280A

A. In *Cooke v. Comm'r*, T.C. Summ. Op. 2017-2:

5. Court:

   a. Here Cooke did not meet his burden to show that he spent most of his time at the property for repair and maintenance such that he did not meet the 14-day/10% test as to use as a residence.

   b. Based on Cooke's testimony and re-creation of logs as to how he spent his time on the trips to the property, the Court concluded that Cook used the property for personal purposes for more than 14 days during each of 2010 and 2011.

   c. A caretaker took care of most maintenance and landscaping work. There were no guests. What maintenance did Cooke need to do? A negligence penalty applied.

Passive Activity Losses Real Property Trades or Businesses

A. ILM 201504010: Real estate agents are in a real property brokerage trade or business, but mortgage brokers are not.

1. Person X is a state licensed real estate agent and works for a real estate brokerage firm. X is not licensed under state law as a real estate broker. X brings together buyers and sellers of real property and helps them negotiate contracts.

2. Person Y is a state licensed mortgage broker who markets mortgage loans and brings together lenders and borrowers. Under state law, Y's mortgage brokerage business is considered to be a real property brokerage business.

3. Issue: Is either X or Y engaged in a real property brokerage trade or business under §469(c)(7)(C)?

Passive Activity Losses
Real Property Trades or Businesses

A. ILM 201504010: Real estate agents are in a real property brokerage trade or business, but mortgage brokers are not.

4. Section 469(c)(7)(C) includes in the term "real property trade or business" any real property "brokerage trade or business." That term is not defined, and federal law, not state law, governs the construction of that term.

5. Congress initially included "finance operations" in the list of qualifying real property trade or business activities in a draft version of what became §469(c)(7)(C), but that item was removed from the final bill.

6. Thus: Congress did not intend for financing activities to qualify, and such activities should not be included in "real property brokerage."

Passive Activity Losses
Real Property Trades or Businesses

A. ILM 201504010: Real estate agents are in a real property brokerage trade or business, but mortgage brokers are not.

7. In addition, based on common meanings of words and dictionary definitions, the common and ordinary construction of "real property brokerage" for purposes of §469(c)(7)(C) involves "bringing together buyers and sellers of real property." This does not include the brokerage of financial instruments.

8. Therefore Y is not engaged in a real property trade or business. X is so engaged. State law status of X or Y is not determinative.

9. In *Hickam v. Comm'r*, T.C. Summ. Op. 2017-66, the Tax Court agreed mortgage brokers and loan originators are not engaged in a real property trade or business under the plain language of §469(c)(7).

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. Issue: May the IRS require taxpayer T to regroup activities under either of the following provisions:
   a. Reg. §1.469-4(e)(2): If a grouping by T is "clearly inappropriate," T must regroup.
   b. Reg. §1.469-4(f): IRS may regroup T's activities if T's grouping is not an appropriate economic unit and a "principal purpose" of T's grouping or failure to regroup is to circumvent the underlying purpose of §469.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. T is an otolaryngologist who practiced first through company X and then through company Y in Years 1 and 2. T owned a majority interest in both X and Y when employed by them.
   a. In Years 1 and 2 T also held a small ownership interest in P, a partnership. Physicians from different medical practices in the relevant city area also owned interests in P.
   b. P in turn owns an interest in R, a partnership. The majority interest in R is owned by Q, which owns interests in medical facilities throughout the U.S.
   c. R provides outpatient surgery facilities for all physicians in the city area, including non-owner physicians.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. The income generated from T's indirect ownership in R (through P) is not tied to the number of surgeries he performs at R's facility or to the revenue generated by those surgeries.
   a. Even if T did not perform any surgeries at R, he would receive the same proportionate share of R's profits.
   b. There are no interdependencies among X, Y, and R. The revenue generated by R through facility charges are separate from the charges for medical services rendered by T through X and Y. T did not invest in P to increase or change his medical practice.
   c. In Years 1 and 2, T performed surgeries at locations other than R.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. T filed returns for Years 1 and 2 and treated P as a separate activity from X and Y.
   a. In Years 1 and 2, T had passive losses or suspended losses from a rental condo activity.
   b. T had income from P in Years 1 and 2 and treated it as passive income, which allowed the entire losses from the rental condo activity to be deducted.
   c. The issue for the IRS was whether T should be required to group his activity in P with his practice entity, either X or Y depending on the time. If so, income from P would no longer be passive.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. Reg. §1.469-4(c) provides that two or more activities may be treated as a single activity if they constitute an "appropriate economic unit" (AEU) for the measurement of gain or loss for §469 purposes. Significant factors include:
   a. Similarities and differences in the types of activities;
   b. The extent of common control and common ownership;
   c. Geographical location; and
   d. Interdependencies between or among the activities (such as selling and buying goods, having the same customers or employees, or having the same books and records).

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. Example in Reg. §1.469-4(f), which allows the IRS to regroup if a T's grouping is not an AEU and a principal purpose of the grouping is to circumvent the purpose of §469:
   a. Five doctors have separate medical practices and each has passive losses through tax shelters or rental real estate activities.
   b. The doctors form partnership P to acquire (from the doctors) and operate X-ray equipment. The doctors have limited partnership interests in P and do not materially participate in P, which is managed by a general partner selected by the doctors.
   c. Almost all of P's services are provided to the doctors and their patients, and P's fees are set at market rates so it has a profit.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. Example, continued:
    d. The doctors treat P's services as a separate activity from their practices and offset the income from P against their passive losses.
    e. The example concludes that the services provided by P do not separately constitute an AEU, and a principal purpose of treating the medical practices of each doctor and P's services as separate activities was to circumvent the purpose of §469.
    f. Therefore the IRS could require the doctors to treat their respective practices and P as a single activity.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. The IRS concluded that the facts in the TAM were distinguishable from the example in the regulation.
    a. In the example, the doctors circumvented the purpose of §469 by converting a portion of their practices into a single passive income generator by contributing equipment to a separate entity which they controlled but in which they did not materially participate.
    b. Then that entity leased back the equipment at market rates to ensure a profit that generated passive income. The entity's services to the doctors was roughly in proportion to the doctors' respective interests in the entity.

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. In the TAM, an unrelated entity, Q, was the majority owner of R and controlled management of the surgical facility operated by R.
   a. T and other partners in P did not have any direct or indirect control over the day-to-day operations of R. The services provided by R to patients of P's partners likely did not comprise substantially all of R's patient services.
   b. It was even less clear that the services provided by R to the patients of P's partners would be roughly in proportion to the partners' interest in P (or their indirect interests in R).

IRS Cannot Regroup Doctor's Interests

A. TAM 201634022:

1. The IRS concluded that it "is not necessarily inappropriate to treat P's activity as a separate economic unit," and the facts do not clearly demonstrate that T acquired his interest in P with a principal purpose of circumventing the purpose of §469.
   a. Therefore the IRS did not have the authority to regroup T's interests in X, Y, and P as a single activity.
   b. The IRS also stated that under the factor test to determine an AEU, there may be more than one reasonable method for grouping T's activities into AEUs.

IRS Cannot Regroup Doctor's Interests

A. See also *Hardy v. Comm'r*, T.C. Memo. 2017-16:

1. Case is similar to the TAM.
2. Plastic surgeon (T) purchased a 12.5% interest in a surgical center (MBJ) where he performed 10% to 20% of his surgeries.
   a. T did not materially participate in the operation of MBJ and his share of income was not dependent on the number of surgeries he performed at MBJ rather than at hospitals or his office.
   b. T initially reported income from MBJ as non-passive, but did not group his surgery practice with the MBJ activity. T then treated the MBJ income as passive and offset losses from other passive activities.

IRS Cannot Regroup Doctor's Interests

A. See also *Hardy v. Comm'r*, T.C. Memo. 2017-16:

1. IRS: By initially reporting the MBJ income as non-passive, T essentially grouped the two activities.
2. Court: No. Simply reporting income from an activity as non-passive does not mean a taxpayer grouped that activity with another activity. T's accountant never elected to group the activities, and initially thought the income was non-passive because the Form K-1 T received reflected SE income.

IRS Cannot Regroup Doctor's Interests

A. See also *Hardy v. Comm'r*, T.C. Memo. 2017-16:

1. IRS: T must group the two activities under Reg. §1.469-4(f) because T's failure to group is not an appropriate economic unit and has a principal purpose to avoid the purposes of §469.
2. Court: No. T's case is not like the example of five doctors in the regulation (discussed above in TAM 201634022, which the Court noted and discussed, even though TAMs may not be cited for precedential value).
    a. T's case is very similar to the facts in the TAM, and like the TAM is distinguishable from the example in the regulations.

IRS Cannot Regroup Doctor's Interests

A. See also *Hardy v. Comm'r*, T.C. Memo. 2017-16:

1. Court:
    a. Weight of evidence supports treating the two activities as separate economic units. T is only a minority owner of MBJ and has no management responsibilities in MBJ. T and MBJ do not share any building space, employees, billing functions, or accounting services.
    b. The two activities perform different services. The income T receives from his surgical practice is not linked to MBJ.
    c. T did not have a principal purpose of circumventing §469. He did not form MBJ to do so. It already existed when he bought his minority interest. T had a business reason for doing so.

IRS Cannot Regroup Doctor's Interests

A. See also *Hardy v. Comm'r*, T.C. Memo. 2017-16:

1. Court: In addition, T's income from MBJ is not subject to self-employment (SE) tax because T was merely an investor in MBJ (which is an LLC taxed as a partnership), and performed no services for MBJ.

   a. Therefore T is treated like a limited partner in MBJ and his distributive share of income is excepted from SE tax under §1402(a)(13).

   b. Compare the *Renkemeyer* case where lawyers who provided services to a LLP were service providers and not mere investors, and were subject to SE tax.

DEPRECIATION
CAPITALIZATION
AMORTIZATION

When Retail Building Is Placed in Service

A. In *Stine LLC v. U.S.*, 2015-1 U.S.T.C. (CCH) ¶50,172 (W.D. La. 2015): Court held that to be "placed in service" it is not required that a building be open for business, but it must be substantially complete and available to perform the function for which it was built.

1. Taxpayer T is a retail operation that sells home building materials and supplies. It claimed a "Go Zone" 50% depreciation deduction for two retail store buildings. Eligibility required that the buildings be placed in service prior to the end of 2008.
2. IRS: Buildings were not placed in service in 2008 because they were not open for business to customers until 2009.

When Retail Building Is Placed in Service

A. In *Stine LLC v. U.S.*, 2015-1 U.S.T.C. (CCH) ¶50,172 (W.D. La. 2015):

1. T: It was undisputed that both stores/buildings had been issued certificates of occupancy in 2008 that allowed T to receive equipment, shelving, racks, and merchandise, as well as the appropriate personnel to install and stock those items.
2. IRS: Yes, but it was undisputed that the stores were not open for business to customers, and the certificates of occupancy did not allow customers to enter the buildings.

When Retail Building Is Placed in Service

A. In *Stine LLC v. U.S.*, 2015-1 U.S.T.C. (CCH) ¶50,172 (W.D. La. 2015):

1. Precedent indicates that courts have never applied an "open for business" rule, but instead supports a finding that a building is placed in service when it is "substantially complete," meaning in a condition of readiness and availability to perform the function for which it was built.

2. Here the buildings were substantially complete and were fully functional to house and secure shelving, racks, and merchandise.

3. "<u>Placed in service" does not equate to "open for business</u>."

When Retail Building Is Placed in Service

A. In *Stine LLC v. U.S.*, 2015-1 U.S.T.C. (CCH) ¶50,172 (W.D. La. 2015):

1. In AOD 2017-02, the IRS announced that it will not acquiesce in the case.

2. The IRS did not explain why it reached that position or further illuminate what it believes is the proper test.

Termination Fee Warrants Capital Treatment

A. ILM 201642035:

1. A corporation, XCo, entered into an agreement to acquire the stock of a target corporation by merging a newly formed subsidiary owned by SCo into the target. The agreement required the target to pay a $1 million termination fee if the target terminated the merger agreement. The target received a better offer and terminated the agreement.

    a. The IRS provided guidance on how to treat the termination fee if XCo had $200,000 (Situation 1) or $1.1 million (Situation 2) of costs pursuing the failed merger. Such costs were properly capitalized as costs facilitating the proposed transaction under Reg. §1.263(a)-5(e).

Termination Fee Warrants Capital Treatment

A. ILM 201642035:

2. Section 1234A: Gain or loss due to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer is treated as gain or loss from the sale of a capital asset.

    a. Legislative history indicates that forfeiture of a down payment under a contract to purchase stock was intended to be covered. *See U.S. Freight Co. v. U.S*, 422 F.2d 887 (Ct. Cl. 1970).

    b. In both Situations the target's stock would be a capital asset in XCo's hands upon acquisition. XCo had rights to target stock even though the agreement in question was not with the shareholders of the target.

Termination Fee Warrants Capital Treatment

A. ILM 201642035:

3. In Situation 1, XCo has amount realized of $1,000,000 and subtracts its capitalized facilitation costs of $200,000. Therefore it has capital gain of $800,000.

4. In Situation 2, XCo has a loss of $100,000 ($1,000,000 fee less costs of $1,100,000). XCo's loss is a capital loss and subject to the limitations on capital losses in §§1211 and 1212.

5. Note: Previously, in PLR 200823012 and TAM 200438038, the IRS concluded that merger termination fees should be treated as ordinary income (and loss for the payor). "Better thinking" caused the IRS to change its position.

PERSONAL EXEMPTIONS
MEDICAL & CHARITABLE DEDUCTIONS
CASUALTY LOSSES

Personal Exemptions
Repealed 2018-2025 by TCJA

A. In 2017 the personal exemption amount was $4,050. See Rev. Proc. 2016-55. Would have been $4,150 in 2018 but for TCJA.
Now is zero in 2018 under the TCJA.

B. Phase-out returned in 2013, and will return in 2026 when the individual provisions of the TCJA expire.

C. In 2017 and 2018, the standard deduction for a taxpayer with respect to whom a dependency exemption is (or would have been) allowed on another taxpayer's return is the greater of: (1) $1,050; or (2) earned income plus $350.

   1. This affects the kiddie tax, which has now been changed under the TCJA for 2018-2025 to track the trust rates rather than parents' rates.

Filing Status
Change from Single or HH to Joint Return

A. In *Camara v. Comm'r*, 149 T.C. No. 13 (2017); and *Knez v. Comm'r*, T.C. Memo. 2017-205, the Tax Court held that a married person who initially filed a return as a single person (*Camara*) or as head of household (*Knez*) was not barred by §6013(b)(2) from later filing a joint return.

   1. That section provides that when an individual has filed "a separate return" for a taxable year for which a joint return could have been made, a joint return may not be filed after there has been mailed to either spouse a notice of deficiency with respect to that taxable year.

   2. The IRS claimed in each case that the taxpayer could not file a joint return once the IRS had sent a notice of deficiency with respect to the originally filed single or head of household return because such a return was "a separate return."

Filing Status
Change from Single or HH to Joint Return

A. In *Camara v. Comm'r*, and *Knez v. Comm'r*:

1. Court: A "separate return" within the meaning of the statute means a return on which a married taxpayer has claimed the permissible status of married filing separately, rather than a return on which a married taxpayer has claimed a filing status not properly available to him or her.

2. Prior decisions so hold. See *Ibrahim v. Comm'r*, 788 F.3d 834 (8th Cir. 2015) (erroneously filed head-of-household return is not a "separate return"); and *Glaze v. U.S.*, 641 F.2d 339 (5th Cir. 1981) (same as to an erroneously filed single return).

3. Legislative history also supports this result.

Gay Man's IVF Costs
Not a Deductible Medical Expense

A. In *Morrissey v. Comm'r*, 226 F.Supp.3d 1338(M.D. Fla. 2016):

1. Held: A gay man was not entitled to deduct as medical expenses costs incurred for a surrogate mother to conceive a child through in vitro fertilization (IVF) because the expenses fell outside the plain language of §213.

   a. T, a homosexual male, has a male partner. T and his partner decided to have a child through an IVF process that involved the use of an egg donor and a separate gestational surrogate, persons who were not related to T.

   b. At issue in a refund suit was whether T was entitled to a medical expense deduction of about $36,000 for IVF expenses that he claimed under §213 on an amended return.

Gay Man's IVF Costs
Not a Deductible Medical Expense

A. In *Morrissey v. Comm'r*:

2. Court: The claimed deductions fall outside the plain language of §213 in two ways:

   a. Deductible medical expenses must be expenses paid for the medical care of the taxpayer, his spouse, or a dependent. Expenses paid for medical procedures performed on other individuals such as third-party egg donors and surrogates are not deductible.

   b. The expenses at issue were neither for diagnosis, cure, mitigation, or treatment of any disease of T, his spouse, or a dependent, nor did they affect a structure or function of the body of T, his spouse, or a dependent. *See* §213(d)(1).

Gay Man's IVF Costs
Not a Deductible Medical Expense

A. In *Morrissey v. Comm'r*:

3. Court rejected T's arguments:

   a. T's argument that his "reproductive function" was addressed by the IVF procedure was not persuasive because there was no actual treatment to him.

   b. There is not a parallel to cases where taxpayers pay expenses for kidney or egg donors where the kidney or eggs are implanted in the taxpayer's body. Those cases involve medical treatment of the actual taxpayer.

   c. Prior cases involving IVF expenses for persons other than the T, a spouse, or a dependent support the IRS position, as do cases involving expenses paid for a birth mother of an adopted child.

Gay Man's IVF Costs Not a Deductible Medical Expense

A. In *Morrissey v. Comm'r*:

4. Court also rejected T's constitutional argument that disallowance of the deduction was a violation of his fundamental rights and of the Equal Protection Clause.

   a. Although T claimed that the IRS unconstitutionally discriminated against him on account of his sexual orientation, the Court found the T's sexual orientation had nothing to do with the disallowance.

   b. T simply was not allowed a deduction because the expenses were for persons who were not T, his spouse, or his dependent.

   c. A female who chose to do what T did also would be disallowed a deduction for expenses for a donor and a gestational surrogate who were not her spouse or dependent.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*, T.C. Memo. 2017-165: paraphrasing Ernest Hemingway that there is no hunting like the hunting for tax deductions, the Tax Court reduced a claimed charitable deduction for hunting trophies from $1,425,900 to $163,045, finding that FMV should be determined using comparable sales rather than replacement cost.

1. Gardner was an avid hunter who went on safaris in Africa, Asia, Europe and other countries, often at the rate of 10-12 safaris per year.

2. Gardner preserved the remains of many animals he shot in a professionally designed trophy room in his home. His trophies included "full body mounts," "shoulder mounts," and full animal skins. He also kept less valuable skeletal parts, horns, and antlers.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*:

1. Gardner ultimately wanted to downsize his collection, and was referred to the Dallas Ecological Foundation (DEF) as a potential charitable donee with connections to an experienced appraiser.
   a. Gardner selected a total of 177 items from his collection for donation to DEF, primarily his less valuable items: no full body mounts, only three shoulder mounts, 58 skins, 72 skulls (39 with horns or antlers), and other horns, antlers, tails, hooves, ears, and tusks.
   b. None of the 177 items was of "record book" quality as determined by hunting organizations. One Richard Fullington appraised the items using a "replacement cost" method. He tallied up the expected out-of-pocket expenses for traveling to a hunting site, being on safari for the required number of days, killing and preserving the given body part, shipping it back to the U.S., and other taxidermy and related fees.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*:

1. Fullington appraised each of the 177 items under this "replacement cost" approach. Examples included:
   a. \$75,600 for the tanned skin of a Central Asian Sheep;
   b. \$56,800 for a European mount of the horns of a desert bighorn sheep.
2. The total appraised value of the items was \$1,425,900.
   a. The items were delivered to DEF in 2006. Apparently they were put in storage and later sold or given away. Therefore the parties' respective experts were unable to examine the items themselves later.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*: The Court first noted that the general rule is the FMV of a donated item is determined under a willing seller/willing buyer rule.

   a. The IRS claimed that the donated items were commodities that should be valued by what price they fetch in the marketplace.

   b. The appraisal report of Fullington, who did not testify at trial, was not entered into evidence, although the pictures of each item contained in the report were relied upon by the parties' respective expert witnesses.

   c. An IRS expert used a market approach to appraise each item. He concluded that the aggregate FMV would be $41,140 if each item was in excellent condition, but discounted that to $34,240 because some of the items would have had to have defects.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*:

   1. The IRS expert also noted that most of the items were "remnants and scraps" of a trophy collection, and were "what is left over" when you are done mounting an animal. He sought to identify the best available comparable sale for each item based on market data from auction sites that specialize in selling hunting specimens.

   2. Gardner had two experts. Neither assigned a dollar value to any of the 177 items, but each sought to defend "replacement cost" as the proper valuation method. They claimed a market approach could not capture the FMV of the items because they were "museum quality" pieces uniquely valuable for research. They offered no factual support for that theory.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*:

1. The Court found Gardner's two experts to lack credibility and expertise, and their arguments to be unpersuasive. Essentially, the Court found that the experts "assumed" what they sought to prove.

2. The Court also rejected the testimony of a third Gardner expert who testified as an international hunting consultant on the cost of "fair chase" hunting expeditions. He opined that replacement cost for the 177 specimens would be $2,554,300, more than the value Gardner reported on his return. The Court noted that this expert assumed the cost of 177 separate safaris and shipments to reach his "high end" estimate.

Court Shoots Down Large Charitable Deduction for Big Game Hunter

A. In *Gardner v. Comm'r*:

1. Court: Replacement cost is the relevant measure of value only where the property is unique, the market is limited, and there is no evidence of comparable sales.

2. The taxpayer must establish not only the absence of an active market for comparable items, but also a "probative correlation" between replacement cast and FMV.

3. Here the 177 items were clearly mere commodities and not collectibles that potentially could qualify for a valuation method other than comparable sales. Clearly they did not have a value greater than the $163,045 the IRS allowed.

Charitable Contributions Substantiation Rules

A. Three substantiation rules come into play:

1. For gifts exceeding $250 in value, the taxpayer must obtain a contemporaneous written acknowledgement that states whether the donee provided any goods or services in consideration of the contribution, and provide a description and good-faith estimate of the value of any such goods or services provided (the contemporaneous written acknowledgement or CWA rules);
2. The requirement to maintain reliable written records for noncash contributions in excess of $500; and
3. The rules requiring a qualified appraisal by a qualified appraiser for noncash gifts of property exceeding $5,000.

Charitable Contributions Substantiation Rules

A. The CWA rules:

1. Courts in recent cases have strictly construed §170(f)(8), which imposes the CWA rules, disallowing admitted charitable contributions if the taxpayer lacks the required contemporaneous acknowledgment from the donee that includes all required statements, and rejecting "substantial compliance" claims. *See, e.g., Durden v. Comm'r*, T.C. Memo. 2012-140.
2. On September 16, 2015, the IRS issued proposed regulations (REG-138344-13) that would have <u>allowed the CWA rules to be met if donee organizations filed a new information return that provides the required information</u>. The IRS expected to develop an optional information return that donees voluntarily could choose to file if the CWA rules are applicable, with a copy provided to the donor.

Charitable Contributions
Substantiation Rules

A. The CWA rules:

3. There were numerous objections to the proposed regulations because under the proposal donees would obtain and maintain taxpayer identification numbers.

4. Some critics also argued that optional reporting by donees was not needed because the current CWA rules are clear.

5. <u>On January 8, 2016, the IRS withdrew the proposed regulations. Therefore the historic CWA rules continue to apply</u>.

6. Note that the proposed regulations were issued after the IRS rejected arguments that a failure to comply with the CWA rules could be cured if the donee organization filed an amended Form 990.

Substantiation Rules
Tax Court Uses to Disallow Overreaching

A. In *Ohde v. Comm'r*, T.C. Memo. 2017-137:

1. No deduction for noncash charitable deduction of $145,250 for donating over 20,000 items in 2011 (half were clothing, including 1,040 items for boys, 811 for girls, 658 for men, and 945 for women) to Goodwill Industries where taxpayers failed to provide credible evidence substantiating the value of the items. Penalties applied.

B. In *Gaines v. Comm'r*, T.C. Summ. Op. 2017-15:

1. No deduction for "threadbare" claim of $18,000 clothing deduction, due to lack of substantiation.

Substantiation Rules
Tax Court Uses to Disallow Overreaching

C. In *Izen v. Comm'r*, 148 T.C. No. 5 (2017):

1. Held: T not entitled to a charitable deduction for donation of his 50% interest in a used airplane to a museum because he failed to provide a contemporaneous written acknowledgement (CWA) under §170(f)(12)(B).
   a. In 2007 T and a partner, through an LLC, purchased a 40-year-old aircraft for $42,000. In 2010 T and his partner donated their 50% interests in the plane to an Aeronautical Heritage Society that operates a museum. On an amended return, T claimed a deduction of $338,000.
   b. The return included an acknowledgement letter from the donee, a Form 8283, an "Aircraft Donation Agreement," and an appraisal.

Substantiation Rules
Tax Court Uses to Disallow Overreaching

A. In *Izen v. Comm'r*, 148 T.C. No. 5 (2017):

2. Section 170(f)(12): For charitable contributions of vehicles, including airplanes, where claimed value exceeds $500, no deduction shall be allowed unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment (CWA) of the donee which is attached to the return and states:
   a. Identifying information of the donor and vehicle;
   b. A certification of intended use of the vehicle and duration of such use, and certification the vehicle would not be transferred for money before completion of such use; and
   c. Whether the donee provided any goods or services in exchange for the vehicle, and the value thereof.

Substantiation Rules
Tax Court Uses to Disallow Overreaching

A. In *Izen v. Comm'r*, 148 T.C. No. 5 (2017):

3. The CWA must be contemporaneous, meaning the donee provides it within 30 days of the contribution of the vehicle.
    a. The donee is required to provide the information in the CWA to the IRS in Form 1098-C. For 2010 gifts, the donee had to provide the IRS with the Form by February 28, 2011.
    b. The CWA requirement is a "strict one," and absent a CWA meeting the statutory requirements, no deduction is allowed.
    c. Substantial compliance is not an excuse.

Substantiation Rules
Tax Court Uses to Disallow Overreaching

A. In *Izen v. Comm'r*, 148 T.C. No. 5 (2017):

4. Court: Here the requirements were not met:
    a. T did not include a copy of Form 1098-C with his amended 2010 return on which he first claimed the deduction. The donee's managing director could find no copy of a 1098-C and the IRS had no record of one.
    b. The acknowledgement letter the donee provided with his return was to T's partner, not to T, and did not include the name or tax identification number of T. It also did not state whether the donee had provided any goods or services to T in consideration for the vehicle.
    c. The Aircraft Donation Agreement also did not qualify as a CWA because is was not signed by the donors, did not contain T's tax identification number, was not contemporaneous, and did not contain the required use certification by the donee.

CWA Rules
Not Satisfied by Donee Return

A. In *15 West 17th Street LLC v. Comm'r*, 147 T.C. No. 19 (2016):

1. Section 170(f)(8)(D) provides, with respect to the requirement for a contemporaneous written acknowledgment (CWA) for charitable contributions of $250 or more:

   a. The CWA requirement shall not apply to a contribution if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, which includes the information required.

   b. The IRS has never adopted regulations or a form to implement this exception, although it withdrew proposed regulations in 2016.

   c. Issue: If the donee files a return that includes the required information, may the IRS disallow the donor's deduction?

CWA Rules
Not Satisfied by Donee Return

A. In *15 West 17th Street LLC v. Comm'r*, 147 T.C. No. 19 (2016):

2. In the case at hand, the donor of a conservation easement failed to comply with CWA rules, but the donee filed an amended Form 990 containing the required information.

   a. The provision allowing the IRS to pass regulations permitting a waiver of the CWA rules if the donee files a return with the required information is not self-executing. Passing regulations to permit donee reporting was not mandated by the statute, as the statute does not say "shall."

   b. Dissenters: Court should not give the IRS the power to veto the statutory provision through inaction. The failure to create rules or issue new forms should not render the statute inoperative.

Beware
Syndicated Conservation Easement Transactions

A. Notice 2017-10:

1. IRS identifies some syndicated conservation easement transactions and substantially similar transactions as a listed transaction for purposes of §§ 6111 and 6112.
    a. A promoter offers investors in a pass-through entity the possibility of a charitable contribution deduction for a donation of a conservation easement.
    b. Investors are told their charitable deduction will be at least two and one-half times the amount of the investment.
    c. The entity inflates the value of the easement with a phony appraisal. Clients should be warned if offered such an investment.

TRAVEL & ENTERTAINMENT
REIMBURSEMENTS
MISC. ITEMIZED DEDUCTIONS

2018 Depreciation Limits
Passenger Cars and Other Vehicles

A. Rev. Proc. 2018-25: Vehicles put in service in 2018.

B. Passenger automobile not > 6,000 GVW:

1. 2018: $10,000 + bonus depreciation ($8,000, or + $6,400 if vehicle acquired before 9/28/17 and placed in service in 2018).
2. 2019: $16,000.
3. 2020: $9,600.
4. Then: $5,760.

C. SUV > 6,000 GVW: No §280F limit; $25,000 §179 limit.

D. Truck or van > 6,000 GVW, not an SUV: No limits.

2018 Standard Mileage Rates
Notices 2018-03 and 2018-42

A. Business Travel: **54.5 cents** (up from 53.5 cents in 2017)
No longer can be used for unreimbursed employee business travel due to suspension of miscellaneous itemized deductions.

Depreciation Component: 25 cents (no change).

B. Medical and Moving: 18 cents (but moving limited by TCJA)

C. Charity: 14 cents (amount set by statute)

Qualified Transportation Fringe Benefits Monthly Limits

A. Monthly Vehicle/Transit Pass Limit:

1. $255 in 2016 and 2017 (parity with parking made permanent).
2. $260 in 2018; Rev. Proc. 2017-58.

B. Monthly Qualified Parking Limit:

1. $255 in 2016 and 2017.
2. $260 in 2018; Rev. Proc. 2017-58.

Per Diem Amounts for Fiscal 2017

A. Notice 2017-54 provides the following per diem rates commencing 10/1/2017.

1. For the high-low method: $284 per day for travel to high-cost locality and $191 for travel to any other locality within CONUS. Meals portion is $68 for high-cost locality and $57 for other localities.
2. For the meal and incidental expenses only method: $68 per day for travel to high-cost locality and $57 for travel to any other locality within CONUS.
3. For the incidental expenses only deduction: $5 per day for any CONUS or OCONUS locality of travel.
4. For M&IE rates for transportation industry: $63 CONUS and $68 OCONUS.

MARITAL DISSOLUTIONS

Divorce Expenses
No Deduction for Personal Expenses

A. In *Lucas v. Comm'r*, T.C. Memo. 2018-80, the Tax Court held that an investment adviser could not deduct legal fees incurred to protect $49 million in fees he earned while his divorce was pending.

1. Sky Lucas formed an investment advisory firm ("Vicis") with two partners in 2004. Vicis was the investment adviser for several funds that paid it an annual management fee of 1.5% of assets under management, and also a performance fee equal to 20% of profits earned by the funds each year. Both fees could be deferred and held in specified fund. Vicis took advantage of the deferral.

2. The fund liquidated in 2010 due to the recession, and the deferred fees were distributed to Vicis in 2010.

Divorce Expenses
No Deduction for Personal Expenses

A. In *Lucas v. Comm'r*, T.C. Memo. 2018-80:

1. Lucas' wife, Margaret, filed for divorce in January 2008, and between that date and the date the divorce was granted, Lucas received almost $49 million in distributions from Vicis.
   a. The largest issue in the divorce was the valuation and equitable distribution of Lucas' interest in Vicis, including the $49 million in distributions. Margaret argued that the distributions were part of the marital estate, even though Lucas received them after she filed for divorce, because part of them were deferred compensation.
   b. The Florida divorce court ultimately awarded Margaret $6.6 million in cash and the couple's home, finding that part of the distributions were deferred compensation from prior to the date she filed for divorce.

Divorce Expenses
No Deduction for Personal Expenses

A. In *Lucas v. Comm'r*, T.C. Memo. 2018-80:

1. Lucas incurred almost $3 million of legal and professional fees in connection with the divorce, which he deducted in 2010 and 2011.
   a. The IRS disallowed deductions for divorce legal fees on the grounds they were expenses for personal items under §262.
   b. Lucas: The fees were paid to defend a claim for profits earned in his trade or business, and therefore deductible under §162 or §212.

Divorce Expenses
No Deduction for Personal Expenses

A. In *Lucas v. Comm'r*, T.C. Memo. 2018-80:

1. In *U.S. v. Gilmore*, 372 U.S. 39 (1963): Whether legal fees are deductible expenses or nondeductible personal expenses depends upon whether the claim arises in connection with the taxpayer's profit-seeking activities or his personal activities (the "origin of the claim" test).
    a. The Court in that case held that legal expenses paid to defeat claims arising from a marital relationship were personal and nondeductible.
    b. A "but for" test applies; if the claim would not have existed but for the marriage relationship, the expense of defending it is a personal expense.

Divorce Expenses
No Deduction for Personal Expenses

A. In *Lucas v. Comm'r*, T.C. Memo. 2018-80:

1. Court in *Lucas*: Here it is clear that but for her marriage to Lucas, Margaret would have had no claim to Lucas' interest in Vicis. Her claim to the Vicis distribution stemmed entirely from her marriage to Lucas.
2. It is irrelevant whether a taxpayer's income-producing property would be affected by the outcome of the divorce proceeding. Lucas did not prove his expenses were related to a business or profit-making activity unconnected to the marital claims of Margaret.
3. Therefore no deduction is allowed.

Divorce Expenses
No Deduction for Personal Expenses

A. See also *Barry v. Comm'r*, T.C. Memo. 2018-80, where the Court disallowed a deduction for legal expenses incurred in a breach of contract action that Barry brought in an attempt to recoup alimony he allegedly overpaid to his ex-wife.

1. Barry incurred $25,000 of legal fees when he sued his ex-spouse many years after his divorce from her was final. He claimed that he had overpaid alimony under the couple's separation agreement, and that the legal fees were deductible under §212d(1) as a deduction for expenses paid for the production of income.

2. The Tax Court quickly rejected this claim, relying on *Gilmore*, and noting that the origin-of-the-claim test cannot be avoided simply by relying on §212(1) with respect to legal expenses incurred to recoup alimony.

Alimony Requirements
Divorce or Separation Instrument

A. In *Mudrich v. Comm'r*, T.C. Memo. 2017-101:

1. The Tax Court held that a husband's payment of half of his bonus to his wife during the course of a divorce was not deductible as alimony because it was paid under neither a divorce or separation instrument nor a support order.

   a. Husband H was an attorney who earned a $250,000 bonus in 2006, when he was married to wife W. H filed for divorce in January 2007, the year he received the bonus.

   b. After withholding, the bonus was $156,618, and H paid about half of that amount to W on May 18, 2007. On May 21, 2007, W signed a "bonus agreement" (which H signed on May 18, 2007), under which H paid her as her share of community property half the bonus, net of withholding, and he agreed to report the entire bonus on his 2007 return.

Divorce or Separation Instrument

A. In *Mudrich v. Comm'r*, T.C. Memo. 2017-101:

2. Later in 2007, the divorce court issued a support order providing that H would pay W $3,270 per month in temporary support, plus 31.3% of any income he earned in excess of $12,500 per month.
   a. The support order did not mention the bonus agreement or payment.
   b. H claimed a $127,228 alimony deduction on his 2007 return, representing the bonus payment and 7 monthly temporary support payments.
   c. IRS: The bonus payment was not alimony. It was not paid under a divorce or separation instrument and was not support under the divorce court's support order.

Divorce or Separation Instrument

A. In *Mudrich v. Comm'r*, T.C. Memo. 2017-101:

3. Tax Court:
   a. There was no evidence that the bonus agreement ever became an order in the divorce proceedings. It was not, for example, ever incorporated into any court order.
   b. The bonus agreement also was not a written separation agreement because it recited that the bonus was community property, and was not a clear written statement memorializing the terms of support between the parties and entered into in contemplation of separation status. It merely provided for a division of community property and not support.

Divorce or Separation Instrument

A. In *Mudrich v. Comm'r*, T.C. Memo. 2017-101:

3. Tax Court:

c. In addition, the bonus payment was not made pursuant to the support order the divorce court did issue. The amount of the bonus payment was wholly consistent with the calculation set forth in the bonus agreement, and not consistent with the formula set out in the support order.

d. The bonus payment predated the support order, and it is well established that payments made before the existence of a written divorce or separation instrument are not deductible as alimony.

e. H also failed to prove that he and W lived separately or were legally separated at the time the bonus payment was made, as required by §71(b)(1).

Divorce or Separation Instrument

A. See also *Devaleria v. Comm'r*, T.C. Summ. Op. 2018-5, where the Tax Court held that payments the taxpayer made to his ex-spouse were not alimony because they were made after his obligation to pay alimony ended under the relevant divorce court orders.

1. The taxpayer was obligated to make alimony payments under divorce court orders until August 2013. The taxpayer made some payments after that month and deducted them as alimony.

2. The Tax Court held that such "voluntary" payments not made under divorce court orders were not alimony.

Transfers of an Interest in an IRA

A. In *Kirkpatrick v. Comm'r*, T.C. Memo. 2018-20, the Tax Court held that a husband did not make a nontaxable transfer of an interest in his IRA under §498(d)(6) during divorce proceedings.

1. Kirkpatrick is a doctor who became involved in a contentious divorce with his wife. In September 2012, a divorce court issued an interim consent order that Kirkpatrick "shall transfer to [his wife] the sum of $100,000 directly (and in a non-taxable transaction) into an IRA appropriately titled in [his wife's] name within fourteen (14) days of the entry of this Order." He was also ordered to pay $40,000 to his wife to cover her interim legal fees.
2. Kirkpatrick did not do so, but took withdrawals from his IRA and then sent checks to his wife to cover the $100,000 obligation and the $40,000 obligation. There was no proof the $100,000 found its way to an IRA owned by the wife.

Transfers of an Interest in an IRA

A. In *Kirkpatrick v. Comm'r*, T.C. Memo. 2018- 20:

1. Kirkpatrick claimed that the $140,000 coming from his IRA was not a taxable distribution under §408(d)(6), which provides that the transfer of an "individual's interest" in an IRA to his spouse or former spouse "under a divorce or separation instrument" is not to be considered a taxable transfer made by such individual.
   a. Under *Bunney v. Comm'r*, 114 T.C. 259 (2000), for this provision to apply, (1) there must be a transfer of the IRA participant's interest in the IRA to his spouse or former spouse, and (2) the transfer must have been made under a divorce or separation instrument.
   b. Usually this is accomplished by changing the name on the IRA to that of the spouse or doing a trustee-to-trustee transfer.

Transfers of an Interest in an IRA

A. In *Kirkpatrick v. Comm'r*, T.C. Memo. 2018- 20:

1. Court: Here Kirkpatrick did not meet the requirements. As in *Bunney*, taking a distribution from an IRA and then making a payment to one's spouse does not qualify as a transfer of an interest in that IRA.
2. An "interest in an IRA" is not synonymous with the money or other assets held in the IRA.
3. This is not a case where the "substance" of what happened should control over the "form." There was no evidence the money ever was put in an IRA of the wife, in compliance with the divorce court order.
4. Kirkpatrick received taxable income due to his IRA withdrawals.

Section 1041
Sale After the Divorce Is Over

A. In *Stapleton v. Comm'r*, T.C. Summ. Op. 2017-87:

1. David and Maureen Stapleton married in 1991 and separated and divorced in 2007. Maureen was an established and successful real estate broker in Aspen, Colorado, and David worked as a fundraiser for a nonprofit organization.
   a. They entered into a marital separation agreement in 2007 covering several properties they owned, including the "Horse Ranch Property" (the "HRP") that had been the marital home. Title of the HRP was transferred to David, who was to sell the property, but meanwhile Maureen was responsible for certain expenses on the property, such as interest on the $1.8 million mortgage, until it was sold.
   b. The HRP was listed for sale in 2008 for over $4 million, but due to the recession, the sale price was periodically lowered through 2012 to less than $3 million. An offer for $2.6 million fell through.

Section 1041
Sale After the Divorce Is Over

A. In *Stapleton v. Comm’r*:

1. In December 2012, David asked Maureen if she wanted to buy the HRP. After negotiations they agreed she would pay David $175,000 and assume the then-outstanding debt on the property of about $2 million.

   a. On December 4, 2012, David executed a warranty deed transferring title to the HRP to Maureen.

   b. David claimed a $598,341 loss on the sale to Maureen, and the IRS challenged that loss, claiming that it arose from a transfer of property incident to divorce that is subject to non-recognition under §1041.

Section 1041
Sale After the Divorce Is Over

A. In *Stapleton v. Comm’r*:

1. Section 1041(a) provides that no gain or loss shall be recognized on a transfer of property from an individual to a spouse or to a former spouse if the transfer is “incident to divorce.”

   a. A transfer is incident to divorce if it occurs within one year after the date the marriage ceases, or “is related to the cessation of the marriage.”

   b. The IRS claimed the sale of the HRP to Maureen was related to the cessation of the marriage. David claimed it was not.

Section 1041
Sale After the Divorce Is Over

A. In *Stapleton v. Comm'r*:

1. Reg. §1.1041-1T(b), Q&A 7, provides these rules:
   a. A transfer is related to the cessation of the marriage if it is pursuant to a divorce or separation instrument and the transfer occurs not more than six years after the marriage ceases.
   b. Any transfer not pursuant to a divorce or separation instrument is presumed to be not related to the cessation of the marriage.
   c. <u>This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage</u>.

Section 1041
Sale After the Divorce Is Over

A. In *Stapleton v. Comm'r*:

1. The Tax Court agreed with the IRS, relying on *Young v. Comm'r*, 240 F.3d 369 (4^{th} Cir. 2001); and *Belot v. Comm'r*, T.C. Memo. 2016-113, where post-divorce transfers of property to an ex-spouse were held to be related to the cessation of the marriage because they were made to complete the division of property held by the parties at the time of the cessation of the marriage.

2. Here the HRP was transferred to David at the time of the divorce, but its anticipated sale was delayed for many years due to a challenging real estate market. The later sale to Maureen had the effect of completing the division of property the couple held at the time of their divorce. Therefore it was related to the cessation of the marriage and thus incident to the divorce within the meaning of §1041 and the regulations thereunder.

Innocent Spouse Relief
Time Limits for Judicial Review

A. In *Matuszak v. Comm'r*, 862 F.3d 192 (2d Cir. 2017):

1. When the IRS denies a request for innocent spouse relief, the requesting spouse has 90 days from the date of the IRS final determination to petition the Tax Court for review. *See* §6015(e)(1)(A).

   a. Taxpayer wife and her husband filed joint returns in 2007 and 2008, and in 2012 the husband pleaded guilty to tax fraud during those years, resulting in a total deficiency of $439,000.

   b. In March 2014, the wife requested innocent spouse relief and was granted relief for 2008 but not for 2007. The wife mailed her Tax Court petition challenging the determination one day late. The IRS moved to dismiss the case for lack of jurisdiction.

Innocent Spouse Relief
Time Limits for Judicial Review

A. In *Matuszak v. Comm'r*:

2. Language of §6015(e)(1)(A):

   a. "… The individual may petition the Tax Court (<u>and the Tax Court shall have jurisdiction</u>) to determine the appropriate relief available … if such petition is filed" not later than 90 days after the IRS issues its final notice of determination.

3. Here the 90th day was January 5, 2014, and T did not mail her petition until January 6, 2014.

4. T: Equitable considerations applied because two IRS agents informed her that she had until January 7, 2014, to petition the Tax Court.

Innocent Spouse Relief
Time Limits for Judicial Review

A. In *Matuszak v. Comm'r*:

5. Court:

   a. Although recent cases tend to place filing deadlines on the side of not being jurisdictional, Congress is free to attach conditions that go with the jurisdictional label.

   b. Here the statute clearly states that a 90-day limit is jurisdictional, and the Court must treat it that way, even if equitable considerations suggest extending the prescribed period. This is one of the "rare" statutory periods that speak in clear jurisdictional terms.

6. Courts agreed in *Rubel v. Comm'r*, 856 F.3d 301 (3rd Cir. 2017); and *Nauflett v. Comm'r*, 892 F.3d 649 (4th Cir. 2018).

EMPLOYMENT TAXES

SELF-EMPLOYMENT TAXES

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*, 149 T.C. No. 12 (2017):

1. Section 1402(a)(1)(A) excludes from the definition of "net earnings from self-employment" rentals from real estate *except* this does not apply to any income derived by the owner of land *if:*
   a. Such rental income is "derived under an arrangement" between the owner and another individual which provides that such other individual shall produce agricultural commodities on such land and that there shall be material participation by the owner in such production or management of the production of such commodities; and
   b. There is material participation by the owner with respect to any such agricultural commodity.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. In *McNamara v. Comm'r*, 236 F.3d 410 (8^{th} Cir. 2000), the Court reversed the Tax Court, which had held that rental income a couple received from its wholly owned corporation was received pursuant to an "arrangement" between the parties to produce agricultural commodities within the meaning of the statutory provision.

2. The Eighth Circuit reversed, finding that there was no nexus between the rental agreement and an arrangement requiring the owners' material participation to produce agricultural commodities. The Tax Court in a reviewed decision now has decided to follow the Eighth Circuit reasoning in a similar factual case, and also to no longer follow *Bot v. Comm'r*, T.C. Memo. 1999-333, and *Hennen v. Comm'r*, 1999-306, which the Eighth Circuit also reversed in *McNamara*.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. The Martins owned a farm and in 2000 entered into a 15-year poultry agreement (the BPA) with Sanderson Farms, Inc. (Sanderson), the third largest poultry producer in the U.S.

    a. The Martins were to construct eight large poultry houses with special equipment to house broiler chickens. Sanderson would deliver a flock of broilers along with special feed to the Martins, who would be the "grower" for about 49 days. This process then repeated itself.

    b. In 2004 the Martins organized an S corporation (CL Farms) and entered into oral employee agreements with their company. In 2005 Sanderson approved the Martins' assignment of the remaining term of the BPA to CL Farms, which became solely responsible as the grower of the broilers. Nothing in the assigned BPA required the Martins personally to perform duties as the grower.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. In 2005 the Martins entered into a five-year lease agreement with CL Farms, which rented most of the farm and buildings from the Martins for total rent of $1.3 million. That amount represented fair market rent.

    a. For 2008 and 2009, CL Farms fulfilled all its duties under the BPA and the lease. Although neither agreement obligated the Martins to perform broiler-related work, the Martins did materially participate in that activity. CL Farms, however, also hired numerous laborers to work on the BPA.

    b. The Martins reported their rental income from CL Farms in 2008 and 2009 (more than $259,000 each year), but did not treat it as being subject to self-employment tax. The IRS disagreed.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. The issue for the entire Tax Court in a reviewed decision was whether it should continue to take the position it had on the SE tax issue in *McNamara* (and *Bot* and *Hennen*) (on similar facts, there was an "arrangement" between the land owner and a third party that the owner materially participate in producing agricultural commodities), or whether it should follow the Eighth Circuit and conclude that on such facts there was no sufficient "nexus" between a rental agreement and any arrangement requiring the owners' material participation.

2. The Tax Court by a 12-4 vote concluded that the reasoning of the Eighth Circuit was more persuasive.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. A key finding by the Eighth Circuit was that "rents that are consistent with market rates very strongly suggest that the rental arrangement stands on its own as an independent transaction and cannot be said to be part of an 'arrangement' for participation in agricultural production."

2. The Tax Court concluded that in the prior cases it "did not give sufficient consideration" to the requirement that the rent in question "be derived under" an arrangement requiring the landlord's material participation. Thus there was insufficient consideration given to the "nexus between the rents received" and the "arrangement" that required the landlord's material participation.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. The Tax Court then noted that Congress' intent was to separate true rental income from wages in determining whether SE income existed.
2. If the rent in the situations at issue is at or below market value, and the IRS can show that the rental agreement has a sufficient nexus with an agreement requiring the taxpayer's material participation, the exclusion of rental income from SE income should not apply. If the IRS cannot show that nexus, congressional intent is not frustrated.
3. That serves to place farmers in the same position as their urban contemporaries with respect to rental income that is insufficiently related to their trade or business.

Tax Court Follows *McNamara* SE Tax on Farm Rentals

A. In *Martin v. Comm'r*:

1. Here the rent payments represented fair market rent and were consistent with amounts paid by other Sanderson growers for the use of similar premises. This is sufficient to establish the rental agreement stands on its own.
   a. In addition, the Martins invested more than $1.2 million in the eight 22,000-square-foot broiler houses and other improvements. Thus the rental agreement, "practically speaking," functions as a return on investment rather than a method of income recharacterization.
   b. The IRS did not prove a nexus, having put all of its "proverbial eggs" in the reasoning of the original Tax Court case in *McNamara*.
   c. Therefore the rental agreement was separate and distinct from the Martins' employment obligations, and the rent was not SE income.

In Case You Were Wondering
Tips for “Volunteers” Are FICA Wages

A. ILM 201816010:

1. Taxpayer T engages individuals to perform services at T’s request on T’s premises (greeters at Walmart?). T treats the individuals as “volunteers” and does not directly pay them any form of compensation or benefits. T files no Forms W-2 or 941.
    a. T places “tip boxes” at strategic locations to encourage customers to contribute cash amounts to the volunteers. T does not require customers to make cash contributions and the customers have discretion on how much cash, if any, to contribute.
    b. The amount of cash in the tip boxes is distributed at the end of each shift, based on the determination of the volunteers who performed services during a shift. The volunteers do not provide written statements reporting the cash received to T.

In Case You Were Wondering
Tips for “Volunteers” Are FICA Wages

A. ILM 201816010. The IRS concluded:

1. T had the right to direct and control the individuals as they performed services and therefore they were employees of T.
2. Cash tips are wages for FICA purposes if they exceed $20 per month. The amounts paid here were “tips” under Rev. Rul. 2012-18.
3. Employers must deduct from wages and pay over the employee portion of FICA tax. But the employer’s obligation to deduct employee FICA tax from tips that constitute wages applies only to such tips as are included in a written statement furnished by the employee to the employer, and only to the extent that collection can be made by the employer by deducting the amount of the tax from wages of the employee (excluding tips) as are under its control.

In Case You Were Wondering
Tips for "Volunteers" Are FICA Wages

A. ILM 201816010. The IRS concluded:

4. Tips received by an employee are considered remuneration and are deemed to have been paid by the employer for purposes of the employer portion of FICA taxes.

5. Timing: The remuneration is deemed to be paid when a written statement including the tips is furnished to the employer by the employee.

6. If the employee does not furnish the statement, the remuneration is deemed to be paid on the date on which the IRS issues a notice and demand to the employer under §3121(q). Here the IRS should issue Letter 3523 to trigger the date of payment.

Employee Versus Independent Contractor
Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*, T.C. Memo. 2018-87:

1. The taxpayer LLC has two owners and acquired a 60-unit apartment complex in 2005. Since then, the LLC has engaged Robert Herndon to manage the complex. Herndon had provided services to the prior owner of the complex for many years.

2. The LLC owners maintained an office at the complex, and determined rental policies, operation policies, and rules and regulations for the complex.

3. Herndon served as property manager, resided in the complex, was the only person who worked regularly at the complex, and handled rentals, collection of rent, and general maintenance.

Employee Versus Independent Contractor
Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. The LLC never treated Herndon as an employee and never issued Forms 1099 to him, but paid him a flat amount of $2,000 per month. The IRS determined he was an employee for quarters in 2009 and 2010. The Court agreed with the IRS, applying the Fourth Circuit factor test as follows:
    a. Degree of Control: The "crucial test" the Court applied is whether the service recipient has the right to exercise control over the service provider not only as to the result to be accomplished, but also as to the details and means by which the result is accomplished.

Employee Versus Independent Contractor
Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. Factor test:
    a. Degree of Control: Here the LLC owners established the amount of rents to be charged and the policies and rules for the complex, and only they could change any policies or rules. They had the right to dictate how Herndon carried out his duties, even though they gave him significant authority given his history with the complex. They not only had the right to do so, they in fact did in many cases direct Herndon on how to perform specific tasks. This factor therefore weighed in favor of employee status.

Employee Versus Independent Contractor Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. Factor test:

   b. Investment in Facilities: Although Herndon used a few of his own "handyman" tools when performing general maintenance at the complex, the LLC owned and/or provided most of the facilities and most of the tools and equipment Herndon used to manage the complex. It also provided Herndon with a credit card to purchase necessary materials. This factor favored employee status.

   c. Opportunity for Profit and Risk of Loss: Herndon received a flat monthly amount plus his apartment at the complex. That favored employee status.

Employee Versus Independent Contractor Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. Factor test:

   d. Right to Discharge the Worker: The LLC had the right to discharge Herndon at any time for any reason, and Herndon could resign at any time. This favored employee status.

   e. Integral Part of Business and Permanency of Relationship: Herndon performed critical tasks and had an extensive role in managing the complex. The breadth of his tasks reflected his integral part in the business and favored employee status, as did the fact Herndon continued working as manager from the time the LLC acquired the complex through the time of trial.

Employee Versus Independent Contractor Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. Factor test:

   f. Parties' Beliefs on Relationship: The two owners did not testify at trial and Herndon did not expressly testify on what relationship he intended in 2006. Herndon did sometimes work as a handyman for other homes and buildings in the neighborhood, receiving compensation on a "bid basis." This factor was therefore neutral.

   g. Provision of Employee Benefits: The LLC did not provide Herndon with any benefits such as health insurance or a retirement plan, but did allow him vacation time without reducing his monthly remuneration. This factor was neutral.

Employee Versus Independent Contractor Apartment Manager Was Employee

A. In *Hampton Software Development LLC v. Comm'r*:

1. Court conclusion:

   a. The Court summarily concluded that based on the entire record, Herndon was an employee of the LLC.

   b. The Court also rejected the claim that the LLC was entitled to relief under §530, which grants relief even if a service provider is an employee, if (1) the service recipient has not treated the worker as an employee for any period and has consistently treated the worker as not being an employee on tax returns; and (2) the service recipient has a "reasonable basis" for not treating the worker as an employee. The first factor was not satisfied, as the LLC never filed Forms 1099.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

1. T is a financial consultant and develops investment portfolios for clients.
   a. On February 2, 2006, T entered into a representation agreement with Linsco/Private Ledger Financial Services (LPL), under which he was an independent contractor.
   b. On February 7, 2006, T incorporated Fleischer Wealth Plan (FWP) as his solely owned S corporation. On February 28, 2006, T entered into an employment agreement with FWP, and was to be paid an annual salary to be a financial advisor.
   c. In March 2006 T entered into a broker contract with MassMutual as an independent contractor, with no mention of FWP.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

2. T earned all his income from work under his agreements with LPL and MassMutual. His contracts with them were never amended to mention or include FWP.
   a. In each of the years 2009-2011, T reported wage income of about $35,000 from FWP, and attached a Schedule E reporting nonpassive income from FWP. No amount was reported as SE income, but T did claim a self-employed health insurance deduction. He attached no Forms 1099 from LPL or MassMutual to his returns.
   b. For those years, FWP reported gross receipts between $147,600 and $289,000 based on Forms 1099 T received from LPL or MassMutual.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

3. In short, the income T received under his agreements with LPL and MassMutual and reflected on Forms 1099 issued by them was "run through" FWP, T's S corporation.
   a. T only treated $35,000 each year as salary subject to FICA taxes, and the net income of FWP after that salary was treated as active S corp income not subject to SE tax.
   b. IRS: The gross receipts reported by FWP (based on the Forms 1099 issued by LPL and MassMutual) were really SE income that should have been reported on Schedules C. It asserted deficiencies of about $14,000 each for 2009, 2010, and 2011.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

4. Court: Income is taxed to the person who earned it, and corporations are separate entities from their owners. When a service-provider employee and his corporation are at issue, the decisive issue is "who controls the earning of the income."
5. For the corporation, not its service provider, to be the controller of the income, two elements are required:
   a. The individual providing the services must be an employee of the corporation whom it can direct and control in a meaningful sense.
   b. A contract must exist between the service recipient and the corporation recognizing the corporation's controlling position.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

5. Court: The second requirement is not met here because:
   a. FWP did not enter into a contract (or anything else) with LPL or MassMutual that exhibited its control over T.
   b. There was no mention of FWP in the LPL agreement, and FWP was not even incorporated when T entered into the LPL contract. T did not enter into the purported employment agreement with FWP until three weeks after the LPL agreement.
   c. There also was no mention of FWP in the broker contract T signed with MassMutual, and T signed that contract in his individual capacity. There was no evidence Mass Mutual was aware of whether FWP had any control over T.

Shifting Income to an S Corporation
Not So Fast

A. In *Fleischer v. Comm'r*, T.C. Memo. 2016-238:

6. Court: T's argument that LPL and MassMutual could not have contracted directly with FWP because FWP was not a registered entity under applicable securities laws fails because:
   a. There was no proof that FWP was prohibited from registering to purchase or sell securities under applicable securities law.
   b. The fact that FWP was not registered does not allow T to assign the income he earned in his personal capacity to FWP.
7. T cited no authority supporting his position where the corporation or entity at issue did not have agreements with the service recipients. T loses.

2018 Social Security Wage Base

A. The social security wage base was $127,200 in 2017 and is $128,400 in 2018.

1. In 2018 an employee's maximum tax rose to $7,961 (6.2% X $128,400), up from $7,886 in 2017.
2. Benefits in 2018 increased 2%, about $26 per month, the biggest percentage increase since 2012. Increases in Medicare Part B premiums offset the rise in benefits.
3. Problem: The "base" Medicare premium stays at $134 in 2018. Beneficiaries who are not protected under "hold harmless" provisions may have a higher base premium in 2018, a rule that applied in 2016 and 2017 due to low inflation.

PARTNERSHIPS & LLCs

Bipartisan Budget Act of 2015

A. “Simplifies” partnership audits, effective after 2017:

1. Current rules provide three regimes for partnership audits:
   a. If 10 or fewer partners, IRS audits each partner separately.
   b. If more than 10 partners, TEFRA rules apply.
   c. If 100 or more partners and P/S elects to be an Electing Large Partnership (ELP), adjustments flow through for the year of adjustment rather than the year under audit. Only about 103 partnerships file ELP Form 1065B.
2. Act: Repeals TEFRA and ELP rules and replaces with centralized system for audit, adjustment, assessment, and collection of tax.

Bipartisan Budget Act of 2015

B. Streamlined audit approach:

1. IRS will examine P/S items for a particular year (the reviewed year). Any adjustments will be taken into account by the P/S (not the individual partners) in the year that the audit or judicial review is completed (the adjustment year). Send bill to P/S, using highest assumed rates.
2. P/S have option to demonstrate that the adjustment would be lower if it were based on certain partner-level information from the reviewed year rather than imputed amounts determined solely on the partnership’s information in such year.

Bipartisan Budget Act of 2015

B. Streamlined audit approach:

3. Alternative to taking the adjustment into account at the P/S level: The P/S could issue adjusted information returns (adjusted Schedule K-1s) to the reviewed-year partners, in which case those partners would take the adjustment into account on their individual returns in the adjustment year through a "simplified amended-return process."

4. P/S option: Initiate an adjustment for a reviewed year with it taken into account in the adjustment year.

5. <u>But P/Ss with **100 or fewer partners** (each of which is either an individual, C corporation, S corporation, or estate of a deceased partner) can opt out of the entity-level audit</u>. Election out must be done each year on a timely filed return.

Partnership Audit Regulations

A. On June 13, 2017, the IRS re-released proposed regulations (REG-136118-15) on the repeal of the current rules governing partnership audits under the Bipartisan Budget Act of 2015.

1. Proposed regulations initially were issued in January 2017, shortly before the inauguration of President Trump, but were withdrawn due to executive orders issued shortly thereafter.

2. The IRS released final regulations (T.D. 9829) effective January 2, 2018, on the provisions under §6221(b) that allow certain partnerships to opt out of the new rules. Partnerships with disregarded entities as partners continue to be unable to opt out under these regulations.

Partnership Audit Regulations

A. On June 13, 2017, the IRS re-released proposed regulations (REG-136118-15) on the repeal of the current rules. In addition:

3. In November 2017, the IRS issued proposed partnership audit regulations (REG-120232-17 and REG-120233-17) that provide rules that address how pass-through partners take into account adjustments related to paying an imputed underpayment. For tiered partnerships, these regulations provide rules for "pushing out" adjustments beyond the first tier.

4. In February 2018, the IRS issued proposed regulations (REG-118067-17) providing rules for partnerships to adjust basis and capital accounts under the new partnership audit rules.

Partnership Audit Regulations

A. On June 13, 2017, the IRS re-released proposed regulations (REG-136118-15):

5. The above regulations are lengthy and complex and will be modified before they are finalized.

6. *Details will be discussed in Richard B. Robinson's presentation today at 11:00 a.m., "What You Need to Do to Prepare for the New Centralized Partnership Audit Rules."*

Status of Proposed Regulations Disguised Sales and Certain Debt Allocations

A. In January 2014 the IRS issued proposed regulations (REG-119305-1) to clarify disguised sales rules under §707 and revise rules concerning the determination of partners' shares of liabilities under §752.

1. The latter revisions received strong opposition from partnership practitioners.
2. On October 4, 2016, the IRS issued final (T.D. 9787), temporary (T.D. 9788), and re-proposed (REG-122855-15) regulations that follow up on the previous proposed regulations. These regulations eliminated or reduced leveraged partnerships, curtailed bottom-dollar guarantees, and restricted deficit restoration obligations.

Status of Proposed Regulations Disguised Sales and Debt Allocations

A. These regulations were then reviewed under executive orders issued by President Trump, and were in part identified as burdensome by the Treasury Department in Notice 2017-38.

1. In June 2018, the IRS issued proposed regulations (REG-131186-17) that eliminate the prior proposed and temporary regulations (T.D. 9788) on the treatment of liabilities for disguised sale purposes under §707.
2. So-called "bottom-dollar guarantees" under the prior regulations continue to be regulations under the prior regulations.
3. Under the eliminated temporary regulations, the IRS treated almost all liabilities as nonrecourse liabilities for disguised sale purposes, a dramatic shift from prior rules.

Status of Proposed Regulations
Disguised Sales and Debt Allocations

A. These regulations were then reviewed under executive orders issued by President Trump, and were in part identified as burdensome by the Treasury Department in Notice 2017-38.

4. Under the new proposed regulations, the IRS will go back to the old approach of applying separate rules for a partnership's recourse and nonrecourse liabilities.

5. That approach treats a partner's share of <u>recourse</u> liabilities in Reg. §1.707-5(a)(2)(i) as the same share of recourse liabilities under §752. It then treats a partner's share of <u>nonrecourse</u> liabilities in Reg. §1.707-5(a)(2)(ii) by applying the same percentage the partner used to determine its share of excess nonrecourse liabilities under Reg. §1.752-3(a)(3), which looks only to a partner's profit interest in allocating liability.

Short Takes

A. In *Mack v. Comm'r*, T.C. Memo. 2016-229:

1. In 2011 taxpayer T was a partner of a partnership that reported his distributive share of income as $479,743.

   a. T reported only $75,000 of the income on his return, contending that fiduciary duties under state law required him to use the remainder of his share to pay partnership expenses to keep the business from failing.

2. Held: T was liable for tax on his full distributive share of partnership income.

   a. An payment of partnership expenses by T was a contribution to capital and he can deduct his share of the expenses. An accuracy-related penalty applied.

Short Takes

B. In *Malone v. Comm'r*, 148 T.C. No. 16 (2017):

1. Partnership PS reported on its return that partner T had a distributive share of both ordinary income and capital gain.
   a. T failed to report the ordinary income and did not inform the IRS of his inconsistent treatment of partnership income.
   b. The IRS asserted an accuracy-related penalty along with a deficiency. T claimed the penalty was not subject to deficiency procedures under TEFRA rules for partnership audits.
2. Court: T loses. Section 6222 requires a partner to treat partnership items consistently or to notify the IRS, and references penalties, including those under §6662. No TEFRA exclusions from deficiency procedures applied.

Short Takes

C. In *Seaview Trading LLC v. Comm'r*, 858 F.3d 1251 (9th Cir. 2017); and *Mellow Partners v. Comm'r*, 890 F.3d 1070 (D.C. Cir. 2018).

1. Section 6231(a)(1): TEFRA audit procedures do not apply if an entity has 10 or fewer partners, each of whom is an individual, a C corporation, or an estate of a deceased partner.
   a. Reg. §301.6231(a)(1)-1(a): This small partnership exception does not apply if any partner is a "pass-thru" partner, defined as any partnership, estate, trust, S corporation, nominee, or other similar person.
   b. Issue: Are disregarded entities, single member LLCs, pass-thru partners, such that the exception to TEFRA rules does not apply?
   c. Courts: Yes. So says Rev. Rul. 2004-88 and all precedent.

Temporary Regulations
Partners and DREs Owned by the Partnership

A. On May 4, 2016, the IRS issued final and temporary regulations (T.D. 9766):

1. They address situations where individual partners in a partnership that owns a DRE are treated as employees of the DRE. That allows such employees to receive Forms W-2 and participate in tax-favored employee benefit plans.

    a. Reg. §301.7701-2(c)(iv) now provides that a DRE under the check-the-box rules is treated as a corporation for purposes of employment taxes.

    b. That rule, however, does not apply for SE tax purposes. An example illustrates that the owner of a single-member LLC, a DRE, is treated as a sole proprietor subject to SE tax.

Temporary Regulations
Partners and DREs Owned by the Partnership

A. On May 4, 2016, the IRS issued final and temporary regulations (T.D. 9766):

1. Some taxpayers read the current regulations as allowing individual partners in a partnership that owns a DRE to be treated as employees of the DRE. They argue that the lack of a partnership example in the regulations permits that reading.

2. The new regulations amend Reg. §301.7701-2 to clarify that a DRE that is treated as a corporation for employment tax purposes is not treated as a corporation for purposes of employing either an individual owner who is treated as a sole proprietor, or an individual that is a partner in a partnership that owns the DRE.

Temporary Regulations
Partners and DREs Owned by the Partnership

A. On May 4, 2016, the IRS issued final and temporary regulations (T.D. 9766):

1. The IRS noted that the rules are not clear in this area for tiered partnerships, and requested comments on that issue.

2. In order to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments, the temporary regulations will apply on the later of:

   a. August 1, 2016; or

   b. The first day of the latest-starting plan year following May 4, 2016, of an affected plan sponsored by an entity that is a DRE for any purpose.

Small Partnership Exception
Timely Filing Requirement

A. In *Battle Flat LLC v. U.S.*, 2015-2 U.S.T.C. ¶50,469 (D. S.D. 2015), the Court held that a partnership did not qualify for the small partnership reasonable cause exception to the §6698 late filing penalty for a partnership tax return when some partners did not timely file their personal income tax returns.

1. T is a partnership with 10 or fewer partners that was assessed a penalty under §6698 for failure to timely file its partnership tax return for 2007 and 2008. T claimed a reasonable cause defense.

2. Rev. Proc. 84-35: A domestic partnership with 10 or fewer partners will satisfy the reasonable cause defense to the §6698 penalty if it is established that all partners fully reported their respective shares of partnership items on <u>timely filed</u> income tax returns.

Small Partnership Exception Timely Filing Requirement

A. In *Battle Flat LLC v. U.S.*:

1. Three of the partners failed to timely file their personal income tax returns.
2. Battle Flat asked the Court to not enforce Rev. Proc. 84-35, arguing that the reasonable cause exception is satisfied so long as all partners in a small partnership file their personal returns, timely or not.
3. Court: Stop looking a gift horse in the mouth. Rev. Proc. 84-35 goes beyond what is required by statute with respect to reasonable cause. It requires timely filing by the partners. Period.
4. And: The timely filing requirement is reasonable.

S CORPORATIONS AND SHAREHOLDERS

S Corporations
Reminder of Prior Year Events Relevant to 2018

A. Key S corporation rules in recent years:

1. Rev. Proc. 2013-30 consolidates rules relating to the grant of relief by the IRS for late S corporation elections and related elections, including late corporate classification elections.

2. Final Reg. §1.1366-2(a) discarded the "actual economic outlay" approach to determine basis for loans made to S corporations.

   a. Such basis is the basis in "any bona fide indebtedness of the S corporation that runs directly to the shareholder," determined under general federal tax principles, and under all the facts and circumstances.

No Debt Basis for Guaranty
Even if Judgment Entered Against Guarantor

A. In *Phillips v. Comm'r*, T.C. Memo. 2017-61, *aff'd*, 2018-1 U.S.T.C. (CCH) ¶50,253 (11th Cir. 2018):

1. Taxpayers guaranteed debts of an S corporation that was engaged in the real estate business in Florida and went bankrupt after the 2008 recession. Lenders obtained judgments of more than $105 million against the taxpayer/guarantors, who did not pay the judgments, but who increased their basis in the S corporation and carried back losses.

2. Held: Being a guarantor did not increase S corporation basis, and the fact that judgments were entered against the guarantor owners of the S corporation was irrelevant. They made no economic outlay. Same: *Hargis v. Comm'r*, T.C. Memo. 2016-232, *aff'd*, 2018-1 U.S.T.C. (CCH) ¶50,295 (8th Cir. 2018); *Tinsley v. Comm'r*, T.C. Summ. Op. 2017-9.

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*, T.C. Memo. 2018-16:

1. Meruelo is a real estate developer who owned 49% of the stock in an S corporation (Merco) that was formed to purchase a condo complex in 2004. Meruelo borrowed almost $5 million to cover his share of a non-refundable deposit required by a bankruptcy court to secure the purchase, and transferred that amount to Merco through another S corporation.
    a. Subsequently Merco entered into hundreds of transactions with various affiliated entities in which Meruelo held an interest. The affiliates paid expenses of each other or on Merco's behalf to simplify accounting and enhance liquidity. The payor treated payments as accounts receivable and the payee treated them as accounts payable. From 2004 to 2008, Merco showed substantial net accounts payable to its affiliates.

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Merco netted its accounts payable to its affiliates each year against its accounts receivable from its affiliates.
    a. If Merco had net accounts payable at the end of each year, it was reported as a "shareholder loan" on its tax return and it allocated 49% of this "debt" to Meruelo.
    b. To show debt from Merco to Meruelo, Merco's preparer drafted a promissory note in 2004 under which Meruelo made available to Merco a $10 million unsecured line of credit at a 6% interest rate.
    c. No documentary evidence supported that adjustments to "principal" on the "debt" were made annually, that there were payments of interest or principal, or that Meruelo made any payments on the "loans" the affiliates extended to Merco when they paid its expenses or advanced cash.

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. In 2008, Merco incurred a loss of more than $26.6 million when banks foreclosed on the condo complex it bought in 2004. Merco allocated 49% of the loss to Meruelo.
   a. Under special NOL carry-back rules for 2008, Meruelo carried back a $13 million loss to 2005 and received a tentative refund.
   b. IRS: Meruelo only had a $5 million basis in Merco in 2005 (the amount of funds he originally contributed to Merco), and the IRS therefore disallowed about $8 million of the carry-back loss. The resulting 2005 deficiency was about $2.6 million.
   c. Meruelo: I had additional debt basis in Merco of about $13 million due to the inter-company transfers between Merco and its affiliates.

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Prior to 2014 final regulations: Basis for S corporation debt allowing a shareholder to claim losses is limited to debt or an "investment" in the corporation that represents an "actual economic outlay" by the shareholder, who must "incur a cost on a loan" that leaves him poorer in a material sense.
2. Meruelo: The 2014 amendments to Reg. §1366-2 eliminate the need to show an "actual economic outlay" so as to increase debt basis in an S corporation.
3. The regulation limits basis to "bona fide indebtedness" of the S corporation that "runs directly to the shareholder."

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Court:

   a. The test under the new regulation is the same test set forth in prior case law in that the debt of the S corporation must run directly to the shareholder.

   b. In addition, the new regulation provides that the existence of the bona fide debt shall be determine "under general federal tax principles." The "actual economic outlay" doctrine is a general tax principle that the Tax Court has applied in "cases too numerous to mention" to determine whether a shareholder "has made a bona fide loan that gives rise to an actual investment" in the corporation.

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Court:

   c. And principles developed in other tax contexts, requiring that a corporation's debt to a shareholder "be genuine and reflect economic reality," apply with equal force to §1366(d)(1).

2. Meruelo claimed that the transactions among Merco and its affiliates should be recast as loans to the shareholders of each creditor affiliate, followed by loans from the shareholders to Merco (back-to-back loan theory).

Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Court: Back-to-back loans can qualify, but the debt of the S corporation must run directly to the shareholder to create basis.
   a. A corollary of this rule is that the debt of an S corporation running to a pass-through entity that advanced the funds and is closely related to the taxpayer does not satisfy that requirement.
   b. Transfers between related parties are examined with special scrutiny, and taxpayers bear a heavy burden of demonstrating that the substance of transactions differ from their form.
   c. Here no loan transactions were contemporaneously documented, and Merco's "debt" ran to its affiliates, not directly to Meruelo. There was no "bona fide" debt from Merco to Meruelo.

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Back-to-Back Loans
Bona Fide Debt Test Still Applies

A. In *Meruelo v. Comm'r*:

1. Court: Also rejected the argument that Meruelo used the affiliates as an "incorporated pocketbook" to pay Merco's expenses on his behalf.
   a. This argument only has been successful where the taxpayer establishes that he had a "habitual practice" of having his wholly owned corporation pay money to third parties on his behalf.
   b. Here Meruelo was not the sole shareholder of the 11 distinct Merco affiliates that advanced funds to Merco or paid its expenses. Also Meruelo's alleged "incorporated pocketbook" not only disbursed funds but regularly received them. No incorporated pocketbook cases have similar facts, and are otherwise distinguishable.

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IRS Ceases to Issue PLRs in Three Areas

A. The IRS announced on March 3, 2017, that it will no longer issue letter rulings to S corporations in three areas:

1. Disproportionate distributions;
2. Specific second-class of stock regulations issues; or
3. Incorrect entity filings (such as elections with missing or incorrect information).

B. The IRS may clarify its decision in the next annual "no-rule revenue procedure," or may publish other guidance. Reason: resource constraints and doubts as to value of such rulings.

No Deduction for Accrued Compensation to ESOP Participants

A. In *Petersen v. Comm'r*, 148 T.C. No. 22 (2017):

1. Held:
   a. An S corporation's employee stock ownership plan (ESOP) was a trust for purposes of §267, and employee participants were related persons. Therefore accrued but unpaid compensation to the participants could not be deducted by the S corporation until the employees included the amounts in income.
2. A couple owned an S corporation (Petersen), and set up an ESOP in 2001 for the benefit of employees.
   a. In 2009 and up to October 2010 the ESOP owned about 20% of Petersen. Thereafter the ESOP owned 100% of the company.

No Deduction for Accrued Compensation to ESOP Participants

A. In *Petersen v. Comm'r*, 148 T.C. No. 22 (2017):

3. At the end of 2009, Petersen had accrued but unpaid wage expenses of $1 million, which was paid to the employees by 1/31/2010. About 89% of that amount was attributable to employee participants in the ESOP.
    a. Petersen also had accrued but unpaid vacation pay expenses of $473,000, which was paid to employees by 12/31/2010. About 94% was attributable to ESOP participants.
    b. Petersen claimed deductions on its 2009 return for the accrued but unpaid payroll expenses. The IRS disallowed the deductions under §267(a)(2) to the extent those expenses were attributable to ESOP participants.

No Deduction for Accrued Compensation to ESOP Participants

A. In *Petersen v. Comm'r*, 148 T.C. No. 22 (2017):

4. Rules under §267(a)(2), (e) and (c)(1):
    a. A payment to a person who is related under §267(b) may not be deducted until it is included in the recipient's income;
    b. An S corporation and any person who directly or indirectly owns any stock are deemed to be related persons; and
    c. Stock owned by a trust is treated as being owned by its beneficiaries.
5. Therefore if the ESOP was a "trust" of which the ESOP employee participants were beneficiaries, they would be treated as owners of the stock and be related parties to Petersen.

No Deduction for Accrued Compensation to ESOP Participants

A. In *Petersen v. Comm'r*, 148 T.C. No. 22 (2017):

6. Petersen: There was no intention to create a trust, and the ESOP could not be a trust for §267 purposes as a matter of law.
7. Court: There was a trust under the ESOP rules that held assets for the ESOP beneficiaries, who had liquidation rights.
   a. Fact that Utah law excludes employee benefit plans from the definition of a trust does not matter because federal law controls.
   b. Fact that there was an ESOP plan as well as a trust does not dictate that there is no trust for §267 purposes
   c. The trust here met the Reg.§301.7701-4(a) definition of a trust and that is enough for §276(a)(2) to apply. IRS wins.

TAX ACCOUNTING
METHODS OF ACCOUNTING

Rescission Doctrine Did Not Apply

A. In *Yoklic v. Comm'r*, T.C. Memo. 2017-143:

1. In 2012 taxpayer T filed a claim for unemployment benefits in Arizona and was granted and paid $3,360 by August 2012.
   a. In subsequent determination letters by October 25, 2012, Arizona notified T that he was not entitled to the benefits. T was entitled to object by November 26, 2012, but took no action.
   b. T returned the benefits to Arizona by check dated September 26, 2013.
   c. Arizona filed Form 1099-G reporting the payments as income for 2012. T did not include the payments received on his 2012 return or any other return.

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Rescission Doctrine Did Not Apply

A. In *Yoklic v. Comm'r*, T.C. Memo. 2017-143:

2. Court: T had a claim of right to the payments in 2012 and generally they were income in 2012. The doctrine of rescission is an exception to the claim-of-right doctrine. T need not include income received under a claim of right if, in the year of receipt, the taxpayer:
   a. Recognizes an existing and fixed obligation to repay the amount received; and
   b. Makes provisions for repayment. *See Gaddy v. Comm'r*, 38 T.C. 943 (1962).
   c. T loses. He did not make provisions for repayment in 2012, and did not repay the amount until 2013.

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Cash-Method Taxpayers and §468 Can Deduct Estimated Future Expense

A. In *Gregory v. Comm'r*, 2017 U.S. Tax Ct. LEXIS 35:

1. In 1988 taxpayer T incorporated a landfill business (TDSL), which was a cash-method taxpayer.
    a. TDSL was successful and T discovered §468, which allows "a taxpayer" who owns a landfill to elect to deduct currently a portion of what it will cost to clean up the landfill in the future.
    b. T made the election and claimed the deduction allowed. The IRS disallowed the deduction, asserting that §468 applies only to accrual-method taxpayers, even though it does not so state.
    c. Court: The statute allows the deduction if "a taxpayer" makes the election. That is plain and unambiguous. A "taxpayer " under §7701(a)(14) is any person subject to any internal revenue tax.

Tax Benefit Rule Did Not Apply

A. In *Estate of Backemeyer v. Comm'r*, 147 T.C. No. 17 (2016), the Tax Court held that the tax benefit rule does not require recapture of deductions for farm expenses claimed by a husband on his 2010 return when the husband died in 2011 and his surviving wife deducted those same expenses when she took over the farm.

1. Facts: Husband H was a Schedule C farmer and wife W worked an in insurance company. H incurred expenses in 2010 for "farm inputs" such as seed, fertilizer, and fuel that he planned to use in connection with planting crops in 2011.
2. H died in March 2011 before using these farm inputs.

Tax Benefit Rule Did Not Apply

A. In *Estate of Backemeyer v. Comm'r*:

1. In 2011 W operated the farm, and used all of the farm inputs H had purchased in 2010 in the farming operation.
2. As a cash method taxpayer, H deducted the cost of the farm inputs he purchased in 2010 on the joint return of H and W.
3. W deducted the cost of those same farm inputs on her 2011 return to the tune of $235,693.
4. The IRS disallowed the 2011 deductions, claiming they amounted to a "double deduction," and in the alternative that recapture applied under the tax benefit rule.

Tax Benefit Rule Did Not Apply

A. In *Estate of Backemeyer v. Comm'r*:

1. After concessions, the only issue the Court decided was whether the tax benefit rule required the recapture in 2011 of farm input deductions claimed by H and W on their 2010 return.
2. The tax benefit rule in §111 provides that "gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed."

Tax Benefit Rule Did Not Apply

A. IRS: *Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983) (consolidated with a case called *Bliss Dairy*) controls:

   a. A corporation deducted the cost of cattle feed in Year 1, and early in Year 2 liquidated and distributed the feed and other assets to shareholders, who continued the business and deducted their basis in the feed in Year 2.

   b. The Court held that the tax benefit rule applied because the liquidation of the corporation resulted in a conversion of the feed from a business to a non-business use, representing an action inconsistent with the prior deduction in Year 1, and therefore requiring application of the tax benefit rule.

   c. IRS: In *Backemeyer,* H's death resulted in the same type of conversion and triggers the tax benefit rule.

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Tax Benefit Rule Did Not Apply

A. W's argument:

   1. When H died and W inherited the farm inputs which she later used in her own separate farming operation, she was deemed to had simultaneously sold the inputs and then purchased them for use in farming, with no gain on the deemed sale because she had a full stepped-up basis in the inputs.

   2. Separate Schedules F for 2011 were filed for H's and W's respective farm businesses. She properly received a stepped-up basis and had a "fresh start" for the tax attributes of the inherited inputs.

   3. This was no scheme to create a double deduction. H died.

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Tax Benefit Rule Did Not Apply

A. W relied on *Frederick v. Comm'r*, 101 T.C. 35 (1993), which provides a four-part test to apply the tax benefit rule:

1. Amount was deducted in the prior year;
2. The deduction resulted in a tax benefit;
3. An event occurs in the current year that is "fundamentally inconsistent with the premises on which the deduction was originally based"; and
4. No non-recognition rule in the Code applies.

B. W claimed #3 and #4 were not satisfied here.

Tax Benefit Rule Did Not Apply

A. Court analysis:

1. The four-part test in *Frederick* applies.
2. A current event is considered "fundamentally inconsistent" with the premises on which the prior deduction was originally based "when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken."
3. In *Hillsboro* (*Bliss Dairy*), the event was a liquidation. That case does not control whether the tax benefit rule applies when a death is the current event.

Tax Benefit Rule Did Not Apply

A. Court analysis:

1. Had H died in 2010, there would have been no recapture of the 2010 deduction amount for the inputs.

   a. Why? Because the estate tax effectively “recaptures” a deduction by its normal operation, without need to separately apply the tax benefit rule.

   b. When H died, all his assets became subject to estate tax at fair market value (even though the inputs had a zero basis). The FMV of the inputs was stipulated to be their cost. Thus, since the inputs had a zero basis, they were subject to the estate tax on the same base as their purchase price, for which H had claimed the 2010 deduction.

Tax Benefit Rule Did Not Apply

A. Court analysis:

1. Based on the foregoing, the Court stated that requiring recapture of the deduction for the inputs in 2011 would result in “double taxation” on the value of the inputs, because precedent provides that “the same receipt” cannot be made “the basis of both income and estate tax” since an item cannot in the circumstances be both income and corpus.

2. Therefore applying the tax benefit rule in the present case is impermissible when the inputs were subject to tax as part of H’s estate. It was irrelevant whether H’s estate did not actually owe any estate tax due to the unified credit or marital deduction. H’s estate was “subject to” the estate tax regime.

Tax Benefit Rule Did Not Apply

A. Court analysis:

1. In addition, the Supreme Court's prior approach calls for a "line between merely unexpected events and inconsistent events."
2. In *Hillsboro*, the corporate liquidation involved forethought and affirmative intent. Death ordinarily does not involve such planning. Although death may be beneficial for tax purposes, it is "difficult to regard it as a tax avoidance scheme."
3. If death were "fundamentally inconsistent" with expensing business inputs, every sole proprietor would face double taxation under both the income tax and estate tax on all inputs purchased but not yet used.

Tax Benefit Rule Did Not Apply

A. Court analysis:

1. The Court rejected the IRS "double deduction" argument because the estate tax intervened between the two deductions, and the IRS had conceded that H's Schedule F business should be treated as being separate from W's Schedule F business.
2. Here the sole cause for the allowance of two deductions was the stepped-up basis rules. If those rules had not applied and W had taken a zero basis in the inputs, she would have no deduction. Congress is presumed to know the law, and could have foreclosed a second T/B expense deduction in cases involving a stepped-up basis if it had wished.

Updated Guidance on Method Changes

A. Previously, **Rev. Proc. 2017-30** listed the automatic changes in methods of accounting to which the automatic change procedures in Rev. Proc. 2015-13 (as clarified and modified in Rev. Proc. 2015-33, and Rev. Proc. 2016-1) apply.

B. **Rev. Proc. 2018-31:** Updates Rev. Proc. 2017-30, as modified, and identifies 10 significant changes:

1. Four remove obsolete method changes, and three make method changes unavailable after December 2017 due to the TCJA.
2. Two changes remove waivers of the 5-year limit on automatic method changes for specific mark-to-market method changes.

Updated Guidance on Method Changes

A. **Rev. Proc. 2018-31:** Updates Rev. Proc. 2017-30 and identifies 10 significant changes:

3. The last change in the automatic method change list adds a waiver of the five-year limit for advance payment method changes following Rev. Proc 2004-34.
4. That revision was announced previously in Notice 2018-35, which allows taxpayers to follow Rev. Proc. 2004-34 until the IRS completes guidance under §451(c), which provides for the TCJA codification of Rev. Proc. 2004-34.

Updated Guidance on Method Changes

A. The IRS has issued Rev. Proc. 2018-29 to modify Rev. Proc. 2017-30 to add a new automatic method change to conform with new financial accounting standards.

1. This was a follow-up to a request for comments in Notice 2017-17 as to how to change a method for recognizing income when the change is a result of adoption by T of new financial accounting standards issued by the FASB when the change is made for the same taxable year as the adoption.
2. Rev. Proc. 2018-29 concerns Accounting Standards Codification Topic 606 (Revenue from Contracts With Customers). <u>It does not address amendments to §451 under the TCJA, as later guidance will address those amendments</u>.

Updated Guidance on Method Changes

A. Note: The IRS has revised Form 3115.

1. See last 11 pages of updated instructions for list of automatic DCNs.
2. Tax software has been updated and automatic method changes are now much easier.

TAX PRACTICE AND PROCEDURE

Short Takes
Practitioner Guidance

A. Rev. Rul. 2018-7: Over/under payment rates under §6621 go up in second quarter of 2018.

1. Beginning April 1, 2018, applicable interest rates will increase to 5% for overpayments (4% for a corporation, and 2.5% for corporate overpayments exceeding $l0,000), and 5% for underpayments (7% for large corporate underpayments).

2. The general over/underpayment rate is the sum of the federal short-term rate plus 3%.

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Short Takes
Practitioner Guidance

A. In March 2018 the IRS announced in IR-2018-52 that it will begin to ramp down and end the current 2014 Offshore Voluntary Disclosure Program (OVDP) on September 28, 2018.

1. The original OVDP began in 2009. Since then over 56,000 taxpayers used the program to comply voluntarily, paying a total of $11.1 billion in back taxes, interest and penalties.
2. Disclosures in the program peaked in 2011 and then steadily declined.
3. The separate Streamlined Filing Compliance Procedures will remain in place for the time being.

Short Takes
Practitioner Guidance

A. Proposed regulations (REG-102951-16):

1. Reg. §301.6011-2 provides that specified information returns need not be e-filed unless the person must file at least 250 returns during the calendar year, but this threshold applies separately to each type of information return filed.
2. This non-aggregation rule, due to technology, is no longer needed to reduce taxpayer burden and cost. Therefore the proposed regulations remove it and require e-filing for all information returns if a person is required to file, in the aggregate, at least 250 returns covered by Regulation §301.6022(2)(b). The new rule will not apply to information returns required to be filed before January 1, 2019.

Short Takes
Practitioner Guidance

A. In April 2018 Taxpayer Advocate (TA) Nina Olson issued a directive that halts assignments of collection of tax debts to private debt collection agencies in cases of taxpayers earning less than 250% of the federal poverty level (FPL).

1. Such directives can be rescinded by the IRS Commissioner or a deputy commissioner. On June 20, 2018, Kirsten Wielobob, deputy commissioner for services and enforcement, rescinded Olson's directive.

    a. Since the new private debt collection program started in April 2017, 20,862 taxpayers (25%) who had tax debts assigned to private agencies had earned income below the FPL; another 21% had income less than 250% of the FPL.

Short Takes
Practitioner Guidance

A. The IRS also has rescinded a directive issued by Olson concerning revocation of passports if a taxpayer has a seriously delinquent tax debt (more than $51,000).

1. In April 2018, Olson issued a directive asking the IRS not to certify debt as "seriously delinquent" in terms of passport revocation if the taxpayer has an open case with the Taxpayer Advocate Service.

2. The IRS claims it already has an appeal process for taxpayers in the situation Olson describes.

3. Problem: Exceptions to passport revocation do not include tax debts that have been deemed uncollectible.

Short Takes
Practitioner Guidance

A. The TA also has a beef with the IRS about its handling of its "first-time" penalty abatement policy.

1. In PMTA 2018-002, the IRS concluded that it has the authority to automatically waive penalties for some taxpayers under its first-time abatement policy.
   a. Chapter 20 of the Internal Revenue Manual, however, has a "stacking rule" under which the IRS considers first-time penalty abatement before considering the reasonable cause defense.
   b. The TA claims that this policy is taking away taxpayers' rights to argue that any return errors were due to reasonable cause, and is preventing them from using the first-time abatement as a remedy for later penalties.

Short Takes
Practitioner Guidance

A. The TA also claims that the IRS is making mistakes in analyzing reasonable cause by relying on its "reasonable cause assistant" software.

1. That software is made available to IRS employees who have no training on how to determine reasonable cause, and who therefore are incapable of overriding the "assistant" when appropriate.
2. The TA and other commentators also question the IRS' reliance on §6751(b)(2) for its position that if a penalty is automatically assessed (e.g., when reporting mismatches as to Forms 1099 and W-2 are not adequately explained by the taxpayer), its imposition does not require managerial approval.

Short Takes
Practitioner Guidance

A. Managerial approval of penalties.

1. 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."

    a. In *Graev v. Comm'r*, 147 T.C. No. 16 (2016) (*Graev II*), the Tax Court held that IRS compliance with §6751(b)(1) was not ripe for review in a deficiency case because the penalty has not yet been assessed.

    b. In *Chai v. Comm'r*, 851 F.3d 190 (2d Cir. 2017), the Court held that the Tax Court erred, and the IRS must show that it complied with §6751(b)(1) as part of its burden of production and proof.

Short Takes
Practitioner Guidance

A. Managerial approval of penalties.

1. In *Graev v. Comm'r*, 149 T.C. 23 (2018) (*Graev III*), the Tax Court adopted the holding in *Chai* as its own, but concluded that the IRS met the approval requirements.

    a. In *Graev* the taxpayer claimed large cash and noncash charitable contribution deductions for a facade easement contribution. An IRS Revenue Agent disallowed the deductions and proposed a 40% gross valuation misstatement penalty under §6662(h) (rather then merely a 20% valuation misstatement). The agent's immediate supervisor approved the penalty proposal in writing.

    b. Later an attorney in the Chief Counsel's office directed that only a 20% valuation misstatement penalty be asserted, which was approved by his immediate supervisor.

Short Takes
Practitioner Guidance

A. Managerial approval of penalties.

1. The Tax Court concluded that the IRS met the requirements of §6751(b)(1), even though the revenue agent's immediate supervisor had not approved the change from the 40% penalty to the 20% penalty, or approved a change in applicability of the penalty to noncash contributions.
   a. Here a Chief Counsel office attorney's immediate supervisor approved that changes, and therefore the IRS complied with the statute.
   b. Later, the Tax Court in four cases issued Orders providing that it would not re-open the record after a completed trial to allow the IRS to meet its new burden of production on penalties (i.e. show it met the requirements of § 6751(b)(1)).

Short Takes
Practitioner Guidance

A. Managerial approval of penalties.

1. See also *Dynamo Holdings LP v. Comm'r*, 150 T.C. 10 (2018), where the Tax Court held that partnerships bear the burden of production in penalty challenges.
   a. Reason: The rule that the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty, by its own terms, applies only to individuals.
   b. Importance of case: Taxpayers other than individuals probably have the burden to raise noncompliance with §6751(b)(1) and might waive such penalty defense if it is not timely raised.

Short Takes
Practitioner Guidance

A. Managerial approval of penalties.

1. See also *Blackburn v. Comm'r*, 150 T.C. No. 9 (2018), where an individual in a collection due process hearing involving the trust fund recovery penalty claimed that the IRS did not comply with §6751(b).
   a. The Tax Court found it unnecessary to decide whether the trust fund recovery penalties are subject to the statute because there was no abuse of discretion by the Appeals officer in concluding that all requirements of law and administrative procedure had been met under §6330(c)(1).
   b. Here Form 4183 (Recommendation re: Trust Fund Recovery Penalty Assessment) was in the administrative record, and it showed that the revenue officer's immediate supervisor approved the trust fund penalty, even if the Form was not signed.

Short Takes
Practitioner Guidance

A. Listen to TurboTax when it tells you your return has been rejected by the IRS.

1. In *Spottiswood v. U.S.*, 2018-1 U.S.T.C. (CCH) ¶50,226 (N.D. Ca. 2018), the Court refused to abate late-filing penalties stemming from the IRS' rejection of a couple's original e-filed return that contained an incorrect Social Security number, finding that they did not show reasonable cause for the untimely filing because Turbo Tax promptly informed them of the rejection in an e-mail.
2. The couple used TurboTax software to prepare their 2012 joint return and made a mistake when inputting a dependent's Social Security number. The return was transmitted to Turbo Tax on April 12, 2013, to be e-filed. The IRS rejected the return on that date and notified Turbo Tax, which notified the couple by email.

Short Takes
Practitioner Guidance

A. Listen to TurboTax when it tells you your return has been rejected by the IRS.

1. The Turbo Tax software also had a "check e-file status" for the 2012 return that the couple did not check until 18 months later. Both the Turbo Tax email and the software informed the couple that the return had been rejected because a dependent's Social Security number or last name did not match what the IRS had in its records.

2. The couple did not file their 2012 return until January 7, 2015, and at that time paid the $395,619 tax due. The IRS assessed a late filing penalty of $89,000, a late payment penalty of more than $41,000, and underpayment interest of $26,216.

Short Takes
Practitioner Guidance

A. Listen to TurboTax when it tells you your return has been rejected by the IRS.

1. The couple ultimately conceded the late payment penalty, but argued the late filing penalty was unfair because the IRS should not have rejected their return because it qualified as a tax return under the *Beard* test. They claimed if the same error had occurred on a paper return, it would not have been rejected.

2. Court: So what? The IRS rejected their e-filing because it contained an error and the IRS could not calculate the couple's tax liability. The couple did not show the IRS violated any return processing standards.

Short Takes
Practitioner Guidance

A. Listen to TurboTax when it tells you your return has been rejected by the IRS.

1. Court: The couple did not show reasonable or good cause. Turbo Tax notified them on the same day their return was rejected and they did not check the email account they gave to Turbo Tax, or check their software.

   a. They also failed to notice that the $395,619 tax due had not been withdrawn from their bank.

   b. The Turbo Tax precautions were not just buried in "fine print."

   c. They also inaccurately represented that their state return had been e-filed without issue. The taxpayers lose.

Short Takes
Practitioner Guidance

A. Reliance on a preparer to e-file is no penalty defense.

1. In *Haynes v. U.S.*, 2017-2 U.S.T.C. (CCH) ¶50,278 (W.D. Tex. 2017), a couple hired a CPA to prepare and file their 2010 return, and he timely obtained an extension of time to file until October 17, 2011.

   a. On the extended due date, the CPA attempted to e-file the return, but the IRS rejected that attempt under error code 0242 (listing an individual taxpayer's Social Security number on the line designated for an "employer identification number").

   b. The CPA somehow missed the rejection and advised the Haynes that their return had been timely filed. About 11 months later, the IRS notified the Haynes that it had not received their 2010 return. In December 2012, the CPA filed the return on paper.

Short Takes
Practitioner Guidance

A. Reliance on a preparer to e-file is no penalty defense.

1. In *Haynes v. U.S.*:

   a. The IRS assessed a late-filing penalty, and the Haynes filed a reasonable cause request for abatement and refund of the penalty. The IRS disallowed the request and the Haynes filed a refund suit.

   b. The IRS relied on a long line of cases starting with *U.S. v. Boyle*, 469 U.S, 241 (1985), where the Supreme Court stated that a taxpayer may not delegate his responsibility to file a timely return, and reliance on a preparer does not constitute reasonable cause. Reasonable cause may exist if a taxpayer justifiably relies on substantive legal advice of a tax professional.

Short Takes
Practitioner Guidance

A. Reliance on a preparer to e-file is no penalty defense.

1. In *Haynes v. U.S.*: the Haynes argued that *Boyle* and its progeny should not apply because:

   a. The cases only applied to paper-filed returns;

   b. E-filing a tax return is a form of substantive legal advice;

   c. A defective return transmitted to and rejected by the IRS is nonetheless a timely-filed return;

   d. An alleged failure of the CPA's software to provide notification of the IRS rejection of the return was beyond the Haynes' control and establishes reasonable cause; and

   e. Reliance on an experienced and prominent CPA is reasonable cause.

Short Takes
Practitioner Guidance

A. Reliance on a preparer to e-file is no penalty defense.

1. The Court rejects the taxpayers' arguments:
    a. The line of cases under *Boyle* give no support to any argument that paper returns and e-filed returns should be treated differently.
    b. E-filing is not substantive tax advice, even if it can be complex.
    c. There is no basis in fact or law to support the position that a defective return rejected by the IRS is a timely-filed return.
    d. The alleged software failure of not receiving notice the return was rejected does not rise to the level of "circumstances beyond the taxpayers' control."
    e. Reliance on a great CPA is irrelevant under *Boyle*.

Short Takes
Practitioner Guidance

A. Reliance on a preparer to e-file is no penalty defense.

1. The Haynes are appealing the district court's application of *Boyle* given the convoluted nature of e-filing. Stay tuned.
2. They are relying on a footnote in *Boyle* that states that a taxpayer should not be penalized for circumstances beyond his control.
3. They also argue that the complexity of the "difficult substantive task" of e-filing is evidenced in part by 98 pages of potential IRS error codes that accompany the process.
4. IRS: An e-filed return is not filed until the IRS acknowledges acceptance. The CPA should have taken action and not assumed that "no news is good news." The Haynes also did not inquire why the IRS did not seek payment of the $50,000 balance due on their return.

Short Takes
Practitioner Guidance

A. On November 29, 2016, the IRS issued final regulations (T.D. 9798) that increase, effective January 1, 2017, the user fees for installment agreements, and introduce two new types of online installment agreements.

1. Proposed schedule of user fees:

   a. Regular installment agreements, $225 (up from $120).

   b. Regular direct debit installment agreements, $107 (up from $52).

   c. Online payment agreements, $149.

   d. Direct debit online payment agreements, $31.

   e. Restructured or reinstated installment agreements, $89 (up from $50).

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Short Takes
Practitioner Guidance

A. New online installment agreements:

1. A taxpayer sets up an agreement online and agrees to make manual payments either electronically or by mailing a check. Fee is $149.

2. A taxpayer agrees to make automatic payments through a direct debit from a bank account. Fee is $31.

3. The current user fee for low-income taxpayers is $43 regardless of payment method, and is not changed.

B. Effective 2/27/2017: User fee for OIC increased from $186 to $300. *See* proposed REG-108934.

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Short Takes
Practitioner Guidance

A. In *Tilden v. Comm'r*, 846 F.3d 882 (7th Cir. 2017):

1. The deadline for filing a petition in Tax Court, generally 90 days after a notice of deficiency, is jurisdictional.

2. The Tax Court, however, cannot disregard a taxpayer's and the IRS' agreement that the taxpayer's petition was timely filed.

   a. IRS had initially claimed T's petition was untimely when T used Stamps.com to obtain a postmark. After reconsidering the facts, the IRS stipulated that the petition was timely.

   b. The Tax Court dismissed the case anyway, finding that because the 90-day requirement for filing is jurisdictional, the Court was not obliged to accepting an agreement by the parties.

Short Takes
Practitioner Guidance

A. In *Tilden v. Comm'r*, 846 F.3d 882 (7th Cir. 2017):

1. Seventh Circuit:

   a. Precedent supports the rule that the timely filing requirement is jurisdictional. But it does not follow that the Tax Court could disregard the parties' agreement that a particular petition has been timely filed.

   b. True, litigants cannot stipulate to jurisdiction, but they may agree on the <u>facts</u> that determine jurisdiction. Here the IRS agreed to the operative facts of how T's petition was mailed. The Tax Court misapplied the law on those facts, erroneously concluding that a postal tracking date was the equivalent of an official postmark. The parties' factual stipulation was controlling.

Short Takes
Practitioner Guidance

A. See also *Pearson v. Comm'r*, 149 T.C. No. 20 (2017):

1. A divided Tax Court in a reviewed decision held that the date on a Stamps.com postage label was a "postmark not made by the United States Postal Service" within the meaning of §7502(b).
   a. Therefore that postage label date was the date of filing a Tax Court petition if the taxpayer complied with Reg. §301.7502-1(c)(1) (a postmark not made by the USPS is the date of filing if the item was received not later than it would normally have arrived if it had been postmarked by the USPS).
   b. Two judges dissented, finding that the Stamps/com postage label printed by the customer and affixed to his own mail was not a "postmark" not made by the USPS.

Short Takes
Practitioner Guidance

A. In *Dees v. Comm'r*, 148 T.C. No. 1 (2017) (reviewed decision 10-7):

1. The IRS issued a notice of deficiency that, because of a clerical error, stated "Deficiency: $.00" on the front of the notice.
   a. Only in exhibits to the notice did the IRS state that it was denying the taxpayer's claim for the §36B premium tax credit under the ACA.
   b. T did figure out what the IRS intended and filed a timely Tax Court petition.
   c. The Tax Court has jurisdiction only if a valid notice of deficiency was timely sent to the taxpayer.

Short Takes
Practitioner Guidance

A. In *Dees v. Comm'r*, 148 T.C. No. 1 (2017) (reviewed decision 10-7):

1. Majority:

   a. First, Court must determined if objectively the notice informs T of the years and amounts at issue. If so, the notice is valid.

   b. If not, the Court must determine if T subjectively discerned the intent of the IRS.

   c. Here the notice failed the first inquiry, but T's own petition showed that he knew what the IRS intended.

   d. Therefore the petition is valid.

Short Takes
Practitioner Guidance

A. In *Dees v. Comm'r*, 148 T.C. No. 1 (2017) (reviewed decision 10-7):

1. Concurring opinions:

   a. The second part of the majority's test is neither necessary nor supported by case law. It will open up a can of worms.

   b. Another concurring judge stated that it was enough that the IRS determined a deficiency and sent T a notice.

2. Dissenting Judges:

   a. Although the IRS need not get the amount of deficiency perfectly correct, "$ 0" is not a deficiency. The notice was not valid.

Short Takes
Practitioner Guidance

A. In *Marinello v. U.S.*, 138 S.Ct. 1101 (2018), the Court held that a defendant can only be convicted of obstructing or impeding the due administration of the tax code under §7212(a) if there is some connection between the relevant conduct and a pending proceeding or one "then reasonably foreseeable by the defendant."

1. The omnibus clause of §7212(a) makes it a felony punishable by up to three years in prison for any person to "corruptly" obstruct or impede "the due administration of" title 26.

2. Marinello was convicted for obstructive conduct that included failing to maintain corporate records, failing to fully inform his accountant of relevant facts, and destroying business records.

Short Takes
Practitioner Guidance

A. In *Marinello v. U.S*:

1. On appeal, the Second Circuit declined to rule that "the due administration" language required both that the IRS has begun some sort of investigation or proceeding with regard to the defendant and that the defendant knew about it.

2. Marinello argued that without an "investigation element," the obstruction charge could reach any conduct that might make the IRS' job harder if the defendant intended an unlawful benefit.

3. To "rein in" the bounds of the omnibus clause, the Supreme Court settled on a nexus in time, causation, or logic between the defendant's obstructive conduct and "a particular administrative proceeding such as an investigation, an audit, or other targeted" action.

Short Takes
Practitioner Guidance

A. In *Marinello v. U.S.*:

1. The Supreme Court stated that the required administrative proceeding does not include "routine, day-to-day" or "ordinary course" work performed by the IRS, highlighting tax return review. "Just because a taxpayer knows that the IRS will review her tax return every year does not transform every violation of the Tax Code into an obstruction charge."

2. In addition, the proceeding must have been either pending or reasonably foreseeable when the defendant engaged in the obstructive conduct. It is not enough for the IRS to claim that the defendant knew it may "catch on to his unlawful scheme eventually."

3. The case resolves a split among the Circuits.

Short Takes
Practitioner Guidance

A. In *Larson v. U.S.*, 888 F.3d 578 (2d Cir. 2018):

1. John Larson allegedly failed to register tax shelters and the IRS assessed a penalty of about $61 million under §6707. Pre-payment administrative relief was denied by the IRS.

   a. Larson paid about $1.4 million of the penalty and filed a refund claim. The IRS rejected it and Larson filed a refund suit. The District Court dismissed his complaint for lack of jurisdiction and failure to state a claim, finding that the "full payment" rule for refund claims applies to §6707 penalties.

   b. The Second Circuit affirmed, holding that the full-payment rule applied, and that Larson's due process and other claims were properly dismissed by the trial court.

Short Takes
Practitioner Guidance

A. In *Larson v. U.S.*:

1. Section 1346(a)(1) gives federal district courts original jurisdiction of civil actions against the U.S. for the recovery of any internal revenue tax erroneously assessed or collected, or any penalty collected without authority. Larson's claim arose under this provision.

   a. Under this provision, a taxpayer must pay the disputed amount in full as a jurisdictional prerequisite to a tax refund action (the "full-payment" or *Flora* rule). Congress has allowed partial-payment review for some assessable penalties, but not for those under §6707. Cases do not support Larson's argument that the full-payment rule only applies in deficiency cases where review in Tax Court (without pre-payment) is an option.

Short Takes
Practitioner Guidance

A. In *Larson v. U.S.*:

1. The Court also rejected Larson's claims that requiring him to pre-pay the penalty when he was unable to:

   a. Violated his Fifth Amendment right to due process;

   b. Deprived him of his right to appeal under the Administrative Procedures Act; or

   c. Constituted an excessive fine under the Eighth Amendment.

2. Court: Although the pre-payment rule may result in economic hardship in some cases, and Larson's case is particularly "troubling" when he is unable to pre-pay, it is Congress' responsibility to amend the law to address that issue.

Short Takes
Practitioner Guidance

A. In *Adolphson v. Comm'r*, 842 F.3d 478 (7^{th} Cir. 2016):

1. Facts: The IRS failed to give proper notice of levy and of a right to a collection due process (CDP) hearing to taxpayer T, but proceeded to levy on T's property.
   a. Due to lack of notice, T was unable to timely request a CDP hearing and received no such hearing, and therefore no notice of determination was issued by an Appeals Officer either sustaining or voiding the levies issued by the IRS.
   b. To appeal to the Tax Court under the CDP rules in §6330, T must receive a notice of determination and file a Tax Court petition within 30 days. T filed a petition nonetheless and asked the Court to void the levies.

Short Takes
Practitioner Guidance

A. In *Adolphson v. Comm'r*:

1. Issue: Does the Tax Court have jurisdiction to hold the levies invalid despite the lack of a notice of determination, which is the "ticket to the Tax Court" in usual CDP cases?
2. Prior line of cases starting with *Buffano v. Comm'r*, T.C. Memo. 2007-32: Tax Court said it had no jurisdiction without a notice of determination, but nonetheless invalidated levies after finding T was prevented from requesting a timely CDP hearing by the IRS' failure to mail the required final notice of intent to levy to T's last known address.
3. How can the Court do that if it has no jurisdiction?

Short Takes
Practitioner Guidance

A. In *Adolphson v. Comm'r*:

1. Seventh Circuit: It is illogical to say the Tax Court has no jurisdiction if there is no notice of determination under §6330, but at the same time allow the Court to rule that levies are void.
2. But the *Buffano* approach has an equitable appeal: The IRS should not be able to avoid Tax Court review of its collection actions by violating the rules and depriving a taxpayer of the right to a CDP hearing and a notice of determination.
3. Too bad. That is the system Congress devised.

Short Takes
Practitioner Guidance

A. In *Adolphson v. Comm'r*:

1. Seventh Circuit conclusion: T's remedy in such a case is to file a refund suit in U.S. district court.
2. "Troubling though this 'remedy' may be, given the expense and potential delays inherent in such a suit, there is no lawful basis for expanding the tax court's jurisdiction to resolve the perceived problem."
3. "Absent a notice of determination the tax court simply has no lawful authority to hear a taxpayer's claim under §6330(d)."

Recent Procedural Guidance

A. On March 23, 2016, the IRS issued Rev. Proc. 2016-22 to update Rev. Proc. 87-24 and clarify and describe the practices for the administrative appeals process in cases docketed in the Tax Court.

1. Generally, Chief Counsel will refer docketed cases to Appeals for settlement unless:
    a. Appeals issued the notice of deficiency or made the determination that is the basis of the case being in Tax Court; or
    b. The taxpayer notifies counsel that the taxpayer wishes to forego settlement consideration by Appeals.

Recent Procedural Guidance

A. Rev. Proc. 2016-22:

1. Docketed cases will not be referred to Appeals if:
    a. The issue in the case is one that has been designated for litigation by the Office of Chief Counsel; or
    b. A referral is not in the "interest of sound tax administration" (for example, if the case involves issues common to other litigated cases and it is important that the IRS maintain a consistent position).
2. The procedure provides rules for the timing of referrals and the return of cases to Counsel. Appeals has the sole authority to resolve a case through settlement until the case is returned to Counsel.

Short Takes
Practitioner Guidance

A. In *Grimm v. Comm'r*, T.C. Memo. 2017-44:

1. Taxpayer T had 30 days after a CDP hearing determination to appeal to the Tax Court.
    a. T used a private postage meter in mailing his petition to the Tax Court in Washington, D.C., from his business in New Carlisle, Ohio. The private postmark date was February 2, 2016, and the petition was received by the Tax Court 24 days later on February 26, 2016, which was 46 days after the date of the IRS determination letter.
    b. The parties agreed that the ordinary delivery time for mail between the two locations was 3-4 days. T did not present any evidence on why the item was delayed in the mail.

Short Takes
Practitioner Guidance

A. In *Grimm v. Comm'r*, T.C. Memo. 2017-44:

2. T relied on the timely mailed/timely filed rule, asserting that the postmark from the private postage meter was within 30 days from the date of the determination letter. *See* §7502.
    a. A document with a U.S. Postal Service postmark generally is considered filed on the date of the postmark, but special rules apply if the postmark on the envelope is made other than by the U.S. Postal Service (Reg. §301.7502-1(c)(1)(iii)).
    b. In such case, for the normal postmark rule to apply, the document must be received by the IRS no later than the time when a properly mailed item "would ordinarily be received if it were postmarked at the same point of origin by the U.S. Postal Service" on the last date for timely filing.

Short Takes
Practitioner Guidance

A. In *Grimm v. Comm'r*, T.C. Memo. 2017-44:

3. Reg. §301.7502-1(c)(1)(iii); if the document is received after the time when an item would ordinarily be received, the postmark rule does not apply unless the taxpayer establishes:
   a. That the document was actually deposited in the U.S. mail by the due date;
   b. That the delay in receipt was due to a delay in the transmission of the mail; and
   c. The cause of the delay.

Short Takes
Practitioner Guidance

A. In *Grimm v. Comm'r*, T.C. Memo. 2017-44:

4. T could not remember the exact circumstances of mailing his petition, but testified:
   a. He regularly uses a private postage meter in his business of running a small newspaper, and his usual business practice is to place items in a designated tray immediately after applying postage with his meter; and
   b. The mail carrier then picks up the mail from the tray the same day or perhaps the next day.
5. Court: Not good enough. The petition arrived well after a timely mailed petition would be expected to arrive and T did not meet his burden of proving why it was delayed. T loses.

Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*, 2017 U.S. Tax Ct. LEXIS 43:

1. Held: T was limited to the 2-year look-back (LB) period in §6511(a) and (b)(2)(B) instead of the 3-year LB period specified in the last sentence of §6512(b)(3) because her deficiency notice was not mailed to her "during the third year after the due date (with extensions) for filing the return of tax."

    a. By April 15, 2013, T had made $112,000 in tax payments toward her 2012 tax liability and secured a 6-month filing extension.

    b. T did not file a return by October 15, 2013, or thereafter, and the IRS issued a deficiency notice on June 19, 2015, prior to T filing any return for 2012.

Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*:

2. T then filed her 2012 return on August 29, 2015, reporting an overpayment of $32,441, which was not disputed by the IRS.

    a. IRS: T may not get a refund because her 2012 tax payments were made outside an applicable 2-year LB period keyed to the 6/19/2015 date on which the deficiency notice was mailed.

    b. T: I am entitled to the 3-year look-back period specified in the last sentence of §6512(b)(3).

    c. Section 6511: Timely refund claim is later of 3 years from time return is filed or 2 years after payment of tax. If 3-year rule applies, LB period is 3 years plus any extended period to file. If 2-year rule applies, LB period is 2 years.

Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*:

3. Section 6512(b) grants the Tax Court Jurisdiction to award a litigant a refund if it determines an overpayment of tax.
   a. Section 6512(b)(3)(B): Tax Court may award a refund for taxes paid within the LB period applicable under §6511(b)(2) as if, on the date of the deficiency notice, a refund claim had been filed (hypothetical claim).
   b. Section 6511(b)(2): LB period is 3 years from the time the return was filed, plus any extended period to file; but only 2 years if no return filed.
   c. Here, no return was filed as of the date of the hypothetical refund claim on the date of the notice of deficiency.

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Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*:

4. Problem: Here the hypothetical refund claim was filed on June 19, 2015, but the return was not filed until August 29, 2015.
   a. Because the hypothetical refund claim was filed <u>before</u> the tax return, it was not filed within 3 years from the time the return was filed. The 3-year LB period did not apply.
   b. If the 3-year LB period does not apply, under §6511(b)(2)(B) the LB period is 2 years.
   c. Because the hypothetical claim was deemed filed on June 19, 2015, the 2-year LB only allowed recovery of taxes paid on or after June 19, 2013, and T had paid all her 2012 taxes as of April 15, 2013.

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Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*:

5. In 1997, Congress amended §6512(b)(3) after the Supreme Court held, in the case of a non-filer, that a 2-year LB period applied. The amendment provided a 3-year LB period in certain circumstances involving non-filers:

   a. In a case where a hypothetical refund claim is deemed filed on the date of the deficiency notice, and "<u>where the date of the mailing of the notice of deficiency is during the third year after the due date (with extensions) for filing the return of tax and no return was filed before such date," the LB period shall be 3 years</u>.

   b. That amendment is in the last sentence to §6512(b)(3).

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Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm'r*:

6. IRS: T cannot rely on the amendment and claim a 3-year look-back. Under the "plain language" rule, the parenthetical phrase "with extensions" modifies "due date."

   a. Here the extended due date was 10/15/2013, and the "third year" after due date began on 10/15/2015. Deficiency notice was mailed on 6/19/2015, not during the third year after the due date.

   b. T: This leaves a 6-month hole in Tax Court jurisdiction to give refunds. Whenever the deficiency notice is mailed during the second half of the second year after the extended due date (as was the case here) T only gets a 2-year LB period. When the notice is mailed in the third year following the extended due date, T gets a 3-year LB period. That is crazy.

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Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm’r*:

7. T: The parenthetical “(with extensions)” does not modify “due date,” the immediately preceding noun, but rather modifies the phrase “the third year.”
   a. Then the third year would be determined by reference to the original due date and be prolonged to include a six-month extension. Then T would get her refund.
   b. T also claimed that “with extensions” should modify “3 years” and afford a look-back period of 3.5 years.
8. Court: Neither of T’s constructions are plausible, and are contrary to normal English syntax.

Short Takes
Look-back Period on Refund Claims

A. In *Borenstein v. Comm’r*:

9. Court:
   a. When the plain language of a statute is not ambiguous, the Court must follow the statute.
   b. Legislative history, contrary to T’s argument, does not establish a Congressional intent that all non-filers be treated identically during the 3-year period following the initial due dates of their returns.
   c. T’s reliance on an “anti-absurdity” canon is misplaced given the plain language of the statute and the fact that Congress is aware of how to apply extensions to an original return date. Congress, not courts, must fix a statute if it needs change on policy grounds.

Late Returns and Bankruptcy Discharge

A. The Bankruptcy Code excepts from discharge any debt for a tax with respect to a return that is required but not filed. In addition, discharge is not available for a return that is filed late and within two years of the time the bankruptcy petition is filed.

1. Prior to 2005 the word "return" was not defined, and courts relied upon the definition of a "return" under case law. Courts were split on whether a late return filed before assessment of tax by the IRS constituted a valid return for bankruptcy purposes.

2. In 2005 Congress added a "hanging paragraph" to 11 U.S.C. §523(a): the term "return" means a return that satisfies the requirements of non-bankruptcy law, "including applicable filing requirements."

Late Returns and Bankruptcy Discharge

A. Three recent appellate decisions, including *In re Mallo*, 774 F.3d 1313 (10^{th} Cir. 2014), all hold that meeting the "applicable filing requirements" language requires a timely filed return.

1. <u>In short: If a return is even one day late, taxes due under that return may not be discharged</u>.

2. Other lower courts have rejected that interpretation, finding that a document may be a "return" under prior case law even if it is filed late, but prior to assessment of tax.

3. Critics: Congress never meant to enact a "one-day-late rule" and render the two-year late filing rule superfluous.

Late Returns and Bankruptcy Discharge

A. In *U.S. v. Martin*, 542 B.R. 479 (9^{th} Cir. BAP 2015):

1. Bankruptcy Appellate Panel of the Ninth Circuit disagreed with the three Circuit Courts of Appeal that applied a one-day-late rule.
    a. The Court rejected a "literal" construction of the hanging paragraph, and concluded that under a "contextual" reading of the provision, a modified *Beard* test previously adopted in the Ninth circuit should apply
    b. The Court did not believe that Congress intended to make such a "substantial and exceptionally harsh change" to nondischargeability by adding the hanging paragraph.

Late Returns and Bankruptcy Discharge

A. In *U.S. v. Martin*, 542 B.R. 479 (9^{th} Cir. BAP 2015):

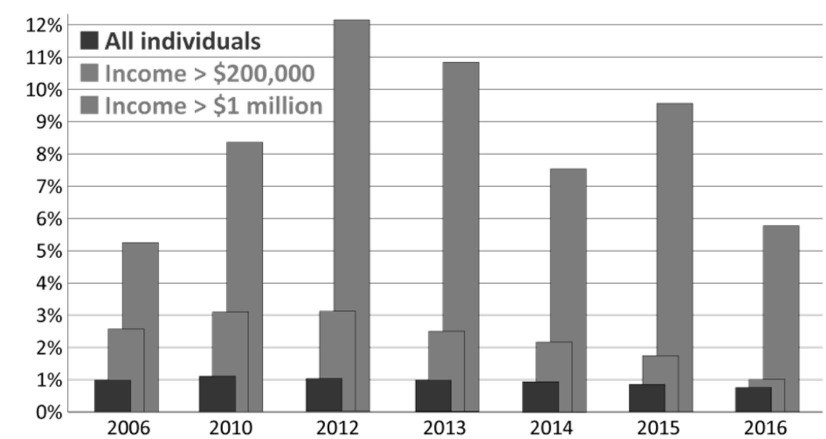
1. The Ninth Circuit also found an internal inconsistency in the hanging paragraph. If the "one-day-late" interpretation was correct, there was no need for the paragraph to provide a rule for returns under §6020.
2. In addition, the construction by the other Circuits renders meaningless the two-year rule for late returns provided in §523(a)(1) of the Bankruptcy Code.
3. Now that there is a Circuit split, will the Supreme Court agree to hear the issue?

2016 Fiscal Year Audit Rates

A. Highlights: Overall audit rate will fall to a 15-year low.

1. Overall audit rate for individuals dropped again, from 0.83% in 2015 to 0.7% in 2016, and is expected to fall to 0.6% in fiscal 2017. For all individuals, the field audit rate was 0.16%. For individuals with income of $200,000 or more it was 0.60%, and for those with income of $1 million or more it was 2.4%.
2. In 2016 audit rates for taxpayers with AGI of more than $1 million decreased by about 46% compared to 2015.
3. The number of revenue agents dropped to 10,244 in 2016 from 13,888 in 2010 (down 26%), largely due to budget cuts since 2010.
4. Audit rates for S corporations dropped slightly from 0.4% to 0.3%. The partnership audit rates dropped from 0.5% to 0.4%.

Audit Rates for Individuals



Source: IRS Data Book

Audit Coverage by AGI
Individual Returns in 2016

AGI Category	% of Returns Filed	% Audit Coverage
No AGI Shown	1.70%	3.25%
$1 to $25,000	37.45%	0.80%
$25,000 to $50,000	23.21%	0.49%
$50,000 to $75,000	13.20%	0.41%
$75,000 to $100,000	8.52%	0.52%
$100,000 to $200,000	11.72%	0.62%
$200,000 to $500,000	3.38%	1.01%
$500,000 to $1,000,000	0.54%	2.06%
$1,000,000 to $5,000,000	0.25%	4.60%
$5,000,000 to $10,000,000	0.01%	10.46%
$10,000,000 or more	0.01%	18.79%

Source: IRS Data Book

Audit Rates
S Corporations and Partnerships

	1997	2010	2015	2016
S Corps				
# of Exams	23,898	16,327	18,595	15,869
# of Returns	2,290,900	4,414,661	4,605,3766	4,688,683
Coverage	1.04%	0.37%	0.40%	0.30%
Partnerships				
# of Exams	9,811	12,406	19,212	14,645
# of Returns	1,653,100	3,423,583	3,766,567	3,862,691
Coverage	0.59%	0.36%	0.50%	0.40%

Source: IRS Data Book

Audit Rates
Corporations

Asset Size	1996	2009	2012	2015	2016
$10-50M	19.90%	10.00%	10.50%	5.80%	4.70%
$50-100M	21.30%	14.30%	20.70%	11.30%	10.30%
$100-250M	27.60%	13.60%	23.20%	14.20%	11.10%
> $250M	49.60%	25.70%	29.40%	22.20%	19.30%
All corps with assets greater than $10M	25.30%	14.60%	17.80%	11.10%	9.50%

Source: IRS Data Book

IRS Collection Activity
Number of Levies, Liens and Seizures

Activity	1996	2008	2010	2015	2016
Levies	3,108,926	2,631,038	3,616,818	1,464,026	869,196
Liens	750,225	768,168	1,096,376	515,247	470,602
Seizures	10,449	610	605	426	436

Source: IRS Data Book

TRANSFER TAXES

Inflation Adjusted Amounts

ITEM	2017	2018
Estate Tax Exclusion	$5,490,000	$11,180,000
Gift Tax Exclusion	$5,490,000	$11,180,000
GST Tax Exclusion	$5,490,000	$11,180,000
Highest Tax Rate	40% (at $1 million)	40% (at $1 million)
Gift Tax Annual Exclusion	$14,000	$15,000
§2032A Max. Reduction	$1,120,000	$1,140,000
§6166 “2% portion” Interest	$1,490,000	$1,520,000
Annual Exclusion; Foreign Spouses	$149,000	$152,000

Reduction in Estate Taxes
2002-2018

Taxable Estate:	**$5,000,000**	**$20,000,000**	**$100,000,000**
2002 Estate Tax (exclusion amount $1,000,000 and max rate of 50%)	$1,930,000	$9,430,000	$49,430,000
2009 Estate Tax (exclusion amount $3,500,000 and max rate of 45%)	$675,000	$7,425,000	$43,425,000
2018 Estate Tax (exclusion amount $11,180,000 and max rate of 40%)	$ 0	$3,528,000	$35,528,000
% Saved from 2002	**100%**	**62.6%**	**28.1%**

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IRS Data on 2016 Estate Tax Returns

A. Estates filed 5,219 taxable estate tax returns in 2016, up 6.1% from the 4,918 taxable returns filed in 2015.

1. The estate tax garnered about $18.3 billion in 2016, up 7.2% form the $17.1 billion received in net estate taxes in 2015.

   a. Most taxable returns were from estates valued between $5 million and $10 million, while those in the $10 million to $20,000 range were the second most common taxable returns.

   b. For estates valued at $50 million or more, 300 returns were subject to tax in 2016 in the total amount of about $7.6 billion (up from 266 such returns paying $7.4 billion in 2015).

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Proposed Regulations Under §2704 Withdrawn Under Executive Order Procedures

A. Proposed regulations (REG-163113-02) were issued on August 4, 2016, to eliminate the use of certain lapsing rights or restrictions that some taxpayers have used to allegedly understate the fair market value of assets for transfer tax purposes.

1. Section 2704(a) provides that the lapse of an individual's voting or liquidation rights in a corporation or partnership shall be treated as a transfer if that individual and members of his family control the entity both before and after the lapse.
    a. The amount of the deemed transfer is equal to the difference in value of the individual's interest in the entity before and after the lapse.

Proposed Regulations Under §2704

A. Proposed regulations (REG-163113-02) issued 8/4/2016:

1. Section 2704(b) provides that any "applicable restriction" shall be disregarded in determining the value of a transferred interest in a corporation or partnership if:
    a. There is a transfer of an interest in the entity to a member of the transferor's family; and
    b. The transferor and members of his or her family hold, immediately before the transfer, control of the entity.
2. An "applicable restriction" includes one that limits the ability of the entity to liquidate, or that lapses or can be removed after the transfer in question by the transferor or a family member.

Proposed Regulations Under §2704

A. Proposed regulations (REG-163113-02) issued 8/4/2016:

1. An "applicable restriction," however, shall not include any restriction imposed, or required to be imposed, by any federal or state law.
2. Estate planners have avoided §2704(a) by using certain *intervivos* transfers, including death-bed transfers. They also have used the state law exception to avoid §2704(b), and have successfully lobbied state legislatures over the years to expand that exception.
3. The regulations generally eliminated such "loopholes" and overruled cases permitting them.

Treasury Acts on the §2704 Regulations

A. As noted above, in Notice 2017-38 Treasury implemented a President Trump executive order by identifying recent tax regulations that it believed were overly complex and burdensome on taxpayers.

1. Treasury identified the §2704 regulations and concluded they should be withdrawn because they "through a web of dense rules and definitions, would have narrowed longstanding exceptions and dramatically expanded the class of restrictions that are disregarded." New requirements were "unclear," their effect on traditional valuation discounts "was uncertain," and they were "unworkable." Policy gains also were uncertain.

Simplified Method to Obtain Extension Portability Election

A. The American Taxpayer Relief Act of 2012 made the ability to elect "portability" of a deceased spousal unused exclusion amount ("DSUE amount") permanent.

1. Generally, if an estate is required to file an estate tax return, portability may be elected only by filing a timely return and no extensions are allowed.

2. If, however, a return is not required but an estate wishes to file a return so as to elect portability, relief to obtain an extension to file the election is permitted under Reg. §301.9100-3 if the taxpayer acted reasonably and in good faith.

Simplified Method to Obtain Extension Portability Election

A. The American Taxpayer Relief Act of 2012 made the ability to elect "portability" of a deceased spousal unused exclusion amount ("DSUE amount") permanent.

1. The IRS issued Rev. Proc. 2014-18 to provide a simplified method to obtain an extension of time to file a portability election, but that method expired on 12/31/2014.

2. After that, the IRS got many PLR requests for an extension of time to file the election.

3. IRS: there is a continuing need for estates with no filing requirement to obtain an extension of time to elect portability under a simplified method with no user fee.

Simplified Method to Obtain Extension Portability Election

A. Rev. Proc. 2017-34:

1. When an estate is not required to file an estate tax return, the due date to file a return to elect portability is 9 months after the date of death or the last day of any period covered by an extension of time to file.
2. An estate required to file an estate tax return may not obtain an extension of time to file a portability election.
3. <u>The new simplified method is available to estates of decedents having no filing requirement for a period the last day of which is the later of (a) January 2, 2018; or (b) the second anniversary of the decedent's date of death</u>.

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Simplified Method to Obtain Extension Portability Election

A. Scope of Rev. Proc. 2017-34: The simplified method is available to the executor of the estate if:

1. The decedent was survived by a spouse and died after 12/31/2010, and was a citizen or resident of the U.S. on the date of death;
2. The executor is not required to file an estate tax return;
3. The executor did not file an estate tax return within the normal time required for such filing; and
4. The executor satisfies all the requirement of the new procedure.

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Simplified Method to Obtain Extension Portability Election

A. Requirements of Rev. Proc. 2017-34:

1. The executor must file a complete and properly prepared Form 706 on or before the later of January 2, 2018, or the second anniversary of the decedent's date of death.
2. State at the top of the Form 706: "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER §2010(c)(5)(a)."
3. If eligibility and requirements are met, the Form 706 will be considered to have been timely filed.
4. Relief is null and void if it turns out the estate was required to file an estate tax return.

Simplified Method to Obtain Extension Portability Election

A. Rev. Proc. 2017-34: Special rule:

1. The extension of time to elect portability under the simplified method does not extend the period during which the surviving spouse or his or her estate may make a claim for credit or refund under §6511(a).
2. Example: Wife W dies on 1/1/2014 survived by husband H. W's estate consisted of $2 million in cash and she made no lifetime gifts. W's executor is not required to file an estate tax return and does not do so.
   a. H dies on 1/30/2014 with a taxable estate of $8 million. H's estate files a return claiming an exclusion amount of $5,340,000 (the amount for a 2014 decedent) and pays estate tax.

Simplified Method to Obtain Extension Portability Election

A. Example (continued):

1. W's executor then uses the simplified method and files a Form 706 on 12/1/2017 meeting all requirements and reporting a DSUE amount of $5,340,000. The return is accepted.
   a. To recover the estate tax paid by H's estate, its executors must file a refund claim by 10/30/2017 (three years after H's estate tax return was filed, as required under §6511), even though a Form 706 to elect portability had not been filed by W's estate by that time.
   b. The refund claim by H's estate will be considered a protective claim that can be processed once W's estate is deemed to have made a timely portability election and H's estate notifies the IRS that the refund claim is ready for consideration.

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Simplified Method to Obtain Extension Portability Election

A. Other rules:

1. The effective date of the new procedure is June 9, 2017.
2. Through the later of January 2, 2018, or the second anniversary of a decedent's date of death, the exclusive procedure for obtaining an extension of time to make a portability election for eligible estates is the new simplified method. No PLRs.
3. If there is a pending request for a PLR to make a late election as of the effective date, the IRS will close its file and refund the user fee, and the estate may obtain relief under the new procedure with no user fee.

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Portability and Void QTIP Elections

A. Rev. Proc. 2016-49:

1. A QTIP election allows the estate of a deceased spouse to claim a marital deduction for property placed in a trust that provides that all income shall be paid for life to a surviving spouse.
    a. Price of the election: The surviving spouse must include the value of the property in the trust in his or her estate.
    b. Problem: An executor makes an unnecessary QTIP election (one not needed to reduce the estate tax to zero). Surviving spouse then had to unnecessarily include the property in the QTIP trust in his or her estate.
    c. Solution: Rev. Proc. 2001-38 provided a procedure to disregard and nullify an unnecessary QTIP election.

Portability and Void QTIP Elections

A. Rev. Proc. 2016-49:

1. With portability a new problem: A QTIP election may be desirable even if not needed because it would increase the deceased spousal unused exclusion (DSUE) amount.
    a. A surviving spouse may use (and exhaust) the QTIP trust assets for retirement needs so that there is nothing in his or her estate, and then have a higher DSUE amount to cover other assets.
2. Rev. Proc. 2016-49 continues to provide rules to disregard and nullify an unnecessary QTIP election, but those rules expressly do not apply if the executor of the estate made a portability election. Therefore consider the QTIP implications: If you make a portability election, you cannot later nullify an unnecessary QTIP election.

Guidance to Same-Sex Spouses
Exclusion Amount and GSTT Exemption

A. Notice 2017-15:

1. Taxpayers will be permitted to establish a transfer's qualification for the marital deduction and to recover the applicable exclusion amount previously applied on a return because of such transfers.

2. Taxpayers may take such action even if the limitations period applicable to a return for the assessment of tax or for claiming a credit or refund under §§6501 or 6511 has expired.

3. Taxpayers must recalculate the remaining applicable exclusion amount on a Form 709 or 706 (or amended Form), attaching a statement supporting a claim for the marital deduction and detailing the recalculation of the remaining applicable exclusion amount. Similar rules apply with respect to the GSST exemption.

THE END

Thank you for attending,
and please come back next year!

What You Need to Do to Prepare for the New Partnership Audit Rules

Richard B. Robinson
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Denver, CO

WHAT YOU NEED TO DO TO PREPARE FOR THE NEW CENTRALIZED PARTNERSHIP AUDIT RULES

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PART I

OVERVIEW

SUMMARY OPERATING RULES

- New Partnership Audit Rules Effective Tax Years Beginning after December 31, 2017 for any "Partnership-Related Item" Consisting of Computational Rules and Administrative Rules
- Default Rule: Partnership Level Audit and Payment of Income Tax Deficiency (the "Imputed Underpayment")
- Imputed Underpayment Calculated by Multiplying Net Positive Adjustments by Highest Corporate or Individual Income Tax Rate
- Elections-Out, Modifications, Pull-In Elections and Push-Out Elections
- Partnership Representative has Exclusive Contact with IRS and Control of Audit and Judicial Proceedings
- Administrative Adjustment Requests Replace Amended Returns

PARTNERSHIP LEVEL DETERMINATION
REVIEWED YEAR/ADJUSTMENT YEAR

Reviewed Year

- 2018 Audit Commenced in 2020.
- Sally Partnership Representative for 2018 and Tim for 2020.

50% A
50% B

Adjustment Year

- $1 mm Imputed Underpayment for 2018 Agreed and Paid in 2022.
- Sara Partnership Representative for 2022, Tim for 2020 and Sally for 2018.

20% A
40% C
40% D Corp.

SUMMARY AMENDMENTS NEEDED

- Provisions Governing Selection, Resignation, Removal, Responsibilities, Authority, Indemnification, Standard of Care, Liability, etc. of Partnership Representative
- Provisions Governing Elections Out, Imputed Underpayment Modifications, Push-Out Elections and Pull-in Elections
- Provisions Governing Audit Notices, Decision Making Procedures, Audit Related Elections and Tax Payments
- Provisions Addressing Allocations of Notational Items and Imputed Underpayments, Basis and Capital Accounts
- Provisions Governing Duties of Partners and Partnership to Partnership Representative and Duties of Partners to the Partnership
- Prepare for More Audits, More Taxes Paid and More Litigation

POST-2017 AUDIT PROCEDURES

- Commencement of Audit
- Notice of Proposed Partnership Adjustments or "NOPPA" (Examination Report)
- Modifications to Imputed Underpayment and Pull In Elections
- Notice of Final Partnership Adjustment or "FPA" (Deficiency Notice)
  - Partnership Pays Imputed Underpayment
  - Partnership Contests Imputed Underpayment in Court
  - Push-Out Election Results in Partners Paying Deficiency

PART II

OPERATING RULES

ELECTION-OUT

- Separate Election for Each Year on Tax Return
- Partner Level Determination and Partner Payments
- Not More Than 100 Partners All of Whom are Eligible Partners For The Entire Year
- Eligible Partners: Individuals, Corporations, Certain Foreign Entities, S Corporations (Shareholders Counted Separately for 100 Partners but not Ineligible Partners), Estate of Deceased Taxpayers
- Ineligible Partners: Partnerships, Trusts, Disregarded Entity, Other Types of Estates
- Partnership Representative Still Required

ELECTION OUT NO PARTNERSHIP LEVEL DETERMINATION

Reviewed Year

- Election Out
- 2018 Audit Commenced in 2020.
- Partner Level Audit and Tax Payments.
- Sally Partnership Representative for 2018

50% A

50% B

Adjustment Year

- No Partnership Level Audit or Tax Payments

20% A

40% C

40% D Corp.

PARTNERSHIP REPRESENTATIVE

Tax Audits

Tax Litigation and Settlements

Partnership Representative
Separate Designation for Each Year

Tax Audit Notices/ Communications

Tax Audit Elections

PARTNERSHIP REPRESENTATIVE

- New Designation Required for Each Partnership Tax Year
- Designation Made on Timely Filed Tax Return
- Designation Continues for Tax Year Selected Until Revocation, Resignation, Death or Incapacity
- Partnership May Have Different Partnership Representative for Reviewed Year and for Adjustment Year

PARTNERSHIP REPRESENTATIVE

- Can Be Individual or Entity
- No Requirement to be Partner
- If Entity a Natural Person Must be Appointed to Act for the Entity
- Substantial Presence in U.S., Address, Phone Number, TIN and Available to Meet IRS
- Capacity to Act
- General Partner or LLC Manager Most Likely Candidate

PARTNERSHIP REPRESENTATIVE

- Resigning/Revoked Partnership Representative Can Designate a Successor
- Partnership Designates Successor if No Valid Designation
- IRS Designates a Successor if No Valid Designation
- No Valid Resignation/Revocation Prior to Commencement of Audit or Filing AAR
- No filing AAR Solely to Resign/Revoke

IMPUTED UNDERPAYMENT

- Partnership Level Determination for All Partnership-Related Items
- Partnership Level Determination of Tax Deficiency from Audit Adjustments for Reviewed Year for Any Partnership-Related Item (Any Item or Amount With Respect to the Partnership that is Relevant in Determining the Income Tax Liability of Any Person)
- Total Net Positive Adjustments (Netting each of the 702(a)(1) – (8) Categories) Multiplied by Highest §1 or §11 Rate for Reviewed Year
- Imputed Underpayment is Payable in the Adjustment Year

IMPUTED UNDERPAYMENT

- An Adjustment Resulting in Imputed Underpayment Must be Taken into Account by the Partnership in the Adjustment Year
- Adjustments Reallocating Distributive Shares from one Partner to another are not netted when computing the Imputed Underpayment. Any reallocation that results in a reduction to one or more partners is taken into account on the Adjustment Year return.
- Adjustments of Different Character (Capital or Ordinary) are not Netted Together
- Not Applicable for Taxes on Self-Employment, Taxes on Net Investment Income and Withholding Tax on Foreign Individuals and Foreign Corporations
- Net Adjustments Subject to Disallowance or Limitation Under Other Provisions of Code Not Taken Into Account.

IMPUTED UNDERPAYMENT

- Adjustments are reflected through Notational Items Allocated to Adjustment Year Partners.
- Corresponding Basis, 704(c) and Capital Accounts Adjustments.
- Allocations of Notational Items are deemed to satisfy the 704(b) rules if allocated in the manner in which the corresponding actual items would have been allocated under the 704(b) regulations to the review year partners or to their successors.
- Successors are either a transferee that succeeds to the transferors capital account or the remaining partners to the extent their interests are increased as a result of the liquidation of a partner’s interest.

PARTNERSHIP LEVEL DETERMINATION REVIEWED YEAR/ADJUSTMENT YEAR

Reviewed Year

2018 Audit commenced 2020
Sally Partnership Representative for 2018

50% A
50% B

Adjustment Year

$1 mm Imputed Underpayment for 2018 Agreed and Paid in 2022
Sara Partnership Representative for 2022 but not for 2018

20% A
40% C
40% D Corp.

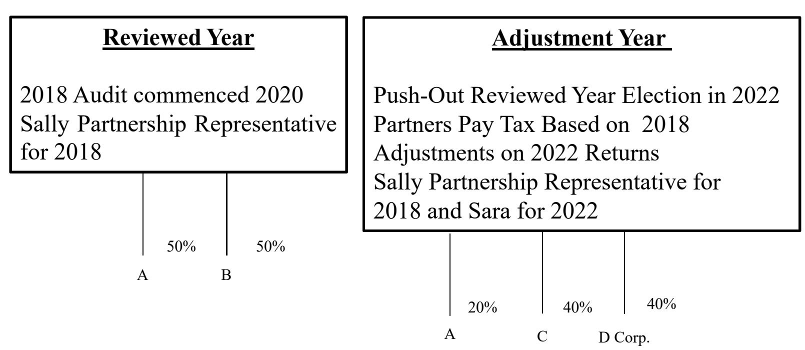
MODIFICATIONS OF IMPUTED UNDERPAYMENT

- Partnership Representative Requests Modifications from IRS after NOPPA and Provides Substantiation
- Amended Return Modification
- Tax-Exempt Partner Modification
- Tax Rate Modification
- For Reallocation Adjustments Amended Return Modifications or Pull-In Procedure Require All Affected Partners file Amended Returns or follow Pull-In Procedure.

PUSH-OUT ELECTION

- Push-Out Election Filed Within 45 Days of FPA
- Push-Out Election Statements sent to IRS and Partners within 60 Days after later of (1) Expiration of Time to File for Court Review; or (2) Court Decision is Final
- Push-Out Election Requires Reviewed Year Partners to Report Adjustments Resulting in Imported Underpayment and Pay Tax for the Reporting Year Tax Return (Calendar Year in which Push-Out Election Statement is Sent) and All Affected Years.
- Reviewed Year Partners Pay Additional Reporting Year(s) Amount. If Partner is a Pass Through Entity, It Can Push Out to Its Partners or Pay the Tax Due Itself
- Interest on Tax from Push-Out Election is 2 Percentages Points Higher than Underpayment Rate
- TCA 2017 Expressly Permits Negative Adjustments To Be Taken Into Account in a Push-Out Election

PUSH-OUT ELECTION



PULL-IN PROCEDURES

- New Procedure for Reducing Imputed Underpayment Without Filing Amended Return
- Partner Provides Information on Forms Provided by IRS to Establish Adjustment to Tax Attributes, Amount of Tax for Reviewed Year and Each Intervening Year and Payment of the Tax
- Pull-In Procedure Available to Tiered Partners including S corporation Partners
- Amended Return Modifications and Pull-In Procedures Based on NOPA and not FPA.IRS will Provide Procedures for Pull-In Procedure
- Interest Rate for Pull-In Procedure Not Subject to 2 Percentage Point Increase

ADMINISTRATIVE ADJUSTMENT REQUESTS ("AARs")

- AAR Used to Report Corrections to Partnership Return
- AAR Used to Request Refunds
- AAR Resulting in Imputed Underpayments Must be Paid by Partnership or If Election Similar to Push-Out Election Payments Made Be Reviewed Year Partners
- Refund Adjustments Reported by Reviewed Year Partners

PARTNERSHIP CEASES TO EXIST

- Reviewed Year Adjustments Reported by Former Partners for What Would be Adjustment Year
- IRS Can Determine Partnership Ceases to Exists if Ceases to Carry on Business (§708(b)(1)(A)) or No Ability to Pay Tax

PART III

DRAFTING CONSIDERATIONS

ELECTION-OUT

- Should the election out be mandatory, discretionary or the default rule unless a majority (or supermajority) vote not be make such election on that year's returns?
- Partnership Representative should have the responsibility to determine if the partnership is eligible for the election out?
- Should the partnership agreement contain restrictions on transfers to ineligible partners?
- Should penalties apply for transfer to ineligible partners?
- Should ineligible partners be required to transfer the partnership interest to an eligible partner to permit the partnership to make an election out?

DESIGNATION, QUALIFICATION AND ACCEPTANCE

- The partnership representative (or designated individual or an entity) can be a general partner, a manager or a member manager, or any other individual such as the partnership's CPA or attorney.
- The method and criteria for selecting the partnership representative should be set forth in the partnership/operating agreement.
- The partnership representative could be identified in the partnership/operating agreement or in a separate service agreement.

DESIGNATION, QUALIFICATION AND ACCEPTANCE- Continued

- The agreement should contain a representation by or require a separate certificate from the partnership representative to that effect he/she/it meets the US presence requirements.
- The partnership representative should accept the position in writing.
- The partnership representative should agree to be bound by the terms of the partnership/operating agreement and/or the service agreement.
- The partnership and the partnership representative should negotiate provisions addressing indemnification, authority exculpation, standard of care, waiver of claims and potential conflicts.

DESIGNATION, QUALIFICATION AND ACCEPTANCE - Continued

- Conflicts Example: Ann, the partnership representative, is a partner and the imputed underpayment results from the reallocation of income from Clara to Ann. If Ann and Clara both file amended returns reporting the adjustments or there is a push-out election, Ann will pay additional tax and Clara will receive a refund. Otherwise, the partnership will pay the imputed underpayment and Clara will report the negative adjustment on her Adjustment Year Return.

TERM OF APPOINTMENT; RESIGNATION AND REVOCATION

- The agreement should address the length of the designation. Should it continue until death, incapacity, resignation or revocation. Note: a separate designation must be made annually on the partnership return for each partnership tax return for that year.

- A revocation or resignation for a tax year cannot be made prior to the commencement of an audit for that year or the filing of an AAR (AAR cannot be filed solely to effect a resignation or revocation).

- The agreement should address the anomaly of a resignation or revocation that is not effective for the partnership audit rules, but is effective under the terms of the partnership agreement or state law.

TERM OF APPOINTMENT; RESIGNATION AND REVOCATION Continued

- The agreement should contain provisions requiring a resigning or revoked partnership representative to designate the successor chosen by the partnership.

- The agreement should require the resigning or revoked partnership representative to file all necessary forms, agreements and take all actions as directed by the partnership or the success partnership representative prior to the date the resignation or revocation is effective for purposes of the new audit rules.

PARTNERSHIP REPRESENTATIVE AUTHORITY

- The new audit rules give the partnership representative for the Reviewed Year the sole and exclusive authority vis a vis the IRS (including Chief Counsel) and Justice Department to represent and to bind the partnership and the partners with respect to all matters, decisions and elections related to a federal income tax audit and/or judicial proceedings for the Reviewed Year.

- The agreement can provide the partnership representative with a general statement of authority and responsibility that might reference the new audit rules or the agreement could list specific duties, responsibilities and authority.

- The agreement should specify whether the partnership representative's exercise of authority is mandatory, discretionary and/or conditioned on the consent of someone else (such as the general partner, manager, partners or members).

PARTNERSHIP REPRESENTATIVE AUTHORITY Continued

- The proposed regulations state that the partnership representative's authority is absolute notwithstanding any provision of the agreement or state law to the contrary. As a matter of contract between the partnership representative and the partnership, the partnership agreement can impose restrictions on the partnership representative's actions that could give rise to a cause of action against the partnership representative.

- The agreement should acknowledge and affirm the partnership representative's authority to bind the partnership and the partners in connection with the audit.

PARTNERSHIP ELECTIONS

- Should all elections authorized by the new audit rules be mandatory or discretionary? These elections include: (1) the election out of the new audit rules; (2) the pull-in election; and (3) the push out election.

- Should the partnership representative be required to obtain the consent of someone else (general partner, manager, partners or members) before making these elections?

- The agreement should specify what information and notices about the audit and judicial proceedings is required to be provided to the partners.

PARTNERSHIP ELECTIONS
Continued

- The partnership representative should have the authority to require partners to provide all necessary information and individual tax information in connection with the audit.

- The partnership representative should have the authority to impose penalties or specific performance to obtain the information.

- The partnership representative should have the authority to require the partners to file amended returns without filing a push-out election in order to qualify for amended return modifications.

DUTY TO INFORM PARTNERS

- The agreement should specify the content and the frequency of the audit information provided by the partnership representative to the partnership, the general partner, the manager and/or to the partners/members.

- Should the partnership representative be required to provide copies of all notices and information received regarding the audit and resulting litigation or should periodic summaries be sufficient?

- The partnership representative should be required to provide copies of all elections and statements required by new audit rules to the partnership and the partners, including election out, pull-in election and push out elections.

- The partnership representative should be required to provide timely information regarding AARs to the partners/members.

ALLOCATION OF NOTATIONAL ITEMS CORRECTING ECONOMIC DISTORTIONS

- Partnership representative must have authority to allocate notational items to reviewed year partners or successors in the same manner the corresponding adjustment would have been allocated in the reviewed year.

- Should the partnership representative have the authority to issue capital calls to pay the imputed underpayments?

- Should the partnership representative's authority to correct economic distortion extend to reviewed year partners who are not adjustment year partners?

MODIFICATIONS

- Should the partnership representative have the authority to require reviewed year partners to amend returns to establish an amended return modification? Should the partnership representative have authority to imposed penalties on partners who fail to comply?
- Should the partnership representative have the authority to require a tax exempt partner to provide information and a certification of tax exempt status in order to establish a tax exempt partner modification? Should the partnership representative have authority to imposed penalties on partners who fail to comply?
- Should the partnership representative have authority to require corporate and individual partners to provide information and certifications to establish a tax rate modification?

STANDARD OF CARE

- Should the partnership representative's actions be judged based upon a fiduciary duty standard; a business judgement standard; a negligence, or gross negligence standard; a bad faith standard or some other standard of care?
- Will the partnership provide indemnification and costs of defense for claims made against the partnership representative by the partners, by the IRS or by third parties in connection with the performance of the required duties and if so under what circumstances?

STANDARD OF CARE
Continued

- The partnership representative should be authorized to engage and pay experts and professionals to assist with the audit; to cause the partnership to pay those costs and fees; and to rely on advice of professionals without liability for any resulting damages, costs or losses.

- Should the agreement require the partnership to purchase errors and omissions insurance to protect the partnership representative?

DUTY OF CONFIDENTIALITY

- Should a duty of confidentiality be imposed on the partnership representative and the partners?

- What exceptions to the confidentiality obligation should be set forth in the agreement?

INDEMNIFICATION, EXPENSES, FEES AND COMPENSATION

- The partnership should be obligated to indemnify the partnership representative, except for certain specified actions, such as breach of fiduciary duty, negligence, gross negligence, bad faith or willful neglect.
- The partnership should be obligated to pay for all costs, expenses and fees related to the audit and advance defense fees, costs and expenses in the event the partnership representative is sued.
- The agreement should provide for compensation to the partnership representative.

PARTNERSHIP AND PARTNERS DUTY TO PROVIDE INFORMATION AND TO TAKE SPECIFIC ACTIONS

- The partnership and the partners could release and agree not to sue the partnership representative, its officers, directors or affiliates except for specified actions such as negligence, gross negligence, bad faith or willful neglect.
- The partners should be obligated to provide information requested by the partnership representative including individual tax returns and liabilities relevant to its duties and the relevant elections.
- The partners could be required to timely file amended tax returns and to timely pay any tax due.

PARTNERSHIP AND PARTNERS DUTY TO PROVIDE INFORMATION AND TO TAKE SPECIFIC ACTIONS – Continued

- The agreement could specify that the partners will not be released from any from obligations except by the partnership representative in writing and that these obligations will continue after withdrawal or the disposition of their interests.

- The partners could be required to notify the partnership representative of any inconsistent reporting with the partnership return and of any IRS individual settlement of any partnership item.

- The agreement could require the partners to commit to satisfy their obligations under a push-out or pull-in elections including timely filing amended returns and paying any taxes due.

CAPITAL CALLS AND RESERVES

- Should the partners be subject to capital calls by the partnership representative to pay the imputed underpayment, correct economic distortions and pay costs, expenses and fees associated with the audit?

- What penalties should apply for failure to contribute?

- Should the partnership representative be permitted to establish reserves to pay the imputed underpayment, correct economic distortions and pay costs, expenses and fees associated with the audit?

MISCELLANEOUS MATTERS

Survival of Partner Duties.

- Should partner duties continue upon termination of the partnership?
- Should a partner's duties continue upon withdrawal of the partner or transfer of the partnership interest?

MISCELLANEOUS MATTERS Continued

Transfers or Sales of Partnership Interests.

- Should the transferor provide warranties and representations about prior tax years?
- Should the transferor be obligated to indemnify and hold transferee liable for imputed underpayments?
- Potential problem arises for any type of transfers including gifts, bequests, redemptions and sales.

PART IV

SAMPLE PROVISIONS

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Partnership Representative [Generic Duties and Authority]

For tax years beginning after December 31, 2017, [TBD] is hereby designated as the partnership representative.

The partnership representative shall have all of the authority, duties and responsibilities as set forth in Code §§ 6221 – 6241 and the regulations thereunder (the "Partnership Audit Rules").

DRAFTING CONSIDERATIONS SAMPLE PROVISIONS

Partnership Representative [Generic Duties and Authority]-Continued

The partnership representative must accept such appointment in writing and provide a written confirmation to the partnership that it satisfies the substantial presence requirement of Code § 6223(a) and the regulations thereunder.

A partnership representative shall serve until his, her, or its death, resignation, incapacity, bankruptcy, revocation/removal or a determination by the Internal Revenue Service that the designation is not effective.

DRAFTING CONSIDERATIONS SAMPLE PROVISIONS

Partnership Representative [Generic Duties and Authority]-Continued

The partnership representative shall [or may with the consent of [TBD]] [or may in her sole and absolute discretion] timely file such election forms, statements and other information required by the Partnership Audit Rule (a) to make the election out of the Partnership Audit Rules if the partnership is eligible for such election; and (b) to make the push-out election, for each [any] tax year of the partnership.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Partnership Representative [Specific Duties and Authority]

For tax years beginning after December 31, 2017, [TBD] is the partnership representative.

The partnership representative shall have all of the authority, duties and responsibilities as set forth in Code §§ 6221 – 6241 and the regulations thereunder (the "Partnership Audit Rules") including but not limited to elections related to an audit; matters arising from the audit; the audit proceedings, including receiving notices of the commencement of an audit and requests for information; providing information to the IRS with regards to the audit; meeting with IRS personnel to discuss and settle the audit; extending the statute of limitations for the partners and the partnership; binding the partnership and the partners to a settlement with respect to the

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Partnership Representative [Specific Duties and Authority]-Continued

audit matters; electing not to contest the notice of final partnership adjustments in court or to contest all or any portion of the matter in court and to choose the court forum; filing an election out; making decisions regarding the payment of the imputed underpayment; making a push-out election; entering into a closing agreement with the IRS; requesting multiple imputed underpayments; filing an ARR; and deciding whether to settle with IRS appeals or to settle litigation and whether to appeal an adverse court decision.

The partnership representative must accept such appointment in writing and provide a written confirmation to the partnership that it satisfies the substantial presence requirement of Code § 6223(a) and the regulations thereunder. A tax matters partner/partnership representative shall serve until his, her, or its death, resignation, incapacity, bankruptcy, revocation/removal or a determination by the Internal Revenue Service that the designation is not effective.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Partnership Representative [Specific Duties and Authority]-Continued

The partnership representative shall [or may with the consent of [TBD: general partner, manager, management committee, partners or members, whichever is applicable] or may in her sole and absolute discretion] timely file such election forms, statements and other information required by the Partnership Audit Rule (a) to make the election out of the Partnership Audit Rules if the partnership is eligible for such election; and (b) to make the push-out election, for each [any] tax year of the partnership.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Resignation.

A partnership representative may resign at any time by giving written notice to [TBD: manager, general partner, management committee, partners, or members].

The resignation of the partnership representative shall take effect upon the appointment of a successor partnership representative or at such other time agreed upon by [TBD: manager, general partner, management committee, partners, or members, whichever is applicable].

The resigning partnership representative shall follow the directions of [TBD: manager, general partner, management committee, partners, or members, whichever is applicable] in connection with the appointment of a successor partnership representative and the filing of such statements, forms and other document with the IRS as required by the Partnership Audit Rules.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Resignation – continued.

Notwithstanding the foregoing, in the event such resignation is not effective for purposes of the Partnership Audit Rules, the resigning partnership representative shall take any and all actions and sign and deliver any and all documents, instruments, elections and agreement as directed by the [TBD: manager, general partner, management committee, partners, or members, whichever is applicable] until such resignation is effective for purposes of the Partnership Audit Rules.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Revocation of Designation.

The designation of partnership representative may be revoked with or without cause by a written notice from the [TBD: manager, general partner, management committee, partners, or members, whichever is applicable].

The partnership representative whose designation has been revoked shall follow the directions of [TBD: manager, general partner, management committee, partners, or members, whichever is applicable] in connection with the appointment of a successor partnership representative and the filing of such statements, forms and other document with the IRS as required by the Partnership Audit Rules.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Revocation of Designation -continued.

Notwithstanding the foregoing, in the event such revocation is not effective for purposes of the Partnership Audit Rules and in any event prior to the effective appointment of a successor, the partnership representative whose designation has been revoked shall take any and all actions and sign and deliver any and all documents, instruments, elections and agreement as directed by the [TBD: manager, general partner, management committee, partners or members, whichever is applicable] until such revocation is effective for purposes of the Partnership Audit Rules.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Vacancies. If there is a vacancy in the position of partnership representative, a successor partnership representative shall be designated by [TBD: manager, general partner, management committee, partners, or members, whichever is applicable].

Compensation. The partnership representative may receive reasonable compensation for the services rendered [TBD].

Costs, Expenses and Professional Fees. The partnership shall reimburse the partnership representative for all costs and expenses reasonably incurred in connection with her actions under the Partnership Audit Rules.

The partnership representative is hereby authorized to engage professionals, experts and advisors in connection with its performance of its duties under the Partnership Audit Rules and incur costs, expenses, professional and other fee on behalf of the partnership.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Standard of Care; Liability for Certain Acts.

The partnership representative shall act in good faith and shall use commercially reasonable best efforts to carry out the duties, authority and responsibilities set forth in this Agreement and the Partnership Audit Rules.

Unless fraud, deceit, gross negligence, willful misconduct or a wrongful taking shall be proved by a non-appealable court order, judgment, decree or decision, the partnership representative shall not be liable or obligated to the partnership or to any of the partners for any breach of fiduciary duty, for any mistake of fact or judgment, or for the doing of any act, or the failure to do any act, which may cause or result in any loss or damage to the partnership or to its members.

The partnership representative does not, in any way, guarantee the results of any partnership audit.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Partnership Representative Has No Exclusive Duty to Company.

The partnership representative shall not be required to act in such capacity as her sole and exclusive function. The partnership representative shall devote such time to this position as is commercially reasonably to fulfill her obligations, responsibilities and duties.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Indemnification of the Partnership Representative.

The partnership representative shall be indemnified and held harmless by the partnership under the following circumstances and in the manner and to the extent indicated:

In any threatened, pending or completed action, suit or proceeding to which the partnership representative is or was a party or is threatened to be made a party by reason of the fact that she is a partnership representative involving an alleged cause of action for damages arising from the performance of her activities in such capacity;

The partnership shall indemnify and hold the partnership representative harmless against costs, liabilities, damages and expenses, including attorney's fees, judgments and amounts paid in settlement, actually and reasonably incurred by her in connection with such action, suit, or proceeding if the

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Indemnification of the Partnership Representative, continued.

partnership representative acted in good faith and in a manner she reasonably believed to be in, or not opposed to, the best interests of the partnership and the partners; and provided that her conduct has not been found by a non-appealable court judgment, order, decree, or decision to constitute gross negligence, fraud, willful or wanton misconduct.

The termination of any action, suit, or proceeding by judgment, order, or settlement shall not, of itself, create a presumption that the partnership representative did not act in good faith and in a manner which she reasonably believed to be in and not opposed to the best interests of the company.

To the extent the partnership representative has been successful on the merits or otherwise in defense of any action, suit, or proceeding, or in defense of any claim, issue, or matter therein, the company shall indemnify the partnership representative against the expenses, including attorney's fees, actually and reasonably incurred by her in connection therewith.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Indemnification of the Partnership Representative, continued.

The company shall advance such expenses to the partnership representative in advance of the conclusion of such action, suit or proceeding.

The indemnification set forth in this paragraph shall in no event cause the members to incur any liability beyond their capital contributions, plus their share of any undistributed profits of the company, nor shall it result in any liability of the members to any third party.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Correction of Economic Distortions.

The partners intend that the economic consequences of an imputed underpayment for any reviewed year shall be borne by the reviewed year partners in the same manner as if the adjustments had been correctly reported on the reviewed year partnership return.

Therefore, notwithstanding anything to the contrary herein, [TBD: general partner, manager or management committee whichever is applicable] shall make such offsetting special allocations of partnership income, gain, loss or deduction in whatever manner it determine appropriate so that, after such offsetting allocations are made, each partner's capital account balance at the end of the adjustment year is to the extent possible, equal to the capital balance such partners would have had if all partnership items in the reviewed year had been allocated to the partners in accordance with the adjustments as determined by the notice of final partnership adjustments, any settlement with the IRS, the Justice Department or the final court

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Correction of Economic Distortions - continued.

decision, whichever is applicable. In addition, the [TBD: general partner, manager or management committee whichever is applicable] shall have the authority to require reviewed year partners who have transferred their partnership interests to reimburse the partnership for the imputed underpayment.

In addition, the [TBD: general partner, manager or management committee whichever is applicable] shall have the authority to require reviewed year partners who have transferred their partnership interests to reimburse the partnership for the imputed underpayment.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Limitation on Authority of Partnership Representative.

Notwithstanding anything to the contrary herein, the partnership representative shall not make any election, settlement or take any actions to settle or to litigate any adjustments set forth in the notice of final partnership adjustment under the Partnership Audit Rules without the consent of [TBD: the general partner, the manager, a vote of the majority of the partners/members or the management committee, whichever is applicable].

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Duties Owed by the Partners to the Partnership Representative.

Each partner hereby covenants and agrees to promptly provide the partnership representative with all information regarding the partner's tax returns and tax liabilities as requested from time to time, including but not limited to proof that the partner has filed an amended return and paid any resulting tax, the partner's address, taxpayer identification number and current contact information, the partner's status as a tax-exempt partner, the tax rate applicable to the partner and the partner's status as an eligible partner.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Duties Owed by the Partners to the Partnership Representative – continued.

The partner's obligations hereunder shall continue notwithstanding the partner ceasing to be a partner whether resulting from a transfer, sale, withdrawal or other disposition of her partnership interest.

Each partner shall notify the partnership representative of any inconsistent treatment of any partnership item on the partner's return and of any settlement with the IRS regarding any partnership items.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Reliance on Advice. The partnership representative may rely on the services and advice of attorneys, accountants and other professional advisors or experts. The partnership representative shall not be liable to the partnership or to any partner for damages, losses, or costs, any loss of value or any liability arising from such reliance.

Binding Effect of Actions by Partnership Representative. The partnership and the partners hereby agree and acknowledge that (a) the actions of the partnership representative in connection with the Partnership Audit Rules shall be binding on the partnership and the partners; and (b) neither the partnership nor the partners have any right to contact the IRS or participate in an audit or proceedings under the Partnership Audit Rules.

DRAFTING CONSIDERATIONS
SAMPLE PROVISIONS

Communications to Partners. The partnership representative shall provide reports to the partners on a reasonable basis to keep them reasonably informed of the status, issues and resolution of any partnership income tax audit.

Ineligible Partners. The transfer of a partnership interest to an ineligible partner shall not be permitted except upon the written consent of [TBD: general partner, manager, management committee, partners or members whichever is applicable].

Any purported transfer shall be null and void [or trigger the buy-sell provisions in the partnership agreement].

If any partner is an ineligible partner on the date that is 90 days prior to the due date for filing the election out for any tax year, such partnership interest shall be transferred to an eligible partner prior to the due date for filing such election.

Navigating §199A: The 20% Pass-Through Deduction

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Making Sense of the Section 199A Deduction

Tony Nitti,
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July 23, 2018

The Tax Cuts & Jobs Act

- What's the point of this deduction?
  - Under pre-2018 law, the double taxation rate on owners of C corporations was 50.47%
  - Under pre-2018 law, the top rate on Schedule C/S corp/partnership income was 39.6% (really 40.8% when factoring in the PEASE limitation on itemized deductions)
  - Under 2018 law, the double taxation rate on owners of C corporation is down to 39.8% (21% corporate rate; 23.8% dividend tax)
- As a result, the advantage flow-through owners enjoyed relative to C corporations would have shrunk from 11% down to 0.2%.
- To preserve the competitive advantage, allowing a 20% deduction will reduce the effective top rate on non-corporate business income to 29.6%.
- This way, these business owners keep a 10% advantage over C corporation shareholders.

The Tax Cuts & Jobs Act

Section 199A:

- Step 1:
  - The bill provides a deduction of 20% of "qualified business income," capped at the GREATER OF:
    - 50% of the individual's allocable share of the W-2 wages deducted by the business.
    - 25% of the individual's allocable share of the W-2 wages deducted by the business PLUS the individual's share of 2.5% of the unadjusted basis of property used in business
- Plus Step 2:
  - 20% of qualified REIT dividends and qualified publicly traded partnership income.

The Tax Cuts & Jobs Act

- Limited by Step 3:
  - The total deduction determined by adding Steps 1 and 2 is then subject to an overall limitation equal to 20% of the excess of:
    - the taxable income for the year, over
    - the sum of net capital gain for the tax year.
  - By imposing this overall limitation, Section 199A ensures that the 20% deduction is not taken against income that is taxed at preferential tax rates.
  - *Example: In 2018, A, a married taxpayer, has $100,000 of qualified business income, $100,000 of long-term capital gain, and $30,000 of itemized deductions in 2018, for total taxable income of $170,000. A's tentative Section 199A deduction is $20,000 (20% * $100,000). The deduction is limited, however, to 20% of taxable income ($170,000) in excess of net capital gain ($100,000), or $70,000. Thus, A's deduction for 2018 is reduced to $14,000.*

The Tax Cuts & Jobs Act

- Who gets to take the deduction?
  - Sole proprietors reporting directly on Schedule C
  - Owners of rental property reported directly on Schedule E
  - Shareholders in an S corporation
  - Partner in a partnership
- Who can't take the deduction?
  - An employee
  - A C corporation
- What about tiered entities (i.e., a partnership that owns another partnership)
  - The deduction is allowable to all entities other than corporations (including trusts).
  - This means that for tiered entities, the deduction would first be determined at the higher-tiered partnership, and then again by the partners of the higher-tiered partnership.
  - Section 199A(f)(4)(B) provides that regulations will be issued governing tiered entities.

The Tax Cuts & Jobs Act

- What is a "qualified business?"
  - Any "trade or business" other than:
    - A specified service business, or
    - The business of being an employee.

The Tax Cuts & Jobs Act

- What is a "specified service business" that is not eligible for the deduction?
  - Section 199A references Section 1202(e)(3)(A), which states:
    - "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."
  - Then, Section 199A does the following:
    - Removes architects and engineers from the list of disqualified businesses
    - Adds the following as disqualified businesses: investing and investing management, trading, or dealing in securities, partnership interests, or commodities.

The Tax Cuts & Jobs Act

- Reminder: The prohibition on specified service businesses does NOT apply if taxable income is less than:
  - $315,000 if married,
  - $157,500 for all other taxpayers.
- The prohibition is "phased-in" over the next:
  - $100,000 of income if married,
  - $50,000 of income for all other taxpayers.

The Tax Cuts & Jobs Act

- What is "qualified business income?"
  - Ordinary business income from a sole proprietorship, rental property, S corporation or partnership
  - Does not include:
    - Interest income
    - Dividend income
    - Long-term capital gain
    - Short-term capital gain
    - Income that is not effectively connected with a U.S. trade or business

The Tax Cuts & Jobs Act

- W-2 Limitation
  - The 20% of QBI deduction is limited to the GREATER OF:
    - 50% of the taxpayer's allocable share of the W-2 wages of the business, or
    - 25% of the taxpayer's allocable share of the W-2 wages of the business, PLUS 2.5% of the taxpayer's allocable share of the unadjusted basis of qualified property of the business.
- What are "W-2 wages"
  - Wages paid to an employee, plus Section 401(k) deferrals and deferred compensation.
  - Do they include wages paid to an S corporation shareholder? More on that later.
  - Have to be wages reported on a payroll tax return.
- How do we determine a shareholder or partner's "allocable share" of W-2 wages?
    - Shareholder in S corporation: pro-rata, per-share/per-day.
    - Partner in a partnership: wages must be allocated in the same percentages as the partnership's wage deduction.

II. The Tax Cuts & Jobs Act

Individual business income

Example: A owns a 20% capital stake in a partnership, but under the terms of the agreement, A is allocated 80% of any depreciation but only 30% of Schedule K-1, Line 1 ordinary income.

Because A is allocated 30% of the partnership's wage deduction via the allocation of Line 1 income, A is stuck being allocated only 30% of the partnership's W-2 wage expense for the purposes of these limitations.

The Tax Cuts & Jobs Act

- The “2.5% of basis” limitation.
  - This was a last-minute giveaway to landlords. Without this rule, many owners of rental property would get no deduction, because rental LLCs often don’t pay W-2 wages.
- Qualified property:
  - Has to be property subject to depreciation (so no land or inventory).
  - You use the original, unadjusted basis throughout the depreciable period.
- What is the depreciable period?
  - Starts on the date the property is placed in service and goes the LONGER of:
    - 10 years, or
    - The life of the property for depreciation purposes.

The Tax Cuts & Jobs Act

Example: S Co. purchases a piece of machinery on November 18, 2014. The machinery is used in the business, and is depreciated over 5 years. Even though the depreciable life of the asset is only 5 years, the owners of S Co. will be able to take the unadjusted basis of $10,000 into consideration for purposes of this second limitation for ten full years, from 2014-2023, because the qualifying period runs for the LONGER of the useful life (5 years) OR 10 years.

Consider the same facts, only the asset is a non-residential rental building that is depreciated over 39 years. The shareholders of S Co. will be able to take their share of the building's basis into consideration from 2014-2052, the last full year of the asset's depreciation schedule.

The Tax Cuts & Jobs Act

- The basis is NOT reduced by depreciation.
- Any asset that is fully depreciated by the end of 2018, that was placed in service BEFORE 2008, will not count towards basis.
- How does a partner in a partnership determine their allocable share?
  - A partner's share of the asset basis is determined in the same manner as their share of the depreciation deductions of the partnership.

Example: A owns 20% of the capital of a partnership, is allocated 80% of depreciation, and only 30% of Schedule K-1, Line 1, ordinary income or loss. While A would be allocated 30% of the W-2 wages paid by the partnership, he would be allocated 80% of the unadjusted basis of the property, because that is the percentage of depreciation he is allocated.

The Tax Cuts & Jobs Act

- Reminder: The W-2 based limitations do NOT apply if taxable income is less than:
  - $315,000 if married,
  - $157,500 for all other taxpayers.
- The W-2 limitations are "phased-in" over the next:
  - $100,000 of income if married,
  - $50,000 of income for all other taxpayers.

The Tax Cuts & Jobs Act
Case Study

- A and B are married.
- Taxable income is $700,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $500,000
  - A's share of S corporation W-2 wages: $180,000
  - A's share of the unadjusted basis of assets used in S corporation's business: $600,000
- The S corporation is NOT a personal service business

The Tax Cuts & Jobs Act

Case Study

- What is the amount of A's deduction?
- Because A and B's taxable income is $700,000, they are above the phase-out threshold. As a result, the two W-2-based limitations apply.
- First step: determine 20% of your QBI
  - $500,000 * 20% = $100,000
- Second step: The deduction of $100,000 is now limited to the GREATER OF:
  - 50% of your share of the W-2 wages of the business of $180,000, or **$90,000**, or
  - 25% of your share of the W-2 wages of the business ($45,000) PLUS your share of 2.5% of the unadjusted basis of the qualifying assets used in the business (2.5% * $600,000, or $15,000) = **$60,000**
- Thus, A's deduction is the lesser of:
  - $90,000, or
  - $110,000
- A is entitled to a deduction of $90,000.

The Tax Cuts & Jobs Act

Case Study

- A and B are married.
- Taxable income is $200,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $100,000
  - A's share of S corporation W-2 wages: $10,000
  - A's share of unadjusted basis of assets used in S corporation's business: $40,000
- The S corporation is NOT a personal service business.

The Tax Cuts & Jobs Act

Case Study

- What is the amount of A's deduction?
- First step: determine 20% of your QBI
  - $100,000 * 20% = $20,000
- Second step: The deduction of $20,000 is NOT limited, because taxable income is less than $315,000.
- As a result, the W-2 limitations do not apply, and A is entitled to a deduction of $20,000.

The Tax Cuts & Jobs Act

Case Study

- A and B are married.
- Taxable income is $375,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $300,000
  - A's share of S corporation W-2 wages: $40,000
- The S corporation IS NOT a personal service business

The Tax Cuts & Jobs Act

Case Study

- What is A’s deduction?
- This is where things get complicated, because A is in the phase-out range, with taxable income > $315,000 but < $415,000.
- Step 1: We start by asking the following question: what would A's deduction have been if his taxable income was less than $315,000?
  - This is simple: at that level of income, the W-2 limits wouldn't apply, and A would take a deduction of 20% of QBI of $300,000 or $60,000.

The Tax Cuts & Jobs Act

Case Study

Step 2: How does A's $60,000 deduction compare to what it WOULD have been if the W-2 limits did apply in full? If they applied, A's $60,000 deduction would have been limited to the GREATER OF:

- 50% of $40,000 or $20,000, or
- 25% of $40,000 plus 2.5% of $0, or $10,000.

So if the W-2 limitations HAD applied, A would have been entitled to a deduction of only $20,000. This means that if taxable income had been $315,000 or less, the new law would have given A a break in the form of $40,000 of additional deduction ($60,000 - $20,000).

This is known as the "excess amount" in Section 199A(b)(3)(A)(ii).

Tentative deduction:	$60,000
less: W-2 limit:	($20,000)
Excess Amount	$40,000

The Tax Cuts & Jobs Act
Case Study

Once your taxable income is above the threshold, however, you start to lose the benefit of this excess amount, bit-by-bit, over the next $100,000 of taxable income ($50,000 if you're not married filing jointly). But by how much?

Step 3: Look at it this way: A gets a TOTAL RANGE of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $40,000 "get out of jail free" card is totally eliminated. So it makes sense that the $40,000 benefit should be reduced based on how far you are into that $100,000 range. Start by determining by how much your taxable income exceeds your threshold:

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

The Tax Cuts & Jobs Act
Case Study

Next, we put it into percentage terms. Here is how much of his "get out of jail free" card of $40,000 A should no longer be entitled to:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage of benefit A should lose:	**60%**

The Tax Cuts & Jobs Act
Case Study

Step 4: A started with an "excess amount" of $40,000: a $60,000 deduction when a $20,000 W-2 limit would have otherwise applied.

Now that A has burned through 60% of that phase-in range, he should lose 60% of that $40,000 benefit, or $24,000. Thus, as a final step, we reduce A's $60,000 deduction by the amount of the "get out of jail free" card that he has lost because his income is too high:

20% of QBI deduction:	$60,000
Reduction in $40,000 benefit because income is over $315,000:	($24,000)
Final deduction	**$36,000**

A's deduction is $36,000. As opposed to $60,000 if taxable income had been $315,000 or less. The deduction would be $20,000 (50% of W-2 wages) by the time taxable income gets to $415,000.

The Tax Cuts & Jobs Act
Case Study

- A and B are married.
- Taxable income is $700,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $500,000
  - A's share of S corporation W-2 wages: $180,000
  - A's share of the unadjusted basis of assets used in S corporation's business: $600,000
- The S corporation is a personal service business
- Section 199A(d)(1)(A) provides that owners of a personal service business (accounting, health, law, etc…) are not eligible for the deduction.
- Thus, A gets no deduction.

The Tax Cuts & Jobs Act
Case Study

- A and B are married.
- Taxable income is $200,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $100,000
  - A's share of S corporation W-2 wages: $10,000
  - A's share of unadjusted basis of assets used in S corporation's business: $40,000
- The S corporation is a personal service business.
- While owners of personal service businesses generally can't claim the deduction, there is an exception where taxable income is less than $315,000 (if married, $157,500 if single).

The Tax Cuts & Jobs Act
Case Study

- What is A's deduction?
- A personal service business with income less than $157,500/$315,000 may claim the deduction.
- Also remember, if income is below those thresholds, the W-2 limitation doesn't apply.
- As a result, A is entitled to a deduction of 20% of $100,000, or $20,000.

The Tax Cuts & Jobs Act
Case Study

- A and B are married.
- Taxable income is $375,000.
- A is a 50% owner of an S corporation
  - A's share of S corporation income: $300,000
  - A's share of S corporation W-2 wages: $40,000
  - A's share of the unadjusted basis of assets used in S corporation's business: $10,000
- The S corporation IS a personal service business; A is a lawyer.

The Tax Cuts & Jobs Act
Case Study

- Step 1: We start by determining what A's deduction would have been if his taxable income had been less than $315,000. This is determined by taking the LESSER OF:
  - 20% of QBI of $300,000, or $60,000, or
- the GREATER OF:
  - 50% of W-2 wages of $40,000, or $20,000, or
  - 25% of $W-2 wages of $40,000 + 2.5% of basis of property of $0, or $10,000.
- Because taxable income is less than $315,000 in this hypothetical, not only does A get to take the deduction despite being a lawyer, in addition, the W-2 limits don't apply at that level of income. Thus, had taxable income been $315,000 or less, he would have gotten the full $60,000.
- Because taxable income is greater than $315,000, however, we must now determine how much of that $60,000 deduction A has to give up.

The Tax Cuts & Jobs Act

Case Study

Step 2: We begin by figuring out, once again, how much of his $100,000 "phase-in" threshold A has exceeded, although now it's probably more accurately described as a "phase-out" threshold. The math looks the same as before:

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of the benefit A should lose:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage:	**60%**

The Tax Cuts & Jobs Act

Case Study

Step 3: Thus, A should lose 60% of his benefit. Section 199A(d)(3)(B) accomplishes this by requiring A to compute his "applicable percentage," which is simply 100% - the percentage from Step 2:

Starting Percentage	100%
Less: percentage from Step 2:	(60%)
Applicable percentage	**40%**

A is only entitled to take into consideration, in computing his deduction, the applicable percentage of his allocable share of QBI, W-2 wages, and basis of assets. Like so:

	Allocable Share	Applicable % (40%)
QBI	$300,000	$120,000
W-2 Wages	$40,000	$16,000
Basis of Assets	$0	$0

The Tax Cuts & Jobs Act
Case Study

- Next, we determine A's deduction under the general rules using these new numbers:
- Step 4: A's deduction is equal to the LESSER OF:
  - 20% of QBI of $120,000, or $24,000,
  - or the GREATER OF:
    - 50% of W-2 wages of $16,000, or $8,000, or
    - 25% of W-2 wages of $16,000 , or $4,000, plus 2.5% of basis, or $0, for a total of $4,000.
- Thus, A's tentative deduction is $8,000.
- However, the W-2 limit doesn't apply if taxable income is less than $315,000, and is phased in as income goes from $315,000 to $415,000.
- BIG QUESTION: Do we now have to jump through those hoops as well? If so, on to Step 5, which starts by figuring out the excess amount the new law would have given A if the W-2 limit didn't apply at all:

The Tax Cuts & Jobs Act
Case Study

- Step 5: The excess amount is the excess of the deduction allowed to A in the absence of a W-2 limit over what the deduction would be if the limit applied in full force. Thus, it is $16,000 ($24,000-$8,000).
- Next, we have to reduce that excess benefit based on how much A's taxable income exceeds $315,000.
- Step 6: A gets a TOTAL RANGE of $100,000 of taxable income -- from $315,000 to $415,000 -- before his $16,000 "get out of jail free" card is totally eliminated. So it makes sense that the $16,000 benefit should be reduced based on *how far A is into that $100,000 range.*

Taxable income:	$375,000
Less: threshold:	($315,000)
Excess taxable income:	**$60,000**

The Tax Cuts & Jobs Act

Case Study

- A has gone $60,000 of the way through a $100,000 phase-in range. Putting this into percentage terms, here is how much of his excess amount of $16,000 A should no longer be entitled to:

Excess taxable income:	$60,000
Divided by: Total phase-in range	$100,000
Percentage of benefit A should lose:	**60%**

- Step 7: A started with a benefit of $16,000: a $24,000 deduction when a $8,000 W-2 limit would have otherwise applied. Now that A has burned through 60% of that phase-in range, he should lose 60% of that $16,000 benefit, or $9,600.

20% of QBI deduction:	$24,000
Reduction in $24,000 benefit because income is over $315,000:	($9,600)
Final deduction	**$14,400**

The Tax Cuts & Jobs Act

Case Study

Is there a big planning opportunity?

- ABC law firm has three partners and six associates.
- All six associates are married.
- All six associates are paid wages of $300,000.
- For all six associates, taxable income is $315,000.

The Tax Cuts & Jobs Act

Case Study

- The wages paid to the six associates are taxed at rates as high as 24% under the new law. Thus, the total income tax on the $315,000 of taxable income is $64,000.
- Payroll taxes on $300,000 of wages are $25,200, of which $12,600 are the obligation of the associate.
- Thus, total tax is $76,600.

The Tax Cuts & Jobs Act

Case Study

Instead, the law firm can encourage the six associates to form an LLC.

- The law firm then pays $1,800,000 to the LLC, which allocates the income $300,000 to each associate and distributes the cash to them.
- Because taxable income is less than $315,000 for each associate, they can take a 20% deduction against QBI of $300,000 even though a law firm is a personal service business.
- In addition, even though the new LLC pays no wages, the W-2 limitation does not apply below taxable income of $315,000.
- As a result, each associate is entitled to take a deduction of $60,000, reducing taxable income to $255,000.
- The income tax on $255,000 is $50,000, an amount that is $14,000 less than that of the tax on the wages.

The Tax Cuts & Jobs Act
Case Study

- But don't forget, each associate will now pay self-employment tax on the $300,000 of income allocated to each member. As a result, they will be on the hook for the full $25,200 of payroll taxes, an amount that is $12,600 greater than the obligation when they were an employee.
- So is it worth it? Sure, each associate will get a deduction for ½ of self-employment taxes, but they will also lose out on certain fringe benefits like health coverage.

The Tax Cuts & Jobs Act
Case Study

- A and B are married.
- Taxable income is $2,000,000.
- A is a 50% owner of an LLC
  - A's share of LLC rental income: $1,000,000
  - A's share of LLC W-2 wages: $0
  - A's share of the unadjusted basis of assets used in LLCs business: $9,000,000

The Tax Cuts & Jobs Act

Case Study

- What is A's deduction

Step 1:	take the LESSER OF: 20% of QBI of $1,000,000	$	200,000	
	and the GREATER OF:			$200,000
	50% of W-2 wages	$	-	
	25% of W-2 wages + 2.5% of unadjusted basis of $9,000,000	$	225,000	

- No deduction would have been available under the Senate bill.
- Under the final bill, a full deduction is available because of the 2.5% of basis rule.

The Tax Cuts & Jobs Act

- Problem #1: What to do About Fiscal Year Qualified Businesses?

The Tax Cuts & Jobs Act

- It appears the deduction is available for any tax year beginning after December 31, 2017, as determined by the taxpayer claiming the deduction.
- *Example: A, an individual, is a shareholder in an S corporation with a fiscal year-end of June 30. On A's 2018 Form 1040, A may claim the Section 199A deduction for the qualified business income earned by the S corporation for its tax year beginning July 1, 2017 and ended June 30, 2018.*
- Query, however, how this interacts with Section 199, which was repealed for tax years beginning *after* 12/31/2017.

The Tax Cuts & Jobs Act

- Problem #2: What is a "Trade or Business" for Section 199A Purposes?

The Tax Cuts & Jobs Act

- This "trade or business" language could prove problematic for small rental owners.
- When it says the income must be earned in a "trade or business," does it mean a Section 162 trade or business?
  - If so, rentals could face a problem. One hundred years of case law haven't answered the question as to whether a rental activity rises to the level of a Section 162 trade or business.
    - A large commercial property – particularly one that isn't a triple-net lease – should qualify.
    - But what about a single residence that requires little involvement?

The Tax Cuts & Jobs Act

- Evidence in Sec. 199A indicates that Congress intended for all rental activities to be treated as qualified trades or businesses.
- Sec. 199A(b)(1)(B) permits a noncorporate taxpayer to deduct 20% of any qualified dividends from a real estate investment trust (REIT). REITs are prohibited by statute from engaging in rental activities that require significant personal services; as a result, REITs largely generate the very type of passive income — for example, rental income earned via a triple-net lease — that if earned by a non-REIT rental activity could cause the activity to fail to rise to the level of a Sec. 162 trade or business.
- Thus, it follows that if a 20% deduction is permitted against dividends earned by a REIT, the deduction should similarly be permitted against even the most hands-off of rental activities.

The Tax Cuts & Jobs Act

- Problem #3: Is Section 1231 Gain Included in Qualified Business Income?

The Tax Cuts & Jobs Act

- In general, a Sec. 1231 asset is any depreciable asset or real property used in a trade or business for more than one year. A Sec. 1231 asset is specifically excluded from the definition of a capital asset.
- When an S corporation or partnership sells a Sec. 1231 asset, the transaction is not characterized as long-term capital gain or loss at the business level; rather, the item simply retains its character as Sec. 1231 gain or loss as it passes through to the owners.
- At the individual owner level, the taxpayer must net together all Sec. 1231 gains and losses. A net gain is treated as long-term capital gain, while a net loss is deducted as an ordinary loss.
- Because a Sec. 1231 asset is, by definition, not a capital asset but rather an asset used in a trade or business, gain from the sale of such an asset should not be treated as investment-related income. As a result, until guidance from the IRS provides otherwise, Sec. 1231 gains and losses should be included in qualified business income.

The Tax Cuts & Jobs Act

- Problem #4: What to do About PEOs or Commonly Controlled Payroll Companies?

The Tax Cuts & Jobs Act

- Problems with the W-2 wage limitation:
  - What to do about leased employees/PEOs?
    - It does not appear that a grouping regime is coming.
    - If so, why add the 2.5% of basis rule?
  - This problem could be remedied through an elective grouping regime that allows owners to aggregate their qualified trades or businesses for purposes of Sec. 199A. For example, the W-2 wages paid by a centralized management company could be combined with the qualified business income of the operating companies, enabling the owners to claim a deduction that would otherwise be unavailable.

The Tax Cuts & Jobs Act

- Sec. 199A(f)(4) requires the IRS to issue regulations "for requiring or restricting the allocation of items and wages under this section . . . as the Secretary determines appropriate."
- The IRS will not have to look far for a framework to be used in allocating W-2 wages among commonly controlled entities because a predecessor to Sec. 199A — Sec. 199 — dealt with a similar conundrum.
- Sec. 199, provided a deduction to domestic producers. That deduction, however, was limited to 50% of the W-2 wages of the taxpayer for the year. For determining a taxpayer's W-2 limitation, regulations under Sec. 199 permitted the taxpayer to take into account any wages paid by another entity and reported by the other entity on Forms W-2, provided that the wages were paid to employees of the taxpayer for employment by the taxpayer. The result was that a "common law employer" was allocated wages for the purposes of the W-2 limitation even if the wages were paid by a related party, PEO, or employee leasing firm.

The Tax Cuts & Jobs Act

- Problem #5: What do we do About a Qualified Business Loss?

The Tax Cuts & Jobs Act

- Problems with Section 199A: Netting of income/losses
  - Must determine qualified business income for EACH separate qualified business.
  - QBI is NOT required to be a positive number.
  - Then, you start the process of claiming the deduction by taking 20% of qualified business income. Again, the rules do NOT say that the deduction must be a positive number, only that it be LESS than the W-2 limitations.
  - This seems to indicate that you can generate a "negative deduction" from one business to reduce or offset a positive deduction.

The Tax Cuts & Jobs Act

- *Example: In 2018, A, a married taxpayer, is allocated $400,000 of qualified business income from business 1 and $300,000 of qualified business loss from qualified business 2. Assume that business 1 paid $200,000 of W-2 wages, and that A's taxable income is in excess of $415,000, so that the limitations apply in full.*
- *A is required to compute his Section 199A deduction for each separate business. His deduction attributable to business 1 is $80,000, the lesser of 20% of $400,000 ($80,000) or 50% of business 1's W-2 wages ($100,000).*
- *If Section 199A did not permit a negative deduction, A would claim no deduction – positive or negative – from business 2. Thus, A's total deduction would be $80,000, despite the fact that his net qualified business income from businesses 1 and 2 was only $100,000.*
- *By allowing qualifying business income to be negative, when determining his deduction attributable to business 2, A takes into account a $300,000 qualified business loss. His tentative deduction related to the business is a negative $60,000, which by definition, will always be less than any W-2 or basis-based limitations. Thus, the $60,000 negative deduction reduces the $80,000 positive deduction attributable to business 1, leaving A with a $20,000 deduction on $100,000 of net qualified business income.*

The Tax Cuts & Jobs Act

- This result is supported by an explanation and example found in the conference committee report, which offered a description of the original Senate version of what would later become the Section 199A deduction. The report states:
  - "if the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year."
- The language continues:
  - "…Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent taxable year is reduced (but not below zero) by 20% of any carryover qualified business loss."

The Tax Cuts & Jobs Act

- This intent was illustrated by the following example:

Example: In 2018, A is allocated qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B. A is not permitted a deduction under Section 199A in 2018 and has a carryover qualified business loss of $30,000 to 2019.

In 2019, A has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the Section 199A deduction for 2019, A reduces the 20% deductible amount determined for the qualified business income of $70,000 ($14,000) from qualified businesses A and B by 20% of the $30,000 ($6,000) carryover business loss. Thus, A is entitled to a deduction of $8,000 in 2019.

The Tax Cuts & Jobs Act

- The result in this example was later codified in Section 199A(c)(2), which provides that "if the net amount of qualified income, gain, deduction and loss with respect to qualified trades or businesses of the taxpayer for any tax year is less than zero, then the net loss is treated as a loss from a qualified trade or business in the succeeding tax year."
- in certain scenarios, the requirement that a taxpayer compute the Section 199A deduction on a business-by-business basis could conceivably lead to a situation where the taxpayer generates a net negative deduction. Consider the following example:
- *Example: TP has QBI of $400,000 from business 1, but business 1 pays only $100,000 of W-2 wages. A's tentative deduction attributable to business 1 of $80,000 is limited to $50,000 (50% of $100,000). A has a QBL of $300,000 from business 2, and continues to generate a negative deduction of $60,000 attributable to business 2 (20% of a $300,000 qualified business loss). Thus, the net result is that A has $100,000 of net qualified business income, but a net negative Section 199A deduction of $10,000.*

The Tax Cuts & Jobs Act

- Problem #6: What is a Specified Service Business?

The Tax Cuts & Jobs Act

- What is a "specified service business" that is not eligible for the deduction?
  - Section 199A references Section 1202(e)(3)(A), which states:
    - "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."
  - Then, Section 199A does the following:
    - Removes architects and engineers from the list of disqualified businesses
    - Adds the following as disqualified businesses: investing and investing management, trading, or dealing in securities, partnership interests, or commodities.

The Tax Cuts & Jobs Act

- While clearly, traditional doctors, accountants, and attorneys will fall victim to this definition, many businesses will not fit so neatly into one of the disqualified categories.
- Making matters worse, the history of Section 1202 will offer little illumination, because while the provision has been in the Code since 1993, it has only recently become widely-utilized. As a result, there is currently little guidance in the form of administrative rulings or judicial precedent to shed light on what types of businesses might fall within this description.

The Tax Cuts & Jobs Act

- What can we learn from other areas of the Code?
- Section 448 excludes “personal service corporations” from the general requirement that a C corporation use the accrual method of accounting once average gross receipts exceeds a threshold. For these purposes, a corporation is in the business of the performance of services if more than 95% of the time spent by employees is devoted to the performance of services in the fields of health, law, engineering, architecture, actuarial science, performing arts, or consulting, a list of businesses that is nearly identical to that found in Section 1202(e)(3)(A).

The Tax Cuts & Jobs Act

- Section 448 regulations:
  - performance of services in the field of health means “the provision of services by physicians, nurses, dentists, and other similar healthcare professions,” but does not include “the provision of services not directly related to the medical field, even though the services may purportedly relate to the health of the service recipient, such as the operation of health clubs or health spas.” Similar clarification is provided for the fields of consulting and the performing arts.
  - Performing arts: means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists. Does not include the provision of services by those who are not themselves performing artists. Also does not include those who broadcast or otherwise disseminate the performance of such artists to members of the public (i.e., employees of a radio station).

The Tax Cuts & Jobs Act

- Problem #7: How will the “Catch-All” Work?

The Tax Cuts & Jobs Act

- Problems with the catch-all:
  - It threatens any taxpayer who is not engaged in one of the businesses specifically listed as disqualified.
  - Consider the case of a personal trainer. Under Section 199A (via Section 1202(e)(3)(A)), the argument can be made that the trainer is not in the field of health or athletics. A review of the Section 448 regulations would support this position, because a personal trainer is not directly working in the medical field.
  - Application of the catch-all, however, would likely yield a different result. What does a personal trainer offer aside from his or her expertise and reputation?

The Tax Cuts & Jobs Act

- Problems with the catch-all:
  - While Section 199A uses the term "specified *service* trade or business" to describe its disqualified businesses, the language of the catch-all found in Section 1202(e)(3)(A) does not require that the taxpayer be providing services; rather, it merely requires that the principal asset of the business be the reputation or skill of its employees or owners.

The Tax Cuts & Jobs Act

- Problems with the catch-all:
- Compare two restaurants — the first a prominent chain, the second a stand-alone bistro with a world-renowned, five-star chef. Neither restaurant is in a listed disqualified service field under Sec. 199A, and so the initial presumption is that both eateries generate qualified business income eligible for the Sec. 199A deduction.
- Now, consider the application of the catch-all. The principal asset of the chain restaurant is clearly not the skill of its employees or owners; after all, if the chef at one of the locations leaves the restaurant, he or she will be replaced and life will go on. As a result, the chain restaurant should not fall victim to the catch-all.

The Tax Cuts & Jobs Act

- The bistro, however, may not be so fortunate. In this scenario, it is much more likely that the business's principal asset is the skill and reputation of the five-star chef who prepares its food.
- Put in simple terms, if that chef leaves the bistro, the business probably shutters its doors, adding further evidence that it is the expertise of the chef that drives the business.
- Thus, based on the current structure of Sec. 199A, it would not be unreasonable to conclude that the second restaurant is a specified service business. But why should the owners of the two restaurants be treated differently when they both provide the same mix of food and services to customers?

The Tax Cuts & Jobs Act

- Possible fixes:
  - The Service could prevent a great number of these disputes by quickly issuing guidance providing that a specified service business is meant to be just that, a *service business.*
  - Regulations could provide a quantitative test similar to the one found in the Sec. 448 regulations, providing that a business can be a "specified service business" for the purposes of Sec. 199A only if more than 95% of the activities of the business during the year involve the performance of services by owners and employees. This would remedy the disparate treatment between the two restaurants reflected above, as neither would likely meet the definition of a service business under this standard.

The Tax Cuts & Jobs Act

- Additional guidance is also needed regarding the meaning of the term "principal asset" and how the various assets of a business are to be measured and compared for purposes of the catch-all. For example, assume that a service business — one that is not engaged in one of the disqualified fields in Sec. 1202(e)(3)(A) — pays more than 50% of its gross revenue to employees in the form of wages. Does this mean the "principal asset" of the business is attributable to the skill of the employees? If this were the case, the employer might be incentivized to replace employees with automation, a move that runs contrary to one of the stated goals of the Act (job creation) as well as an apparent incentive behind Sec. 199A's W-2 wages limitation (to encourage employers to pay higher wages).
- Regulations governing the principal-asset test should clarify that the focus of the test is on the expertise or reputation of the owner of the business, rather than that of its employees. This would accomplish the desired effect of the prohibition on specified service businesses — to prevent the owner of a business from converting personal service income into qualified business income eligible for a 20% deduction — without inadvertently incentivizing business owners to reduce wages or eliminate employees.

The Tax Cuts & Jobs Act

- Problem #8: Inconsistent Treatment Among Business Types

The Tax Cuts & Jobs Act

- Is there a big problem with the new Section 199A deduction?
- Based on a strict interpretation of the statute, it doesn't treat all business owners equally.
- Consider the following fact pattern:
  - A is the sole owner of a business.
  - A builds and sells a product.
  - A has no employees; rather, he gets by with the help of a few independent contractors.
  - The business has no substantial fixed assets.
  - Assume that in 2018, the business generates $500,000 of ordinary income. Assume further that this is also A's taxable income on his 2018 return. Let's look at how A's deduction varies depending on how he chooses to operate his business:

The Tax Cuts & Jobs Act

- Sole proprietorship:
  - With income of $500,000 reported on Schedule C, A would begin the process of computing his deduction by simply multiplying his qualified business income (QBI) of $500,000 by 20%, yielding a tentative deduction of $100,000.
  - The deduction, however, is limited to 50% of the W-2 wages paid by the business. As a sole proprietorship, A cannot pay himself wages, and because there are no other employees, the business has no W-2 wages; as a result, the "50% of W-2 Wages" limitation is $0. In addition, because A's taxable income is above the top threshold of $415,000, the limitation applies in full.
  - Thus, A gets no deduction in 2018.

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- S Corporation:
- To comply with the “reasonable compensation” requirement, A pays himself $125,000 in wages during 2018. This reduces his flow-through income from $500,000 to $375,000.
- In computing qualified business income, Section 199A(c)(4) provides that QBI does not include "reasonable compensation paid to the taxpayer." This has been widely interpreted -- and I have shared the same view -- to mean that the $125,000 of wages A receives and reports on his Form 1040 are not included in his calculation of QBI and are thus not eligible for the 20% deduction.
- Thus, A is entitled to claim a deduction of $62,500, equal to the LESSER OF:
  - his QBI deduction of $75,000 ($375,000 * 20%), or
  - his W-2 limitation of $62,500 ($125,000 *50%).

The Tax Cuts & Jobs Act

	Sole Proprietorship	S Corporation	Partnership
Business Income	$ 500,000	$ 500,000	$ 500,000
W-2 Wages	n/a	$ (125,000)	
Guaranteed Payments	n/a	n/a	$ (125,000)
Net Income	$ 500,000	$ 375,000	$ 375,000
QBI	$ 500,000	$ 375,000	$ 375,000
Tentative deduction (20% of QBI)	$ 100,000	$ 75,000	$ 75,000
50% of W-2 limitation	$ -	$ 62,500	$ -
Final Deduction	**$ -**	**$ 62,500**	**$ -**

The Tax Cuts & Jobs Act

- Now, consider this fact pattern:
  - Assume instead that in 2018, the same business laid out in the last Case Study generates $200,000 of ordinary income. Assume further that this is also A's taxable income on his 2018 return. Let's look at how A's deduction varies depending on how he chooses to operate his business.
- *Sole Proprietorship*
  - With income of $200,000 reported on Schedule C, A's tentative deduction is $40,000.
  - Because A's taxable income is below the threshold of $315,000, the W-2 limitation does not apply. As a result, A gets a full deduction of $40,000 in 2018.

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- *S Corporation*
  - Even with income of only $200,000, A is required to take reasonable compensation if he hopes to get his hands on that $200,000 in cash without problems with the IRS. Assume he pays himself $80,000; this reduces his flow-through income from $200,000 to $120,000. If we embrace the popular view that this also reduces his QBI eligible for the 20% deduction to $120,000, A's tentative deduction becomes $24,000 (20% * $120,000). Because A's taxable income is less than the $315,000 threshold, the W-2 limitations do not apply.
  - Thus, A is entitled to claim a deduction of $24,000.

The Tax Cuts & Jobs Act

Summary

	Sole Proprietorship		S Corporation		Partnership	
Business Income	$	200,000	$	200,000	$	200,000
W-2 Wages	n/a		$	(80,000)		
Guaranteed Payments	n/a		n/a		$	(80,000)
Net Income	$	200,000	$	120,000	$	120,000
QBI	$	200,000	$	120,000	$	120,000
Tentative deduction (20% of QBI)	$	40,000	$	24,000	$	24,000
50% of W-2 limitation	n/a		n/a		n/a	
Final Deduction	**$**	**40,000**	**$**	**24,000**	**$**	**24,000**

The Tax Cuts & Jobs Act

What is the fix?

Consider what the House said in its version of HR 1

Net business income or loss includes the amounts received by the individual taxpayer as wages, director's fees, guaranteed payments and amounts received from a partnership other than in the individual's capacity as a partner, that are properly attributable to a business activity. These amounts are taken into account as an item of income with respect to the business activity. For example, if an individual shareholder of an S corporation engaged in a business activity is paid wages or director's fees by the S corporation, the amount of wages or director's fees is added in determining net business or loss with respect to the business activity. This rule is intended to ensure that the amount eligible for the 25-percent tax rate is not erroneously reduced because of compensation for services or other specified amounts that are paid separately (or treated as separate) from the individual's distributive share of passthrough income.

The Tax Cuts & Jobs Act

- Only by assuming that:
  - Section 199A(c)(4) requires us to add back wages paid to a shareholder and guaranteed payments to a partner in computing the shareholder or partner's QBI, and
  - The W-2 wage limitation should NOT include any wages paid to the shareholder computing the deduction...
- ...can we achieve equity between the three business types.
- But is this correct? It doesn't matter. We have to follow the statutory construction, even if it doesn't make sense.

The Tax Cuts & Jobs Act

	Sole Proprietorship	S Corporation	Partnership
Income before wages	$ 200,000	$ 200,000	$ 200,000
W-2 Wages	n/a	$ (80,000)	n/a
Guaranteed Payments	n/a	n/a	$ (80,000)
Net Income	$ 200,000	$ 120,000	$ 120,000
QBI	$ 200,000	$ 120,000	$ 120,000
Addback: wages/guaranteed payments received by taxpayer	$ -	$ 80,000	$ 80,000
Final QBI	$ 200,000	$ 200,000	$ 200,000
Tentative deduction	$ 40,000	$ 40,000	$ 40,000
W-2 Limitation (does not include amounts paid to s/h or partner)	n/a	n/a	n/a
Final deduction	**$ 40,000**	**$ 40,000**	**$ 40,000**

The Tax Cuts & Jobs Act

	Sole Proprietorship	S Corporation	Partnership
Business Income	$ 500,000	$ 500,000	$ 500,000
W-2 Wages	n/a	$ (125,000)	
Guaranteed Payments	n/a	n/a	$ (100,000)
Net Income	$ 500,000	$ 375,000	$ 400,000
QBI	$ 500,000	$ 375,000	$ 400,000
Tentative deduction (20% of QBI)	$ 100,000	$ 75,000	$ 80,000
50% of W-2 limitation	$ -	$ 62,500	n/a
Final Deduction	$ -	$ **75,000**	$ -

	Sole Proprietorship	S Corporation	Partnership
Income before wages	$ 500,000	$ 500,000	$ 500,000
W-2 Wages	n/a	$ (125,000)	n/a
Guaranteed Payments	n/a	n/a	$ (125,000)
Net Income	$ 500,000	$ 375,000	$ 375,000
QBI	$ 500,000	$ 375,000	$ 375,000
Addback: wages/guaranteed payments received by taxpayer	$ -	$ 125,000	$ 125,000
Final QBI	$ 500,000	$ 500,000	$ 500,000
Tentative deduction	$ 100,000	$ 100,000	$ 100,000
W-2 Limitation (does not include amounts paid to s/h or partner)	$ -	$ -	$ -
Final deduction	$ -	$ -	$ -

The Tax Cuts & Jobs Act

- Reasonable compensation:
  - There is, however, another potential solution to the inequity described immediately above. As discussed previously, Sec. 199A(c)(4) provides that qualified business income does not include any reasonable compensation paid to the taxpayer by any qualified trade or business for services. Some have speculated that this provision seeks to expand the reasonable-compensation requirement beyond shareholders in an S corporation, requiring sole proprietors and partners in a partnership to treat a portion of their business income as reasonable compensation. This would reduce the qualified business income eligible for the Sec. 199A deduction, putting them on equal footing with a shareholder in an S corporation.

The Tax Cuts & Jobs Act

- Applying a reasonable-compensation standard to sole proprietors and partners would not remedy all of the inequities currently resulting under Sec. 199A. For example, future regulations could require a partner to withdraw reasonable compensation from a partnership, but what form would this payment take? The IRS has long held the position that a partner cannot be paid W-2 wages. If reasonable compensation paid to a partner were instead categorized as a guaranteed payment, Sec. 199A, as currently constructed, would not include that amount in the W-2 limitation, potentially preventing partners with taxable income in excess of the threshold at which the W-2 limitations apply from claiming a deduction.

The Tax Cuts & Jobs Act

- More importantly, expanding the reasonable-compensation requirement beyond shareholders in an S corporation would be a departure from current policy and layer additional complexity onto an already nebulous reasonable-compensation standard. Over a half-century has passed since the reasonable-compensation standard was established for S corporations, and the issue continues to generate significant disputes between taxpayers and the IRS, often ending in litigation. Any attempt to apply such an imprecise standard to sole proprietors and partners would only exacerbate an already problematic provision of the law.

The Tax Cuts & Jobs Act

- Problem #9: What are the Structuring Alternatives for Disqualified Businesses?

The Tax Cuts & Jobs Act

- Problems with structuring around "specified service business" designation.
  - Many businesses are talking about "packing," (i.e., inserting qualifying businesses into disqualified businesses.
  - For example, a law firm acquires commercial building to get into the rental business.
  - Or a famous actress launches a skin care line.
  - Will this work?

The Tax Cuts & Jobs Act

- I'm not convinced, for two reasons:
  - Section 1202 requires only that a disqualified business be "involved in the performance of services."
  - Compare this to Section 448, which provides that a corporation is only a personal service corporation if "more than 95% of the time spent by employees is on services in a prohibited field.
  - In the former example, all it takes is ANY disqualified services to taint the business. So would the law firm taint the real estate? I assume it would.
- Failing that, it appears Section 199A is determined on a business-by-business basis. So the IRS would likely carve out the law firm income and make that disqualified.

The Tax Cuts & Jobs Act

- Another option is "cracking." You break apart a qualified business from a disqualified business.
- For example, a group of doctors forms a new entity to handle all of the human resources, billing, accounting, etc..for the doctors.
- Is this new business not in the field of health?
- Section 448 regulations state that providing administrative and support services to a disqualifying business will cause the corporation to be a personal service corporation.
- Might future guidance on Section 199A say the same thing, killing the "cracking idea?"
- It shouldn't kill it with self-rentals.

Evolving Impact of Cybersecurity

Ishita Sharma and Adam S. Wright
Ernst & Young LLP
Denver, CO

Tax Institute Event

Evolving impact of cybersecurity

July 23, 2018

Introduction

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EY Advisory
Risk Practice

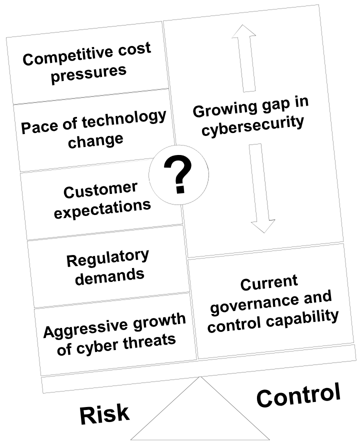
Agenda

- Why is cybersecurity such a big issue?
- Marketplace response to growing cybersecurity risk
  - Stakeholder concerns
  - Regulatory activities
  - Financial audit and tax implications
- What can business do?
- Teaming to address the cybersecurity risk
- AICPA's cybersecurity initiative
  - Evaluating and reporting on cybersecurity risk management programs
- Questions
- Appendix

Why is cybersecurity such a big issue?

Cybersecurity trends

A variety of concerns affecting the marketplace



87%

Number of board members and C-level executives who said they lack confidence in their companies' level of cybersecurity[1]

Cybersecurity risks continue to increase in a world with **no boundaries** and **no rules**.

These risks need to be effectively evaluated as part of Internal Audit's risk assessment and detailed audit activities.

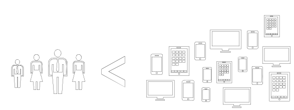
[1] EY's 19th Global Information Security Survey 2016-17.

Landscape: increasing cyber threats

Cyber trends in the marketplace

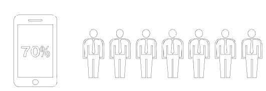
1 The technological pace is increasing

It is estimated that there will be **25b connected "things"** by 2020[1]



1. http://www.gartner.com/newsroom/id/2905717

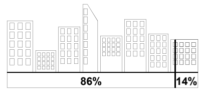
By 2018, **70%** of **mobile professionals** will conduct all of their work on **personal smart devices**[2]



2. https://www.gartner.com/doc/2422315/bring-device-facts-future see #2

2 Accelerating cyber threats

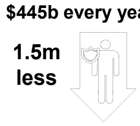
86% of respondents do not believe their information security fully meets the organization's needs[3]



3. http://www.ey.com/giss

3 Creating greater cost and resource drain

Attacks and breaches cost businesses **$445b every year**[4]



There will be an estimated shortfall of **1.5m professionals** in the global information security workforce within five years.[5]

4. http://www.garp.org/#!/risk-intelligence/all/all/a1Z40000003NYkb
5. https://www.isc2cares.org/uploadedFiles/wwwisc2caresorg/Content/GISWS/FrostSullivan-(ISC)%C2%B2-Global-Information-Security-Workforce-Study-2015.pdf

How is the world changing for international businesses?

Cybersecurity is a priority issue from board level down

There is a growing focus on what is going wrong where cyberspace meets the physical world:

- Customers having their personal details stolen and used is unacceptable
- The theft of intellectual property is detrimental to prosperity
- Data losses and the subsequent remediation costs are a significant burden
- The hacking and manipulation of media, communications, government administration and defense systems is seen as a significant threat to national security.

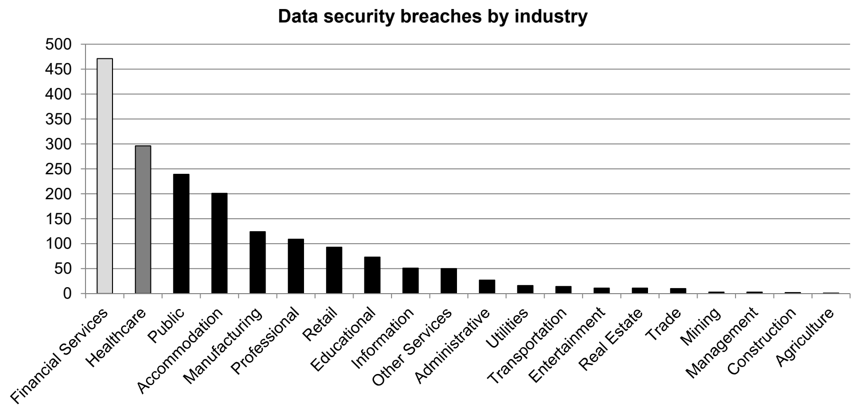
Operating in a digital world invites new challenges and threats

- Smart devices and services can deliver unintended consequences and a mass vulnerable data
- Social media is ‘always on’ and information widely shared, without a full appreciation of privacy and security
- Information is increasingly stored in the cloud or with third parties, resulting in less control, increased risk and a more complex cyber ecosystem
- Human behaviors are changing in positive and negative ways
- New legislation and regulations are forcing changes in processes which can open up new vulnerabilities and widen the attack surface of the organization

Impact of cyber attacks by industry

Financial services sector continues to be a cyber target

The industries most affected by data security breaches in 2016 were financial services, healthcare and public industries.



Source: Verizon 2017 Data Breach Investigations Report

Cybersecurity

Why is cybersecurity such a big issue?

- Cybersecurity risks can significantly affect an entity's ability to effectively control <u>logical access</u> to its system:
  - New access points onto your network:
    - Via malware or phishing attacks
    - Via connections with third parties
    - Via new technologies (e.g., cloud applications)
    - Via other new and evolving attack vectors
  - Historical control strategies may not be responsive to new risks
    - Historical focus: Focus on "prevent" and a little bit of "detect":
      - Configuration hardening
      - Access administration
      - Administrator access
      - Separation of duties
      - Basic access monitoring

Cybersecurity

Why is cybersecurity such a big issue?

- Through the use of technology, issues can occur faster, be more widespread and affect others (including business partners)
- More is at risk than many assume:
  - Access to sensitive data that can be monetized
  - Access to sensitive data to facilitate market manipulation:
    - Contract bids
    - Merger and acquisition (M&A) activity
    - Succession plans
    - Financial forecasts
    - Business plans
  - Manipulation of automated processes:
    - Modification of programming to industrial control systems, robotic systems, etc.
    - Modification of business rules utilized in processing (e.g., calculations, interfaces, detection and monitoring thresholds)
  - Client dissatisfaction

So what:

- Penalties/fines
- Lawsuits
- Liabilities / losses

- Lost business
- Decreases market value / Goodwill impairment
- Shareholder lawsuits

- Inaccurate processing
- Quality control issues
- Liabilities / losses
- Lawsuits
- Inefficiencies

- Decreases market value / Goodwill impairment
- Shareholder lawsuits

Cybersecurity

Why is cybersecurity such a big issue?

2018+ cyber threat predictions

- Ransomware is here to stay
- Social engineering / phishing will continue to increase
- Mobile and IoT devices will be targeted
- Cloud implementations
- Industry will prioritize new technology over security
- Nation-state activity will increase

Marketplace response to growing cyber risks

Cybersecurity

Marketplace response to growing cyber risk

Various **“interested parties”** are concerned about your entity’s ability to appropriately deal with cyber attacks and breaches.

- **Boards and audit committees** – Expected to have an appropriate understanding of the business implications of cyber risks
- **PCAOB** – Gathering information on how entities (and their auditors) are considering the risks
- **Various federal and state-level regulators** – Issuing guidance to help improve cyber preparedness (e.g., Commerce, CFPC, FDA, FDIC, Federal Reserve, FINRA, HHS, NERC, NAIC, OCC, Treasury)
- **SEC** – Continues to highlight the importance of risk identification in speeches and comments
- **National Association of Corporate Directors** – Publisher of general articles and handbooks for boards seeking guidance on cyber preparedness
- **Significant investors, customers and consumers** – Asking for more transparency into an entity’s cyber risks and processes, as well as privacy and how personally identifiable information (PII) is handled
- **Business partners** – Want to understand the adequacy of your cybersecurity risk management program before connecting systems

Cybersecurity
Marketplace response to growing cyber risk

Financial audit and tax implications

- While the risks related to cybersecurity are growing and evolving, there have been no related changes to professional auditing standards (and none are anticipated at this time).
  - Cybersecurity represents a potential "business risk" to the entity being audited.
  - During their risk assessment activities, the external auditor considers the various business risks the entity faces to assess the risk of material misstatement to the financial statements.

Nothing has really changed

- If there is deemed to be a potential risk of material misstatement, the auditor may elect to obtain a high-level understanding of:
  - The processes and controls implemented by the entity to manage cybersecurity risks.
  - The type and extent of communications that take place between management and the Audit Committee.
- If it is determined that there is a heightened level of risk, the auditor may elect to change the nature, timing and extent of their auditing procedures.

Cybersecurity
Regulatory activities

Common themes within released and proposed regulatory requirements – See Appendix for more details on various regulatory requirements

- The need to:
  - Better understand the risks facing the entity along with their potential business impacts
  - Challenge the effectiveness of the entity's overall cybersecurity risk management program
  - Better understand the IT assets that connect to the entity's network
  - Challenge the effectiveness of the entity's vendor risk management program
  - Challenge the effectiveness of the entity's incident response program
  - Challenge the effectiveness of the entity's resiliency program
  - Challenge the effectiveness of processes and controls over the access to, use of, storage of and transfer of personal data without explicit consent

What can businesses do?

Cybersecurity

What can businesses do?

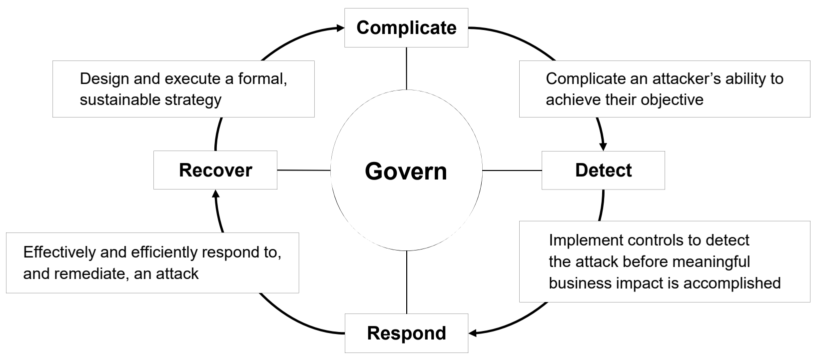
Understand …		
Why	**Why would someone target you?** (i.e., what assets do you have that others may want)	• Financial gain • Theft of intellectual property • Disruption of operations • Market manipulation
Who	**Who might target you?**	• Nation states • Organized crime • Insiders / partners • Hacktivists • Competitors • Independent hackers

How	**How could access to your system be gained?**	• Via web applications
		• Social engineering
		  – Phishing
		  – Malware
		  – Physical
		• Exploit vulnerabilities
		  – Internal
		  – External
		  – Wireless
		• Via business partners
		• Via new technologies

Cybersecurity trends

Managing cybersecurity risk – key concepts

- It is no longer feasible to effectively prevent cyber attacks from occurring, especially those initiated by a sophisticated attacker.
- Since absolute prevention is not feasible, companies must move to a posture of **preparedness** and **timely response,** or as we have advocated, an approach that focuses on four main tenets – **complicate**, **detect**, **respond** and **recover**.



Cybersecurity

What can businesses do?

Invest in a robust cyber risk management program

Complicate

- Policies & configuration standards
- Security awareness
- Network / host / application security
- Vulnerability management
- Identity management
- Data protection
- Vendor management
- Network architecture
- Data classification / high-value asset identification

Complicated the effort required to breach your environment

Detect

- Threat intelligence
- Security monitoring
  - Activity / Behavioral analysis

Quickly respond to new threats and unusual user activities

Respond / Recover

- Incident response
- Crisis management
- Disaster recover planning
- Business continuity planning

Act quickly to minimize the impact on the business

Cybersecurity
Recommendations to consider

- Requires companies to expand their focus into other security domains that may not have received a lot of attention in the past:
  - Security awareness: To help deal with malware and phishing attacks
  - Threat intelligence: To gain early insight into new threats and vulnerabilities
  - Vendor risk management: To help deal with the ever-increasing list of key business and control-related activities being outsourced
  - Enhanced security solutions: Token-based security, encryption, etc.
  - Security code development training: To train web application developers to design and develop more secure code
  - Asset management: To understand who is connecting to your network
  - Security architecture: To leverage segmentation and other architectural means to restrict a user's ability to traverse a network

Unfortunately, at some organizations these other security domains are not be as mature as they need to be

Cybersecurity
What can businesses do?

- **The challenge**
  - Frequently, cyber risk management programs:
    - Are modeled after generic frameworks, rather than customized based on a comprehensive assessment of the organization's specific risks
    - Are not fully aligned with the organization's ERM program, business objectives, etc.
    - Are lacking a comprehensive inventory of all IT assets that connect to the organization's network
    - Lack of alignment and agreement in terms of identifying high value assets which should be protected versus protecting all data equally
    - Are lacking an effective strategy to manage the risks associated with using third-parties to operate key processes and controls within the program
    - Rely on processes and controls that: (1) lack standardization across the organization and (2) are not sufficiently mature to effectively address the organization's risk
  - While periodic assessments are often performed on the program by the IT group, Internal Audit or an outside advisor to evaluate their effectiveness, the value derived varies considerably based on:
    - The experience of the group performing the assessment
    - The scope of the assessment
    - The depth and breadth of the procedures performed

While cybersecurity budgets are increasing, most organizations require more to manage the risk effectively

- ►Mounting threat levels require a more robust approach to cybersecurity.
- ►Most organizations continue to increase their spending on cybersecurity, though not all.
- ►The vast majority believe they need up to 50% more cybersecurity funding to enable the cybersecurity function to be in line with the existing risk tolerance of the organization.
- ►76% of survey respondents said the cybersecurity budget would increase if they suffered a damaging breach.

59%
of respondents this year say their budgets increased over the last 12 months

87%
say they need up to 50% more funding to meet requirements

Only 12%
expect an increase of over 25% in their cybersecurity budget

Organizations struggle to interpret the harm from attacks, resulting in lower budgets than required

- ►64% said an attack that did not appear to have caused any harm would be unlikely to prompt an increase in the organization's cybersecurity budget.
- ►Harm is generally being done by an attack even it is not immediately obvious.
- ►Organizations should assume that all attacks cause harm – they just may not have discovered the damage yet.

Only 4%
of organizations are confident that they have fully considered the information security implications of their current strategy, and that their risk landscape incorporates and monitors cyber threats, vulnerabilities and risks.

Teaming to address the cybersecurity risk

Teaming to address cybersecurity risk
Impact of cybersecurity risk

Typical responsibilities of a internal audit / compliance function

- Ensure effective and efficient processes are in place and operating effectively to support the entity's business objectives
- Help ensure that management stays in compliance with any applicable business and tax regulatory requirements
- …
- …
- …

Cybersecurity risk should not change any of these traditional responsibilities; however, more may be added

How to address cybersecurity risks
It starts with the risk assessment

- **Assessing the business impact of cybersecurity risk on an entity involves:**
  - Understanding the unique business-related risks impacting the entity's sector
  - Asking appropriate questions of senior management to understand:
    - The risks the entity is currently facing
    - The risks the entity will face in the future based on proposed business plans

… that may have a cybersecurity dynamic.

How to address cybersecurity risks
It starts with the risk assessment

Do you know what assets you have that others may want?

Do you know how your business plans could make these assets more vulnerable?

Do you understand how these assets could be accessed or disrupted?

Would you know if you were being attacked and if the assets have been compromised?

Do you have a plan to react to an attack and minimize the harm caused?

Do you practice your plan on a regular basis so everyone is clear on procedures?

How to address cybersecurity risks
It starts with the risk assessment

- Risk management focus areas
- New regulatory/compliance requirements
- Past cybersecurity incidents within organization/industry
- Minimizing loss

CRO concerns

Tax

- How much of your environment is outsourced? How do you manage the access management lifecycle?
- Would you know if you were being attacked and if the assets have been compromised?
- Do you have a plan to react to an attack and minimize the harm caused?
- Do you practice your plan on a regular basis so that everyone is clear on procedures?
- Have you prepared for physical attacks as well as cyber attacks?
- How do you manage the dialogue with the public/consumers in the event of a breach/incident?
- How would a cyber attack impact your competitive advantage?
- Are you prepared to deal with the damage to your brand and reputation?
- Could you be liable for penalties and compensatory payments to customers and regulatory bodies?
- Have you considered the costs associated with recovering from cyber attacks vs. the costs to mitigate cybersecurity risks?

How to address cybersecurity risks
Translating risks into an action plan

- Similar to other areas of your business:
  - The results of the risk assessment should drive the development of the action plan
  - The focus of the action plans should be to evaluate the **maturity** and **operating effectiveness** of the underlying processes and controls within the cybersecurity risk management program
    - Point-in-time testing may be useful at times (e.g., evaluating the deployment of a new activity monitoring system)
    - Recommendations should be focused on maturing, expanding the scope, and standardizing the underlying processes and controls to a level commensurate with the level of business risk
- For entities that are not highly regulated (i.e., not forced to implement robust controls), the maturity level of certain programs may be lower than you originally anticipated
- Be hesitant to place too much reliance on penetration testing
  - Its simply a point-in-time test on the adequacy of the underlying processes and controls; provided enough time, the attacker will always get in
  - Best suited for IT to execute to identify where process enhancements are needed
  - Consider as an option when a “wake-up call” is needed

How to address cybersecurity risks
Translating risks into an action plan

Illustrative examples of potential cybersecurity audits ***(See Appendix for Potential Audit Scope)***

Comprehensive cybersecurity program risk management assessment	**Third party security risk management assessment**	**Scenario-based technical testing**	**Software security assessment**
Cybersecurity governance assessment	**Security event and incident management assessment**	**Data protection program assessment**	**Enterprise resilience assessment (business continuity and recovery)**
Identity and access management analytics	**Vulnerability management assessment**	**Privacy assessment**	**Incident response tabletops**

Challenges to auditing cybersecurity

- **Resources, resources, resources**
  - The shortage of qualified resources is not expected to change anytime soon
  - Regulators in the Financial Services sector have issued proposed standards that will mandate heighten levels of cybersecurity expertise at multiple levels with these institutions
    - Within line business unit management – *the first line of defense*
    - Within the Enterprise Risk Management group – *the second line of defense*
    - Within internal audit – *the third line of defense*
    - Within IT
- **Frameworks, methodologies, and enablers**
  - NIST's Cybersecurity Framework is a nice start
    - Keep in mind that it was never intended to be used as an "assessment framework"
  - AICPA Cybersecurity Reporting *updated* Trust Services Criteria (available March/April 2017)
    - Incorporates relevant elements of the COSO principals, COBIT 5, NIST's Cybersecurity Framework, NIST's Special publication 800 series, ISO/IEC 27000 series standards, HIPAA Security Rule, PCI's Data Security Standard, etc.
    - Outlines control objectives as well as drilled-down "areas of focus"

AICPA's cybersecurity initiative

Evaluating and reporting on cybersecurity risk management programs

AICPA's cybersecurity initiative

AICPA's suite of services

Reporting/criteria	Intended audience	Benefits
SOC for service organization ► SOC 1 – ICFR	► Accounting/Internal Audit ► Business unit management	► Provides information on the controls over the processing of financial transactions by a service organization
► SOC 2 and 3 – Trust Services Criteria	► Business unit management ► Vendor risk management ► Accounting/Internal Audit ► Chief information security officer (CISO) ► Business continuity plan (BCP)	► Provides information on controls related to security, availability, confidentiality, process integrity and/or privacy at a service organization to support vendor risk management needs
SOC for cybersecurity ► Trust Services Criteria	► Board/audit committee ► Management ► Investors ► Analysts	► Provides relevant, validated information on the effectiveness of an entity's cybersecurity risk management program, typically performed enterprise-wide
SOC for supply chain ► Trust Services Criteria *Under development; available in 2018*	► Business unit management ► Supplier risk management ► Accounting/Internal Audit ► CISO ► BCP	► Provides information on controls related to security, availability, and manufacturing/distribution processes at a supply chain vendor to support supply chain risk management needs

Cybersecurity

Questions

Appendix

Cybersecurity
Regulatory activities

Securities & Exchange Commission

- In February 2018, updated cybersecurity disclosure guidance was issued, which reaffirmed the importance of complying with the 2011 guidance and provided additional clarity in certain areas
  - Disclosure of the cybersecurity risks facing the company and material cyber events that have occurred
  - How the Board exercises its oversight responsibilities over the management of cybersecurity risk
  - How cybersecurity events are evaluated for potential disclosure
  - Rules against insider trading
- In 2017, new enforcement division programs:
  - "Cyber Unit" targeting market misconduct, (e.g., market manipulation, hacking nonpublic information, violations of distributed ledger technology, threats to trading platforms, etc.)
  - "Retail Strategy Task Force" targeting misconduct impacting retail investors

> *"Companies should be providing better … [and] sooner disclosure about intrusions that may affect shareholder investment decisions… Across our markets, there should be better disclosure as to the cyber-risks we face."*
> ***SEC Commissioner Jay Clayton before the Senate Banking Committee, September 26, 2017***

Cybersecurity
Regulatory activities

- Cybersecurity-related guidance has been, or is expected from various sector-based regulators

<u>Sector-specific guidance</u>

- Financial services:
  - Banking and capital markets – Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation
  - Insurance – National Association of Insurance Commissioners
  - Wealth and asset management – Financial Industry Regulatory Authority
- Heath care – Health & Human Services – Office of Civil Rights
- Life sciences – Health & Human Services – Food and Drug Administration
- Automotive – National Highway Traffic Safety Administration
- Power and utilities – Nuclear Regulatory Commission
- Aerospace and defense – Department of Defense
- Technology – Department of Commerce (Federal Information Security Management Act and Federal Risk and Authorization Management Program
- Service – Department of Commerce (FISMA)

Cybersecurity
Regulatory activities

- As well as state and country-specific privacy-related regulators

State-specific guidance

- New York Department of Financial Services

Country-specific guidance

- EU – Global Data Privacy Regulation
- Asia-Pacific:
  - Cross-Border Privacy Regulation
  - China Cybersecurity Law
  - Singapore Personal Data Protection Act
  - Japan Personal Data Protection Information Act
  - Philippines privacy protection regulations
  - India draft data privacy regulations
- Russian Data Residency Law

While certain organizations will be **directly** affected by these requirements, others may be **indirectly** affected if they "support" the delivery of the underlying services (i.e., they act as a service provider)

Cybersecurity
Regulatory activities

NAIC – Insurance Data Security Model Law

- Objective – To raise the bar relative to expectations over:
  - Information protection
    - Outlines specific requirements relative to the entity's Information Security Program
      - Risk assessment process
      - Risk management activities
      - Oversight by the Board – Oversight, annual review
      - Oversight of third-party service providers
      - Program adjustments
      - Incident response plan
      - Annual certification to Commissioner of domiciliary state

      Limited specifics provided; based on "… size and complexity of the licensee" and results of the risk assessment
  - Investigation & breach notification
    - Notification to the Commissioner within 72 hours
    - Notification to Consumer within state-specific reporting time frame
- Penalties – Assessed in accordance with state-specific statutes
- Adopted on October 24, 2017; effective on date of state-specific adoption

Cybersecurity
Regulatory activities

New York Department of Financial Services (NYDFS) – cybersecurity requirements for financial services companies – revised

- Requires:
  - A comprehensive cybersecurity program
  - Designation of a qualified individual to serve as the CISO
  - Retention of qualified/trained cybersecurity personnel to manage the entity's cybersecurity risks
  - A periodic risk assessment of the cybersecurity program
- Based on its risk assessment, requires:
  - Periodic monitoring and testing (e.g., annual penetration testing, biannual vulnerability assessments)
  - Use of multifactor authentication and encryption in certain circumstances
  - Requires an annual compliance representation
  - Retention of extensive logging and audit trails
  - Extensive third-party vendor management activities
- Effective date – March 1, 2017; specific requirements staggered through March 1, 2019

GDPR will change how we handle data

1 Harmonisation and some progress
- Risk-based approach
- Pan-European lead DPA

2 Wider scope
- Wider definition of personal data
- Processing children data under 16 require parental consent

3 Increased obligations
- Privacy by Design
- DP Officer

4 Strengthened rights of individuals
- Right to erasure
- Data portability

5 Increased enforcement, fines, liability
- Regulatory fines up to 4% of annual worldwide turnover

6 Larger role for European Data Protection Board
- Tasked with making sure the regulation is applied around the EU.

Cybersecurity
Regulatory activities

EU General Data Protection Regulation (GDPR)

- The EU General Data Protection Regulation (GDPR) will be effective on **May 25, 2018**
  - **Organizations less than 7 months to become compliant**
- This regulation applies to any organization (regardless of geographic location) that controls or processes the data of an EU resident
- Failure to comply can result in fines of up to 4% of total annual worldwide revenue or €20,000,000, whichever is greater

Common business activities that can impacted by the GDPR include the following:

Cybersecurity
Regulatory activities

Is your client likely to be impacted by the GDPR?

- Does your client **do business in the EU?**
- Does your client **offer products or services to EU residents**?
- Does your client **monitor the behavior** of EU residents (e.g., for marketing purposes)?
- Does your client have **employees based in the EU?**
- Does your client **process personal data of EU residents** (e.g., national IDs, gender, nationality or health data)?
- Does your client **process personal data of EU residents** for other organizations?
- Does your client **transfer EU personal data internationally**?
- Does your client **rely on consent** for processing of personal data?
- Does your client have **any subsidiaries or affiliate organizations in the EU?**
- Does your client have **any plans or aspirations to do business in the EU in the future**?

If you answer **Yes** to any of these questions, then GDPR could impact your client and your client has less than one year to prepare for compliance.

Cybersecurity
Regulatory activities

Extraterritorial application	► Applies to all companies that control and/or process EU personal information; both those established in the EU, as well as organizations that target EU consumers or have employees based in the EU
Consent	► Consumer consent to process data must be freely given and for specific purposes; not implied ► Customers must be informed of their right to withdraw their consent, and processes must support effecting withdrawal/ceasing to use or share their personal data ► Consent must be "explicit" in the case of sensitive personal data or trans border data flow
New individual rights	► **The right to be forgotten** – Individuals have the right to ask data controllers to erase all personal data without undue delay in certain circumstances ► **The right to data portability** – Where individuals have provided personal data to a service provider, they can require the provider to "port" the data to another provider, provided this is technically feasible ► **The right to object to profiling** – The right not to be subject to a decision based solely on automated processing
Privacy impact assessments	► Organizations must undertake Privacy Impact Assessments as a precursor to conducting "risky" large-scale processing of personal data
Privacy by design	► Organizations must design privacy and data protection into the development of business processes and new systems

Cybersecurity
Regulatory activities

Data Protection Officers (DPOs)	► DPOs must be appointed if an organization conducts large-scale systematic monitoring or processes large amounts of sensitive personal data
Accountability for personal data	► Organization must prove they are accountable by: ► Establishing a culture of monitoring, reviewing and assessing data processing procedures ► Minimizing the collection, use and retention of personal data to that which is minimally necessary ► Documenting data processing policies, procedures and operations that must be made available to the data protection supervisory authority on request
Security	► Must demonstrate implementation of appropriate technical and organizational measures to achieve the security of personal data
Mandatory and rapid breach notification	► Organizations must notify supervisory authority of data breaches "without undue delay" or within 72 hours, unless the breach is unlikely to be a risk to individuals ► If there is a high risk to individuals, those individuals must be informed as well
Fines of up to 4% of annual worldwide revenue	► Fines for a breach of the GDPR are substantial. Regulators can impose fines of up to 4% of total annual worldwide revenue or €20,000,000, whichever is greater

How to build a cybersecurity audit plan

Translating risks into an audit plan

Potential audits	Potential audit scope
Comprehensive cybersecurity program risk management assessment	Addresses concerns of management, board, business partners and other stakeholders regarding maturity/adequacy of the entity's cybersecurity risk management program. Some companies focus on specific framework (e.g., NIST Cybersecurity Framework, as a baseline).
Cybersecurity governance assessment	Addresses concerns of management, board, business partners and other stakeholders regarding the extent of oversight, related expectations and responsibilities of relevant parties regarding cybersecurity.
Third party security risk management assessment	Addresses the risk related to third parties doing business with a company especially as it pertains to accessing, processing or hosting data.
Identity and access management analytics	Addresses various challenges in identifying, understanding, and evaluating identities and user access within the client's environment, including *segregation-of-duties identification.*

How to build a cybersecurity audit plan

Translating risks into an audit plan

Potential audits	Potential audit scope
Security event and incident management assessment	Addresses the process by which events and incidents are managed within the organization from a people, process and technology perspective.
Vulnerability management assessment	Addresses the process by which a company identifies, evaluates and addresses vulnerabilities applicable to its IT environment.
Scenario-based technical testing	Emulates real-world attacks in attempting to gain access to critical business assets, identifying only vulnerabilities needed to gain access to those targets and providing the organization with a realistic view of their organizational risk.
Data protection program assessment	Addresses what data is deemed critical to an organization, how that data is classified and the controls around that data. This audit can leverage data loss prevention tools to scan or monitor a company's data repositories and network to identify confidential or sensitive data, its location and access rights. This can include monitoring the type of data being transmitted to approved and non-approved cloud services.
Privacy assessment	Provides a clearer understanding of applicable privacy requirements and evaluate the current state of their control environment.

How to build a cybersecurity audit plan
Translating risks into an audit plan

Potential audits	Potential audit scope
Software security	Addresses the process by which security controls are considered throughout the development life cycle.
Enterprise resilience assessment (business continuity and recovery)	Addresses how the organization identifies critical business processes, related impacts, prioritization of related applications and the recovery process.
Incident response tabletop	Allows for a hands-on experience to determine the adequacy of incident response plans.
Standards audits	Addresses readiness of the organization to meet specific standard, e.g., Payment Card Industry Data Security Standards, ISO 27001.

While a multi-year audit plan may be outlined for cyber risks, the IA team should plan for flexibility in prioritization and timing of these audits to account for the evolving threat landscape.

Cybersecurity reporting
Frequently asked questions

Reporting necessity

- **Question** – are these types of reports really needed?
- **Response** – as noted previously, at the present time there is no legislative or regulatory requirements mandating cybersecurity reporting at the entity-level, and none are anticipated in the near-term; as a result, this level of reporting would be voluntary on the part of the organization.
- The decision on whether to undertake an entity-level examination (or the initial step of having an assessment performed to help identify issues requiring remediation) would be based on the unique needs of the organization and its stakeholders, and their expectations of future legislative or regulatory requirements. Conversely, the decision on whether to: (1) require service organization/ supply chain reports from key vendors and (2) prepare service organization/supply chain reports for your customers will be driven by market demand and evolving risk management requirements.

Legislative/regulatory mandates

- Question – what is the anticipated time frame for when the market should expect to see legislative or regulatory requirements relating to third-party reporting over an entity's cybersecurity risk management program?
- Response – given the evolving legislative and regulatory climate in Washington DC, it is difficult to predict what will happen in the coming years. However, given that: (1) cyber events are continuing to occur at a rapid pace and (2) there are currently 12 House and Senate committees that have jurisdiction over some element of cybersecurity and numerous federal regulatory bodies that are actively studying and evaluating what can be done to support the marketplace, many believe that the possibility of a medium-term or long-term legislative regulatory requirement cannot be dismissed.

Cybersecurity reporting
Frequently asked questions

Understanding the benefits
- **Question** – should the receipt of an unqualified opinion on a cybersecurity report provide readers with confidence that the entity's environment will never be materially impacted by a cybersecurity event?
- **Response** – the underlying objective of the AICPA's initiative was never intended to achieve this lofty goal, and given the pace of change within the marketplace, this level of comfort can never be realistically achieved. The objective was to enhance the level and quality of communication taking place between entities and their stakeholders to a point where more effective risk management decisions can be made relative to this evolving business risk.
- The receipt of an unqualified opinion on a cybersecurity report is intended to convey that the entity has implemented reasonable controls to complicate, detect, respond and recover from a cybersecurity event: (1) when measured against criteria that have been vetted in the marketplace and deemed to be suitable for the intended purpose and (2) based on specific cybersecurity objectives the entity is obligated to achieve.

Using other criteria as a basis
- **Question** – our organization has aligned the development of our cybersecurity risk management program around another framework (e.g., the NIST Cybersecurity Framework, ISO 207001, internally-developed hybrid framework, etc.). Are we required to utilize the evaluation criteria that has been developed by the AICPA?
- **Response** – the AICPA guidance does not require that the evaluation criteria developed in conjunction with the reporting model be utilized in all instances. If an organization, and their auditor, determine that an alternate set of criteria are "suitable" to evaluate the identified subject matter (as defined by the AICPA) and available to intended users, the alternate criteria can be utilized.
- Keep in mind that various frameworks being leveraged in the marketplace were originally developed as a "management framework" to assist organizations in establishing a program, versus an "assessment framework" that would be used to evaluate a program's effectiveness. As a result, certain frameworks may not satisfy the suitability requirement.

Cybersecurity reporting
Frequently asked questions

Segment-level reporting
- **Question** – our organization is in the process of deploying our comprehensive cybersecurity risk management program across the enterprise on a segment-by-segment basis. Does the guidance allow us to perform cybersecurity reporting at a level less than the entity as a whole (e.g., covering one or more of our key business segments)?
- **Response** – the AICPA guidance would not prohibit an organization from issuing a cybersecurity report on a scope that is less than the entity as a whole; however, the distribution of the deliverable would need to be limited to internal users (e.g., Board, internal management) to avoid any misunderstanding regarding the scope of the examination.

The value of an assessment
- **Question** – how high of a bar has the AICPA set for the marketplace to obtain an unqualified opinion?
- **Response** – the criteria against which an entity's cybersecurity risk management program will be evaluated were developed after considering a combination of various market-recognized frameworks (e.g., COSO's Internal Control – Integrated Framework, AICPA's Trust Services Principles, COBIT 5, NIST's Cybersecurity Framework, NIST's Special publication 800 series, ISO/IEC 27000 series standards, HIPAA Security Rule, PCI's Data Security Standard).

  Entities that have proactively adopted these (or other) comprehensive frameworks when designing their cybersecurity risk management program, and have considered the need for enterprise-wide adoption will not be surprised by the areas of focus; conversely, entities that have adopted a less rigorous strategy, or piecemeal deployment may find that their processes and/or control procedures, may require enhancement.

  Accordingly, an assessment of your organization's cybersecurity risk management program may be warranted if management is concerned that their process and/or control procedures:
  - Do not address all of the relevant risks
  - Are not being applied across the entire enterprise
  - Are not being adequately documented
  - Are not being consistently applied

Cybersecurity reporting
Frequently asked questions

Possible incremental uses

- **Question** - can these reports be used to help satisfy reporting obligations under other regulatory or legislative reporting requirements being discussed in the marketplace such as the Advance Notice of Proposed Rulemaking (ANPR) and the Global Data Privacy Regulation (GDPR)?
- **Response** - possibly. As the ANPR is still in the early stage of development, the final reporting obligations are not yet know; similarly, the compliance requirements under the GDPR have not been specifically identified. However, the cybersecurity reporting options may prove to be an appropriate reporting structure to help entities satisfy certain reporting obligations.

Basis for management assertion

- **Question** – since a management assertion is included in the report, does management need to conduct its own independent evaluation and testing of controls, similar to Internal Controls over Financial Statements?
- **Response** – management is required to have a basis for its assertion, which would include an evaluation as to the effectiveness of its controls. This is similar to the internal control reporting required under Section 404 of Sarbanes-Oxley, as well as other SOC reports. While independent testing of controls may form part of that basis, other control evaluation techniques may also be appropriate, such as continuous control monitoring. Given the comprehensive nature of an entity level examination, we encourage management to utilize the AICPA evaluation criteria (or other suitable criteria, see previous discussion) as the basis of its evaluation, and perform testing and other techniques covering a minimum of two control execution cycles to help ensure the controls are operating effectively.

Cybersecurity reporting
Frequently asked questions

Areas that may require remediation

- **Question** – the scope of these examinations will likely touch parts of the Company's control environment that have not been previously subjected to extensive evaluation and testing. Where would you recommend that we focus our initial assessment efforts to help ensure that adequate time is available to remediate any issues identified?
- **Response** – every organization will have unique challenges relating to the maturity of their control environment; factors affecting this maturity include the complexity of the Company's operations, the level of control standardization it has achieved, the use of third-party service providers to support key control/process areas, the extent of merger, acquisition and divesture activities, etc. However, the following are examples of key areas that will be covered within an examination that may require additional efforts to mature the program:
  - **Inventory of IT assets connected to the network and access points to the network** – The entity will be expected to have a comprehensive inventory of all IT assets that can connect to the enterprise network, along with processes for adding and retiring assets, monitoring for change activity that does not follow the standard process, monitoring of new software added to the system, etc. In addition, the entity will be expected to have complete and accurate records on the access points through which its network can be accessed.
  - **Incident management** – The entity will be expected to have a incident management program that includes comprehensive processes for monitoring, detecting and resolving detected incidents as appropriate.
  - **Vendor risk management** – The entity will be expected to have a comprehensive vendor risk management program in place to evaluate vendors (initially and on an ongoing periodic basis) that are provided system access and/or support the execution of key processes and controls within the cybersecurity risk management program. Unlike other SOC reports, a carve-out option is not available to exclude such vendors from the scope of the examination; accordingly, the entity must have appropriate controls in place to effectively evaluate and monitor the services provided.
  - **Threat & vulnerability management** – The entity will be expected to have a comprehensive threat and vulnerability management program in place to identify new threats and vulnerabilities that could impact the entity, evaluate their impact, and respond to the identified risks.

IRS

Safeguarding Taxpayer Data

A GUIDE FOR YOUR BUSINESS

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The Need to Safeguard Taxpayer Data

Today's identity thieves are a formidable enemy. They are an adaptive adversary, constantly learning and changing their tactics to circumvent the safeguards and filters put in place to stop them from committing their crimes. Some of the individuals committing identity theft refund fraud are members of high-tech global rings engaged in full-scale organized criminal enterprises for stealing identities and profiting from that information. As the criminals' efforts increase in sophistication, so do the number and scope of data breaches, which serves to further expand the network and warehousing of stolen and compromised identity information, and in turn increases the potential for that stolen identity information to ultimately reverberate through the tax system.

In 2015, the IRS called together major players in the tax industry—tax return preparers, software providers, state tax agencies, payroll providers and financial institutions—for a Security Summit to increase the cooperation in place to fight a common enemy—the identity thieves. Tax preparers are critical players in this partnership, and, because of the taxpayer information they store, increasingly a target for data theft.

Safeguarding taxpayer data is a top priority for the IRS. It is the legal responsibility of government, businesses, organizations, and individuals that receive, maintain, share, transmit or store taxpayers' personal information. Taxpayer data is defined as any information that is obtained or used in the preparation of a tax return (e.g., income statements, notes taken in a meeting, or recorded conversations). Putting safeguards in place to protect taxpayer information helps prevent fraud and identity theft and enhances customer confidence and trust.

This guide will help non-governmental businesses, organizations, and individuals that handle taxpayer data to understand and meet their responsibility to safeguard this information. IRS *e-file* and paper return preparers, Intermediate Service Providers, Software Developers, Electronic Return Originators, Reporting Agents, Transmitters, their affiliates, and service providers can use this guide to determine their data privacy and security needs and implement safeguards to meet them.

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These safeguards will help you:

- Preserve the confidentiality and privacy of taxpayer data by restricting access and disclosure;
- Protect the integrity of taxpayer data by preventing improper or unauthorized modification or destruction; and
- Maintain the availability of taxpayer data by providing timely and reliable access and data recovery.

For a brief description of related laws and regulations, refer to the table in “Safeguarding Taxpayer Data, References to Applicable Laws and Regulations.” For references to standards and best practices, refer to the table in “Safeguarding Taxpayer Data, References to Applicable Standards and Best Practices.”

As the criminals’ efforts increase in sophistication, so do the number and scope of data breaches, which serves to further expand the network and warehousing of stolen and compromised identity information, and in turn increases the potential for that stolen identity information to ultimately reverberate through the tax system.

It is critical that we work in partnership to combat identity theft. Major software providers are required to report data thefts to the IRS. We urge individual tax preparers to notify their local IRS Stakeholder Liaison of any data theft to lessen the impact on clients and the tax system.

Getting Started

If you handle taxpayer information, you may be subject to the Gramm-Leach Bliley Act (GLB Act) and the Federal Trade Commission (FTC) Financial Privacy and Safeguards Rules. Whether or not you are subject to the GLB Act and the FTC Rules, you could benefit from implementing the general processes and best practices outlined in FTC information privacy and safeguards guidelines.

Financial institutions as defined by FTC include professional tax preparers, data processors, their affiliates and service providers who are significantly engaged in providing financial products or services. They must take the following steps to protect taxpayer information. Other businesses, organizations and individuals handling taxpayer information should also follow these steps because they represent best practices for all.

- Take responsibility or assign an individual or individuals to be responsible for safeguards;
- Assess the risks to taxpayer information in your office, including your operations, physical environment, computer systems and employees, if applicable. Make a list of all the locations where you keep taxpayer information (computers, filing cabinets, bags, and boxes taxpayers may bring you);
- Write a plan of how you will safeguard taxpayer information. Put appropriate safeguards in place;
- Use only service providers who have policies in place to also maintain an adequate level of information protection defined by the Safeguards Rule; and
- Monitor, evaluate and adjust your security program as your business or circumstances change.

The FTC has fact sheets and guidelines on privacy and safeguards for businesses on their Web site at www.ftc.gov. In addition, you may seek outside professional help to assess your information security needs.

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To safeguard taxpayer information, you must determine the appropriate security controls for your environment based on the size, complexity, nature and scope of your activities. Security controls are the management, operational, and technical safeguards you may use to protect the confidentiality, integrity and availability of your customers' information. Examples of security controls are:

1. Locking doors to restrict access to paper or electronic files;
2. Requiring passwords to restrict access to computer files;
3. Encrypting electronically stored taxpayer data;
4. Keeping a backup of electronic data for recovery purposes;
5. Shredding paper containing taxpayer information before throwing it in the trash;
6. Do not email unencrypted sensitive personal information.

Further, Authorized IRS e-file Providers that participate in the role as an Online Provider must follow the IRS six security, privacy, and business standards to better serve taxpayers and protect their individual income tax information collected, processed, and stored. See "Safeguarding IRS *e-file*" in Publications 1345 for more information.

All Authorized IRS e-file Providers who own or operate a Web site through which taxpayer information is collected, transmitted, processed, or stored must register their Uniform Resource Locator (URL). See instructions for submitting the URL information.

For additional examples of security controls, refer to the National Institute of Standards and Technology (NIST) SP 800-53 publication listed in "Safeguarding Taxpayer Data, References to Applicable Standards and Best Practices."

Putting Safeguards in Place

The following checklist includes many activities that can be included in an information security program. It can help you put in place security procedures and controls to protect taxpayer information.

It is important to consider all the safeguards that are applicable to your business.

>

Checklist 1

Administrative Activities

ONGOING	DONE	N/A	
☐	☐	☐	Complete a Risk Assessment. Identify the risks and potential impacts of unauthorized access, use, disclosure, disruption, modification or destruction of information and information systems that can be used to access taxpayer data. How vulnerable is your customer's data to theft, disclosure, unauthorized alterations or unrecoverable loss? What can you do to reduce the impact to your customers and your business in such an event? What can you do to reduce vulnerability?
☐	☐	☐	Write and follow an Information Security Plan that:
☐	☐	☐	• Addresses every item identified in the risk assessment.
☐	☐	☐	• Defines safeguards you want affiliates and service providers to follow
☐	☐	☐	• Requires a responsible person to review and approve the Information Security Plan.
☐	☐	☐	• Requires a responsible person to monitor, revise, and test the Information Security Plan on a periodic (recommended annual) basis to address any system or business changes or problems identified.
☐	☐	☐	Periodically (recommended annually) perform a Self-Assessment to:
☐	☐	☐	• Evaluate and test the security plan and other safeguards you have in place.
☐	☐	☐	• Document information safeguards deficiencies. Create and execute a plan to address them.
☐	☐	☐	Retain a copy of the Self-Assessment and ensure it is available for any potential reviews.
☐	☐	☐	If required by the FTC Privacy Rule, provide privacy notices and practices to your customers.
☐	☐	☐	Specify in contracts with service providers the safeguards they must follow and monitor how they handle taxpayer information.
☐	☐	☐	Ask service providers to give you a copy of their written security policy on safeguarding information.

Checklist 2

Facilities Security

ONGOING	DONE	N/A	
☐	☐		Protect from unauthorized access and potential danger (e.g., theft, floods and tornados) all places where taxpayer information is located.
☐	☐		Write procedures that prevent unauthorized access and unauthorized processes.
☐	☐		Assure that taxpayer information, including data on hardware and media, is not left un-secured on desks or photocopiers, in mailboxes, vehicles, trash cans or rooms in the office or at home where unauthorized access can occur.
☐	☐		Authorize and control delivery and removal of all taxpayer information, including data on hardware and media.
☐	☐		Lock doors to file rooms and/or computer rooms.
☐	☐		Provide secure disposal of taxpayer information, such as shredders, burn boxes or temporary file areas until it can be securely disposed.

In 2015, the IRS called for a Security Summit to increase the cooperation in place to fight identity thieves.

Tax preparers are critical players in this effort, because of the taxpayer information they store, increasingly a target for data theft.

Checklist 3

Personnel Security

ONGOING	DONE	N/A	
☐	☐	☐	Create and distribute Rules of Behavior that describe responsibilities and expected behavior regarding computer information systems as well as paper records and usage of taxpayer data. Have all information system users complete, sign, and submit an acknowledgement that they have read, understood, and agree to comply with the rules of behavior. An example of rules of behavior can be found in Appendix A of NIST SP-800 18 *Guide for Developing Security Plans for Federal Information Systems*.
☐	☐	☐	Ensure personnel from third-party providers such as service bureaus, contractors, and other businesses providing information technology services meet the same security requirements as those applied to your personnel.
☐	☐	☐	Address Rules of Behavior for computer system management.
☐	☐	☐	When interviewing prospective personnel, explain the expected Rules of Behavior.
☐	☐	☐	When possible, perform a background and/or reference check on new employees who will have contact with taxpayer information. Conduct background screenings that are appropriate to the sensitivity of an assigned position.
☐	☐	☐	Screen personnel prior to granting access to any paper or electronic data. This will help ensure their suitability for a position requiring confidentiality and trust.
☐	☐	☐	Have personnel who will have access to taxpayer information sign nondisclosure agreements on the use of confidential taxpayer information.
☐	☐	☐	Develop and enforce formal compliance policies and processes, including possible disciplinary action, for all personnel who do not comply with the businesses' established information security policies and procedures.
☐	☐	☐	Terminate access to taxpayer information (e.g., login IDs and passwords) for those employees who are terminated or who no longer need access.
☐	☐	☐	For each employee who is terminated, conduct an exit interview and ensure the employee returns property that allows access to taxpayer information (e.g., laptops, media, keys, identification cards and building passes).
☐	☐	☐	Train staff on Rules of Behavior for access, non-disclosure and safeguards of taxpayer information. Provide refresher training periodically.

Checklist 4

Information Systems Security

ONGOING	DONE	N/A	
☐	☐		Information systems include both automated and manual systems made up of people, machines and/or methods for collecting, processing, transmitting, storing, archiving and distributing data. To help ensure the accuracy, validity, consistency and reliability of taxpayer data, you should manage taxpayer data information systems based on the guidelines below.
☐	☐		Grant access to taxpayer information systems only on a valid need-to-know basis that is determined by the individual's role within the business.
☐	☐		Put in place a written contingency plan to perform critical processing in the event that your business is disrupted. It should include a plan to protect both electronic and paper taxpayer information systems. Identify individuals who will recover and restore the system after disruption or failure.
☐	☐		Periodically test your contingency plan.
☐	☐	☐	Back up taxpayer data files regularly (e.g., daily or weekly) and store backup information at a secure location.
☐	☐	☐	Maintain hardware and software as needed and keep maintenance records.

Taxpayer data is defined as any information that is obtained or used in the preparation of a tax return (e.g., income statements, notes taken in a meeting, or recorded conversations).

Checklist 5

Computer Systems Security

ONGOING	DONE	N/A	
☐	☐	☐	Identify and authenticate computer system users who require access to electronic taxpayer information systems before granting them access.
			You can manage user identities by:
☐	☐	☐	• Identifying authorized users of electronic taxpayer information systems and grant specific access rights/privileges.
☐	☐	☐	• Assigning each user a unique identifier.
☐	☐	☐	• Verifying the identity of each user.
☐	☐	☐	• Disabling user identifiers after an organization-defined time period of inactivity.
☐	☐	☐	• Archiving user identities.
☐	☐	☐	Implement password management procedures that require strong passwords.
☐	☐	☐	Require periodic password changes.
☐	☐	☐	Disable and remove inactive user accounts.
☐	☐	☐	Protect electronic taxpayer information systems connected to the Internet with a barrier device (e.g., firewall, router or gateway). Any failure of these devices should not result in an unauthorized release of taxpayer data.
☐	☐	☐	When storing taxpayer information electronically, consider following best practices and store it on separate secure computers or media that are not connected to a network and that are password protected and encrypted.
☐	☐	☐	Encrypt taxpayer information when attached to email.
☐	☐	☐	Encrypt taxpayer information when transmitting across networks.
☐	☐	☐	Regularly update firewall, intrusion detection, anti-spyware, anti-adware, anti-virus software and security patches.
☐	☐	☐	Monitor computer systems for unauthorized access by reviewing system logs.
☐	☐	☐	Lock out computer system users after three consecutive invalid access attempts.
☐	☐	☐	Remove all taxpayer information once the retention period expires by using software designed to securely remove data from computers and media prior to disposing of hardware or media. The FTC Disposal Rule has information on how to dispose of sensitive data.
☐	☐	☐	As recommended by the FTC, reduce risks to computer systems by performing vulnerability scans and penetration tests periodically. You can learn more about this at the FTC Web site in their article "FTC Facts for Business – Security Check: Reducing Risks to Your Computer Systems."

Checklist 6

Media Security

ONGOING	DONE	N/A	
☐	☐	☐	Store computer disks, removable media, tapes, compact disks, flash drives, audio and video recordings of conversations and meetings with taxpayers, and paper documents in a secure location, cabinet, or container.
☐	☐	☐	Secure media storage areas, including rooms, cabinets, and computers by locks or key access. Where appropriate, employ an automated mechanism to ensure only authorized access.
☐	☐	☐	Restrict authorized access to media storage.
☐	☐	☐	Limit removal of taxpayer information to authorized persons and perform information access audits regularly.
☐	☐	☐	Securely remove all taxpayer information when disposing of computers, diskettes, magnetic tapes, hard drives, or any other electronic media that contain taxpayer information. The FTC Disposal Rule has information on how to dispose of sensitive data.
☐	☐	☐	Shred or burn paper documents before discarding them.

It is critical that we work in partnership to combat identity theft. Major software providers are required to report data thefts to the IRS.

Checklist 7

Certifying Information Systems For Use

ONGOING	DONE	N/A	
☐	☐	☐	Determine if risks are acceptable to certify systems for use.
☐	☐		Sign an authority to operate.
			If you use a certified independent certification company, consider the following:
☐	☐		• On a periodic (recommended annual) basis, have an independent individual or business with relevant security expertise, evaluate the security plans, controls, and any other safeguards implemented in your business against best practices.
☐	☐		• Have a report generated from the audit that certifies that your business follows best practices.
☐	☐		• Ensure the report highlights any deficiencies and provides recommendations for their correction.
☐	☐		• Develop a plan for your business to correct any deficiencies found and to ensure that the plan is successfully executed.
☐	☐		• Retain a copy of the audit report to ensure it is available for any potential reviews.
☐	☐		• Be prepared to show how you mitigate risks.

Reporting Incidents

Safeguarding personally identifiable taxpayer information is of critical importance to retaining the confidence and trust of taxpayers. Appropriately handling information security incidents is also very important to retaining the confidence and trust of taxpayers.

An information security incident is an adverse event or threat of an event that can result in an unauthorized disclosure, misuse, modification or destruction of taxpayer information. If you believe an information security incident has occurred that affects the confidentiality, integrity, or availability of taxpayer data or the ability for the taxpayer to prepare or file a return, you may need to report the incident. The following table includes examples of types of incidents.

INCIDENT TYPE	DESCRIPTION
Theft	Unauthorized removal of computers, data/records on computer media or paper files.
Loss/Accident	Accidental misplacement or loss of computers, data/records on computer media or paper files.
Unauthorized Access	A person or computer gains logical or physical access without permission to a network, system, application, data, or other resource.
Unauthorized Disclosure/ Usage	A person violates disclosure or use policies such asIRC sections 6713 & 7216. See "Laws and Regulations" for information on IRC sections 6713 & 7216.
Computer System/ Network Attack	A virus, worm, Trojan horse, or other code-based malicious entity infects a host and causes a problem such as disclosure of sensitive data or denial of services.

Recommended actions for incident reporting are as follows:

- Individuals (e.g., employees and contractors) who detect a situation that may be an information security incident should immediately inform the individual designated by the business to be responsible for handling customer information security.
- The individual responsible for handling customer information security should gather information about the suspected incident.
- If you believe the incident compromises a person's identity or their personal or financial information, we recommend you refer to the FTC document, Information Compromise and the Risk of Identity Theft: Guidance for Your Business. Among other things, this reference will help you determine when to notify local law enforcement, the Federal Bureau of Investigation, the U.S. Secret Service, the U.S. Postal Inspection Service, affected businesses, and customers. See the "Safeguarding Taxpayer Data, References to Applicable Standards and Best Practices" table for the Internet link to this FTC document.

Laws and Regulations

Many federal, state, city, and local government laws and regulations are in place to safeguard taxpayer data. The following table includes a brief description of some of them and provides references to more detailed information.

TYPE	SUMMARY OF APPLICABLE LAWS AND REGULATIONS
Federal/Privacy and Security	The *Gramm-Leach-Bliley Financial Modernization Act of 1999* – This statute (otherwise known as the Gramm-Leach-Bliley Act) (GLB Act), among other things, directed FTC to establish the Financial Privacy Rule and the Safeguards Rule.
Federal/Security	*FTC Standards for Safeguarding Customer Information Rule (16 CFR Part 314)* – This Rule (otherwise known as the Safeguards Rule) requires financial institutions, as defined, which includes professional tax preparers, data processors, affiliates, and service providers to ensure the security and confidentiality of customer records and information. It protects against any anticipated threats or hazards to the security or integrity of such records. In addition, it protects against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer. This Rule requires that financial institutions develop, implement and maintain an Information Security Program. The plan should be written in one or more accessible parts and contain administrative, technical, and physical safeguards that are appropriate to the business' size and complexity, nature and scope of activities, and sensitivity of customer information handled.
	Sarbanes-Oxley Act of 2002 (17 CFR Parts 232, 240 and 249) – Section 404 requirements apply to all Securities and Exchange Commission (SEC) reporting companies with a market capitalization in excess of $75 million. It requires companies to establish an infrastructure to protect and preserve records and data from destruction, loss, unauthorized alteration or other misuse. This infrastructure must ensure there is no room for unauthorized alteration of records vital to maintaining the integrity of the business processes.

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TYPE	SUMMARY OF APPLICABLE LAWS AND REGULATIONS
Federal/Privacy	*FTC Privacy of Consumer Financial Information Rule (16 CFR Part 313)* – This Rule (otherwise known as the Financial Privacy Rule) aims to protect the privacy of the consumer by requiring financial institutions, as defined, which includes professional tax preparers, data processors, affiliates, and service providers to give their customers privacy notices that explain the financial institution's information collection and sharing practices. In turn, customers have the right to limit some sharing of their information. Also, financial institutions and other companies that receive personal financial information from a financial institution may be limited in their ability to use that information. The FTC Privacy Rule implements sections 501 and 502(b)(2) of the GLB Act requirements.
	Title 26: Internal Revenue Code (IRC) § 301.7216.1 – This provision imposes criminal penalties on any person engaged in the business of preparing or providing services in connection with the preparation of tax returns who knowingly or recklessly makes unauthorized disclosures or uses of information furnished to them in connection with the preparation of an income tax return.
	Title 26: Internal Revenue Code (IRC) § 6713 – This provision imposes monetary penalties on the unauthorized disclosures or uses of taxpayer information by any person engaged in the business of preparing or providing services in connection with the preparation of tax returns.
	Internal Revenue Procedure 2007-40 – This procedure requires Authorized IRS e-file Providers to have security systems in place to prevent unauthorized access to taxpayer accounts and personal information by third parties. It also specifies that violations of the GLB Act and the implementing rules and regulations promulgated by the FTC, as well as violations of the non-disclosure rules contained in IRC sections 6713 and 7216 or the regulations promulgated there under are considered violations of Revenue Procedure 2007-40, and are subject to penalties or sanctions specified in the Revenue Procedure.
State/Privacy and Security	*State Laws* – Many state laws govern or relate to the privacy and security of financial data, which includes taxpayer data. They extend rights and remedies to consumers by requiring individuals and businesses that offer financial services to safeguard nonpublic personal information. For more information on state laws that your business must follow, consult state laws and regulations.

Standards and Best Practices

Federal and state governments as well as private industry provide many information security standards and best practice guidelines to safeguard consumer information such as personal tax data. The National Institute of Standards and Technology (NIST) provides security guidelines and practices for federal agencies that nongovernmental organizations may also use. Below is a list of references on a variety of information safeguard topics that can help you understand and comply with laws, regulations and best practices that may apply to your business.

TYPE	REFERENCES TO APPLICABLE STANDARDS AND BEST PRACTICES
Federal/Privacy	"Getting Noticed: Writing Effective Financial Privacy Notices"
	"Information Compromise and the Risk of Identity Theft: Guidance for Your Business"
Federal/Security	"FTC Facts for Business: Financial Institutions and Customer Information: Complying with the Safeguards Rule"
	FTC Disposal Rule (2005) – "FTC Business Alert: Disposing of Consumer Report Information? Rule Tells How"
	"Security Check: Reducing Risks to Your Computer Systems"
	NIST SP 800-18, Guide for Developing Security Plans for Federal Information Systems: Provides guidance on developing an Information Security Plan and includes a sample plan in Appendix A.
	NIST SP 800-53, Recommended Security Controls for Federal Information Systems and Organizations
	NIST SP 800-61 Revision 2, Computer Security Incident Handling Guide
	NIST SP 800-30 Revision 1, Guide for Conducting Risk Assessments
Private Industry/ Security	Industry Standards and Best Practices – Many private industry companies provide best practice advice on protecting information systems and safeguarding customer data. You can get more information on industry standards and best practice by researching the Internet and other resources.

Glossary

Adware
Computer advertising software that may or may not monitor computer use to target ads.

Authorized IRS e-file Provider
A business authorized by the IRS to participate in IRS e-file as an Electronic Return Originator, an Intermediate Service Provider, a Reporting Agent, a Software Developer, an Online Provider, or a Transmitter.

Confidentiality
Restrictions placed on information access and disclosure, including means for protecting personal privacy and proprietary information.

Denial of Service
An attack that prevents or impairs the authorized use of networks, systems or applications by exhausting resources.

Electronic Return Originator (ERO)
Authorized IRS e-file Provider that originates the electronic submission of returns to the IRS.

Encrypt
To convert plain text to unintelligible text using a cryptographic algorithm.

Identity Theft
Misuse of someone else's personal information to obtain new accounts or loans or commit other crimes.

Information Resources
Information and related resources, such as staffing, funding and information technology.

Information Security
The process that ensures the protection of information and information systems from unauthorized access, use, disclosure, disruption, modification or destruction.

Information System
A set of information resources designated for the organization of data for the collection, processing, maintenance, use, sharing, dissemination or disposition of information.

Information Technology
Equipment, system or subsystem of equipment that is used in the handling of data. Information technology includes computers, ancillary equipment, software, firmware and similar procedures, services (including support services) and related resources.

Integrity
The authenticity or unimpaired condition of information; including reliability for non-repudiation of origin.

Intermediate Service
Provider receives tax information from an ERO (or from a taxpayer who files electronically using a personal computer, modem, and commercial tax preparation software), processes the tax return information, and either forwards the information to a Transmitter or sends the information back to the ERO (or taxpayer for Online Filing).

Intrusion Detection
The act of detecting actions that attempt to compromise the confidentiality, integrity or availability of a resource.

IRS *e-file*
The brand name of the electronic filing method established by the IRS.

Management Safeguards
The security safeguards or countermeasures for an information system that focus on the management of risk and the management of information system security.

Non-repudiation
The process in which there is assurance that the sender of information is provided with proof of delivery and the recipient is provided with proof of the sender's identity for future validation purposes.

Online Provider
An Online Provider allows taxpayers to self-prepare returns by entering return data directly into commercially available software, software downloaded from an Internet site and prepared off-line, or through an online Internet site.

Operational Safeguards
Security for an information system that is primarily implemented and executed by people rather than by a system.

Reporting Agent
originates the electronic submission of certain returns for its clients and/or transmits the returns to the IRS. A Reporting Agent must be an accounting service, franchiser, bank, or other entity that complies with Rev. Proc. 2012-32, 2012-34 I.R.B. 267, and is authorized to perform one or more of the acts listed in Rev. Proc. 2012-32 on behalf of a taxpayer. Reporting Agents must submit Form 8655, Reporting Agent Authorization, to the IRS prior to or at the same time that they submit an IRS e-file Application.

Risk
The likelihood that the unwanted impact of an incident will be realized.

Risk Assessment
The process of identifying risks and determining the probability of occurrence, the resulting impact and additional security controls that would mitigate this impact.

Risk Management
The process of managing risks through risk assessment; cost-benefit analysis; the selection, implementation, and assessment of security controls; and the formal authorization to operate the system. The process includes consideration of effectiveness, efficiency and constraints due to laws, directives, policies, or regulations.

Safeguard
Protective measures prescribed to meet the security requirements specified for an information system. Safeguards may include security features, management constraints, personnel security and security of physical structures, areas, and devices.

Security Controls
Safeguards designed to protect the confidentiality, integrity and availability of a system and its information.

Security Plan
Formal document that provides an overview of the security requirements for the information system and describes the security controls in place or planned for meeting those requirements.

Security Requirements
Requirements that are derived from laws, policies, instructions, regulations or business (mission) needs to ensure the confidentiality, integrity and availability of the information being processed, stored or transmitted.

Service Provider
Any individual or business that maintains, processes, or is given access to customer information through the provisions of a service agreement with another individual or business.

Software Developer
develops software for the purposes of formatting electronic return information according to IRS *e-file* specifications and/or transmitting electronic return information directly to the IRS.

Spyware
Software installed into an information system to gather information on individuals or organizations without their knowledge.

Tax Preparer
Any person who is engaged in the business of preparing or assisting in preparing tax returns.

Technical Safeguards
Controls for a system that are primarily implemented and executed by the information system through mechanisms contained in the hardware, software or firmware components of the system.

Threat
Any circumstance or event with the potential to adversely impact operations, assets or individuals through an information system via unauthorized access, destruction, disclosure, modification of information and/or denial of service.

Transmitter
transmits electronic tax return information directly to the IRS. EROs and Reporting Agents may apply to be Transmitters and transmit return data themselves, or they may contract with accepted Third-Party Transmitters that will transmit the data for them. A Transmitter must have software and computers that allow it to interface with the IRS.

Trojan Horse
A computer program used to attack a computer system by secretly allowing, among other things, unauthorized access or alteration of data or software.

User
Individual or system process authorized to access an information system.

Virus
A computer program used to compromise a computer system by performing functions that may be destructive. A virus may alter other programs to include a copy of itself and execute when the host program or other executable component is executed.

Vulnerability
Weakness in a system through procedures, internal controls or implementation that could be exploited or triggered by a threat source.

Worm
A computer program used to compromise a computer system by impacting performance. A worm can travel from computer to computer across network connections replicating itself.

NOTE: The Internal Revenue Service prepared this guide as an outreach educational effort for all tax preparers, transmitters, and software developers. If you have any comments or suggestions for future updates, please send an e-mail to:

Safeguard.data.tp@irs.gov

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TAXES. SECURITY. TOGETHER.

The IRS, the states and the tax industry are committed to protecting you from identity theft. We've strengthened our partnership to fight a common enemy – the criminals – and to devote ourselves to a common goal – serving you. Working together, we've made many changes to combat identity theft, and we are making progress. However, cybercriminals are constantly evolving, and so must we. The IRS is working hand-in-hand with your state revenue officials, your tax software provider and your tax preparer. But, we need your help. We need you to join with us. By taking a few simple steps, you can better protect your personal and financial data online and at home.

Please consider these steps to protect yourselves from identity thieves:

Keep Your Computer Secure

- Use security software and make sure it updates automatically; essential tools include:
  - Firewall
  - Virus/malware protection
  - File encryption for sensitive data
- Treat your personal information like cash, don't leave it lying around
- Check out companies to find out who you're really dealing with
- Give personal information only over encrypted websites – look for "https" addresses.
- Use strong passwords and protect them
- Back up your files

Avoid Phishing and Malware

- Avoid phishing emails, texts or calls that appear to be from the IRS and companies you know and trust, go directly to their websites instead
- Don't open attachments in emails unless you know who sent it and what it is
- Download and install software only from websites you know and trust
- Use a pop-up blocker
- Talk to your family about safe computing

Protect Personal Information

Don't routinely carry your social security card or documents with your SSN. Do not overshare personal information on social media. Information about past addresses, a new car, a new home and your children help identity thieves pose as you. Keep old tax returns and tax records under lock and key or encrypted if electronic. Shred tax documents before trashing.

Avoid IRS Impersonators. The IRS will not call you with threats of jail or lawsuits. The IRS will not send you an unsolicited email suggesting you have a refund or that you need to update your account. The IRS will not request any sensitive information online. These are all scams, and they are persistent. Don't fall for them. Forward IRS-related scam emails to phishing@irs.gov. Report IRS-impersonation telephone calls at www.tigta.gov.

Additional steps:

- Check your credit report annually; check your bank and credit card statements often;
- Review your Social Security Administration records annually: Sign up for My Social Security at www.ssa.gov.
- If you are an identity theft victim whose tax account is affected, review www.irs.gov/identitytheft for details.

START WITH SECURITY

A GUIDE FOR BUSINESS

LESSONS LEARNED FROM FTC CASES

FEDERAL TRADE COMMISSION

START WITH SECURITY

1. Start with security.
2. Control access to data sensibly.
3. Require secure passwords and authentication.
4. Store sensitive personal information securely and protect it during transmission.
5. Segment your network and monitor who's trying to get in and out.
6. Secure remote access to your network.
7. Apply sound security practices when developing new products.
8. Make sure your service providers implement reasonable security measures.
9. Put procedures in place to keep your security current and address vulnerabilities that may arise.
10. Secure paper, physical media, and devices.

When managing your network, developing an app, or even organizing paper files, sound security is no accident. Companies that consider security from the start assess their options and make reasonable choices based on the nature of their business and the sensitivity of the information involved. Threats to data may transform over time, but the fundamentals of sound security remain constant. As the Federal Trade Commission outlined in *Protecting Personal Information: A Guide for Business,* you should know what personal information you have in your files and on your computers, and keep only what you need for your business. You should protect the information that you keep, and properly dispose of what you no longer need. And, of course, you should create a plan to respond to security incidents.

In addition to *Protecting Personal Information*, the FTC has resources to help you think through how those principles apply to your business. There's an online tutorial to help train your employees; publications to address particular data security challenges; and news releases, blog posts, and guidance to help you identify – and possibly prevent – pitfalls.

There's another source of information about keeping sensitive data secure: the lessons learned from the more than 50 law enforcement actions the FTC has announced so far. These are settlements – no findings have been made by a court – and the specifics of the orders apply just to those companies, of course. But learning about alleged lapses that led to law enforcement can help your company improve its practices. And most of these alleged practices involve basic, fundamental security missteps. Distilling the facts of those cases down to their essence, here are ten lessons to learn that touch on vulnerabilities that could affect your company, along with practical guidance on how to reduce the risks they pose.

1 Start with security.

From personal data on employment applications to network files with customers' credit card numbers, sensitive information pervades every part of many companies. Business executives often ask how to manage confidential information. Experts agree on the key first step: Start with security. Factor it into the decisionmaking in every department of your business – personnel, sales, accounting, information technology, etc. Collecting and maintaining information "just because" is no longer a sound business strategy. Savvy companies think through the implication of their data decisions. By making conscious choices about the kind of information you collect, how long you keep it, and who can access it, you can reduce the risk of a data compromise down the road. Of course, all of those decisions will depend on the nature of your business. Lessons from FTC cases illustrate the benefits of building security in from the start by going lean and mean in your data collection, retention, and use policies.

Don't collect personal information you don't need.

Here's a foundational principle to inform your initial decision-making: No one can steal what you don't have. When does your company ask people for sensitive information? Perhaps when they're registering online or setting up a new account. When was the last time you looked at that process to make sure you really need everything you ask for? That's the lesson to learn from a number of FTC cases. For example, the FTC's complaint against ***RockYou*** charged that the company collected lots of information during the site registration process, including the user's email address and email password. By collecting email passwords – not something the business needed – and then storing them in clear text, the FTC said the company created an unnecessary risk to people's email accounts. The business could have avoided that risk simply by not collecting sensitive information in the first place.

Hold on to information only as long as you have a legitimate business need.

Sometimes it's necessary to collect personal data as part of a transaction. But once the deal is done, it may be unwise to keep it. In the FTC's ***BJ's Wholesale Club*** case, the company collected customers' credit and debit card information to process transactions in its retail stores. But according to the complaint, it continued to store that data for up to 30 days – long after the sale was complete. Not only did that violate bank rules, but by holding on to the information without a legitimate business need, the FTC said BJ's Wholesale Club created an unreasonable risk. By exploiting other weaknesses in the company's security practices, hackers stole the account data and used it to make counterfeit credit and debit cards. The business could have limited its risk by securely disposing of the financial information once it no longer had a legitimate need for it.

Don’t use personal information when it’s not necessary.

You wouldn’t juggle with a Ming vase. Nor should businesses use personal information in contexts that create unnecessary risks. In the ***Accretive*** case, the FTC alleged that the company used real people’s personal information in employee training sessions, and then failed to remove the information from employees’ computers after the sessions were over. Similarly, in ***foru International***, the FTC charged that the company gave access to sensitive consumer data to service providers who were developing applications for the company. In both cases, the risk could have been avoided by using fictitious information for training or development purposes.

2 Control access to data sensibly.

Once you’ve decided you have a legitimate business need to hold on to sensitive data, take reasonable steps to keep it secure. You’ll want to keep it from the prying eyes of outsiders, of course, but what about your own employees? Not everyone on your staff needs unrestricted access to your network and the information stored on it. Put controls in place to make sure employees have access only on a “need to know” basis. For your network, consider steps such as separate user accounts to limit access to the places where personal data is stored or to control who can use particular databases. For paper files, external drives, disks, etc., an access control could be as simple as a locked file cabinet. When thinking about how to control access to sensitive information in your possession, consider these lessons from FTC cases.

Restrict access to sensitive data.

If employees don’t have to use personal information as part of their job, there’s no need for them to have access to it. For example, in ***Goal Financial***, the FTC alleged that the company failed to restrict employee access to personal information stored in paper files and on its network. As a result, a group of employees transferred more than 7,000 consumer files containing sensitive information to third parties without authorization. The company could have prevented that misstep by implementing proper controls and ensuring that only authorized employees with a business need had access to people’s personal information.

Limit administrative access.

Administrative access, which allows a user to make system-wide changes to your system, should be limited to the employees tasked to do that job. In its action against ***Twitter***, for example, the FTC alleged that the company granted almost all of its employees administrative control over Twitter's system, including the ability to reset user account passwords, view users' nonpublic tweets, and send tweets on users' behalf. According to the complaint, by providing administrative access to just about everybody in-house, Twitter increased the risk that a compromise of any of its employees' credentials could result in a serious breach. How could the company have reduced that risk? By ensuring that employees' access to the system's administrative controls was tailored to their job needs.

3 Require secure passwords and authentication.

If you have personal information stored on your network, strong authentication procedures – including sensible password "hygiene" – can help ensure that only authorized individuals can access the data. When developing your company's policies, here are tips to take from FTC cases.

Insist on complex and unique passwords.

"Passwords" like 121212 or qwerty aren't much better than no passwords at all. That's why it's wise to give some thought to the password standards you implement. In the ***Twitter*** case, for example, the company let employees use common dictionary words as administrative passwords, as well as passwords they were already using for other accounts. According to the FTC, those lax practices left Twitter's system vulnerable to hackers who used password-guessing tools, or tried passwords stolen from other services in the hope that Twitter employees used the same password to access the company's system. Twitter could have limited those risks by implementing a more secure password system – for example, by requiring employees to choose complex passwords and training them not to use the same or similar passwords for both business and personal accounts.

Store passwords securely.

Don't make it easy for interlopers to access passwords. In ***Guidance Software***, the FTC alleged that the company stored network user credentials in clear, readable text that helped a hacker access customer credit card information on the network. Similarly, in ***Reed Elsevier***, the FTC charged that the business allowed customers to store user credentials in a vulnerable format in cookies on their computers. In ***Twitter***, too, the FTC said the company failed to establish policies that prohibited employees from storing administrative passwords in plain text in personal email accounts. In each of those cases, the risks could have been reduced if the companies had policies and procedures in place to store credentials securely. Businesses also may want to consider other protections – two-factor authentication, for example – that can help protect against password compromises.

Guard against brute force attacks.

Remember that adage about an infinite number of monkeys at an infinite number of typewriters? Hackers use automated programs that perform a similar function. These brute force attacks work by typing endless combinations of characters until hackers luck into someone's password. In the ***Lookout Services***, ***Twitter***, and ***Reed Elsevier*** cases, the FTC alleged that the businesses didn't suspend or disable user credentials after a certain number of unsuccessful login attempts. By not adequately restricting the number of tries, the companies placed their networks at risk. Implementing a policy to suspend or disable accounts after repeated login attempts would have helped to eliminate that risk.

Protect against authentication bypass.

Locking the front door doesn't offer much protection if the back door is left open. In ***Lookout Services***, the FTC charged that the company failed to adequately test its web application for widely-known security flaws, including one called "predictable resource location." As a result, a hacker could easily predict patterns and manipulate URLs to bypass the web app's authentication screen and gain unauthorized access to the company's databases. The company could have improved the security of its authentication mechanism by testing for common vulnerabilities.

4 Store sensitive personal information securely and protect it during transmission.

For many companies, storing sensitive data is a business necessity. And even if you take appropriate steps to secure your network, sometimes you have to send that data elsewhere. Use strong cryptography to secure confidential material during storage and transmission. The method will depend on the types of information your business collects, how you collect it, and how you process it. Given the nature of your business, some possibilities may include Transport Layer Security/Secure Sockets Layer (TLS/SSL) encryption, data-at-rest encryption, or an iterative cryptographic hash. But regardless of the method, it's only as good as the personnel who implement it. Make sure the people you designate to do that job understand how your company uses sensitive data and have the know-how to determine what's appropriate for each situation. With that in mind, here are a few lessons from FTC cases to consider when securing sensitive information during storage and transmission.

Keep sensitive information secure throughout its lifecycle.

Data doesn't stay in one place. That's why it's important to consider security at all stages, if transmitting information is a necessity for your business. In ***Superior Mortgage Corporation***, for example, the FTC alleged that the company used SSL encryption to secure the transmission of sensitive personal information between the customer's web browser and the business's website server. But once the information reached the server, the company's service provider decrypted it and emailed it in clear, readable text to the company's headquarters and branch offices. That risk could have been prevented by ensuring the data was secure throughout its lifecycle, and not just during the initial transmission.

Use industry-tested and accepted methods.

When considering what technical standards to follow, keep in mind that experts already may have developed effective standards that can apply to your business. Savvy companies don't start from scratch when it isn't necessary. Instead, they take advantage of that collected wisdom. The ***ValueClick*** case illustrates that principle. According to the FTC, the company stored sensitive customer information collected through its e-commerce sites in a database that used a non-standard, proprietary form of encryption. Unlike widely-accepted encryption algorithms that are extensively tested, the complaint charged that ValueClick's method used a simple alphabetic substitution system subject to significant vulnerabilities. The company could have avoided those weaknesses by using tried-and-true industry-tested and accepted methods for securing data.

Ensure proper configuration.

Encryption – even strong methods – won't protect your users if you don't configure it properly. That's one message businesses can take from the FTC's actions against ***Fandango*** and ***Credit Karma***. In those cases, the FTC alleged that the companies used SSL encryption in their mobile apps, but turned off a critical process known as SSL certificate validation without implementing other compensating security measures. That made the apps vulnerable to man-in-the-middle attacks, which could allow hackers to decrypt sensitive information the apps transmitted. Those risks could have been prevented if the companies' implementations of SSL had been properly configured.

5 Segment your network and monitor who's trying to get in and out.

When designing your network, consider using tools like firewalls to segment your network, thereby limiting access between computers on your network and between your computers and the internet. Another useful safeguard: intrusion detection and prevention tools to monitor your network for malicious activity. Here are some lessons from FTC cases to consider when designing your network.

Segment your network.

Not every computer in your system needs to be able to communicate with every other one. You can help protect particularly sensitive data by housing it in a separate secure place on your network. That's a lesson from the ***DSW*** case. The FTC alleged that the company didn't sufficiently limit computers from one in-store network from connecting to computers on other in-store and corporate networks. As a result, hackers could use one in-store network to connect to, and access personal information on, other in-store and corporate networks. The company could have reduced that risk by sufficiently segmenting its network.

Monitor activity on your network.

"Who's that knocking on my door?" That's what an effective intrusion detection tool asks when it detects unauthorized activity on your network. In the ***Dave & Buster's*** case, the FTC alleged that the company didn't use an intrusion detection system and didn't monitor system logs for suspicious activity. The FTC says something similar happened in ***Cardsystem Solutions***. The business didn't use sufficient measures to detect unauthorized access to its network. Hackers exploited weaknesses, installing programs on the company's network that collected stored sensitive data and sent it outside the network every four days. In each of these cases, the businesses could have reduced the risk of a data compromise or its breadth by using tools to monitor activity on their networks.

6 Secure remote access to your network.

Business doesn't just happen in the office. While a mobile workforce can increase productivity, it also can pose new security challenges. If you give employees, clients, or service providers remote access to your network, have you taken steps to secure those access points? FTC cases suggest some factors to consider when developing your remote access policies.

Ensure endpoint security.

Just as a chain is only as strong as its weakest link, your network security is only as strong as the weakest security on a computer with remote access to it. That's the message of FTC cases in which companies failed to ensure that computers with remote access to their networks had appropriate endpoint security. For example, in ***Premier Capital Lending***, the company allegedly activated a remote login account for a business client to obtain consumer reports, without first assessing the business's security. When hackers accessed the client's system, they stole its remote login credentials and used them to grab consumers' personal information. According to the complaint in ***Settlement One***, the business allowed clients that didn't have basic security measures, like firewalls and updated antivirus software, to access consumer reports through its online portal. And in ***Lifelock***, the FTC charged that the company failed to install antivirus programs on the computers that employees used to remotely access its network. These businesses could have reduced those risks by securing computers that had remote access to their networks.

Put sensible access limits in place.

Not everyone who might occasionally need to get on your network should have an all-access, backstage pass. That's why it's wise to limit access to what's needed to get the job done. In the ***Dave & Buster's*** case, for example, the FTC charged that the company failed to adequately restrict third-party access to its network. By exploiting security weaknesses in the third-party company's system, an intruder allegedly connected to the network numerous times and intercepted personal information. What could the company have done to reduce that risk? It could have placed limits on third-party access to its network – for example, by restricting connections to specified IP addresses or granting temporary, limited access.

7 Apply sound security practices when developing new products.

So you have a great new app or innovative software on the drawing board. Early in the development process, think through how customers will likely use the product. If they'll be storing or sending sensitive information, is your product up to the task of handling that data securely? Before going to market, consider the lessons from FTC cases involving product development, design, testing, and roll-out.

Train your engineers in secure coding.

Have you explained to your developers the need to keep security at the forefront? In cases like ***MTS***, ***HTC America***, and ***TRENDnet***, the FTC alleged that the companies failed to train their employees in secure coding practices. The upshot: questionable design decisions, including the introduction of vulnerabilities into the software. For example, according to the complaint in ***HTC America***, the company failed to implement readily available secure communications mechanisms in the logging applications it pre-installed on its mobile devices. As a result, malicious third-party apps could communicate with the logging applications, placing consumers' text messages, location data, and other sensitive information at risk. The company could have reduced the risk of vulnerabilities like that by adequately training its engineers in secure coding practices.

Follow platform guidelines for security.

When it comes to security, there may not be a need to reinvent the wheel. Sometimes the wisest course is to listen to the experts. In actions against ***HTC America***, ***Fandango***, and ***Credit Karma***, the FTC alleged that the companies failed to follow explicit platform guidelines about secure development practices. For example, Fandango and Credit Karma turned off a critical process known as SSL certificate validation in their mobile apps, leaving the sensitive information consumers transmitted through those apps open to interception through man-in-the-middle attacks. The companies could have prevented this vulnerability by following the iOS and Android guidelines for developers, which explicitly warn against turning off SSL certificate validation.

Verify that privacy and security features work.

If your software offers a privacy or security feature, verify that the feature works as advertised. In ***TRENDnet***, for example, the FTC charged that the company failed to test that an option to make a consumer's camera feed private would, in fact, restrict access to that feed. As a result, hundreds of "private" camera feeds were publicly available. Similarly, in ***Snapchat***, the company advertised that messages would "disappear forever," but the FTC says it failed to ensure the accuracy of that claim. Among other things, the app saved video files to a location outside of the app's sandbox, making it easy to recover the video files with common file browsing tools. The lesson for other companies: When offering privacy and security features, ensure that your product lives up to your advertising claims.

Test for common vulnerabilities.

There is no way to anticipate every threat, but some vulnerabilities are commonly known and reasonably foreseeable. In more than a dozen FTC cases, businesses failed to adequately assess their applications for well-known vulnerabilities. For example, in the ***Guess?*** case, the FTC alleged that the business failed to assess whether its web application was vulnerable to Structured Query Language (SQL) injection attacks. As a result, hackers were able to use SQL attacks to gain access to databases with consumers' credit card information. That's a risk that could have been avoided by testing for commonly-known vulnerabilities, like those identified by the Open Web Application Security Project (OWASP).

8 Make sure your service providers implement reasonable security measures.

When it comes to security, keep a watchful eye on your service providers – for example, companies you hire to process personal information collected from customers or to develop apps. Before hiring someone, be candid about your security expectations. Take reasonable steps to select providers able to implement appropriate security measures and monitor that they're meeting your requirements. FTC cases offer advice on what to consider when hiring and overseeing service providers.

Put it in writing.

Insist that appropriate security standards are part of your contracts. In ***GMR Transcription***, for example, the FTC alleged that the company hired service providers to transcribe sensitive audio files, but failed to require the service provider to take reasonable security measures. As a result, the files – many containing highly confidential health-related information – were widely exposed on the internet. For starters, the business could have included contract provisions that required service providers to adopt reasonable security precautions – for example, encryption.

Verify compliance.

Security can't be a "take our word for it" thing. Including security expectations in contracts with service providers is an important first step, but it's also important to build oversight into the process. The ***Upromise*** case illustrates that point. There, the company hired a service provider to develop a browser toolbar. Upromise claimed that the toolbar, which collected consumers' browsing information to provide personalized offers, would use a filter to "remove any personally identifiable information" before transmission. But, according to the FTC, Upromise failed to verify that the service provider had implemented the information collection program in a manner consistent with Upromise's privacy and security policies and the terms in the contract designed to protect consumer information. As a result, the toolbar collected sensitive personal information – including financial account numbers and security codes from secure web pages – and transmitted it in clear text. How could the company have reduced that risk? By asking questions and following up with the service provider during the development process.

9 Put procedures in place to keep your security current and address vulnerabilities that may arise.

Securing your software and networks isn't a one-and-done deal. It's an ongoing process that requires you to keep your guard up. If you use third-party software on your networks, or you include third-party software libraries in your applications, apply updates as they're issued. If you develop your own software, how will people let you know if they spot a vulnerability, and how will you make things right? FTC cases offer points to consider in thinking through vulnerability management.

Update and patch third-party software.

Outdated software undermines security. The solution is to update it regularly and implement third-party patches. In the ***TJX Companies*** case, for example, the FTC alleged that the company didn't update its anti-virus software, increasing the risk that hackers could exploit known vulnerabilities or overcome the business's defenses. Depending on the complexity of your network or software, you may need to prioritize patches by severity; nonetheless, having a reasonable process in place to update and patch third-party software is an important step to reducing the risk of a compromise.

Heed credible security warnings and move quickly to fix them.

When vulnerabilities come to your attention, listen carefully and then get a move on. In the ***HTC America*** case, the FTC charged that the company didn't have a process for receiving and addressing reports about security vulnerabilities. HTC's alleged delay in responding to warnings meant that the vulnerabilities found their way onto even more devices across multiple operating system versions. Sometimes, companies receive security alerts, but they get lost in the shuffle. In ***Fandango***, for example, the company relied on its general customer service system to respond to warnings about security risks. According to the complaint, when a researcher contacted the business about a vulnerability, the system incorrectly categorized the report as a password reset request, sent an automated response, and marked the message as "resolved" without flagging it for further review. As a result, Fandango didn't learn about the vulnerability until FTC staff contacted the company. The lesson for other businesses? Have an effective process in place to receive and address security vulnerability reports. Consider a clearly publicized and effective channel (for example, a dedicated email address like security@yourcompany.com) for receiving reports and flagging them for your security staff.

10 Secure paper, physical media, and devices.

Network security is a critical consideration, but many of the same lessons apply to paperwork and physical media like hard drives, laptops, flash drives, and disks. FTC cases offer some things to consider when evaluating physical security at your business.

Securely store sensitive files.

If it's necessary to retain important paperwork, take steps to keep it secure. In the ***Gregory Navone*** case, the FTC alleged that the defendant maintained sensitive consumer information, collected by his former businesses, in boxes in his garage. In ***Lifelock***, the complaint charged that the company left faxed documents that included consumers' personal information in an open and easily accessible area. In each case, the business could have reduced the risk to their customers by implementing policies to store documents securely.

Protect devices that process personal information.

Securing information stored on your network won't protect your customers if the data has already been stolen through the device that collects it. In the 2007 ***Dollar Tree*** investigation, FTC staff said that the business's PIN entry devices were vulnerable to tampering and theft. As a result, unauthorized persons could capture consumer's payment card data, including the magnetic stripe data and PIN, through an attack known as "PED skimming." Given the novelty of this type of attack at the time, and a number of other factors, staff closed the investigation. However, attacks targeting point-of-sale devices are now common and well-known, and businesses should take reasonable steps to protect such devices from compromise.

Keep safety standards in place when data is en route.

Savvy businesses understand the importance of securing sensitive information when it's outside the office. In ***Accretive***, for example, the FTC alleged that an employee left a laptop containing more than 600 files, with 20 million pieces of information related to 23,000 patients, in the locked passenger compartment of a car, which was then stolen. The ***CBR Systems*** case concerned alleged unencrypted backup tapes, a laptop, and an external hard drive – all of which contained sensitive information – that were lifted from an employee's car. In each case, the business could have reduced the risk to consumers' personal information by implementing reasonable security policies when data is en route. For example, when sending files, drives, disks, etc., use a mailing method that lets you track where the package is. Limit the instances when employees need to be out and about with sensitive data in their possession. But when there's a legitimate business need to travel with confidential information, employees should keep it out of sight and under lock and key whenever possible.

Dispose of sensitive data securely.

Paperwork or equipment you no longer need may look like trash, but it's treasure to identity thieves if it includes personal information about consumers or employees. For example, according to the FTC complaints in ***Rite Aid*** and ***CVS Caremark***, the companies tossed sensitive personal information – like prescriptions – in dumpsters. In ***Goal Financial***, the FTC alleged that an employee sold surplus hard drives that contained the sensitive personal information of approximately 34,000 customers in clear text. The companies could have prevented the risk to consumers' personal information by shredding, burning, or pulverizing documents to make them unreadable and by using available technology to wipe devices that aren't in use.

Looking for more information?

The FTC's Business Center (**business.ftc.gov**) has a Data Security section with an up-to-date listing of relevant cases and other free resources.

About the FTC

The FTC works for the consumer to prevent fraudulent, deceptive, and unfair practices in the marketplace. The Business Center gives you and your business tools to understand and comply with the law. Regardless of the size of your organization or the industry you're in, knowing – and fulfilling – your compliance responsibilities is smart, sound business. Visit the Business Center at **business.ftc.gov**.

Your Opportunity to Comment

The National Small Business Ombudsman and 10 Regional Fairness Boards collect comments from small businesses about federal compliance and enforcement activities. Each year, the Ombudsman evaluates the conduct of these activities and rates each agency's responsiveness to small businesses. Small businesses can comment to the Ombudsman without fear of reprisal. To comment, call toll-free 1-888-REGFAIR (1-888-734-3247) or go to **sba.gov/ombudsman.**

Federal Trade Commission
business.ftc.gov
June 2015

Selected Issues in Tax Accounting Methods and Tax Reform

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Denver Tax Institute

July 23, 2018

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Notice

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

Tax Reform: Bonus Depreciation Overview

- **Expands** bonus depreciation to include:
  - Purchases of used property
  - Certain qualified films and theatrical productions
- **Restricts** bonus depreciation to exclude:
  - Property used in utilities
  - Trades or businesses that have floor plan financing indebtedness
- Repeals the election to accelerate AMT credits in lieu of bonus depreciation
- A special rule allows taxpayers to elect 50% bonus

Tax Reform: Bonus Depreciation

For property acquired on or after September 28, 2017 and placed in service on or after:

Placed in Service Date	General Rule	Longer Production Period Property
September 28, 2017 – December 31, 2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent

Tax Reform: Bonus Depreciation

For property acquired before September 28, 2017 and placed in service on or after:

Placed in Service Date	General Rule	Longer Production Period Property
September 28, 2017 – December 31, 2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent

Tax Reform: Real Property Depreciation

- Electing real property trades or businesses depreciation must apply alternative depreciation system ("ADS") to real property
  - Businesses that elect to not have the interest limitation apply
  - Means longer recovery period and no bonus depreciation
- The ADS recovery period for residential rental property is shortened from 40 years to 30 years
- Eliminates qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant improvement property

Tax Reform: Qualified Improvement Property

- Consolidation of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property into one definition of “qualified improvement property”
  - All three were eligible for 15-year recovery periods under prior law
  - Statute fails to designate new QIP for 15-year life, which means it falls under default recovery period of 39 years and **not** eligible for full expensing
  - Legislative history states that qualified improvement property ("QIP") recovery period reduced from 39 years to 15 years; however, this does not appear in the statutory text
  - Without Technical Corrections, government announced at ABA there is **no** correction/remedy for taxpayers

Tax Reform: Qualified Improvement Property

- Particularly impactful to retail/restaurant industry which operates on Jan. 31 or March 31 year-ends
  - Faced with unexpectedly less-generous tax treatment and likelihood of amending their annual filings once (if) the law is fixed
- Important to consider company’s overall position
  - Many new and growing companies operate from a loss position and certain capital intensive companies are in a loss position since taking advantage of bonus depreciation since 2001
  - Further complicated by repeal of NOL carrybacks

Tax Reform: Section 179 Expensing

Section 179 Expensing

- Increased limit to $1 million for five years with a $2.5 million phase-out threshold, both indexed for inflation in future years
- Expanded to include
  - Qualified improvement property
  - Improvements to non-residential roofs, HVAC, fire protection and alarm systems, and security systems placed in service after the date the non-residential property was first placed in service
  - Personal property used predominantly to furnish lodging or in connection with furnishing lodging

Interest Deductibility

- Disallows a deduction for net business interest expense in excess of 30 percent of a business' adjusted taxable income (ATI), plus floor plan financing interest
- ATI is generally taxable income not including the following:
  - any income, deduction, gain, or loss not properly allocable to a trade or business;
  - business interest income and expense;
  - any net operating loss deduction;
  - the new "qualified business income deduction" (i.e., the 20 percent deduction for certain pass-through income under new section 199A); and
  - for tax years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization, or depletion
- For years beginning after 2017 and before 2022, ATI approximates EBITDA
- After 2021, will approximate EBIT

New Section 451(b) for Income

- Under new section 451(b), income recognized when:
  - All events have occurred that fix the right to receive the income, AND
  - The amount can be determined with reasonable accuracy
  - But not later than the year in which revenue is recognized for financial reporting purposes "applicable financial statement"
- The test now translates to the earliest of when received, due, earned, or recognized for financial reporting purposes
- The law also requires allocating transaction price among discrete performance obligations consistently with allocation for book purposes
- Does not revise the rules associated with when an amount is "realized" for Federal income tax purposes (e.g., sale vs. lease, mark-to-market vs. realize upon sale)
- Does not override special methods of accounting

New Section 451(c) for Advance Payments

- Codifies the deferral method in Rev. Proc. 2004-34
- Obsoletes two year deferral Treas. Reg. section 1.451-5
- See also Notice 2018-35

Small Business Tax Reform

- Expansion of section 179 expensing
- Small business accounting method reform and simplification
  - Section 263A (uniform capitalization)
  - Section 448 (cash versus accrual method)
  - Section 460 (accounting for long-term contracts)
  - Section 471 (accounting for inventories)
- Modification of treatment of S corporation conversions to C corporations

Tax Reform: R&E Expenses

Research & experimentation (R&E) expenses
• Not effective until costs paid or incurred in tax years beginning after Dec. 31, 2021 • Repeals current expensing under Section 174(a) and deferral under Section 174(b) • Costs are required to be capitalized and amortized over five years beginning with the midpoint of the year in which they are incurred • Foreign R&E required to be capitalized and amortized over fifteen years • Software development is included as an R&E expenditure

Tax Reform: Changes to NOL Provisions

- Deductibility of a taxpayer's NOLs is limited to 80% of the taxpayer's taxable income
- All NOL carrybacks are eliminated, except for two-year carrybacks for farms and certain casualty and disaster insurance companies
- 80% limitation applies to losses arising in taxable years <u>beginning after December 31, 2017</u>
- Elimination of NOL carrybacks applies to losses arising in taxable years <u>ending after 12/31/17</u>
  - Conference Agreement states that the new NOL carryback rules apply to losses arising in taxable years <u>beginning after 12/31/17</u>
  - This disparity between Conference Agreement and the statute could negatively impact fiscal year taxpayers

Tax Reform: Changes to NOL Provisions (cont'd)

- Taxpayers should fully evaluate any NOLs currently captured on their balance sheets as deferred tax assets and pay attention to the timing of such losses because the changes vary depending on the type and timing of such losses
- Although NOLs may be carried forward, with the new 20% haircut, NOLs are relatively more valuable currently than they will be in future years

Tax Reform: Elimination of Section 199 Deduction

- Repeals the deduction for domestic production activities provided in section 199 for taxable years beginning after December 31, 2017.
- Section 199 allows taxpayers to claim a deduction equal to 9% of qualified production activities income.
- Although 21% reduced corporate rate is suggested to provide a larger benefit, companies that historically took advantage of this provision should evaluate domestic production.
- Section 199 may be claimed for any open years beginning before January 1, 2018, which means that TPs within the scope of the provision should consider filing amended returns to take full advantage of the provision.

Reduction in Corporate Tax Rate

- Corporate tax rate 21 percent effective for tax years beginning after 12-31-17
- Fiscal year taxpayer - blended rate under section 15; see Notice 2018-38
- Accelerate deductions to, or deferral of income from, a lower rate year
  - Accounting method changes
  - Transactional planning
- Rate reduction indirectly enhances R&E benefit through operation of IRC §280C

Tax Reform: Key Considerations

- Maximize the time value of money by utilizing ordinary procedural tools to defer income and accelerate deductions
- Minimize exposure to risk while implementing TCJA absent guidance or technical corrections
- When decision-making is complicated by uncertainties in the new tax law, companies will want to engage in best practices to define and document their decision-making process to minimize future controversy
- Keep options open

Planning for 2017 Tax Returns

- Rate cut presents opportunity to turn timing differences like accounting methods into permanent tax savings
  - Still time to take advantage of changes in accounting methods for the 2017 tax returns
    - Defer revenue
    - Accelerate deductions
  - But not for CFCs
    - Notice 2018-26 states that for purposes of the one-time Code Sec. 965 tax liability, taxpayers must disregard any method change not filed before November 2, 2017, for a specified foreign corporation if the method change reduces the Code Sec. 965 tax liability for a year ending in 2017 or 2018
    - This rule applies irrespective of whether or not the change in method of accounting was made in accordance with the normal procedures described in Rev. Proc. 2015-13, or whether such change in the method of accounting was properly made

Fixed Asset Planning

- Depreciation automatic method change
- Cost segregation
- Can be filed even in final year of the taxpayer
- Repairs automatic method change
- If did not file the repairs change in past 5 years
- Certain fiscal year filers are still eligible for scope waiver
- Section 174 Prototypes automatic method change
- Develop custom machinery or equipment
- Alternative is to argue Rev. Rul. 58-74

Method Change Planning

- Deferral of advance payments under Rev. Proc. 2004-34
- Software development costs
- Prepaid expenses (e.g. insurance, software maintenance)
- Rebates – recurring item exception
- Certain inventory methods
- Taxes– Payroll, Real Property and Personal Property
- Self-insured medical expenses

Mandatory Repatriation under Section 965

- Subpart F income of a specified foreign corporation (SFC) for its last taxable year beginning before January 1, 2018 (inclusion year) is increased by the greater of its deferred foreign income as of November 2, 2017 or December 31, 2017.
- A US shareholder's mandatory income inclusion is taxed at the following rates:
  - Aggregate foreign cash position: 15.5 percent
  - Other deferred income: 8 percent
- Example:

Accumulated E&P subject to tax (subpart F inclusion):	$10,000		
Liquid assets taxed @ 15.5 percent:	$6,700	=	$1,039
Illiquid assets (residual portion of E&P) taxed @ 8 percent:	$3,300	=	$264
Tentative repatriation tax:		=	$1,303
Gross up @ highest 2017 corporate rate (35 percent)		=	$3,723
Deduction to subpart F inclusion ($10K less $3,723)		=	$6,277

Section 965 – Accounting Method Issues

- CFCs must convert E&P to U.S. GAAP and then to U.S. tax, including U.S. tax accounting methods. Section 964; Treas. Reg. §1.964-1
- Before Notice 2018-26, planning focused on accounting method issues that reduce the cash/cash equivalent portion of E&P rather than the non-cash portion, as cash and cash equivalent repatriations are proposed to be taxed at a higher rate.
- Notice 2018-26 limits the impact of tax accounting method changes in the mandatory repatriation context:

  The Treasury Department and the IRS also intend to issue regulations, pursuant to the grant of authority under section 965(o), providing that any change in method of accounting made for a taxable year of a specified foreign corporation that ends in 2017 or 2018 will be disregarded for purposes of determining the section 965 tax liability of a United States shareholder if such change in method of accounting would otherwise reduce the section 965 tax liability of such United States shareholder. The rule described in this section 3.04(b) will apply whether or not such change in method of accounting was made in accordance with the procedures described in Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (or successor), and whether or not such change in method of accounting was properly made. These regulations will not apply to a change in method of accounting for which the original and/or duplicate copy of any Form 3115, Application for Change in Accounting Method, requesting the change was filed before the specified date, November 2, 2017.

Base Erosion Anti-Abuse Tax (BEAT)

An addition to the regular tax liability for large taxpayers with a base erosion percentage of 3 percent or greater.

Regular taxable income	=	$100
Plus, base erosion payments	+	$130
Modified taxable income	=	$230
x 10 percent (5 percent in 2018)	=	$23
Regular taxable income	=	$100
Tax @ 21 percent (less $5 credits)	=	$16
Add back R&D and section 38 credits	=	$19

BEAT = $4 ($23 less $19)

BEAT – Accounting Method Issues

- Base erosion payments - amounts paid or accrued to a related foreign person that are deductible:
- Do not include COGS or reductions to gross receipts
  - Accounting method changes (Form 3115) may be required
  - Section 263A
  - Licensing costs (e.g., sales based royalties)
  - Reverse planning
- Include interest expense – interest disallowed under section 163(j) is allocated first to payments to unrelated persons
- Include payments for the acquisition of property that gives rise to a depreciation or amortization deduction (base erosion tax benefit based on cost recovery)
- Include payments that are subpart F income

Update:
Ethics for Tax Professionals

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Ethical Considerations for Tax Professionals

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Ethical Considerations for Tax Professionals

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

Agenda

- Introduction – Tax Professionals & Ethical Dilemmas
- ABA Model Rules of Professional Conduct
- Some State Rules
- AICPA Statements on Standards for Tax Services
- Circular 230
- Return Preparer Penalties
- Attorney Client Privilege & Accountant Client Privilege
- Discussion of Hypothetical Situations

ABA Model Rules of Professional Conduct

ABA Model Rules of Professional Conduct

- Promulgated by the ABA – Revised 2009
- Adopted in Most States (including Colorado*)
- Addressed primarily to certain aspects of law practice (client-lawyer relationship, role as counselor and advocate, transactions with non-clients, public service, etc.)
- Some special rules for lawyers in law firms.

* With some differences

Model Rule 2.1

Independence. "[I]n representing a client, a lawyer shall exercise independent professional judgment and render candid advice."

What does this rule require?

Giving advice that the client may not want to hear.

Model Rule 1.6 – Confidentiality of Information

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 necessary to is permitted by paragraph (b).

Rule 1.6 (b) – Exceptions to Confidentiality

A lawyer may reveal information relating to the representation of a client:

1) to prevent death or substantial bodily harm;

(2) to prevent client from committing a crime or fraud that will result in substantial injury to the financial interests or property;

(3) to prevent injury to financial interests that will result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these rules;

(5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, or a criminal charge or civil claim against the lawyer based upon his conduct, or in any proceeding concerning the lawyer's representation;

(6) to comply with other law or court order;

(7) to detect and resolve conflicts of interest arising from the lawyer's change of employment.

Rule 1.7 – Conflict of Interest – Current Clients

General Rule: A lawyer shall not represent a client if the representation involves a concurrent conflict of interest.

Concurrent Conflict of Interest:

(1) the representation of one client will be directly adverse to another client's interest;

(2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client or a former client.

Waiver. But lawyer may continue the representation if : (1) the lawyer reasonably believes that he will be able to provide competent and diligent representation; (2) not prohibited by law; (3) does not involve assertion of claim by one client against the other in the same proceeding; and (4) informed consent is given in writing.

Rule 1.11 – Former & Current Government Officers & Employees

A lawyer who has formerly served as a public officer or employee of the government shall not represent a client in connection with a matter in which the lawyer participated personally and substantially as a public officer or employee, unless the appropriate government agency gives its informed consent, confirmed in writing.

But firm can invoke "Chinese Wall."

Rule 1.13 – Organization as Client

General Rule:

A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

Rule 1.13 – Continued

A lawyer for an organization who learns that an officer, employee or other person associated with the organization is engaged in an action, or is about to act, or refuses to take action that will result in a violation of a legal obligation to the organization or will result in harm to the organization, must proceed to act in the best interest of the organization.

Rule 1.13 – Continued

"Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law."

Rule 1.13 – Continued

(1) If despite the lawyer's best efforts, the highest authority that can act on behalf of the organization insists upon or fails to address in a timely or appropriate manner an action or refusal to act that is clearly a violation of the law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, THEN

the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure but only if and to the extent that the lawyer reasonably believes necessary to prevent substantial injury to the organization.

Rule 1.13 – Continued

The rule on the previous slide does not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

Rule 1.13(e) – Organization as Client

"A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organizations highest authority is informed of the lawyer's discharge or withdrawal."

Rule 1.13(f) – Organization as Client

"In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when the lawyer knows or reasonably knows or reasonably should know that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing."

Rule 1.13(g) – Organization as Client

"A lawyer representing an organization **may** also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7 [Conflict of Interest – Current Clients]. If the organization's consent to the **dual representation** is required by Rule 1.7, the consent shall be given by an appropriate official in the organization other than the individual who is to be represented, or by the shareholders." (Emphasis supplied)

RULES APPLICABLE TO TAX ADVISORS

MANY SOURCES BUT COMMON THEMES

Various Roles of the Tax Advisor

- Tax Preparation
- Tax Advice – Oral and Written
- Representation Before State Taxing Authority
- Representation Before the IRS
- Determining Necessity for Tax Reserve

Standards for Tax Positions

- Not Frivolous
- Reasonable Basis -- 20%?
- Realistic Possibility of Success -- 30%?
- Substantial Authority -- 40%?
- More Likely Than Not -- > 50%
- Should -- 70% - 80%?
- Will -- ≥ 90%

Rules/Codes Applicable to CPAs (in addition to the Federal Tax Rules)

AICPA Code of Professional Conduct

AICPA Statements on Standards for Tax Services

State Statutes and Regulations (e.g., New York Rules of the Board of Regents; Texas Admin. Code)

State Societies of CPAs (e.g., Colorado Society of CPAs, Texas Society of CPAs, New York State Society of CPAs, California Society of CPAs)

Colorado Statutes

- Colo. Rev. Stat. § 12-2-101 et seq. (2017) – Accountants
- See also 3 CCR 705.1 (CPAs)

AICPA Code of Professional Conduct

- Introduction
- Section 50 - Principles of Professional Conduct
- Section 90 - Rules: Applicability and Definitions
- Section 100 - Independence, Integrity and Objectivity
- Section 200 - General Standards Accounting Principles
- Section 300 - Responsibilities to Clients
- Section 400 - Responsibilities to Colleagues
- Section 500 - Other Responsibilities and Practices

AICPA

Statements on Standards for Tax Services

Statements on Standards for Tax Services - Statement No. 1 Tax Return Positions

- A member should not recommend a tax return position unless the member has a **good-faith belief** that the position has a **realistic possibility** of being sustained if challenged.
- Same rule for signing tax returns.
- But may recommend (and sign) if position is "not frivolous" and the issue is appropriately disclosed.
- Must advise regarding possible application of penalties.
- Members should not recommend a position or sign a return reflecting a position that exploits that audit selection process or serves as a mere arguing position advanced to obtain leverage.
- A member has both the right and responsibility to be an advocate for the taxpayer with respect to any position satisfying these standards.

Notes to Statement No. 1

- Statement No. 1 is applicable to any tax return, including state tax returns.
- If tax authority imposes higher standards, member must follow those higher standards. *See, e.g.*, Circular 230, § 10.34.
- A member has a responsibility to both the taxpayer and the tax system.
- Although a member should advise the taxpayer with respect to disclosure, it is the taxpayer's responsibility to decide whether and how to disclose.
- Defines tax return preparation to include giving advice directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of the return.

Statements on Standards for Tax Services No. 2 – Answers to Questions on Returns

"A member should make a reasonable effort to obtain from the taxpayer information necessary to provide appropriate answers to all questions on a tax return before signing as preparer."

Reasonable grounds for omitting an answer:

1) The information is not readily available and the answer is not significant.

2) Genuine uncertainty exists regarding the meaning of the question in relation to the particular return.

3) The answer to the question is voluminous; in such cases, a statement should be made on the return that the date will be supplied upon examination.

Statements on Standards for Tax Services No. 3 – Certain Procedural Aspects of Preparing Returns

In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or third parties.

If tax authority requires the maintenance of records or substantiation as a condition for deductibility, a member should make appropriate inquiries whether condition has been met.

When preparing a tax return, a member should consider information actually known to the member from another person's tax return if the information is relevant to that return and its consideration is necessary to properly prepare that tax return.

Statements on Standards for Tax Services No. 4 – Use of Estimates

"Unless prohibited by statute or rule, a member may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer's estimates should not be presented in a manner that does not imply greater accuracy than exists."

Commentary to Statement No. 4

Specific disclosure that an estimate is used for an item in the return is not generally required; however, such disclosure should be made in unusual circumstances where nondisclosure might mislead the taxing authority regarding the degree of accuracy of the return as a whole. Some examples of unusual circumstances include the following:

1) Taxpayer is dead or seriously ill at the time the return is filed.

2) Taxpayer has not received K-1 at the time return filed.

3) There is litigation pending that bears on the return.

4) Fire, computer failure, or natural disaster destroyed the relevant records.

Statements on Standards for Tax Services No. 5 – Departure from a Previous Position

Applies to positions determined in an administrative proceeding or in a court decision with respect to a prior return.

The tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different position in a later year's return unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement.

Notes to Statement No. 5

- Mere consent to a disposition of an item is not binding.
- Settlement concessions are not binding.
- Members can consider later court decisions, rulings, or other authorities decided subsequently
- But consent in an earlier administrative proceeding should be considered.

Statements on Standards for Tax Services No. 6 – Knowledge of Error – Return Preparation

- A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return. A member should recommend the corrective measures to be taken. Such recommendation may be given orally. A member is not allowed to inform the taxing authority without the taxpayer's permission, except when required by law.
- If "appropriate action not taken" and member is asked to prepare the next year's return, member should consider whether to withdraw from the engagement.
- It is the taxpayer's decision whether to correct the error.

Statements on Standards for Tax Services No. 6 – Knowledge of Error

- A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return or a taxpayer's failure to file a return.
- If error on return is discovered during an administrative proceeding, same rule applies regarding correcting the error.
- If a member is requested to prepare the current year's return and the taxpayer has not taken appropriate action to correct an error in a prior year's return, member should consider whether to withdraw from preparing the current year return.
- In an administrative proceeding, a member should request the taxpayer's agreement to disclose the error to the taxing authority and lacking such agreement, the member should consider whether to withdraw from representation.
- Explanatory notes talk about potential for conflict of interest if representation is continued.

Statements on Standards for Tax Services No. 7 – Form/Content of Advice to Taxpayers

- No particular format or guidelines but if the advice is in writing, member should comply with "relevant taxing authorities standards" applicable to written advice.
- A member should use judgment to ensure that tax advice provided to a taxpayer reflects professional competence and appropriately serves the taxpayer's needs.
- A member has no obligation to communicate with the taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided.

Circular 230

Title 31 Code of Federal Regulations, Subtitle A, Part 10 (June 2014)

Circular 230

- Regulates practice before the U.S. Treasury Department.
- Amended in February 1984 to provide standards for tax shelter opinions.
- On July 26, 2002, final regulations were issued incorporating non-tax shelter related matters.
- In December 2004, final regulations governing tax shelter advice issued – applicable to advice given after June 20, 2005.
- Revised in July 2011 to among other things require the Commissioner to establish the Office of Professional Responsibility and to require the registration of tax return preparers.
- Revised June 2014 – Substantially revised provisions relating to requirements for written tax advice. Eliminated provisions relating to covered opinions and limited scope opinions.

Office of Professional Responsibility

- Current Director – Stephen Whitlock
- Mission is to ensure all tax practitioners, tax preparers, and other third parties in the tax system adhere to professional standards and follow the law.
- Legal Analysis Branch: (1) investigates allegations of misconduct; (2) negotiates appropriate levels of discipline; (3) initiates disciplinary proceedings before Administrative Law Judges, when necessary.
- In 2017, beginning inventory of cases was 429; office received 1,641 new cases; closed 1,781. Ending inventory was 289.
- Actual disbarments or suspensions are rare. Most cases closed with soft closing letters, reprimands, negotiated agreements. Cases can be closed also “without action” and “without sanction.”

Circular 230 – § 10.21 Knowledge of Client’s Omission

A practitioner who, having been retained by a client with respect to a matter administered by the IRS, knows that the client has not complied with the U.S. revenue laws 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 and must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Question: Is there an affirmative duty to recommend that the client correct the noncompliance, error or omission?

Organization of Circular 230

- Subpart A – Rules Governing Authority to Practice
- Subpart B – Duties & Restrictions Relating to Practice Before the IRS
- Subpart C – Sanctions for Violations of the Regulations
- Subpart D – Rules Applicable to Disciplinary Proceedings
- Subpart E – General Provisions

Circular 230 - § 10.20 Information To be Furnished

In response to a proper and lawful request by a duly authorized officer or employee of the IRS, must "promptly" submit requested records or information unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

Must notify IRS if records are unavailable and must provide any information regarding the identity of any third party that may have possession or control of the requested information. But asking client is sufficient.

A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the IRS to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

Circular 230 – § 10.22 Diligence As To Accuracy

A practitioner must exercise "due diligence" in preparing or assisting in preparation of tax returns or other documents to be submitted to IRS.

Must also exercise due diligence in determining the correctness of oral or written representations made by practitioner to the Treasury Dept.

Practitioner generally can rely on the work product of other professionals.

Circular 230 – § 10.23 Prompt Disposition of Pending Matters

Prompt Disposition of Pending Matters –

A practitioner may not unreasonably delay the prompt disposition of any matter before the IRS

Circular 230 – § 10.27 Fees

- Practitioner may not charge an "unconscionable fee."
- Contingent fees are generally prohibited but may be charged in connection with:
  - The examination of or challenge to an original return or an amended return filed within 120 days of notice of examination with respect to original return
  - Services rendered in connection with a claim for credit or refund related to interest or penalties assessed by the IRS
  - Services rendered in connection with any judicial proceeding

Note: Contingent fees include fees payable only if the position avoids challenge by the IRS or is sustained after challenge; a fee based on a percentage of the taxes saved or the result attained; as well as a fee arrangement in which the practitioner agrees to reimburse all or a portion of a fee in the event that a position taken is challenged.

Circular 230 – § 10.29 Conflicting Interests

A practitioner shall not represent a client in his or her practice before the IRS if the representation involves a conflict of interest.

A conflict of interest exists if "the representation of one client will be directly adverse to another client" or "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."

Notwithstanding the existence of a conflict of interest, the practitioner may represent a client if the practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client, the representation is not prohibited by law; and each affected client waives the conflict of interest and gives informed consent confirmed in writing.

Circular 230 – § 10.33 Best Practices

Best Practices – Advisors should provide clients with the highest quality representation by adhering to best practices in providing advice and preparing or assisting with the preparation of IRS submissions. Best practices include:

1. Communicating clearly regarding terms of engagement including the scope of the engagement.

2. Establishing the relevant facts and evaluating the reasonableness of any assumptions or representations.

3. Arriving at a conclusion supported by both law and facts.

4. Advising the client regarding the import of the conclusions reached (for example, effect on § 6662 penalty).

5. Acting fairly and with integrity in practice before the IRS.

6. Professional Practice Partners – Must take reasonable steps to ensure that the firm's procedures are consistent with these best practices.

Circular 230 – § 10.34 Standards for Tax Returns & Other Documents

(a) Tax Returns

(1) A practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund that practitioner knows or reasonably should know contains a position that -

Lacks a reasonable basis.

Is an unreasonable position as described in § 6694(a)(2).

Is a willful attempt to understate the liability for tax or a reckless or intentional disregard of rules or regulations.

(2) Advise a client to take a position on a tax return or claim for refund that contains a position as described above.

Circular 230 – § 10.34 (Cont.)

(b) Regarding documents, affidavits and other papers:

(1) Practitioner may not advise a client to take a position on a document submitted to the IRS unless the position is not frivolous.

(2) A practitioner may not advise the client to submit a document to the IRS:

(a) the purpose of which is to delay or impede the administration of the Federal tax laws.

(b) that is frivolous.

(c) contains or omits information 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.

Circular 230 – § 10.34 (Cont.)

- Requires practitioner to inform client of penalties that are reasonably likely to apply to client with respect to position taken on return IF practitioner advised client with respect to the position or prepared or signed return. Rule also applies to other papers.
- Practitioner also must inform client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.
- Section also provides a rule that a practitioner advising a client to take a position on a tax return, document or affidavit or other paper to be submitted to the IRS, may rely in good faith without verification upon information furnished by the client. HOWEVER, practitioner may not ignore the implications of information furnished to, or actually known by, the practitioner, and must take reasonable inquiries if the information appears to be incorrect, inconsistent with an important fact or incomplete.

Circular 230 – § 10.37 Requirements for Written Advice

- Must not be based on unreasonable factual or legal assumptions
- Must reasonably consider all relevant facts
- Use reasonable efforts to identify and ascertain relevant facts
- Not rely on representations, findings or agreements if reliance would be unreasonable
- Relate applicable law and authorities to facts
- Not take into account the possibility that a tax return will not be audited or that the matter may not be raised on audit

Circular 230 – § 10.37 – Standard of Review

- In evaluating whether a practitioner giving written advice concerning one or more Federal Tax matters has complied with the requirements of this section, the Commissioner will apply a 'reasonable practitioner standard" which considers all facts and circumstances, including the scope of the engagement and type and specificity of the advice.
- This same standard applies to an opinion the practitioner knows (or has reason to know) will be used or referred to by a person other than the practitioner in promoting, marketing, or recommending to one or more taxpayers, a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of tax. However, under this situation when determining whether a practitioner has failed to comply with this section emphasis will be given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

Circular 230 – § 10.50 Sanctions

The Secretary of the Treasury has the authority to censure, suspend, or disbar any practitioner from practice before the IRS if the practitioner is shown to be incompetent, disreputable, or "with intent to defraud" knowingly misleads or threatens a client or prospective client.

Section also authorizes Secretary to disqualify an appraiser for violation of these rules.

Monetary penalties can be imposed but cannot exceed the gross income derived from the conduct giving rise to the penalty.

Circular 230 – 10.51 Incompetence and Disreputable Conduct

- Conviction of any criminal offense under the federal tax laws
- Convection of any felony for which the conduct involved renders the practitioner unfit to practice
- Giving false or misleading information to the Department of the Treasury
- Willfully failing to make a Federal tax return or willfully evading or attempting to evade any assessment or payment of tax
- Willfully assisting a client to violate tax laws
- Attempt to influence official action of officer or employee of the IRS by threats, false accusations, duress or coercion, or by the offer of any special inducement (gifts, things of value)
- Disbarment or suspension from practice as an attorney or CPA
- Contemptuous conduct in connection with practice before the IRS

Circular 230 – 10.51 Incompetence and Disreputable Conduct

- Giving a false opinion
- Willfully failing to sign a tax return prepared by the practitioner
- Willfully disclosing or using a tax return or tax return information in a manner not authorized by the IRC
- Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when required to do so
- Willfully representing at taxpayer before an officer or employee of the IRS unless the practitioner is authorized to do so

PENALTY PROVISIONS FOR TAX PROFESSIONALS

- IRC § 6694 – Return Preparer Penalty
- IRC § 6695 – Failure to Furnish Copy, Sign, Etc.
- IRC § 6700 – Promoting Abusive Tax Shelters
- IRC § 6701 – Aiding & Abetting Understatements
- IRC § 6707 – Failure to Furnish Tax Shelter Information
- IRC § 6708 – Failure to Maintain Lists
- IRC § 6713 – Disclosure or Use of Tax Information
- IRC § 7206 – Fraudulent & False Returns & Statements

PENALTY PROVISIONS FOR TAX PROFESSIONALS

- Some states have enacted similar provisions with regard to state tax matters
  - E.g., California (Return Preparer Penalty, CA. Revenue and Taxation Code § 19166**)** , New York and Georgia (Return Preparer Penalty, Georgia Code 48-2-62)
- Colorado Code Provisions
  - Colo. Rev. Stat. § 39-22-621(2)(g) (2017) (Preparer Penalty)

§ 6694 – Return Preparer Penalty

- Penalty for Understatements due to Unreasonable Positions and Willful or Reckless Conduct or Intentional Disregard of Rules and Regulations
- Unreasonable Position. If a "tax return preparer" (A) **prepares** any return or claim for refund to which any part of an understatement in paragraph (2), and (B) **knew (or reasonably should have known)** of the position, such "tax return preparer" shall pay a penalty with respect to each such return or claim in an amount equal to the greater of $1,000 or 50% of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

§ 6694 – Return Preparer Penalty

- Unreasonable Position.
- Non-Tax Shelter Transactions – If there is **substantial authority** for the position, there is no penalty under § 6694.
- Non-Tax Shelter Transactions – If there is a **reasonable basis** for the position and **appropriate disclosure** is made, there is no penalty under § 6694.

§ 6694 – Return Preparer Penalty

- Unreasonable Position.
- For Tax Shelter Transactions, the position is unreasonable unless it is reasonable to believe that the position would MLTN be sustained on the merits.
- Tax Shelter Transactions are described in:
  - § 6662(d)(2)(C)(ii); or
  - Reportable transactions described in § 6662A
- § 6694(a)(3) – No penalty for unreasonable position if there is reasonable cause for the understatement and the tax return preparer acted in good faith.

§ 6694 – Return Preparer Penalty

- Understatements Due to Willful or Reckless Conduct. If the "tax return preparer" prepares any return or claim for refund with respect to which any part of the understatement of liability is due to a **willful attempt to understate the liability for tax** on the return or claim or **a reckless or intentional disregard of the rules or regulations**, then the penalty is the greater of $5,000 or 75% (50% for TYE on or before 12/18/15) of the income derived with respect to such return or claim.
- No Double Penalty under § 6694(a) and (b). The penalty imposed under this subsection is reduced for penalties imposed under the unreasonable position penalty.

§ 6694 – Return Preparer Penalty

- § 6694(d) – Abatement of penalty where liability not understated
- § 6694(e) – Understatement of liability defined
- § 6694(f) provides that "Tax Return Preparer" defined in § 7701(a)(36)
  - Signing Tax Return Preparers
  - Non-signing tax return preparer – defined by reference to factors
- Exception -- Officer, general partner, member, S/H or employee regularly and continuously employed by taxpayer who prepares return or claim for refund for taxpayer is not a return preparer for these purposes.

§ 6694 – Return Preparer Penalty

- Treas. Reg. § 1.6694-2 provides different rules for "Signing Tax Return Preparers" and "Non-signing Tax Return Preparers."
- Adequate Disclosure for Signing Tax Return Preparers where reasonable basis but not substantial authority – Preparer satisfies this standard where
  - Position disclosed in accordance with § 1.6662-4(f) or in tax return in accordance with annual revenue procedure described § 1.6662-4(f)(2);
  - Preparer provides TP with prepared return that includes disclosure in accordance with § 1.6662-4(f); or
  - For returns or claims subject to § 6662 penalties (other than the substantial understatement penalty), tax return preparer advises TP of the penalty standards applicable to TP pursuant to § 6662.

§ 6694 – Return Preparer Penalty

- Adequate Disclosure for Non-Signing Tax Return Preparers where reasonable basis but not substantial authority – Non-Signing Preparer satisfies this standard where
  - Adequate if non-signing preparer advises TP of any opportunity to avoid penalties under § 6662 that could apply and if relevant the standards for disclosure to the extent possible.
  - Adequate of non-signing preparer provides advice to the other tax return preparer that disclosure may be required.
- Contemporaneous Documentation - Regulations emphasize the need to contemporaneously document the advice to TP.

§ 6694 – Return Preparer Penalty

- Reasonable Cause and Good Faith Exception
  - Treasury regulations provide a list of factors to consider, including nature, frequency and materiality of errors, tax return preparer's normal office practice, reliance on advice of others, reliance on generally accepted administrative industry practice
- Reliance on Information Provided by Taxpayer
  - Treas. Reg. § 1.6694-1(e) provides that tax return preparer can generally rely in good faith without verification upon information furnished by the taxpayer
- Regulations have not been revised to reflect changes made by
  - P.L. 110-343 (Emergency Economic Stabilization Act of 2008)
  - P.L. 110-28 (U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007)

§ 6694 – Return Preparer Penalty

- Treas. Reg. § 301.7701-15(b)(4) – IRS will investigate preparation by a tax return preparer of a tax return or claim and will send report of the examination to the tax return preparer before assessment of either penalty.
- Unless the period of limitations may expire, IRS will also send, before assessment a 30-day letter to the tax return preparer notifying him of the proposed penalty and offering further administrative consideration and a final administrative determination before assessment.
- § 6694(c) – Special refund claim procedures – payment of 15% of assessed penalties
  - Suit for Refund in District Court
  - Suspension of the period of limitations on collection

§ 6694 – Return Preparer Penalty

- Note the cross-reference in Circular 230, § 10.34(a) - A practitioner shall not **willfully, recklessly, or through gross incompetence**, (A) sign a return or claim or (B) advise a client to sign a return or claim or (C) prepare a portion of a tax return or claim containing a position, that the practitioner **knows or reasonably should know** contains a position described in
  - §6694(a)(2) (unreasonable position) or
  - §6694(b)(2) (willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of the rules or regulations).

Privileges

Is Tax Advice Protected?

Attorney Client Privilege

A confidential communication between an attorney and a client. Key Elements:

1) Communication is made when the client is a client or is seeking to become a client.

2) The advisor is acting as a lawyer (as opposed to say a business advisor).

3) Communication is made between client and lawyer exclusively.

4) Communication must have occurred for the purpose of securing a legal opinion or legal services or in connection with some legal proceeding and not for the purposes of committing a crime.

5) Privilege belongs to the client and can be claimed or waived only by the client (usually through his or her attorney).

Accountant Client Privilege

- IRC § 7525 of the IRC.
- Intended to provide equal privilege for tax advice between taxpayers and any "federally authorized practitioner."
- Does not apply to: (i) written communications in connection with tax shelters, (ii) criminal matters, or (iii) work product
- State Rules?

Work Product Doctrine

- Protects materials prepared in anticipation of litigation.
- Is not limited to materials prepared or collected by the attorney it includes materials prepared by the client or agents of the attorney.
- Although broader than the attorney client privilege, rules of evidence permit production when substantial need can be shown.

HYPOTHETICALS

HYPOTHETICAL 1 - PRIVILEGE

ABC received a tax opinion from Law Firm regarding a transaction which concludes that the tax treatment of the transaction "should" be sustained if challenged by the either the IRS or State W's tax authority but the opinion goes on to outline various arguments that the IRS or State W could assert that would at a minimum cause trouble. ABC's outside auditors question the transaction and ask for a copy of the opinion. The VP of Tax comes to you and asks for advice.

Should we provide the opinion to the auditor? If we do, can we later assert that it is privileged? What if we read it to the auditor over the phone but we don't give them a copy? What if we outline the memo and give the auditor the outline but not the memo?

HYPOTHETICAL 2 – PREPARING TAX RETURNS

- You prepared individual client's tax return for 2017
- You are currently preparing client's tax return for 2018 and learn that information he provided to you in 2017 was incorrect and this information if corrected would result in a substantial tax liability for 2017.
- What do you do?

HYPOTHETICAL 3 – PREPARING TAX RETURNS

- After advising your client that he should amend the 2017 return and the consequences of failing to do so, he tells you "thanks for the information but I will take my chances with the IRS."
- The incorrect information in 2017 has an impact on the 2018 return but the client tells you to ignore that and file consistently with the 2017 return.
- What do you do?

HYPOTHETICAL 4 – RETURN PREPARATION

You received a telephone call from ABC Co. on October 13, 2018 from ABC Co.'s Tax Director. The Tax Director asks you this question: "We have been unable to get financial data from three of our African subsidiaries as the result of a typhoon that disrupted our communications with these offices. We intend to use last year's information to fill out the Forms 5471 for these subsidiaries as an estimate of their financial data. We will amend later when we get better numbers. Is this OK?

Would it matter if there was no typhoon but the CFC's were just being non-responsive?

Would it matter if there was a good reason to think that last years numbers and this year's numbers are going to very different?

Do you need to disclose in the return that you are using last year's numbers?

HYPOTHETICAL 5 – IRS AUDITS

You are representing ABC Co. in connection with its current IRS audit. The IRS has requested interviews of employees X, Y and Z about a certain transaction. You appear at the interview –

Are you representing ABC Co., the employees or both?

HYPOTHETICAL 6 – IRS AUDITS

You are attending the witness interviews described in the previous situation. During one of the breaks, employee X, who has been sitting in on the interview of employee Y, takes you aside and says “I know for a fact that what employee X just said is not true. He is lying.”

What do you do?

HYPOTHETICAL 7 – IRS AUDITS

You are assisting ABC Co. in their current IRS audit. The IRS has asked questions about an account labeled "consulting fees." You have reviewed the records and are concerned that this account may in fact being used to record bribe payments made in violation of the FCPA. You also note that the entries to this account began about three years ago and continue to the present day. You communicate your concern to the VP of Tax. He/she instructs you to "forget about it – there is no way that anyone in this company would be that stupid."

What, if anything, do you do next?

HYPOTHETICAL 8 – IRS AUDITS

You are engaged to represent ABC Co. in its current IRS audit. The IRS Team issues the standard Rev. Proc. 94-69 request. You ask the Tax Director if there are any errors or omissions in the return that Big Co. wants to disclose in response to this request. The Tax Director says "Oh, there are some errors all right but I would rather wait and see if the IRS catches them."

What do you do in this situation?

HYPOTHETICAL 9 – IRS AUDITS

During the same audit, the IRS Team Coordinator, with whom you have developed a cordial relationship, says to you “I am wondering why ABC Co. doesn’t charge a royalty for the use of its trade name by its CFC in the UK. I would think the trade name is valuable and that you probably have a valuation of that trade name somewhere in your records.” He does not issue an IDR for any trade name valuation but you know that one exists and that it shows a substantial value for the trade name. You also know that the ABC Co. thinks the trade name is worth much less than the value determined in the appraisal and definitely does not want the IRS to see this appraisal if it can be avoided.

What ethical obligations, if any, do you have in this situation?

HYPOTHETICAL 10 – IRS AUDITS

You are representing ABC Co in its current IRS audit. In discussion with the VP of Tax and You discover that Big Co. deducted $5 Million in interest with respect to a loan from a related company but that the interest had not actually been paid. Under Section ABC Co. is not entitled to the deduction until it actually pays the interest. So far the IRS has not asked any questions about the interest deduction.

Can you ethically “lie low” and hope the question doesn’t get asked.

Do you have a duty to tell someone at ABC Co. about this?

Do you have a duty to request permission to disclose this to the IRS agent?

Would it make any difference if for the tax year at issue ABC Co. was in a net operating loss position that was carried forward to another year and if the interest deduction were corrected it would not result in tax due for the year in question.

HYPOTHETICAL 11 - APPEALS

You have settled a case with appeals that had a number of issues. The Appeals Officer sends you a calculation to review. You note that the calculation has an error but that the error is only $5,000. You do not want to incur any more fees on this engagement. Can you ethically just agree to this calculation? Do you need to consult your client?

HYPOTHETICAL 12 - APPEALS

ABC Co. settled a long and contentious case with Appeals. The settlement was made on an issue by issue basis with Appeals allowing certain percentages of the amounts in dispute. You, as ABC's representative, received a calculation and briefly reviewed it but did not spend much time on it. You told Appeals the calcs were "OK." The Form 870 AD was prepared using the numbers calculated by Appeals. The settlement provided for a refund of $40 million which was paid.

Several months later, ABC Co. realizes that there was a big error in the calculation. The calculations allow both a deduction and depreciation for the same expenses. You know that Appeals would never have agreed to that since the issue was whether the costs in question were either currently deductible or capitalizable. The error caused the refund to be overstated by $20 million.

ABC Co. asks you if they can just keep the money – since after all it matches the Form 870AD that it signed and everyone knows a Form 870AD is binding (or is it). What do you advise?

HYPOTHETICAL 13 – RELIANCE

MMM LLP, the largest CPA firm in the US (and your current employer), has recommended a strategy to ABC Co. that will allow ABC Co. to repatriate cash from some of its CFC's without paying tax on the cash. MMM has issued a MLTN opinion to ABC Co. and while the transaction certainly has tax advantages it is clearly not a listed transaction or a principal purpose transaction.

ABC Co.'s VP of Tax (with whom you have a good relationship) calls you and asks you: "Do you think we need to get get another opinion – say from a law firm so that there is no question that we have penalty protection if this transaction is challenged and we lose the benefits? How do you reply?

HYPOTHETICAL 14 – WORKING FOR FREE

Practitioner introduces client to a transaction in 2016 that substantially reduces client's tax liability, In 2018, client's return is selected for audit and client contact's practitioner. Practitioner tells Client that he will represent the client in audit at no charge.

Has practitioner committed a violation of Circular 230, Section 10.29?

Will OPR be interested in this practitioner?

HYPOTHETICAL 15 – PRIVILEGED MATTERS

You assisted Mr. Money with his IRS audit. During the course of the audit, you prepared a memorandum outlining the litigation hazards associated with the XYZ transaction. The case is not settled at Appeals and Mr. Money files a petition with the U. S. Tax Court. A discovery request is made for "any non-privileged memoranda discussing the XYZ transaction." Is your memorandum protected from production?

HYPOTHETICAL 16 – PRIVILEGED MATTERS

ABC Co. received a tax opinion for Law Firm regarding the ABC transaction which concludes that the tax treatment of the transaction "should" be sustained if challenged by the IRS but the opinion goes on to outline various arguments the IRS could assert that would at a minimum cause trouble. ABC Co.'s outside auditors question the transaction and ask for a copy of the opinion. The VP of Tax comes to you and asks for advice.

Should ABC Co. provide the opinion to the auditor? If it does, can it later assert that it is privileged? What if ABC Co. provided only an outline the memo but not the memo itself?

HYPOTHETICAL 17 - SPOLIATION

In 2012, ABC Co. was approached by PQR, LLP, a well-established law firm about a tax strategy designed to shift income from the US to newly formed CFC's located in lower tax jurisdiction countries. Although "aggressive", the strategy did not appear to violate any IRS statutes or rules and if done correctly, was intended to have economic substance. Various emails were exchanged back and forth between the Tax VP and the partner at PQR discussing the strategy and issues connected to it including the need to establish a bona fide business purpose for creating the CFC's and transferring certain operations to the CFC's. The emails included suggestions by the partner as to ABC Co. could best document a business purpose for the transaction. In 2014, Big Co. decides to go forward with the strategy.

(Continued – Next Slide)

HYPOTHETICAL 17 - Continued

In 2016, the IRS notified ABC Co. that it is under audit for tax year 2014. Big Co. is requested to extend the limitations period for extension and does so. In 2015, the IRS team issued various IDRs about the transaction but did not request emails. In early 2016, the IRS issues a Notice of Proposed Adjustment contesting the transaction. Eventually the case went to the Office of Appeals.

In 2017, Appeals refused to compromise on this issue. In 2018, ABC Co. paid the deficiency and filed a refund suit in federal district court contesting the denial of its claim for refund. DOJ issues a discovery request for all emails discussing the transaction going back to 2012. ABC Co. has a policy to destroy emails after 5 years and the emails no longer exist. DOJ moves for sanctions arguing that ABC Co.'s destruction of the emails was spoliation?

Should ABC Co. be sanctioned for the destruction of the emails?

HYPOTHETICAL 18 – RESPONDING TO IRS REQUESTS

You are in-house tax professional for Big Co. You are handling the current State W tax audit for tax year 2011. The auditor has requested copies of the 2011 tax return workpapers prepared by a big four accounting firm (B4AF). Under Texas law, and the law of most states, these workpapers are the property of B4AF but Big Co. has the right to request a copy and be provided a copy if a request is made. You have reviewed the workpapers at B4AF's offices and are concerned because the workpaper file includes a memorandum discussing a transaction that occurred in 2011 which can be challenged and also includes emails from the Tax Director at Big Co. to the B4AF partner questioning whether this transaction "will hold up on audit."

Can you respond that "Big Co. does not have custody of these workpapers"?

Can you provide a copy of the workpapers (after having received them from B4AF) but remove the memo and the email because neither of these things are "workpapers?"

HYPOTHETICAL 19 – RESPONDING TO IRS REQUESTS

State W tax auditor issues a request for "any and all documents related to the XYZ transaction including emails, memoranda, contracts, and any other writings describing the transaction or referring to it in any way." You know that despite Big Co.'s policy that emails are not be retained for more than 12 months (unless they are considered important in which case they are transferred to a permanent electronic file) that the VP of Tax is "old school" and rarely deletes anything from his computer. You are concerned that there may be some damaging emails on his computer since you know that he had serious misgivings about this transaction when it was done.

Can you ethically negotiate with the tax auditor to delete emails from this request?

Can the VP of Tax delete his emails that are more than 12 months old after this request was issued?

HYPOTHETICAL 20 – TAX RETURN ERRORS

You are a tax attorney and/or CPA employed by Big Co. and responsible for handling the current State X tax audit. You ask the Tax Director if there are any errors or omissions in the return that should be considered in preparing for the audit. The Tax Director says "Oh, there are some errors all right but I would rather wait and see if the auditor catches them."

What do you do in this situation?

HYPOTHETICAL 21 - JOINT RETURNS—REPRESENTATION OF SPOUSES

H and W are married. H is a househusband who manages the couple's home and children. W is a successful singer and entertainer who travels throughout the United States. H and W file joint returns, and W's income singing and entertaining is reported on the income tax returns of H and W.

A, a Colorado licensed attorney who offices in Denver, has provided advice to H and W over the years in connection with tax, business and other matters.

H and W's U.S. and Colorado income tax returns for 2015 and 2016 are audited and the IRS issues a notice of deficiency alleging that H and W have not reported substantial amounts of income from W's entertainment business during 2015 and 2016.
Should A file a Tax Court petition on behalf of both H and W? Are there any issues that A should consider in doing this.?

HYPOTHETICAL 22 - ATTORNEY INVOLVEMENT IN STRUCTURING MATTER

H and W are married. H is a househusband who manages the couple's home and children. W is a successful singer and entertainer who travels throughout the United States. H and W file joint returns, and W's income singing and entertaining is reported on the income tax returns of H and W.
A, a Colorado licensed attorney who offices in Denver, has provided advice to H and W over the years in connection with tax, business and other matters.

A assists W in claiming a large charitable donation deduction for the donation of a conservation easement that W made to a charitable land trust. H was unaware of W's donation to the charitable land trust.

A charitable donation deduction was claimed on the joint federal income tax return of H and W for 2015. The IRS issues a notice of deficiency disallowing the charitable donation deduction.

Can A represent either or both of H and W in the Tax Court case challenging the disallowance of the deduction?

HYPOTHETICAL 23 - PARTNERSHIP

A through Y are partners in Partnership A-Y. A is the tax matters partner of the partnership. The IRS challenges deductions claimed by Partnership A-Y and issues a notice of final partnership administrative adjustment ("FPAA").

One of the adjustments that is at issue in the partnership concerns a portion of the capital contributions of partners D, E and F. The IRS determines that there was a disguised sale of partnership assets to D, E and F and determines that there is gain to the partnership. The partners in Partnership A-Y, other than D, E and F are concerned that the IRS might contend that the gain from the disguised sale may be allocated to them. Partners D, E and F want Partnership A-Y to contend that there is no income from any disguised sale, but if there is any disguised sale gain, they want the gain allocated to all partners on a pro rata basis.

TMP A goes to Attorney Z and asks if Z can file a Tax Court petition in response to the FPAA. Since A is going to use partnership funds to pay Z's fees, all of the partners in A-Y want Z to represent not only Partnership A-Y, but the other partners in A-Y, as well.

What should Z do? The case is a very interesting case of first impression and involves an issue about which Z authored an article in a well-known tax publication.

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Current Developments in Corporate Taxation

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CURRENT DEVELOPMENTS IN CORPORATE TAXATION

Presented at the 68th Annual Denver Tax Institute

David Strong – Morrison & Foerster, LLP
Tax Partner and Co-Chair of Federal Tax Practice / Managing Partner Denver Office

July 24th, 2018

David Strong – Professional Biography

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Dave is the past chair of the Corporate Tax Committee of the Tax Section of the American Bar Association and a frequent speaker on corporate and other tax matters at local, regional, and national seminars and continuing legal education programs. Dave is a fellow of the American College of Tax Counsel and also an adjunct professor and member of the faculty at The University of Denver Law School (Graduate Tax Program), where he teaches a class on corporate reorganizations, spin-offs, recapitalizations, and restructurings.

Dave received his J.D. from Stanford Law School and his LL.M. in Taxation from New York University. Prior to moving to Denver, Dave worked as both a transactional tax attorney and as an investment banker in New York City.

Disclaimer

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No part of these materials constitutes written tax advice that may be either used or relied upon by any person for any purpose.

Agenda

- Overview of TCJA's impact on corporate M&A, VC, PE transactions
- Recent administrative guidance and judicial decisions
  - Rev. Proc. 2018-12 (Section 368 / "continuity of interest")
  - Notice 2018-30 (Section 382)
  - Notice 2018-28 (Section 163(j))
  - Summa Holdings / Mazzei
- Section 1202 / "qualified small business stock"

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OVERVIEW OF TCJA'S IMPACT ON CORPORATE M&A, VC, AND PE TRANSACTIONS

Background

- On December 22, 2017, President Trump signed the final version of the tax reform bill, commonly referred to as the Tax Cuts and Jobs Act (the "Act")
- The Act was generally promoted by the Republican-controlled Congress and the Trump Administration as a means to encourage investment and to promote growth in the U.S. economy
- Although the actual economic impact remains to be seen, there is no question that the Act dramatically alters domestic and international taxation in a variety of highly meaningful ways

Overview

- Headline Areas of Change
  - Tax Rates
  - Tax Deductions / Tax Preferences / Tax Attributes
  - International Provisions
  - Executive Compensation & Benefits
  - Pass-Throughs
- Potential Impacts / Implications
- Case Study / Ares Management

Tax Rates

- Reduction in the corporate graduated rate structure (with a maximum rate of 35%) to a flat rate of 21%
- Elimination of the corporate alternative minimum tax
- Creates a top marginal tax rate of 29.6% for investors in certain types of qualifying "pass-through" businesses (partnerships, LLCs taxed as partnerships, and electing Subchapter "S" corporations)
- Retains 20% individual income tax rate on long-term capital gain, including qualifying "carried interest" allocations, provided a three-year holding period is satisfied for any gains derived from certain investment assets (including securities, commodities, or real estate held for rental or investment)

Tax Deductions / Preferences / Attributes

- Allowance for 100% immediate expensing for the full cost of certain new and used business assets (in general, includes most tangible assets but excludes intangibles)
- Limitation on the deductibility of interest on indebtedness to 30% of "EBITDA" (as defined in the Act) until 2021, and to 30% of "EBIT" (again, as defined in the Act) for 2022 and thereafter
- Reduction in the corporate dividends received deduction from 70% to 50% (in the case of equity interests in subsidiaries of less than 20%), and from 80% to 65% (in the case of equity interests in subsidiaries of 20% or greater, but less than 80%)
- Elimination of capital gain treatment for certain sales of "self-created" patents (or inventions or trade secrets), which will instead be treated as ordinary income if sold by the person who created the patent or who has a transferred basis from the person who created the patent
- Prohibition on the carryback of NOLs and limitation on the use of NOLs generated in 2018 and thereafter to 80% of taxable income

International Provisions

- *Quasi-Territorial System* – Dividends from 10%-owned foreign corporations generally exempt from US taxation
  - *Transition Tax* – A one-time "deemed repatriation" tax on U.S. shareholders of certain foreign affiliates with previously untaxed foreign earnings (15.5% on earnings from cash and equivalents and 8% on other earnings, and potentially payable in installments over 8 years)
- *Preferential Tax Rate on Foreign IP Income by US Corporations* – Certain foreign-sourced IP income subject to a preferential tax rate of 13% (16.4% starting in 2026)
  - *Minimum Tax on IP Income by Foreign Subsidiaries* – U.S. shareholders of certain foreign affiliates subject to tax on the group's "global intangible low-taxed income" ("GILTI")
- *Base Erosion Tax* – Punitive tax on US corporations that make excessive deductible payments to foreign affiliates ("BEAT")

Executive Compensation & Benefits

- Retains 409A without change
- Allows eligible employees of qualifying private companies with broad-based equity incentive plans, that involve employee participation of 80% or more, to elect to defer income taxes that would normally arise in connection with option exercises and restricted stock unit ("RSUs") settlements for up to five years, subject to early acceleration upon triggering events
- Eliminates the ability of public companies to exclude performance-based compensation and commissions from the $1 million deduction limit under Section 162(m)

Pass-Throughs

"Qualified Business Income" Deduction

- New deduction for non-corporate persons equal to 20% of domestic "qualified business income" ("QBI") from a partnership, S corporation, sole proprietorship, trust or estate
- Effectively can reduce an individual's highest marginal tax rate on QBI from 37% to 29.6%
- The deduction for QBI generally is limited to the greater of: (i) 50% of W-2 wages paid to employees of the qualified trade or business; or (ii) the sum of 25% of W-2 wages and 2.5% of investments in qualified property
- The QBI deduction is not available to high income owners of most service businesses/partnerships (including investment management businesses and law firms)

Pass-Throughs (continued)

"Carried Interest"

- New 3-year holding period for gains "with respect to" certain partnership interests to qualify for long-term capital gain treatment (20% v. 37%)
- Applies to partnership profits interests received in connection with performing services (commonly referred to as "carried interests") for a business that consists of raising or returning capital, and investing in, disposing of, identifying or developing "specified assets"
- "Specified assets" include securities, commodities, real estate held for rental or investment, cash or cash equivalents, and derivatives referencing the foregoing
- Partnership interests whose interest in capital are commensurate with capital contributions are excluded—meaning?
- Applicable to certain real estate assets (*i.e.*, "Section 1231 assets")?

Potential Impacts – M&A / PE / VC Transactions

- Choice of Entity Considerations
  - Corporation v. Pass-Through (in general, perhaps more use of corporate form)
  - Up-C/Hybrid Structures (Up-Cs perhaps less desirable)
- Deal Structure / Terms
  - Stock Purchases v. Asset Purchases (potential opportunities for asset sales)
  - Transaction Expenses / NOLs (certain NOLs less valuable)
  - Financing / Capital Structure (highly leveraged deals more expensive)
  - Tax Representations (new representations to be developed)
  - Financial Modeling (incorporation of new rules into modeling / valuations)
- Impact on Specific Industries
  - Technology Sector (asset deals not likely)
  - Highly Leveraged Industries (hindered by interest limitations)
  - Non-Service Based Businesses (potential to use 29.6% rate for pass-throughs)

Case Study – PE Fund Conversions (Ares / KKR)

- Ares Management was the first "publicly traded partnership" / PE firm to convert to a "C" corporation (February 2018)
- Ares shares immediately went up 12%
- Drivers include: the elimination of the need for "lumpy" cash distributions to investors, consistent dividend story, lower administrative burden, lower effective tax rate on fee income, and access to wider range of potential investors (enhancing liquidity)
- KKR also recently announced plans to convert as well (May 2018)
- KKR shares also trading up and analyst targets going higher

Checklist of Common Client Issues (Post-Tax Reform)

- Choice of entity
- Capital structure / limitations on interest deductions
- Cash management
- Utilization of net operating losses
- Structure of international operations / location of IP

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RECENT ADMINISTRATIVE GUIDANCE AND JUDICIAL DECISIONS

Overview

- Rev. Proc. 2018-12 (Section 368 / "continuity of interest")
- Notice 2018-30 (Section 382)
- Notice 2018-28 (Section 163(j))
- Summa Holdings / Mazzei

Rev. Proc. 2018-12

- COI requirement under Reg. §1.368-1(e) requires that, in substance, a substantial part of the value of the target shareholders' proprietary interests (i.e., stock) in target be preserved in order to qualify as a reorganization under Sec.368(a)
- Generally, COI is measured at either the day before the date on which there is a binding contract (such date. the "Pre-Signing Date") (the "Signing Date Rule") or the effective date of the merger (the "Closing Date") (the "Closing Date Rule")

Rev. Proc. 2018-12 – Example

- The following basic example illustrates the signing-date rule contained in the final regulations:
  - On January 3 of Year 1, an acquiring corporation ("X") and a target corporation ("T") sign a binding contract pursuant to which T will be merged with and into X on June 1 of Year 1.
  - Pursuant to the contract, the T shareholders will receive 40 X shares and $60 cash in exchange for all the outstanding stock of T.
  - On January 2 of Year 1, X stock is worth $1 per share. On June 1 of Year 1, T merges with and into X pursuant to the terms of the contract and as of that date X stock has declined in value and is worth only $.75 per share.

Rev. Proc. 2018-12 – Example

- Under the final regulations, and despite the decline in the value of X stock between signing and closing, the transaction will satisfy the continuity of interest requirement and will have the ability to qualify as a tax-free reorganization.

- Specifically, pursuant to the signing-date rule, the value of the X stock to be delivered to the T shareholders will be deemed to represent 40% of the total consideration package (40 X shares * $1 per share = $40).

- By comparison, if the closing-date value for X stock was used, the transaction may not qualify as a tax-free reorganization because the value of the X stock to be delivered to the T shareholders would represent only approximately 33% of the total consideration package (40 X shares * $.75 per share = $30).

Rev. Proc. 2018-12 (continued)

- Rev. Proc. 2018-12 provides three safe harbor methods for valuing stock by lacking an average value over a measurement period

- Establishes certain requirements that must be satisfied in order for the safe harbors to apply, depending on whether the Signing Date Rule or the Closing Date Rule applies

- Taxpayers may use either (i) the daily volume weighted average price, (ii) the daily average high-low trading price, or (iii) the average of the daily closing prices

Rev. Proc. 2018-12 (continued)

- Taxpayers may use a measuring period of at least 5 but not more than 35 consecutive trading days
- Measuring period must end no earlier than 3 trading days before the Pre-Signing Date/Closing Date and no later than the last trading day before the Pre-Signing Date/Closing Date (or the Pre-Signing Date/Closing Date if that is a trading day)
- Service is willing to entertain requests for rulings and determination letters regarding transactions and legal issues to which the safe harbor does not apply and regarding the applicability of the safe harbor itself

Notice 2018-30 (Section 382)

- Notice 2018-30 modified Notice 2003-65 to reflect the TCJA's addition of Section 168(k) to the Code
- Notice 2003-65 provided two approaches for applying Section 382(h) to determine items of built-in gain and built-in loss following an ownership change: (i) the Section 338 approach and (ii) the Section 1374 approach
- Notice 2018-30 provides that the hypothetical cost recovery deductions used in the Section 338 approach described in Notice 2003-65 to identify recognized built-in gain or recognized built-in loss under Section 382 are determined <u>without regard</u> to Section 168(k)
- Similarly, in computing the amount of cost recovery deductions that are not attributable to an asset's built-in loss on the change date under the Section 1374 approach described in Notice 2003-65, the hypothetical deductions that would have been allowable had the loss corporation purchased the assets for its fair market value on the change date are determined without regard to Section 168(k)

Notice 2018-28 (Section 163(j))

- On April 2nd, 2018, the IRS issued Notice 2018-28, which announces that Treasury and the IRS intend to issue regulations clarifying certain aspects of Section 163(j)

- The Notice addresses the following issues:
  - The treatment of carryforwards of disallowed interest under old Section 163(j)
  - The definition of "business interest expense" for C corporations
  - The application of Section 163(j) to consolidated groups
  - Section 163(j)'s effect on E&P
  - Double counting of business interest income by partners and partnerships

Summa Holdings / Mazzei

- Summa Holdings (6th Circuit – 2017)
- Mazzei (Tax Court holding appealable to 9th Circuit –2018)
- Both Cases addressed "substance over form" issues in heavily structured Roth IRA transactions utilizing "DISCs"
- The 6th Circuit in Summa sided with the taxpayer (overturning the original Tax Court decision – relying on strict interpretation of the Code)
- The Tax Court in Mazzei sided with the IRS (holding that the substance of the transaction was not consistent with its form)
- Highlights continuing vitality of substance over form doctrine, the potential for different judicial outcomes in similar contexts, and need for cautious planning based on facts and circumstances

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SECTION 1202 / "QUALIFIED SMALL BUSINESS STOCK"

Overview

- Section 1202 can provide significant benefits / exclusions from U.S. federal income tax
- Can shape / affect the choice of entity decision
- Key areas often overlooked in relation to Section 1202 planning:
  - Definition / meaning of "active business"
  - Shareholder redemptions
  - Working capital requirement / subsequent cash infusions
  - Carried interest / interests held through partnerships
  - Incorporation of a partnership
  - Contribution to a partnership

Section 1202 / "Qualified Small Business Stock" – Overview

- In general, under current law Section 1202 allows a non-corporate taxpayer to potentially exclude up to 100% of a substantial portion (or possibly all) of the gain realized from the sale or exchange of qualified small business ("QSB") stock held for more than five years.
- Section 1202(b)(1) provides that the aggregate amount of excludable "eligible gain" effectively allowable under Section 1202(a) with respect to QSB stock issued by a corporation and disposed of by a taxpayer in any given taxable year equals the greater of: (i) $10 million (reduced by the aggregate amount of any "eligible gain" previously excluded by the taxpayer for prior taxable years as a result of dispositions of QSB stock issued by the corporation); or (ii) 10 times the aggregate adjusted bases of QSB stock issued by the corporation and disposed of by the taxpayer during the taxable year.
- In addition, Section 1045 allows a taxpayer to potentially roll-over gain from the sale of QSB stock that has been held for more than 6 months.

Primary Requirements for Section 1202 QSBS

- There are four main requirements that must be satisfied before gain on the sale of stock is potentially eligible for the exclusion under Section 1202.
- (1) Stock of a C-corporation acquired at "original issuance"
- (2) Qualified small business requirement
- (3) Active business requirement
- (4) Five-year holding period

Stock of a C-corporation

- For purposes of Section 1202(c)(1), the issuing corporation must be a C-corporation.
- In addition, it should be noted that for purposes of the "active business requirement" of Section 1202(e) the issuing corporation must also be an "eligible corporation" as defined in Section 1202(e)(4).
- Section 1202(e)(4) defines an "eligible corporation" as any domestic corporation other than: (i) a DISC (a "domestic international sales corporation" as defined in Section 992(a)) or former DISC; (ii) a corporation with respect to which an election under Section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect; (iii) a RIC (regulated investment company), REIT (real estate investment trust), or REMIC (real estate mortgage investment conduit); and (iv) a cooperative.

"Original Issuance"

- Pursuant to Section 1202(c)(1)(B), QSB stock must generally be acquired at "original issue" (directly or through an underwriter) in exchange for money or other property, or as compensation for services performed for such corporation (other than services performed as an underwriter of such stock).
    - The concept of "property"
    - Restrictions on redemptions
    - Incorporation of a partnership
    - Section 83(b) elections
    - Convertible securities, options, warrants
    - Stock acquired by gift or upon death of holder
    - Stock received in certain corporate transactions
    - Stock held through pass-through entities

"Qualified Small Business" – In General

- Section 1202(d)(1) defines a "qualified small business" as a domestic C corporation if:
  - (i) the aggregate gross assets of such corporation (or any predecessor thereof), at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance of the stock being tested for potential qualification as QSB stock, do not exceed $50 million;
  - (ii) the aggregate gross assets of such corporation immediately after the issuance of the stock being tested for potential qualification as QSB stock (determined by taking into account amounts received in the issuance) do not exceed $50 million; and
  - (iii) such corporation agrees to submit to the IRS and its shareholders any "reports" that the IRS may "require to carry out the purposes of" Section 1202.

"Aggregate Gross Assets" Test

- For purposes of Section 1202(d)(1), the term "aggregate gross assets" means the sum of the amount of cash and the aggregate adjusted bases of all other property of the corporation (with the adjusted basis of any property contributed to the corporation being determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution).
- However, stock that otherwise qualifies as QSB stock as of the date of issuance will not lose that status solely by virtue of the fact that a corporation subsequently exceeds the $50 million threshold.
- In addition, and also for purposes of aggregate gross asset test of Section 1202(d)(1), certain aggregation rules under Section 1202(d)(3)(A) provide that corporations that are part of a "parent-subsidiary controlled group" shall be treated as one corporation.

“Active Business Requirement” – In general

- For purposes of Section 1202(c)(2)(A), a corporation shall be treated as satisfying the “active business requirement” of Section 1202(e) for any period if during such period (i) at least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more “qualified trades or businesses” (as defined in Section 1202(e)(3)) and (ii) such corporation is an “eligible corporation” (as defined in Section 1202(e)(4)).

- Under Section 1202(e)(3), the term “qualified trade or business” means any trade or business <u>other than</u>:

  - (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;

  - (B) any banking, insurance, financing, leasing, or similar business;

  - (C) any farming business (including the business of raising or harvesting trees);

  - (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under Section 613 or 613A; and

  - (E) any business of operating a hotel, motel, restaurant, or similar business.

“Active Business Requirement” – Special Rules

- Start-up and R&D activities
- Stock in other corporations
- Working capital
- Real estate holdings
- Computer software royalties

PLR 201436001

- The facts of the Ruling involved a company that operated in the pharmaceutical industry and aided clients in the commercialization of experimental drugs. The company's main business activities were researching the effectiveness of drug formulations, conducting clinical tests, and manufacturing drugs. The company also helped clients develop successful drug-manufacturing processes and solve other problems encountered in the pharmaceutical industry. The company's assets included manufacturing and clinical facilities along with intellectual property assets, such as a patent portfolio. The company also possessed several valuable relationships in the pharmaceutical industry.

- In analyzing whether the company was engaged in a "qualified trade or business" under Section 1202(e)(3), the IRS explained that "the thrust of § 1202(e)(3) is that businesses are not qualified trades or businesses if they offer value to customers primarily in the form of services, whether those services are the providing of hotel rooms, for example, or in the form of individual expertise (law firm partners)."

- The IRS noted that the company in the Ruling used its specific manufacturing and intellectual property assets to create value for customers, and was akin to a manufacturer of parts in the automobile industry. Accordingly, despite recognizing the company's connections to the pharmaceutical industry, which is a component of the "health" industry (a clearly prohibited field), the IRS ruled that the company's activities did not amount to the performance of services in the health industry within the meaning of Section 1202(e)(3). The Ruling specifically noted that the "Company is not in the business of offering service in the form of individual expertise."

Five Year Holding Period Requirement – In General

- In general, the holding period of QSB stock begins on the date of issuance whether or not the QSB stock was received in a taxable or non-taxable transaction.

- Special tacking rules, however, apply to the computation of the holding period if the QSB stock is converted into other stock of the same corporation, or if the QSB stock is acquired as a gift, by inheritance, or as a transfer from a partnership. In particular, the holding period of stock received in a conversion includes the holding period for the converted stock and the holding period of stock received by gift, inheritance or from a partnership includes the period the stock was held by the donor, decedent or partnership.

- The holding period also tacks in the case of QSB stock exchanged for stock of another corporation that is treated as QSB stock in a transaction described under Sections 351 or 368.

- The holding period of stock acquired in a Section 1045 rollover transaction generally includes the holding period of the QSB stock disposed of in the rollover transaction.

Section 1202(i) Basis Rules

- Section 1202(i) provides that, for purposes of Section 1202, when the taxpayer transfers property (other than money or stock) to a corporation in exchange for stock in such corporation, such stock shall (i) be treated as having been acquired by the taxpayer on the date of such exchange, and (ii) the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.

- One critical aspect of the "basis equals fair market value" rule of Section 1202(i) (that is not readily apparent from the plain statutory language of Section 1202) is that the amount of any previously unrecognized gain that is carried over to the QSB stock will be taxed in full at the time of the subsequent sale or exchange (such that only subsequent appreciation in the QSB stock constitutes "eligible gain" for purposes of Section 1202(b)(1)).

Pre-Investment Planning

- In addition to the wide variety of traditional factors (both tax and non-tax) that should be evaluated when structuring an investment, the potential benefits that may be available under Section 1202 should be seriously considered.

- In general, attempting to plan into Section 1202 may make sense in a situation where, among other things:

  - (i) a five-year holding period is at least a possibility (particularly given the longer investment "holds" experienced in recent years following the economic downturn);
  - (ii) the aggregate gross asset value of the business is expected to be equal to or less than $50 million;
  - (iii) the general profile of the expected business operations are such that the "active business requirement" of Section 1202(e) should be satisfied;
  - (iv) there is not a current need to extract after-tax cash flow from the business during the operational phase (such that a "double" corporate-level tax on distributions would not be an issue);
  - (v) the expected overall equity growth of the business, and related potential benefits under Section 1202 on exit, are sufficient to overcome a corporate-level tax during the operational phase;
  - (vi) the expected investor base is composed of non-corporate taxpayers that can actually potentially benefit from Section 1202; and
  - (vii) the expected investor base and/or management has the ability to commit the necessary amount of time and resources to ensure that the applicable requirements of Section 1202 are satisfied at all relevant times prior to exit.

Making the Investment

- Once a decision has been made to affirmatively structure an investment with a view toward potentially obtaining the benefits of Section 1202, the parties should consult with their tax and other advisors to ensure that the relevant requirements are satisfied and that important information is properly documented at the outset.

- For example, a third-party valuation of the business would generally be advisable, both for purposes of ensuring that the $50 million aggregate asset value threshold is not exceeded and to establish a fair market value basis with respect to any property contributions being made by investors.

- In addition, service providers that receive restricted stock should also use any valuation data to assess whether it may be advantageous to make a Section 83(b) election with respect to such stock.

- Finally, the parties should also decide whether they wish to be bound by any operational covenants that are intended to facilitate the preservation of the requirements of Section 1202.

Issues Requiring Ongoing Evaluation / Operational Covenants

- In general, following an investment the investor base and/or management must continue to monitor the ongoing operations of the business in order to ensure that the requirements of Section 1202 are continuously satisfied (along with any specific operational covenants that the parties may have agreed to in connection with such requirements).

- In addition, sufficient records should be maintained in the event that any information requests are ultimately made by the IRS pursuant to Section 1202(d)(1)(C).

- Although the parties are likely to focus upon the general satisfaction of the "active business requirement" of Section 1202(e), there are a variety of subsidiary issues embedded in Section 1202(e) (as well as other issues) that the parties may inadvertently overlook. These issues include:

  - Availability of look-through rule for subsidiaries
  - No portfolio stock or securities
  - Subsequent infusions of cash; working capital
  - Maximum real estate holdings
  - Shareholder holding periods
  - Redemptions
  - Subsequent transactions / restructurings
  - Subsequent changes in law or changes in interpretation

Planning for exit

- Exits before the expiration of the 5-year holding period
- Exits after the expiration of the 5-year holding period
- Tax filing requirements and document retention

MORRISON
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State Hot Topics: Tax Reform and Market Sourcing

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State Hot Topics – Tax Reform and Market Sourcing
Denver Tax Institute

June 24, 2018

Agenda – State Hot Topics

State Tax Issues Raised by Federal Tax Reform

- State Conformity to IRC
- Overview of Key Provisions
- Selected State Legislative Responses to Tax Reform

Market-Based Sourcing for Apportionment

- Colorado's Adoption
- Various State Approaches
- Practical Considerations

Questions

State Tax Issues Raised by Federal Tax Reform

State corporate tax code conformity to IRC – as of July 1, 2018

Rolling conformity to IRC currently in effect

Conforms to IRC as of a specific date (as noted for each affected state)

Selectively conforms (as noted for each affected state to 'IRC currently in effect', or to 'IRC as of a specific date.')

Not applicable b/c state does not levy an entity level tax with an IRC reference point

Selective Conformity

AL - Current
AR - Varies by IRC section
CA - 1/1/15
MS - Current

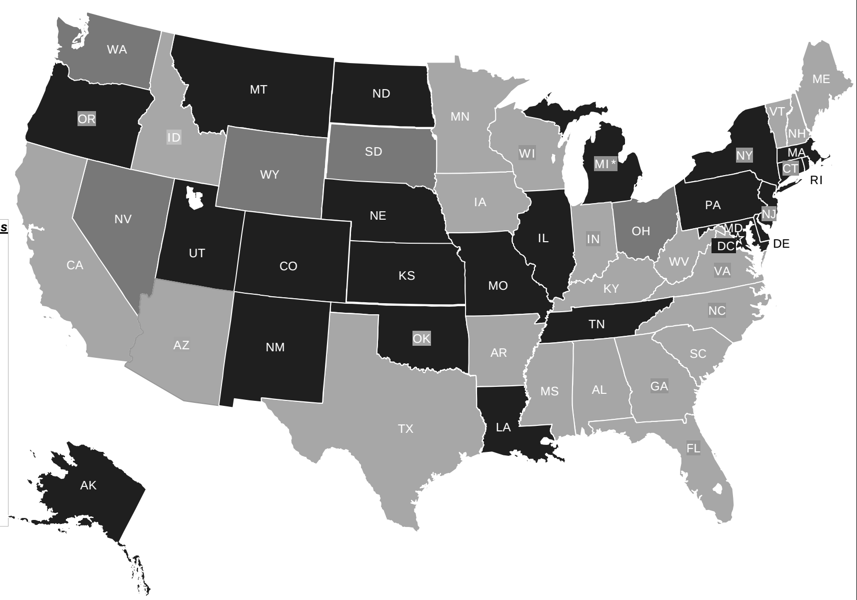
Specific Date Conformity

AZ - 1/1/17
FL - 1/1/18
GA – 2/9/18
HI - 2/9/18
ID – 12/21/17 or 12/31/17
IN - 2/11/18
IA - 1/1/15
KY - 12/31/17
ME - 12/31/16
MI* - Current or 1/1/18
MN - 12/16/16
NH - 12/31/16
NC – 2/9/18
SC - 12/31/16
TX - 1/1/07
VA – 2/9/2018
VT - 12/31/16
WI – 12/31/17
WV - 12/31/17

State conformity to IRC references specific (and/or decouples from specific) Tax Reform provisions

ID - 12/21/17 (2017 TY) or 12/31/17 (2018 TY)
VA – 2017 tax year conformity only
GA – 2/9/2018. Selective nonconformity
FL – 1/1/2018. Nonconformity to 100% bonus
WI – 12/31/2017. Selective nonconformity
AZ – 2017 tax year conformity only
OR – Selective nonconformity
NY – Selective nonconf. to deemed repatriation provs., eff. 1/1/17
IN – 2/11/2018 (effective 1/1/2018). Nonconformity to 163j
CT - Nonconformity to 163j
OK – 965(h) election is available
NC - 2/9/2018. Selective nonconformity
HI - 2/9/2018. Selective nonconformity
NJ - Selective nonconformity

****Contact a tax advisor for more information****



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Tax reform—Multistate considerations
Overview of key provisions

Provision	"To-Do"	Impact	Observation
Federal Corporate Rate Reduction	• Analyze state deferred tax asset inventory • Evaluate impact of proposed federal accounting method changes/other decisions to accelerate deductions/defer income and update plans to enhance utilization of state deferred tax assets • Consider accelerating payment of known state tax liabilities (fiscal year taxpayers): – Voluntary disclosure/amnesty – Resolve state tax disputes – RAR reporting	• Strategic utilization of deferred state tax assets • Pay state taxes under higher federal tax rate • Taxpayers may consider restructuring if 21% corporate rate is more/less favorable than passthrough tax treatment with new federal QBI deduction	• State tax deferred assets may grow in relative importance due to declining federal tax rates and may be overlooked in federal tax planning • Resolving of state tax disputes during period of higher federal tax rates may yield other non-tax benefits (e.g., eliminate ASC 740 reserves for state tax liabilities resolved through VDA; state audit resolution may free up resources, etc.)
Immediate Federal Expensing	• Evaluate state conformity to IRC Section 168(k) • Coordinate taxpayer planning regarding immediate expensing and repatriation of foreign E&P • Identify state and local C&I opportunities • Evaluate whether any state ITC or R&D credits use federal basis which will need to be valued or eliminated • Assess impact on valuation allowance analysis	• State conformity to immediate expensing expected to vary; current non-conforming states generally expected to continue non-conformity • Complexity in tracking conformity may require technology solutions • State and local C&I opportunities should remain available • State/federal basis differences	• Need to monitor state legislative response to amended IRC Section 168(k) • Negotiated incentives can have long lead time

Tax reform—Multistate considerations (cont.)
Overview of key provisions (cont.)

Provision	"To-Do"	Impact	Observation
Limitations on Federal Income Tax Deduction for Interest	• Evaluate state conformity to proposed amendments to IRC Sec. 163(j) imposing limits on deductions for interest expense • Evaluate any overlap with existing state limitations applicable to third party and affiliated indebtedness • Evaluate state impact of taxpayers shifting away from debt (e.g., franchise taxes) • Assess impact on valuation allowance analysis	• States generally anticipated to support interest expense limitation though conformity may not be automatic • Limitation on interest expense may lead to more equity financing, which could have an impact on state capital taxes	• If limitation on interest expense deduction leads to less intercompany borrowing, it could impact whether certain entities qualify as financial institutions for state tax purposes • State filing group differences may create additional issues (e.g., who does the state consider the "taxpayer" for purposes of the limitation)
Repatriation Rates*: 15.5% for cash, 8% for non-cash	• Model impact of increased Subpart F income recognition for state taxes; develop plan for managing state exposure • Calculate inventory of pre-deemed repatriation and post-repatriation foreign E&P • Develop plan for actual repatriation • Assess impact on valuation allowance and deferred taxes	• Strategic plan for Subpart F income recognition may mitigate state tax exposure on deemed recognition • Strategic plan for repatriation of after-tax foreign E&P may mitigate state tax exposure on actual repatriation • Credits & incentives for domestic investment of foreign E&P • Apportionment considerations (i.e., receipts factor)	• State tax treatment of Subpart F income varies • State tax conformity to IRC Section 965 varies • States that are unable to tax deemed repatriation may seek avenues to impose tax on actual repatriation • State and local C&I opportunities may be significant upon reinvestment

Tax reform—Multistate considerations (cont.)
Overview of key provisions (cont.)

Provision	"To-Do"	Impact	Observation
Federal Tax on "Global Intangible Low-Taxed Income" ("GILTI") and Related Deduction under new IRC Section 250	• Evaluate state conformity to new IRC Sections 250 and 951A • Evaluate state income tax treatment of GILTI/250 deduction • Evaluate current state taxation of GILTI (e.g., WW, 80/20, etc.) • Consider structuring and other tax planning options • Assess impact on valuation allowance analysis	• State conformity to Subpart F and treatment of Subpart F income may varies; generate planning considerations • Prevention of double-taxation of foreign income • May lead to more comprehensive restructuring discussions	• State taxation of GILTI may lead to more complex state apportionment calculations and unitary business determinations • Coordinate GILTI with state tax provisions for deductibility (or not) of payments to related parties for intangibles
Deduction for "Foreign-Derived Intangible Income" ("FDII")	• Evaluate state conformity to new IRC Section 250 • Evaluate state income tax treatment of FDII deduction • Evaluate current state taxation of FDII (e.g., 80/20, foreign source income exclusions, etc.) • Assess impact on valuation allowance analysis	• Apportionment considerations (i.e., receipts factor) • May lead to more comprehensive restructuring discussions	• Coordinate FDII deduction with state tax provisions that exclude foreign source income

Tax reform—Multistate considerations (cont.)
Overview of key provisions (cont.)

Provision	"To-Do"	Impact	Observation
Federal "base erosion anti-abuse tax" ("BEAT") on Taxable Income in Excess of Deductible Payments to Related Foreign Parties	• Potential for state legislative action to conform to new IRC Sec. 59A unclear • Consider state add-back provisions • Consider state implications of structuring and other tax planning options	• If recipient of base erosion payments is already included in state returns (e.g., WW, 80/20, tax haven), state taxation of base erosion payment could be double-taxation • May lead to more comprehensive restructuring discussions	• Need to monitor state legislative response to new federal minimum tax • Need to consider impact of unitary business determinations and state related party definitions on new tax calculations

Tax reform—Multistate considerations (cont.)
Overview of key provisions (cont.)

Provision	"To-Do"	Impact	Observation
100% DRD on Repatriated Foreign E&P (the new participation exemption system)	• Under current law, general conformity to new IRC Section 245A may occur • For states that may include, consider potential applicability of differing state treatment of distributions from unitary and non-unitary foreign affiliates	• Increased complexity of federal-state differences in income inclusion	• State budgetary pressures may lead to states refusing to conform to IRC Section 245A and 100% DRD
Net Operating Loss Modifications	• NOL deductions limited to 80% of taxpayer's (pre-NOL) taxable income • Most carrybacks eliminated • Indefinite carryforward allowed • House proposal to adjust carryforwards for time value of money not adopted • Assess impact on valuation allowance analysis	• States that follow federal NOL provisions would be impacted upon conformity to the new IRC • States generally already impose state-specific carryforward and carryback provisions • State conformity to other modifications expected to vary	• These changes could cause states that allow carrybacks to revisit allowing carrybacks and/or consider to limitations NOL utilization

Tax reform—Multistate considerations (cont.)
Overview of key provisions (cont.)

Provision	"To-Do"	Impact	Observation
Elimination of Federal Deductions/Credits	• Evaluate state conformity to repeal of/limitations on federal incentives • Evaluate state-specific opportunities for similar incentives (e.g., state-specific WOTC) • Assess impact on valuation allowance analysis	• States generally anticipated to conform to federal base-broadening measures given balanced budget mandates, but isolated opportunities may remain	• States may preserve state-only application of repealed/limited federal incentives by conforming to old version of law (e.g., Oregon R&D credit did not conform to federal R&D credit expiration)
Passthrough Income (New 20% deduction for qualified business income)	• Evaluate state conformity to new qualified business income ("QBI") deduction and new IRC Sec. 199A (including states already imposing entity-level income taxes on passthroughs) • Consider state impact of restructuring that could follow federal corporate rate reduction below passthrough income rates • Evaluate federal QBI definition in new IRC Sec. 199A and taxpayer apportionment/ allocation determinations for state business/ non- business income purposes	• State budgetary pressures may limit state conformity to new federal deduction • Taxpayers may consider restructuring if 21% corporate rate is more/less favorable than passthrough tax treatment with new federal QBI deduction	• Need to monitor state legislative response to new federal deduction • States imposing gross receipts taxes on passthroughs will not experience direct adverse budget impact from new federal QBI deduction

Selected state responses to federal tax reform

As of June 1, the following states have enacted legislation updating conformity to the IRC, and/or otherwise decoupling from various federal tax reform provisions.

Arizona – Applicable to 2017 tax year, new law generally conforms state corporate and personal income tax references to the IRC in effect on January 1, 2017, including federal tax reform provisions that are retroactively effective during the tax years beginning from and after December 31, 2016 through December 31, 2017. Applicable for tax years beginning from and after December 31, 2017, Arizona conforms state corporate and personal income tax references to the IRC as in effect on January 1, 2017.

Connecticut - On May 31, 2018, Governor Dannel Malloy signed SB 11 which enacted a new pass-through entity (PET) income tax applicable to taxable years commencing on or after January 1, 2018, levied at the top personal income tax rate and offset by a credit at the personal or corporate income tax level.

In addition, SB 11 makes additional changes to Connecticut's tax laws affecting individuals and corporations, applicable to taxable years commencing on or after January 1, 2017 unless otherwise noted, including the following:

- Decouples from IRC Section 163(j) for corporate income tax purposes.
- Amends the required add-back of expenses related to the dividend received deduction (DRD) at five percent of all dividends received for corporate tax purposes.
- Decouples from IRC Section 168(k) bonus depreciation for individual income tax purposes. (Note - SB 11 maintains Connecticut's historical decoupling of IRC Section 168(k) for purposes of the corporation business tax.)
- Effective July 1, 2018, authorizes municipalities to issue residential property tax credits to eligible individual taxpayers who make contributions to approved community supporting organizations.

Selected state responses to federal tax reform (cont.)

As of June 1, the following states have enacted legislation updating conformity to the IRC, and/or otherwise decoupling from various federal tax reform provisions (continued)

Florida - H.B. 7093 updates Florida's conformity to the IRC to January 1, 2018, and extends Florida's decoupling from federal bonus depreciation to include assets placed in service before January 1, 2027

Georgia - Conforms to the IRC as of February 9, 2018 but decouples from a number of significant federal tax reform provisions including the interest deduction limitations of IRC Sec. 163(j) and the full expensing of assets under IRC Sec. 168(k). Subsequent legislation explicitly allows 100% subtractions under IRC Sec. 250 (though taxpayers that subtract 100% of GILTI cannot claim GILTI deduction under IRC Sec. 250).

Idaho - Effective January 1, 2017, conforms to IRC as in effect on December 21, 2017, and selectively updates conformity to IRC Sections 965 as in effect on December 31, 2017. Effective for 2018 tax years, conforms to IRC for 2018 tax years to January 1, 2018, as well as disallows deductions under IRC Secs. 245A, 250 and 965(c).

Selected state responses to federal tax reform (cont.)

As of June 1, the following states have enacted legislation updating conformity to the IRC, and/or otherwise decoupling from various federal tax reform provisions (continued)

Indiana - On May 14, 2018, Indiana Governor Eric Holcomb signed House Bill 1316(ss), which includes the following notable amendments to Indiana tax law:

- Effective retroactive to January 1, 2018, updates the IRC conformity date to February 11, 2018 for both individual and corporate income tax purposes
- For tax years beginning after 12/25/2016, requires deemed repatriation income under IRC Section 965(a) to be added back for corporate income tax purposes and requires the deduction under IRC Section 965(c) to be added back for individual income tax purposes
- Expands the foreign source dividend deduction for corporate income tax purposes to include income associated with IRC Section 965 and IRC Section 951A for taxable years after December 25, 2016
- Prescribes rules for the treatment of receipts in apportionment for IRC Section 965 and IRC Section 951A for taxable years beginning after December 25, 2016.
- Effective retroactive to January 1, 2018, decouples from IRC Section 163(j) interest limitations rules.
- Effective retroactive to January 1, 2018, updates the Indiana Net Operating Loss (NOL) carryforward period from being tied to IRC Section 172(b) to being limited to a 20 year carryforward period

Kentucky – Legislation enacted on April 13 updates the IRC conformity to December 31, 2017 effective for taxable years beginning on or after January 1, 2018

Selected state responses to federal tax reform (cont.)

As of June 1, the following states have enacted legislation updating conformity to the IRC, and/or otherwise decoupling from various federal tax reform provisions (continued)

Michigan - Conforms to the IRC in effect on January 1, 2018, or, at the option of the taxpayer, as in effect for the tax year.

New York - Effective for taxable years beginning on or after January 1, 2017, new law provides the following:

- Expands the definition of exempt CFC income under Article 9-A to include the federal repatriation amount calculated pursuant to IRC Sec. 965(a) (as adjusted by IRC Sec. 965(b) and without regard to IRC Sec. 965(c)) regardless of whether the shareholder with the IRC 965 inclusion conducts a unitary business with the CFC or CFCs giving rise to the IRC 965 inclusion amount.
- Entire net income is determined without application of either (i) the IRC Sec. 965(c) deduction or (ii) the foreign derived intangible income deduction allowed pursuant to IRC Sec. 250(a)(1)(A).
- The existing deduction from entire net income for amounts treated as dividends under IRC Sec. 78 is permitted only to the extent such amounts were not deducted under IRC Sec. 250.

Ohio – March 30 law change generally incorporates into Ohio's corporate and individual income tax laws those IRC amendments made since March 30, 2017 (previously, February 14, 2016), and permits a taxpayer whose taxable year ends after that date, but before the effective date of these incorporated changes (i.e., before March 30, 2018), to elect to apply the IRC as it existed for that taxable year. Ohio continues to decouple from certain federal income tax provisions, including those involving the IRC Section 179 deduction and IRC Section 168(k) bonus depreciation.

Selected state responses to federal tax reform (cont.)

As of June 1, the following states have enacted legislation updating conformity to the IRC, and/or otherwise decoupling from various federal tax reform provisions (continued)

Oklahoma - On May 7, 2018, HB 3715 was signed permitting taxpayers (that have elected to make installment payments of their federal tax due pursuant to the provisions of IRC Sec. 965(h)) to also have such election apply to their payment of Oklahoma income taxes “attributable to the income upon which such installment payments are based.”

Oregon - Effective for taxable years beginning on or after January 1, 2017, Oregon taxpayers must add back amounts deducted under IRC Section 965(c), repeals Oregon’s tax haven law and creates new credit intended to prevent double-taxation of foreign E&P through IRC Section 965 and Oregon’s tax haven law. (Note – Oregon is a “rolling conformity” IRC adoption state. Accordingly, Oregon automatically conforms to the provisions of the 2017 Tax Reform Act that pertain to the calculation of taxable income.) Effective for tax years beginning on or after January 1, 2018, Oregon requires taxpayers add back the 199A deduction

Virginia - Conformity to the IRC in effect on February 9, 2018 but limits conformity to federal tax reform legislation to 2017 tax year only.

West Virginia - Conforms to the IRC as of December 31, 2017, effective for tax years beginning on or after January 1, 2018

Wisconsin - For tax years beginning after December 31, 2016 and before January 1, 2018, Wisconsin conforms to the IRC as amended and in effect through December 31, 2016. For tax years beginning after December 31, 2017, Wisconsin conforms to the IRC as amended and in effect through December 31, 2017 but does not conform to provisions of federal tax reform (e.g., IRC Secs. 163(j), 168(k), 245A, and 951A).

Selected state responses to federal tax reform
Proposed legislation and administrative guidance

Alabama - On April 27, 2018, Alabama DOR issued a notice instructing Alabama taxpayers on how to report IRC Sec. 965 amounts. For corporate taxpayers, transition tax income and deductions (including state DRD on net amounts for shareholders that own at least 20% of relevant CFCs) will be reporting on Form 20, Schedule A, with supporting schedules.

California - The FTB released a Preliminary Report on Specific Provisions of the Federal Tax Cuts and Jobs Act stating “Existing California [Corporate Tax Law (“CTL”)] does not incorporate by reference IRC sections 245A, 951A, and 965. In addition, the water’s-edge provisions within the California CTL do not specifically refer to IRC sections 245A, 951A, and 965; therefore, existing California water’s-edge provisions do not conform to those repatriation provisions.” See also Assembly Constitutional Amendment 22 (imposes 10% surtax on net income of all corporations that is over $1 million for 2018 tax years forward).

Illinois - S.B. 3152 introduced on February 16 would, for tax years beginning after December 31, 2017, disallow for state purposes deductions under Section 250(a)(1)(A) of the Internal Revenue Code for corporate taxpayers.

Maryland - Comptroller released a supplement to its earlier report outlining what it views as the Maryland corporate tax impact of the major federal corporate changes (generally increase corporate income tax collections).

Minnesota - H.F. 2942 includes IRC conformity provisions, while decoupling from certain provisions and specifying that Minnesota would require an addition for amounts deducted under IRC Sec. 965(c).

Pennsylvania - Previously issued Corporation Tax Bulletin 2017-02 requires a 100% deduction under IRC 168(k) to be added back to taxable income, with no additional mechanism for cost recovery with respect to qualified property, effective for property placed in service after September 27, 2017. H.B. 2017 would allow additional depreciation deductions equal to depreciation amounts otherwise allowed under IRC Secs. 167 and 168 without regard to Sec. 168(k).

2018 Legislative Activity—Legislative Calendar

Jurisdiction	Legislative Calendar	Jurisdiction	Legislative Calendar
Alabama	1/9/2018–4/24/2018	Idaho	1/8/2018–3/27/2018
Alaska	1/16/2018–5/16/2018 (may be extended)	Illinois	1/23/2018 (House) and 1/30/2018 (Senate)–5/31/2018 (both House and Senate)
Arizona	1/8/2018–4/17/2018	Indiana	1/3/2018–3/14/2018
Arkansas	2/12/2018–Will last for 30 days, with 3 15-day extensions possible	Iowa	1/8/2018–4/17/2018
California	1/3/2018–8/31/2018	Kansas	1/8/2018–4/6/2018
Colorado	1/10/2018–5/9/2018	Kentucky	January–late March
Connecticut	2/7/2018–5/9/2018 (may adjourn early)	Louisiana	3/12/2018–no later than 6/4/2018
Delaware	1/9/2018–6/30/2018	Maine	1/3/2018–4/18/2018 (may be extended)
District of Columbia	Generally in session year-round	Maryland	1/10/2018–4/9/2018
Florida	1/9/2018–3/9/2018	Massachusetts	1/10/2018–6/30/2018 (may be extended into July)
Georgia	1/8/2018 + no more than 40 working days	Michigan	Current session runs through December 2018
Hawaii	1/17/2018–5/3/2018	Minnesota	2/20/2018–5/21/2018

2018 Legislative Activity—Legislative Calendar (cont.)

Jurisdiction	Legislative Calendar	Jurisdiction	Legislative Calendar
Mississippi	January–late March	Pennsylvania	1/22/2018–6/29/2018 (Senate) and 6/30/2018 (House)
Missouri	1/3/2018–5/18/2018	Rhode Island	1/2/2018–mid-July, 2018 (estimated)
Montana	No legislative sessions in even-numbered years unless special session called	South Carolina	1/9/2018–no later than 5/10/2018
Nebraska	1/3/2018–4/18/2018	South Dakota	1/9/2018–3/26/2018
Nevada	No legislative sessions in even-numbered years unless special session called	Tennessee	1/9/2018–late April/early May
New Hampshire	1/3/2018–6/30/2018	Texas	Next regular session will commence on 1/8/2019
New Jersey	Generally in session	Utah	1/22/2018–3/8/2018
New Mexico	1/16/2018–2/15/2018	Vermont	1/3/2018–5/4/2018
New York	January, 2018–6/20/2018	Virginia	1/1/2018–3/10/2018 w/reconvened session to commence on 4/18/2018
North Carolina	1/10/2018–6/30/2018 (approx.)	Washington	1/8/2018–3/8/2018
North Dakota	1/3/2019–4/26/2019	W. Virginia	1/10/2018–3/10/2018
Ohio	The legislative schedule is set in six-month increments; the last currently scheduled session for the first half of 2018 is 6/27/2018	Wisconsin	1/16/2018–3/22/2018
Oklahoma	2/5/2018–5/25/2018 (special session)	Wyoming	2/12/2018–3/10/2018
Oregon	2/5/2018–3/11/2018 (may be extended)		

Market-Based Sourcing for Apportionment

State Recently Changing to Market-Based Sourcing Rules

Nearly thirty states have currently adopted market-based sourcing rules for sales other than of tangible personal property. States that have recently transitioned to market-based rules include:

- Arizona (elective phase-in 2014-2017)
- California (elective in 2011 and 2012, mandatory in 2013)
- Colorado (2019)
- Connecticut (2016)
- Kentucky (2018)
- Louisiana (2016)
- Massachusetts (2014)
- Missouri (effective August 28, 2015)
- Montana (2018)
- Nebraska (2014)
- New Jersey (2019)
- New York City (2015)
- New York State (2015)
- Oregon (2018)
- Pennsylvania (2014)
- Rhode Island (2015)
- Tennessee (July 1, 2016)
- Washington D.C. (2015)

Colorado's Adoption of Market-Based Sourcing

- Colorado H.B. 1185 by Governor John Hickenlooper on June 4, 2018
- Effective for tax years beginning on or after January 1, 2019
- Implements market-based sourcing for sales of services and intangible property
- Closely follows the model provisions adopted by the Multistate Tax Commission (MTC)

Colorado H.B. 1185 (cont.)

Colorado will source sales of services and intangibles to Colorado if the taxpayer's "market" for sales is in Colorado:

- Receipts from the sales of services will be sourced to Colorado "if and to the extent the service is delivered to a location" in Colorado.
- For the sale of intangibles, the taxpayer's market is in Colorado if and to the extent the property is used in Colorado, provided that a contract right, government license, or similar intangible property that authorizes the holder to conduct a business activity in a specific geographic area is used in Colorado if the geographic area includes all or part of Colorado.
- For the rental, lease, or license of intangible personal property, the taxpayer's market is in Colorado if and to the extent the property is used in Colorado, provided that the intangible property is utilized in marketing a good or service to a consumer is used in Colorado if that good or service is purchased by a consumer who is in Colorado.
- All other receipts from sales of intangible property not specifically addressed in the statute are excluded from both the numerator and denominator of the receipts factor.
- If the state of assignment cannot be determined by applying these rules, then the state of assignment must be reasonably approximated. If the state of assignment cannot be determined or reasonably approximated, such receipts are excluded from the receipts factor.

State Approaches to Interpreting the “Market” Can Vary

“Market” for Services

- Customer location
- Where the benefit of the service is received by customer
- Where the service is received
- Where the service is delivered

“Market” for Intangibles

- Where the intangible is used
- Where the intangible has a business situs
- Where the intangible is domiciled

Look-through approach

- Based on location of the customer’s customer

Market-based sourcing – practical issues

Reality is that market sourcing can be difficult to apply regardless of whether based on location of delivery, client benefit or something else

- Based on terms of contract?
- Location from where request for service is made/ordered?
- Based on a look through to the client's customer’s location?
- Location from which customer is billed and/or domiciled?
- What level of analysis and data collection is required by a seller?

Consider complex services that appear to benefit an entire organization – Where is the “benefit received” if the customer is a multistate (or multinational) company?

- Cloud computing services
- Accounting and legal services

Look-through approach

- Sourcing receipts based on the location of the customer’s customer
  - States have adopted this approach either through regulation or enforcement efforts
    - California applies such an approach to mutual fund service providers (Cal. Code Regs. tit. 18, § 25137-14)
  - Such an approach may lead to a large compliance burden for taxpayer’s because they may not control the data necessary to accurately source the receipts

Sales Sourcing Considerations

Service Revenue

- Where is the service performed?
- Is the service performed in multiple locations?
- Is the customer a national account serviced in multiple locations?
- Where is the contract negotiated?
- Where is the customer domiciled?
- Where is the office of the customer which ordered the sale?
- What type of service revenue is being sold?
- Is the service part of a bundled transaction?

What is the revenue stream?

License of an Intangible

- Where is the license utilized?
- Does the customer have the right to sublicense?
- Does the contract give the customer rights to a specific marketing area/zone?

Tangible Personal Property

- How is the product shipped?
- Do customers pick up at the seller's warehouse?
- Is product being sold to a retailer's warehouse or through a distribution company?

Records are key, so plan ahead !!!

Questions?

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Real Estate Update

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DENVER TAX INSTITUTE

Real Estate Update

July 24, 2018

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OVERVIEW—PHASES OF "TAX" REPRESENTATION

I. OVERVIEW—PHASES OF "TAX" REPRESENTATION

A. Tax Planning (at the Tip of the Spear)

1. What is the client's tax objective?

    a. Capital gain? § 1031 exchange?

    b. 20% deduction under § 199A? Increased expensing?

2. Structuring the transaction—planning phase

3. Documenting the transaction

4. Meeting minutes, assertions of facts confirming client intent, debt vs. equity?

    a. Condemnation—Case Study. In *815 Riverside Co. v. Commissioner*, 54 T.C.M. (CCH) 886, 889 (1987), the IRS successfully used factual statements contained in the corporate minutes to foreclose Section 1033 deferral of the sales proceeds. The minutes stated (. . . we do not want to pressure the City since the City may be unwilling to purpose the property at all."). The IRS used this statement as conclusive evidence that the property was not sold under a threat of condemnation, and thus the sale did not qualify for Section 1033 relief.

    b. Capital Gains—Case Study. In a very recent case, *Sugar Land Ranch Development LLC v. Commissioner*, T.C. Memo. 2018-21 (February 22, 2018), the Tax Court relied upon LLC "minutes" to find that the LLC held land for investment at the time of the land's sale, and therefore the LLC secured capital gain in the amount of $12,656,033.

B. Tax Return Reporting—Return Positions

1. Disclosure

2. Omission from return

3. Return position standards

4. ***Penalties much more common today***

    a. ***Pollard*** Case Study. In 2013, the Tax Court issued its memorandum opinion in *Pollard v. Commissioner*, T.C. Memo. 2013-88 (2013). The Tax Court upheld the IRS disallowance of a charitable deduction from an easement donation to Boulder County, Colorado. The case is an excellent case study for many substantive points, but the negligence penalty analysis is particularly instructive. The Tax Court rejected the taxpayer's attempt to establish good faith reliance upon both the advice of a real estate lawyer and the advice of Boulder County employees. The Tax Court noted (the Boulder County officials . . . "did not provide him with dispassionate tax advice; rather their goal was to complete the donation . . .").

C. **IRS Disputes**

1. Civil Tax Audits—follow-up from positions asserted on tax return

a. Disclosure of "substantiation" or backup documentation supporting position or omission from the return

b. Creating trust during audit process and establishing client's credibility

2. Criminal Investigations

a. *Dobrich v. Commissioner*, 1997 Tax Court Memorandum Decision "backdating" 45 day § 1031 written identification of replacement property (multiple million dollar civil tax fraud penalty upheld after criminal tax fraud conviction).

b. Former Tax Court Judge Diane Kroupa—case study—attempted questionable substantiation—tax adviser complacency at the tip of the sword

D. **Listing of Standards**

1. Return Position Standards

MORE LIKELY THAN NOT—Required for "Tax Shelters" and "Reportable Transactions"—Subjective Standard allowing for Judgment (**Greater Than 50%** chance of success)

SUBSTANTIAL AUTHORITY—Required for Taxpayer and Return Preparer to avoid penalties of IRC § 6662(a), and § 6694(a), respectively

Some Commentators place at about 40% probability of success

Objective Standard—Different from both More Likely and Realistic Possibility standards

REALISTIC POSSIBILITY OF SUCCESS—Generally abandoned under new return preparer penalty regime, but maintained by AICPA in SSTS. (Subjective Standard allowing For Judgment)

Historically considered by IRS as 1/3 chance of success

ADEQUATE DISCLOSURE / REASONABLE BASIS / GOOD FAITH BELIEF DEFENSE

Required for all non-frivolous Return Positions lacking Substantial Authority

Required for All Tax Shelter Positions and Reportable Transactions

FRIVOLOUS—Patently improper—forget it!

TOPIC II— IMPACT OF 2017 TAX CUT AND JOBS ACT ON REAL ESTATE TRANSACTIONS AND INVESTMENTS

II. INTRODUCTION

A. The enactment of the Tax Cut and Jobs Act, Public Law No. 115-97, 131 Stat. 2054 (Dec. 22, 2017), changed the tax landscape for all taxpayers, but the legislation has a particularly significant impact on pass-through entities and their owners.

B. While the new rules certainly create many tax savings opportunities, careful planning is necessary to ensure that pass-through entities can take advantage of the new opportunities contained in the 2017 Tax Cut and Jobs Act.

C. Given the speed with which the legislation was passed, there are many unanswered questions as to how the new rules will apply. Additional guidance is expected this year that will address the many open issues.

D. Since enactment, one of the Treasury Department's highest priorities has been additional guidance. We do expect detailed proposed regulations to be released this summer with the intent that final regulations be completed before year end.

III. C CORPORATION CHANGES

A. Corporate income tax rate is permanently lowered to ***21%*** beginning in 2018

B. Corporate AMT permanently repealed

C. Dividends received deduction reduced

IV. PASS-THROUGH DEDUCTION—IN GENERAL—SECTION 199A

A. New "below the line" deduction for "qualified business income" from pass-through entities and sole proprietorships

B. Maximum deduction is 20% of "qualified business income" (QBI)

C. Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction

D. Effectively reduces the rate on pass-through income to eligible taxpayers to ***29.6%***

E. Sunsets in 2026

V. PASS-THROUGH DEDUCTION—QUALIFIED BUSINESS INCOME

A. Generally, the ***ordinary income***, gain, deduction, and loss of a qualified trade or business will constitute "qualified business income."

1. What is a "qualified trade or business"?

    a. Any business other than a ***specified service business*** or the trade or business of performing services as ***an employee.***

    b. Specified service business—a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or where the principal asset of the business is the reputation or skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities.

    c. Two real estate focused businesses may (or may not) generate Section 199A qualified business income. As written, it is unclear whether a real estate brokerage firm or a mortgage brokerage firm could qualify for Section 199A relief.

    d. Scope of the ***Reputation and Skill Clause***. The scope of the reputation and skill clause is not clear. Possible guidance could be found in *Owen v. Commissioner*, 103 T.C.M. (CCH) 1135 (2012) and Private Letter Ruling 201436001 (September 5, 2014) and Private Letter Ruling 201717010 (January 23, 2017). Most are hoping that additional guidance will limit the reputation and skill clause to specialized service businesses described in § 199A.

B. Excluded items: the taxpayer's wages (or reasonable compensation), guaranteed payments, and investment-type income (capital gains, interest, dividends)

VI. PASS-THROUGH DEDUCTION—ADDITIONAL LIMITS

Subject to certain limits and thresholds, the deduction generally is the sum of:

A. The lesser of:

1. 20% of the taxpayer's qualified business income; or

2. The greater of:

    a. 50% of the W-2 wages with respect to the business, or

    b. 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property

B. Plus 20% of REIT dividends and distributions from publicly traded partnerships

VII. PASS-THROUGH DEDUCTION—DOLLAR LIMITS

Availability and/or calculation of the deduction is subject to limits based on the taxpayer's income and the type of business conducted:

Total Taxable Income	**Not Exceeding Threshold (Single - $157,500 / Joint - $315,000)**	**Threshold Plus Phase In**	**Over Threshold (Single - $207,501 / Joint - $415,001**
Specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-out, W2/basis limit phased in	No deduction permitted
Non-Specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-in of W2/basis limit	20% deduction permitted but fully subject to W2/basis limit

VIII. PASS-THROUGH DEDUCTION—2.5% OF BASIS LIMIT

A. The basis taken into consideration is "unadjusted basis," meaning it is not reduced by any depreciation deductions.

B. Only basis of <u>depreciable tangible property</u> "counts." Thus, purchased goodwill and other intangibles, even if amortizable, do <u>not</u> count.

C. "***Unadjusted basis***" (i.e., original cost) "counts" for the longer of useful life or 10 years.

1. Lose all basis once fully depreciated—"cliff vesting" concept

2. Allocated among partners in proportion to allocation of depreciation expense

3. Get 10 years for 5-, 7- and 10- year property

4. Get 10 years even for "bonus depreciation" property

IX. PASS-THROUGH DEDUCTION—EXAMPLE

A. <u>Example 1</u>: A wholly-owned business purchases an office building for $10M ($7M building, $3M land). The building generates annual rental income of $900,000. The maximum potential allowable pass-through deduction would be $180,000 (20% of $900,000). If the business paid no wages, the business would qualify for a deduction of only $175,000 (2.5% x $7M = $175,000).

B. <u>Example 2</u>: Same facts as Example 1, but assume $8M is allocated to the building. The deduction would not be limited and thus the full $180,000 (2.5% x $8M = $200,000) would be deductible.

C. Example 3: Same facts as Example 1, but assume the business pays $100,000 of W-2 wages. The ***full $180,000 pass-through deduction*** would now be available, calculated as follows:

1. 25% x $100,000 of W-2 wages = $25,000

2. 2.5% x $7M unadjusted basis = $175,000

3. $25,000 + $175,000 = $200,000

X. PASS-THROUGH DEDUCTION—TAXABLE INCOME LIMIT

A. Deduction is limited to 20% of the excess of taxable income over net capital gain

B. Example: $100,000 of QBI, $200,000 of long-term capital gain and $50,000 of itemized deductions, resulting in taxable income of $250,000.

C. Before application of this limit, deduction is equal to 20% of QBI of $100,000, or $20,000

D. Taxable income less net capital gain is $50,000 ($250,000-$200,000 = $50,000).

E. So the deduction will be reduced under this limit from $20,000 to 20% of $50,000, or ***$10,000***

XI. PASS-THROUGH DEDUCTION—OPEN ISSUES

A. Is rental real estate a "qualified trade or business"?

B. ***Aggregation/grouping issues***—multiple projects under common ownership

1. Real estate management company model—do management company wages count?

2. Two buildings, one fully-depreciated, with high income, the other brand new, with no or little income.

3. If treated as separate businesses, no 20% deduction available

4. If they can be aggregated, 20% deduction available

C. When is a principal asset of the business "the reputation or skill of one or more of its employees"?

D. Will "reasonable comp" principles apply to partnerships?

XII. PASS-THROUGH DEDUCTION—PLANNING OPPORTUNITIES

A. Switch from W-2 employee to 1099 independent contractor (IC) sole proprietorship

1. Loss of employee benefits (e.g., health insurance, 401K, etc.)

2. IC must pay all self-employment taxes

3. Employer may prefer paying W-2 employees in order to "max out" on its pass-through deduction

4. Need to revisit employee vs. IC classification criteria

B. Can a "specified service business" "spin off" qualifying portions of its business (e.g., HR, IT, IP)?

C. Separate books and records for two lines of business, one a "specified service business" and the other a "qualified trade or business"?

XIII. PASS-THROUGH DEDUCTION—PLANNING

A. "Multiply" $157,500 per person threshold through children and trusts

B. Switch from guaranteed payments (which don't qualify) to preferred returns (which do qualify)

C. S corp vs. LLC

1. Wages paid to S corp owners "count" towards W-2 limit, guaranteed payments to LLC don't because of K-1 rule

2. Possible solution—use tiered structure, employed at lower-tier, own equity through upper-tier

3. "reasonable comp" requirement for S corps

D. Switch from 1099 (IC) to W-2 employee to increase W-2 limit

XIV. CHOICE ENTITY—EFFECTIVE RATES

As a result of the new lower corporate rate, should taxpayers reconsider their choice of entity?

	C Corporation	**Pass-Through**
Income Tax Rate	21%	29.6% (effective)*
Dividend/Exit Tax Rate	20% + 3.8% = 23.8%	0%
Aggregate Tax Rate	39.8%	29.6%
State/Local Tax Deduction	100%	Property taxes deductible, SALT income taxes not deductible

* Assumes no 3.8% tax applicable and full use of the 20% pass-through deduction

XV. CHOICE OF ENTITY—OTHER CONSIDERATIONS

A. Potential for future changes

B. Easy to move into C corp status, but difficult to move out

1. Triggering of Section 311(b) gain on conversion/liquidation

2. But S corp election possible after potential five-year "BIG" tax concerns

C. Limits on ability to defer C corp distributions

1. Cash needs of shareholders

2. Accumulated earnings tax

3. Personal holding company rules

D. Many disadvantages to C corp status

XVI. CHOICE OF ENTITY—REITs

A. REITs do especially well:

1. Only one level of tax

2. Shareholders entitled to a 20% qualified business income deduction for ordinary distributions—***with no W2/basis limits or complications***

B. But REIT compliance and maintenance rules are onerous

XVII. EXCESS BUSINESS LOSS LIMITATION

A. Taxpayers cannot claim business losses in excess of threshold amounts ($250,000 for single filers / $500,000 for joint filers)

B. Previously, concern was generally whether a taxpayer was "passive" or "active" with respect to the business activity

C. Now, even "active" losses cannot be used to offset wages or investment income

D. Income and loss from all businesses first netted against each other

E. Excess loss not suspended until sale, but "rolls into" NOL carryforward, subject to "80% limit" annually

F. Taxpayers no longer able to pay "zero tax"

XVIII. CARRIED INTEREST—§ 1060

A. New 3 year holding period for certain long-term capital gains

B. Holding period applies to sale of either underlying asset or partnership interest

C. Applies only to businesses that raise capital from third party investors for certain types of investments (e.g., securities, commodities, rental real estate)

XIX. LIKE-KIND EXCHANGES

A. Like-kind exchanges still are permitted for real estate

B. No property other than real estate can be exchanged in a like-kind exchange

C. What about TPP included in real estate? Will this always constitute taxable "boot"? Will there be a *de minimis* exception?

XX. INTEREST EXPENSE LIMITATION

A. Generally, no deduction for interest expenses that exceed 30% of the taxpayer's adjusted taxable income

B. For pass-through entities, the limit applies at the entity (not the owner) level

C. Applies to new and existing debt

D. Real estate business can elect out of the limit, but in exchange, depreciation periods extended and no bonus depreciation except for TPP and land improvements

XXI. BONUS DEPRECIATION

A. 100% bonus depreciation deduction for qualified property, whether new or used, acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023

B. Phases down beginning in 2023 and sunsets in 2026

C. If a real estate business elects out of the interest expense limit, depreciation periods extended and no bonus depreciation except for TPP and land improvements

D. In addition, Section 179 deduction increased to $1M and now indexed for inflation

XXII. TECHNICAL TERMINATIONS OF PARTNERSHIPS

A. Under former Section 708(b)(1)(B), a partnership terminated upon a sale or exchange of 50% or more of a partnership's equity within 12 months

B. This provision in now repealed–no restart of depreciation periods, no filing short-year return on termination, and no "clean slate" for elections

XXIII. NOL LIMITATIONS—SECTION 172 MODIFICATIONS

A. No NOL carrybacks, only carryforwards

B. Carryforward is indefinite

C. Amount of an NOL carryforward that is deductible in any taxable year is limited to 80% of that year's taxable income

D. "Old rules" still apply to pre-2018 NOLs (but statute contains a "glitch")

XXIV. OPPORTUNITY ZONES

The Opportunity Zones Program was enacted as part of the 2017 Tax Cuts and Jobs Act to address uneven economic recovery and persistent lack of growth that have left many communities across the country behind. In the broadest sense, the newly-enacted federal Opportunity Zone (OZ) program provides a federal tax incentive for investors to invest in low-income urban and rural communities through favorable treatment of reinvested capital gains and forgiveness of tax on new capital gains. In Colorado, Opportunity Zones may help address a number of challenges:

- Promoting economic vitality in parts of the state that have not shared in the general prosperity over the past few years

- Funding the development of workforce and affordable housing in areas with escalating prices and inventory shortages

- Funding new infrastructure to support population and economic growth
- Investing in startup businesses that have potential for rapid increases in scale and the ability to "export" outside the state of Colorado
- Upgrading the capability of existing underutilized assets through capital improvement investments

This economic and community development tax incentive program provides a new impetus for private investors to support distressed communities through private equity investments in businesses and real estate ventures. The incentive is deferral, reduction and potential elimination of certain federal capital gains taxes. U.S. investors currently hold trillions of dollars in unrealized capital gains in stocks and mutual funds alone—this is a significant untapped resource for economic development.

Opportunity Funds which invest in Opportunity Zones provide investors the chance to put that money to work rebuilding the nation's distressed communities. The fund model will enable a broad array of private equity fund managers and investors to pool their resources, increasing the scale of investments going to under-served areas.

A. Opportunity Funds

The U.S. Treasury is finalizing their regulations to implement this new law and guide the Opportunity Funds. Investment groups are organizing and contemplating opportunities.

Opportunity Funds are a new class of investment vehicle that must be organized as a corporation or a partnership. The funds will specialize in attracting investors with similar risk/reward profiles to aggregate and deploy their capital in rural and low-income urban communities. Opportunity Funds will be comprised of private capital and guided by market principals. The funds must invest 90% of their assets in opportunity zone assets. Funds may invest in opportunity zones via stock, partnership interests, or business property.

Fund assets must create new business activity. If invested in an existing business, the fund must double the investment basis over 30 months. The finds can create new businesses or new real estate or infrastructure. Funds may not be invested in certain types of businesses like golf courses, country clubs, gambling establishments and a few other specifically excluded types of businesses.

B. Why Will Investors Choose an Opportunity Fund

Some investors have a social investment drive—they want their capital to improve communities they know and love. **The Opportunity Fund creates an additional incentive to inves**t in communities by deferring and possibly eliminating the capital gain tax on long-term investments. Volatility in the stock market has many investors sitting on unrealized capital gains; they can transfer these into Opportunity Funds putting the full value of the capital gain to work.

The law allows for the temporary deferral of inclusion of the capital gain in gross income for those capital gains that are reinvested into Opportunity Funds. The law sun-sets in 2026; therefore, investments will need to occur in the near-term for investors to realize the full capital gains tax benefits.

Capital Gains Incentives:

- Capital gains rolled into an Opportunity Fund.

    1. No up-front tax bill on the rolled-over capital gain.

    2. Reduction of tax on the rolled-over capital gain investment for long-term holding.

        - A 5 year holding increases the rolled-over capital gains basis by 10%.

        - A 7 year holding increases the rolled-over capital gain investment basis 5% for a total of 15%.

    3. Investors can defer their original tax bill until December 31, 2026, at the latest, or until they sell their Opportunity Fund investments, if earlier.

- Opportunity Fund investments held in the fund for at least 10 years are not taxed for capital gains.

C. **Opportunity Zones**

Colorado's Office of Economic Development and International Trade (OEDIT) conducted an inclusive and rigorous process to nominate census tracts for Opportunity Zone status. OEDIT produced metrics for evaluation, took public input, and collaborated with regional economic development partners who brought extensive human intelligence to the table to select census tracts with need and opportunity characteristics that present a good case for private capital investment. Colorado's Opportunity Zones present a portfolio of investment opportunities from urban to rural, and business starts to infrastructure. A majority of the census tracts are outside of the Front Range and touch much of the state with the goal of raising up our rural economies. The census tracts nominated have been approved. Colorado's OZs are now set for the duration of the program (through 2026).

Every state and territory could designate up to 25% of eligible census tracts as OZs; Colorado has 126 census tracts designated as Opportunity Zones. Private equity in Opportunity Funds will seek the best investment opportunities aligned with their missions and return requirements—it is important to remember that OZs in Colorado will frequently be competing with OZs throughout the United States for capital investments.

TOPIC III—CAPITAL GAIN PLANNING

I. CAPITAL GAINS AND LOSSES

A. Definitional Rules

1. "***Capital Asset***." Section 1221(a) defines "***capital asset***" as "***property held*** by the taxpayer (whether or not the property is connected to the taxpayer's trade or business)" ***and not excluded under eight special definitions*** or carve-outs. The statute contains several important carve-outs, two of which often relate to real estate.

2. ***Statutory Exclusions***. Section 1221 lists eight specific categories of property which will not fall within the definition of a "capital asset."

   a. ***<u>Real Property and Depreciable Property Used in the Trade or Business</u>***. Under Section 1221(a)(2), real property and depreciable property used in a trade or business is excluded from the definition of "capital asset." Most real estate used in a trade or business creeps back into capital gain status under Section 1231 as a "quasi-capital asset." Such property falls within the definition of "property used in the trade or business" set forth in Section 1231(b)(1) and is then worked in the definition of net capital gains.

   b. ***<u>Dealer or Inventory Property</u>***. Property held primarily for sale to customers in the ordinary course of a taxpayer's trade or business is excluded from the definition of a capital asset. Section 1221(a)(1).

   c. <u>Purpose of Inventory Carve-Out</u>. The purpose of Section 1221(1) is to differentiate between the profits and losses arising from the everyday operation of a business on the one hand . . . and the realization of appreciation in value accrued over a substantial period of time" on the other. *Malat v. Riddell*, 383 U.S. 569, 572, (1966) (*per curiam*). *See* Bernstein, "**<u>Primarily 'For Sale'"; A Semantic Snare</u>**, 20 Stan. L. Rev. 1093 (1968).

B. Inventory and "Dealer Property" Statutory Carve-Out.
Inventory and dealer property are ***not eligible*** for capital gain treatment. Such assets are not eligible to be treated as a capital asset under Section 1221(a)(1).

1. ***What is "Inventory"?*** "Inventory" is property that the taxpayer's "stock in trade" or other property of a kind that is included in the taxpayer's inventory if on hand at the end of the close of the year. Section 1221(a)(1).

2. ***What is "Dealer Property"?*** "Dealer property" is property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business." Section 1221(a)(1).

3. Neither the Code Nor the Treasury Regulations Define "Dealer Property." But the Cases Do.

   a. The Term "Primarily." The U.S. Supreme Court has held that the term "primarily" means of "first importance" or "principally." *Malat v. Riddell*, 383 U.S. 569 (1966). In determining whether the property is being held "primarily" for sale, the courts will look to why the property was being held at the time of the sale or exchange. *Mauldin v. Commissioner*, 195 F.2d 714 (10th Cir. 1952). *See also Continental Can Co. v. Commissioner*, 422 F.2d 405 (Cl. Ct. 1970) *cert. denied*, 400 U.S. 819 (1970).

   b. Held for Sale in the Ordinary Course of the Taxpayer's Trade or Business. In determining whether a taxpayer has held real property for "sale in its trade or business," the courts have developed many factors which may be considered, none of which is more determinative than another. *Biedenharn Realty Co. v. United States*, 526 F.2d 409 (5th Cir. 1976), *rev'g on reh'g*, 509 F.2d 171 (5th Cir. 1975), *cert. denied*, 429 U.S. 819 (1976). These factors are often referred to as the *Wintrop* factor test. *See United States v. Wintrop*, 417 F.2d 905 (5th Cir.1969).

   c. "Busyness." "In the area of real estate where the problem of determining the difference between business and investment most often arises, the courts have used 'busyness' to develop a number of testing factors which are applied with varying degrees of relevance to the particular facts of each case. The Fifth Circuit has decided more real estate cases than any other Circuit. Therefore, the court in *United States v. Wintrop* categorized the various factors most often cited in prior decisions. Courts have since approached the list of factors with an air of reverence befitting Judge Goldberg's own description of them in Wintrop as the "seven pillars of capital gain." Rentenbach & Sowell, *In the Trade or Business of an Isolated Sale of Real Estate*, 51 Tenn. L. Rev. 319, 337 (1984).

   d. The Nine Factor Test. In analyzing whether the taxpayer is holding the real estate "primarily for sale" to customers in the ordinary course in a trade or business, the cases generally evaluate nine factors:

   e. The ***purpose*** for which the property was ***initially acquired***;

f. the ***purpose*** for which the property was ***subsequently held***;

g. the extent to which ***improvements***, if any, were made to the property by the taxpayer;

h. the frequency, number, and continuity of sales;

i. the ***extent and nature*** of the transactions involved;

j. the ordinary business of the taxpayer;

k. the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property;

l. the listing of property with brokers; and

m. the ***purpose*** for which the property was ***held at the time of sale***.

4. ***Multi Factors Taken as a Whole***. The application of these factors is a factual issue. And as the Tax Court held in *Maddux Constr. Co. v. Commissioner*, 54 T.C. 1278, 1284 (1970), ("None of the factors are conclusive standing alone, but rather all of the factors taken as a whole govern.") *Id.*

5. ***Does a Real Estate Developer Always Have Inventory or Dealer Property?***

a. ***DuVal* Tax Court Case**. In *DuVal v. Commissioner*, T.C. Memo. 1994-603, 68 T.C.M. (CCH) 1375, the Tax Court held that property donated to a county for a public library ***constituted a capital asset*** not subject to the limitations of § 170(e)(1)(A).

(1) ***DuVal and Developer Status***. *DuVal* involved a developer who purchased property zoned for agricultural use in Virginia. To facilitate development after the seller refused to divide the tract, the developer submitted a rezoning request for residential designation on the rear tract and mixed-use designation on the front. While his rezoning application was pending, the county approached the developer to donate land for a new library. The developer agreed and the county approved his rezoning request.

(2) *IRS Tried to Limit Basis*. When the developer claimed a deduction for the donation, the IRS denied that the donated property qualified for a charitable deduction and asserted a deficiency. The IRS also determined that, if the property did qualify as a charitable contribution, § 170(e)(1)(A)

would limit the deduction to the developer's basis in the property.

(3) *Tax Court Sustains the* ***Fair Market Value Deductions***. The court allowed the deduction, finding that the ***developer had not held the donated property in the ordinary course of his business***. 68 T.C.M. at 1382 (i.e., the property was not dealer property). The court reasoned that the developer had not wanted to buy the commercial-type property, treated it separately on his books, and did not develop it, or even advertise it for sale, during the time that he owned it. *Id.* at 1383.

C. The Nine Factors Applied in Real Estate Cases

1. ***Real Estate Business Activities***. In a series of highly factual Tax Court cases, the court has attempted to apply the nine factor test. *See, e.g., Wineman v. Commissioner*, 1 T.C.M. (CCH) 791, 793 (1943) (Taxpayer held not to be dealer in property when taxpayer's practice concerning real estate had shown "a great preponderance of retention and devotion to investment purposes"); *Gamble v. Commissioner,* 14 T.C.M. (CCH) 1115, 1118 (1955) (Taxpayer held to be dealer in property because purpose for acquiring property was for resale, taxpayer had engaged in a high frequency of continuous sales, and taxpayer had been intimately and continuously engaged in the sale of land); and *Black v. Commissioner,* 45 B.T.A. 204 (1941) (Taxpayer engaging in multiple transactions involving buying and selling of buildings, and subdividing and developing of large tracts of land for sale held to be a dealer in property).

   a. <u>Dealer Status</u>? The Tax Court has recognized the distinction between dealers and traders in *Kemon v. Commissioner,* 16 T.C. 1026, 1032-1033(1951) *acq.*, 1951-2 C.B. 3. The Tax Court recognized dealers as:

   > "Those who sell 'to customers' are comparable to a merchant in they purchase their stock in trade . . ., with the expectation of selling at a profit, ***not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers*** who will purchase from them at a price in excess of their cost. . . . ***Such sellers are known as 'dealers.'***"

   "In contrast to 'dealers' are those sellers . . . who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell . . . . The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as 'traders.'" (citations omitted)

2. ***Number, Frequency and Continuity of Sales***. The federal courts recognize an important factor that analyzes the number, frequency and continuity of real estate sales. This factor has been seen as one of the most significant factors. *See, e.g., Biedenharn Realty Co. v. United States,* 526 F.2d 409 (5th Circ. 1976). The greater the sales activities, the greater the likelihood that the taxpayer will be deemed to be a dealer and the real estate will be dealer property.

   a. Illustrative Cases. In *Buono v. Commissioner,* 74 T.C. 187 (1980), *acq.*, 1981-1 C.B. 1, taxpayer was held not to be engaged in a trade or business due to lack of frequent sales and isolated nature of transaction. *See also Suburban Realty Co. v. United States,* 615 F.2d 171 (5th Cir. 1980), *cert. denied*, 449 U.S. 920 (1980) capital gains treatment was denied because taxpayer had engaged in ***substantial and continuous sales activity***.

3. ***Substantiality of Sales***. Another factor is the substantiality or magnitude of sales and the amount of income derived by a taxpayer from its regular business as compared to the amount of gain from the sale of the subject property. *See, e.g., Guardian Industries Corp. v. Commissioner,* 97 T.C. 308 (1991) (asset held to be dealer property as net income attributable to sales of such asset, when compared to net income from all of taxpayer's activities accounted for approximately 37-39% of taxpayer's net income) and *Rooster v. Commissioner,* 49 T.C.M. (CCH) 1594, 1610 (1985) ("The amount of income generated from property sales and the proportionate share of this income in relation to the taxpayer's other income may also be considered in determining whether the activities constitute a trade or business.")

4. ***Purpose for Acquisition and Reason for Which Property Is Held***. The courts also consider the purpose for which property is originally acquired and held. Property acquired and held for future appreciation is a favorable factor. *See, e.g., Biedenharn Realty Co. v. United States,* 526 F.2d 409 (5th Circ. 1976).

5. ***Catch All Category***. Even though a nine factor test, the courts will often consider a catch all factor category. In this catch all category, the court will consider (1) whether the taxpayer develops the property by subdividing, grading, rezoning, or installing roads and utilities (*see, e.g., Bush v. Commissioner,* 610 F.2d 426 (6th Cir. 1979); (2) the methods used by the taxpayer to effect the sale of property, including advertising, use of brokers or agents or substantial personal sales efforts by the taxpayer itself (*See, e.g., Biedenharn Realty Co. v. United States,* 526 F.2d 409 (5th Cir.

1976), *rev'g on reh'g*, 509 F.2d 171 (5th Cir. 1975), *cert. denied*, 429 U.S. 819 (1976); (3) whether the taxpayer has held the property for a substantial length of time (*See, e.g., Palos Verdes Corp. v. United States,* 201 F.2d 256 (9th Cir. 1953); and (4) the relationship of the property to the taxpayer's business *See, e.g., Gartrell v. United States,* 619 F.2d 1150 (6th Cir. 1980) and *Guardian Industries Corp. v. Commissioner,* 97 T.C. 308 (1991)).

D. **The "To Customers" Limitation**

1. ***To Customers in the Ordinary Course***. The "dealer property" definition has an important limitation that is often overlooked. Careful Land-banking structures will consider this additional limitation as it can shore up capital gain structures. *See* Friedlander, **"To Customers": The Forgotten Element in the Characterization of Gains on Sales of Real Property**, 39 TAX L. REV. 31 (1983). This limitation restricts the dealer property carve-out to held for sale to customers in the ordinary course of a trade or business.

    a. This requirement that the property must be held primarily for sale to customers "in the ordinary course" distinguishes those who are "dealers" in property from those who are merely "investors."

    b. Even if the taxpayer is holding the land primarily for sale, the land can still receive capital gain treatment if the taxpayer avoids "dealer" status. In other words, the landowner has not purchased the property because she has, or hopes to find, a market of buyers who will purchase from her at a price in excess of her cost.

    c. Taxpayer has depended upon such circumstances as a rise in value or an advantageous purchase to enable to her to sell at a price in excess of her cost. ***Thus, taxpayer qualifies as an "investor" and not a "dealer."***

E. **Boree—Tax Court and Eleventh Circuit Decisions**

1. ***Boree Background Facts.*** Between 2002 and 2006, Mr. Boree's LCC, Glen Forest, sold to individual buyers 64 lots comprising 841 acres for prices ranging from $3,000 to $6,000 per acre. Glen Forest's business operations consisted exclusively of the sale of these lots and its efforts in pursuit of developing the West Glen Estates subdivision; it conducted no other business and held no other assets. On the Schedules K-1 for 2002-2004 that it issued to taxpayer, Glen Forest, a limited liability company ***reported that it had sustained ordinary (non-capital) losses on the sale of these lots*** and that taxpayer's share of such losses exceeded $100,000.

    From 2005 to 2007, Boree reported the activities associated with Glen Forest on Schedule C, "Profit or Loss from Business." Taxpayers did not capitalize the costs associated with the West Glen Estates property, i.e., add them to their basis in the property, but instead characterized those costs as ordinary and necessary business expenses and took deductions for them. Taxpayers deducted expenses of $293,445 in 2005, $138,168 in 2006, and $46,360 in 2007 for Glen Forest. Taxpayers also claimed ordinary losses of $147,196, $63,228, and $15,633 for 2005-2007 on Schedule C, as their business expenses exceeded their business income. Although taxpayers took deductions of $46,360 for ordinary and necessary business expenses in 2007, they nevertheless treated the large gain ***($8,578,636)*** from the sale of their remaining lots in bulk as a long-term capital gain, rather than as ordinary income, on their tax return.

The sale of the remaining West Glen Estates lots to Adrian Development, pursuant to the April 2006 purchase agreement, closed on February 6, 2007. On that date, Glen Forest, LLC conveyed 1,067.63 acres to "Adrian Development at Baker LLLP"; 841 acres of West Glen Estates land had been previously been sold in lots. The property sold to Adrian included tracts from approved Phases I to III of West Glen Estates, tracts that were part of the proposed Planned Unit Development, and lots in the remaining acreage. Adrian paid $9,608,670 for the property or roughly $9,500 per acre.

After an examination of taxpayers' return, the IRS determined that the sale to Adrian was of property held primarily for sale to customers in the ordinary course of taxpayers' business and thus should be taxed as ordinary income rather than as a capital gain.

2. ***2014 Tax Court Opinion***. In its May 2014 opinion, the Tax Court upheld ordinary income characterizations noting that Boree "consistently treated Glen Forest as a business" by such activities as subdividing the West Glen Estates property, building a road, spending significant time and money on zoning activities, and continuing to pursue development activities after the Board had adopted the moratoria and requirements. *Boree v. Commissioner*, T.C. Memo 2014-85 (2014). The Tax Court added that taxpayers consistently represented Glen Forest as a real estate business to the buyers of its property, to the Board, and on their 2005, 2006, and 2007 tax returns. And between 2002 and 2006, taxpayers made frequent and substantial sales of property to customers in the ordinary course of business.

The Tax Court noted the LLC "continued to engage in significant sales and development activities; reported their sales of lots [in 2005] as ordinary income; deducted, rather than capitalized, expenses relating to their real estate activities; and did not segregate the property sold to Adrian Development from the rest of the [West Glen Estates] property." The Tax Court thus found that taxpayers' actions from the time Glen Forest acquired the [West Glen Estates] property, through the date of the

Adrian transaction, reflect their intent to develop [that] property and sell subdivided lots to customers." Accordingly, the Tax Court concluded, taxpayers' "income from the Adrian transaction was ordinary" and was not entitled to capital-gains treatment on their 2007 tax return.

a. Accuracy Penalty Upheld.

The Tax Court further held that taxpayers were liable for the 20% accuracy-related penalty based on a substantial understatement of tax, finding no evidence that taxpayers had established "reasonable cause" for their tax treatment of the Adrian transaction or that their 2007 return was prepared in good faith.

3. ***Eleventh Circuit Opinion***. In September 2016, the Eleventh Circuit Court of Appeals issued its decision in *Boree v. Commissioner*, 837 F.3d 1093 (4th Cir. 2016). The opinion contains important lessons for landowners seeking to secure capital gains.

In its September 2016 opinion, the Eleventh Circuit Court of Appeals sustained the Tax Court on the ordinary income characterization but reversed the Tax Court's penalty affirmance. 837 F.3d 1093.

The opinion provides that:

> In determining whether property is held for sale in the ordinary course of business within the meaning of § 1221(a)(1) of the I.R.C., considerations 'include (1) whether the taxpayer was engaged in a trade or business, and if so, what business; (2) whether the taxpayer was holding the property primarily for sale in that business; and (3) whether the sales contemplated by the taxpayer were 'ordinary' in the course of that business. Suburban Realty Co., 615 F.2d at 178. There is no real dispute at this point that prior to the enactment of the county land use restrictions, Glen Forest held the West Glen Estates property for sale in the ordinary course of the business of developing a subdivision When Glen Forest acquired the West Glen Estates property in 2002, it began subdividing and selling lots immediately. Soon thereafter, Glen Forest began seeking approval for subdivision of the property and submitted plans for development in multiple phases. ***Within a few months, the Borees executed covenants and restrictions for the entire property, which identified Glen Forest as the "developer" of West Glen Estates, and provided Glen Forest a board position in the homeowners association as long as the "[d]eveloper holds for the sale in the ordinary course of business at least five percent (5%) of the acreage in all phases of the property."*** Mr. Boree repeatedly represented West Glen Estates to the Baker County Board of Commissioners and the Northeast Florida

> Regional Planning Commission as a planned residential subdivision. Through all of its efforts, including building an expensive unpaved road, obtaining various permits, creating easements, setting up a homeowners association, and submitting development plans in multiple phases to the board for approval, Glen Forest always identified itself as the "developer" of the project.

837 F.3d at 1102.

F. **Taxpayer Success in Sugar Land Ranch Development**. On February 22, 2018, the United States Tax Court issued its decision in *Sugar Land Ranch Development LLC v. Commissioner*, T.C. Memo. 2018-21 (February 22, 2018). The case serves as an excellent case study for taxpayers with land in the development process. Even with a clear prior development intent and history, the taxpayer did secure capital gain on the sale of two parcels—one parcel produced gain of $11,086,640, and the second parcel produced gain of $1,569,393 (total capital gains reported—$12,656,033).

As part of the taxpayer's evidence, the Tax Court relied upon the "highly credible testimony" of two principals and the "2008 unanimous consent and the 2009 member resolution." These two documents are attached as **Addendum A**.

The Tax Court found that the LLC was formed to be in the business of selling residential and commercial lots to customers. But the LLC "ceased to hold its property primarily for sale in that business" and began to hold it only for investment.

> Importantly, when the parcels were sold, they were not sold in the ordinary course of the LLC's business: The LLC did not market the parcels by advertising or other promotional activities. The LLC did not solicit purchasers for the parcels, nor does any evidence suggest that the LLC's managers or members devoted any time or effort to selling the property; the Buyer approached the LLC. Most importantly, sale of the parcels was essentially a bulk sale of a single, large, and contiguous tract of land (which was clearly separated from any other properties by an easement and the levee) to a single seller—clearly not a frequent occurrence in the LLC's ordinary business.

Finally, the Tax Court addressed "sloppy" tax return entries.

> The IRS points out that on its 2012 Form 1065 return listed its principal business activity as "Development" and its principal product or service as "Real Estate." Although this circumstance may count against petitioners to some limited degree, we believe that these statements "are by no means conclusive of the issue." *See Suburban Realty*, 615 F.2d at 181.

Considering the record as a whole, we are inclined to believe that these stock descriptions were inadvertently carried over from earlier returns.

II. LAND-BANKING (SECTION 1221)—CAPITAL GAIN PLANNING

A. **Using the Lower Capital Gain Rates: An Introduction to "Land-Banking**." Many real estate clients enter the development process consumed with the ups and downs of the "entitlement" process. Land-use battles are time-consuming, costly and—in many cases—turn into a full contact sport. ***Income tax issues are often lost in the process.***

1. "***Front-Loading***." Critical and determinative tax reduction strategies can and should be introduced or "front loaded" early in the development process. The predominant tax reduction strategy is "land-banking."

2. ***"Land-Banking" Defined***. "Land-Banking" is the process of breaking real estate development activity into discrete pieces with different activities performed by different taxpayers. Some taxpayers perform investment activities, others perform development activities.

a. <u>Landowners</u>. Landowners or investors purchase, in their own names, or in an entity, undeveloped land that might be suitable for future development. The land would be held for appreciation.

b. <u>Selling "Ripe" Land</u>. When the land is ripe for development, the landowner sells to their wholly-owned corporation at its fair market value. ***Gain on this sale is returned as capital gain.***

c. <u>Corporation as the Developer</u>. After purchasing the real estate, the corporation acts as the "dealer." ***The additional profit derived by the corporation from developing the land is taxed as ordinary income.***

B. **Analyzing a Land-Banking Arrangement**

1. There are three levels of inquiry when analyzing a land-banking arrangement.

a. Will the land be viewed as held for sale to customers in the ordinary course of a trade or business and thus gain taxed as ordinary income;

b. Will the corporation's purchase transaction be respected as a purchase, or ***will the purported sale be recharacterized as a capital contribution***; and

c. Will the activity of the corporation be imputed to the landowner, the corporation treated as the agent of the landowner, or the entire project treated as one joint venture.

2. ***Land-Banking Case Study***. Assume a new client walks into your office explaining that she owns 800 acres of real property in a fast growing Front Range county with a tax basis of $100,000. She wants to maximize her profit by "entitling" the property and wants to develop a new subdivision. Your client has at least two possibilities.

a. Option A. Client completes the rezoning process breaking the 800 acre parcel into lots and sells platted homesites to several homebuilders over a three year period for total sales proceeds of $32,000,000. Client realizes ordinary income of $31,900,000 ($32,000,000 - $100,000).

Tax Rate 39%—Federal Income Tax Liability = ***$12,441,000.***

b. Option B. Client creates a wholly-owned S corporation and sells the parcel to the S corporation for $30,000,000 realizing a $29,900,000 capital gain taxed at ***20 percent***. The S corporation then undertakes the rezoning and sells platted lots to the homebuilders for $32,000,000 realizing ordinary income of $2,000,000.

Federal Tax Liability = ***$6,760,000*** ($5,980,000 + $780,000).

III. THE SERVICE'S MISUNDERSTANDING OF REAL ESTATE TRADE OR BUSINESS

A. Personal Activities Attack

1. ***The Taxpayer Efforts Rule***. In litigating land-banking cases, the Service repeatedly tries to argue that if a property owner's efforts increase the value of property, the property is held primarily for sale to customers in the ordinary course of business. This theory is known as the taxpayer efforts rule. The courts have consistently refused to adopt this theory. Personal efforts solely will not foreclose capital gain treatment.

2. ***1967 Wintrop Case***. In *United States v. Wintrop*, 417 F.2d 905 (5th Cir. 1969), the taxpayer subdivided and improved inherited property and, through such efforts, increased the value of the property. The Service argued "capital gains treatment is available only where the appreciation in value is the result of external market changes occurring over a period of time." *Id.* at 907-08. The Fifth Circuit rejected the Service's argument that "Betton Hills was not a capital asset merely because its increase in value was due in part to the taxpayer's effort." *Id.* at 907.

Indeed, many cases have accorded capital gain treatment "where taxpayer efforts have contributed to value . . . ." As is stated in *Barrios' Estate v. Commissioner*, 265 F.2d 517, 520 (5th Cir. 1959), "[t]o contend that reasonable expenditures and efforts, in such necessary undertakings are not entitled to capital gains treatment is to reject entirely the established principle that a person holding lands under such circumstances may subdivide it for advantageous sale." ***The taxpayer's personal efforts are not the only factors to consider***.

3. ***No Blanket Rule***. *Wintrop* concluded "that this blanket interdiction of capital gains treatment where there has been any laying on of hands is belied by the past decisions of this court." *Id.* at 909. (Ultimately, however, the *Wintrop* court found that the taxpayer's activities, including active participation in subdividing, improving, marketing, and selling the property rose to the level of a trade or business. Therefore, it denied capital gain treatment to the taxpayer.)

4. ***The Very Favorable Buono Case***. In *Buono v. Commissioner*, 74 T.C. 187 (1980), *acq.*, 1981-2 C.B. 1, a Subchapter S corporation acquired a tract of undeveloped land and spent a significant amount of time and money to prepare a subdivision application for a portion of the property. It also challenged new zoning requirements that would render the plat useless. It took the taxpayer approximately four years to obtain approval of the plat. After the plat was approved, the taxpayer sold the subdivided portion of the property.

5. ***Tax Court Says No Taxpayer Effort Rule***. In *Buono*, the Service argued that since the taxpayer's efforts increased the value of the property, the property lost its status as a capital asset. The Tax Court stated, "[t]he cases which respondent cited as authority for a blanket 'taxpayer effort' rule fail to lend support to such a proposition. Although the appreciation at issue in each of the cases was attributable mainly to the efforts of the taxpayer, such a factor supported a finding that the substantiality and frequency of the activities in question were sufficient to put the taxpayer in the real estate business. In other words, the fact that a taxpayer's activities contributed to the property's appreciation did not acquire significance independent of the question whether these activities constituted a trade or business under Section 1221(a). That question should not be resolved by examining only whether the property's appreciation is due mainly to the taxpayer's efforts. Rather, the focus of the inquiry is whether the taxpayer's activities rise to the level of a trade or business." *Id.* at 205.

6. ***Factual Analysis***. The Tax Court disposed of this issue by stating: "In an area of the tax law which is essentially factual, we cannot adhere to a blanket rule that any activity which results in appreciation necessarily constitutes a section 1221(1) business." *Id.*

7. ***Trade or Business Activity Test***. Based on the decision in these decisions and others, it appears the courts have not embraced a Taxpayer Efforts Rule. Thus, a taxpayer may, through its efforts, increase the value of property without causing the property to lose its status as a capital asset. The test is whether the taxpayer's activities rise to the level of a trade or business, not whether they increase the value of the property. *See also S&H, Inc. v. Commissioner*, 78 T.C. 234 (1982).

IV. SALE TO THE DEALER VS. CAPITAL CONTRIBUTION

A. **"Real Note."** In reviewing this second issue, the sale to the dealer corporation must be upheld as a sale. It is critical that the note received by the selling landowner be a "real note. " Under the case law, a promissory note received in exchange for the transfer of property to a corporation will be deemed a real note provided such note is not for an amount substantially lower than the value of the property transferred, if the note is interest bearing, and if there is an intention that the note be repaid. *See, e.g., Alderson v. Healy,* 65-1 USTC ¶ 9239 (D. Montana 1965) and *Burr Oaks Corp. v. Commissioner,* 365 F.2d 24 (7th Cir. 1966).

1. ***Capital Contribution***. If the note is not found to be a "real note" under which payments are expected to be made with a reasonable interest rate, the transaction will be seen as a capital contribution under Section 351. *See, e.g., Utley v. Commissioner,* 906 F.2d 1033 (5th Cir. 1990) (transfer of property to corporation held to be installment sale and not capital contribution).

2. ***Carryover Basis***. In such a case, the dealer corporation will receive a carryover basis in the property. Upon a subsequent sale or exchange of the land, the corporation will recognize ordinary income. The amount of this gain will be equal to the full amount of the appreciation on the land, and such income will be subject to ordinary income.

B. **Sale v. Capital Contribution—"Undeveloped Real Estate."** As summarized very well in the case law, "the sale versus capital contribution problem arises from a situation which often confronts taxpayers with holdings in undeveloped real estate." *Bradshaw v. United States,* 683 F.2d 365, 371 (Cl. Ct. 1982) ("it is not uncommon for a landowner with a large tract of land suitable for development to want to ***freeze as capital gain the appreciation in the value*** of the property that has accrued during its ownership.")

1. ***Deprives of Participation***. While an outright sale of the property achieves this result, it also deprives the landowner of any participation in the profits to be reaped from its ultimate development. *Id.*

2. ***Runs the Risk***. On the other hand, if the landowner develops and sells the property himself, he runs the risk of being treated as a dealer of the property and any gain generated through sales, including the gain

associated with the land's appreciation in value while undeveloped, is taxable to him at ordinary income rates. *See, e.g.*, *Goodman v. United States*, 182 Ct. Cl. 662, 390 F.2d 915, *cert. denied*, 393 U.S. 824 (1968); *Suburban Realty Co. v. United States*, 615 F.2d 171 (5th Cir.), *cert. denied*, 449 U.S. 920 (1980).

3. ***"Apparently Viable" Solution***. In the face of such a dilemma, taxpayers have devised an apparently viable solution. By selling the real property to a controlled corporation, they can realize their capital gain on the appreciation which has accrued during their ownership and, at the same time, preserve their opportunity to later participate in the developmental profits as shareholders of the development corporation. Moreover, the corporation obtains a cost basis in the real property, thereby reducing the amount of ordinary income to be received from subsequent sales. *Id.* at 372.

4. ***IRS Challenge***. Not unexpectedly, the Commissioner has repeatedly challenged the characterization of such a transaction as a sale, instead maintaining that the transfer is, in reality, a capital contribution and that the transferee corporation is only entitled to a carryover basis for the property. *See, e.g.*, *Burr Oaks Corp. v. Commissioner*, 365 F.2d 24 (7th Cir. 1966), *cert. denied*, 385 U.S. 1007; *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116 (5th Cir. 1959).

5. ***Court Accepts Sale Treatment.*** In the *Bradshaw* case, the court dismissed the IRS claims finding "the various formalities of a sale were strictly observed," and "the fact that the subject transaction was between a corporation and its sole shareholder does not by itself support the characterization of the transaction as a contribution to capital. A shareholder may contract with his controlled corporation so long as the arrangement is fair and reasonable." *Id.* at 372, n.18. Therefore, the corporation's tax basis for figuring gain on the sale of lots was the $250,000 recited as the purchase price of the lots.

C. **Sale Upheld in Bradshaw**. In *Bradshaw v. United States*, 683 F.2d 365 (Ct. Cl. 1982) the selling shareholder successfully upheld a land-banking transaction since '[t]he various formalities of a sale were strictly observed." *Id.* at 373.

1. ***Bradshaw's Facts***. *Bradshaw* involved a sale by Bradshaw's father of 40.427 acres of a larger tract to his newly created and wholly owned corporation, Castlewood Inc. The sales price was $ 250,000. The $ 250,000 was represented by five $ 50,000 interest-bearing notes, with one note maturing each year over a five-year period starting three years after the sale. Castlewood improved and subdivided the land, borrowing the money from another family member.

2. ***The IRS Theory***. The IRS unsuccessfully contended that "Congress has dictated that no tax consequences shall attach to a transaction where direct ownership of property is changed into indirect ownership through a proprietary interest in a corporation." *Id.* at 373. The circumstances in this cases purported sales demonstrate that the transferor, in fact retained a continuing interest in the property transaction, the transaction is more appropriately characterized as a capital contribution."

D. **Colorado Land-Banking Case and Capital Gain Case**

1. ***The Phelan Decision***. In 2004, Tax Court Judge Gerber released the Court's decision in *Phelan v. Commissioner*, 88 T.C.M. (CCH) 223 (2004). The case involved Colorado taxpayers and a 1,050 acre residential real estate development project in Monument, Colorado.

a. <u>Favorable Capital Gain Sustained</u>. In its decision, the Tax Court rejects the Service's attempt to recharacterize real estate property sales as "ordinary income." ***Favorable capital gain treatment was sustained***.

b. <u>Strong Case Law Cited</u>. Citing *Bramblett*, and *Buono*, Tax Court Judge Gerber recognized that the Colorado real estate development project ***was held as an investment*** and therefore the taxpayer was ***not engaged in the real estate development business***. The Service failed in its efforts to attribute land development activities to the "investment" landholder entity. The Tax Court opinion recognizes directly that the ***landowner's sales were "unsolicited."***

V. AGENCY, SHAM THEORIES

A. **Land-Banking Structuring Overview**. Land-banking is a very useful strategy for landowners who have held investment property for an extended period, and now wish to realize "development" gains.

1. ***Preserving Capital Gains.*** Landowners may be willing to accept ordinary income treatment of the appreciation in the property's value resulting from development efforts. But the landowners certainly desire to preserve capital gains for market appreciation realized when the property was held for investment.

2. ***"Freezing" of Capital Gain***. Through land-banking, ***the landowner "freezes" the investment gain*** by selling the property to a controlled entity, which in turn, will develop and market the property to third parties.

B. **IRS Agency Attack**. In evaluating land-banking structures, the IRS attempts to ***"attribute" development activities*** to the landowner under an agency or co-joint venture theory. In other words, the IRS attempts to attribute the related corporation's activities to landowner on either an ***agency or co-venture theory***.

1. ***Bramblett Facts.*** For example, in *Bramblett v. Commissioner*, the IRS argued that the landowner formed the developer corporation and therefore the activities of the development corporation must be taken into consideration. Under this theory, the corporation's sales are attributed back and used to warrant a determination that landowner was in a trade or business of developing the real estate. *See* 59 T.C.M. (CCH) at 882.

2. ***Taxpayer's Position***. In response, the landowner argued that the corporation's activities should not be attributed to the landowner because the landowner and the corporation were separate and distinct entities for tax purposes and the corporation was not acting as the landowner's agent. As argued in the Tax Court, "there is no authority for attributing the activities of the corporation to the landowner and disregarding the sale of the property." 59 T.C.M. (CCH) at 882.

3. ***Tax Court's Conclusion.*** In its memorandum decision, the Tax Court agreed with the IRS stating that:

> The point to be made here, however, is that evidence of the corporation's activities and their correlation with activities of the joint venture is proof of the nature of the business of the joint venture. Notwithstanding the carefully planned declarations of intent by the joint venturers, the totality of the evidence supports the conclusion that the business of the joint venture was sale of land and that the resulting gains should be taxed as ordinary income. Petitioners have not satisfied their burden of proving otherwise. 59 T.C.M. (CCH) at 883, 884.

C. **The Favorable Bramblett Appellate Decision**. In the key 1992 Fifth Circuit decision, the court ***expressly overruled*** Tax Court's agency and joint venture conclusions set forth above.

1. ***The Bramblett Facts.*** In *Bramblett v. Commissioner*, 960 F.2d 526 (5th Cir. 1992), four individuals were both partners in the landowner entity and shareholders in the development company (a corporation). Each one owned the same percentage interest in each entity. The landowner purchased various property for investment purposes, made no improvements on the land, but over a three-year period, made five sales of property to the development corporation, that proceeded to develop the property. The landowner reported its gain as long-term capital gain.

2. ***The IRS Position on Appeal***. On appeal, the IRS pointed out that the landowner never received any cash from its sales to the corporation until after the corporation, in turn, had sold the property. The IRS also emphasized that the corporation's only transactions involved real estate acquired from the landowner. As the IRS viewed the structure, the landowner and the developer corporation were jointly engaged in the

development and sale of the property. Thus, gain realized should be ordinary income to both of them, not merely to the landowner. The IRS characterized the separate entity relationship as unreal and a fiction.

3. ***The Fifth Circuit Opinion***. The Fifth Circuit reversed the Tax Court decision, concluding that it was not fatal that:

- the corporation made no payments to the landowner until after it collected on the sale of the property;
- the developer corporation routinely entered into contracts of sale to third parties even before buying the property from the landowner; and
- ownership of the two entities was identical.

930 F.2d at 533.

4. ***No Sham, No Agency***. The court held that the development corporation was neither a sham nor an agent for the landowner, and the record did not support the conclusion that the landowner directly engaged in the business of selling land.

5. ***No Substance Over Form, No Attribution***. The court did not accept the IRS argument of substance over form to allow attribution of the corporation activities to the landowner. "The business of a corporation is not ordinarily attributable to its shareholders," *Id.* at 533. "There was at least one substantial business reason for having Town East develop the land and sell it—that being the almost unlimited liability of a developer from a multitude of sources." "Mesquite East held the land as an investment and is therefore entitled to capital gains treatment on the gain realized by the sale." *Id.* at 534.

6. ***Older Case Law Swept Away***. Prior to this case, many practitioners looked to the Tax Court as creating the judicial pegs for land-banking planning. In *Ralph E. Gordy v. Commissioner*, 36 T.C. 855 (1961) the Tax Court supported land-banking through the transfers to two corporations that the taxpayer retained a 60 percent ownership interest. These transfers did not warrant a conclusion that at the time of the transfer petitioner held this property primarily for sale to customers in the ordinary course of his trade or business. The Tax Court opinion did note that the other 40 percent of the stock was owned by family members.

VI. OTHER IMPORTANT CODE SECTIONS CONCERNING LAND-BANKING

A. **Related Party Provisions**. At least two important provisions also should be considered in structuring a land-banking transaction.

1. ***Section 1239.*** Under Section 1239, any gain recognized from the sale or exchange of property, directly or indirectly, between "related persons," is treated as ordinary income if the property is depreciable for the purchaser. In considering the scope of this "related party" definition, ownership will be attributed to both parties under the IRC Section 267. This includes ownership by the taxpayer's spouse, ancestors, lineal descendants, brothers and sisters, and proportionate interests in trusts, estates, partnership, and corporation.

   a. <u>Purpose of Section 1239</u>**.** The purpose of Section 1239 is to deny capital gain treatment on sales in which the related taxpayer would receive a stepped-up basis for depreciation purposes, with the sale taxed at the lower capital gains rates.

2. ***Section 707(b)(2)***. Under Section 707(b)(2), gain recognized from the sale or exchange of property, directly or indirectly, in a "related partnership transaction" shall be treated as ordinary income. This rule applies if the "transferee" entity or buyer holds the asset as an ordinary income asset. In other words, the buyer's status will taint the seller's gain as an ordinary income.

   a. <u>"Related Partnership Transaction."</u> A "related party transaction is a transaction between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest or the profits interest in the in the partnership, or between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or the profits interest of both. The attribution rules of Section 267 apply in determining the ownership of a capital or profits interest in a partnership.

3. ***Do Not Use Partnership as a Land-Banking Purchaser***. Section 707(b)(2) is a critical provision to avoid. Land-banking does not work if buyer entity is a partnership or entity taxed as a partnership such as an LLC.

TOPIC IV—COORDINATING INCOME AND ESTATE PLANNING FOR REAL ESTATE OWNERS

I. VALUATION DISCOUNTS

Planning for real estate owners almost always involves valuation issues, as real estate is an illiquid asset that is predominantly owned—at least in the investment context—in limited partnerships and limited liability companies. Real estate investors are somewhat shielded from the "lack of business purpose" argument that the Internal Revenue Service (the "Service") often raises with taxpayers trying to obtain discounts for minority interests in entities owning passive stock portfolios.

The applicability and amount of valuation discounts (and premiums) are some of the most frequently litigated areas in estate and gift tax planning. The inherently subjective nature of valuation lends itself to disputes between taxpayers and the Service.

A. Fair Market Value of a Closely-Held Business Interest

1. Definition. Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts. *United States v. Cartwright*.

    a. Hypothetical Buyer and Seller. The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. *See, e.g., Estate of Bright v. U.S.*

    b. Maximize Profit. The "willing buyer-willing seller" principle is an objective test rather than a subjective test. The court in *Estate of Watts v. Commissioner*," explained that the test requires the transaction be analyzed from the viewpoint of a hypothetical seller whose only goal is to maximize his profit on the sale of his interest.

2. Revenue Ruling 59-60. Rev. Rul. 59-60 is the most authoritative pronouncement by the Service as to the approach, methods, and factors to be considered in valuing shares of closely-held business entities for estate and gift tax purposes. Rev Rul. 59-60 acknowledges that opinions as to value may differ widely and each case is unique, such that no generally applicable valuation formula or approach can be devised. Among the factors to be considered are the following:

    a. The nature of the business and the history of the enterprise from its inception.

b. The economic outlook in general and the condition and outlook of the specific industry in particular.

c. The book value of the stock and the financial condition of the business.

d. The earning capacity of the company.

e. The dividend-paying capacity.

f. Whether or not the enterprise has goodwill or other intangible value.

g. Sales of the stock and the size of the block of stock to be valued.

h. The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

The Service extended the application of Rev. Rul. 59-60 to partnership interests in Rev. Rul. 65-192.

3. <u>Methodology</u>. Real estate interests are typically valued based on one or more of the following valuation methodologies:

   a. Market approach;

   b. Income approach; and

   c. Cost approach.

4. <u>Process</u>. The valuation of a business interest or real estate interest is typically a three-step process:

   a. First, the value of 100% of the underlying asset is determined.

   b. Second, the fractional ownership interest is applied to the value of the underlying asset to determine the aliquot value of the ownership interest.

   c. Third, valuation discounts or premiums are applied to the ownership interest to determine its fair market value. If more than one discount is applied, the discounts are multiplicative. In other words, rather than adding the two discounts together and applying them to the fractional interest, the first discount is applied to the fractional interest, and the second discount is applied to that resulting value to arrive at the fair market value.

5. <u>Gift Tax Valuation</u>. Code § 2512 discusses the valuation of gifts. It provides that "if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

    a. Gift transfer taxes are imposed only on what is received by the transferee, not on what was owned by the transferor.

    b. Thus, if grantor who owns 100% of an entity gives away a 20% interest to each of his four children, each 20% interest should be valued at a discount for lack of control.

6. <u>Estate Tax Valuation</u>. Code § 2031 discusses the valuation of assets held in the gross estate. It provides that "[t]he value of the gross estate of the decedent shall be determined by including to the extent provided for in this part, the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated." Estate transfer taxes are imposed on what was held by the decedent at his date of death and passed to his estate, not on what is transferred to the beneficiaries.

7. <u>Valuation Discounts</u>. The most frequently discussed valuation discounts include:

    a. Fractional interest or "cost to partition" discounts;

    b. Minority interest discounts;

    c. Lack of marketability discounts;

    d. Capital gains or General Utilities discounts;

    e. Blockage discounts;

    f. Key person discounts; and

    g. Securities laws discounts.

This section of the outline will focus on fractional interest, minority interest, and lack of marketability discounts, as these are the most common discounts applicable to a gift of direct or indirect interest in real estate,

B. Fractional Interest Discounts

A fractional interest discount is somewhat unique to real estate as the discount applied to the ownership of an undivided interest in an asset, such as a co-tenancy interest. In a co-tenancy, each co-tenant or co-owner of the property has the right to possess and use the joint property, so long as the rights of the other co-owners are not adversely affected. Because of the lack of immediate control and the problems associated with dealing with co-owners, the hypothetical willing buyer would discount the fractional interest being acquired.

The fractional interest discount is sometimes called a "cost to partition discount." Unlike owners of closely-held businesses that do not have the unilateral right to realize their pro rata share of the underlying value of the business's assets by causing a dissolution of the business, owners of undivided interests in real estate generally do have the power to partition. However, partitioning property is expensive and, depending upon the location of the property, partitioning may be unavailable due to the local zoning laws,

There are several risks that arise from a possible partition suit:

- Usually a partition suit takes from two to five years and there is no guarantee of success, which would discourage an investor who contemplated suing for a partition after purchasing an interest.
- The partition suit necessitates the payment of legal fees, engineers and surveyor's fees.
- There is no guarantee that the partitioned property would be able to be sold in a timely manner.
- The sale price may be affected by the fact that it is a court sale.

The risk of a partition proceeding is one of the factors that gives rise to a fractional interest discount. A number of other factors support a fractional interest discount, including:

- Owners of undivided interests have unlimited liability.
- Undivided interests require unanimous consent for all decisions.
- It is difficult to use an undivided interest as collateral for a loan because creditors are reluctant to accept such an interest as collateral.
- Each owner has the right to use the property, subject to the rights of the other owners, although profits, if any, are shared and distributed in proportion to ownership interests.

In 54 documented undivided interest transactions, one study found the average discount to be 35%. In a more recent study, the average discount in 24 transactions was 47%. Following is a sampling of the case law.

Case Name	Property Being Valued	Deciding Court	Accepted Discount
Estate of Henry v. Commissioner	1/3 interest in undeveloped farm land.	Tax Court	10%
Estate of Campanari v. Commissioner	1/3 interest in real estate	Tax Court	12.5%
Estate of Eggleston v. Commissioner	1/7th interest in commercial real estate located in Pittsburgh	Tax Court	36%
Estate of Tishman v. Commissioner	1/2 interest in real estate located in Richmond, Virginia	District Court, E.D. Va.	15%

Case Name	Property Being Valued	Deciding Court	Accepted Discount
Estate of Whitehead v. Commissioner	1/2 interest in a ranch	Tax Court	20%
Propstra v. Commissioner	1/2 community property interest in real estate	Ninth Circuit	15%
Estate of Sels v. Commissioner	fractional interests in 11 tracts of timberland	Tax Court	60%
Mooneyham v. Commissioner	1/2 interest in real estate located in Sunnyvale, California	Tax Court	15%
Pillsbury v. Commissioner	77% interest in real estate where consent of minority owner needed to exercise ownership rights	Tax Court	15%
Lefrak v. Commissioner	7.5% tenant in common interest in 20 office and apartment buildings in NYC	Tax Court	28%
Cervin v. Commissioner	50% interest in a 657.3-acre farm and homestead in Texas	Tax Court	20%
Barge v. Commissioner	25% interest in 44,972 acres of timberland	Tax Court	27.8%
Estate of Williams v. Commissioner	50% interests in Florida timberland	Tax Court	44%
Estate of Brocato v. Commissioner	9 multiple-dwelling properties in San Francisco's Marina district	Tax Court	20%
Estate of Busch v. Commissioner	1/2 interest in real estate located in Alameda County, California	Tax Court	10%
Estate of Baird v. Commissioner	16 undivided fractional interests in timberland	Tax Court	60%
Estate of Forbes v. Commissioner	QTIP trust holding a 42% undivided interest in real estate	Tax Court	30%
Ludwick v. Commissioner	50% tenant in common interest in a residence in Hawaii transferred to QTIP	Tax Court	17%

Note that timberland tends to garner higher discounts, as there is a longer holding period before timber investments begin to generate cash flow.

C. Lack of Marketability and Lack of Control Discounts

1. Minority Interest Discounts. A lack-of-control discount, also referred to as a minority interest discount, is appropriate when valuing an interest in an entity that, by itself, does not give the holder of the interest the right to decide when distributions of earnings will be made, when the entity will be liquidated, and other issues that affect the financial benefits of ownership in the entity.

   a. In an operating business, lack of control may also mean the interest holder will not be assured of being an officer or employee of the entity.

   b. In the context of a family limited partnership or LLC, which usually involves passive investments, the lost opportunity to be an employee of the entity may not be financially significant.

c. The rights associated with control have been more particularly stated as follows:

(1) Elect directors and appoint management.

(2) Determine management compensation and perquisites.

(3) Set policy and change the course of business.

(4) Acquire or liquidate assets.

(5) Select people with whom to do business and award contracts.

(6) Make acquisitions.

(7) Liquidate, dissolve, sell out, or recapitalize the company.

(8) Sell or acquire treasury shares.

(9) Register the company's stock for a public offering.

(10) Declare and pay dividends.

(11) Change the articles of incorporation or bylaws.

S. Pratt, Valuing a Business: The Analysis and Appraisal of Closely-held Companies, 55-56 (1989), cited in *Estate of Murphy v. Commissioner*.

d. For many years, the Service challenged a minority interest discount because of the theory of family attribution—i.e., minority interests held by a family should be aggregated to form a controlling block because the family is more likely to act as one unit. The Service consistently lost on this issue.

e. In Rev. Rul. 93-12, the Service abandoned the family attribution theory. Rev. Rul. 93-12 involved a gift by a 100% shareholder of a corporation of 20% of his stock to each of his five children. The Service ruled that the family's control of the entity would not be considered in valuing the 20% interests. The Service stated:

> For estate and gift tax valuation purposes, the Service will follow *Bright, Propstra, Andrews* and *Lee* in not assuming that all voting power held by family members may be aggregated for purposes of determining whether the transferred shares should be valued as a part of a controlling interest. Consequently, a minority discount would not be disallowed solely because a transferred

interest, when aggregated with interests held by family members, would be a part of a controlling interest. This would be the case whether the donor held 100% or some lesser percentage of the stock immediately before the gift.

2. Lack of Marketability Discount. A lack-of-marketability discount takes into account the fact that an owner of an interest in a non-publicly-traded entity will have more difficulty than an owner of an interest in a publicly-traded entity in finding a willing buyer and, in order to sell the interest, may incur expenses, such as legal, accounting, and syndication fees. The fact that there is not a readily accessible market to sell interests in a closely-held business substantially increases the risks of ownership due to the inability to achieve liquidity within a short period of time.

   a. In *Mandelbaum v. Commissioner*, Judge Laro of the Tax Court listed the following elements of value as factors that have to be taken into account in determining the appropriate discount for limited marketability:

      (1) The value of the corporation's privately traded securities vis-a-vis its publicly-traded securities (or, if the corporation does not have stock that is traded both publicly and privately, the value of a similar corporation's public and private stock);

      (2) An analysis of the corporation's financial statements;

      (3) The corporation's dividend-paying capacity, its history of paying dividends, and the amount of its prior dividends;

      (4) The nature of the corporation, its history, its position in the industry, and its economic outlook;

      (5) The corporation's management;

      (6) The degree of control transferred with the block of stock to be valued;

      (7) Any restriction on the transferability of the corporation's stock;

      (8) The period of time for which an investor must hold the stock to realize a sufficient profit;

      (9) The corporation's redemption policy;

      (10) The cost of effectuating a public offering of the stock to be valued, e.g., legal, accounting, and underwriting fees.

b. Minority interest and lack of marketability are often applied at the same time. However, a lack of marketability discount may be applied to a majority or controlling interest in an entity.

c. Similarly, where a controlling block of closely-held stock is transferred, a lack of marketability discount may be applied simultaneously with a control premium.

II. DEATH OF THE REAL ESTATE INVESTOR

A. Balance Sheet Tensions

Where the real estate developer does not have a taxable estate, it is preferable to wait until the developer's death to make transfers of appreciated and negative basis property. This way, the real estate will receive an adjustment to basis to its fair market value at death under Section 1014.

This recommendation is often welcomed by real estate investors, who want to present strong balance sheets to their lenders. The financial strength of the real estate developer is an important underwriting consideration for the lender.

However, when the real estate developer has a taxable estate, this advice will necessarily change. One of the first action items for the attorney-advisor is to convince the real estate developer client to remove assets that the developer has already transferred by gift or sale from his or her balance sheet. There are two important reasons for this:

1. Previously-gifted assets are not owned by the real estate developer and are not available to satisfy claims of creditors.

2. The inclusion of the previously-gifted assets on the balance sheet gives the Service an argument that the real estate developer continued to control the gifted assets (or continued to use them for his or her benefit to obtain better financing terms) and should be included in the developer's estate under Section 2036.

If possible, the planner should persuade the real estate developer to include his or her descendants in deals early on in the developer's career, in smaller percentages or dollar amounts, so that the impact on the balance sheet is minimal but the investments have a long-term growth horizon.

B. Planning Considerations in Anticipation of Death

If the real estate investor's estate is taxable, planning for valuation discounts becomes important. It can also be important to position the estate to claim blockage discounts or to qualify for Section 6166 relief, both of which are discussed in this Section. The following transfers of real estate may prove crucial in anticipation of a real estate investor's death:

1. Planning for Basis Adjustment. If it becomes apparent that one spouse is going to predecease the other, the real estate investor can transfer a significant portion of his or her low-basis or "negative basis" real estate interests to the ill spouse so that the property gets a step-up in basis at the death of the ill spouse.

    a. This is helpful when the real estate will be used to fund a credit shelter trust or will be bequeathed to someone other than the healthy spouse.

    b. If the real estate interest is to be transferred back to the healthy spouse via the ill spouse's estate plan within one year of the transfer, the step-up in basis will not apply unless the real estate interest comes back in the form of a QTIP trust or other entity that is considered a different taxpayer from the surviving spouse.

2. Planning for Valuation Discounts. If the real estate investor has a controlling interest in real estate holding entities as well as a taxable estate, it makes sense to gift or sell a portion of the investor's interest to his or her spouse, other family members, or trusts for the benefit of such persons in order to bring the investor's interest in such entities to less than fifty percent (50%). This way, the estate of the real estate investor should be eligible for valuation discounts for lack of marketability and lack of control.

3. Funding Less Wealthy Spouse's Estate/GST Tax Exemption. If a client wants to take advantage of funding a credit shelter trust or a GST exempt QTIP trust at the first spouse's death (irrespective of the ability to elect portability), but one spouse lacks sufficient assets, real estate can be transferred to the less wealthy spouse.

    a. Transferring an illiquid and non-controlling interest in real estate may be less controversial to the wealthier client than transferring business assets or liquid assets.

    b. If the less wealthy spouse dies first, the real estate interest gets a step-up in basis and can be sold to the surviving spouse or a third party to fund the credit shelter trust or GST exempt QTIP with cash and securities.

C. Valuation Discounts to Reduce Taxable Estate

Certain valuation discounts are available at the death of the real estate developer that may not be available for gifted property. These are the blockage discount and the key person discount.

1. Blockage or Market Absorption Discount. The law of supply and demand supports the application of a blockage discount where the sale of an

exceptionally large block of one type of property may generate less proceeds than if the seller were to "trickle out" each piece of that block separately at the market price. The market may only handle so many pieces of one type of property in a limited time, and, when the tendered number of a single type of property is greater than the number that the market can absorb, the market is unable to handle the exceptionally large block. Thus, a seller desiring to sell such a large block at one time may be forced to sell the block at a price per piece that is less than the quoted price for each piece.

a. <u>Treasury Regulations</u>. Blockage discounts are specifically addressed under Treas. Reg. §§ 20.2031-2(e) and 25.2512-2(e); however, the regulations suggest a very limited role for blockage discounts by stating that they are only available in "certain exceptional cases." The case law is substantially more liberal and accepts blockage discounts where the taxpayer adequately demonstrates the appropriateness of the discount.

b. <u>Terminology</u>. A "blockage" discount is typically used to describe the discount applied to the sale of a large block of stock, whereas a "market absorption discount" is typically used to refer to the sale of other types of property, such as art, other collectibles, and real estate.

c. <u>Case Law</u>. Market absorption discounts have been applied to real estate, including in the following cases:

   (1) *Estate of Sturgis v. Commissioner* (20% market absorption discount applied to 11,298.86 acres of undeveloped land);

   (2) *Carr v. Commissioner* (30% market absorption discount applied to 175 developed lots; no discount applied to 437.5 undeveloped lots);

   (3) *Estate of Folks v. Commissioner* (20% market absorption discount applied to five leased lumberyards with the same tenant and in the same geographical area);

   (4) *Estate of Grootemaat v. Commissioner* (15% market absorption discount applied to undeveloped lots totaling 302 acres);

   (5) *Estate of Auker v. Commissioner* (6.189% market absorption discount applied to apartment complexes); and

   (6) *Estate of Brocato v, Commissioner* (In addition to 20% fractional interest discount, 11% blockage discount

awarded for 7 of 9 multiple tenant dwellings in San Francisco's Marina District).

2. Key Person Discount. Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform services for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.

   a. Rev. Rul. 59-60 explains that in valuing the stock of a closely-held business, the loss of a key person may have a depressing effect upon the value of such business. The ruling also states that the loss of the key person and the absence of management succession potentialities should be taken into consideration in analyzing the future expectancy of the business. However, the ruling further explains that consideration must be given to whether the business is of a type that will not be impaired by the absence of the individual and whether the loss to the business is either adequately covered by life insurance or mitigated by the ability to employ competent management for the same consideration that was paid to the decedent.

   b. The Tax Court has rejected the Service's assertion that the loss of a key person can be offset by life insurance proceeds and other factors. In *Estate of Rodriguez v. Commissioner*, the court rejected the Service's assertion that no adjustment was necessary merely because the business held a life insurance policy on the key person's life. In the court's opinion, this understated the importance of the key person.

   c. In *Estate of Feldmar v. Commissioner*, the Court rejected the Service's assertion that no key person discount should be applied because the loss of the decedent's services was more than compensated by insurance, on the basis that insurance proceeds are more in the nature of a non-operating asset and thus would not enter into a going concern valuation. The *Feldmar* court held that an investor would expect a 35% discount for the loss of a key employee "because (the business) suffered a serious loss when (the) decedent took to his grave his considerable expertise." The Court reduced the discount to 25% to account for the possibility of the business finding a new leader to replace the decedent.

   d. Other cases involving the application of a key person discount include: *Estate of Huntsman v. Commissioner*; *Estate of Mitchell v. Commissioner*; *Estate of Yeager v. Commissioner*; *Furman v. Commissioner*.

e. It is arguable that the death of a key real estate developer who had extensive political, capital-raising, banking, construction and other relationships, as well as an excellent reputation for building quality, successful projects, would give rise to a key person discount for such developer's real estate interests.

D. **Section 754 Election**

When a real estate owner dies, there is an opportunity—with respect to each partnership or LLC interest held by the owner—to make an election under Section 754 (the "754 Election") to marry a partner's inside basis and outside basis.

"Inside basis" refers to the basis a partnership holds in its assets, and how that basis is reflected in the partners' capital accounts.

"Outside basis" refers to the basis of the partnership interest in the hands of the partner, and how that basis is reflected in the partner's own books and records.

1. Overview of the Election.

a. Adjustment to Outside Basis. A partner's outside basis is determined by Section 722 upon the formation of the partnership. In the case of a substituted partner who buys an interest from a withdrawing partner, the outside basis is governed by Section 1012. Upon the death of the partner, Section 1014 controls.

(1) Sections 1014(a)(1) and 1014(c) provide that, upon a partner's death, his outside basis in the partnership interest is equal to the interest's fair market value as of the decedent's date of death or the alternate valuation date (if applicable), less any income in respect of a decedent associated with the partnership interest.

(2) In addition, the recipient's holding period for purposes of determining long term gains versus short term gains is deemed to be more than one year.

b. Adjustment to Inside Basis. If a 754 Election is in effect, the deceased partner's inside basis is adjusted upwards or downwards to match the partner's outside basis, in the manner provided in Section 743(b). Any adjustment to basis made pursuant to Section 743(b) is made with respect to the transferee partner only, and not to all of the other partners in the partnership.

(1) If the 754 Election results in an increase in the deceased partner's inside basis, then the successor in interest to the deceased partner (the "successor partner") should have less

gain than the other partners in the event of a later sale for a profit, or a larger share of the loss than the other partners.

(2) In addition, a basis increase allows the successor partner to claim higher depreciation deductions than the other partners as a result of his or her higher inside depreciable basis.

(3) The increase or decrease in inside basis is allocated to the affected partner's share of each asset of the partnership, on a pro rata basis.

(4) Once the 754 Election is made, the basis adjustment applies to all transfers of partnership interests and distributions of partnership property in the year of the election and all subsequent years.

2. <u>Downsides to the 754 Election</u>. While the 754 Election sounds straightforward and worthwhile, there are many downsides:

a. The recordkeeping of maintaining different basis adjustments to the capital accounts of different partners is burdensome.

b. If partnership assets are worth less than their basis at the partner's death, the 754 Election causes a step-down in basis, which will increase the successor partner's gain after a later liquidity event. The basis step-down is a particular risk where valuation discounts are taken on a minority partnership interest at the deceased partner's death.

c. The election is irrevocable without the consent of the IRS, and the IRS does not typically grant consent unless there is a business purpose for the revocation other than tax savings.

d. Once the election is made, it applies to all future tax years unless the IRS grants a revocation. This means the election applies at the deaths of all other partners, whether it would be beneficial to that partner's heirs or not. In addition, once the 754 Election is in effect, it also applies to adjust the inside basis of the partnership when certain types of distributions are made under I.R.C. 734(b).

e. One prominent tax adviser offers this advice:

> Unless the § 754 election will produce significant short-term benefits, it should probably not be made because of its impact on the remaining partners. For example, if the partnership redeems the estate shortly after death, the estate will fully utilize its outside basis in calculating its gain or

> loss with no need for the inside step-up afforded by the election. Or if the partnership does not plan to sell any of its major assets anytime soon, a step-up on the inside basis from the § 754 election does not produce any immediate tax savings. In both cases, if the partnership had made the election, it might have wasted it for little or no benefit, while causing significant impact on the remaining partners for the duration of the partnership. So in cases like these where the estate's interest is very small or assets will not be sold or depreciated, the partnership should probably not make the election. Whether or not to make the election is one of the hardest decisions a partnership can make.

Carol A. Cantrell, Income Tax Problems When the Estate or Trust Is a Partner, ALI CLE—Planning Techniques for Large Estates (2013).

3. Making the Election. The 754 Election can be made in a tax year in which one of the following circumstances occurs:

   a. A distribution of property is made to a partner.

   b. A partner dies.

   c. There is a transfer of a partnership interest by sale or exchange.

   If the election is not made for the year in which the partner dies, it could also be made in the year the estate's interest is distributed to the successor partner, as this should be treated as a sale or exchange pursuant to Section 761(e).

   A partnership makes the 754 Election by attaching a written statement, signed by any one of the partners, to its timely filed return (including extensions thereof) for the year in which the partner died or the transfer occurred. There is an example of a written statement to be submitted at Treas. Reg. § 1.754-1(b)(2). The partnership should also check the box on line 12a of Form 1065, Schedule B, indicating that it is making the election. If the partnership is multi-tiered, with parent and subsidiary entities, the 754 Election must be made at each level.

4. Community Property. In community property states, if one spouse to the marriage dies owning a partnership interest that is treated as community property, one-half of the value of that interest will be included in the deceased partner's estate. Rev. Rul. 79-124 makes clear that, when a 754 Election is in effect, the basis adjustment will be made to the deceased partner's entire partnership interest, not just the one-half interest included in his estate. The same would be true if the non-partner spouse died first and had to include one-half of the community property interest in the

partnership in her estate. Her husband's entire partnership interest would receive a basis adjustment.

5. QTIP Property. When a QTIP trust includes a partnership interest at the surviving spouse's death, there is no clear guidance as to whether the partnership may make a 754 Election based on the surviving spouse's death.

   a. Conservative View. Some commentators suggest the election cannot be made because the partner (the QTIP trust) has neither sold, transferred, distributed its interest or died, which are prerequisites for the QTIP trust to adjust its share of the inside basis of partnership property under Section 754.

      (1) Even if that is the case, the 754 Election should be able to be made once the QTIP trust transfers its interest in the partnership to the residual beneficiaries, as such a transfer should be considered a sale or exchange under Section 761(e).

      (2) If the partnership takes this conservative view that the 754 Election is not permitted at the QTIP beneficiary's death, and relies on a distribution to the QTIP residuary beneficiaries to trigger the 754 Election, such distribution should be made as soon as possible after the surviving spouse's death so that a second appraisal is not needed to re-determine fair market value of the transferred partnership interest.

   b. Another Reasoned View. Other commentators argue that the surviving spouse's death should give rise to an opportunity for a 754 Election. The partnership interest will be included in the surviving spouse's gross estate under Section 2044, and Section 2044 treats such property as "passing from the decedent." In addition, Section 1014(b)(10) treats property includible in the gross estate of the decedent under Section 2044 as having "passed from the decedent" for purposes of acquiring an adjusted basis equal to fair market value on the decedent's date of death. Given that the partnership interest is included in the surviving spouse's gross estate under Section 2044 and is treated as "passing from the decedent" to the residuary beneficiaries of the QTIP trust, the partnership should be able to make a 754 Election.

6. IRS Audit of Estate Tax Return. If the estate is taking an aggressive position with respect to valuation discounts for the partnership interest and an IRS audit of the estate tax return is expected, it may be difficult to determine whether to make the 754 Election. If the IRS adjusts the

discount down and thus increases the value of the partnership interest to the point where its fair market value exceeds the inside basis, the estate or its beneficiaries may prefer to have the 754 Election in place. In this situation, it is better to err on the side of not making the 754 Election, as the IRS has been generous in granting relief for late elections.

The deceased partner's estate or successor partner has the following options for making the 754 Election after the IRS audit is complete:

a. File for an automatic extension of time to make the 754 Election under Treas. Reg. 301-9100-2 if the IRS audit is complete by September 15th of the second year following the year the estate transferred the interest to the successor partner.

b. File a request for relief under Treas. Reg. 301-9100-3 and pay the user fee if it can be shown that the partnership acted reasonably and not solely on the basis of hindsight.

c. The successor partner may be entitled to equitable relief if the statute of limitations period has expired.

7. Section 2036 Estate Inclusion.

a. PLR 200626003. In PLR 200626003, a taxpayer transferred a 1/4 tenant in common interest in real estate to each of his three children and retained a 1/4 interest for himself. Later, the taxpayer and his three children contributed the real estate to an LLC in exchange for 25% LLC interests. At the time of the taxpayer's death, he was receiving 100% of the income from the LLC. As a result, 100% of the value of the LLC was included in the taxpayer's estate under Section 2036. The taxpayer's Will distributed his 25% LLC interest to his three children, in equal shares. The LLC did not make a 754 Election on its partnership return for the year of the taxpayer's death. The stated reason was that, although the LLC and its partners were aware of the election, the benefit it provided to the 25% interest did not outweigh the complexity of creating multiple bases.

After the audit included the entire value of the real estate in the taxpayer's estate, the LLC requested permission to make a late 754 Election under Treas. Reg. § 301.9100-3. The request was denied because Treas. Reg. § 301.9100-3(b)(3)(iii) provides that the taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer uses hindsight in requesting relief.

Nevertheless, the ruling did provide that because the actual real estate was included in decedent's estate under Section 2036, rather than the 100%

LLC interest, the basis of the real estate was adjusted to fair market value and thus the LLC's inside basis was adjusted under Section 1014.

b. ***Jorgensen v. Commissioner***. The Tax Court reached this same conclusion in Jorgensen v. Commissioner where partnership assets were included in the decedent's gross estate under § 2036. The assets brought back in to Erma Jorgensen's estate included partnership interests that had been gifted to other family members many years prior to her death. Shortly after her death, the partnership sold certain stocks for significant gain. The descendants of Erma Jorgensen, who had owned their partnership interests for around 10 years at that point, reported the gain. Once the gifted partnership interests were brought back into the estate, the other partners requested, and the Tax Court granted, relief under the doctrine of equitable recoupment in Section 6214(b). This allowed the other family members to step up the inside basis of partnership assets and reduce the gains they had previously reported, even though the statute of limitations period had closed.

8. Summary of When to Make and Not Make the 754 Election.

a. When 754 Election Should Be Made.

(1) The fair market value of the partnership assets on the date of death is greater than their cost basis, even after applying valuation discounts, and the estate's interest in the partnership is significant.

(2) The fair market value of the partnership assets on the date of death is greater than their cost basis, and the partnership plans to sell all or part of its assets soon after the partner's death.

b. When 754 Election Should NOT Be Made.

(1) If the fair market value of the partnership assets on the date of death is less than their cost basis.

(2) If the estate's interest in the partnership is not significant, it is probably best to not make the election, to avoid the accounting burdens of varying basis accounts.

c. When to Extend the Partnership Return and Wait and See.

(1) The FMV of the partnership assets on the date of death is greater than their cost basis, but not after applying valuation discounts. In that case, wait and see if the IRS will adjust the discounted value of the partnership interest

such that the value of the partnership interest is greater than the cost basis.

(2) The partnership can file a late 754 Election on an original or amended return, but this is only worthwhile if the estate's interest is significant and there has been or is likely to be a gain recognition event.

III. PLANNING FOR LIQUIDITY TO PAY ESTATE TAXES

If an estate lacks sufficient liquid assets to pay estate taxes or other expenses, it may need to obtain a loan to cover the costs of administration. Among the options available to the estate are the following:

- Use of life insurance to provide liquidity
- Extension of time to pay under Section 6161
- Installment payment of estate tax under Section 6166
- Borrowing from a third-party commercial lender
- Using a "*Graegin* loan" to borrow from a related party, such as a trust, family member, or business entity.

A. **Life Insurance**

1. Many real estate investors plan to ensure estate liquidity through the purchase of life insurance.

2. In many cases, the insurance policy will be purchased through an irrevocable life insurance trust. The trust will be designed to avoid the business owner-insured's retention of any incidents of ownership over the insurance policy. If properly drafted and structured, the trust will receive the insurance death benefits estate tax free.

3. Typically, the business owner will gift money to the trust to pay the premiums. The beneficiaries of the trust will have *Crummey* withdrawal powers, designed to qualify for the gift tax annual exclusion. Assuming the *Crummey* withdrawal powers are not exercised, the Trustee of the trust will use the gifted funds to pay the premiums on the life insurance policies.

4. In drafting the trust agreement, it is important not to obligate the trustee to use funds in the trust to pay any of the costs of administration or federal estate taxes or state death taxes owed by the estate of the insured (or the estate of the survivor of the husband and wife in the case of a second-to-die policy). However, the trustee can and should be given the right either to lend money to or to purchase assets from the estate of the insured and the estate of the insured's spouse. The agreement should provide that any loan to the estate of the insured or the insured's spouse be properly

secured and adequate interest be paid and that the purchase of assets be made for full and adequate consideration in money or money's worth.

5. The purchase of assets by the irrevocable trust from the estate should result in little or no taxable income to the estate, since the estate will receive a step-up in basis for income tax purposes for assets included in the decedent's gross estate.

6. Life insurance could be purchased by a funded defective grantor trust holding income producing assets. This would permit the trust to forego the use of *Crummey* withdrawal powers as a source of premium funding, as the rents and other income from the real estate interest could be used to pay premiums. This can be particularly useful when the premiums to be paid are large, the client's family is small, or both. The could also be beneficial from a GST tax perspective, since the GST exemption allocated to the defective grantor trust can be further leveraged,

B. Extension of Time to Pay under Section 6161

Under Section 6161, the Secretary of the Treasury is authorized to grant extensions for payment of federal tax under a variety of circumstances.

1. Overview.

    a. Section 6161(a)(1) permits an extension for payment of federal estate tax of up to twelve months from the date the tax is due. The taxpayer is not required to provide a rationale or grounds for the extension request.

    b. Section 6161(a)(2) authorizes the Secretary to extend for reasonable cause the time for payment of federal estate tax for periods of up to ten (10) years from the date prescribed for payment of tax, or, in the case of installment payments due under Code § 6166, twelve (12) months after the due date for the last installment.

    c. Further, Code § 6161(b)(2) permits an extension for payment of deficiencies in federal estate tax for a period not to exceed four (4) years from the date otherwise fixed for payment of the deficiency, again for reasonable cause.

    d. Code § 6161(a)(2) also applies to payment of generation-skipping transfer tax.

    e. Trustees of qualified domestic trusts may request an extension of time for payment of tax on property remaining in the QDOT at the death of the surviving spouse.

2. Reasonable Cause. Treasury Regulation § 20.6161-1(a)(1) gives four examples of reasonable cause.

a. Example 1 involves a situation where the estate has sufficient liquid assets to pay the tax when due, but these assets are located in several jurisdictions and the executor is having difficulty marshaling them to be available for the payment of tax. There is a basis for a reasonable cause extension in this example, although it would be a relatively short extension.

b. Example 2 involves a situation where the estate contains assets that are the right to receive payments in the future, such as annuities, royalties, receivables, and contingent fees. The executor cannot readily borrow against these assets except under terms that would inflict severe losses on the estate. There is a reasonable cause for extension.

c. Example 3 involves a claim of the estate that has substantial value but that cannot be collected without litigation. The example assumes that the size of the gross estate is not ascertainable, since the nature and amount of collection here could not be determined. A reasonable cause for extension would be present.

d. Example 4 involves a situation where the estate does not have sufficient funds to pay taxes, family allowances, and claims without borrowing at a rate of interest higher than that generally available. The estate includes assets that the executor has attempted unsuccessfully to convert into cash. There is reasonable cause for extension.

C. Section 6166 Relief for Closely-Held Businesses

To ease some of the financial hardship created when a closely-held business constitutes the majority of the decedent's estate, an executor may elect under Section 6166 to pay the estate tax owed over a 14-year period, if certain requirements are met.

1. Under Section 6166(a)(3), the executor of the estate may elect to completely defer the estate tax for a period of up to five (5) years and subsequently pay the tax in up to ten (10) annual installments.

2. For decedents dying after December 31, 1997, the estate must pay interest at the rate of 2% per year on the portion of the deferred tax attributable to the first $1 million (as adjusted for inflation) of closely-held business property. For tax year 2018, the inflation adjusted amount is $1,520,000. The interest paid on the deferred estate tax is not deductible as an expense of the estate.

3. The interest rate imposed on the amount of the deferred estate tax attributable to the taxable value of closely-held business property in excess of the limitation amount is 45% of the rate generally applicable to underpayments of tax, and this amount is also not deductible.

4. In order to be eligible for the tax deferral election under Section 6166, the value of the interest in the closely-held business must comprise at least 35% of the value of the gross estate reduced by the expenses, indebtedness and losses of the estate. If the estate owns at least a 20% interest in more than one business, these interests may be aggregated for the purpose of satisfying the 35% test.

5. The tax deferral allowed by Code § 6166 applies only to interests in closely-held businesses as defined by the section. A decedent owns an interest in a closely-held business under this section if the decedent is one of the following:

   a. A sole proprietor; or

   b. A partner in a partnership with no more than 45 partners, or where 20% or more of the total capital interest in such partnership is owned by the decedent; or

   c. A shareholder who owns 20% or more in value of the voting stock of a corporation, or such corporation has 45 or fewer shareholders.

6. When determining whether there are 45 or fewer shareholders or partners in a corporation or partnership respectively, all stock or partnership interests owned by the decedent's siblings, spouse, lineal descendants, and ancestors are deemed to be owned by the decedent. Likewise, in determining whether the 20% value test is met, the decedent not only owns his or her own stock or partnership interest but is also deemed to own the interests held by his or her siblings, spouse, lineal descendants and ancestors.

7. In addition, the decedent must have been actively engaged in the trade or business; (not a passive investment activity). The management of investment type assets does not qualify as a trade or business. The tax deferral election to pay the estate tax in ten installments must be made within the time allowed for filing the estate tax return, which is, nine months from the decedent's death, including any extension of time granted for the filing of the return.

8. <u>Service Must Exercise Discretion in Requiring Bond or Special Lien</u>.

   a. In *Estate of Edward P. Roski Sr. et al. v. Commissioner*, the Tax Court held 1) that it has jurisdiction to review an IRS determination denying an estate's election under Code § 6166 to pay its taxes in installments, and 2) that the IRS abused its discretion in making that determination, because the IRS does not have authority to require a bond or special lien in every case under Section 6166. The executor of the Roski estate (the "Estate") filed a timely estate tax return and attached a notice of election under Code § 6166 to defer payment of the tax owed. The IRS notified the Estate that because of the election, it would be required to either post a bond or provide a special lien under Code § 6324A. The Estate responded by requesting that the IRS exercise its discretion and not require the Estate to post a bond or provide a special lien. In support of this request, the Estate cited the following facts:

(1) the Estate was unable to find a company to post the bond;

(2) the well-established business that was part of the Estate provided assurance that adequate funds would be available to pay the Estate tax liability, thereby mitigating any default risks;

(3) the executor was a highly respected businessman who at all times had fulfilled his tax obligations;

(4) the government already had security under the Code § 6324 lien; and

(5) the imposition of a special lien would have negative effects on the Estate's business.

Nonetheless, the IRS issued a notice of determination denying the election, because the Estate failed to provide the bond or special lien. The Tax Court denied the IRS's motion for summary judgment, finding that the IRS had abused its discretion in applying a bright-line rule that an estate must provide a bond or special lien.

b. Notice 2007-90. In response to the *Roski* case, the IRS issued Notice 2007-90 which sets forth the factors the IRS will consider when determining whether deferred estate tax installment payments under Section 6166 pose a sufficient credit risk to justify the requirement of a bond or special lien:

(1) Duration and stability of the business. This factor considers the nature of both the closely-held business on which the estate tax is deferred and the assets of that business, as well as the relevant market factors that will affect the business's future success, its recent financial history, and the experience of its management, in an effort to predict the

likelihood of its success and survival through the deferred payment period.

(2) Ability to pay the installments of tax and interest in a timely manner. This factor considers how the estate expects to be able to make the annual payments of tax and interest when due, and the objective likelihood of realizing that expectation. Facts relevant to this factor may include the nature of the business's significant assets and liabilities, and the business's cash flow (both historical and anticipated).

(3) Compliance History. This factor addresses the business's history regarding compliance with all federal tax payment and tax filing requirements, in an effort to determine whether the business and its management respect and comply with all tax requirements on a regular basis. This factor also addresses the estate's compliance history with respect to federal tax payment and filing requirements,

The above list is non-exclusive. The IRS will consider all relevant facts and circumstances, in addition to the factors identified on the list, in determining whether the requirement of a bond or special lien is justified. No single factor is determinative, and not all factors may be relevant to every estate.

ORIGINAL

UNITED STATES TAX COURT

U. S. TAX COURT
FILED AT
Houston
MAR 27 2017

SUGAR LAND RANCH DEVELOPMENT, LLC, SUGAR LAND ADVISORS LLC, TAX MATTERS PARTNER, Petitioner,	§	
v.	§	DOCKET NO: 5835-16
COMMISSIONER OF INTERNAL REVENUE, Respondent.	§	

SUPPLEMENTAL STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto may be accepted as authentic and are incorporated in this stipulation and made a part hereof; provided, however, that either party has the right to object to the admission of any such facts and exhibits in evidence on the grounds of relevancy and materiality, but not on other grounds unless expressly reserved herein, and provided, further, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

31. Attached as Exhibit 18-J are agendas of partner meetings held in 2012.

32. Attached as Exhibit 19-P is a "Unanimous Consent of Manager of Sugar Land Ranch Development, LLC." Respondent objects to the admission of this document on the grounds of authenticity and hearsay.

33. Attached as Exhibit 20-P is a SLRD Member Resolution. Respondent objects to the admission of this document on the grounds of authenticity and hearsay.

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Date: 3/27/17

UNANIMOUS CONSENT OF
MANAGERS OF SUGAR LAND RANCH DEVELOPMENT, L.L.C
(LAND HELD FOR INVESTMENT)

December 16, 2008

The undersigned, being all of the managers of **SUGAR LAND RANCH DEVLEOPMENT, L.L.C.**, a Texas limited liability company (the "Company"), do hereby adopt the following resolutions:

Whereas the Company is a Texas limited company formed on March 18, 1998, by and between **SUGAR LAND HOLDING CORP. ("SL Corp.")** and **SUGAR LAND ADVISORS, L.L.C. (SL Advisors")**. The Company's primary purpose is to acquire and hold for investment purpose one or more parcels of real property located in Fort Bend County, Texas.

Whereas during 1998, SL Corp. made cash contribution of $1,900,000 for 85% interest in the Company and SL Advisors made cash contribution of $10 for a 15% interest in the Company.

Whereas the Company has obtained entitlement from the City of Sugar Land but has not platted any of the parcels for the purpose of developing the land into sellable lots.

Whereas the cost of development has sky-rocketed and financing by institutions is getting increasingly difficult to obtain.

Whereas the Company has not made substantial land improvements to develop the lots nor has the Company has built any roads to sub-divide the property during the past 10 years.

It is resolved, that this Company approves and affirms a long-term investment plan to hold the parcels of land for investment purposes only and not to sub-divide or develop the parcels of land for purposes of selling lots to builders or individual home buyers.

As an attestation of the accuracy of the foregoing, and of their assent to the statements made herein, the undersigned have hereunto subscribed their names and signatures.

Larry D. Johnson, Manager

Lawrence Wong, Manager

ADDENDUM A-3

SUGAR LAND RANCH DEVELOPMENT LLC
MEMBER RESOLUTION

The undersigned being majority Members of the Sugar Land Ranch Development, LLC which was approved by and filed in the Office of the Secretary of State of Texas on March 18, 1998, hereby consent, pursuant o the provisions of the Texas Business Organization Code, in lieu of holding a formal meeting of the Members of the LLC, to the adoption of the following resolutions:

WHEREAS, at the current time, the business environment is the most uncertain for residential development in a generation. There has been an unprecedented collapse in the subprime mortgage market in 2007;

AND WHEREAS, the economic tightening has cascaded throughout the world and including the local HOUSTON METROPOLITAN markets;

AND WHEREAS, it is increasingly uncertain when this downward part of the business cycle will bottom out;

AND WHEREAS, our bankers are beginning to call upon us to increase our capital upon threat of calling our loans and cancelling our lines of credit;

AND WHEREAS, we are anticipating the necessity to raise another $10,000,000.00 , or more to protect our investment;

AND WHEREAS, we have been holding this land for over 10 years since March 18, 1998;

AND WHEREAS, in accordance with Section 1237 of the Internal Revenue Code we have only done such activities as capital investments that would improve the value of the land and make it suitable to be sold;

AND WHEREAS, now it is increasingly uncertain as to when the market will recover sufficiently to repay our investment and any profit;

AND WHEREAS, more prolonged downward pressure on the local market may make it impossible to raise additional capital and protect our investments, and existing credit;

RESOLVED, that for all of the above reasons, in the opinion of the MANAGING MEMBERS, it is in the best interests of the Sugar Land Ranch Development LLC to not subdivide the property, but instead to liquidate the land and to wind up the affairs of the entity at the earliest possible time;

AND FURTHER RESOLVED, that it is in the best interests of the LLC to limit our holding costs and risks of the loss of the asset and so to make our highest priority best efforts to raise sufficient capital to hold the property until it can be sold and to prevent any appearance or evidence of distress or urgency to depress the bargaining position of the LLC during the selling process;

AND FURTHER RESOLVED, that Members be authorized to solicit capital from any sources available provided that the Confidential Nature of the LLC's position be protected by such Members until such time as said capital is secured and committed;

AND FURTHER RESOLVED, that until such time as the above RESOLUTION is accomplished, the Members will use their best efforts to provide or raise such capital as necessary to protect the existing capital already invested in the entity;

AND FURTHER RESOLVED, that immediately upon the execution of this RESOLUTION, the LLC will begin to market the land as an unsubdivided tract.

The Members hereby certify that they are duly qualified pursuant to the Laws of the State of Texas and that the foregoing is a true representation of a RESOLUTION duly adopted and agreed to on November 19, 2009.

IN WITNESS WHEREOF, the undersigned have executed their names and hereby affirmed the above RESOLUTION.

MEMBERS:
BY: SUGAR LAND HOLDING CORP

Lawrence Wong, President

BY: SUGAR LAND ADVISORS, LLC

Larry Johnson, Member

Inside, Outside, Upside Down: Balancing the Basics of Basis Adjustments at Death

Griffin H. Bridgers
Hutchins & Associates LLP
Denver, CO

INSIDE, OUTSIDE, UPSIDE DOWN

BALANCING THE BASICS OF BASIS ADJUSTMENTS UNDER CODE SECTION 1014

Griffin Bridgers

Hutchins & Associates LLC

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The 30,000 View

- Gifts and inheritances are not included in gross income
- However, transferors of gifts and inheritances are subject to gift or estate tax, and possibly generation-skipping transfer tax
  - We will refer to these as "transfer taxes" in this talk
- In other words, the burden of taxation is shifted from transferee to transferor with respect to transfers of private wealth

Reconciliation in a Perfect World

- Ignoring all deductions, exclusions, and credits, transfer taxes are applied to the *fair market value* of property at the date of transfer or valuation date
- In other words, transferors pay transfer tax on both basis, and built-in gain, in transferred assets
- However, transferors do not pay transfer tax on built-in loss
- Therefore, since appreciation has been subjected to one layer of tax, should transferees also pay tax when this appreciation is recognized as gain?
- Enter Code Section 1014
- However, since it is rare to pay transfer tax out of pocket until cumulative wealth transfers exceed $11,180,000 for a transferor, Code Section 1014 represents a major opportunity in estate planning

1014 In a Nutshell

- The basis of property transferred by a decedent is:
  - Its fair market value
  - As reported for estate tax purposes
    - Includes discounts and special use valuation
  - As determined on the applicable valuation date
    - Is either date of death, or alternate valuation date (6 months after date of death)
- Applies to all property included in gross estate for estate tax purposes, even if no estate tax liability
- If capital asset sold by transferee within one year of decedent's death, post-death gain is deemed to be long-term

Different Rules for Gifts

- Gifted property is generally not eligible for step-up in basis
- IRS wants to discourage gifting for the purpose of:
  - Avoiding taxation on gains
  - Shifting tax losses to other taxpayers
- As a result, for property whose FMV is greater than basis, transferee gets a carryover basis
- For property whose FMV is less than basis, FMV is transferee's basis for purposes of determining loss
  - Sale for an amount between date-of-gift FMV and basis generates no gain or loss
- On rare occasions that gift tax is actually paid out of pocket, can get partial "step-up" for portion of gift tax that its attributable to built-in gain on date of gift

Limitations of Code Section 1014

- Does not apply to IRD (biggest impact is for qualified retirement plans and IRAs)
  - Designated beneficiaries of these accounts have to report tax-deferred growth as ordinary income, except in the case of Roth held for more than 5 years
- Step-down rule applies for loss property
- Benefit is directly inverse to estate tax valuation
  - If property in gross estate is discounted, basis will reflect discount
  - Will IRS take opposite stance and start asserting discounts instead of opposing them?
- If no estate tax is due, how do you value property that is not publicly traded?
  - Cannot use alternate valuation date
  - Would IRS assert same valuation standards as for estate tax return in order to establish basis?

Current Estate Planning Environment

- No estate tax for estates (plus lifetime adjusted taxable gifts) under the applicable exclusion amount
  - Current applicable exclusion amount is $11,180,000, indexed for inflation every year
  - Can also be increased by deceased spousal unused exclusion amount (portability)
  - Set to drop down to pre-inflation base of $5,000,000 in 2026
- Avoidance of estate tax in a vacuum no longer effective tax planning
  - Previous tax planning sought to remove assets from gross estate of surviving spouse and children
  - Now, tax planning warrants the creation of estate inclusion where possible

How do you Trigger Estate Inclusion?

- Assets in a marital trust for which the marital deduction has applied, through a general power of appointment or QTIP election, get a step-up at surviving spouse's death
- All other assets in trust may only get a step-up at a beneficiary's death if:
  - The asset is distributed or loaned to the beneficiary before death; or
  - the beneficiary holds a general power of appointment over those assets at death
  - May require modification of terms of trust, decanting, or distribution in excess of defined standards in trust
- Assets in business entities
  - Can step-up in outside basis of decedent's interest be shifted to the assets inside the entity?

A Rare Gift for Partnerships: The 754 Election

- At death of partner, partner's outside basis in partnership interest is stepped-up to fair market value, plus liabilities, minus IRD (such as uncollected receivables)
- However, unless and until transferee liquidates partnership interest, transferee does not get benefit of basis step-up
- Enter the 754 election
  - Allows inside basis of partnership assets to be adjusted with respect to transferee *only*
  - Adjustment is difference between transferee's adjusted outside basis in partnership interest and transferee's share of adjusted inside basis of partnership assets

Benefits and Limitations of 754 Election

- Eliminates timing issue, allowing transferee to immediately benefit from increase in partnership interest basis under Code Section 1014
  - Eliminates transferee's allocable share of pre-death gain and recapture
  - Basis increase treated as newly-acquired property with respect to transferee under Code Sections 167 and 168 (but not 179)
  - Eliminates decedent's share of 704(c) gain
- Limitations
  - Does not affect capital account of transferee
  - May result in step-down of partnership assets

Other Partnership Planning Techniques

- May be able to shift basis between partners to leverage 1014 basis step-up (look up research of Paul Lee with Northern Trust)
- In some cases, assets of family partnerships may be included in gross estate of decedent who transferred assets to partnership due to retention of control, even if decedent's proportionate share of partnership assets is less
  - Right to control beneficial enjoyment
  - Right to use property
  - Right to liquidate partnership, alone or in concert with other family members
- While estate tax planning previously aimed to avoid this result, we may now want to embrace it
  - However, possibility of double-estate taxation has not been reconciled – see *Powell v. Commissioner*

S Corporations

- No ability to achieve step-up in inside basis of S corporation due to death of S corporation shareholder
  - Repeal of *General Utilities* prevents this result
- Timing issue is present – S corporation must be liquidated in order for transferee shareholder to benefit from step-up
  - Liquidation increases stepped-up basis of transferee, giving "double" basis
  - Distribution in redemption of stock in liquidation generates loss
  - Result is a tax wash
- Not available for C corporation, as step-up in basis of decedent's stock would not reduce deemed corporate gain on liquidation
- Also beware built-in gain tax for S corporations converted in previous 5 years, as well as tax on old and cold C corporation earnings and profits

Other Areas of Benefit (or Detriment) for 1014 Basis Adjustments (not all-inclusive)

- No investment tax credits for new basis under 1014
- No 179 expensing for new basis under 1014
- New basis eliminates recapture of depreciation and depletion
- Transfer at death not subject to anti-churning rules for intangibles if basis determined under 1014
- No deemed disposition gain on transfer of property to foreign trust at death if basis determined under 1014
- No step-up for PFIC stock
- Before applying basis step-up to DISC stock, must reduce basis by dividend that would have been payable if there was a deemed disposition of DISC stock at death

The Future of 1014 Adjustments

- Beware future elimination of estate tax
  - Planning solely for basis step-up may be detrimental if 1014 repealed
- See Code Section 1022 (applicable only by election in 2010) for precedent of what could happen
  - Created limited basis step-up in case of estate tax repeal through EGTRRA sunset
  - Questionable whether general power of appointment would have triggered basis increase
- See also Canadian system
  - Deemed disposition of all assets at death
  - Also, deemed disposition of all assets in trust every 21 years
  - Part of initial (pre-election) Trump tax proposals

QUESTIONS?

- *gbridgers@hutchinslaw.com*
- *Thank you!*

INSIDE, OUTSIDE, UPSIDE DOWN

An analysis of the effects of Code Section 1014 on inside basis and outside basis for appreciated and depreciated property

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INSIDE, OUTSIDE, UPSIDE DOWN

I. Introduction

One of the greatest gifts in the Internal Revenue Code is the adjustment of basis (to fair market value) provided for assets which are acquired, or treated as acquired, from a decedent under Code Section 1014. In a perfect world, the utility of this Code section is a natural offshoot of Code Section 102, which excludes inheritances from gross income, and Code Section 2001, which imposes the estate tax on a decedent's taxable estate. In other words, the latter two Code sections represent a shift of the burden of taxation for wealth transfers from the recipient to the decedent/transferor. Since the estate tax is imposed on the fair market value, and not the basis, of property in the taxable estate, which would presumably take into account unrealized appreciation or loss, it is natural that the taxation (or exclusion from taxation) of such amounts at the death of the decedent would cause such gains or losses to no longer be recognized, or deducted, by the recipient for income tax purposes.

This analysis is fairly tax-neutral in a perfect world. However, the world is not perfect, especially when it comes to the Internal Revenue Code. Multiple levels of legislative change have eliminated the tax-neutrality of Code Section 1014. To begin with, the difference between the highest applicable estate tax rate (40%) and the highest applicable income tax rates (37% for ordinary income and net short-term capital gains, and 20% for net long-term capital gains, plus up to 3.8% for net investment income) means that the decedent would bear a greater tax burden on unrecognized gains than the transferee of inherited property if all deductions, exclusions, and credits are ignored. However, this effect is substantially reduced by the presence of the estate tax applicable exclusion amount under Code Section 2010. The estate tax applicable exclusion amount, currently $11,180,000, generally sets a floor on the amount of the estate tax base to which the estate tax may be applied. In other words, for a decedent dying in 2018, the maximum estate tax rate, assuming there are no other lifetime adjusted taxable gifts, applies only to the extent a decedent's taxable estate exceeds $11,180,000.

For the sake of simplicity, the economic effect of Code Section 1014 can largely be pegged to whether or not a decedent's estate must file a an estate tax return under Code Section 6018. If so, the standard for establishing the increased, or decreased, basis of property will generally be the value reported on the estate tax return – either the fair market value on the decedent's date of death or the fair market value as of the alternate valuation date. *See* IRC Sections 2031 or 2032. Such amount would include any discounts claimed on the estate tax return. In addition, such amount could be further adjusted, for example, to take into account the special use of real property. *See* IRC Section 2032A. If an estate tax return is required, the basis of property must be reported to the Service, and the recipients of such property, under Code Sections 1014(f) and 6035. *If no estate tax return must be filed*, the valuation of property would presumably follow the same general rules applicable to taxable estates, as set forth in Code Section 1014(a). One should note, however, that the alternate valuation date and special-use valuation generally only apply where the decedent's estate is otherwise required to file an estate tax return. Given this reality, and the incentive to maximize basis in the absence of estate tax liability, fair market value will almost always represent the best standard for determining the basis of property acquired from a decedent.

Due to the cross-references set forth in Code Section 1014(a), it is likely that the Service would apply a consistent standard for valuation for purposes of both the estate tax, and Code Section 1014, even in cases where no estate tax return must be filed. However, if no estate tax return is required, the expense of an appraisal may not be reasonable or practical depending on the class of property. The degree of estimation of the basis of property under Code Section 1014 should therefore be balanced by the risk of examination upon a subsequent sale of such property. In such a case, an appraisal for estate tax valuation purposes may include discounts, such as discounts for lack of marketability, lack of control, or fractional interests. However, an appraisal solely for purposes of determining basis under Code Section 1014 would likely ignore such discounts. Given these competing concerns from Taxpayers and the Service, it is difficult to predict what would happen in an examination where basis (but not estate tax) is a concern.

One important limitation in the Code Section 1014 basis adjustment is the exclusion of items of income with respect to a decedent (IRD) under Code Sections 691 and 1014(c). Perhaps the greatest impact of this exclusion is on qualified retirement accounts, for which beneficiaries will still be required to report deferred income in accordance with the rules of Code Section 401(a)(9). The analysis of this issue is outside of the scope of this outline. However, it is important to note that the beneficiaries of IRD may be able to deduct, for income tax purposes, the portion of any estate tax which is attributable to their share of such IRD.

The balance of this outline explores special cases where the basis adjustment under Code Section 1014 can cause headaches. We will look closely at the effects of the basis adjustment on loss property in Part II, interests in partnerships under Part III, and on S corporation stock under Part IV. We will conclude with a synopsis of other income tax provisions affected by the Code Section 1014 basis adjustment.

II. Loss Property

One major drawback to the Code Section 1014 basis adjustment is that it applies to all property which is treated as owned by the decedent for estate tax purposes, including property the basis of which is greater than its fair market value. In other words, for property which would generate a loss if sold at death (instead of being transferred to heirs), its basis is reduced to its date-of-death fair market value. The effect of this adjustment is that built-in tax losses cannot be preserved for recipients of the property.

This treatment is consistent with the basis determination for lifetime gifts under Code Section 1015(a), which generally provides for a transferred basis only for appreciated property. In the case of loss property (the basis of which is greater than its date-of-gift fair market value), the donee is denied the ability to benefit from a gifted tax loss. In other words, if the donee sells the gifted property for an amount less than the date-of gift fair market value, this amount will be the basis for purposes of determining loss, and if the property is sold for an amount less than the transferred basis (but greater than the date-of-gift fair market value), no gain or loss will be recognized due to the basis being determined to be equal to the amount realized.

The practical effect of this limitation is invoked where a practitioner is intentionally planning to cause assets to be included in a taxpayer's gross estate for estate tax purposes, in order to receive a step-up in income tax basis. Such planning provides the greatest benefit where the taxpayer's gross estate is anticipated to be less than the estate tax applicable exclusion amount, but where the taxpayer plans to hold substantially appreciated assets until death. However, by causing the taxpayer to become the owner, for estate tax purposes, of depreciated assets which would not otherwise have been included in the taxpayer's gross estate, the benefit of the tax loss is lost due to a step-down in income tax basis at the taxpayer's death. For this reason, it is important to plan for flexibility when engaging in this type of income tax planning.

III. Partnerships

Within a partnership, a partner's basis depends on two factors. First, the partner has an *inside* basis in the partnership, which is often the partner's share of the basis of partnership assets, subject to adjustments set forth in Code Section 704. Such term may also be applied to the basis of assets in the hands of the partnership; i.e., the basis of assets *inside* the partnership. Second, the partner has an *outside* basis in the partnership, which represents the sum of the inside basis plus the partner's share of partnership liabilities under Code Section 752.

In the case of a transfer of a partnership interest, Code Section 742 expressly states that the basis of the partnership interest shall be determined under Chapter I, Subchapter O, Part II of the Code, which includes Code Section 1014. The Regulations (Treas. Reg. § 1.742-1) confirm this result, stating that basis of a deceased partner's interest will be its date-of-death fair market value (or fair market value at the alternate valuation date), increased by the deceased partner's share of partnership liabilities, and decreased by any items of IRD attributable to such deceased partner's interest (such as the partner's share of accounts receivable). This basis is thereafter subject to adjustment for the interest's share of partnership tax attributes under Code Section 705.

In effect, this adjustment to basis represents an increase in the deceased partner's outside basis with respect to his or her interest. However, as is often the case with transfers of partnership interests, the transferee of this stepped-up interest runs the risk of being (at least temporarily) taxed on previously-taxed capital if this increase is not shifted to the assets inside of the partnership – such might be the case if the partnership sells an asset, with the transferee partner being allocated a share of the gain on the sale of the asset (as well as recapture). For this reason, Code Section 743 permits the partnership to make the election, under Code Section 754, to allocate the basis increase (or decrease) under Code Section 1014 to the assets of the partnership with respect to the transferee partner.

The specific allocation of this increase is governed by Code Section 755. For the sake of time, this outline does not examine the specific mechanics of the allocation of the basis increase. It is important to note, however, the following general effects of the basis increase on the transferee partner:

- Basis increase can generate depreciation and amortization deductions as if it is property newly placed in service (other than under Code Section 179)
- 704(c) gain attributable to deceased partner is eliminated
- Gain recapture with respect to the deceased partner is eliminated

- Disposition of partnership property only generates distributive share of gain or loss accruing after the valuation date of the deceased partner's interest with respect to transferee partner
- *However*, capital account of transferee partner is not changed

In the absence of a Code Section 754 election, a timing issue is created - the transferee partner would not be able to take advantage of the disparity in basis unless and until there is a distribution in complete liquidation of his or her interest. At that time, the partner would be able to offset his or her post-transfer share of partnership gain with a loss recognized on liquidation of his or her interest. However, with the election, the remaining partners would not have to wait until a liquidation of their partnership interests. Until that time, the share of any estate tax of a deceased partner generated by the value of partnership assets would not be treated as previously-taxed capital with respect to the partnership or partners themselves. This is in sharp contrast to S corporation stock, where the basis increase under Code Section 1014 cannot be shifted to the basis of assets held by the corporation.

It is important to note that the 754 election applies to both a step-up, and step-down, in the basis of a deceased partner's interest under Code Section 1014. It is also important to note that it applies on a tax-year basis. Therefore, if a 754 election was in place for a previous partnership transaction (such as a sale of an interest or a distribution of property to a partner), there could be an inadvertent step-down in the basis of assets inside the partnership if, for example, a partner dies unexpectedly with an outside basis which is much greater (ignoring share of partnership liabilities) than the corresponding share of the basis of partnership assets.

Even in cases where no 754 election is made, the IRS in some cases forces a step-down in the basis of partnership assets following the death of a partner. This is the result where, at the time of the partner's death, the aggregate adjusted basis of the partnership's assets in the hands of the partnership exceeds the aggregate fair market value of such assets by more than $250,000.

Finally, in analyzing the 754 election, the effect of Code Section 704(c) should be analyzed. While a benefit of the 754 election is the elimination of precontribution gain of a deceased partner under Code Section 704(c), any lifetime transfers of partnership interests will result in a shifting of such precontribution gain to the transferee partners. Without such a provision, the 754 election could, in theory, allow an elimination of 704(c) gain in full at the death of the contributing partner. However, it is clear that this gain is allocated to partnership *interests*, and not *partners* themselves. On the other hand, there is one question gaining traction amongst estate planning practitioners – that is, whether a disproportionate amount of partnership *assets* may be allocated to a deceased partner.

Code Section 1014(b)(9) generally allows for a step-up in income tax basis (or step-down) for all assets included in the gross estate. There are a variety of circumstances under which assets contributed by a deceased partner may be included in the gross estate, such as the retention of disproportionate use, income, or control of partnership assets under Code Sections 2036 and/or 2038. It is possible that, with respect to one or more of these retained rights, partnerships could be drafted to effectively shift capital for *income* tax purposes from the deceased partner to other partners, without a corresponding shift for *estate* tax purposes. In such a case, presumably, both the assets of the partnership and the decedent's interest in the partnership would be entitled to a basis increase without the need for a 754 election. However, the result would be double-taxation for estate tax purposes. There is little guidance on this issue other than the case of *Powell v. Commissioner*, 148 T.C. 18 (2017), in which (under very *bad* facts for the taxpayer) the Tax Court forced inclusion of partnership assets in the taxpayer's estate. The Tax Court's opinion in *Powell* acknowledged the double taxation issue, but did not directly resolve it. While this planning technique may be valuable under the current estate tax exclusion amount, this potential for double taxation may create too much of a wildcard to be able to effectively depend on the technique of forced asset inclusion in the gross estate.

IV. S Corporation Stock

As alluded to in our discussion on partnerships, the basis in S corporation stock owned by a decedent can be adjusted to its fair market value under Code Section 1014. However, any basis *increase* cannot be shifted to assets inside the S corporation. This result stems from the repeal of the *General Utilities* doctrine, as codified in Code Section 311, which states that appreciated assets cannot escape a corporation without the corporation recognizing gain on the transfer. It is still possible to reap the benefit of a basis increase to a shareholder's stock, but such benefit only is recognized in the case of a liquidation. Therefore, the same timing issue that is present with a partnership not making a 754 election with respect to a deceased partner's interest is present in all cases with an S corporation with a deceased shareholder.

The sole strategy to achieve the tax benefit of a step-up in income tax basis of S corporation stock occurs solely with respect to the successor in interest to the decedent's stock through a corporate liquidation. In such a case, under Code Section 1366, any distribution of appreciated property to a shareholder would increase the shareholder's basis in his or her S corporation stock by the shareholder's share of deemed corporate gain under Code Sections 311 and 336. This increase would add to the shareholder's already stepped-up basis from Code Section 1014. Correspondingly, the shareholder would recognize, in many cases, an offsetting loss under Code Section 331 equal to the difference between their basis in the stock (which would have included double the appreciation in the shareholder's share of the S corporation's appreciated assets) and the fair market value of the assets being distributed. As a result, the shareholder would end up with a tax-free distribution of corporate assets, the basis of which in the hands of the shareholder would be equal to their fair market value on the date of the decedent's death.

Given the limitations of this approach, basis step-up planning for S corporation shares is practical only in cases where the death of a shareholder is reasonably likely to create the economic need to liquidate the S corporation. Further, such an approach works only where the shareholders' tax liability can be minimized. Accordingly, it is important to analyze the possibility of the built-in gain tax under Code Section 1374, as well as the gain to be incurred by all other shareholders on liquidation under Code Sections 311, 336, and 1366.

Assuming these hurdles can be successfully navigated, it is also important to note that the stepped-up basis of S corporation stock will be determined net of any items of IRD under Code Section 1367(b)(4). This rule is similar to the rule applicable to partnerships, above. However, in the case of an S corporation, there is no need to analyze the effect of a shareholder's share of corporate debt.

<u>V</u>. <u>Other Issues</u>

There are other areas in which the Code Section 1014 basis increase has special significance. The following list is intended to highlight some, but not all, of these special tax provisions.

Investment Credits. The Code Section 1014 basis increase is generally not treated as new basis for purposes of the various investment tax credits such as the low-income housing credit and the credit for historical rehabilitation.

Code Section 179 Expensing. New basis under Code Section 1014 is not treated as newly-purchased property for purposes of the deduction under Code Section 179. This treatment does not, however, affect the ability to depreciate stepped-up basis as property newly placed in service under Code Sections 167 and 168.

Intangibles. Under Code Section 197(f)(9), the anti-churning rules do not apply to inherited intangibles whose basis is determined under Code Section 1014.

Sale of Mining Property. For purposes of determining the gain on sale of mining property, with respect to any mining property for which basis is determined under Code Section 1014, the adjusted exploration expenditures shall be deemed to be zero.

Transfer to Foreign Trust or Foreign Estate. Where the basis of property is determined under Code Section 1014, any transfer of such property to a foreign trust or foreign estate by reason of the death of a U.S. transferor will not result in gain.

Character of IRD. The character of IRD in the hands of the estate or recipient is not affected by Code Section 1014.

DISC Stock. With respect to DISC stock, before applying the Code Section 1014 basis increase, the basis will be reduced by the amount which would have been treated as a dividend had the decedent sold the DISC stock immediately prior to the estate tax valuation date, including any distributions made between death and the alternate valuation date. The decedent's holding period is also tacked to a transferor's holding period with respect to any DISC stock for which the basis was previously determined under Code Section 1014.

Term Interests. Prior basis increases under Code Section 1014 are disregarded in dispositions of certain term interests.

Holding Period. Where the basis of property is determined under Code Section 1014, the holding period is deemed to be more than one year for purposes of capital gains and losses for any disposition occurring within one year of the decedent's death.

Depreciation Recapture. Determination of basis under Code Section 1014 has the effect of eliminating any increase for purposes of calculating the recomputed basis. The recapture amount under Code Section 1245 is the amount by which the lower of the recomputed basis, or the amount realized, exceeds the adjusted basis. Therefore, the recipient of property from a decedent will not, in effect, pay tax on recaptured depreciation accumulating during the life of the decedent.

Recapture of 1254 Costs. No gain is recognized on a transfer of oil or gas property at death, and the recipient of such property will not have to recapture 1254 costs accumulating prior to the decedent's death if and when such property is disposed of.

PFIC Stock. No step-up in basis is allowed for PFIC stock under Code Section 1014. Where the stock is appreciated, its basis will be stepped down to the decedent's carryover basis in the PFIC stock.

Individual Tax Planning Workshop

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68th Annual Tax Institute
Individual Tax Planning Workshop
2018

Prof. Edward J. Roche, Jr.
Ret. Prof. Mark A. Vogel

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APPENDICES

APPENDIX A

Draft Form 1040
U.S. Individual Income Tax Return

Form **1040** Department of the Treasury—Internal Revenue Service (99)
U.S. Individual Income Tax Return
2018 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing status: ☐ Single ☐ Married filing jointly ☐ Married filing separately ☐ Qualifying widow(er) ☐ Head of household

Your first name and initial	Last name	Your social security number

Your standard deduction: ☐ Someone can claim you as a dependent ☐ You were born before January 2, 1954 ☐ You are blind

Spouse or qualifying person's first name and initial (see inst.)	Last name	Spouse's social security number

Spouse standard deduction: ☐ Someone can claim your spouse as a dependent ☐ Your spouse was born before January 2, 1954
☐ Your spouse is blind ☐ Your spouse itemizes on a separate return or you were dual-status alien

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	☐ Full-year health care coverage (see instructions)
City, town or post office, state, and ZIP code. If you have a foreign address, attach Schedule 6.		If more than four dependents, see instructions and check here . . . ▶ ☐

Dependents (see instructions):

(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see inst.): Child tax credit	Credit for other dependents
				☐	☐
				☐	☐
				☐	☐
				☐	☐

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparers

Print/Type preparer's name	Preparer's signature	PTIN	Check if: ☐ 3rd Party Designee
Firm's name ▶		Firm's EIN ▶	☐ Self-employed

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

1	Wages, salaries, tips, etc. Attach Form(s) W-2	1	
2a	Tax-exempt interest . . . 2a	b Taxable interest	2b	
3a	Qualified dividends . . . 3a	b Ordinary dividends	3b	
4a	IRAs, pensions, and annuities . 4a	b Taxable amount	4b	
5a	Social security benefits . . 5a	b Taxable amount	5b	
6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22 and check here ▶ ☐	6	
7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1 line 36, from line 6 and check here ▶ ☐	7	
8	**Standard deduction or itemized deductions** (from Schedule A) If attaching Schedule A, check here . ▶ ☐	8	
9	Qualified business income deduction (see instructions)	9	
10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-	10	
11	Tax (see inst) (check if any from: a ☐ Form(s) 8814 b ☐ Form 4972 c ☐) **Add** any amount from Schedule 2 and check here ▶ ☐	11	
12	Child tax credit/credit for other dependents **Add** any amount from Schedule 3 and check here ▶ ☐	12	
13	Subtract line 12 from line 11	13	
14	Other taxes. Attach Schedule 4	14	
15	Total tax. Add lines 13 and 14	15	
16	Federal income tax withheld from Forms W-2 and 1099	16	
17	Refundable credits: **a** EIC (see inst.) **b** Sch 8812 **c** Form 8863 **Add** any amount from Schedule 5 and check here ▶ ☐	17	
18	Add lines 16 and 17. These are your total payments	18	

Standard Deduction for—

- Single or married filing separately, $12,000
- Married filing jointly or Qualifying widow(er), $24,000
- Head of household, $18,000
- If you checked any box under Standard deduction, see instructions.

Refund

19	If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you **overpaid**	19	
20a	Amount of line 19 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	20a	
b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
d	Account number		
21	Amount of line 19 you want **applied to your 2019 estimated tax** ▶ 21		

Direct deposit? ▶ See instructions. ▶

Amount You Owe

22	**Amount you owe.** Subtract line 18 from line 15. For details on how to pay, see instructions ▶	22	
23	Estimated tax penalty (see instructions) ▶ 23		

SCHEDULE 1
(Form 1040)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 01

Name(s) shown on Form 1040 | **Your social security number**

Additional Income	1–9b	Reserved			1–9b
	10	Taxable refunds, credits, or offsets of state and local income taxes			10
	11	Alimony received			11
	12	Business income or (loss). Attach Schedule C or C-EZ			12
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐			13
	14	Other gains or (losses). Attach Form 4797			14
	15a	Reserved			15b
	16a	Reserved			16b
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			17
	18	Farm income or (loss). Attach Schedule F			18
	19	Unemployment compensation			19
	20a	Reserved			20b
	21	Other income. List type and amount ▶			21
	22	Combine the amounts in the far right column. If you don't have any adjustments to income, enter here and on Form 1040, line 6. Otherwise, go to line 23			22
Adjustments to Income	23	Educator expenses	23		
	24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	24		
	25	Health savings account deduction. Attach Form 8889	25		
	26	Moving expenses for members of the armed forces. Attach Form 3903	26		
	27	Deductible part of self-employment tax. Attach Schedule SE	27		
	28	Self-employed SEP, SIMPLE, and qualified plans	28		
	29	Self-employed health insurance deduction	29		
	30	Penalty on early withdrawal of savings	30		
	31a	Alimony paid **b** Recipient's SSN ▶	31a		
	32	IRA deduction	32		
	33	Student loan interest deduction	33		
	34	Reserved	34		
	35	Reserved	35		
	36	Add lines 23 through 35			36
	37	Subtract line 36 from line 22. Enter here and on Form 1040, line 6			37

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2018**

SCHEDULE 2
(Form 1040)

Department of the Treasury
Internal Revenue Service

Tax

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

2018

Attachment Sequence No. **02**

Name(s) shown on Form 1040	Your social security number

Tax	**38–43**	Reserved	**38–43**	
	44	Tax (see instructions)	**44**	
	a	Tax on child's unearned income. Attach Form(s) 8814	**44a**	
	b	Tax on lump-sum distributions. Attach Form 4972	**44b**	
	c	Other taxes. List type and amount	**44c**	
	45	Alternative minimum tax. Attach Form 6251	**45**	
	46	Excess advance premium tax credit. Attach Form 8962	**46**	
	47	Add lines 38 through 46. This is your tax. Enter here and on Form 1040, line 11	**47**	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U **Schedule 2 (Form 1040) 2018**

SCHEDULE 3
(Form 1040)

Department of the Treasury
Internal Revenue Service

Nonrefundable Credits

▶ **Attach to Form 1040.**
▶ **Go to *www.irs.gov/Form1040* for instructions and the latest information.**

OMB No. 1545-0074

2018

Attachment
Sequence No. **03**

Name(s) shown on Form 1040	**Your social security number**

Nonrefundable Credits

48	Foreign tax credit. Attach Form 1116 if required	48	
49	Credit for child and dependent care expenses. Attach Form 2441	49	
50	Education credits from Form 8863, line 19	50	
51	Retirement savings contributions credit. Attach Form 8880	51	
52	Child tax credit and credit for other dependents	52	
53	Residential energy credit. Attach Form 5695	53	
54a	General business credit. Attach Form 3800	54a	
b	Credit for prior year minimum tax. Attach Form 8801	54b	
c	Other credits (see instructions)	54c	
55	Add lines 48 through 54. These are your **total nonrefundable credits.** Enter here and on Form 1040, line 12	55	

SCHEDULE 4
(Form 1040)

Department of the Treasury
Internal Revenue Service

Other Taxes

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. **04**

Name(s) shown on Form 1040 | **Your social security number**

Other Taxes	**57**	Self-employment tax. Attach Schedule SE	**57**	
	58a	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137	**58a**	
	b	Uncollected social security and Medicare tax on wages. Attach Form 8919	**58b**	
	59	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	**59**	
	60a	Household employment taxes. Attach Schedule H	**60a**	
	b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	**60b**	
	61	Health care: individual responsibility (see instructions)	**61**	
	62a	Additional Medicare tax from Form 8959	**62a**	
	b	Net investment income tax from Form 8960	**62b**	
	c	Instructions; enter code(s) ▶	**62c**	
	63	Section 965 net tax liability installment from Form 965-A	**63**	
	64	Add lines 57 through 63. These are your **total other taxes.** Enter here and on Form 1040, line 14	**64**	

SCHEDULE 5
(Form 1040)

Department of the Treasury
Internal Revenue Service

Other Payments and Refundable Credits

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 05

Name(s) shown on Form 1040 | **Your social security number**

Other Payments and Refundable Credits

65	Reserved	65		
66	2018 estimated tax payments and amount applied from 2017 return	66		
67a	Reserved	67a		
b	Reserved	67b		
68–69	Reserved	68–69		
70	Net premium tax credit. Attach Form 8962	70		
71	Amount paid with request for extension to file (see instructions)	71		
72	Excess social security and tier 1 tax withheld	72		
73	Credit for federal tax on fuels. Attach Form 4136	73		
74a	Amounts from Form 2439	74a		
b	Health coverage tax credit. Attach Form 8885	74b		
c	Reserved	74c		
d	Other amounts (see instructions)	74d		
75	Add lines 65, 66, 67a, and 68 through 74. These are your total **other payments and refundable credits.** Enter here and on Form 1040, line 17d	75		

INTERNAL USE ONLY
DRAFT AS OF
June 5, 2018

SCHEDULE 6
(Form 1040)

Department of the Treasury
Internal Revenue Service

Foreign Address and Third Party Designee

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. **05A**

Name(s) shown on Form 1040			**Your social security number**
Foreign Address	Foreign country name	Foreign province/county	Foreign postal code
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**		
	Designee's name ▶	Phone no. ▶	Personal identification number (PIN) ▶

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71483N **Schedule 6 (Form 1040) 2018**

APPENDIX B

COLAs for 2018 & 2017

APPENDIX B

COLAs for 2018 & 2017

1. Individuals COLAs for 2018 & 2017.

   a. Standard Deduction:

      Single - $12,000 ($6,350 for 2017)
      Head of Household - $18,000 ($9,350 for 2017)
      Married filing Joint - $24,000 ($12,700 for 2017)

   b. Personal exemptions - $0 for 2018 & $4,050 for 2017

   c. Kiddie tax - $1,050 for 2018 & 2017

   d. Qualified as dependent on another tax return - Earned income plus $350, limited to $6,350 for 2017 and $12,000 for 2018

   e. Adoption credit - $13,570 and $203,540 to $243,540 for 2017 and $13,810 and $207,140 to $247,140 for 2018

   f. Gift tax exclusion - $15,000 for 2018 & $14,000 for 2017

   g. Gift tax exemption - $5,490,000 for 2017 and $11,180,000 for 2018

   h. FICA wage base:

      1) $97,500 for 2007

      2) $102,000 for 2008

      3) $106,800 for 2009, 2010 and 2011

      4) $110,100 for 2012

      5) $113,700 for 2013

      6) $117,000 for 2014

      7) $118,500 for 2015 and 2016

      8) $127,200 for 2017

      9) $128,400 for 2018

      10) $132,300 for 2019 *(Projected)*

2. Pension COLAs.

   a. Defined contribution plans - \$55,000 for 2018 & \$54,000 for 2017

   b. Compensation - \$275,000 for 2018 & \$270,000 for 2017

   c. Section 401(k) - \$18,000 & \$6,000 for 2017 and \$18,500 & \$6,000 for 2018

   d. Simple IRA - \$12,500 & \$3,000 for 2018 & 2017

   e. IRA - \$5,500 & \$1,000 for 2018 & 2017

3. Per Diem Rates.

   a. High-cost - \$282 for 2017 and \$284 for 2018

   b. Low-cost - \$189 for 2017 and \$191 for 2018

   c. Meals:

      High-cost - \$68 for 2017 & 2018
      Low-cost - \$57 for 2017 & 2018

   d. Incidental expenses - \$5 for 2017 & 2018

4. Nanny Tax - \$2,000 for 2017 & \$2,100 for 2018

5. Standard Mileage Rate - \$.545 for 2018 & \$.535 for 2017

6. EIC and investment income not in excess of \$3,450 for 2017 & \$3,500 for 2018

7. Section 179 Deduction:

   a. \$510,000 and \$2,030,000 for 2017

   b. \$1,000,000 and \$2,500,000 for 2018

APPENDIX C

Fact Sheet 2018-9

APPENDIX C

Fact Sheet 2018-9
April 20, 2018

The Tax Cuts and Jobs Act, signed Dec. 22, 2017, changed some laws regarding depreciation deductions.

Businesses can immediately expense more under the new law

A taxpayer may elect to expense the cost of any section 179 property and deduct it in the year the property is placed in service. The new law increased the maximum deduction from $500,000 to $1 million. It also increased the phase-out threshold from $2 million to $2.5 million.

The new law also expands the definition of section 179 property to allow the taxpayer to elect to include the following improvements made to nonresidential real property after the date when the property was first placed in service:

- Qualified improvement property, which means any improvement to a building's interior. Improvements do not qualify if they are attributable to:
    - the enlargement of the building,
    - any elevator or escalator or
    - the internal structural framework of the building.
- Roofs, HVAC, fire protection systems, alarm systems and security systems.

These changes apply to property placed in service in taxable years beginning after Dec. 31, 2017.

Temporary 100 percent expensing for certain business assets (first-year bonus depreciation)

The new law increases the bonus depreciation percentage from 50 percent to 100 percent for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. The bonus depreciation percentage for qualified property that a taxpayer acquired before Sept. 28, 2017, and placed in service before Jan. 1, 2018, remains at 50 percent. Special rules apply for longer production period property and certain aircraft.

The definition of property eligible for 100 percent bonus depreciation was expanded to include used qualified property acquired and placed in service after Sept. 27, 2017, if all the following factors apply:

- The taxpayer didn't use the property at any time before acquiring it.
- The taxpayer didn't acquire the property from a related party.
- The taxpayer didn't acquire the property from a component member of a controlled group of corporations.
- The taxpayer's basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.

Also, the cost of the used qualified property eligible for bonus depreciation doesn't include any carryover basis of the property, for example in a like-kind exchange or involuntary conversion.

The new law added qualified film, television and live theatrical productions as types of qualified property that are eligible for 100 percent bonus depreciation. This provision applies to property acquired and placed in service after Sept. 27, 2017.

Under the new law, certain types of property are not eligible for bonus depreciation. One such exclusion from qualified property is for property primarily used in the trade or business of the furnishing or sale of:

- Electrical energy, water or sewage disposal services,
- Gas or steam through a local distribution system or
- Transportation of gas or steam by pipeline.

This exclusion applies if the rates for the furnishing or sale have to be approved by a federal, state or local government agency, a public service or public utility commission, or an electric cooperative.

The new law also adds an exclusion for any property used in a trade or business that has floor-plan financing. Floor-plan financing is secured by motor vehicle inventory that a business sells or leases to retail customers.

Changes to depreciation limitations on luxury automobiles and personal use property

The new law changed depreciation limits for passenger vehicles placed in service after Dec. 31, 2017. If the taxpayer doesn't claim bonus depreciation, the greatest allowable depreciation deduction is:

- $10,000 for the first year,
- $16,000 for the second year,
- $9,600 for the third year, and
- $5,760 for each later taxable year in the recovery period.

If a taxpayer claims 100 percent bonus depreciation, the greatest allowable depreciation deduction is:

- $18,000 for the first year,
- $16,000 for the second year,
- $9,600 for the third year, and
- $5,760 for each later taxable year in the recovery period.

The new law also removes computer or peripheral equipment from the definition of listed property. This change applies to property placed in service after Dec. 31, 2017.

Changes to treatment of certain farm property

The new law shortens the recovery period for machinery and equipment used in a farming business from seven to five years. This excludes grain bins, cotton ginning assets, fences or other land improvements. The original use of the property must occur after Dec. 31, 2017. This recovery period is effective for property placed in service after Dec. 31, 2017.

Also, property used in a farming business and placed in service after Dec. 31, 2017, is not required to use the 150 percent declining balance method. However, if the property is 15-year or 20-year property, the taxpayer should continue to use the 150 percent declining balance method.

Applicable recovery period for real property

The new law keeps the general recovery periods of 39 years for nonresidential real property and 27.5 years for residential rental property. But, the new law changes the alternative depreciation system recovery period for residential rental property from 40 years to 30 years. Qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property are no longer separately defined and given a special 15-year recovery period under the new law.

These changes affect property placed in service after Dec. 31, 2017.

Under the new law, a real property trade or business electing out of the interest deduction limit must use the alternative depreciation system to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property. This change applies to taxable years beginning after Dec. 31, 2017.

Use of alternative depreciation system for farming businesses

Farming businesses that elect out of the interest deduction limit must use the alternative depreciation system to depreciate any property with a recovery period of 10 years or more, such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings and certain land improvements. This provision applies to taxable years beginning after Dec. 31, 2017.

2018
Inflation Adjustments
(*See* Rev. Proc. 2017-58, Rev. Proc. 2018-18 & Rev. Proc. 2018-22.)

COLAs for 2017 / 2018
(Yes)

1. <u>Individuals COLAs for 2017 & 2018</u>.

a. Standard Deduction:

Single – $6,350 for 2017 & $12,000 for 2018

Head of Household – $9,350 for 2017 & $18,000 for 2018

Married filing Joint – $12,700 for 2017 & $24,000 for 2018

COLAs for 2017 / 2018
(Yes)

1. **Individuals COLAs for 2017 & 2018.**

   b. **Personal exemptions – $4,050 for 2017 (and in October 2017 was $4,150 for October 2018) – Now $0 for 2018**

   c. **Basic standard deduction for Kiddie tax – $1,050 for 2017 & 2018**

   d. **Qualified as dependent on another tax return – Earned income plus $350, limited to $6,350 for 2017 & $350 plus earned income for 2018, but limited to $12,000. (*See* Form 8814 and Form 8615.)**

   e. **Adoption credit – $13,570 and $203,540 to $243,540 for 2017 & $13,810 and $207,140 to $247,140 for 2018.**

COLAs for 2017 / 2018
(Yes)

1. **Individuals COLAs for 2017 & 2018.**

   f. **Gift tax exclusion – Gift of a present interest - $14,000 for 2017 & $15,000 for 2018. (Exemption $5,490,000 for 2017 & $11,180,000 for 2018.**

   g. **FICA wage base (* Projected Amounts):**

      1) $97,500 for 2007
      2) $102,000 for 2008
      3) $106,800 for 2009
      4) $106,800 for 2010
      5) $106,800 for 2011
      6) $110,100 for 2012
      7) 2013 - $113,700
      8) 2014 - $117,000
      9) 2015 - $118,500
      10) 2016 - $118,500
      11) 2017 - $127,200
      12) 2018 - $128,400
      13) 2019 - $132,300 *
      14) 2020 - $142,500 *****
      15) 2021 - $148,800 *****
      16) 2022 - $155,100 *****
      17) 2025 - $175,200 *

COLAs for 2017 / 2018
(Yes)

2. **<u>Pension COLAs</u>. (*See* Notice 2016-62 for 2017 amounts & Notice 2017-64 for 2018.)**

   a. **Defined contribution plans – $54,000 for 2017 & $55,000 for 2018**

   b. **Compensation – $270,000 for 2017 & $275,000 for 2018**

   c. **Section 401(k) – $18,000 and $6,000 for 2017 & $18,500 and $6,000 for 2018**

   d. **Simple IRA – $12,500 and $3,000 for 2017 & 2018**

   e. **IRA – $5,500 for 2017 & 2018 and $1,000 catch-up**

COLAs for 2017 / 2018
(Yes)

3. **<u>Per Diem Rates</u>. (Notice 2016-58 for 2017 & Notice 2017-54 for 2018.)**

   a. **High-cost – <u>$282 for 2017 & $284 for 2018</u>**

   b. **Low-cost – <u>$189 for 2017 & $191 for 2018</u>**

   c. **Meals:**

      High-cost – <u>$68 for 2017 & 2018</u>
      Low-cost – <u>$57 for 2017 & 2018</u>

Who can use the per diems?

– ER as reimbursement to EE
– EE & SE may use meals only

   d. **Incidental expenses – $5 for 2017 & 2018** (Fees and tips, but transportation costs between lodging and restaurant and mailing costs for filing travel vouchers are not incidental expenses.)

COLAs for 2017 / 2018
(Yes)

4. **Nanny Tax – Schedule H – $2,000 for 2017 & $2,100 for 2018.**

5. **Standard Mileage Rate – $.535 for 2017 & $.545 for 2018.**

6. **EIC and investment income not in excess of $3,450 for 2017 & $3,500 for 2018. (*See* Form 8867 for EIC, CTC, and AOTC.)**

7. **Section 179 Deduction:**

   a. **$510,000 and $2,030,000 for 2017 ($1,000,000 & $2,500,000 for 2018)**

      1) **For 2017, portable heating, air conditioning and ventilation units are eligible property (*see* Rev. Proc. 2017-33). For 2018, HVAC, roofs, security systems, fire protection systems and alarm systems eligible for § 179.**

      2) **For 2018, QIP also qualifies for § 179, Bonus and 15-Year.**

COLAs for 2017 / 2018
(Yes)

8. **Bonus Depreciation:**

   a. **50% for 2017**

   b. **After September 27, 2017, 100% for the rest of 2017 and 100% for 2018.**

COLAs for 2017 / 2018
(No)

9. **<u>AMT</u>: (*See* 2017 Form 6251.)**

   a. **Exemption Amounts:**

      1) **Joint returns & surviving spouses – $84,500 for 2017 & phaseout for 2017 is $160,900 – For 2018, $109,400 & phaseout at $1,000,000.**

      2) **Singles – $54,300 for 2017 & phaseout for 2017 is $120,700 – For 2018, $70,300 & phaseout at $500,000.**

      3) **Estates & Trusts – $24,100 for 2017 & phaseout for 2017 is $80,450 – For 2018, $24,600 & phaseout at $81,900.**

   b. **28% Rate – $187,800 for 2017 ($191,500 for 2018)**

2017 Standard Mileage Rates
Notice 2016-79 & Notice 2018-3
(Yes)

	2017	2018
• Business Travel:	53.5 cents	54.5 cents
Depreciation Component:	25 cents	25 cents
• Medical and Moving:	17 cents	18 cents
• Charity:	14 cents	14 cents

Limo owner may use standard mileage rate as long as four or less autos.

(amount set by statute)

*** See also Notice 2018-42, which reminds EE that there is no mileage deduction.**

2017 Depreciation Limits
Passenger Cars and Other Vehicles (Yes)

- **Rev. Proc. 2017-29 – Vehicles placed in service in 2017 and Rev. Proc. 2018-25 for vehicles placed in service in 2018 (and for vehicles acquired before September 28, 2017 and after September 27, 2017 that are placed in service in 2018).**

- **Passenger automobile (or truck or van) not > 6,000 GVW:**

  1. **2017: $3,160 ($3,560), and if new, bonus depreciation ($8,000). ($10,000 for 2018 and $8,000 for new or used for bonus depreciation in 2018)**
  2. **2018: $5,100 ($5,700). ($16,000 for 2018)**
  3. **2019: $3,050 ($3,450). ($9,600 for 2018)**
  4. **Then: $1,875 ($2,075). ($5,760 for 2018)**

2017 Depreciation Limits
Passenger Cars and Other Vehicles (Yes)

- **SUV > 6,000 GVW: No §280F limit; $25,000 §179 limit.**

- **Truck or van > 6,000 GVW, not an SUV: No limits. Would you recommend § 179 or bonus depreciation? – If take, no standard mileage rate later on.**

New Way to Pay Taxes (Yes)

- **New way to pay taxes in cash: 7-Eleven is there for you.**

1. **On April 6, 2016, the IRS announced in IR-2016-56 a new payment option for individuals who need to use cash to pay their tax liability, and do not wish to travel to an IRS taxpayer assistance center.**

    a. **IRS has partnered with ACI Worldwide's OfficialPayments.com and the PayNearMe Company so that individuals can pay at more than 7,000 7-Eleven stores nationwide.**

    b. **To use OfficialPayments.com, visit the IRS.gov payments page, and select cash option in the "other ways you can pay" section.**

    c. **Limit: $1,000 payment per day, and a $3.99 fee applies per payment. (*See also* Form 9465 and Credit Card.)**

Penalty Amounts

- **Failure to file a partnership return – $200 for 2017 & 2018**
- **Failure to file an S corporation return – $200 for 2017 & 2018**
- **Failure to be due diligent for EITC, CTC, AOTC and Head of Household – See Form 8867 – $510 for 2017 & $520 for 2018**
- **Penalty for not having minimal essential health care is $695 for 2017 and 2018**
- **FSA – $2,600 for 2017 & $2,650 for 2018**

Tax Cuts and Jobs Act
Changes That Affect Individuals
And
Bipartisan Budget Act &
Consolidated Appropriations Act

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

1. **<u>Rate Brackets</u> – The Act keeps seven individual tax brackets. Rather than having the highest bracket begin at $500,000 of taxable income for single filers and $1,000,000 for joint filers with a top rate of either 38.5% or 39.6%, <u>the final Act provides a top rate of 37% beginning at $500,000 for single filers, $600,000 for joint filers and $12,500 for Estates & Trusts (see also L.62 for Form 8959 & Form 8960 – Max rate almost 42%)</u>.**

2. **<u>Kiddie Tax</u> – The Act simplifies the calculation of the Kiddie Tax where the child has unearned income of more than $2,100. (Form 8814 & Form 8615)**

3. **<u>Deduction for Qualified Business Income</u> – The Act provides a 20% (rather than 23%) deduction for qualified trade or business income of pass-through entities and sole proprietors that yields a maximum rate on such income of 29.6%. (Qualified Business Income (QBI), Specified Service Business (SSB) & Qualified Trade or Business (QTB) – § 199A)**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

4. <u>State and Local Tax Deduction</u> – <u>The Act allows a state/local tax deduction of up to $10,000 for any combination of income, property or sales taxes</u>. Foreign real property taxes are not deductible. Prior bills repealed all SALT deductions except for real property taxes up to $10,000 – Also applies to Form 1041. (*See* Notice 2018-54 & N.J.)

5. <u>Mortgage Interest Deduction</u> – The Act allows a deduction for mortgage interest on up to $750,000 of acquisition debt and repeals the deduction for home equity interest. Allows a deduction for interest on debt for vacation homes. (*See* IR 2018-32 – Old Debt is before 12-16-17 & New Debt is after 12-15-17.)

6. <u>Like-Kind Exchanges</u> – The Act allows limits like-kind exchanges under §1031 to real property exchanges. Exchanges of personal property will no longer qualify as a like-kind exchanges.

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

7. <u>Estate Tax Repeal</u> – The Act doubles the estate and gift tax exclusion amount, but does not repeal the estate and GST tax in 2025. The exemption amount in 2018 is $11,180,000 and may make a gift of a present interest of $15,000 without filing Form 709 in 2018. Portability remains available.

8. <u>Section 179 Expensing</u> – The Act increases the § 179 deduction amount and phase-out threshold to $1 million and $2.5 million, and expands covered property. It also allows for 100% bonus depreciation for five years and then phases down bonus depreciation over the next four years. (*See* Fact Sheet 2018-9 for 2018 depreciation rules.)

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

9. Method of Accounting – The Act allows taxpayers, including corporations, with average annual gross receipts of $25 million or less to use the cash method, even if inventories are required, and to avoid UNICAP rules. (*See* Notice 2018-35, § 471(c) & § 448 – *See* Rev. Proc. 2018-31, Rev. Proc. 2018-29 and Rev. Proc. 2018-35.) What is the spread period for a negative § 481 adjustment?

10. Luxury Auto Limits – The Act increases passenger automobile depreciation limitations. (*See* § 280F – $10,000, $16,000, $9,600 & $5,760 as well as $8,000 bonus depreciation – Luxury auto is $50,000.)

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

11. Recovery Period – The Act reduces the class life of residential rental property from 40 years to 30 years (foreign residential rental property).

12. AMT – The Act eliminates the Corporate AMT and all but eliminates the AMT for most individuals. (*See* Rev. Proc. 2018-18, Rev. Proc. 2018-22 – AMT exemption for Trust & Estate is $89,100.)

13. Individual Mandate Repeal – The Act repeals the individual mandate to have insurance under the Affordable Care Act (ACA). – But the Republicans should introduce and pass their version of the ACA by September 30, 2018.

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

14. **<u>Education-Related Incentives</u> – The Act allows for a distribution of up to $10,000 from a § 529 plan for elementary and high school education. But the State must amend its version of the § 529 plan to allow for such distribution.**

15. **<u>Miscellaneous Itemized Deductions</u> – The Act repeals the deduction for miscellaneous itemized deductions (which includes deductions for expenses for the production of income, such as investment advice, tax preparation expenses (*see* Rev. Rul. 92-29, IRA custodian fees, investment advisory fees and expenses on Form 2106, etc. – Schedule A – 2% AGI & Form 1041 Line 15(c)).**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

16. **<u>Standard Deduction and Personal Exemption</u> – The Act increases the standard deduction to $24,000 for joint filers, $18,000 for heads of household, $12,000 for single filers, and repeals the personal exemptions (age & blind is $1,300 (MFJ) and $1,600 (singles)). The proposed personal exemption for 2018 was $4,150 and the proposed standard deduction for 2018 for MFJ was $13,000 – Family of four would have been entitled to a standard deduction of $13,000 & $16,600 for P.E. for a total of $29,600. Now all that entitled to is a lousy $24,000. – True/False?**

17. **<u>Child Tax Credit</u> – The Act allows a child tax credit of $2,000, but the credit would phaseout for couples with income over $400,000 ($200,000 for singles) and leaves the age at under 17. The Act, however, adds a $500 nonrefundable credit for each dependent of the taxpayer who is not a qualifying child under age 17. The Act also increases the refundable CTC to $1,400 for earnings in excess of $2,500.**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

18. **<u>Charitable Contribution</u> – The Act keeps the charitable contribution deduction with minor changes (60% of AGI rather than 50% of AGI for cash contributions). Think of IRA to charity if age 70.5.**

19. **<u>Medical and Dental Expenses and Casualty Losses</u> – The Act keeps the medical expense deduction and provides for a 7.5% AGI threshold for 2017 and 2018. The Act also limits casualty losses to those incurred in a presidentially-declared disaster area. (Reverts to 10% AGI in 2019.)**

20. **<u>Graduate Students</u> – The Act keeps the exclusion from gross income of tuition waivers for graduate students (§ 117(d)(2)).**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

21. **<u>Head of Household Due Diligence Requirements</u> – The Act directs the Treasury Department to issue due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. A penalty of $500 ($520 adjusted for 2018) applies for each failure to meet these requirements. (*See* Form 8867 – EIC, CTC & AOTC.)**

22. **<u>Carried Interest Loophole</u> – The Act addresses the carried interest rules that allow investment managers to have income taxed at capital gains rates by increasing the holding period of the relevant interest to three years (if do not meet the three-year holding period, the gain is taxed as a STCG.) (*See* Notice 2018-18 & § 1061.)**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

23. **<u>Installment Agreements User Fees</u> – The Act does not prohibit increases in the amount of user fees charged by the IRS for installment agreements. (*But see* Bipartisan Budget Act which freezes the fees – *See* Form 9465.)**

24. **<u>Bonus Depreciation</u> – The Act allows 100% additional first-year depreciation (bonus depreciation) for all qualified property placed in service after September 27, 2017, and before January 1, 2023. It also consolidates the definition of qualified improvement property, provides a 15-year recovery period, and allows qualified improvement property to qualify for the § 179 deduction. (For new or used property, and bonus depreciation will be available for a partnership which makes a § 754 election if the property qualifies.) – See Fact Sheet 2018-9.**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

25. **<u>Sale of Partnership Interests</u> – The Act (a) taxes gain on the sale of a partnership interest on a look-through basis; (b) modifies the definition of substantial built-in loss on transfers of a partnership interest; and (c) <u>takes into account charitable contributions and foreign taxes in determining the limitation on a partner's share of partnership loss. The Act also eliminates the rules for a technical termination</u>.**

26. **<u>Limit on NOL Deductions</u> – The Act limits a business's net operating loss deduction to 80 percent of taxable income (determined without regard to the deduction and all NOL generated in 2018 and later may only be carried forward). Does not apply to an NOL from 2017 and before.**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

27. **<u>Alimony Deduction</u> – The Act eliminates the deduction for alimony by the payor spouse and the inclusion of alimony in the income of the payee spouse for divorce or separation instruments executed on or after January 1, 2019. (*See* Line 11 and Line 31 of Form 1040.) The Act also eliminates § 682 (*see* Notice 2018-37). What will be the impact on Form 8332 and spousal support & child support guidelines?**

28. **<u>Moving and Entertainment Expenses</u> – The Act denies a deduction for all entertainment-related expenses and disallows a deduction for all moving expenses except for members of the Armed Forces. (*See* IRS Publication 15-B which deals with 2018 Fringe Benefits and Notice 2018-42.)**

The Tax Cuts and Jobs Act
Introduction

A. 30 Highlights That Affect Individuals:

29. **<u>Limitation on Deductibility of Losses</u> – For taxpayers other than a corporation, the Act disallows a deduction for aggregate "excess losses" (losses in excess of $250,000 for single filers and $500,000 for joint returns) attributable to the taxpayer's trades or businesses and losses that are deductible under the passive loss rules. (*See* § 461(l).)**

30. **<u>Qualified Equity Grants</u> – If the taxpayer receives a qualified equity grant under § 83(i), he/she can defer recognizing income for up to five years.**

Tax Cuts and Jobs Act
Details

B. Bipartisan Budget Act of 2018 (Signed by the President on February 9, 2018).

1. List of Provisions in the Bipartisan Budget Act.

a. Introduced by Senator Orrin Hatch on December 20, 2017. – Why this date?

b. <u>All extensions are through December 31, 2018, unless otherwise stated</u>.

Tax Cuts and Jobs Act
Details

B. Bipartisan Budget Act of 2018.

2. The items included in the Bipartisan Budget Act include:

a. Qualified principal residence debt exclusion from COD income (Form 982).

b. Treat mortgage insurance premiums as qualified residence interest (Form 1098).

c. Above-the-line deduction for qualified tuition and related expenses (L.34).

d. Credit for residential energy property, with modifications, through December 31, 2021 for Solar Credit and December 31, 2017 for Insulation Credit.

Tax Cuts and Jobs Act
Details

B. Bipartisan Budget Act of 2018.

3. There are also a number of miscellaneous provisions in Bipartisan Budget Act including:

a. Limit increasing the fee for installment agreements (*see* Form 9645),

b. Form 1040SR for Seniors (wonder what that form will look like),

c. Tax relief for victims of California wildfires and for Hurricanes Harvey, Irma and Maria.

Tax Cuts and Jobs Act
Details

C. Consolidated Appropriations Act (Signed by the President on March 23, 2018).

1. Contains a number of technical corrections to the FAST Act, the ABLE Act, makes a number of clerical corrections and deadwood-related provisions and makes a number of technical corrections related to the partnership audit rules. (*See* § 25A for education credits.)

2. Also fixed what was referred to as the "grain glitch."

a. Issue. The provision in § 199A that provided farmers with a tax advantage for selling crops to farmer-owned cooperatives, but not for sales to private or investor-owned grain handlers was a mistake—the so-called "grain glitch."

b. Glitch Fix. The Appropriations Act makes significant changes to § 199A(g) to fix this problem and makes a number of other technical changes that affect agricultural or horticultural cooperatives.

Tax Cuts and Jobs Act
Details

Tax Cuts and Jobs Act
Details

1. <u>Cost Recovery</u>.

   a. **For 2017, QLIP, QRIP & QRP property was eligible for a § 179 deduction, for 50% bonus depreciation and 15-year recovery period if the property was:**

      1) **Subject to a lease**

      2) **Lease was not with a related party**

      3) **The improvement was to the interior portion of a building (except for QRP) and**

      4) **The underlying property was placed in service more than three years ago.**

Tax Cuts and Jobs Act Details

1. <u>Cost Recovery</u>.

   b. For property placed in service after September 27, 2017, qualified improvement property (QIP) is eligible for 100% bonus depreciation.

   c. For tenant finish made in 2018, QIP property replaces QLIP, QRIP & QRP property and QIP property is eligible for the 100% bonus depreciation, the § 179 deduction and may be depreciated over a 15-year recovery period.

   d. According to a person on the Joint Conference Committee, bonus depreciation is available to a partnership which makes a § 754 election on the purchase of an interest in a tax partnership as long as the underlying property is eligible for bonus. A distribution of property where the tax partnership has a § 754 election does not qualify for the bonus depreciation.

Tax Cuts and Jobs Act Details

1. <u>Cost Recovery</u>.

   e. Taxpayers could fully and immediately expense 100% of the cost of qualified property (as now defined for bonus depreciation purposes) acquired and placed in service after 9/27/2017 and <u>before 1/1/2023</u>. (Certain property with a longer production period would receive an additional year.)

   f. <u>"Qualified property" means depreciable property which</u>:

      1) Has a recovery period of 20 years or less;

      2) Is certain computer software or water utility property; or

      3) Is qualified improvement property.

Tax Cuts and Jobs Act
Details

1. **Cost Recovery.**

   g. **All qualified improvement property (into which QLIP, QRIP, and QRP were consolidated) is eligible for bonus depreciation; and if the property qualifies as QIP, it is also eligible for a § 179 deduction (beginning in 2018) and is eligible for a 15-year recovery period (beginning in 2018). (*See* Example 4 in Rev. Proc. 2017-33 and § 168(e)(6).)**

      1) **QIP property means any improvement to an interior portion of a building which is nonresidential real property if such improvement is made after the date the building was first placed in service.**

Tax Cuts and Jobs Act
Details

1. **Cost Recovery.**

   h. **A provision that qualified property would not include any property used by a regulated public utility company or used in a real property trade or business is not included in the final Act.**

   i. **In addition to 100% bonus depreciation through 2022, the Act provides for 80% bonus in 2023, 60% bonus in 2024, 40% bonus in 2025 and 20% bonus in 2027.**

Tax Cuts and Jobs Act
Details

1. **Cost Recovery.**

   j. **For a taxpayer's first tax year ending after 9/27/2017, the taxpayer may elect to apply 50% bonus rather than 100%.**

   k. **Property must both be acquired and placed in service after 9/27/2017 in order for the new rules to apply.**

   l. **The bonus requirement that the original use of the property begins with the taxpayer is repealed. <u>Property is eligible if it is the taxpayer's first use</u> (<u>means the purchase of used property is eligible for bonus depreciation</u>). For bonus depreciation, the property must be purchased (no gift, only additional boot paid on a LKE, and must not be acquired from a related party).**

QIP Example

- **Your client is the first tenant of a newly constructed building. The owner of the building received a Certificate of Occupancy for the building on February 28, 2018. The owner of the building finished the exterior of the building and minimally finished the interior of the building with only elevators, heating, ventilation, A/C system, plumbing, restrooms and concrete floor. T will lease one floor of the building beginning April 1, 2018. T (or the landlord) is responsible for the cost of the tenant finish. The cost of the tenant finish will be $100,000. What options are available? (*See* Rev. Proc. 2017-33 and *Stine*.) <u>What result if property is later sold</u>? – (*See* § 1250 & O.I.)**
  - **<u>§ 179 – Yes</u> – Meets the definition of qualified improvement property.**
  - **<u>Bonus Depreciation – Yes</u> – The tenant finish meets the definition of qualified improvement property.**
  - **<u>15-Year Property – Yes</u> – Meets the definition of qualified improvement property.**

Tax Cuts and Jobs Act
Details

1. <u>Cost Recovery</u>.

m. Qualified property includes specified plants planted or grafted after September 27, 2017. (*See* Rev. Proc. 2018-35.)

n. Qualified property also includes qualified film, television and live theatrical productions placed in service after that date, for which a deduction otherwise would have been allowable under §181 without regard to dollar limits in that section.

o. <u>Qualified property does not include any property used in a T/B that has had floor plan financing indebtedness unless the taxpayer is exempt from interest deduction limits due to meeting the small business gross receipts test</u>.

Tax Cuts and Jobs Act
Details

1. <u>Cost Recovery</u>.

p. The election to accelerate AMT credits in lieu of bonus depreciation is repealed.

q. <u>The Act keeps the §280F increased amount of $8,000 bonus depreciation for passenger automobiles placed in service after December 31, 2017</u>. (*See* § 168(k)(2)(F) and <u>Rev. Proc. 2018-25 for autos acquired after 9/27/17 and placed in service in 2018</u>.)

r. <u>The depreciation limitations under §280F for passenger automobiles are increased to $10,000 for the year the vehicle is placed in service</u> (plus any allowed bonus), $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years.

Tax Cuts and Jobs Act
Details

1. **<u>Cost Recovery</u>.**

    s. **Other provisions related to cost recovery include:**

    1) **<u>Computer or peripheral equipment are removed from the definition of listed property</u>. (Automobiles are only item left.)**

    2) **For a farming business, the depreciation recovery period is reduced from seven to five years for any machinery or equipment (other than grain bins, cotton ginning asset, fence, or other land improvement) the original use of which commences with the taxpayer and is placed in service after 12/31/2017.**

TI-ITP.18

Tax Cuts and Jobs Act
Details

1. **<u>Cost Recovery</u>.**

    s. **Other provisions related to cost recovery include:**

    3) **The Act repeals the required use of the 150% declining balance method of depreciation for property used in a farming business (*i.e.*, for three, five, seven and ten-year property). The 150% declining balance method continues to apply to any 15 or 20-year property to which the straight line method does not apply. A "farming business means a business as defined in § 263A(e)(4).**

TI-ITP.18

Tax Cuts and Jobs Act
Details

1. <u>Cost Recovery</u>.

    s. Other provisions related to cost recovery include:

    4) The Act requires a farming business electing out of the limitation of the deduction for interest to use the ADS to depreciate any property with a recovery period of 10 years or more (*e.g.*, property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).

    5) The Act modifies a special rule for recovering costs related to citrus plants lost or damaged due to casualty.

Tax Cuts and Jobs Act
Details

1. <u>Cost Recovery</u>.

    t. <u>Recovery period for real property is not reduced</u>.

    1) The Senate bill shortened the recovery period for determining the depreciation deduction for nonresidential real and residential rental property to 25 years, with the ADS recovery period reduced from 40 to 30 years.

    2) The final Act maintains the present law MACRS recovery periods of 39 for nonresidential real property and 27.5 years for residential rental property, <u>but the ADS period has been reduced from 40 years to 30 years for residential property (think of rental property located in Mexico)</u>.

Tax Cuts and Jobs Act
Details

1. **Cost Recovery.**

   u. **Rules for improvement property consolidated.**

      1) **The Act eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a 15-year MACRS recovery period for "qualified improvement property" ("QIP"). Senate had proposed a 10-year period.**

      2) **After 2017, QIP is depreciable over 15 years and qualifies for the § 179 deduction, without regard to whether the property is leased, placed in service more than 3 years after the building was, is a restaurant, or is associated with a related party.**

TI-ITP.18

Tax Cuts and Jobs Act
Details

1. **Cost Recovery.**

   u. **Rules for improvement property consolidated.**

      3) **Restaurant building property placed in service after 2017 that does not meet the definition of QIP is depreciable over 39 years as nonresidential real property. (Enlargement of restaurant in 2018.)**

      4) **Section 179(f) is amended to conform with the new single definition of QIP. Restaurant building property that does not meet the definition of QIP is not eligible for §179 expensing.**

      5) **Note that QIP can qualify for bonus depreciation.**

TI-ITP.18

Tax Cuts and Jobs Act
Details

2. **<u>Section 179 Deduction</u>.**

   a. **The deduction limitation under §179 is increased to $1 million and the phase-out threshold increased to $2.5 million, indexed for inflation (along with the $25,000 SUV limitation). (*See* § 179(b).)**

      1) **<u>Expands definition of qualified real property to include these improvement to nonresidential real property: Roofs, HVAC property, fire protection and alarm systems, and security systems. The § 179 deduction is also available to all Qualified Improvement Property</u> *(See* § 179(e).)**

      2) **<u>Expands §179 to cover certain depreciable tangible personal property used to furnish lodging</u> (*see* § 50(b)(2) & the flush language to § 179(d)). – But see Reg. § 1.263(a)-1(f).**

Tax Cuts and Jobs Act
Details

3. **<u>Modification of NOL Deduction</u>.**

   a. **Taxpayers may deduct an NOL carryover or carryback only to the extent of 80% of taxable income (determined without regard to the NOL deduction). The 80% limitation does not apply to a property and casualty insurance company. (*See* § 172(a)(2). N/A to NOL from 2017 and before.)**

   b. **Generally repeals all NOL carrybacks, but provides a special two-year carryback for small businesses and farms in the case of certain casualty and disaster losses. Carryforwards are indefinite. (*See* § 172(b). N/A to NOL from 2017.)**

   c. **Property and casualty insurance company have a two-year carryback and a 20-year carryforward.**

Tax Cuts and Jobs Act
Details

4. **Like-Kind Exchanges of Real Property.**

   a. **Deferral of gain under §1031 is allowed only for like-kind exchanges of real property, effective for transfers after 2017. For 2017, could one exchange a BTC for an APA?**

   b. **Applies to exchanges completed after 12/31/2017. (But what is the effect on SE income?)**

   c. **A transition rule allows a like-kind exchange of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before 12/31/2017. (Trade in road grader for a bulldozer – Taxable sale; but for property purchased, take §179 deduction or bonus depreciation.)**

Tax Cuts and Jobs Act
Details

5. **Entertainment and Meal Expenses.**

   a. **No deduction is allowed with respect to:**

      1) **An activity generally considered to be entertainment, amusement or recreation; – (professional golfer vs. not a professional)**

      2) **Membership dues with respect to any club organized for business pleasure, recreation or other social purposes; or**

      3) **A facility or portion thereof used in connection with any of the above items. (*See* § 274(a).)**

Tax Cuts and Jobs Act
Details

5. <u>Entertainment and Meal Expenses</u>.

   b. Repeals the present-law exception to the deduction allowance for entertainment, amusement or recreation that is directly related to (or in some cases associated with) the active conduct of a T/B, and the related rule applying a 50% limit to such deductions.

   c. Disallows a deduction for costs of providing any qualified transportation fringe to employees (parking and bus or transit pass). – See § 274(a)(4) – <u>May reimburse up to $260 per month, but no deduction to the employer</u>. (<u>*See* IRS Publication 15-B.</u>)

   d. Except as necessary for ensuring the safety of an employee, disallows a deduction for any expense incurred for providing transportation (or any payment or reimbursement) for commuting.

Tax Cuts and Jobs Act
Details

5. <u>Entertainment and Meal Expenses</u>.

   e. <u>Taxpayers generally may continue to deduct 50% of the food and beverage expenses associated with operating a T/B (*e.g.*, meals consumed by employees on work travel as well as a business lunch), with no deduction allowed for other entertainment expenses</u>.

Examples of Entertainment Expenses

Which of the following expenses are deductible? (Remember, unreimbursed EE business expenses are no longer deductible on Schedule A – See Form 2106.)

1. **An ER reimburses an EE for the cost of meals while the EE is away from home overnight for a temporary period of time.**
   – **<u>ANS</u>: 50% deductible by ER.**

2. **A self-employed person has lunch with a client in surroundings which are conducive to a B.F. business discussion and business is actually discussed. (*See* § 274(k).)**
   – **<u>ANS</u>: 50% deductible.**

Examples of Entertainment Expenses

Which of the following expenses are deductible? (Remember, unreimbursed EE business expenses are no longer deductible on Schedule A – See Form 2106.)

3. **An ER has a year end party for staff. The cost is $4,000.**
   – **<u>ANS</u>: 100% deductible. (*See* § 274(e)(4) & § 274(n)(2)(A).)**

4. **An ER leases a luxury sky box lounge which is used by various employees for home games of a professional sports team.**
   – **<u>ANS</u>: 100% deductible. (*See* § 274(e)(4) & § 274(n)(2)(A).)**

5. **An ER provides coffee, doughnuts, bottled water to its employees.**
   – **<u>ANS</u>: 50% deductible since de minimis fringe benefit. (*See* IRS Publication 15-B.) (*See* § 132(e)(1), § 274(n) & § 274(e).)**

Examples of Entertainment Expenses

Which of the following expenses are deductible?

6. **An ER provides a box lunch or a catered lunch to its EEs during busy season.**
   - **ANS: 50% deductible (*See* § 274(e)(1), § 274(n)(2)(A) & § 274(o).)**

7. **An EE takes a client to a sporting event where business is discussed. The EE also pays for the hot dogs, beer, wine, bottled water.**
   - **ANS: None is deductible by the ER if the EE is reimbursed pursuant to an accountable plan.**

Examples of Entertainment Expenses

Which of the following expenses are deductible?

8. **A self-employed person and client play golf at a country club and have dinner after the golf game.**
   - **ANS: Not deductible. (Dinner not deductible unless it is a business dinner.)**

9. **An EE has a business meeting with client and after the meeting the EE takes client and significant other to dinner.**
   - **ANS: Not deductible by the ER, but no tax effect to EE if reimbursed for expenses. (*See* § 274(e)(3).)**

Examples of Entertainment Expenses

Which of the following expenses are deductible?

10. An auto dealership offers hot dogs and drinks to entice the general public to at least look at the inventory of cars and trucks available for purchase (100% deductible under § 274(e)(7)).

a. Assume an investment advisor offers a free dinner to potential clients to educate the client as to the advantages of investing their money with him/her (100% deductible under § 274(e)(7)).

• <u>POINT</u>: The change to entertainment expenses does not affect the deductibility of a business lunch.

Tax Cuts and Jobs Act Details

5. <u>Entertainment and Meal Expenses</u>.

f. For amounts paid after 12/31/2017, the Act expands the 50% limitation on expenses associated with providing food and beverages to employees through an eating facility that meets the requirements for <u>de minimis fringes under §132(e), and for the convenience of the employer under §119(a)</u>.

1) <u>This means that a deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises or provided on or near the employer's business premises through an employer-operated facility is subject to the 50% limit on the deduction</u>. (*See Jacobs*.)

a) <u>Section 274(o) states that the meals which are excluded from the EE's gross income under § 119 are only deductible by the ER to the extent of 50% of the cost</u>.

2) Such amounts are not deductible at all if paid or incurred after 12/31/2025. (*See* § 274(o).)

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- **In *Jacobs v. Comm'r*, T.C. Memo. 2017-20:**

1. **Held: The Boston Bruins' provision of pregame meals to players at away-game city hotels qualified as *de minimis* fringe benefits under §274(n)(2)(B), and therefore the cost of the meals was not subject to the 50% limitation in §274(n)(1).**

2. **Facts: Taxpayers (collectively T) are the owners of the Boston Bruins, an NHL hockey team which each season plays 41 home games and 41 away games, plus potential playoff games.**

   a. **For the taxable years in question, the Bruins traveled to away games with players, coaches, and various other "traveling hockey employees" such as managers, trainers, and media personnel.**

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- In *Jacobs v. Comm'r*, T.C. Memo. 2017-20: Facts.

3. The Bruins contract with away-game city hotels that provide sleeping accommodations and meal rooms where pregame meals are served. The Bruins typically arrive at the away-game city the day before the game. Traveling employees often are provided a meal the evening before an away game, and breakfast, lunch, and a pre-game snack on away-game days. Meetings are conducted at most of these meals.

4. **The Bruins deducted the full cost of the away-game meals, claiming that the 50% limit on expenses for food or beverages in §274(n)(1) did not apply due to the exception for expenses that are excludable from GI under §132(e) because they are *de minimis* fringes.**

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- **In *Jacobs v. Comm'r*, T.C. Memo. 2017-20: Facts.**

  5. **Section 132(e)(2) provides that the operation by an employer of any eating facility for employees shall be treated as a non-taxable *de minimis* fringe if:**

     a. **Such facility is located on or near the business premises of the employer; and**

     b. **Revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.**

  6. **Access to the eating facility must not discriminate in favor of highly compensated employees. An employee entitled under §119 to exclude from GI the value of a meal provided at such facility is treated as having paid an amount equal to the direct operating costs of the facility.**

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- **The Court first found that the meals were provided in a non-discriminatory manner and would constitute a *de minimis* fringe if:**

  1. **The eating facility is owned or leased by the employer;**

  2. **The facility is operated by the employer;**

  3. **The facility is located on or near the business premises of the employer;**

  4. **The meals furnished at the facility are provided during, or immediately before or after, the employee's workday; and**

  5. **The annual revenue derived from the facility normally equals or exceeds the direct operating costs of the facility (the revenue/operating cost test). *See Boyd Gaming Corp. v. Comm'r*, 106 T.C. 343 (1996); Reg. §132-7(a).**

The Boston Bruins
Can Deduct Full Cost of Away-Game Meals
(Yes)

- **<u>First requirement</u>: The eating facility was owned or leased by the employer because:**

  1. **Although the hotel and banquet contracts the Bruins entered into with the hotels were not identified as "leases," the substance of the agreements was that <u>the Bruins paid consideration in exchange for the "right to use and occupy" the hotel meal rooms</u>. That is like a lease.**

  2. The meal rooms were essential to the Bruins' away-game business operations, and the meal rooms were provided without extra charge because the Bruins spent money for lodging and food.

  3. The Bruins dictated aspects regarding the setup of the meal rooms, and required the hotels to keep the location of the meal room private.

The Boston Bruins
Can Deduct Full Cost of Away-Game Meals
(Yes)

- **<u>Second requirement</u>: The meal rooms were "operated by the employer" because:**

  1. **If an employer contracts with another to operate an eating facility for its employees, that facility is considered to be operated by the employer for purposes of §132(e).**

  2. **Here the Bruins' contracted with each away-game city hotel regarding the operation of the meal rooms as well as food preparation and service. The Bruins entered into a detailed advance banquet agreement as to all meals and meal service.**

  3. The Bruins paid a fee for each meal and a service fee. Thus the Bruins were "contracting with another to operate an eating facility for its employees." *See* Reg. §132-7(a)(3).

The Boston Bruins
Can Deduct Full Cost of Away-Game Meals
(Yes)

- **<u>Third requirement</u>: The eating facility was located on or near the "business premises" of the employer because:**

1. **Congress intended that a "commonsense approach" apply. An employer's business premises is a place where employees perform a significant portion of duties or where the employer conducts a significant portion of business. It is not necessary for the eating facility to be located in an employer's principal structure.**

2. Inquiry regarding business premises infers a functional rather than spatial unity or quantitative approach. In *Mabley v. Comm'r*, T.C. Memo. 1965-323, the Court held that a rented hotel suite used for daily executive lunches constituted business premises of a company. Here an integral part of the Bruins' hockey business involved travel for away games and use of hotels for preparation, rest, and meals.

The Boston Bruins
Can Deduct Full Cost of Away-Game Meals
(Yes)

- **<u>Fourth requirement</u>: The revenue/operating cost test was met because an employee entitled under §119 to exclude the value of a meal provided at an employer-operated eating facility shall be treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal. The employees met the §119 test.**

1. **Meals are excludable from gross income of recipient employees under §119 if they are:**

   a. **Furnished for the "convenience of the employer," and**

   b. **Furnished on the business premises of the employer.**

2. Meals are considered for the convenience of the employer if they are furnished "for a substantial non-compensatory business reason."

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- **The Court noted that if a taxpayer provides credible and uncontradicted evidence of business reasons for the provision of meals, the Court "will refrain from second-guessing a taxpayer's business judgment." Here the meals were provided for substantial non-compensatory business reasons because:**

  1. **Pregame meals for players were first and foremost provided for "nutritional and performance reasons," and menus were kept consistent from city to city to avoid players experiencing "unexpected gastric problems" during games.**

  2. **Meals were provided to non-players due to busy schedules and limited time to prepare for games. Meals were "working meals."**

  3. The Bruins provided credible evidence of business judgment that the Court would not second-guess.

The Boston Bruins Can Deduct Full Cost of Away-Game Meals (Yes)

- **<u>Fifth requirement</u>: The Court concluded that the meals were provided during, or immediately before or after, the employee's workday since the IRS conceded that this requirement was satisfied.**

- **<u>Conclusion</u>: The provision of pregame meals and snacks to the traveling hockey employees at away-game city hotels qualifies as a *de minimis* fringe under §274(n)(2). Therefore the Bruins were entitled to deduct the full cost of the meals without regard to the 50% limitation on meals expenses imposed by §274(n)(1).**

Tax Cuts and Jobs Act
Details

6. **Employee Achievement Awards.**

   a. **Amends § 74 definition of "tangible personal property" that may be considered a deductible employee achievement award to exclude:**

      1) **Cash, cash equivalents, gift cards or equivalents (other than arrangement conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer); or**

      2) **Vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities and other similar items. (*See* § 274(j) for qualified plan awards ($1,600) and nonqualified plan awards ($400).)**

Tax Cuts and Jobs Act
Details

7. **Rollovers of Publicly-Traded Securities Gain.**

   a. **The Act repeals the rule permitting gains on the sale of publicly traded securities to be deferred if rolled over to investment in a specialized small business investment company. (§ 1044)**

8. **Self-Created Property and Capital Gain.**

   a. **Excludes from the definition of a capital asset a self-created patent, invention, model, or design, or secret formula or process.**

   b. **Note: Rule in §1235 treating the transfer of a patent prior to its commercial exploitation as long-term capital gain is not repealed.**

Tax Cuts and Jobs Act
Details

9. **Technical Terminations of Partnerships.**

   a. **The Act repeals the §708(b)(1)(B) rule providing for technical terminations of partnerships. (What about cost of new Operating Agreement?)**

   b. **It does not change the present-law rule in §708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners.**

   c. **The Act also limits the amount of a charitable contribution deduction and foreign tax deduction to the partner's basis in its partnership interest. (Yahoo Provision) – Now same as an S corporation.**

Tax Cuts and Jobs Act
Details

10. **Other Partnership Changes.**

    a. **Tax Gain on the Sale of a Partnership Interest on a Look-Through Basis. Under the Act, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business 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 Act requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as non-separately stated income and loss.**

       1) **The Act also requires the transferee of a partnership interest to withhold ten percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.**

Tax Cuts and Jobs Act
Details

10. <u>Other Partnership Changes</u>.

    a. <u>Tax Gain on the Sale of a Partnership Interest on a Look-Through Basis</u>.

        2) The provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales, exchanges, and dispositions on or after November 27, 2017. The provision requiring withholding on sales or exchanges of partnership interests is effective for sales, exchanges, and dispositions after December 31, 2017.

Tax Cuts and Jobs Act
Details

10. <u>Other Partnership Changes</u>.

    b. <u>Modification of the Definition of Substantial Built-In Loss on Transfers of a Partnership Interest</u>. The Act modifies the definition of a substantial built-in loss for purposes of § 743(d), affecting transfers of partnership interests. In addition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

Tax Cuts and Jobs Act
Details

10. **Other Partnership Changes.**

 b. **Modification of the Definition of Substantial Built-In Loss on Transfers of a Partnership Interest.**

 Example: An LLC taxed as a partnership has three members (A, B, and C). The LLC has not made a §754 election. It has two assets, Asset X that has built-in gain of $1 million, and Asset Y that has a built-in loss of $900,000. Under the LLC agreement, any gain on sale or exchange of Asset X is specially allocated to A. The three members share equally in all other LLC items, including in the built-in loss in Asset Y. B and C each has a net built-in loss of $300,000 (one-third of the built-in loss of Asset Y) allocable to their LLC interest. Nevertheless, the LLC does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). C sells his LLC interest to individual D for $33,333.

Tax Cuts and Jobs Act
Details

10. **Other Partnership Changes.**

 b. **Modification of the Definition of Substantial Built-In Loss on Transfers of a Partnership Interest.**

 Example (cont'd): Under the Act, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the LLC were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one-third of the built-in loss of $900,000 in Asset Y). The LLC does not have a substantial built-in loss, but a substantial built-in loss exists under the partner-level test, and the LLC adjusts the basis of its assets accordingly with respect to D.

Tax Cuts and Jobs Act
Details

10. <u>Other Partnership Changes</u>.

c. This provision applies to transfers of partnership interests after December 31, 2017.

Tax Cuts and Jobs Act
Details

11. <u>Carried Interest</u>.

a. The Act does not change the "carried interest" rules that allow some persons such as venture capitalists to receive a partnership interest in exchange for services, and then later receive capital gain with respect such interest. (*See* § 1061 – Makes gain ST rather than LT.)

1) The Act does provide for a three-year holding period in the case of certain net long-term capital with respect to any "applicable partnership interest" held by the taxpayer.

2) The three-year period applies notwithstanding the rules of §83 or any election in effect under §83(b). – <u>See Notice 2018-8 which states that § 1061 applies to an S corporation which holds a partnership interest</u>.

3) <u>Real estate agent foregoes $500,000 commission on the sale of commercial property in exchange for a profits interest in a real estate partnership</u>.

Tax Cuts and Jobs Act
Details

12. <u>Rate Brackets</u>. **Retains seven rate brackets, but changes break points and some of the percentages (but simple as a postcard):**

   a. **Rate bracket thresholds for married filing separately continue to be half the thresholds for joint returns. (Four rate brackets for an estate or trust. <u>Now the super rich and the just rich</u> – <u>See Form 8959 & Form 8960</u>.)**

   b. **<u>Rates for long-term capital gains and qualified dividends remain the same with the same approximate breakpoints for the 0%, 15%, and 20% rates</u>. The special 25% and 28% rates are retained.**

      1) **For 2018, the 15% breakpoint is $77,200 for joint returns and surviving spouses, $51,700 for heads of household, $2,600 for estates and trusts, and $38,600 for other unmarried individuals.**

Tax Cuts and Jobs Act
Details

12. <u>Rate Brackets</u>. **Retains seven rate brackets, but changes break points and some of the percentages (but simple as a postcard):**

   b. **<u>Rates for long-term capital gains and qualified dividends remain the same with the same approximate breakpoints for the 0%, 15%, and 20% rates</u>. The special 25% and 28% rates are retained.**

      2) **The 20% breakpoint is $479,000 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), $452,400 for heads of household, $12,700 for estates and trusts, and $425,800 for other unmarried individuals.**

   c. **The bracket thresholds will be indexed using "chained CPI" instead of CPI, a different measure of inflation that generally results in smaller inflation adjustments under the Code.**

Individual Tax Brackets
TCJA Retains Seven Brackets

Single Filers Income Range	Joint Filers Income Range	Head of Household Income Range	Tax Rate
$0 - $9,525	$0 - $19,050	$0 - $13,600	10.0%
$9,525 - $38,700	$19,050 - $77,400	$13,600 - $51,800	12.0%
$38,700 - $82,500	$77,400 - $165,000	$51,800 - $82,500	22.0%
$82,500 - $157,500	$165,000 - $315,000	$82,500 - $157,500	24.0%
$157,500 - $200,000	$315,000 - $400,000	$157,500 - $200,000	32.0%
$200,000 - $500,000	$400,000 - $600,000	$200,000 - $500,000	35.0%
Over $500,000	Over $600,000	Over $500,000	37%

Comparison
Joint Return Tax Brackets

Joint Filers 2018 Prior Law		Joint Filers TCJA 2018	
$0 - $19,050	10%	$0 - $19,050	10%
$19,050 - $77,400	15%	$19,050 - $77,400	12%
$77,400 - $156,150	25%	$77,400 - $165,000	22%
$156,150 - $237,950	28%	$165,000 - $315,000	24%
$237,950 - $424,950	33%	$315,000 - $400,000	32%
$424,950 - $480,050	35%	$400,000 - $600,000	35%
Over $480,050	39.6%	Over $600,000	37%

MFJ – T.I. $600,000 – O.I. $480,000
– LT $120,000

Comparison
Single Return Tax Brackets

Single Filers 2018 Prior Law		Single Filers TCJA in 2018	
$0 - $9,525	**10%**	**$0 - $9,525**	**10%**
$9,525 - $38,700	**15%**	**$9,525 - $38,700**	**12%**
$38,700 - $93,700	**25%**	**$38,700 - $82,500**	**22%**
$93,700 - $195,450	**28%**	**$82,500 - $157,500**	**24%**
$195,450 - $424,950	**33%**	**$157,500 - $200,000**	**32%**
$424,950 - $426,700	**35%**	**$200,000 - $500,000**	**35%**
Over $426,700	**39.6%**	**Over $500,000**	**37%**

Estates & Trusts
Tax Rates for 2018

If Taxable Income in 2018 is:	Rate
$0 - $2,550	**10%**
$2,550 to $9,150	**24%**
$9,150 to $12,500	**35%**
Over $12,500	**37%**

*** But $2,600 for 0% & $12,700 for 20% on LT & qualified dividends.**

What Is "Middle Class"?
Return Filing by AGI: Individual Returns in 2017

AGI Category	% of Returns Filed
$0 to $50,000	61.46%
$0 to $75,000	74.72%
$0 to $100,000	**83.31%**
$0 to $200,000 --	**95.50%** --------------------------------------
$100,000 to $200,000	12.19%
$200,000 to $500,000	3.60%
$200,000 to $1,000,000	4.18%
$200,000 to > $10 million	**4.46%**
$500,000 to > $10 million	0.87%

***FROM 2017 DATA BOOK – 96% of all individuals have an AGI of less than or equal to $200,000.**

Kiddie Tax Code
26 U.S.C.A. § 1 – Tax Imposed

(j) <u>Modifications for Taxable Years 2018 Through 2025</u>.—

(2) <u>Rate Tables</u>.—

(A) <u>Married Individuals Filing Joint Returns and Surviving Spouses</u>.-- The following table shall be applied in lieu of the table contained in subsection (a):

If taxable income is:	The tax is:
Not over $19,050	10% of taxable income.
Over $19,050 but not over $77,400	$1,905, plus 12% of the excess over $19,050.
Over $77,400 but not over $165,000	$8,907, plus 22% of the excess over $77,400.
Over $165,000 but not over $315,000	$28,179, + 24% of the excess over $165,000.
Over $315,000 but not over $400,000	$64,179, + 32% of the excess over $315,000.
Over $400,000 but not over $600,000	$91,379, + 35% of the excess over $400,000.
Over $600,000	$161,379, + 37% of excess over $600,000.

Kiddie Tax Code
26 U.S.C.A. § 1 – Tax Imposed

(j) <u>Modifications for Taxable Years 2018 Through 2025</u>.—

(2) <u>Rate Tables</u>.—

(B) <u>Heads of Households</u>.--The following table shall be applied in lieu of the table contained in subsection (b):

If taxable income is:	The tax is:
Not over $13,600	10% of taxable income.
Over $13,600 but not over $51,800	$1,360, plus 12% of the excess over $13,600.
Over $51,800 but not over $82,500	$5,944, plus 22% of the excess over $51,800.
Over $82,500 but not over $157,500	$12,698, + 24% of the excess over $82,500.
Over $157,500 but not over $200,000	$30,698, + 32% of the excess over $157,500.
Over $200,000 but not over $500,000	$44,298, + 35% of the excess over $200,000.
Over $500,000	$149,298, + 37% of the excess over 500,000.

TI-ITP.18

Kiddie Tax Code
26 U.S.C.A. § 1 – Tax Imposed

(j) <u>Modifications for Taxable Years 2018 Through 2025</u>.—

(2) <u>Rate Tables</u>.—

(C) <u>Unmarried Individuals Other than Surviving Spouses and Heads of Households</u>.--The following table shall be applied in lieu of the table contained in subsection (c):

If taxable income is:	The tax is:
Not over $9,525	10% of taxable income.
Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525.
Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700.
Over $82,500 but not over $157,500	$14,089.50, + 24% of the excess over $82,500.
Over $157,500 but not over $200,000	$32,089.50, + 32% of the excess over $157,500.
Over $200,000 but not over $500,000	$45,689.50, + 35% of the excess over $200,000.
Over $500,000	$150,689.50, + 37% of the excess over $500,000.

TI-ITP.18

Kiddie Tax Code
26 U.S.C.A. § 1 – Tax Imposed

(j) **Modifications for Taxable Years 2018 Through 2025.—**

(2) **Rate Tables.—**

(D) **Married Individuals Filing Separate Returns.--The following table shall be applied in lieu of the table contained in subsection (d):**

If taxable income is:	The tax is:
Not over $9,525	10% of taxable income.
Over $9,525 but not over $38,700	$952.50, plus 12% of the excess over $9,525.
Over $38,700 but not over $82,500	$4,453.50, plus 22% of the excess over $38,700.
Over $82,500 but not over $157,500	$14,089.50, + 24% of the excess over $82,500.
Over $157,500 but not over $200,000	$32,089.50, + 32% of the excess over $157,500.
Over $200,000 but not over $300,000	$45,689.50, + 35% of the excess over $200,000.
Over $300,000	$80,689.50, + 37% of the excess over $300,000.

TI-ITP.18

Kiddie Tax Code
26 U.S.C.A. § 1 – Tax Imposed

(j) **Modifications for Taxable Years 2018 Through 2025.—**

(2) **Rate Tables.—**

(E) **Estates and Trusts.--The following table shall be applied in lieu of the table contained in subsection (e):**

If taxable income is:	The tax is:
Not over $2,550	10% of taxable income.
Over $2,550 but not over $9,150	$255, plus 24% of the excess over $2,550.
Over $9,150 but not over $12,500	$1,839, plus 35% of the excess over $9,150.
Over $12,500	$3,011.50, +37% of the excess over $12,500.

TI-ITP.18

Tax Cuts and Jobs Act
Details

13. <u>Increase Standard Deduction but Repeal Personal Exemptions</u>.

a. Increases standard deduction to: $24,000 for joint filers and surviving spouses; $12,000 for single filers; and $18,000 for heads of household with at least one qualifying child. Keeps the additional standard deduction for elderly and blind ($1,300 MFJ & $1,600 S).

b. This would reduce the number of itemizers from about 33% under current law to less than 10%.

c. But will many individuals be able to prepare their own Form 1040 using an on-line program or an off-the-shelf program such as Turbo Tax? Mention Charles Schwab and exercise of Qualified ISO – W-2, Line 12(v) showed $190,000 and the Form 1099-B with basis also showed a STCG of $190,000. Individual wondered why he/she owed $100,000 in tax.

Tax Cuts and Jobs Act
Details

13. <u>Increase Standard Deduction but Repeal Personal Exemptions</u>.

c. Deduction for personal exemptions is repealed, resulting in changes to requirements to file a return and withholding rules. Treasury Secretary has discretion to administer withholding rules in 2018 without regard to the new Act.

- <u>But how much gross income may a qualifying relative have in 2018 in order to qualify as a dependent on another person's tax return</u>? Assume a parent lives with you and has a small retirement of $2,500. May you claim the parent as a dependent for CTC?
  - » $0, $2,000, $4,150 or do not know – Huh?

Tax Cuts and Jobs Act
Details

13. **Increase Standard Deduction but Repeal Personal Exemptions.**

d. **Due Diligence Requirement for Head of Household Status.**

1) **The Act directs the Secretary of the Treasury to issue due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. A penalty of $500 ($520 for 2018) would be imposed for each failure to meet these requirements. (*See* Form 8867.)**

2) **A penalty of $500 ($520 for 2018) would be imposed for each failure to meet these requirements.**

3) **This adds due diligence requirement to those that under current law apply to the child tax credit, the education credits, and the earned income tax credit. (*See* Form 8867.) Guidance will be issued.**

Tax Cuts and Jobs Act
Details

14. **Tax Deduction for Qualified Business Income.**

a. **20% deduction for QBI from a QTB & certain limits for SSB.**

b. **What is the definition of a QTB?**

1) **§ 162 – See § 179 – Regular, continuous & substantial basis.**

2) **Schedule E – Rental property by an investor. If sell, gain or loss is § 1231 on Form 4797, but this is a § 212 activity.**

3) **§ 469 – T or B where one can materially participate is APCU ≤ 7 days.**

Tax Cuts and Jobs Act
Details

15. **Reform of Child Tax Credit (CTC).**

a. **Current $1,000 CTC is increased to $2,000, and a non-refundable credit of $500 is allowed for each dependent who is not a qualified child. Age limit remains the same (not age 17 by year end).**

b. **Refundable portion of CTC limited to $1,400, but that amount will be indexed for inflation based on chained CPI in the future until it reaches $2,000.**

c. **Maximum refundable credit limited to 15% of earned income above $2,500 (previously $3,000). (How much if have ten children and earned income is $62,500?)**

d. **Must list valid SSN to claim the CTC. (Not work eligible SSN.) This does not apply to a dependent who is not a qualified child, but no CTC is allowed for which a TIN has been issued after the due date (with extension) for filing the return for such year.**

Tax Cuts and Jobs Act
Details

15. **Reform of Child Tax Credit (CTC).**

e. **Credits are reduced by $50 for each $1,000 of AGI over thresholds.**

f. **The phase-out thresholds are increased from $110,000 for joint filers to $400,000, and from $75,000 for other filers to $200,000. This addresses the marriage penalty as to the credits.**

g. **In a divorce, which parent is entitled to the Child Care Credit and the EIC? ANS: Custodial. But which parent is entitled to CTC, LLC, AOTC and deduction for qualified tuition and fees? ANS: Only the parent that actually takes the child as a dependent. See Form 8332.**

Tax Cuts and Jobs Act
Details

16. **<u>Credits Not Repealed</u>. The following credits are not repealed in the final Act (although they were in one or more prior versions of the bills):**

    a. **Credit for certain persons over age 65 or who retired on disability. (Schedule R)**

    b. **The adoption credit. (Form 8839)**

    c. **The tax credit associated with mortgage credit certificates. (Form 8396)**

    d. **The credit for plug-in electric drive motor vehicles. – Tesla (Form 8910)**

Tax Cuts and Jobs Act
Details

17. **<u>Changes to "Simplify" the "Kiddie Tax"</u>.**

    a. **The Act adopts the House proposal to simplify the kiddie tax by <u>applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income</u> of a child (Form 8615 and Form 8814). <u>How much may a child earn in 2018 and pay no tax</u>? – $12,000**

       1) **Taxable income due to earned income will continue to be taxed according to a single taxpayer's brackets and rates. (*See* § 1(g).)**

       2) **Taxable income due to net unearned income now will be taxed according to brackets and rules applicable to trusts and estates, rather then being taxed at rates "on top" of the parent's income. Unearned income of siblings will no longer be relevant.**

Tax Cuts and Jobs Act
Details

17. **Changes to "Simplify" the "Kiddie Tax".**

    b. **The tax rates for trusts and estates under the Act are:**

       1) **10% on taxable income (TI) between $0 and $2,550.**

       2) **24% on TI between $2,550 and $9,150.**

       3) **35% on TI between $9,150 and $12,500.**

       4) **37% on TI greater than $12,500.**

    c. **Under the new formula in §1(g), the maximum amount taxed below the 24% rate is the sum of the child's "earned TI" plus $2,550. "Earned TI" is the child's TI minus net unearned income.**

Tax Cuts and Jobs Act
Details

17. **Changes to "Simplify" the "Kiddie Tax".**

    d. **The maximum amount taxed at below the 35% rate is the sum of the child's earned TI plus $9,150.**

    e. **The maximum amount taxed at below the 37% rate is the sum of the child's earned TI plus $12,500.**

    f. **This is the same as having the taxable income of the child divided into two amounts, with the net unearned income being taxed at the rates for a trust or estate and the remainder of the taxable income being taxed at the child's rate.**

Tax Cuts and Jobs Act
Details

17. <u>Changes to "Simplify" the "Kiddie Tax"</u>. Example.

   g. Assume in 2018 a child age 16 has wages of $5,000 and interest income of $6,000, and AGI is $11,000. In 2018 the child's basic standard deduction is $1,050 and $2,100 is the amount of unearned income a child may have before the kiddie tax applies.

   h. Here unearned income (interest of $6,000) exceeds $2,100 by $3,900, and therefore the kiddie tax applies. Net unearned income is $3,900.

      1) $11,000 AGI

      2) <u>- 5,350</u> Standard Deduction (earned income $5,000 + $350).

      3) <u>$ 5,650</u> Taxable Income

Tax Cuts and Jobs Act
Details

17. <u>Changes to "Simplify" the "Kiddie Tax"</u>. <u>Example</u>.

   i. $5,650 Taxable Income (net unearned income is $3,900)

      1) The child's "earned TI" is $1,750 (TI of $5,650 minus net unearned income of $3,900).

      2) Maximum amount taxed at less than the 24% trust/estate rate *(e.g.*, at 10%) is earned TI of $1,750 plus $2,550 = $4,300. Tax is $430.

      3) Remaining taxable income of $1,350 ($5,650 - $4,300) will be taxed at the 24% rate, resulting in tax of $324. [Note that maximum amount taxed at less than the 35% trust/estate rate (*e.g.*, at 24%) is earned TI of $1,750 plus $9,150 = $10,900].

      4) <u>Total tax is $754</u> ($430 plus $324).

Tax Cuts and Jobs Act
Details – Kiddie Tax

Example – Assume that child age 16 has the following for 2017:

W-2 Wage	**\$5,000**
Taxable Interest	**\$6,000**

- **What is child's taxable income and tax liability if child is age 16?**
- **Will the kiddie tax apply? Yes. But why?**
  - **Has unearned income in excess of \$2,100**
    - **(\$6,000 – \$2,100 = \$3,900)**

TI-ITP.18

Taxable Income if Qualify as Dependent on Another Person's Tax Return

2017	
W-2	**\$ 5,000**
Tax Int	**6,000**
AGI	**\$11,000**
P.E.	**(0)**
Aug. Std Ded.	**(5,350)**
T.I.	**\$ 5,650**

\$3,900	**\$1,750**
Parental Rate	**Child's Rate**

Deduction from AGI is the greater of:
1. **I.D. – Schedule A – Sales Tax**
2. **Basic Std Ded. – \$1,050**
3. **Aug. Std. Ded. – \$4,500 + \$350 or \$4,850**

- **What advice if the child is age 16 or 17?**

TI-ITP.18

Tax Cuts and Jobs Act
Kiddie Tax

Example – Assume that child age 16 has the following for 2018:

W-2 Wage	**$5,000**
Taxable Interest	**$6,000**

- **What is child's taxable income and tax liability if child is age 16?**
- **Will the kiddie tax apply? Yes. But why?**
  - **Has unearned income in excess of $2,100**
    - **($6,000 – $2,100 = $3,900)**

Tax Cuts and Jobs Act
Details – Kiddie Tax
Age 16

2018	
Wages	**$5,000**
Interest	**6,000**
GI	**$11,000**
D for AGI	**(0)**
AGI	**$11,000**
P.E.	**(0)**
Aug. Std. Ded.	**(5,350)**
T.I.	**$ 5,650**

Deduction from AGI is the greater of:

1. **I.D.**
2. **Basic Std Ded. – $1,050**
3. **Aug. Std. Ded. – $5,000 + $350 or $5,350**

Trust & Estate Rate ($3,900)
$255 (10% x $2,550) + $324 (24% x $1,350)
$579

Child's Rate
(Single)
$1,750
x 10%
$175

- **Total Tax – $754 ($579 + $175)**

Tax Cuts and Jobs Act
Details

18. <u>Work Eligible I.D. Number</u>. <u>The final Act (unlike prior versions) does not include the requirement that a taxpayer must provide a "work-eligible" social security number</u> (SSN) (*i.e.*, not just an ITIN or a SSN issued to foreign legal residents that may not be used for employment purposes) <u>to claim</u>:

a. The refundable portion of the CTC.

b. The refundable portion of the American Opportunity Tax Credit.

c. The refundable Earned Income Tax Credit.

Tax Cuts and Jobs Act
Details

19. <u>Loss Limitation Rules Applicable to an Individual</u>. (§ 461(l))

a. For taxable years beginning after December 31, 2017 and before January 1, 2026, § 461(l) provides that excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent taxable years. (<u>*See* § 461(l) – But what happens if sell a PTP interest with suspended loss of $1,000,000 or a rental property with a suspended loss under the passive loss rules of $280,000?</u>)

b. Under the Act, NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 80 percent of taxable income determined without regard to the deduction for NOLs.

Tax Cuts and Jobs Act
Details

19. Loss Limitation Rules Applicable to an Individual.

c. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount of $250,000 ($500,000 for joint returns). The threshold amount is indexed for inflation. (Is this definition of trade or business the same as under § 199A?)

d. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each shareholder's pro rata share of items of income, gain, deduction, or loss of the entity are taken into account in applying the limitation for the taxable year of the partner or shareholder.

Tax Cuts and Jobs Act
Details

19. Loss Limitation Rules Applicable to an Individual.

e. Regulatory authority is provided to apply the provision to any other passthrough entity to the extent necessary to carry out the provision.

f. Regulatory authority is also provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.

g. The provision applies after the application of the passive loss rules. (*See* § 461(l)(6).)

Tax Cuts and Jobs Act
Details

20. Section 529 Plans – QSTP.

a. **The Act modifies § 529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private or religious elementary or secondary school. (*See* § 529(c)(7).)**

b. **The limitation applies on a per-student basis, rather than a per-account basis.**

c. **States must amend QSTPs to allow for a distribution.**

Tax Cuts and Jobs Act
Details

20. Section 529 Plans.

d. **Thus, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts.**

e. **Any excess distributions received by the individual are treated as a distribution subject to tax under the general rules of § 529.**

Tax Cuts and Jobs Act
Details

20. <u>Section 529 Plans</u>.

f. **The Act initially modified the definition of higher education expenses to include certain expenses incurred in connection with a homeschool.**

1) **After the House initially passed the final Act, however, the Senate parliamentarian ruled that such provisions were "extraneous" and not allowed under Senate reconciliation bill rules. House 12/18; Senate 12/19; House 12/20 & President signed 12/20.**

2) **Therefore the provisions were eliminated from the Act before the House again approved it.**

Tax Cuts and Jobs Act
Details

21. <u>Education Credits</u>.

a. **Under the House bill, the three existing higher education tax credits [the American Opportunity Tax Credit (AOTC), the Hope Scholarship Credit (HSC) and the Lifetime Learning Credit (LLC)] would have been be consolidated into the AOTC after 2017.**

b. **AOTC also would have been expanded to cover a fifth year of post-secondary education at $1,250 maximum, with up to $500 (40%) being refundable. The Senate had no provision.**

c. **<u>Final Act</u>: <u>Did not adopt the House changes, but the Consolidated Appropriations Act eliminated the HOPE Scholarship Credit from § 25A – All references are now to AOTC</u>. (LLC & L.34 – Must see Form 1098-T and in 2018 for AOTC, Form 1098-T Box 1 must be filled in.)**

Tax Cuts and Jobs Act
Details

22. **<u>Discharge of Student Loan Indebtedness</u>.**

    a. **Any income resulting from the discharge of student debt on account of death or total disability of the student will be excluded from taxable income. (*See* § 108(f)(5) – See Form 982.)**

    b. **Effective: For discharges of debt received after 2017 and amounts received in taxable years beginning after 2017.**

    c. **See § 108(f) which allows a student to exclude the student debt discharged for working for various organizations. Doctor, lawyer, graduate student & undergraduate – How does a student with a considerable debt have the debt discharged without recognizing any COD income? – IBR & work for ten years.**

Tax Cuts and Jobs Act
Details

23. **<u>Education-Related Provisions Not Repealed</u>. The following education-related provisions in the Code are not repealed:**

    a. **Deduction for interest on education loans (§ 221) – Form 1098-E**

    b. **Deduction for qualified tuition and related expenses (expires 12/31/2018) (§ 222).**

    c. **Exclusion from income of interest on U.S. savings bonds used to pay qualified higher education expenses (§ 137).**

    d. **Exclusion from income for qualified tuition reduction programs – Graduate students and tuition waivers (§ 117(d)(2)).**

    e. **Exclusion from income for employer-provided education assistance programs ($5,250) (§ 127).**

Tax Cuts and Jobs Act
Details

24. ABLE Accounts – Amounts from qualified tuition programs under §529 accounts may now be rolled over to an ABLE account (savings accounts benefiting disabled persons) without penalty. (*See* § 529A.) Good for a young child with a disability.

    a. The ABLE account must be owned by the designated beneficiary of the § 529 account, or by a member of such designated beneficiary's family.

    b. Such rolled-over amounts count towards the overall limit on amounts that can be contributed to an ABLE account within a taxable year.

    c. Any amount rolled over that is in excess of the limit is included in the gross income of the distributee.

Interest on Vacation Homes – 2016
&
Debt on Principal Residence & V.H. ≤ \$1,000,000

25. Mortgage Interest Expense Deduction.

- Different possibilities include:
  - No rental and all personal use.
  - No rental and no personal use.
  - Rental ≤ 14 days.
  - No personal use and all rental.
  - Personal use ≤ 14 days and rental > 14 days (2010 Schedule E, L.2 – No.)
    (Rental for 90 days and personal use 10 days) – Not used as a residence. – Regulations Method
  - Personal use > 14 days and rental > 14 days (2010 Schedule E, L.2 – Yes.)
    (Rental for 80 days and personal use 20 days) – Used as a residence. – *Bolton* Method

Vacation Home	
Int.	$12,000
Taxes	3,000
Main./Util.	6,000
Dep.	9,000
Total	$30,000

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ **Attach to Form 1040, 1040NR, or Form 1041.** ▶ **See Instructions for Schedule E (Form 1040).**

OMB No. 1545-0074

2010

Attachment Sequence No. **13**

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type and address of each **rental real estate property:**
A	
B	
C	

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of:
- 14 days **or**
- 10% of the total days rented at fair rental value?

(See page E-4)

	Yes	No
A		
B		
C		

Income:		Properties A	Properties B	Properties C		**Totals** (Add columns A, B, and C.)
3 Rents received	3				3	
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-5)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-5)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16					
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19				19	
20 Depreciation expense or depletion (see page E-5)	20				20	
21 Total expenses. Add lines 19 and 20	21					
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-6 to find out if you must file **Form 6198**	22					
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-6 to find out if you must file **Form 8582.** Real estate professionals **must** complete line 43 on page 2	23	( )	( )	( )		
24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses					24	
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here					25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2					26	

Name(s) shown on return. Do not enter name and social security number if shown on other side. | **Your social security number**

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(e)** on line 28 and attach **Form 6198.** See page E-2.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see page E-7 before completing this section. ☐ Yes ☐ No

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if any amount is not at risk
A			☐		☐
B			☐		☐
C			☐		☐
D			☐		☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach **Form 8582** if required)	**(g)** Passive income from **Schedule K–1**	**(h)** Nonpassive loss from **Schedule K–1**	**(i)** Section 179 expense deduction from **Form 4562**	**(j)** Nonpassive income from **Schedule K–1**
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (g) and (j) of line 29a	30	
31	Add columns (f), (h), and (i) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	**(a)** Name	**(b)** Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	**(d)** Passive income from **Schedule K–1**	**(e)** Deduction or loss from **Schedule K–1**	**(f)** Other income from **Schedule K–1**
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38	**(a)** Name	**(b)** Employer identification number	**(c)** Excess inclusion from **Schedules Q,** line 2c (see page E-8)	**(d)** Taxable income (net loss) from **Schedules Q,** line 1b	(e) Income from **Schedules Q,** line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ▶	41	
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code U; and Schedule K-1 (Form 1041), line 14, code F (see page E-8)	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see page E-2), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

SCHEDULE E (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ Attach to Form 1040, 1040NR, or Form 1041.

▶ Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074

2017

Attachment Sequence No. **13**

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2017 that would require you to file Form(s) 1099? (see instructions) . . . . . . ☐ **Yes** ☐ **No**

B If "Yes," did you or will you file required Forms 1099? . . . . ☐ **Yes** ☐ **No**

1a	Physical address of each property (street, city, state, ZIP code)
A	
B	
C	

1b	Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions.		**Fair Rental Days**	**Personal Use Days**	**QJV**
A			A			☐
B			B			☐
C			C			☐

Type of Property:

1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

Income:	**Properties:**		**A**	**B**	**C**
3	Rents received	3			
4	Royalties received	4			
Expenses:					
5	Advertising	5			
6	Auto and travel (see instructions)	6			
7	Cleaning and maintenance	7			
8	Commissions.	8			
9	Insurance	9			
10	Legal and other professional fees	10			
11	Management fees	11			
12	Mortgage interest paid to banks, etc. (see instructions)	12			
13	Other interest.	13			
14	Repairs.	14			
15	Supplies	15			
16	Taxes	16			
17	Utilities	17			
18	Depreciation expense or depletion	18			
19	Other (list) ▶	19			
20	Total expenses. Add lines 5 through 19	20			
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198**	21			
22	Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions)	22	( )	( )	( )

23a	Total of all amounts reported on line 3 for all rental properties	23a	
b	Total of all amounts reported on line 4 for all royalty properties	23b	
c	Total of all amounts reported on line 12 for all properties	23c	
d	Total of all amounts reported on line 18 for all properties	23d	
e	Total of all amounts reported on line 20 for all properties	23e	
24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses	24	
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here .	25	( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2 . . .	26	

Name(s) shown on return. Do not enter name and social security number if shown on other side. | **Your social security number**

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note: If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(e)** on line 28 and attach **Form 6198.** See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if any amount is not at risk
A			☐		☐
B			☐		☐
C			☐		☐
D			☐		☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach **Form 8582** if required)	**(g)** Passive income from **Schedule K-1**	**(h)** Nonpassive loss from **Schedule K-1**	**(i)** Section 179 expense deduction from **Form 4562**	**(j)** Nonpassive income from **Schedule K-1**
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (g) and (j) of line 29a	30	
31	Add columns (f), (h), and (i) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	**(a)** Name	**(b)** Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	**(d)** Passive income from **Schedule K-1**	**(e)** Deduction or loss from **Schedule K-1**	**(f)** Other income from **Schedule K-1**
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38 **(a)** Name	**(b)** Employer identification number	**(c)** Excess inclusion from **Schedules Q,** line 2c (see instructions)	**(d)** Taxable income (net loss) from **Schedules Q,** line 1b	**(e)** Income from **Schedules Q,** line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835.** Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ▶	41	
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code V; and Schedule K-1 (Form 1041), box 14, code F (see instructions) . .	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules . .	43	

Interest & Vacation Homes
No. 1 – No Rental & All Personal Use

		Bus	Non-Bus
Interest	$12,000	No	Sch A
Real Property Taxes	3,000	No	Sch A
Maintenance, Utilities, Insurance, HOA	6,000	No	No
Depreciation	9,000	No	No
Total	$30,000		

How much and where deductible if:

- **No rental and all personal use:**

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Interest & Vacation Homes
No. 1 – No Rental & All Personal Use

Interest	$12,000
Real Property Taxes	3,000
Maintenance, Utilities, Insurance, HOA	6,000
Depreciation	9,000
Total	$30,000

How much and where deductible if:

- **No rental and all personal use:**
  - **ANS: Interest and taxes deductible on Schedule A.**

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Interest & Vacation Homes
No. 2 – No Rental & No Personal Use

	Bus	Non-Bus
Interest	$12,000	$12,000
Real Property Taxes	3,000	3,000
Maintenance, Utilities, Insurance, HOA	6,000	0
Depreciation	9,000	0
Total	$30,000	

How much and where deductible if no rental and no personal use?

- **Interest & Taxes – Schedule A:**
  Qualified residence interest
  OR
  Investment interest on Form 4952

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Interest & Vacation Homes
No. 3 – Rent for ≤ 14 Days

	Bus	Non-Bus
Interest	$12,000	$12,000
Real Property Taxes	3,000	3,000
Maintenance, Utilities, Insurance, HOA	6,000	
Depreciation	9,000	
Total	$30,000	

How much and where deductible if:

- **Rented ≤ 14 days – Referred to as Master's provision:**
  - **Rented for 14 days at $5,000 per day – See § 280A(g).**

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Interest & Vacation Homes
No. 3 – Rent for ≤ 14 Days

Interest	$12,000
Real Property Taxes	3,000
Maintenance, Utilities, Insurance, HOA	6,000
Depreciation	9,000
Total	$30,000

How much and where deductible if:

- **Rented ≤ 14 days – Referred to as Master's provision:**
  - **ANS: - None of the income is taxable and none of the associated rental expenses is deductible.**

    - Interest and taxes deductible on Schedule A.

Interest & Vacation Homes
No. 4 – All Rental

		Bus	Non-Bus
Interest	$12,000	$12,000	$0
Real Property Taxes	3,000	3,000	0
Maintenance, Utilities, Insurance, HOA	6,000	6,000	0
Depreciation	9,000	9,000	0
Total	$30,000	$30,000	$0

How much and where deductible if:

- **All rental and no personal use:**
  - **Rental income $40,000**
    Management fee 15,000

    How much will be reported on Form 1099 Misc. from management company?

Interest & Vacation Homes
No. 5 – Regulations Method
Rental 90 Days; Personal Use 10 Days

		Bus	Non-Bus
Interest	**$12,000**	**$10,800**	**Not Ded?**
Real Property Taxes	**3,000**	**2,700**	**Sch. A - $300**
Maintenance, Utilities, Insurance, HOA	**6,000**	**5,400**	**0**
Depreciation	**9,000**	**8,100**	**0**
Total	**$30,000**	**$27,000**	**$300**

How much and where deductible if:

- **Personal use ≤ 14 days and rental days > 14 days:**
  - **Assume Vacation Home rented for 90 days for total rental income of $30,000. The management fee is $9,000. Days of personal use are ten days.**
  - **See 2010 Schedule E, L.2 – Would you check "yes" or "no"?**

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Interest & Vacation Homes
No. 5 – Rental > 14 Days
& Personal Use ≤ 14 Days

Point: If check "No" on 2010 Schedule E, L.2, make sure that use regulations method (§ 280A(e)) to allocate interest and taxes. Why?

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Interest & Vacation Homes
No. 5 – Regulations Method
Rental 90 Days; Personal Use 10 Days

How much and where deductible if:

- **Personal use ≤ 14 days and rental days > 14 days:**
  - **Regulations Method for allocating expenses – See § 280A(e).**

	Total	90% Business	10% Non-Business	
Interest	**$12,000**	**$10,800**	**$1,200**	**- Not Ded.**
Taxes	**3,000**	**2,700**	**300**	**- Sch. A**
Main./Util.	**9,000**	**8,100**	**900**	**- Not Ded.**
Dep.	**6,000**	**5,400**	**600**	**- Not Ded.**
Total	**$30,000**	**$27,000**	**$3,000**	

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Interest & Vacation Homes
No. 5 – *Bolton* Method
Do Not Use if Personal Use ≤ 14 Days

How much and where deductible if:

- **Personal use ≤ 14 days and rental days > 14 days:**
  - **Bolton Method for allocating expenses: (Bolton Method allocates interest and taxes between business and nonbusiness based on 365 days. Business use percentage for interest and taxes in this example is 90/365.)**

	Total	Business	Non-Business	
Interest	**$12,000**	**$3,000**	**$ 9,000**	**- Not Ded. – Why?**
Taxes	**3,000**	**750**	**2,250**	**- Sch. A**
Main./Util.	**9,000**	**8,100**	**900**	**- Not Ded.**
Dep.	**6,000**	**5,400**	**600**	**- Not Ded.**
Total	**$30,000**	**$17,250**	**$12,750**	

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Interest & Vacation Homes
No. 5 – Rental > 14 Days
& Personal Use ≤ 14 Days

How much and where deductible if:

- Personal use ≤ 14 days and rental days > 14 days:
  - **If you answer "no" on 2010 Schedule E, L.2, should you use the Regulations Method or the Bolton Method to allocate interest and taxes between business and non-business? (<u>ANS</u>: <u>Regulation Method</u> – Why?)**

Interest & Vacation Homes
No. 6 – *Bolton* Method
Rental 80 Days; Personal Use 20 Days

		Bus	Non-Bus
Interest	**$12,000**	**$2,600**	**Sch. A - $9,400**
Real Property Taxes	**3,000**	**700**	**Sch. A - $2,300**
Maintenance, Utilities, Insurance, HOA	**6,000**	**4,800**	**0**
Depreciation	**9,000**	**7,200**	**0**
Total	**$30,000**	**$15,300**	**$11,700**

How much and where deductible if:

- **Personal use > 14 days and rental days > 14 days:**
  - **Assume Vacation Home rented for 80 days for total income of $30,000. The management fee is $12,000. Days of personal use are 20 days.**
  - **See 2010 Schedule E, L.2 – Would you check "yes" or "no"?**

Interest & Vacation Homes
No. 6 – Personal Use > 14 Days

Point: If check "Yes" on Schedule E, L.2, make sure that use *Bolton* method to allocate interest and taxes. Why?

Interest & Vacation Homes
Do Not Use Regulations Method if
No. 6 – Personal Use > 14 Days

How much and where deductible if:

- **Personal use > 14 days and rental days > 14 days:**
  - **Regulations Method for allocating expenses – See § 280A(e):**

	Total	80% Business	20% Non-Business	
Interest	$12,000	$ 9,600	$2,400	- Sch. A
Taxes	3,000	2,400	600	- Sch. A
Main./Util.	9,000	7,200	1,800	- Not Ded.
Dep.	6,000	4,800	1,200	- Not Ded.
Total	$30,000	$24,000	$6,000	

Interest & Vacation Homes
No. 6 – Use the *Bolton* Method if Personal Use More Than 14 Days

How much and where deductible if:

- **Personal use > 14 days and rental days > 14 days:**
  - **Bolton Method for allocating expenses:**

	Total	Business	Non-Business	
Interest	**$12,000**	**$ 2,600**	**$ 9,400**	**- Sch. A**
Taxes	**3,000**	**700**	**2,300**	**- Sch. A**
Main./Util.	**9,000**	**7,200**	**1,800**	**- Not Ded.**
Dep.	**6,000**	**4,800**	**1,200**	**- Not Ded.**
Total	**$30,000**	**$15,300**	**$14,700**	

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Interest & Vacation Homes
(No)

How much and where deductible if:

- **Personal use > 14 days and rental days > 14 days:**
  - If you answer "yes" on Schedule E, L.2, should you use the Regulations Method or the Bolton Method to allocate interest and taxes between business and non-business? **(ANS: Bolton Method - Why? – Allocate more interest and taxes to Sch A and less to Sch E)**
  - **Should you always encourage a client to make sure that their personal use of their Vacation Home exceeds 14 days? – Yes or Maybe, depending on the combined debt of a principal residence and Vacation Home and when debt incurred.**

TI-ITP.18

Tax Cuts & Jobs Act

26. <u>Limit on Mortgage Interest</u>.

a. Overall limit on itemized deductions is repealed for tax years beginning after 2017.

b. Mortgage interest: For years beginning after 12/31/17, acquisition indebtedness is limited to $750,000. A vacation home still qualifies, and the overall debt is limited to $750,000 for the first and second residence (but second residence interest may be treated as investment interest if rental days ≤ 14 days and personal use ≤ 14 days).

Interest & Tax Cuts & Jobs Act

26. <u>Limit on Mortgage Interest</u>.

b. Mortgage interest:

1) For acquisition debt incurred before 12/16/17, this limitation is $1,000,000.

2) <u>No deduction is allowed for home equity debt</u>. (True) – But see *Hurley*, T.C. Summ. Op. 2005-125 – Refinance to reimburse for home improvements may be acquisition debt – But see Notice 88-74 and Reg. § 1.163-10T for time limits (no more than 90 days before and 30 days after).

3) For refinanced debt incurred prior to 12/16/17, the refinanced debt is treated as incurred on the same date that the original debt was incurred for purposes of the limitation amounts applicable to the refinanced debt. Also covers binding agreements to purchase principal residence before 12/15/17.

Limit on Mortgage Interest
What Does it Mean?

- **The TCJA imposes a lower dollar limit on mortgages under § 163(h)(3)(F). Beginning in 2018, taxpayers may only deduct interest on $750,000 of qualified residence loans. The limit is $375,000 for a married taxpayer filing a separate return. These are down from the prior limits of $1 million, or $500,000 for a married taxpayer filing a separate return. <u>The limits apply to the combined amount of loans used to buy, build or substantially improve the taxpayer's main home and second home</u>. (New Debt – *See* IR 2018-32.)**

<u>Example 1</u>: In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home with a fair market value of $800,000. In February 2018, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home and the total does not exceed the cost of the home. Because the total amount of both loans does not exceed $750,000, all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as paying off student loans and credit cards, then the interest on the home equity loan would not be deductible.

Limit on Mortgage Interest
What Does it Mean?

<u>Example 2</u>: In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $250,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages does not exceed $750,000, all of the interest paid on both mortgages is deductible. However, if the taxpayer took out a $250,000 home equity loan on the main home to purchase the vacation home, then the interest on the home equity loan would not be deductible.

<u>Example 3</u>: In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $500,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages exceeds $750,000, not all of the interest paid on the mortgages is deductible. A percentage of the total interest paid is deductible (*see* Publication 936).

Statutory Language
§ 163(h)(3): Interest

(h) <u>Disallowance of Deduction for Personal Interest</u>.

(3) <u>Qualified Residence Interest</u> – For purposes of this subsection—

(F) <u>Special Rules For Taxable Years 2018 Through 2025</u>.—

(i) <u>In General</u>.--In the case of taxable years beginning after December 31, 2017, and before January 1, 2026—

(I) <u>Disallowance Of Home Equity Indebtedness Interest</u>.--Subparagraph (A)(ii) shall not apply.

(II) <u>Limitation On Acquisition Indebtedness</u>.--Subparagraph (B)(ii) shall be applied by substituting "$750,000 ($375,000" for "$1,000,000 ($500,000".

– When do you apply the $750,000?

Statutory Language
§ 163(h)(3): Interest

(h) <u>Disallowance of Deduction for Personal Interest</u>.

(3) <u>Qualified Residence Interest</u> – For purposes of this subsection—

(F) <u>Special Rules For Taxable Years 2018 Through 2025</u>.—

(i) <u>In General</u>.--In the case of taxable years beginning after December 31, 2017, and before January 1, 2026—

(III) <u>Treatment Of Indebtedness Incurred On Or Before December 15, 2017</u>.--Subclause (II) shall not apply to any indebtedness incurred <u>on or before December 15, 2017</u>, and, in applying such subclause to any indebtedness incurred after such date, the limitation under such subclause shall be reduced (but not below zero) by the amount of any indebtedness incurred on or before December 15, 2017, which is treated as acquisition indebtedness for purposes of this subsection for the taxable year. (Old Debt vs. New Debt)

Statutory Language
§ 163(h)(3): Interest

(h) <u>Disallowance of Deduction for Personal Interest</u>.

(3) <u>Qualified Residence Interest</u> – For purposes of this subsection—

(F) <u>Special Rules For Taxable Years 2018 Through 2025</u>.—

(i) <u>In General</u>.--In the case of taxable years beginning after December 31, 2017, and before January 1, 2026—

(IV) <u>Binding Contract Exception</u>.--In the case of a taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, subclause (III) shall be applied by substituting "April 1, 2018" for "December 15, 2017".

Statutory Language
§ 163(h)(4): Interest

(h) <u>Disallowance of Deduction for Personal Interest</u>.

(4) <u>Other Definitions And Special Rules</u> – For purposes of this subsection—

(A) <u>Qualified Residence</u>.

(i) <u>In General</u> – <u>The term "qualified residence" means</u>—

Principal Residence

(I) <u>the principal residence (within the meaning of section 121) of the taxpayer</u>, and

Personal Use > 14 Days

(II) <u>1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1))</u>.

(ii) <u>Married Individuals Filing Separate Returns</u>.

Vacation Home Not Rented or Rented ≤ 14 Days and Personal Use ≤ 14 Days

(iii) <u>Residence Not Rented</u> – <u>For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year</u>. (If rental days are 90 and personal use days are 10, how much of the interest attributable to 10 days is deductible?)

Interest and the $750,000 Debt Limit

- Assume that the debt on the principal residence is $750,000 – The debt is from 2015.
- The year is 2018.
- Purchase a vacation home in 2018 and the debt is $500,000.
- How much of the interest is deductible?
  - All
  - Some
  - None

Interest and the $750,000 Debt Limit

- Assume that in 2018, the property is never rented and personal use is more than 14 days. Since the unit is used for more than 14 days, it is a residence and none of the interest is deductible on Schedule A since the debt exceeds the $750,000 limit.
- Now assume, for 2018, rent the vacation home for 90 days and uses it personally for ten days. The property is not used as a qualified residence within the meaning of § 163(h)(4). If use the regulations method to allocate the expenses, 90% of the interest is deductible on Schedule E and 10% is not deductible since the vacation home is not a qualified residence.

Interest and the $750,000 Debt Limit

- **Now assume that the property is rented for ten days and personal use is also ten days. The property is not used as a qualified residence (and do not elect the "may" treatment under § 163(h)(4)). None of the interest is deductible on Schedule A as acquisition debt, but § 163(d) now allows the interest to be treated as investment interest under § 163(d).**

  – **The language under § 163(h)(4)(A)(iii) states that the unit <u>may</u> be treated as a residence. <u>It does not say "is" treated as a residence</u>.**

  – **Section 163(d)(3)(B)(i) states that investment interest does not include any qualified residence interest.**

Interest and the $750,000 Debt Limit

- **Assume that in 2018, the vacation home is rented for 80 days and used personally for 20 days. Now the vacation home is used as a qualified residence since personal use exceeds 14 days. None of the interest allocated to personal interest is deductible using either the regulations method or the *Bolton* method.**

- **<u>Question</u> – Can we use the regulations method and allocate 80% of the interest to Schedule E? Does the fact that the property is used as a qualified residence disallow an interest expense deduction for any of the interest since the debt is in excess of $750,000?**

  – **My answer is that if use the regulations method, allocate 80% of the interest to business use and both the business interest and 80% of the other business expenses are limited by § 280A. Only the interest allocated to personal use is not deductible since the debt exceeds the $750,000 limit.**

Interest and the $750,000 Debt Limit

- **The simple point is that if the debt on the principal residence is close to the $750,000 limit and an individual purchases a vacation home with debt, a client has three options for the debt on the vacation home:**

  1. **Either rent the property and keep personal use to 14 days or less so the property is not used as a residence; or**

  2. **Do not rent the property for more than 14 days and keep personal use to 14 days or less. The property is not used as a qualified residence and the interest is deductible as investment interest under § 163(d). (*See* Form 4952.)**

  3. **If do rent the property for more than 14 days and personal use is more than 14 days, use the Regulations Method to allocate the interest and taxes as more of the interest and taxes are allocated to business use and less to non-business use.**

Points

- **Points paid**:

  – **Refinancing – Capitalize & amortize**

  – **Purchase of principal residence – Deduct – § 461(g)**

  – **Purchase of vacation home – Capitalize & amortize**

- **How much will be deductible if the 2018 debt is $1,500,000 and the points paid on the purchase of a principal residence are $6,000?**

- **But were the points paid if capitalized as part of the loan?**

Tax Cuts and Jobs Act
Details

27. SALT Deduction.

a. **Deductions for State and local taxes (SALT) on Schedule A and on Form 1041 (Line 11) are modified to permit individuals to claim an itemized deduction of up to $10,000 for the aggregate of:**

1) **State and local property taxes not paid or accrued in carrying on a T/B of for profit activity, and**

2) **State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income taxes).**

3) **Foreign real property taxes may not be deducted under the above provisions.**

Section 164
Taxes

(b) Definitions and Special Rules.--For purposes of this section—

(6) Limitation on Individual Deductions for Taxable Years 2018 Through 2025.-- In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026—

(A) foreign real property taxes shall not be taken into account under subsection (a)(1), and

(B) the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year shall not exceed $10,000 ($5,000 in the case of a married individual filing a separate return).

The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business or an activity described in section 212. For purposes of subparagraph (B), an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed. (*See* Information Letter 2018-0009.)

Tax Cuts and Jobs Act
Details

27. <u>SALT Deduction</u>.

a. Deductions for State and local taxes (SALT) are modified to permit individuals to claim an itemized deduction of up to $10,000 in the aggregate.

4) <u>The above SALT deduction limit does not apply to taxes paid or accrued in carrying on a T/B or to produce income under §212</u>. The provision allows those deduction for SALT that are presently deductible in computing income on an individual's Schedule C, E, F, or Form 4835.

5) Thus, for example, in the case of property taxes, an individual may deduct such items if they were imposed on business assets.

Tax Cuts and Jobs Act
Details

27. <u>SALT Deduction</u>.

a. Deductions for State and local taxes (SALT) are modified to permit individuals to claim an itemized deduction of up to $10,000 in the aggregate.

6) If an amount is paid in a taxable year beginning before 1/1/2018 with respect to a State or local income tax imposed for a taxable year beginning after 12/31/2017, the payment is treated as paid on the last day of the taxable year for which such tax is so imposed.

7) Thus, an individual may not claim an itemized deduction in 2017 on a pre-payment of income tax for a taxable year beginning after 2017. (But could you deduct prepaid 2018 real property taxes on the 2017 return? *See* flush language of § 164(b)(6) – <u>ANS</u>: No.)

Taxes
(Yes)

- What result if a Colorado resident owns a Vacation Home in Hawaii where the income is reported on Schedule E. When filing a nonresident tax return for the State of Hawaii, the individual reported a profit of $50,000 and the tax due to the State of Hawaii is $4,500. May the taxpayer deduct the Hawaii state income taxes paid in 2018 of $4,500 on Schedule E?
  - No. – Deductible only on Schedule A.

Tax Cuts and Jobs Act
Details

28. Casualty Losses.

    a. Taxpayers may only deduct an amount due to a personal casualty loss if the loss was attributable to a disaster declared by the President under §401 of the Robert T Stafford Disaster Relief and Emergency Assistance Act.

Tax Cuts and Jobs Act
Casualty Loss Deduction

- **The Act provides tax relief relating to a "2016 disaster area" (any area covered by a disaster declared by the President under the Stafford Act during the calendar year 2016). (<u>Relief is also available for California wildfires and for Hurricanes Harvey, Irma & Maria.</u>)**

    1. **For a "qualified 2016 disaster distribution" from a qualified retirement plan, a §403(b) plan, or an IRA, and exception to the 10% early withdrawal tax applies.**

    2. **In addition, income due to such a distribution may be included in income ratably over three years beginning with the year of distribution, and the amount of the distribution may be re-contributed to the plan within three years.**

Tax Cuts and Jobs Act
Details

- **The Act provides tax relief relating to a "2016 disaster area":**

    3. **A "qualified 2016 disaster distribution" is one from an eligible plan made on or after 1/1/2016 and before 1/1/2018 to an individual whose principal place of abode at any tie during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss due to the events giving rise to the Presidential disaster declaration.**

    4. **Limit: $100,000. Distributions of more than that are not qualified.**

Tax Cuts and Jobs Act
Details

- **The Act provides tax relief relating to a "2016 disaster area":**

  5. **In the case of a personal casualty loss which arose after 12/31/2015 and before 1/1/2018 in a 2016 disaster area and was due to the events giving rise to the Presidential disaster declaration, <u>such losses are deductible without regard to whether aggregate net losses exceed 10% of AGI. The losses, however, must exceed $500 per casualty. Such losses may be claimed in addition to the standard deduction</u>(extended by Bipartisan Budget Act).**

     a. **In a nutshell, designated disaster area allow:**

        1) **10% AGI deduction;**

        2) **$100 to $500 per occurrence;**

Tax Cuts and Jobs Act
Details

- **The Act provides tax relief relating to a "2016 disaster area":**

  5. **In the case of a personal casualty loss…**

     a. **In a nutshell, designated disaster area allows:**

        3) **Available to non-itemizers;**

        4) **Allows qualified plan distributions;**

        5) **Include ratably over three years;**

        6) **No 10% penalty;**

        7) **May recontribute within a certain time limit.**

Gamblers
Basic Rules
(Yes)

29. **<u>Wagering Losses</u>. Under §165(d), <u>wagering losses may only be deducted up to the amount of wagering gains</u>. (*See* Rev. Proc. 77-29.)**

    a. **Non-professional gamblers must report winnings and then claim an itemized deduction for losses on Schedule A.**

    b. Under recent case law, qualifying as a professional gambler in the trade/business of gambling is difficult, and courts apply a factor test using §183 analysis for hobby loss cases.

    c. **If in the trade/business of gambling the § 165(d) limit still applies. But does it apply not only to actual wagering losses, but also to related expenses such as travel expenses the professional gambler claims on Schedule C?**

Related Expenses for Professional Gamblers
Section 167(d) Limitation
(Yes)

- **In *Mayo v. Comm'r*, 136 T.C. 81 (2011) – (IRS acquiesced on January 13, 2012):**

    1. **IRS conceded Mayo was in the trade/business of gambling. In 2001 he had gains from wagers of $120,000 and losses from wagers of $132,000, plus $11,000 of related gambling expenses for travel, meals, entry fees, and handicapping data.**

        a. **Mayo's Schedule C: receipts of $120,000 and deductions of $143,000, resulting in a loss of $23,000. Deducted both losses from wagers in excess of wagering gains, as well as the related expenses.**

        b. IRS: Disallowed all deductions in excess of the $120,000 wagering gains. Claimed §165(d) applies to all deductions, including related expense deductions.

Related Expenses for Professional Gamblers Section 167(d) Limitation (No)

- In *Mayo v. Comm'r*, 136 T.C. 81 (2011):

1. §165(d) language: "losses from wagering transactions" are allowed only to the extent of the "gains from such transactions."

2. Court: §165(d) applies to professional gamblers under "settled law." Rejects Mayo's argument that it applies only to gamblers not in the trade/business.

3. But does the term "losses from wagering transactions" include related expenses incurred in pursuing a gambling trade/business, or is it limited to losses from actual wagers?

Related Expenses for Professional Gamblers Section 167(d) Limitation (No)

- In *Mayo v. Comm'r*, 136 T.C. 81 (2011):

1. **In *Offutt v. Comm'r*, 16 T.C. 1214 (1951), the Court implicitly held that related expenses are included in the §165(d) limitation, but did not analyze the issue. A 1985 First Circuit case held that related expenses are subject to the limit.**

2. More recently: Tax Court has followed *Offutt* in some cases, but in others has not applied the §165(d) limit to related expenses.

3. IRS has applied *Offutt* inconsistently, sometimes invoking it and sometimes not, and in a 2008 legal memorandum it stated that it would no longer follow *Offutt* or the First Circuit case.

Related Expenses for Professional Gamblers Section 167(d) Limitation (No)

- In *Mayo v. Comm'r*, 136 T.C. 81 (2011):

  1. Tax Court decided clarification was needed to avoid "further administrative inconsistency"

  2. Court examined cases involving the "other side of the coin." Do "gains" from wagering transactions include income related to gambling, but not winnings from wagers themselves?

     a. Generally, to constitute gains, it is not sufficient that the gain arises merely "in connection" with the conduct of the wagering activities; the gain must be the "direct result" of a wager entered into by the taxpayer.

Related Expenses for Professional Gamblers Section 167(d) Limitation (No)

- In *Mayo v. Comm'r*, 136 T.C. 81 (2011):

  1. Court: The "gains" cases narrowly construe §165(d) and the same should apply in "losses" cases.

  2. <u>Related expenses of a professional gambler arise only in connection with wagering activities, and are not the direct result of a wager. Therefore such expenses are not covered by the §165(d) limitation</u>.

  3. The Court stated that *Offutt* should no longer be followed.

  4. Mayo was allowed to deduct the related expenses regardless of §165(d). Actual wagering losses are subject to the limit.

Tax Cuts and Jobs Act
Gambling Losses

- **All deductions for expenses incurred in carrying out wagering transactions (not just gambling losses themselves) would be limited to the extent of wagering winnings. (*See Mayo* for professional gambler.)**

  1. **This limitation, for example, would apply to the traveling and lodging expenses of a professional gambler. (*See* § 165(d).)**

  2. **But if the client is not a professional gambler – What happens?**

Gambling Losses
(Yes)

- **Vacation to Las Vegas:**

		Winnings	Losses
Same Casino same day or 3 separate Casinos	Casino	$10,000	$14,000
	Casino	20,000	38,000
	Casino	20,000	12,000
	Total	$50,000	$64,000

<u>If one session</u>:
L.21 – $0

<u>If three separate sessions</u>:
L.21 – $8,000
Sch. A – ($8,000)

How much of the losses is deductible if each day is a separate session ($42,000) or the three days are one session ($50,000)? (*See* Notice 2015-21.)

Tax Cuts and Jobs Act
Details

30. <u>Charitable Contributions</u>.

a. <u>The 50% contribution base limit for cash contributions to public charities and certain private foundations is increased to 60%</u>. Five-year carryover rules retained.

b. <u>Repeal 80% deduction of amount paid for the right to purchase tickets for college athletic events</u>. (Has an affect on Division I football teams as University of Oklahoma sent letters to season ticket holders in December 2017 to prepay for right to purchase season tickets – Boosters.)

c. Repeal provision that providing a contemporaneous written acknowledgment by donee for gifts of $250 or more is not required if the donee files a return with info per regulations.

d. <u>Mileage rate for charitable purposes is not indexed for inflation</u>.

Section 170
Charitable, Etc., Contributions and Gifts

(b) <u>Percentage Limitations</u>.—

(1) <u>Individuals</u>.--In the case of an individual, the deduction provided in subsection (a) shall be limited as provided in the succeeding subparagraphs.

(G) <u>Increased Limitation For Cash Contributions</u>.—

60% AGI

(i) <u>In General</u>.--<u>In the case of any contribution of cash to an organization described in subparagraph (A), the total amount of such contributions which may be taken into account under subsection (a) for any taxable year beginning after December 31, 2017, and before January 1, 2026, shall not exceed 60 percent of the taxpayer's contribution base for such year</u>.

(ii) <u>Carryover</u>.--If the aggregate amount of contributions described in clause (i) exceeds the applicable limitation under clause (i) for any taxable year described in such clause, such excess shall be treated (in a manner consistent with the rules of subsection (d)(1)) as a charitable contribution to which clause (i) applies in each of the 5 succeeding years in order of time.

Section 170
Charitable, Etc., Contributions and Gifts

(b) <u>Percentage Limitations</u>.—

(1) <u>Individuals</u>.--In the case of an individual, the deduction provided in subsection (a) shall be limited as provided in the succeeding subparagraphs.

(G) <u>Increased Limitation For Cash Contributions</u>.—

(iii) <u>Coordination With Subparagraphs (A) And (B)</u>.—

(I) <u>In General</u>.--Contributions taken into account under this subparagraph shall not be taken into account under subparagraph (A).

(II) <u>Limitation Reduction</u>.--For each taxable year described in clause (i), and each taxable year to which any contribution under this subparagraph is carried over under clause (ii), subparagraph (A) shall be applied by reducing (but not below zero) the contribution limitation allowed for the taxable year under such subparagraph by the aggregate contributions allowed under this subparagraph for such taxable year, and subparagraph (B) shall be applied by treating any reference to subparagraph (A) as a reference to both subparagraph (A) and this subparagraph.

Charitable Contributions
&
Listed Transaction

- **See Notice 2017-10:**

1. **A receives promotional materials that offer prospective investors in an LLC the possibility of a charitable contribution deduction that equals or exceeds an amount that is three and one-half times the amount of A's investment. A purchases an interest in the LLC through entity that holds real property. A pays $40,000 for her interest. The LLC that holds the real property contributes a conservation easement encumbering the property to a tax-exempt entity and allocates a charitable contribution deduction of $150,000 to A (A/B is $10,000). Following that contribution, A reports on her federal income tax return a charitable contribution deduction of $150,000 with respect to the conservation easement. Going one step further, after the contribution, A's interest in the LLC is terminated. – See Rev. Rul. 93-80. Also gives A an ordinary loss of say $30,000. Huh?**

2. **Notice 2017-10 defines the above factual situation as a listed transaction. Would you invest $40,000 for a charitable contribution of $150,000?**

Itemized Deductions - Schedule A
§ 170 - Charitable Contributions
(Yes)

- **Cash and/ or FMV of property – See *Smith v. Comm'r*, T.C. Memo 2014-203 for non-cash contributions and *Kunkel v. Comm'r*, T.C. Memo. 2015-71, *Payne*, T.C. Sum. Op. 2016-30, $250 and Form 8283. (Goodwill – Household items FMV $1,800 or men's clothing FMV $39,700)**
- **Donate $250 or more – Need letter of acknowledgement before file return. See *Durden* and Cat Lady. Contributed $5,000 to the Church of Sub Genius in November 2018. Includes donation of property to Goodwill.**
- **No deduction unless have a cancelled check or receipt**
- **Donate automobiles**
- **Donate a conservation easement or a facade easement to Colorado Land Trust – See Notice 2017-10.**
- **Dave Liniger – REMAX – Donated hunting trophies – Mention *Jonas*.**
- **Kirk Herbsteit – Donated a house to fire department (*See Patel*.) (Deconstruct)**

Charitable Contributions
Substantiation Rules – (Yes)

- **Three substantiation rules come into play:**

1. **For gifts of at least $250 in value**, the taxpayer must obtain a contemporaneous written acknowledgement that states whether the donee provided any goods or services in consideration for the contribution, and provide a description and good-faith estimate of the value of any such goods or services provided;
2. **The requirement to maintain reliable written records for noncash contributions in excess of $500 (books FMV $1,200); and**
3. **The rules requiring a qualified appraisal by a qualified appraiser for noncash gifts of property exceeding $5,000. (Form 8283 and kitchen cabinets FMV $9,000 to Habitat for Humanity.)**

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203 – FMV $28,000
(Yes)

- **The Tax Court ruled, despite its having no doubt that the taxpayer donated property to a charitable organization, that none of taxpayer's contributions were deductible because he failed the charitable contribution substantiation tests.**

- At his Tax Court trial, Mr. Smith, the taxpayer, testified that, after his mother died, he donated furniture from her house to the American Veterans National Service Foundation (AMVETS), a charitable organization, in 2009. These items included seven sofas, four televisions, five bedroom sets, six mattresses, a kitchen set, a dining room set, a china cabinet, and three rugs. For charitable contribution purposes, Smith placed a value of $11,730 on these items.

- He testified that he also donated to AMVETS during 2009 the following items of clothing belonging to him or his children: 180 shirts, 63 pairs of slacks, 153 pairs of jeans, 173 pairs of shoes, 51 dresses, 35 sweaters, nine overcoats, and seven suits. Smith placed a value of $14,487 on those items.

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- And, he testified that he donated to AMVETS during 2009 electronic equipment that included two computer systems, a printer, and a copier. The record did not establish who previously owned this property. Smith placed a value of $1,550 on those items.

- **Smith testified that he had visited AMVETS on several occasions earlier in 2009 and had obtained a number of blank "tax receipts" signed by AMVETS representatives. Smith testified that he consolidated all of the contributions described above on two blank receipts. He filled out each receipt by identifying himself as the "donor," inserting Aug. 30, 2009 as the "date," and indicating the donation values mentioned above. The tax receipts informed the donor that it was his responsibility to determine the fair market values (FMVs) of all items.**

- **Neither tax receipt identified any specific items of donated property. To identify the property he allegedly contributed, Smith prepared a spreadsheet. The record did not establish when this spreadsheet was prepared, and there was no evidence that it was submitted to AMVETS.**

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(Yes)

- In determining that the items listed on his spreadsheet had FMVs of $27,767, Smith testified that he used a Salvation Army website that lists estimated "low" and "high" values for used property. The record included a guide printed from that website. The values that Smith placed on his spreadsheet for many of the items he allegedly donated in 2009 were considerably higher than the "high" values shown in this guide. Smith offered no explanation for this discrepancy.

- **Smith did not take photographs of any of the items he allegedly donated, and he introduced no evidence to establish their condition. He did not obtain an appraisal of any item.**

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- Charitable contribution deductions are allowable only if the taxpayer satisfies substantiation requirements (§ 170(a)(1)). The nature of the required substantiation depends on the size of the contribution and on whether it is a gift of cash or property. There are separate requirements for all contributions of $250 or more (§ 170(f)(8)), contributions of property with a claimed value exceeding $500 (§ 170(f)(11)(B)), and contributions of property with a claimed value exceeding $5,000 (§ 170(f)(11)(C)).

- For contributions exceeding $500, "similar items of property" are aggregated for purposes of the substantiation rules (§ 170(f)(11)(F); Reg. § 1.170A-13(c)(1)(i)). The term "similar items of property" is defined to mean "property of the same generic category or type," such as clothing, jewelry, furniture, electronic equipment, household appliances, or kitchenware (Reg. § 1.170A-13(c)(7)(iii)).

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- Section 170(f)(8)(A) provides that an individual may deduct a gift of $250 or more only if he substantiates the deduction with "a contemporaneous written acknowledgment of the contribution by the donee organization." This acknowledgment must include a description of any property other than cash contributed (§ 170(f)(8)(B)).

- For noncash contributions in excess of $500, taxpayers are required to maintain written records with respect to each item of donated property that include, among other things: (1) the approximate date the property was acquired and the manner of its acquisition; (2) a description of the property in detail reasonable under the circumstances; (3) the cost or other basis of the property; (4) the FMV of the property at the time it was contributed; and (5) the method used in determining its FMV (Reg. § 1.170A-13(b)(2)(ii)(C); Reg. § 1.170A-13(b)(2)(ii)(D); Reg. § 1.170A-13(b)(3)(i)(A); Reg. § 1.170A-13(b)(3)(i)(B)).

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- No deduction is allowed for contributions of clothing or "household items" unless such items are "in good used condition or better" (§ 170(f)(16)(A)). The term "household items" includes furniture, furnishings, electronics, appliances, linens, and other similar items (§ 170(f)(16)(D)).

- For contributions of property valued in excess of $5,000, the taxpayer must generally satisfy the substantiation requirements discussed above and must also: (1) obtain a "qualified appraisal" of the items; and (2) attach to his tax return a fully completed appraisal summary (Reg. § 1.170A-13(c)(2)).

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- The Court disallows all of taxpayer's charitable deduction. The Tax Court found that Smith did not meet the substantiation requirements with respect to any of the contributions and therefore disallowed his entire charitable contribution deduction.

- For purposes of Reg. § 1.170A-13(c)(1)(i), the Court found that there were three categories of property, i.e., the household items from Mr. Smith's mother's house, the clothing, and the electronic equipment. It said that, for all three categories, Smith had to meet the substantiation requirements imposed by § 170(f)(8) and § 170(f)(11)(B) . For the first two categories of items, Smith had to also meet the stricter substantiation requirements imposed by § 170(f)(11)(C).

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- The Court then analyzed whether taxpayer met those requirements:

  – Requirements for contributions of $250 or more: Smith obtained blank signed forms from AMVETS and later filled them out himself by inserting supposed donation values. Because these forms were signed before the property was allegedly donated, the Court questioned whether they constituted an acknowledgment" by AMVETS that it received anything.

  – In any event, the Court said, the AMVETS tax receipts do not contain a "description...of any property...contributed“ (§ 170(f)(8)(B)(i)). Rather, Smith created, at a time that could not be ascertained, a spreadsheet showing the property he allegedly contributed, and there was no evidence that this spreadsheet was ever provided to or seen by AMVETS. Moreover, the only evidence as to the contemporaneous nature of the acknowledgment was the date, August 30, 2009, which Smith placed on the blank receipts himself.

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(Yes)

- **The Court said that Smith failed to satisfy the substantiation requirements for contributions of $250 or more even though <u>Reg. § 1.170A-13(b)(1) provides that receipts are not required when it is impractical to obtain a receipt (such as dropping off the property at a charity's unattended drop site)</u>. But a taxpayer is still required to have reliable written records of the date, the charity and the FMV of the property donated.**

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- <u>Requirements for contributions exceeding $500</u>: Smith allegedly made noncash contributions to AMVETS of clothing, furniture, and electronic equipment, and for each category of items he claimed a value exceeding $500. But he did not maintain written records establishing when or how these items were acquired or what their cost bases were, nor did he maintain written records establishing the items' FMVs at the time they were donated. He testified that he determined these values using a guide from a Salvation Army website, but the values he used were considerably higher than the "high" values the guide displays. He did not maintain photographs or other records to establish the condition of the donated items, and he thus provided no reason to believe that each donated item should be accorded a "high" rather than a "low" value.

- Most of the items Smith allegedly donated consisted of clothing and household items. He presented no evidence that these items were "in good used condition or better" and thus didn't meet the requirements of § 170(f)(16)(A).

Lack of Substantiation – No Deduction
Smith, T.C. Memo. 2014-203
(No)

- **Requirements for contributions exceeding $5,000:** Smith acknowledged that he did not obtain a qualified appraisal for any of the items and did not attach a fully completed appraisal summary to his 2009 tax return. He thus failed to satisfy the substantiation requirements for his claimed contributions of clothing ($14,487) and household furniture ($11,730).

Tax Cuts and Jobs Act
Details

31. **<u>Other Changes on Itemized Deductions and Exclusions</u>.**

a. **The Act <u>repeals</u> all miscellaneous itemized deductions that are subject to the 2% floor under present law. (Schedule 2% AGI & Line 15(c) for Form 1041)**

   1) **<u>Think about a long haul truck driver who is an EE and the effect on this individual</u>.**

b. **The Act <u>repeals</u> the exclusion from gross income and wages of qualified bicycle commuting reimbursements.**

c. **The Act <u>repeals</u> exclusion from income for qualified moving expense reimbursements. (Now W-2, Box 1, 3 & 5 wages.)**

d. **The Act <u>keeps</u> above-the-line school teacher deduction for supplies at $250. (*See* Line 23 of Form 1040.)**

Tax Cuts and Jobs Act
Details

31. **<u>Other Changes on Itemized Deductions and Exclusions</u>.**

    e. **<u>The Act repeals deductions for tax preparation fees</u>, Form 2106 expenses and <u>investment advisory</u> fees. (*See* CCA 220721015 & *Mayer* – Can you elect to capitalize an investment advisory fee as a carrying charge under § 266?)**

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Itemized Deductions - Schedule A
Miscellaneous Itemized Deductions - See § 67
(Yes)

- **Not subject to 2% AGI**
  - **Gambling losses (Repayment of compensation, § 691(c))**
  - **Madoff losses (*See* § 165(c)(2))**
- **Subject to 2% AGI – Not deductible in 2018 to 2025.**
  - **<u>Form 2106 - Unreimbursed employee business expenses (Nonaccountable plan) – What result if ER issues a 1099 for NEC or other income for the EE mileage which is not reimbursed pursuant to an accountable plan</u>?**
  - **Tax preparation fees – But Rev. Rul. 92-29.**
  - **Investment advisory fees – But CCA 200721015.**
  - **Employee home office expense – But have ER reimburse for out-of-pocket expenses.**

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Where Deductible?
(Yes)

A taxpayer paid $1,500 to his/her TRP in 2018 for the preparation of:

1. **Form 1040 – Schedule A – 2% AGI**
2. **Schedule A, B & D – Schedule A – 2% AGI**
3. **Schedule C – Schedule C**
4. **Schedule E – Rent and Royalty – Schedule E, Page 1**
5. **Schedule F or Form 4835 – Schedule F or Form 4835**

Where Deductible?
(Yes)

A taxpayer paid $1,500 to his/her TRP in 2018 for the preparation of:

6. **Schedule E, Page 2:**
   - **K-1 from 1065 – Schedule E, Page 1**
   - **K-1 from 1120S – Schedule A – 2% AGI – ?**
7. **Form 4797 for sale of rental property – Schedule E, Page 1**

Why would U allocate a part of the TRP fee to a Schedule E, Schedule C or Schedule K-1? (*See* Rev. Rul. 92-29.)

Deductible Losses

- **Assume that an individual loans $40,000 to her employer and the employer files for bankruptcy before repaying the loan. What is the character of the loss and where deductible? (*See Graves* & Form 8275.*)***
  - **Business bad debt on Schedule A, 2% AGI (IRS), but then not deductible in 2018, or**
  - **Business bad debt on Form 4797, Part II (ME), or**
  - **Nonbusiness bad debt deductible as STCL on Schedule D (MIDDLE GROUND).**

Member of LLC (Yes)

- **Use of Personal Auto for Business – Use personal auto 10,000 miles for business – Schedule E or Schedule A?**
  - **LLC will not reimburse for business use of personal auto – Deduction $5,450 – Where?**
  - **Tax preparation fee – See Rev. Rul. 92-29.**

Shareholder in S Corporation (Yes)

- **Use of Personal Auto for Business – Use personal auto 10,000 miles for business – Schedule E or Schedule A? (*See Craft* & T.C. Memo 2005-197.)**
  - **S corporation will not reimburse for business use of personal auto – Deduct $5,450 – Where? (*See* Notice 89-35.)**
  - **<u>IRS</u> – Schedule A – 2% AGI**
  - **<u>Me</u> – Schedule E – See Notice 89-35**

Other Interest (Yes)

- **Purchase of Stock in C Corporation – § 163(d). (Schedule A & Form 4952)**
  - **Investment interest**

Other Interest
(Yes)

- **Purchase of Stock in S Corporation or an interest in an LLC – Notice 89-35. (Schedule E)**
  - **Trade or business interest and deductible on Schedule E.**

Other Interest
(Yes)

- **C Corporation Make S Corporation Election**
  - **May the character of the interest change as the character of the underlying investment changes? (*See* PLR 9040066.)**
    - **<u>Yes</u> – Goes from investment interest to trade or business interest.**

Investment Advisory Fees
(Yes)

- **Pay $40,000 in investment advisory fees – 2% AGI – See CCA 200721015. Can you make an election to capitalize under § 266? – *See Mayer*, T.C. Memo. 1994-209.**

- **Purchase vacant land:**

			#1	#2
Expenses:	**Interest**	**$21,000**	**Form 4952**	**Make**
	Taxes	**12,000**	**$10,000**	**§ 266**
	Insurance	**3,000**	**0**	**election**
	Weed control	**1,000**	**0**	
	Total	**$37,000**		

  – **What options are available?**

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IRS Letter Ruling 200721015
(January 16, 2007)

ISSUES

(1) Is a flat fee paid to a stockbroker for investment services a "carrying charge" under Reg. § 1.266-1(b)(1)(iv) of the Income Tax Regulations?

(2) If the conclusion in Issue (1) is Yes, may Taxpayer elect to capitalize this flat fee to a capital account?

CONCLUSIONS

(1) A flat fee paid to a stockbroker for investment services is not a carrying charge under Reg. § 1.266-1(b)(1)(iv).

(2) Because our holding in Issue (1) is No, we do not address Issue (2).

FACTS

On September 10, 2001, Taxpayer and Brokerage Firm entered into a contract entitled "Investment Plan." Under this contract, Brokerage Firm agreed to act as a discretionary investment advisor and a custodian for the assets held in Taxpayer's account. Among other things, Brokerage Firm agreed to review and evaluate Taxpayer's investment objectives and to hire an unaffiliated manager ("Manager") to invest all or a portion of the assets in Taxpayer's account. In return, Taxpayer agreed to pay Brokerage Firm an annual fee of X percent of the market value of the assets in Taxpayer's account ("flat fee"). Payable at the beginning of each calendar quarter, the flat fee is a substitute for the following fees or charges otherwise payable by Taxpayer: (1) brokerage commissions payable to Brokerage Firm; (2) compensation payable to Taxpayer's Brokerage Firm financial consultant; (3) custodian charges payable to Brokerage Firm; and (4) a fee payable to the Manager of Taxpayer's account. On the year-end summary statement issued to Taxpayer, Brokerage Firm shows its quarterly withdrawals of the flat fee from Taxpayer's account. Each quarterly withdrawal is described as being for "Consulting and Advisory Services."

LAW

Section 266 of the Internal Revenue Code provides, in part, that no deduction shall be allowed for amounts paid or accrued for such carrying charges as, under regulations prescribed by the Secretary, are chargeable to capital accounts with respect to property, if the taxpayer elects, in accordance with such regulations, to treat such charges as so chargeable.

Section 1.266-1(a)(1) of the Income Tax Regulations states that the items enumerated in paragraph (b)(1) of section 1.266-1 may be capitalized at the election of the taxpayer. Thus, carrying charges with respect to property of the type described in section 1.266-1(b) are chargeable to a capital account at the election of the taxpayer, notwithstanding that they are otherwise expressly deductible under provisions of subtitle A of the Code. No deduction is allowable for any item so treated.

Section 1.266-1(b)(1) provides that the taxpayer may elect, as provided in paragraph (c) of section 1.266-1, to treat the items enumerated, which are otherwise expressly deductible under the provisions of subtitle A of the Code, as chargeable to a capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purpose of section 1016(a)(1).

As illustrative of the items for which section 266 permits elective capitalization, section 1.266-1(b)(1)(iii) provides that in the case of personal property:

(a) Taxes of an employer measured by compensation for services rendered in transporting machinery or other fixed assets to the plant or installing them therein,

(b) Interest on a loan to purchase such property or to pay for transporting or installing the same, and

(c) Taxes of the owner thereof imposed on the purchase of such property or on the storage, use, or other consumption of such property, paid or incurred up to the date of installation or the date when such property is first put into use by the taxpayer, whichever date is later.

Finally, section 1.266-1(b)(1)(iv) states, in part, that any other carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to a capital account may be capitalized.

Section 1.266-1(b)(2) provides that the sole effect of section 266 is to permit the items enumerated in subparagraph (1) of section 1.266-1(b) to be chargeable to a capital account notwithstanding that such items are otherwise expressly deductible under the provisions of subtitle A of the Code. Section 1.266-1(b)(2) expressly provides that an item not otherwise deductible may not be capitalized under section 266.

Section 1.266-1(b)(3) cautions that in the absence of a provision in section 1.266-1 for treating a given item as a capital item, section 1.266-1 has no effect on the treatment otherwise accorded such item. Thus, items which are otherwise deductible are deductible notwithstanding the provisions of section 1.266-1, and items which are otherwise treated as capital items are to be so treated. Similarly, an item not otherwise deductible is not made deductible by this section. Nor is the absence of a provision in this section for treating a given item as a capital item to be construed as withdrawing or modifying the right now given to the taxpayer under any other provisions of subtitle A of the Code, or of the regulations thereunder, to elect to capitalize or to deduct a given item.

ANALYSIS

Section 1.266-1(b)(1) permits a taxpayer to elect to capitalize a deductible expense if that expense qualifies under the applicable subcategory. The flat fee paid to Brokerage Firm does not qualify under any of the first three subcategories (i.e., § 1.266-1(b)(1)(i), (ii), and (iii)), which concern (1) unimproved and unproductive real property; (2) real property, whether improved or unimproved and whether productive or unproductive; and (3) [tangible] personal property. Furthermore, the flat fee does not qualify as a tax under the fourth subcategory (i.e., § 1.266-1(b)(1)(iv)). Thus, Taxpayer may not elect to capitalize the flat fee under § 1.266-1(b)(1)(iv) unless the fee is an otherwise deductible "carrying charge" that in the Commissioner's opinion is chargeable to a capital account under sound accounting principles. Therefore, assuming for the purposes of this analysis that a flat fee denoted "Consulting and Advisory Services" is deductible in the taxable year paid or incurred, we must decide whether it is a carrying charge and, if so, whether it is chargeable to a capital account under sound accounting principles.

The term "carrying charge" is not defined in § 266 or in its regulations, but definitions of similar terms appearing in §§ 163(b) and 263(g) suggest that carrying charges are expenses incurred when acquiring, financing, and holding property. For example, § 163(b) permits a buyer to claim an interest deduction at the rate of six percent when the total amount of the payments under an installment contract exceeds the purchase price of the property and the contract does not specify an annual rate of interest. In these instances, the excess of the total payments over the purchase price of the property is denoted "carrying charges," and the amount of the taxpayer's interest deduction may not exceed those carrying charges. Similarly, § 263(g) defines "interest and carrying charges" as the sum of interest on indebtedness incurred or continued to purchase or carry the personal property and all other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property. Thus, under § 263(g) "carrying charges" are charges other than interest paid or incurred to carry personal property. See also Black's Law Dictionary (8th Ed. 1999), which defines "carrying charge" as: (1) a cost, in addition to interest, paid to a creditor for carrying installment credit; and (2) expenses incident to property ownership, such as taxes and upkeep.

Although the Service has not ruled on what qualifies as a capitalizable carrying charge under § 1.266-1(b)(1)(iv), it has ruled on what qualifies as a capitalizable cost under related sections. For example, the Service ruled that undeveloped oil and gas leases are unproductive real property and that a lessee may elect to capitalize delay rentals because the payment of delay rentals extends the period in which the lessee may drill wells for the production of oil and gas. Rev. Rul. 55-118, 1955-1 C.B. 320. On the other hand, the Service ruled that advertising expense incurred for unproductive property and maintenance and upkeep costs attributable to improved unproductive real property and real property that is both unimproved and unproductive are not carrying charges. Rev. Rul. 71-475, 1971-2 C.B. 304. Finally, the Service ruled that direct reforestation costs, such as planting and artificial or natural seeding, are capital expenditures subject to depreciation, while indirect expenditures, such as interest paid on money borrowed to satisfy a state law requiring a deposit to guarantee natural reforestation over a specified period of years in lieu of planting, or a service charge on a performance bond in lieu of a cash deposit, may be treated as current deductions subject to an election under § 266. Rev. Rul. 75-467, 1975-2 C.B. 93. Moreover, in a case decided before the enactment of § 263A, the Tax Court held that margin interest is a carrying charge and that the taxpayer may not elect to capitalize margin interest under § 1.266-1(b)(1)(iv) because capitalizing interest to the basis of purchased stock does not accord with sound accounting principles. Purvis v. Commissioner, 65 T.C. 1165 (1976).

Other courts also have provided general guidance concerning whether a payment is an ordinary and necessary business expense or a capitalizable cost and, thus, whether an otherwise deductible expense should be capitalized under sound accounting principles. For example, reversing the Tax Court, one appellate court held that payments by a publisher to an independent contractor for the production of a manuscript are capitalized costs. Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982). A different appellate court sustained the Tax Court's determinations that monthly retainer fees paid for investment advisory services are currently deductible under § 212 but that a one-time fee paid only if the taxpayer invested in a limited partnership is part of the cost of acquiring that limited partnership interest (i.e., a capitalized cost). Honodel v. Commissioner, 722 F.2d 1462 (9th Cir. 1984).

Considering the previously described provisions of the Code and regulations, revenue rulings, and court opinions, we believe that the flat fee denoted "Consulting and Advisory Services" is not a carrying charge under § 1.266- 1(b)(1)(iv). This flat fee is not interest expense incurred under an installment contract. But even if it were, it would not be capitalizable under § 1.266-1(b)(1)(iv). Purvis v. Commissioner, supra. Fees for consulting and advisory services are better viewed as currently deductible investment expenses. Honodel v. Commissioner, supra. Consulting and advisory fees are not carrying charges because they are incurred independent of a taxpayer's acquiring property and because they are not a necessary expense of holding property. Stated differently, consulting and advisory fees are not closely analogous to common carrying costs, such as insurance, storage, and transportation. See, e.g., § 263(b). Having decided that the flat fee denoted "Consulting and Advisory Services" is not a carrying charge, we find it unnecessary to decide whether it is chargeable to capital account under sound accounting principles.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 622-4970 if you have any further questions.

LEWIS J. FERNANDEZ
Associate Chief Counsel (Income Tax & Accounting)

Investment Advisory Fees (Yes)

- **Is it possible to treat a portion of the fees as allocable to the basis of stock purchased, held and sold during the year? (*See* CCA 200721015.)**

Investment Advisory Fees (Yes)

- **See CCA 200721025 which states that a flat fee paid to a stock broker for investment services is not a carrying charge under Reg. § 1.266-1(b)(1)(iv).**

Investment Advisory Fees (Yes)

- **Does one have a reasonable filing position to capitalize the investment advisory fees or is it necessary to enclose Form 8275? Do you have substantial authority?**
  - **IRS – Subject to 2% AGI.**
  - **Wrong – Schedule D short-term or long-term capital loss.**
  - **Me – Capitalize and allocate among stock/securities purchased, held and sold. But, how practical is this?**
    - ➢ **Encountered only one TRP who made this calculation and that was on his personal return.**
  - **Might also consider changing investment advisors (per-trade) or investing in Index Fund. (What about having your retirement account pay the fee?)**

Tax Cuts and Jobs Act Details

32. <u>Medical Expenses</u>.

a. <u>The Act retains the deduction for unreimbursed medical expenses</u>, and provides that for tax year beginning after 12/31/2016 and ending before January 1, 2019, the threshold for deducting medical expenses shall be 7.5% of AGI for all taxpayers. That threshold also applies for AMT purposes. In 2019, the threshold reverts to 10% AGI.

b. What would have happened to a number of individuals who are living in an assisted living facility if Congress eliminated the medical expense deduction?

Tax Cuts and Jobs Act
Details

- **Medical expenses (§ 213) (7.5% AGI in 2018)**

  – **How much of the expenses incurred for assisted reproduction expenses are deductible as a medical expense, including payments to carrier, legal expenses, egg donor fees and psychological testing? Same sex or opposite sex?**

Tax Cuts & Jobs Act – Details
Assisted Reproduction Expenses
PLR 200318017

- The taxpayers in this case, who had repeatedly undergone unsuccessful IVF procedures, decided to try again, using a donor egg. **They requested a ruling as to whether the following expenses associated with procuring a donor egg could be considered deductible medical expenses:**

All qualified as § 213

  – **The donor's fee for her time and expense in following proper procedures to ensure successful egg retrieval.**

  – **The agency fee for procuring the donor and coordinating the transaction between the donor and recipient.**

  – **Expenses for medical and psychological testing of the donor pro to the procedure and insurance for any medical or psychological assistance that the donor may require after the procedure**

  – **Legal fees for preparing a contract between you the taxpayer and the egg donor.**

- **The IRS first stated that "A procedure for the purpose of facilitating pregnancy by overcoming infertility …affects a structure or function of the body and may be medical care," thus allowing deductibility.**

Infertility Expenses
Bottom Line

- **Case law seems to support deductions for medical expenses only when the taxpayer or his/her spouse demonstrates infertility.**
- **Issues that remain:**
  - **Traditional couple – Yes**
  - **Single individual – Carrier expenses – No**
  - **Same-sex couples – Maybe, based on PLR 200318017 (but must be married and must not be men).**
  - **Egg preservation expenses, including harvesting, storing and preserving the eggs. Nothing is directly on point other than PLR 200318017 – No answer.**

Assisted Reproduction Expenses
No Medical Deduction for Same-Sex Partner's In Vitro Fertilization (IVF) Costs – (Yes)

- **In *Morrissey v. U.S.*, 2017-1 USTC ¶ 50,140 (D.C. Fla. 2017), the taxpayer and his same-sex partner attempted to have a child through an IVF process with an unrelated gestational surrogate.**
- **The taxpayer paid approximately $57,000 for the IVF process, which he sought to deduct as medical expenses on his tax return. After the IRS disallowed the claimed deduction, the taxpayer pursued an internal IRS appeal and, upon receiving an adverse ruling, filed a lawsuit.**
- **The District Court agreed with the IRS that the IVF costs were not deductible medical expenses under § 213 because they were not incurred for the medical care of the taxpayer, his spouse, or a dependent.**
- **Furthermore, <u>the IVF costs did not qualify as medical care under § 213 because they were neither for diagnosis, cure, mitigation, treatment, prevention of disease, nor to affect any bodily structure or function of the taxpayer</u>. (What mistake was made – Filed an amended return.)**

Medical Expenses Bottom Line

- **If an expenditure does qualify as a medical expense for someone, how much is really deductible? How many clients will exceed the 7.5% AGI limit and then also itemize their deductions in 2018?**

- **Generally need someone who has an unusual situation to be entitled to a medical expense on Schedule A:**

  - **Expenses of last illness**

  - **Retirement or assisted living**

Tax Cuts and Jobs Act Details

33. Miscellaneous Items.

a. The Act repeals deduction for alimony and provision that alimony is included in the income of the payee. Effective for any divorce decree or separation instrument executed after 12/31/2018, and to any prior instrument modified after that date if the modification expressly provides that the rules under the Act apply to such modifications. (*See* L.11 and L.31 of Form 1040.) (Section 682 is also repealed – *See* Notice 2018-37.)

b. The Act repeals deduction for moving expenses except for members of the Armed Forces (or spouses and dependents) on active duty that move pursuant to a military order and incident to a permanent change of station. (*See* § 217(k) – No more Form 3903.)

Tax Cuts and Jobs Act
Details

33. **<u>Miscellaneous Items</u>.**

c. **Final Act does <u>not</u> include a House provision that would have limited the gross income exclusion for the value of housing provided to an employee for the convenience of the employer (and to employees of educational institutions) to $50,000, with a phase-out if income is above $120,000.**

d. **Final Act does <u>not</u> include a provision that the exclusion under §121 for gain on the sale of a principal residence would apply only if the taxpayer owns and uses a home as a principal residence for <u>five out of the previous eight years</u> (presently two out of the previous five years). In other words, § 121 continues to apply for the $250,000 and $500,000 exclusions.**

Tax Cuts and Jobs Act
Details

33. **<u>Miscellaneous Items</u>.**

e. **The Act does <u>not repeal</u> the exclusion from gross income of an employee of up to $5,000 each year for employer-provided dependent care assistance. (*See* W-2, L.10.)**

f. **The Act does <u>not repeal</u> the exclusion from gross income for employer provided adoption assistance programs (§ 137 & $13,810 for 2018).**

g. **The Act <u>does repeal</u> the employee exclusion from gross income and wages for qualified moving expense reimbursements, except for a member of the Armed Forces on active duty who moves pursuant to a military order. (*See* § 132(g)(2).)**

Cell Phones and Laptops (Yes)

<u>Provisions Relevant to 2018</u>:

- **The Small Business Jobs Act of 2010 removed cellular phones from the definition of listed property under § 280F after 2009, but still must determine business use.**
  a. **Notice 2011-72: If employer provides employees with cell phones or iPads "primarily for non-compensatory business reasons," the value of the business use is a non-taxable working condition fringe.**
  b. **Non-compensatory business reasons include having the employee be available when outside the office, and allowing the employee to talk to clients/customers when outside the office.**
  c. **The value of any personal use of the phone by the employee may be excluded from income as a de minimis fringe benefit.**
  d. **Same rules apply to employer reimbursements if employee is required to use his or her personal cell phone for business purposes.**
- **See § 262(b) & what result if need a cell phone for use in trade or business – Pay $300/month?**

Cell Phones and Laptops (Yes)

- **The Tax Cuts & Jobs Act removed computers and peripheral equipment from the definition of listed property.**
- **Only automobiles are considered as listed property.**
- **Might be of some benefit to a self-employed person but not of much use to an employee who pays for his/her own cell phone and/or laptop. Should the ER reimburse the EE?**

Tax Cuts and Jobs Act
Details

- **If an individual is an employee, what happens to the following items?**

  a. **Union dues**

  b. **Safe deposit box**

  c. **Commuting expenses**

  d. **Home office deduction**

  e. **Cell phone**

  f. **Laptop**

- **Rent the property to ER and have ER issue a Form 1099?**

Tax Cuts and Jobs Act
Details

34. Pension and Retirement Reforms.

a. **Rules allowing recharacterization of IRA contributions (traditional to Roth and vice versa) by making a trustee-to-trustee transfer before the due date for the individual's income tax return are modified. Those rules no longer apply to a conversion contribution to a Roth IRA. (FAQ – A 2017 Roth contribution may be recharacterized until October 15, 2018. – 2016 to 2017 to 2018)**

1) **Therefore recharacterization cannot be used to unwind a Roth conversion.**

2) **Recharacterization is still permitted for other contributions. If an individual contributes to a Roth IRA, she may timely recharacterize it as a contribution to a traditional IRA.**

Tax Cuts and Jobs Act
Details

34. Pension and Retirement Reforms.

b. **Final Act does not adopt pension plan changes concerning hardship distributions, in-service distribution age restrictions, and certain discrimination rules.**

c. **Employees whose plan terminates or who separate from employment while they have a plan loan outstanding will have until the due date for filing their return (including extensions) for that year to contribute the loan balance to an IRA in order to avoid the loan being taxed as a distribution. Currently there is a 60-day rule. (Terminate employment in May 2018, when have a plan loan of $45,000 outstanding – Have until October 2019 to repay the loan – *See* § 402(c)(3)(C).)**

d. **Act does not adopt "Rothification" rules for §401(k) plans or for catch-up contributions.**

Tax Cuts and Jobs Act
Details

35. Transfer Taxes.

a. **The Act doubles the estate and gift tax exemption after 2017. This is accomplished by increasing the basic exclusion amount in §2010(c)(3) from $5 million to $10 million, indexed for inflation after 2011. Portability remains.**

1) **For 2017, the indexed amount was $5,490,000. In Rev. Proc. 2018-18, the amount for 2018 is $11,180,000 and the gift tax amount for 2018 is $15,000.**

2) **The final Act does not repeal the estate and GST tax in 2025, or reduce the gift tax top rate from 40% to 35% in 2025, as had been proposed by the House.**

Tax Cuts and Jobs Act
Details

36. **Alternative Minimum Tax (AMT).**

   a. **The AMT for corporations is repealed.**

   b. **Individual AMT is not repealed, but the exemption amounts are increased from $78,750 to $109,400 for joint returns and from $50,600 to $70,300 for singles and $24,600 for trust or an estate. In the case of an estate or trust, the exemption amount begins to phase out at $81,900 (*see* Rev. Proc. 2018-22). The phaseout thresholds are increased to $1,000,000/$500,000. (*See* § 55(d)(4).) (Might be able to use MTC CF.)**

   c. **For corporations, the Act allows the AMT credit to offset regular tax liability for any taxable year. In addition, the AMT credit is refundable for any year beginning after 2017 and before 2022 in an amount equal to 50% (100% in 2021) of the excess of the minimum tax credit for the year over the amount of the credit allowable for the year against regular tax liability.**

For 2017
What Type of Individual
Was Subject to AMT?

(Note: On the Form 6251, L.2 to 13 are exclusion preferences.)

	Regular	AMT
• **Personal exemptions ***	**Ded.**	**Not Ded.**
• **Schedule A Taxes ***	**Ded.**	**Not Ded.**
• Home equity interest – Real / True	Ded.	Not Ded.
• Medical and dental (2017 – 7.5% AGI)	7.5%	7.5%
• **Miscellaneous itemized deductions 2% AGI ***	**Ded.**	**Not Ded.**
• Private activity bond interest	Not Tax	Tax

For 2017
What Type of Individual
Was Subject to AMT?

		Regular	AMT
• Investment interest – Form 4952 & § 163(d)		If Lted.	More is Ded.
• State income tax refund		If Tax	None is Tax
• **Depreciation**	**§ 179 Deduction**	**Ded.**	**Ded.**
	Bonus Depreciation	**Ded.**	**Ded.**
	200% D.B. – If bonus (*But see* Rev. Proc. 2017-33.)	**200% D.B.**	**200% D.B.**
	Used Property	**200% D.B.**	**150% D.B.**
• **Qualified ISO ***	**What advice if client has the right to purchase 1,000 shares of ER stock at $2/sh and the ER stock is worth $200/sh? - ISO**		
• **LT capital gains ***		**Sch. D**	**Sch. D**
• Standard deduction		Ded.	Not Ded.

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For 2017
What Type of Individual
Was Subject to AMT?

Assume that a MFJ has the following for 2017:

O.I.	**$450,000**		
LT	**150,000**		
AGI	**$600,000**		
P.E. & I.D.	**(150,000)**	**O.I.**	**$300,000**
T.I.	**$450,000**	**LT**	**$150,000**
			(Taxed at 15%)

- **If AMTI is $600,000, which consists of O.I. $450,000 and LT $150,000, how much of the LT $150,000 was taxed at 20%?**
  - **ANS: $129,300. Why? T.I. > $470,700 was taxed at 39.6%**

TI-ITP.18

For 2018
What Type of Individual
Will be Subject to AMT?

(**Note**: On the Form 6251, L.2 to 13 are exclusion preferences.)

	Regular	AMT
• Personal exemptions *	Not Ded.	Not Ded.
• Schedule A Taxes * (Max of $10,000)	Ded.	Not Ded.
• Home equity interest – Real / True	Not Ded.	Not Ded.
• Medical and dental (2018 – 7.5% AGI)	7.5%	7.5%
• Miscellaneous itemized deductions 2% AGI *	Not Ded.	Not Ded.
• Private activity bond interest	Not Tax	Tax

TI-ITP.18

For 2018
What Type of Individual
Will be Subject to AMT?

		Regular	AMT
• Investment interest – Form 4952 & § 163(d)		If Lted.	More is Ded.
• State income tax refund		If Tax	None is Tax
• Depreciation	§ 179 Deduction	Ded.	Ded.
	Bonus Depreciation	Ded.	Ded.
	200% D.B. – If bonus (*But see* Rev. Proc. 2017-33.)	200% D.B.	200% D.B.
	Used Property	200% D.B.	150% D.B.
• Qualified ISO *	What advice if client has the right to purchase 1,000 shares of ER stock at $2/sh and the ER stock is worth $200/sh? - ISO		
• LT capital gains *		Sch. D	Sch. D
• Standard deduction		Ded.	Not Ded.

TI-ITP.18

For 2018
What Type of Individual
Will be Subject to AMT?

Assume that a MFJ has the following for 2018:

O.I.	**$450,000**		
LT	**150,000**		
AGI	**$600,000**		
P.E. & I.D.	**(150,000)**	**O.I.**	**$300,000**
T.I.	**$450,000**	**LT**	**$150,000** (Taxed at 15%)

- **If AMTI is $600,000, which consists of O.I. $450,000 and LT $150,000, how much of the LT $150,000 is taxed at 20%?**
  - **ANS: $121,000. Why? T.I. > $479,000 is taxed at 20% – See § 1(j)(5)(B)**

AMT
Inflation Adjusted Amounts for 2018

	2018	2017
Exemption Amounts:		
Joint returns and Surviving Spouse	**$109,400**	**$84,500**
Unmarrieds	**$70,300**	**$54,300**
MF Separately	**$54,700**	**$42,250**
Estates & Trusts	**$24,600**	**$24,100**
28% for AMTI:		
MF Separately	**$95,550**	**$93,900**
Joint returns, Surviving Spouse, Singles and E & T	**$191,100**	**$187,800**
Phase-Out of Exemption Amounts:		
Joint returns & Surviving Spouse	**$1,000,000**	**$160,900**
Unmarrieds	**$500,000**	**$120,700**
MF Separately	**$500,000**	**$80,450**
Estate & Trust	**$81,900**	**$80,450**

(Source: Rev. Proc. 2018-22.)

Investment Interest – Form 4952 (Yes)

- **Investment Interest**
  - **What result for regular tax and AMT if an individual has the following:**

• AGI	$100,000
• Investment interest expense	18,000
• Taxable interest	6,000
• Qualified dividend income	6,000
• STCG	6,000
• Investment expenses subject to 2% AGI	6,000
• Other expenses subject to 2% AGI	1,000

Investment Interest – Form 4952 (Yes)

- **Regular Tax**
  - **Form 4952 limited to $12,000 & C.F. of $6,000**
- **AMT**
  - **Investment interest that is deductible equals $12,000 & C.F. of $6,000**
- **Would you make an election to tax qualified dividends and LTCG as ordinary income?**

Investment Interest – Form 4952 (Yes)

Regular Tax			AMT		
Inv. Inc:			Inv. Inc.	$12,000	
Tax Int	$6,000		Inv. Exp.	(0)	
STCG	6,000		Net Inv. Inc.		$12,000
Total		$12,000	Inv. Int.		$12,000
Ded. Inv. Exp.		(0)	C.F. Amt.		$ 6,000
Net Inv. Inc.		$12,000			
Inv. Int.		$12,000			
C.F.		$ 6,000			

- Same amount now is deductible for regular tax and AMT.

Tax Cuts and Jobs Act Details

37. Repeal of Individual Mandate Penalty.

a. The penalty for failure of an individual to have minimum essential health insurance coverage under the ACA is reduced to zero effective with respect to health coverage status for months beginning after December 31, 2018. ($400 billion in savings.)

b. Some analysts have projected that about 13 million fewer persons (largely younger and healthier individuals) will no longer purchase insurance and the cost of health insurance premiums will increase by at least 10%.

c. The effect for insurance purchased through ACA exchanges will be increased premium costs that could result in the demise of the ACA.

Tax Cuts and Jobs Act
Details

38. <u>ABLE Accounts</u>.

a. ABLE accounts for disabled persons have a general overall limit on contributions (the gift tax annual exclusion amount of $15,000 in 2018).

1) Under the Act, after the overall limit on contributions is reached, the designated beneficiary of an ABLE account may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the tax year. (*See* § 529A(b)(2)(B)(ii).)

2) A designated beneficiary may also claim the saver's credit for contributions made to his or her ABLE account. (*See* § 25B(d)(1)(D) & IR 2018-139.)

Tax Cuts and Jobs Act

39. <u>Sexual Harassment or Sexual Abuse Settlements</u>.

a. No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

Physical Injury or Sickness

- **What is the difference between compensatory and punitive damages? What is a physical injury – Is it tort or must there be a bruise? See PLR 200041022. – Mention young lady from Fox News who received a $9,000,000 settlement.**
- **What portion of the attorney's fee is deductible and where is it deductible? (*See* § 212(1).)**
- **Mention age discrimination suit filed against Texaco. Settlement for $250,000 and attorney fees and costs are $170,000. Where to deduct costs and attorney fees? Schedule A – 2% AGI or D for AGI?**
- **Mention P.I. Law Firm and payment of expenses – When deductible?**

Physical Injury or Sickness

	Gross Income	Attorney Fees
1. Physical Injury:		
a. Compensatory damages	Not Taxable	Not Deductible
b. Punitive damages	Taxable	Ded. – Sch. A – 2% AGI
2. Age, Race or Sex Discrimination or Contract Dispute w/ ER:		
a. Compensatory damages	Taxable	D for AGI
b. Punitive damages	Taxable	D for AGI

Physical Injury or Sickness

	Gross Income	Attorney Fees
3. **Defamation Claim (Libel or Slander)**:		
a. Compensatory damages	Taxable	Deductible – Sch. A – 2% AGI
b. Punitive damages	Taxable	Deductible – Sch. A – 2% AGI

TI-ITP.18

Physical Injury or Sickness

- **Mention Dennis Rodman & Mr. Amos (ESPN Highlights)**
- **Mention Brenda & Geo Storm**
- **Mention Tim Masters from Ft. Collins who was wrongfully incarcerated from 1999 to 2008. (*See* § 139F.)**

TI-ITP.18

Malpractice Damages May Be Excluded from GI (Yes)

- In *Cosentino v. Comm'r*, T.C. Memo 2014-186:

  1. **T sued an accounting firm (FH) for negligently recommending a tax shelter. T claimed damages of $640,000 and settled the case for $375,000.**

     a. T's claimed damages were fees paid to FH, expenses T otherwise would not have incurred, and State and Federal income taxes, interest, and penalties paid.

     b. T did not include the $375,000 in GI, and the IRS claimed that the entire settlement must be included.

     c. Two prior cases and Rev. Rul. 57-47: A recovery of money from a tax professional for negligent tax advice that cost T extra taxes was a non-taxable return of capital.

Malpractice Damages May Be Excluded from GI (Yes)

- In *Cosentino v. Comm'r*, T.C. Memo 2014-186:

  1. IRS: Prior authorities are distinguishable because T did not pay extra taxes.

  2. Court: The IRS is wrong on the facts. Had T known the recommended transaction was an abusive tax shelter involving basis shifting followed by a §1031 deal where T received boot, T would not have done the deal and then later paid taxes, penalties, and interest to the IRS and Oregon.

     a. But: The tax benefit rule applies with respect to settlement amounts T deducted, such as fees to FH, and T must include in GI settlement amounts for claimed losses T did not in fact suffer, based *pro rata* on the claims in his complaint.

Tax Cuts and Jobs Act
Details

40. <u>Qualified Equity Grants Under § 83(i)</u>.

a. The Act allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer.

b. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

Tax Cuts and Jobs Act
Details

40. <u>Qualified Equity Grants Under § 83(i)</u>.

c. If an employee makes such an election, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer; (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) <u>the date five years after the first date the employee's right to the stock becomes substantially vested</u>; or (5) the date on which the employee revokes her inclusion deferral election.

Tax Cuts and Jobs Act
Details

40. <u>Qualified Equity Grants Under § 83(i)</u>.

d. The deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock.

e. The provision generally applies with respect to stock attributable to options exercised or RSUs (Restricted Stock Units) settled after December 31, 2017.

Tax Cuts and Jobs Act
Details

40. <u>Qualified Equity Grants Under § 83(i)</u>.

f. For § 83(i) to apply, need:

1) Stock which is not publicly traded,

2) Plan must be in writing,

3) At least 80% of all Employees receive stock options or RSU,

4) No § 83(b) election,

5) Includes a qualified ISO.

21st Century Cures Act

21st Century Cures Act
Overview
(Yes) – (Skip to Slide 258.)

- **Effective for tax years beginning after December 31, 2016, qualified small employer health reimbursement arrangements (QSEHRAs) are not treated as group health plans for purposes of the group health plan requirements. As a result, the ACA's prohibitions against cost-sharing for preventive services and lifetime or annual dollar limits on benefits do not apply to QSEHRAs.**

1. **Not ALE. (Do not have at least 50 FT EEs.)**
2. **No group health insurance plan.**
3. **Reimburse $5,050 for 2018 for EE or $10,250 for 2018 for family.**
4. **No Premium Tax Credit (PTC) is available.**

21st Century Cures Act Qualifications

To qualify as a QSEHRA, an arrangement must be provided on the same terms to all eligible employees of the eligible employer. In addition, the arrangement must:

- **Be funded solely by an eligible employer, with no salary reduction contributions under a cafeteria plan allowed;**
- **Provide for the payment or reimbursement of medical care expenses (as that term is defined by § 213(d)) incurred by the eligible employee or the eligible employee's family members (as determined under the terms of the arrangement) after the employee provides proof of coverage to the employer; and**
- **Provide that the total amount of payments and reimbursements for any year cannot exceed $4,950 ($10,000 for family coverage).**

21st Century Cures Act Qualifications

- **The annual dollar limit is adjusted for inflation for years beginning after 2016 in $50 increments.**
- **The arrangement must be provided on the same terms to all eligible employees of the eligible employer. However, an employee's permitted benefit may vary in accordance with the variation in the price of an insurance policy in the relevant individual health insurance market based on the:**
  - Age of the eligible employee (and, in the case of an arrangement which covers medical expenses of the eligible employee's family members, the age of family members); or
  - Number of family members of the eligible employee the medical expenses of which are covered under the arrangement.

21st Century Cures Act
Employers

An eligible employer for purposes of a QSEHRA is any employer that:

- **Is not an applicable large employer (generally, an employer with 50 or more full-time equivalent employees during the previous year); and**
- **Does not offer a group health plan to any of its employees.**

21st Century Cures Act
Employees

An eligible employee means any employee of an eligible employer. However, an employer may exclude the following types of employees from the arrangement:

- **Employees who have not completed 90 days of service;**
- **Employees who have not attained age 25;**
- **Part-time or seasonal employees;**
- **Employees not included in the plan who are included in a unit of employees covered by collective bargaining agreement, if accident and health benefits were the subject of good faith bargaining between employee representatives and employer or employers; and**
- **Employees who are nonresident aliens and who receive no earned income (within the meaning of § 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of § 861(a)(3)).**

21st Century Cures Act
Notice Requirements

- **An eligible employer funding a QSEHRA for any year must not later than 90 days before the beginning of the year provide a written notice to each eligible employee. Failure to provide the required notice may result in a penalty unless the failure is due to reasonable cause and not willful neglect.**

- The notice requirement generally applies with respect to years beginning after December 31, 2016, but a person will not be treated as failing to meet the requirement if the notice is provided no later than 90 days after the date of enactment of the 21st Century Cures Act.

21st Century Cures Act
Additional Items

- **Minimum Essential Coverage.** Payments or reimbursements made under a QSEHRA are not excluded from gross income if for the month in which medical care is provided the individual does not have minimum essential coverage. The payments or reimbursements nevertheless continue to be excluded from wages for employment tax purposes.

- **Premium Assistance Tax Credit.** The 21st Century Cures Act includes provisions coordinating the § 36B premium assistance tax credit with QSEHRAs. Generally, for any month that an employee is provided a QSEHRA, that constitutes affordable coverage, the employee is not eligible for the § 36B premium assistance tax credit.

21st Century Cures Act
Additional Items

- **Excise Tax on High-Dollar Health Plans.** The ACA imposes an excise tax on certain high-dollar health insurance plans (often referred to as "Cadillac plans"). QSEHRAs are still considered group health plans for purposes of the excise tax on high cost employer-sponsored health coverage. In the case of applicable employer-sponsored coverage consisting of coverage under any QSEHRA, the cost of coverage is equal to the total permitted benefit for the year under a qualified small employer health reimbursement arrangement with respect to the employee.

- **Form W-2 Reporting.** The total amount of permitted benefit for the year under a QSEHRA with respect to the employee must be reported on each employee's Form W-2, Wage and Tax Statement. The permitted benefit is the maximum dollar amount of payments and reimbursements that may be made under the terms of the QSEHRA for the year with respect to that employee. The reporting requirement applies to calendar years beginning after December 31, 2016.

21st Century Cures Act
Additional Items

- **Transition Relief.** The relief in Notice 2015-17 for qualified small employer plans from the market reforms has been extended to included plan years beginning on or before December 31, 2016. Under this transition relief, small employers (employers that are not applicable large employers) are excused from the $100 a day per affected employee excise tax.

    1) Employers qualifying for the relief need not file IRS Form Return of Certain Excise Taxes, solely as a result of having such arrangements for the period for which the employer is eligible for the relief. This relief does not extend to stand-alone HRAs or other arrangements to reimburse employees for medical expenses other than insurance premiums.

- **Effective Date.** Except as otherwise provided, the amendments made by the 21st Century Cures Act to small business HRAs apply to years beginning after December 31, 2016. The relief under Notice 2015-17 is treated as applying to any plan year beginning on or before December 31, 2016.

21st Century Cures Act

- **Notice 2017-67:**

  1. **Under a QSEHRA, after an eligible employee provides proof of coverage, payments or reimbursements may be made to that eligible employee for expenses for medical care (as defined in § 213(d) and including expenses for premiums for individual health insurance policies) incurred by the eligible employee or the eligible employee's family members, provided certain requirements are satisfied.**

  2. **Section 9831(d)(4) generally requires an eligible employer to furnish a written notice to its eligible employees at least 90 days before the beginning of a year for which the QSEHRA is provided (or, in the case of an employee who is not eligible to participate in the arrangement as of the beginning of such year, the date on which such employee is first so eligible). Section 9831(d)(4)(B) describes the required contents of the notice.**

21st Century Cures Act

- **Notice 2017-67:**

  3. **Executive Order on HRAs. On October 17, 2017, President Trump issued an Executive Order directing the Treasury and other federal agencies to consider revising guidance, to the extent permitted by law and supported by sound policy, to increase the usability of health reimbursement arrangements (HRAs), expand employers' ability to offer HRAs to their employees, and to allow HRAs to be used in conjunction with non-group coverage.**

  4. **In Notice 2017-67, IRS has provided guidance on the requirements for providing a QSEHRA, the tax consequences of the arrangement, and the requirements for providing written notice of the arrangement to eligible employees. IRS noted that the guidance addresses each of the objectives outlined in the Executive Order and stated that it, with the Treasury Department, anticipates issuing additional guidance in the future.**

21st Century Cures Act

- **Notice 2017-67:**

  5. **Notice 2017-67 provides 79 Questions and Answers (Q&As) that clarify and explain a number of issues relating to QSEHRAs. The specific topics addressed include:**

     a. **Eligible employers;**

     b. **Eligible employees;**

     c. **"Same terms" requirement;**

     d. **Statutory dollar limits;**

     e. **Written notice requirement;**

     f. **Minimum Essential Coverage (MEC) requirement;**

     g. **Proof of MEC requirement;**

21st Century Cures Act

- **Notice 2017-67:**

  5. **Notice 2017-67 provides 79 Questions and Answers (Q&As) that clarify and explain a number of issues relating to QSEHRAs. The specific topics addressed include:**

     h. **Substantiation requirement;**

     i. **Reimbursement of medical expenses;**

     j. **Reporting requirement;**

     k. **Coordination with the premium tax credit (PTC) (W-2, L.12FF);**

     l. **Failure to satisfy the requirements to be a QSEHRA;**

     m. **Integration with Health Savings Account (HSA) requirement; and**

     n. **Effective date.**

Health Care Act

Overview and Timing

Due Diligence:

Form 8962 – PTC

Form 1095-A – PTC

Form 1095-B – Ins.

Form 8965 – Exceptions

2010 Health Care Act Question (Yes)

- **Where does one find affordable healthcare in 2018? (Crowdfunding or HCSM)**
- **If a smaller ER wants to be sure that all EEs have health insurance, what questions should be asked before hiring any EE in the future? (*See* CCA 201547006.)**
- **Remember 21st Century Cures Act.**
- **IRS will not process return if received a Form 1095-A with PTC and do not attach a Form 8962. (*See also* Line 61.)**

2010 Health Care Act
Overview
(Yes)

Intent: Mandate coverage and reduce uninsureds by **32 million** through a combination of incentives and penalties:

1. **Establishing State (Federal) "Exchanges"** through which individuals and small businesses may obtain health insurance, with a tax credit and subsidies available to individuals based on income. **(AK, AZ, NV, OR, CO, IL, NE, NM, CA, HI, ID, OH, WA & WY)**

2. **Providing small businesses with a tax credit to offset the cost. See Form 8941.**

3. **<u>Requiring individuals to have coverage or pay a penalty</u>, and employers with at least 50 full-time equivalent employees to provide coverage, or pay a penalty ($2,000 penalty for FT EEs in excess of 30).**

Health Care Act
Client Interview
(Yes)

- **Do you have health insurance for yourself, spouse and dependents?**
  - **Yes or No ⟶ Then penalty or Form 8965**

- **If you do have health insurance, did you purchase insurance through the Exchange?**
  - **If Yes**
    - **Need Form 1095-A. Why? How does one qualify for the Premium Credit? – Need to reconcile back to Form 8962 (L.46 or L.69)**
  - **If No**
    - **Does the TRP need to see a copy of Form 1095-B?**
    - **See W-2, Line 12dd.**

Health Care Act
(Yes)

Single

- **No health insurance**
- **Reg Tax Due $200**

Reg Tax Due	**$200**	
Penalty Tax	**<u>695</u>**	**– Not lienable & not leviable.**
Total	**<u>$895</u>**	

- **How much would you advise individual to pay? All. Why? See Form 9465 – New fee amounts have been finalized – TD 9798 – $225, $107, and $31.**
- **Will this be a tax debt that will be turned over to the private debt collectors? What will happen after 12-31-18?**

Form 9465
Fee Schedule − TD 9798
(FYI)

TD 9798 increases the existing user fees (except for low-income taxpayers) and creates two new types of online installment agreements, each subject to a separate fee. Five of these rates are based on the full cost of establishing and monitoring installment agreements, while the sixth rate is for low-income taxpayers. **The new fees are:**

1. **A top rate of $225, up from the current rate of $120, applies to taxpayers who enter into installment agreements in person, over the phone, by mail, or by filing Form 9465, Installment Agreement Request, with the IRS.** This includes taxpayers requesting installment agreements with their e-filed returns.
2. **A reduced rate of $107,** up from $52, **applies to a direct debit agreement.**
3. **A taxpayer who sets up an installment agreement through IRS.gov and agrees to make payments either by mailing a check or through the Electronic Federal Tax Payment System (EFTPS) will pay $149.**

Form 9465
Fee Schedule − TD 9798
(FYI)

4. **A taxpayer who sets up an installment agreement online and agrees to make automatic payments through direct debit will pay a $31 fee.**

5. The fee for a restructured/reinstated installment agreement will be $89, up from the current rate of $50.

6. **A low-income taxpayer will pay a $43 fee, the same as the current rate, when setting up any type of installment agreement, other than a direct debit online payment agreement, or when restructuring or reinstating any installment agreement.**

Health Care Act
(Yes)

- **Individual in 2018 signs up for health insurance through the State Exchange. Based on income for 2016, qualifies for $3,000 premium assistance tax credit. (*See* Form 8962 & what happens if SE? *See* Rev. Proc. 2014-41. – *See* Software Program.)**

- **When preparing 2018 tax return, the individual alternatively should have qualified for only an $1,800 credit or should have qualified for a $3,600 credit. What result? (*See* L.46 – repay $1,200 and L.69 of Form 1040 – additional tax paid in $600.)**

- **Final regulations have been issued and eligible individuals will receive a Form 1095-A by January 31 indicating the amount of premium assistance tax credit that he/she received. – Why? (About one-third of 4.6 million individuals who received the credit did not file a Form 8962.) IRS will not process the return without Form 8962 if received a premium assistance credit.**

Premium Tax Credit – Required to Repay *Walker v. Comm'r*, T.C. Sum. Op. 2017-50 (Yes)

- **For the year at issue, a married couple enrolled in health insurance through Covered California, a state-run exchange. They selected a plan with Anthem Blue Cross that required a monthly premium of $1,378. To help offset this cost, the taxpayers elected to receive a monthly advance premium tax credit of $1,077.**
- **After filing their return, the taxpayers separately mailed Form 8962 (Premium Tax Credit (PTC)), which reported Modified Adjusted Gross Income (MAGI) of $75,199.**
- **The IRS determined that the taxpayers were ineligible for the PTC because their MAGI exceeded 400% of the applicable federal poverty line amount.**
- **The taxpayers claimed they would not have purchased insurance through Covered California if they had known they did not qualify for the PTC.**
- **The Tax Court sided with the IRS, concluding it was bound by the statute as written. Therefore, the taxpayers were required to pay back the entire PTC amount.**

Form **8962**
Department of the Treasury
Internal Revenue Service

Premium Tax Credit (PTC)

► Attach to Form 1040, 1040A, or 1040NR.
► Go to *www.irs.gov/Form8962* for instructions and the latest information.

OMB No. 1545-0074
2017
Attachment Sequence No. 73

Name shown on your return | Your social security number

You cannot take the PTC if your filing status is married filing separately unless you qualify for an exception (see instructions). If you qualify, check the box . . . ► ☐

Part I Annual and Monthly Contribution Amount

1	Tax family size. Enter the number of exemptions from Form 1040 or Form 1040A, line 6d, or Form 1040NR, line 7d	1	
2a	Modified AGI. Enter your modified AGI (see instructions) 2a		
b	Enter the total of your dependents' modified AGI (see instructions) 2b		
3	Household income. Add the amounts on lines 2a and 2b (see instructions)	3	
4	Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. a ☐ Alaska b ☐ Hawaii c ☐ Other 48 states and DC	4	
5	Household income as a percentage of federal poverty line (see instructions)	5	%
6	Did you enter 401% on line 5? (See instructions if you entered less than 100%.) ☐ **No.** Continue to line 7. ☐ **Yes.** You are not eligible to take the PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount.		
7	Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions . . .	7	
8a	Annual contribution amount. Multiply line 3 by line 7. Round to nearest whole dollar amount 8a — **b** Monthly contribution amount. Divide line 8a by 12. Round to nearest whole dollar amount	8b	

Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit

9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)?
☐ **Yes.** Skip to Part IV, Allocation of Policy Amounts, or Part V, Alternative Calculation for Year of Marriage. ☐ **No.** Continue to line 10.

10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23.
☐ **Yes.** Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24. ☐ **No.** Continue to lines 12–23. Compute your monthly PTC and continue to line 24.

Annual Calculation	(a) Annual enrollment premiums (Form(s) 1095-A, line 33A)	(b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33B)	(c) Annual contribution amount (line 8a)	(d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-)	(e) Annual premium tax credit allowed (smaller of (a) or (d))	(f) Annual advance payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals						
Monthly Calculation	(a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column A)	(b) Monthly applicable SLCSP premium (Form(s) 1095-A, lines 21–32, column B)	(c) Monthly contribution amount (amount from line 8b or alternative marriage monthly calculation)	(d) Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-)	(e) Monthly premium tax credit allowed (smaller of (a) or (d))	(f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						

24	Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here	24
25	Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here	25
26	Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Form 1040, line 69; Form 1040A, line 45; or Form 1040NR, line 65. If line 24 equals line 25, enter -0-. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27	26

Part III Repayment of Excess Advance Payment of the Premium Tax Credit

27	Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here	27
28	Repayment limitation (see instructions)	28
29	Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Form 1040, line 46; Form 1040A, line 29; or Form 1040NR, line 44	29

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37784Z Form **8962** (2017)

Form **1095-A** **Health Insurance Marketplace Statement** ☐ VOID ☐ CORRECTED OMB No. 1545-2232 **2017**

Department of the Treasury Internal Revenue Service

▶ Do not attach to your tax return. Keep for your records.
▶ Go to *www.irs.gov/Form1095A* for instructions and the latest information.

Part I Recipient Information

1 Marketplace identifier	2 Marketplace-assigned policy number	3 Policy issuer's name	
4 Recipient's name		5 Recipient's SSN	6 Recipient's date of birth
7 Recipient's spouse's name		8 Recipient's spouse's SSN	9 Recipient's spouse's date of birth
10 Policy start date	11 Policy termination date	12 Street address (including apartment no.)	
13 City or town	14 State or province	15 Country and ZIP or foreign postal code	

Part II Covered Individuals

	A. Covered individual name	B. Covered individual SSN	C. Covered individual date of birth	D. Coverage start date	E. Coverage termination date
16					
17					
18					
19					
20					

Part III Coverage Information

Month	A. Monthly enrollment premiums	B. Monthly second lowest cost silver plan (SLCSP) premium	C. Monthly advance payment of premium tax credit
21 January			
22 February			
23 March			
24 April			
25 May			
26 June			
27 July			
28 August			
29 September			
30 October			
31 November			
32 December			
33 Annual Totals			

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 60703Q Form **1095-A** (2017)

Provisions Related to Employers Small Employer Health Insurance Credit (Yes)

- **New §45R: <u>Tax credit in years beginning after 2009</u> for nonelective contributions by <u>eligible small employers that cover at least 50% of the cost of premiums for health coverage of participating employees</u>. New <u>Form 8941</u>.**

- **An eligible small employer is one that has a qualified health care arrangement in effect, and:**

  1. **<u>Has fewer than 25 full-time equivalent employees</u>; and**

  2. **<u>Pays average annual wages not greater than $52,400</u> in years beginning in 2018 (phased out between $26,200 & $52,400). (For 2019, $26,600 to $53,200.)**

  <u>2010: Only 228,000 claimed $278 million in credits; only 14%</u>

Small Employer Health Insurance Credit
Amount of Credit
(Yes)

For years beginning in 2014, the credit is equal to **50%**:

1. **The total amount of nonelective contributions the employer makes for payment of premiums for qualified health insurance coverage of employees (but the credit is available only with respect to premiums paid through a SHOP Exchange (Small Business Health Option Program);** or

2. The total amount of contributions that would have been made if the covered employees were enrolled in a plan that had premiums equal to the amount that the HHS Secretary determines is the average premium for the small group market in the relevant State.

Small Employer Health Insurance Credit
Tax Year 2017
(Yes)

- An eligible small employer receives a credit for any tax year beginning after 2013 during the "credit period."

  1. **The credit period is the two-consecutive-tax-year period beginning with the first tax year in which the employer or a predecessor offers a qualified health plan to employees through a State Exchange.**

  2. No credit period is treated as beginning with respect to a tax year beginning before 2014.

Small Employer Health Insurance Credit
Amount of Credit
(No)

- The credit for a tax year beginning after 2013 only applies to insurance purchased through an exchange and is equal to **50%** of the lesser of:

    1. The total amount of nonelective contributions the employer makes for premiums for qualified health plans offered to its employees through an Exchange; or

    2. The contributions that would have been made if employees were enrolled in in a plan that had a premium equal to the average premium for the small group market in the rating area in which the employee enrolls for coverage.

Individual Provisions
Medicare Tax Increase on Wages and SE Income
(Yes)

- Wage earners: An **additional 0.9% Medicare tax** applies to wages in excess of $200,000 for single taxpayers and $250,000 for joint filers ($125,000 if married and file separately). Effective beginning in 2013. Not employer part.

- Thus the Medicare rate for employees on wages above the threshold will increase to 2.35% (1.45% + 0.9%). The combined employer/employee rate will increase to **3.8%** of such wages (2.35% + 1.45%).

- The additional 0.9% is on the combined wages of the employee and the employee's spouse in the case of a joint return. **See Form 8959 on Line 62 of Form 1040 for 2017.**

- **Is possible to be subject to the .9% tax even if Box 1 wages do not exceed the $200,000 or $250,000. Why?**

Medicare Tax
Form 8959
(Yes)

- **Assume that a single individual gives her TRP a W-2 for 2018. The W-2 has the following information:**

Box 1	**$200,000**	**<u>1040</u>:**	
Box 2	**$40,000**	**Line 64 –**	**<u>$40, 180</u>**
Box 3	**$128,400**	**Line 62 –**	**<u>$180</u>**
Box 5	**$220,000**		

<u>Questions</u>:

1. **Why are Box 5 wages greater than Box 1 wages?**

2. **Is the individual subject to the .9% Medicare tax where the calculation is made on Form 8959?**

Medicare Tax Increase on Wages and SE Income
(No)

- <u>Withholding</u>:

  1. **<u>Employer must withhold the additional tax only if the employee receives wages in excess of $200,000</u>.**

  2. **<u>Employer is not required to determine wages received by the employee's spouse</u>.**

  3. **<u>If there is no withholding, employee is responsible for paying the tax and such tax counts for purposes of determining underpayment of estimated taxes</u>.**

  4. **Is refundable if overpaid.**

Medicare Tax Increase on Wages and SE Income (No)

- **Self-employment (SE) income** in excess of the same thresholds is also subject to the new additional 0.9% tax.

1. The threshold amounts are reduced, but not below zero, by the amount of the taxpayer's wages taken into account in determining the new tax.

2. **<u>The one-half of SE taxes that are deductible under §164(f) does not include the additional tax of 0.9%</u>. (*See* L.58 and L.62.)**

3. Taxpayer reduction in SE income by an amount equal to one-half of the combined SE tax rate will not include the additional tax in the rate used to make such computation.

TI-ITP.18

Mandate for Individuals to Acquire Insurance (No)

- **Requirement to maintain "minimum essential coverage" under new §5000A *(see* Form 8965 for exceptions)*:***

1. An applicable individual shall for each month <u>beginning after 2013</u> (delayed to 3/31/14) ensure that such individual <u>and</u> any dependent are covered under minimum essential coverage.

2. **Annual penalty for failure to comply is equal to the <u>lesser of</u>:**

   a. **<u>The sum of "monthly penalty amounts</u>" for months where a failure occurred; or**

   b. **An amount equal to the national average premium for Exchange plans that have a bronze level of coverage (the penalty cap).**

TI-ITP.18

Minimum Essential Coverage Penalty (No)

- Monthly penalty amount is equal to 1/12 of the **<u>greater of</u>**:

  1. **The "flat dollar amount," the lesser of:**

     a. **<u>$695</u>** <u>per individual</u> **($695 for 2018)** (the "applicable dollar amount") for all individuals where there was a failure to meet coverage requirements, and for persons not age 18, 50% of the normal amount); or

     b. <u>300% of the applicable dollar amount</u> for the calendar year; **or**

  2. **An amount equal to the following percentage of the excess of household income over the amount of AGI triggering the requirement to file a return under §6012(a)(1): 2.5% for 2018. (AGI - $12,000 (S) & $24,000 (MFJ))**

- **What is the penalty if a single individual with an AGI of $72,000 has no health insurance? (<u>ANS</u>: $1,500.) (What about MFJ & $94,000 & $1,750?)**

Minimum Essential Coverage Penalty (No)

- **Example: What is the penalty for a single T with household income of $72,000 ($60,000 more than filing requirement of AGI of $12,000)? In 2018, monthly penalty is 1/12 of the <u>greater</u> of:**

  1. **The flat dollar amount, which is the <u>lesser</u> of**

     a. **$695** ($325 x 1 adult); or

     b. $2,085 (300% x $325); or

  2. **$1,500** (25% x $60,000 excess household income).

- **<u>The penalty is $1,500</u>**.

<u>MFJ</u>	
AGI	**$94,000**
Less	**<u>(24,000)</u>**
Net	**$70,000**
x	**<u>2.5%</u>**
Penalty	**<u>$ 1,750</u>**

Penalty is greater of ($695 x 2) or $1,750.

Minimum Essential Coverage Penalty (No)

- Example: In 2018 H and W have three children under age 18 and fail to buy insurance. Household income exceeds the filing threshold amount by $20,000. The national average premium for bronze coverage is $6,000. The monthly penalty amount is 1/12 of the **greater of**:

1. The flat dollar amount, which is the **lesser of**

    a. $2,432.50 ($695 x 2 adults plus $347.50 x 3 children); or

    b. **$2,085** (300% x $695); or

2. $500 (2.5% x $20,000 excess household income).

- **The penalty is $2,085** (less than the $6,000 cap). But what is the cost of insurance compared to the penalty?

Minimum Essential Coverage Applicable Individuals and Exceptions (No)

1. Mandate applies to all individuals other than inmates, non-citizens/nationals and illegal aliens, and individuals who qualify for a religious conscience exemption or who are a member of a "health care sharing ministry."

2. But no penalty for:

a. Individuals who cannot afford coverage: If coverage offered through an employer or the lowest cost bronze plan available through an Exchange would cost the individual an amount in excess of 8% of household income.

b. Individuals whose household income is less than the amount of gross income requiring the individual to file a return under §6012(a)(1).

Minimum Essential Coverage Defined (Yes)

- **The term "minimum essential coverage" means any of the following:**

  1. Coverage under government sponsored programs such as **Medicare, Medicaid,** and CHIP.

  2. Coverage under a qualified employer-sponsored plan.

  3. Coverage under a health plan offered in the individual market within a State.

  4. Coverage under "grandfathered" health plans (existing employer plans) or plans recognized by the Secretary of HHS.

  5. **See Form 8965 (and instructions) and Notice 2014-76 for laundry list of exceptions. Sign up for health insurance offered by Religious Organizations. – Christian Healthcare Ministries, Medi-Share & Samaritan Ministries International. (For SE person, premium went from $2,500/mo. to $350/mo. by joining HCSM.)**

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF THE CHIEF COUNSEL

June 22, 2016

Number: **2016-0051**
Release Date: 9/30/2016

CONEX-118202-16

UIL: 106.00-00, 5000A.00-00

The Honorable Joseph Donnelly
U.S. House of Representatives
Washington, DC 20515

Attention:

Dear Representative Donnelly:

I am responding to your inquiry of June 3, 2016, on behalf of your constituent, . Your constituent asked if an employer can contribute to the premiums of employees who decline coverage in an employer group health plan and instead participate in a health care sharing ministry.

A health care sharing ministry (HCSM) is a tax-exempt organization. Its members share a common set of ethical or religious beliefs as well as medical expenses in accordance with those beliefs.

Members of a HCSM are exempt from the requirement in section 5000A of the Internal Revenue Code to keep minimum essential coverage. However, coverage by an HCSM is not minimum essential coverage. In addition, the law does not consider membership in an HCSM as health insurance and payments for participating in a HCSM are not deductible medical care.

Because participation in a HCSM is not employer-provided coverage under an accident or health plan, the law does not exclude employer payment for the cost of employee participation from the employee's gross income. Instead, the law considers it as taxable income and wages to the employee.

I hope this information is helpful. If you have questions, please call me at or at .

Sincerely,

Christine Ellison, Acting Chief
Health and Welfare Branch
Office of Associate Chief Counsel
(Tax Exempt and Government Entities)

Department of the Treasury – Partial Response to Representative Joseph Donnelly Dated June 22, 2016

- **Members of a HCSM are exempt from the requirement in section 5000A of the Internal Revenue Code to keep minimum essential coverage. However, coverage by an HCSM is not minimum essential coverage. In addition, the law does not consider membership in an HCSM as health insurance and <u>payments for participating in a HCSM are not deductible medical care</u>.**

- **Because participation in a HCSM is not employer-provided coverage under an accident or health plan, the law does not exclude employer payment for the cost of employee participation from the employee's gross income. Instead, the law considers it as taxable income and wages to the employee.**

Minimum Essential Coverage How Will the IRS Collect the Penalty? (Yes)

- Any penalty shall be included with the taxpayer's return for the year in which there was a failure in any month.

- The penalty shall be paid upon notice and demand and shall be assessed and collected in the same manner as an assessable penalty under §§6671-6725, except:

  1. No taxpayer shall be subject to any criminal prosecution or criminal penalty for failure to timely pay the penalty; and

  2. **<u>The IRS may not file a notice of lien or levy on any property in connection with the failure to pay the penalty</u> (<u>private debt collectors</u>). But it can offset refunds, including those due to refundable credits! Estimate that 4 million middle and lower-income individuals will pay $4 billion in penalties.**

2010 Health Care Act Subsidized Coverage (No)

- **Individuals to be covered by a State Exchange-offered plan may be eligible for:**

  1. **A "premium assistance tax credit" (discussed below); and/or**

  2. **Reduced cost-sharing for items such as deductibles and co-payments, funded by the Federal government.**

- **<u>These benefits will apply to persons with household incomes that do not exceed 400% of the Federal poverty line (FPL</u>). For 2018, FPL is $12,140 for an individual (400% is $48,560) and $25,100 for a family of four (400% is $100,400) – But higher in Alaska ($15,180 for one & $31,380 for four) & Hawaii ($13,960 for one & $28,870 for four).**

Premium Assistance Refundable Credit Examples of Maximum Annual Premium (No)

Applying the applicable percentages to **2018** FPL amounts results in <u>maximum annual premiums</u>, by family size, equal to:

FPL %	**%**	**Number of Family Members**			
		1	**2**	**3**	**4**
100%	2.01%	$244	$331	$418	$505
150%	3.02%	$550	$746	$941	$1,137
200%	6.34%	$1,540	$2,087	$2,635	$3,183
300%	8.10%	$2,950	$4,000	$5,050	$6,099
400%	9.56%	$4,642	$6,294	$7,946	$9,598
FPL	100%	**$12,140**	**$16,460**	**$20,780**	**$25,100**

Premium Assistance Refundable Credit Final Regulations (No)

- Final Reg. §1.36B-1 to -5.

1. The premium credit is available even if an employer offers minimum essential coverage if that coverage is "unaffordable" or does not provide "minimum value."

   a. To provide minimum value, plan must cover 60% of the total allowed costs of benefits provided under the plan. See proposed regulations (REG-125398-12) under §36B as to calculation of minimum value.

   b. A plan is "affordable" only if the portion of the annual premium the employee must pay for "self-only" coverage does not exceed 9.5% of the employee's household income. Does not matter if employee share for family coverage exceeds 9.5%. Controversy.

IRS Guidance on HRAs (Yes)

- **In Notice 2013-54 – Huh?**

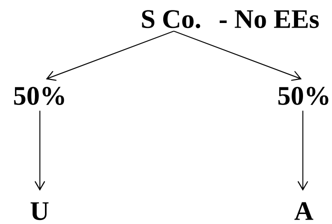
1. Provides guidance on the application of the market reforms under the Health Care Act to health reimbursement arrangements (HRAs), health flexible spending arrangements (health FSAs), and employer payment plans (EPPs).

   a. Point: Such employer arrangements can be integrated with group health plans to determine if market reform requirements are met.

   b. Rule: Cannot use an HRA to pay premiums at an Exchange and also get the premium credit under §36B. Employees may not receive both the credit and the tax-free reimbursements from the employer.

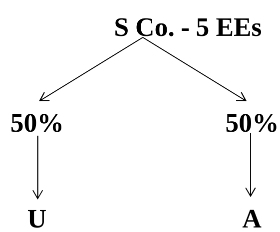
   – **Employer may not pay the premiums on behalf of an employee and treat the premium as a fringe benefit under § 106 unless the payment is for group health insurance or the amount is treated as compensation.**

IRS Guidance and Notice 2015-17 (Yes)



S Co. pays health insurance premiums on behalf of U & A. U & A sign up for health insurance by acquiring individual plans that meet their specific needs. **<u>ANS</u>: Not in violation of Notice 2013-54 since not a fringe under § 106. Box 1 wages, but not Box 3 & Box 5 wages. <u>See Notice 2008-1 & Ann. 92-16 and Notice 2015-17</u>. Also not an eligible employee under the Cures Act.**

IRS Guidance and Notice 2015-17 (Yes)



<u>Options</u>:

1. **Group Health Ins. Plan – Yes**
2. **Box 1, Box 3 & Box 5 – Yes**
3. ***<u>See</u>* <u>21st Century Cures Act</u> (QSEHRA):**
   - **Not ALE & no group health plan**
   - **Reimburse $5,050 ($10,250 if family)**
   - **No premium credit available**

S Co. pays health insurance premiums on behalf of U & A and five EEs, and treats the amount paid on behalf of five EEs as a fringe benefit under § 106. All EEs and U & A sign up for health insurance by acquiring individual plans that meet their specific needs. **<u>ANS</u>: Premiums paid on behalf of U & A should be Box 1 wages, but not Box 3 & Box 5 wages. <u>Notice 2015-17</u> – Premiums paid on behalf of five EEs in violation of ACA & §4980D unless premiums are paid for group health insurance. What happens if have eight employees and only five need insurance?**

Employer Payment of Employee Coverage Provided Under a Spouse's Group Health Plan CCA 201547006 – (Yes)

- **An employer may exclude from an employee's gross income payments for the cost of health insurance coverage provided through the spouse's group health plan, but only to the extent the spouse has paid for all or part of the coverage on an after-tax basis. No exclusion from income is available where coverage is paid through salary-reduction under a § 125 cafeteria plan.**

- **Who should a small ER hire if they want to guarantee that their EEs have health insurance? Questions:**
  1. **Are you married?**
  2. **Does your spouse work for federal or state government (ALE)?**
  3. **Are you entitled to participate in your spouse's health plan?**

  You are hired if you answer YES to all questions. Why?

Long-Term Care Insurance Eligible Deductible Premiums in 2018

Age 40 or less:	**$420**
Age 41-50:	**$780**
Age 51-60:	**$1,560**
Age 61-70:	**$4,160**
Over age 70:	**$5,200**

- **Would you recommend that a client purchase long-term care insurance? Think of Dr. Kevorkian & hospice?**

THE END

Thank you for attending!

Prof. Edward J. Roche, Jr.
Ret. Prof. Mark A. Vogel

International Tax Potpourri

Mark M. Hrenya
Hrenya Senatore LLP, Denver, CO

John R. Wilson
Holland & Hart LLP, Denver, CO
and Graduate Tax Program

Tax Cuts and Jobs Act International Provisions

Mark M. Hrenya and John R. Wilson

International Tax Potpourri
Denver Tax Institute
July 24, 2018

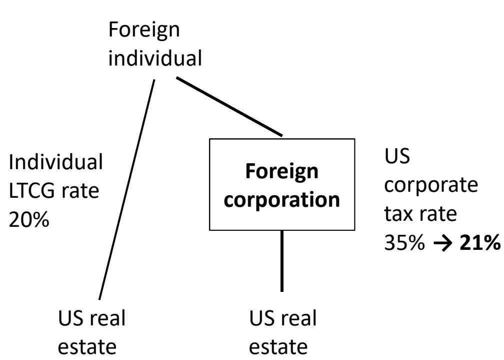
INBOUND

1. Classification of taxpayers.
2. Estate and gift tax considerations.
3. Nonbusiness (FDAP) income and withholding.
4. FATCA withholding regime.
5. Business (effectively connected) income.
6. Special rules for real estate: net election and FIRPTA.
7. Repatriating U.S. earnings.
8. Inbound compliance.

U.S. ESTATE AND GIFT TAXATION

U.S. Citizens/Residents (residence determined under domicile test)	**Nonresidents**
Transfers of worldwide assets subject to tax	Only transfers of "U.S.-situs" assets potentially subject to tax
Lifetime exemption via unified credit ($11.18 million in 2018)	Lower exemption via credit at death ($60,000)
Annual gift exclusion ($15,000 in 2018)	Same, but most transfers of intangible property exempt
Unlimited marital deduction if citizen spouse, QDOT rules and annual exclusion for marital gifts ($152,000 in 2018) if noncitizen spouse	Same
No relief under U.S. treaties	Treaties may provide relief

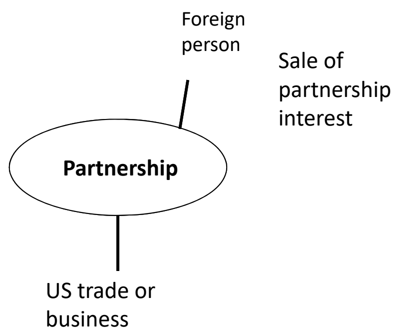
EFFECT OF 2017 TAX ACT



Traditionally, the standard planning approach of blocking the U.S. estate tax by interposing a foreign corporation may have created a U.S. income tax cost.

The new lower corporate rate will lessen this effect, making planning easier.

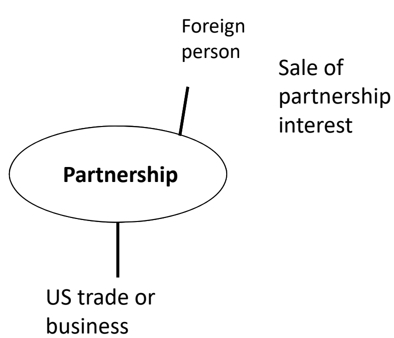
ECI ON SALE OF PARTNERSHIP INTEREST?



Suppose a foreign person owns an interest in a partnership with a U.S. trade or business. The foreign person sells its partnership interest.

Is the foreign person subject to ECI taxation on the gain attributable to the underlying U.S. trade or business assets?

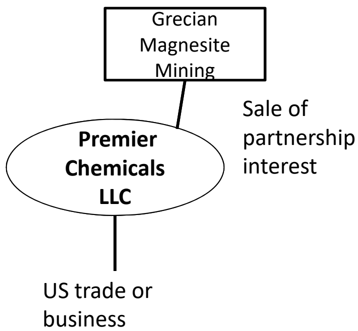
ECI ON SALE OF PARTNERSHIP INTEREST?



In Rev. Rul. 91-32, the IRS asserted that the answer was “yes”.

There was, however, no statutory support for this.

GRECIAN MAGNESITE MINING

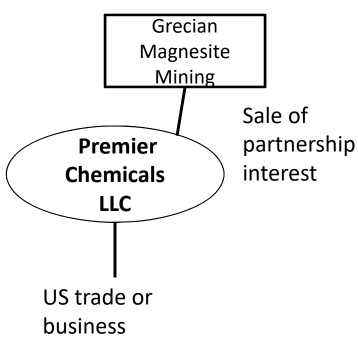


Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (2017), addressed these facts.

The taxpayer was a Greek corporation that invested in a U.S. LLC treated as a partnership for U.S. tax purposes.

The Greek corporation's partnership interest was later redeemed.

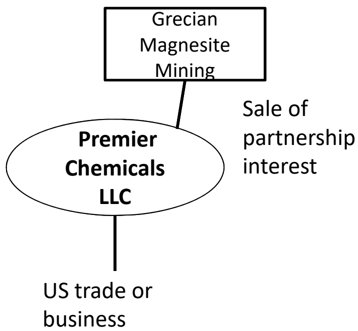
GRECIAN MAGNESITE MINING



Part of the recognized gain was clearly subject to U.S. tax under FIRPTA, to the extent attributable to the U.S. real property held by the LLC. *See* IRC § 897(g); Temp. Reg. § 1.897-7T.

As to the remaining gain, the Tax Court declined to follow Rev. Rul. 91-32, finding that the gain was treated as gain from the sale of a capital asset, the partnership interest, under the plain language of the statute. *See* IRC § 741.

GRECIAN MAGNESITE MINING



The gain was foreign-source income by default under Section 865(a), and was not attributable to a U.S. office within the meaning of Sections 865(e)(2) and 864(c)(5). The LLC's office was not treated as the Greek corporation's office for this purpose.

The Tax Court declined to impose penalties under Section 6662 with respect to the incorrectly reported FIRPTA portion of the gain. Although the Greek corporation was the preparer's first international client, the Greek corporation had no reason to believe that the preparer was not competent, and the Forms 1120-F for earlier years had been prepared correctly. The Greek corporation therefore had reasonable cause and acted in good faith.

The government is appealing the Tax Court's decision to the D.C. Circuit.

2017 TAX ACT: OVERRULE OF GRECIAN MAGNESITE MINING

1. Gain or loss from the sale or exchange of a partnership interest is ECI to the extent the transferor would have had ECI had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. *See* New IRC § 864(c)(8).

2. The transferee of a partnership interest must withhold 10 percent of the amount realized unless the transferor certifies its U.S. status. If the transferee fails to withhold the correct amount, the partnership is required to withhold the underage from distributions to the transferee partner.

   See Notice 2018-8 (PTP notice); Notice 2018-29 (guidance on forthcoming regulations; no withholding required on partnership distributions until further guidance).

SECTION 864(c)(8)

IRC 864(c)(8) Gain or loss of foreign persons from sale or exchange of certain partnership interests.

(A) In general. Notwithstanding any other provision of this subtitle, if a nonresident alien individual or foreign corporation owns, directly or indirectly, an interest in a partnership which is engaged in any trade or business within the United States, gain or loss on the sale or exchange of all (or any portion of) such interest shall be treated as effectively connected with the conduct of such trade or business to the extent such gain or loss does not exceed the amount determined under subparagraph (B).

SECTION 864(c)(8)

IRC 864(c)(8) Gain or loss of foreign persons from sale or exchange of certain partnership interests.

* * *

(B) Amount treated as effectively connected. The amount determined under this subparagraph with respect to any partnership interest sold or exchanged—

(i) in the case of any gain on the sale or exchange of the partnership interest, is—

(I) the portion of the partner's distributive share of the amount of gain which would have been effectively connected with the conduct of a trade or business within the United States if the partnership had sold all of its assets at their fair market value as of the date of the sale or exchange of such interest, or

(II) zero if no gain on such deemed sale would have been so effectively connected, and

(ii) in the case of any loss on the sale or exchange of the partnership interest, is—

(I) the portion of the partner's distributive share of the amount of loss on the deemed sale described in clause (i)(I) which would have been so effectively connected, or

(II) zero if no loss on such deemed sale would be have been so effectively connected.

For purposes of this subparagraph, a partner's distributive share of gain or loss on the deemed sale shall be determined in the same manner as such partner's distributive share of the non-separately stated taxable income or loss of such partnership.

(C) Coordination with United States real property interests. If a partnership described in subparagraph (A) holds any United States real property interest (as defined in section 897(c)) at the time of the sale or exchange of the partnership interest, then the gain or loss treated as effectively connected income under subparagraph (A) shall be reduced by the amount so treated with respect to such United States real property interest under section 897.

SECTION 1446(f)

IRC § 1446(f) Special rules for withholding on dispositions of partnership interests.

(1) In general. Except as provided in this subsection, if any portion of the gain (if any) on any disposition of an interest in a partnership would be treated under section 864(c)(8) as effectively connected with the conduct of a trade or business within the United States, the transferee shall be required to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition.

SECTION 1446(f)

IRC § 1446(f) Special rules for withholding on dispositions of partnership interests.

(2) Exception if nonforeign affidavit furnished.

(A) In general. No person shall be required to deduct and withhold any amount under paragraph (1) with respect to any disposition if the transferor furnishes to the transferee an affidavit by the transferor stating, under penalty of perjury, the transferor's United States taxpayer identification number and that the transferor is not a foreign person.

(3) Authority of secretary to prescribe reduced amount. At the request of the transferor or transferee, the Secretary may prescribe a reduced amount to be withheld under this section if the Secretary determines that to substitute such reduced amount will not jeopardize the collection of the tax imposed under this title with respect to gain treated under section 864(c)(8) as effectively connected with the conduct of a trade or business with in the United States.

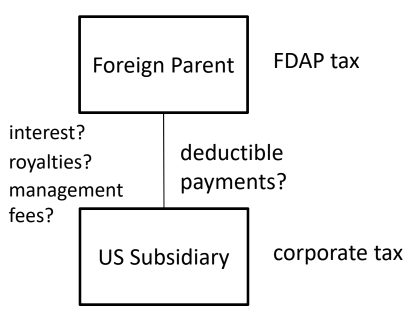
SECTION 1446(f)

IRC § 1446(f) Special rules for withholding on dispositions of partnership interests.

(4) Partnership to withhold amounts not withheld by the transferee. If a transferee fails to withhold any amount required to be withheld under paragraph (1), the partnership shall be required to deduct and withhold from distributions to the transferee a tax in an amount equal to the amount the transferee failed to withhold (plus interest under this title on such amount).

See Notice 2018-8 (PTP notice); Notice 2018-29 (guidance on forthcoming regulations; no withholding required under IRC § 1446(f)(4) until further guidance).

OBJECTIVE OF INBOUND FINANCING



These sorts of payments are generally referred to as "earnings stripping" payments.

Inbound structures are in theory subject to two U.S. taxes, the corporate tax on the subsidiary and the FDAP withholding taxes on payments to the foreign parent.

However, certain intercompany payments that are deductible by the subsidiary and not taxable to the parent can eliminate both U.S. taxes as a practical matter.

DOS AND DON'TS OF INBOUND FINANCING

Do maximize deductible "earnings stripping" payments to foreign persons, which payments are subject to little or no U.S. withholding or other tax (e.g., interest, royalties, management fees), but:

1. Don't be a pig.

   (arm's-length principle, Section 163(j) limitation on interest deductions, new Section 59A base erosion and anti-avoidance tax)

2. Don't be an impostor.

   (conduit financing regulations, treaty limitations on benefits)

3. Don't game the tax systems.

   (limitations on hybrid financing structures)

NEW DEBT-EQUITY REGULATIONS

In October 2016, the IRS finalized new, highly controversial debt-equity regulations. If these regulations survive the Trump Administration, they will be critically important to inbound financing. The regulations include:

1. Documentation requirements: Treas. Reg. § 1.385-2.
2. Debt instruments issued in distributions and similar transactions treated as stock: Treas. Reg. § 1.385-3.

OLD SECTION 163(j)

Prior to the 2017 tax act, in addition to traditional debt-equity principles, the otherwise available interest deduction for corporations had to pass muster under the formula limitations of Section 163(j), added in 1989.

Old Section 163(j) was repealed and replaced by the 2017 tax act.

OLD SECTION 163(j)

1. End of year debt: equity > 1.5 : 1.
2. Excess interest expense: interest > 50% of "adjusted taxable income."
3. Disqualified interest: interest paid to related person subject to treaty relief, or not subject to gross-basis U.S. tax and covered by "disqualified guarantee."
4. Disallowance was lesser of excess interest expense and disqualified interest, carried forward to future years.
5. Reporting required on Form 8926.

NEW SECTION 163(j)

1. New Section 163(j) is a rule of general application, not limited to inbound taxpayers or corporations.
2. It generally denies deductions for interest in excess of 30 percent of adjusted taxable income.
3. Disallowed interest is treated as paid in the succeeding taxable year, subject to the same limitation.
4. Small businesses and certain other businesses, most notably real estate businesses, are exempted from the limitation.

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(1) In general.

The amount allowed as a deduction under this chapter for any taxable year for business interest shall not exceed the sum of—

(A) the business interest income of such taxpayer for such taxable year,

(B) 30 percent of the adjusted taxable income of such taxpayer for such taxable year, plus

(C) the floor plan financing interest of such taxpayer for such taxable year.

The amount determined under subparagraph (B) shall not be less than zero.

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(2) Carryforward of disallowed business interest.

The amount of any business interest not allowed as a deduction for any taxable year by reason of paragraph (1) shall be treated as business interest paid or accrued in the succeeding taxable year.

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(3) Exemption for certain small businesses.

In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, paragraph (1) shall not apply to such taxpayer for such taxable year. In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if such taxpayer were a corporation or partnership.

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(5) Business interest.

For purposes of this subsection, the term "business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. Such term shall not include investment interest (within the meaning of subsection (d)).

(6) Business interest income.

For purposes of this subsection, the term "business interest income" means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Such term shall not include investment income (within the meaning of subsection (d)).

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(7) Trade or business.

For purposes of this subsection—

(A) In general. The term "trade or business" shall not include—

(i) the trade or business of performing services as an employee,

(ii) any electing real property trade or business,

(iii) any electing farming business, or

NEW SECTION 163(j)

IRC § 163(j) Limitation on business interest.

(8) Adjusted taxable income.

For purposes of this subsection, the term "adjusted taxable income" means the taxable income of the taxpayer—

(A) computed without regard to—

(i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,

(ii) any business interest or business interest income,

(iii) the amount of any net operating loss deduction under section 172,

(iv) the amount of any deduction allowed under section 199A, and

(v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion, and

(B) computed with such other adjustments as provided by the Secretary.

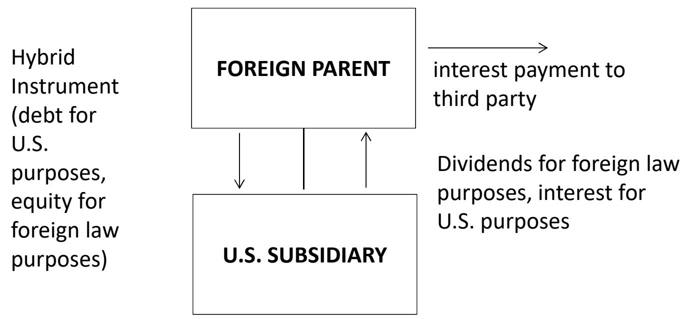
HYBRID FINANCING EXAMPLES

Suppose that a treaty parent company wishes to borrow funds from an unrelated bank and pass on the funds for use by its U.S. subsidiary. Assume that dividends, as viewed by the foreign country, are not subject to tax. Can the parent and the U.S. subsidiary both obtain an interest deduction in their respective countries (a "double dip")? Consider:

1. Hybrid entities
2. Treaty shopping structures
3. Reverse hybrid entities
4. Hybrid instruments

Until the 2017 tax act, some of these structures obtained the desired result, while others were blocked. Now see new Section 267A.

HYBRID INSTRUMENT



NEW SECTION 267A

IRC § 267A. Certain related party amounts paid or accrued in hybrid transactions or with hybrid entities.

(a) In general.

No deduction shall be allowed under this chapter for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity.

NEW SECTION 267A

IRC § 267A. Certain related party amounts paid or accrued in hybrid transactions or with hybrid entities.

(c) Hybrid transaction.

For purposes of this section, the term "hybrid transaction" means any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for purposes of this chapter and which are not so treated for purposes the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

NEW SECTION 267A

IRC § 267A. Certain related party amounts paid or accrued in hybrid transactions or with hybrid entities.

(d) Hybrid entity.

For purposes of this section, the term "hybrid entity" means any entity which is either—

(1) treated as fiscally transparent for purposes of this chapter but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or

(2) treated as fiscally transparent for purposes of such tax law but not so treated for purposes of this chapter.

NEW SECTION 59A: THE BEAT

1. New Section 59A, added by the 2017 tax act, is termed the "base erosion and anti-avoidance tax," or "BEAT." It restricts earnings stripping through a new minimum tax.
2. The BEAT generally applies at a 10 percent rate (5 percent for 2018) and is computed without deductions for earnings stripping items.
3. The BEAT applies only to large C corporations, those with average gross receipts of $500 million or greater.
4. Although the BEAT was principally designed for inbound structures, it can also apply to U.S. multinationals with foreign operations.

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(a) Imposition of tax.

There is hereby imposed on each applicable taxpayer for any taxable year a tax equal to the base erosion minimum tax amount for the taxable year. Such tax shall be in addition to any other tax imposed by this subtitle.

BEAT OBSERVATIONS

1. The BEAT rules will seemingly have greater application to thin-margin taxpayers.
2. The BEAT liability is computed with allowance for business credits, including the research credit, but not for other credits, including the foreign tax credit.
3. Since the BEAT applies to deductions (including depreciation), the characterization of transactions (e.g., royalties vs. COGS) will be important.
4. The general Section 163(j) limitation on interest will be applied first to unrelated interest, leaving related interest subject to disallowance for BEAT purposes.

MORE BEAT OBSERVATIONS

1. The BEAT applies only if the "base erosion percentage" (amount of base erosion deductions to total deductions) is at least 3 percent (2 percent for banks or registered securities dealers). This creates a cliff effect.
2. To the extent a FDAP withholding tax applies to the payment, the payment is not treated as a base erosion payment (proportional to the amount of such tax).
3. Certain service payments qualifying for the services cost method under Treas. Reg. § 1.482-9 are not treated as base erosion payments.

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(b) Base erosion minimum tax amount.

For purposes of this section—

(1) In general.

Except as provided in paragraphs (2) and (3), the term 'base erosion minimum tax amount' means, with respect to any applicable taxpayer for any taxable year, the excess (if any) of—

(A) an amount equal to 10 percent (5 percent in the case of taxable years beginning in calendar year 2018) of the modified taxable income of such taxpayer for the taxable year, over

(B) an amount equal to the regular tax liability (as defined in section 26(b)) of the taxpayer for the taxable year, reduced (but not below zero) by the excess (if any) of—

(i) the credits allowed under this chapter against such regular tax liability, over

(ii) the sum of—

(I) the credit allowed under section 38 for the taxable year which is properly allocable to the **research credit** determined under section 41(a), plus

(II) the portion of the applicable section 38 credits not in excess of 80 percent of the lesser of the amount of such credits or the base erosion minimum tax amount (determined without regard to this subclause).

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(c) Modified taxable income.

For purposes of this section—

(1) In general.

The term 'modified taxable income' means the taxable income of the taxpayer computed under this chapter for the taxable year, determined without regard to—

(A) any base erosion tax benefit with respect to any base erosion payment, or

(B) the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year.

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(c) Modified taxable income.

For purposes of this section—

(2) Base erosion tax benefit.

(A) In general. The term 'base erosion tax benefit' means—

(i) any deduction described in subsection (d)(1) which is allowed under this chapter for the taxable year with respect to any base erosion payment,

(ii) in the case of a base erosion payment described in subsection (d)(2), any deduction allowed under this chapter for the taxable year for depreciation (or amortization in lieu of depreciation) with respect to the property acquired with such payment,

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(d) Base erosion payment.

For purposes of this section—

(1) In general.

The term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter.

(2) Purchase of depreciable property.

Such term shall also include any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer in connection with the acquisition by the taxpayer from such person of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation).

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(d) Base erosion payment.

For purposes of this section—

(5) Exception for certain amounts with respect to services.

Paragraph (1) shall not apply to any amount paid or accrued by a taxpayer for services if—

(A) such services are services which meet the requirements for eligibility for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure), and

(B) such amount constitutes the total services cost with no markup component.

If the services are marked up, how does this exception apply?

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(c) Modified taxable income.

For purposes of this section—

(2) Base erosion tax benefit.

(B) Tax benefits disregarded if tax withheld on base erosion payment.

(i) In general. Except as provided in clause (ii), any base erosion tax benefit attributable to any base erosion payment—

(I) on which tax is imposed by section 871 or 881, and

(II) with respect to which tax has been deducted and withheld under section 1441 or 1442,

shall not be taken into account in computing modified taxable income under paragraph (1)(A) or the base erosion percentage under paragraph (4).

(ii) Exception. The amount not taken into account in computing modified taxable income by reason of clause (i) shall be reduced under rules similar to the rules under section 163(j)(5)(B) (as in effect before the date of the enactment of the Tax Cuts and Jobs Act).

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(c) Modified taxable income.

For purposes of this section—

(3) Special rules for determining interest for which deduction allowed.

For purposes of applying paragraph (1), in the case of a taxpayer to which section 163(j) applies for the taxable year, the reduction in the amount of interest for which a deduction is allowed by reason of such subsection shall be treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties.

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(e) Applicable taxpayer.

For purposes of this section—

(1) In general.

The term 'applicable taxpayer' means, with respect to any taxable year, a taxpayer—

(A) which is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation,

(B) the average annual gross receipts of which for the 3-taxable-year period ending with the preceding taxable year are at least $500,000,000, and

(C) the base erosion percentage (as determined under subsection (c)(4)) of which for the taxable year is 3 percent (2 percent in the case of a taxpayer described in subsection (b)(3)(B)) or higher.

NEW SECTION 59A

IRC § 59A Tax on base erosion payments of taxpayers with substantial gross receipts.

(c) Modified taxable income.

For purposes of this section—

(4) Base erosion percentage.

For purposes of paragraph (1)(B)—

(A) In general. The term 'base erosion percentage' means, for any taxable year, the percentage determined by dividing—

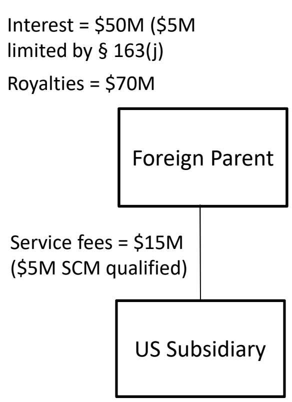
(i) the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year, by

(ii) the sum of—

(I) the aggregate amount of the deductions (including deductions described in clauses (i) and (ii) of paragraph (2)(A)) allowable to the taxpayer under this chapter for the taxable year, plus

(II) the base erosion tax benefits described in clauses (iii) and (iv) of paragraph (2)(A) allowable to the taxpayer for the taxable year.

BEAT EXAMPLE



Tax liability before BEAT:

$100 million * 21% - $5 million tax credits

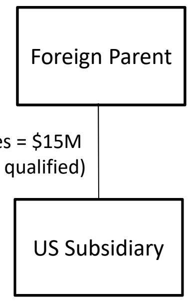
= $16 million

Gross receipts = $500M
Taxable income = $100M
$5M tax credits ($3M from R&D credit)

BEAT EXAMPLE

Interest = $50M ($5M limited by § 163(j)

Royalties = $70M



Service fees = $15M ($5M SCM qualified)

Gross receipts = $500M
Taxable income = $100M
$5M tax credits ($3M from R&D credit)

Base erosion payments:

Interest not subject to § 163(j):	$45M
Royalties:	$70M
Non-SCM service fees	<u>$10M</u>
Total	$125M

Base erosion percentage:

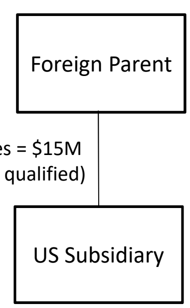
Base erosion payments/total deductions

= $125M/$400 ≥ 3%

BEAT EXAMPLE

Interest = $50M ($5M limited by § 163(j)

Royalties = $70M



Service fees = $15M ($5M SCM qualified)

Gross receipts = $500M
Taxable income = $100M
$5M tax credits ($3M from R&D credit)

Regular tax floor:
Regular tax less tax credits, excluding R&D credit

= $21M - $2M = $19M

Modified taxable income:
Taxable income + Base erosion payments

= $100M + $125M = $225M

BEAT liability:
10% * $225M - $19M = $3.5M

Total tax liability:
$16M + $3.5M = $19.5M

OUTBOUND

1. U.S. expatriate taxation (Section 911).
2. Foreign tax credit.
3. Classification of foreign entities (check the box).
4. Subpart F (controlled foreign corporations).
5. New GILTI, FDII and dividend exemption rules.
6. International restructurings.
7. Transfer pricing.
8. Passive foreign investment companies.
9. Outbound compliance.

FOREIGN TAX CREDIT

FOREIGN TAX CREDIT CHANGES

1. The foreign tax credit continues to be crucially important despite the partial move to an exemption system.
2. For example, if a taxpayer operates in a pass-through structure, worldwide taxation (credit system) will still apply.
3. The foreign tax credit now is separately basketed for two new categories of income: foreign branch income (broken out from general limitation income) and income taxed under the new GILTI rules.

SECTION 904 BASKETING

IRC § 904(d) Separate application of section with respect to certain categories of income.

(1) In general.

The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to—

(A) any amount includible in gross income under section 951A (other than passive category income)

(B) foreign branch income,

(C) passive category income, and

(D) general category income.

GENERAL AND PASSIVE BASKETS

IRC § 904(d)(2) Definitions and special rules.

For purposes of this subsection—

(A) Categories.

(i) Passive category income. The term "passive category income" means passive income and specified passive category income.

(ii) General category income. The term "general category income" means income other than income described in paragraph (1)(A), foreign branch income, and passive category income.

PASSIVE INCOME

IRC § 904(d)(2)(B) Passive income.

(i) In general. Except as otherwise provided in this subparagraph, the term "passive income" means any income received or accrued by any person which is of a kind which would be foreign personal holding company income (as defined in section 954(c)).

(ii) Certain amounts included. Except as provided in clause (iii), the term "passive income" includes, except as provided in subparagraph (E)(iii) or paragraph (3)(I), any amount includible in gross income under section 1293 (relating to certain passive foreign investment companies).

(iii) Exceptions. The term "passive income" shall not include—

(I) any export financing interest, and

(II) any high-taxed income.

FOREIGN PERSONAL HOLDING COMPANY INCOME

IRC § 954(c) Foreign personal holding company income.

(1) In general.

For purposes of subsection (a)(1), the term "foreign personal holding company income" means the portion of the gross income which consists of:

(A) Dividends, etc. Dividends, interest, royalties, rents, and annuities.

HIGH-TAXED INCOME

IRC § 904(d)(2)(F) High-taxed income.

The term "high-taxed income" means any income which (but for this subparagraph) would be passive income if the sum of—

(i) the foreign income taxes paid or accrued by the taxpayer with respect to such income, and

(ii) the foreign income taxes deemed paid by the taxpayer with respect to such income under section 902 or 960,

exceeds the highest rate of tax specified in section 1 or 11 (whichever applies) multiplied by the amount of such income (determined with regard to section 78). For purposes of the preceding sentence, the term "foreign income taxes" means any income, war profits, or excess profits tax imposed by any foreign country or possession of the United States.

FOREIGN BRANCH INCOME

IRC § 904(d)(2)(J) Foreign branch income.

(i) In general. The term "foreign branch income" means the business profits of such United States person which are attributable to 1 or more qualified business units (as defined in section 989(a)) in 1 or more foreign countries. For purposes of the preceding sentence, the amount of business profits attributable to a qualified business unit shall be determined under rules established by the Secretary.

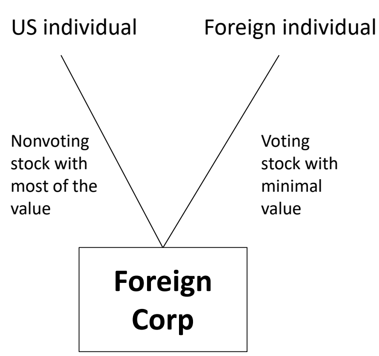
(ii) Exception. Such term shall not include any income which is passive category income.

SUBPART F

SUBPART F CHANGES

1. Change to definitions of CFC and U.S. shareholder.
2. Elimination of Section 958(b)(4) prohibition on downward attribution.
3. Elimination of 30-day requirement for Subpart F inclusion.
4. Impact of lower corporate tax rate on high tax exception.

DEFINITION OF CONTROLLED FOREIGN CORPORATION



Suppose a U.S. individual owns all the nonvoting stock of a foreign corporation with most of the value. A foreign individual owns all the voting stock with minimal value. Is the foreign corporation a CFC?

Formerly, assuming that this ownership was respected, the foreign corporation was not a CFC, because the US individual was not a "U.S. shareholder." The 2017 tax act changes this result.

DEFINITION OF CONTROLLED FOREIGN CORPORATION

IRC § 957 Controlled foreign corporations; United States persons.

(a) General rule.

For purposes of this title, the term "controlled foreign corporation" means any foreign corporation if more than 50 percent of—

(1) the total combined voting power of all classes of stock of such corporation entitled to vote, or

(2) the total value of the stock of such corporation,

is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

DEFINITION OF U.S. SHAREHOLDER (BEFORE 2017 TAX ACT)

IRC § 951(b) United States shareholder defined.

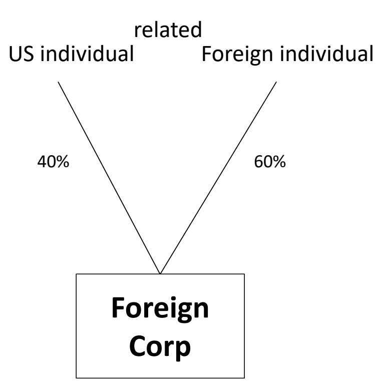
For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined **voting** power of all classes of stock entitled to vote of such foreign corporation.

DEFINITION OF U.S. SHAREHOLDER (AFTER 2017 TAX ACT)

IRC § 951(b) United States shareholder defined.

For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

DEFINITION OF CONTROLLED FOREIGN CORPORATION



But what if the daughter owns an interest in a U.S. partnership?

A U.S. individual owns 40% of a foreign corporation. His foreign daughter owns the remaining 60%. Is the foreign corporation a CFC? Who are the "U.S. shareholders"?

This corporation is not a CFC, and the U.S. individual is not a U.S. shareholder, because the shares held by the foreign individual are not attributed under Section 958(b)(1).

CONSTRUCTIVE OWNERSHIP (BEFORE 2017 TAX ACT)

IRC § 958(b) Constructive ownership.

For purposes of sections 951(b), 954(d)(3), 956(c)(2), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation for purposes of section 956(c)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957, except that—

(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

(2) In applying subparagraphs (A), (B), and (C) of section 318(a)(2) , if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

(3) In applying subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C) .

(4) Subparagraphs (A), (B), and (C) of section 318(a)(3) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

Paragraphs (1) and (4) shall not apply for purposes of section 956(c)(2) to treat stock of a domestic corporation as not owned by a United States shareholder.

CONSTRUCTIVE OWNERSHIP (AFTER 2017 TAX ACT)

IRC § 958(b) Constructive ownership.

For purposes of sections 951(b), 954(d)(3), 956(c)(2), and 957, section 318(a) (relating to constructive ownership of stock) shall apply to the extent that the effect is to treat any United States person as a United States shareholder within the meaning of section 951(b), to treat a person as a related person within the meaning of section 954(d)(3), to treat the stock of a domestic corporation as owned by a United States shareholder of the controlled foreign corporation for purposes of section 956(c)(2), or to treat a foreign corporation as a controlled foreign corporation under section 957, except that—

(1) In applying paragraph (1)(A) of section 318(a), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.

(2) In applying subparagraphs (A), (B), and (C) of section 318(a)(2) , if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

(3) In applying subparagraph (C) of section 318(a)(2), the phrase "10 percent" shall be substituted for the phrase "50 percent" used in subparagraph (C) .

(4) [Stricken.]

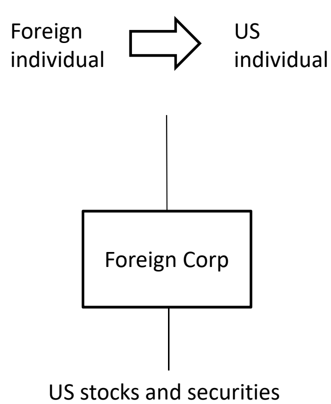
Paragraph (1) shall not apply for purposes of section 956(c)(2) to treat stock of a domestic corporation as not owned by a United States shareholder.

LEGISLATIVE HISTORY

Conference Report:

"Furthermore, the Senate Finance Committee explanation states that the provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under Section 318(a)(3) to a U.S. person that is not a related person (within the meaning of Section 954(d)(3)) to such U.S. shareholder as a result of the repeal of Section 958(b)(4)."

ELIMINATION OF 30-DAY RULE



A foreign individual holds publicly traded US stocks and securities through a an eligible foreign entity (treated as a corporation for U.S. tax purposes) to block the U.S. estate tax.

The foreign individual dies and leaves the foreign entity to his U.S. daughter, who makes a check-the box election for the entity, effective five days after the foreign individual's death.

Does the U.S. daughter have Subpart F income on the deemed liquidation of the entity?

SECTION 951(a) (BEFORE 2017 ACT)

IRC § 951 Amounts included in gross income of United States shareholders.

(a) Amounts included.

(1) In general.

If a foreign corporation is a controlled foreign corporation **for an uninterrupted period of 30 days or more during any taxable year,** every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

SECTION 951(a) (AFTER 2017 ACT)

IRC § 951 Amounts included in gross income of United States shareholders.

(a) Amounts included.

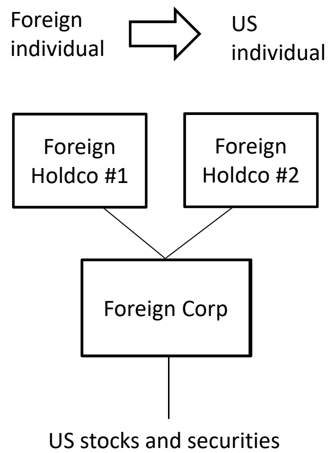
(1) In general.

If a foreign corporation is a controlled foreign corporation **at any time during any taxable year,** every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

POSSIBLE SOLUTION



Check the box for lower-tier entity soon before death (creating taxable liquidation not subject to U.S. tax, but stepping up basis of U.S. assets); check the box for upper tier entities soon after death.

HIGH TAX EXCEPTION

IRC § 954(b)(4) Exception for certain income subject to high foreign taxes.

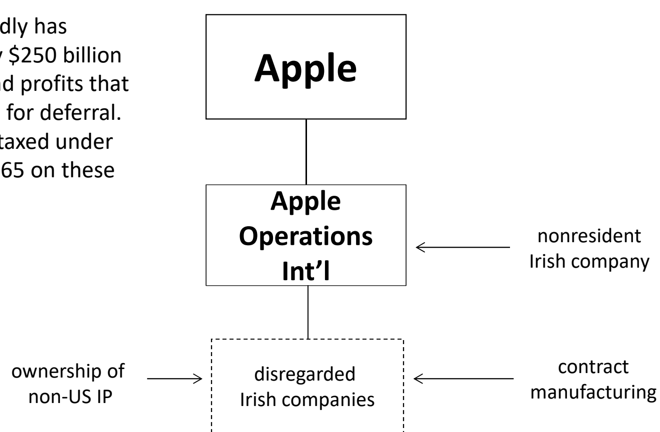
For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11.

90% * 21% = 18.9%

SECTION 965

APPLE

Apple reportedly has approximately $250 billion of earnings and profits that have qualified for deferral. How is Apple taxed under new Section 965 on these earnings?



Low tax earnings qualifying for deferral

SECTION 965

1. For the last taxable year of a "deferred foreign income corporation" beginning before January 1, 2018, the Subpart F income of such corporation is increased by the greater of the "accumulated post-1986 deferred foreign income" of such corporation on either November 2, 2017 or December 31, 2017.
2. A "deferred foreign income corporation" is a "specified foreign corporation" of a 10-percent U.S. shareholder which has accumulated post-1986 earnings greater than zero on either of such dates.
3. A "specified foreign corporation" is any CFC and any foreign corporation with respect to which one or more domestic corporations is a 10-percent U.S. shareholder. Non-CFC PFICs are excluded.

SECTION 965

1. "Accumulated post-1986 deferred foreign income" is post-1986 earnings and profits except to the extent attributable to ECI earnings or to PTI earnings that, if distributed, would be excluded under Section 959.
2. If a taxpayer is a U.S. shareholder with respect to at least one deferred foreign income corporation and at least one E&P deficit corporation, the amount otherwise taken into account under Section 965(a) are reduced by the allocable portion of the deficits.

SECTION 965

1. A portion of the Section 965 income inclusion is deductible; the deduction varies depending on whether the deferred foreign income is held in cash assets (lower deduction) or business assets (higher deduction).
2. The deduction results in an effective reduced rate of tax on the included income: 15.5 percent (cash assets) or 8 percent (business assets).
3. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income.
4. The increased tax liability may generally be paid over an 8 year period.

SECTION 965

1. The IRS has issued preliminary guidance on various Section 965 issues. *See* Notice 2018-7; Notice 2018-13; Rev. Proc. 2018-17; Notice 2018-26; and IRS FAQs.
2. Regulations are expected soon.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(a) Treatment of deferred foreign income as subpart F income. In the case of the last taxable year of a deferred foreign income corporation which begins before January 1, 2018, the subpart F income of such foreign corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of—

(1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or

(2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(c) Application of participation exemption to included income.

(1) In general.

In the case of a United States shareholder of a deferred foreign income corporation, there shall be allowed as a deduction for the taxable year in which an amount is included in the gross income of such United States shareholder under section 951(a)(1) by reason of this section an amount equal to the sum of—

(A) the United States shareholder's 8 percent rate equivalent percentage of the excess (if any) of—

(i) the amount so included as gross income, over

(ii) the amount of such United States shareholder's aggregate foreign cash position, plus

(B) the United States shareholder's 15.5 percent rate equivalent percentage of so much of the amount described in subparagraph (A)(ii) as does not exceed the amount described in subparagraph (A)(i).

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(c) Application of participation exemption to included income.

(2) 8 and 15.5 percent rate equivalent percentages.

For purposes of this subsection—

(A) 8 percent rate equivalent percentage. The term “8 percent rate equivalent percentage” means, with respect to any United States shareholder for any taxable year, the percentage which would result in the amount to which such percentage applies being subject to a 8 percent rate of tax determined by only taking into account a deduction equal to such percentage of such amount and the highest rate of tax specified in section 11 for such taxable year. In the case of any taxable year of a United States shareholder to which section 15 applies, the highest rate of tax under section 11 before the effective date of the change in rates and the highest rate of tax under section 11 after the effective date of such change shall each be taken into account under the preceding sentence in the same proportions as the portion of such taxable year which is before and after such effective date, respectively.

(B) 15.5 percent rate equivalent percentage. The term “15.5 percent rate equivalent percentage” means, with respect to any United States shareholder for any taxable year, the percentage determined under subparagraph (A) applied by substituting “15.5 percent rate of tax” for “8 percent rate of tax”.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(d) Deferred foreign income corporation; accumulated post-1986 deferred foreign income.

For purposes of this section—

(1) Deferred foreign income corporation. The term “deferred foreign income corporation” means, with respect to any United States shareholder, any specified foreign corporation of such United States shareholder which has accumulated post-1986 deferred foreign income (as of the date referred to in paragraph (1) or (2) of subsection (a)) greater than zero.

(2) Accumulated post-1986 deferred foreign income. The term “accumulated post-1986 deferred foreign income” means the post-1986 earnings and profits except to the extent such earnings—

(A) are attributable to income of the specified foreign corporation which is effectively connected with the conduct of a trade or business within the United States and subject to tax under this chapter, or

(B) in the case of a controlled foreign corporation, if distributed, would be excluded from the gross income of a United States shareholder under section 959. To the extent provided in regulations or other guidance prescribed by the Secretary, in the case of any controlled foreign corporation which has shareholders which are not United States shareholders, accumulated post-1986 deferred foreign income shall be appropriately reduced by amounts which would be described in subparagraph (B) if such shareholders were United States shareholders.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(e) Specified foreign corporation.

(1) In general. For purposes of this section, the term "specified foreign corporation" means—

(A) any controlled foreign corporation, and

(B) any foreign corporation with respect to which one or more domestic corporations is a United States shareholder.

(2) Application to certain foreign corporations. For purposes of sections 951 and 961, a foreign corporation described in paragraph (1)(B) shall be treated as a controlled foreign corporation solely for purposes of taking into account the subpart F income of such corporation under subsection (a) (and for purposes of applying subsection (f)).

(3) Exclusion of passive foreign investment companies. Such term shall not include any corporation which is a passive foreign investment company (as defined in section 1297) with respect to the shareholder and which is not a controlled foreign corporation.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(g) Disallowance of foreign tax credit, etc.

(1) In general. No credit shall be allowed under section 901 for the applicable percentage of any taxes paid or accrued (or treated as paid or accrued) with respect to any amount for which a deduction is allowed under this section.

(2) Applicable percentage. For purposes of this subsection, the term "applicable percentage" means the amount (expressed as a percentage) equal to the sum of—

(A) 0.771 multiplied by the ratio of—

(i) the excess to which subsection (c)(1)(A) applies, divided by

(ii) the sum of such excess plus the amount to which subsection (c)(1)(B) applies, plus

(B) 0.557 multiplied by the ratio of—

(i) the amount to which subsection (c)(1)(B) applies, divided by

(ii) the sum described in subparagraph (A)(ii).

(3) Denial of deduction. No deduction shall be allowed under this chapter for any tax for which credit is not allowable under section 901 by reason of paragraph (1) (determined by treating the taxpayer as having elected the benefits of subpart A of part III of subchapter N).

(4) Coordination with section 78. With respect to the taxes treated as paid or accrued by a domestic corporation with respect to amounts which are includible in gross income of such domestic corporation by reason of this section, section 78 shall apply only to so much of such taxes as bears the same proportion to the amount of such taxes as—

(A) the excess of—

(i) the amounts which are includible in gross income of such domestic corporation by reason of this section, over

(ii) the deduction allowable under subsection (c) with respect to such amounts, bears to

(B) such amounts.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(h) Election to pay liability in installments.

(1) In general. In the case of a United States shareholder of a deferred foreign income corporation, such United States shareholder may elect to pay the net tax liability under this section in 8 installments of the following amounts:

(A) 8 percent of the net tax liability in the case of each of the first 5 of such installments,

(B) 15 percent of the net tax liability in the case of the 6th such installment,

(C) 20 percent of the net tax liability in the case of the 7th such installment, and

(D) 25 percent of the net tax liability in the case of the 8th such installment.

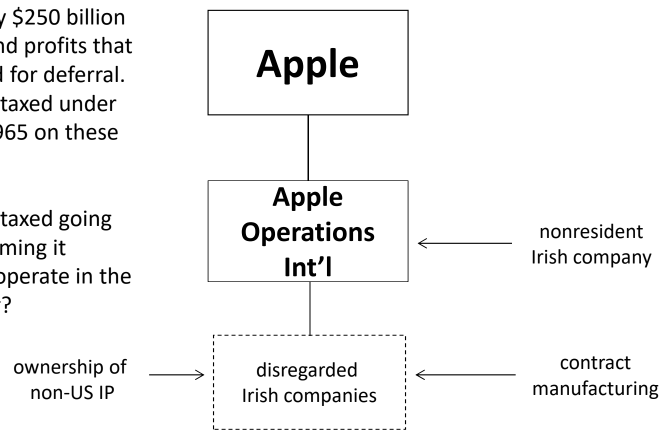
(2) Date for payment of installments. If an election is made under paragraph (1), the first installment shall be paid on the due date (determined without regard to any extension of time for filing the return) for the return of tax for the taxable year described in subsection (a) and each succeeding installment shall be paid on the due date (as so determined) for the return of tax for the taxable year following the taxable year with respect to which the preceding installment was made.

GILTI

APPLE

Apple reportedly has approximately $250 billion of earnings and profits that have qualified for deferral. How is Apple taxed under new Section 965 on these earnings?

How is Apple taxed going forward, assuming it continues to operate in the same manner?



Low tax earnings qualifying for deferral

NEW GILTI REGIME

1. The 2017 tax act establishes an effective new category of quasi-Subpart F income for U.S. shareholders of CFCs attributable to "global intangible low-taxed income" or "GILTI." See new § 951A.

2. GILTI is calculated as income not otherwise subject to special treatment under Subpart F over a prescribed percentage return on the basis of tangible business property (less interest expense).

3. A portion of the income inclusion will be offset by a 50 percent deduction, resulting in an effective lower rate of U.S. tax on the income (generally 10.5 percent for C corporations).

4. For C corporations, 80 percent of the attributable foreign income taxes will be allowed as a Section 960 credit, with no carryover.

5. If the applicable foreign taxes are 13.125 percent or greater, there arguably should be no U.S. tax after the foreign tax credit.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(a) In general. Each person who is a United States shareholder of any controlled foreign corporation for any taxable year of such United States shareholder shall include in gross income such shareholder's global intangible low-taxed income for such taxable year.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(b) Global intangible low-taxed income. For purposes of this section—

(1) In general. The term "global intangible low-taxed income" means, with respect to any United States shareholder for any taxable year of such United States shareholder, the excess (if any) of—

(A) such shareholder's net CFC tested income for such taxable year, over

(B) such shareholder's net deemed tangible income return for such taxable year.

(2) Net deemed tangible income return. The term "net deemed tangible income return" means, with respect to any United States shareholder for any taxable year, the excess of—

(A) 10 percent of the aggregate of such shareholder's pro rata share of the qualified business asset investment of each controlled foreign corporation with respect to which such shareholder is a United States shareholder for such taxable year (determined for each taxable year of each such controlled foreign corporation which ends in or with such taxable year of such United States shareholder), over

(B) the amount of interest expense taken into account under subsection (c)(2)(A)(ii) in determining the shareholder's net CFC tested income for the taxable year to the extent the interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(c) Net CFC tested income. For purposes of this section—

(1) In general. The term "net CFC tested income" means, with respect to any United States shareholder for any taxable year of such United States shareholder, the excess (if any) of—

(A) the aggregate of such shareholder's pro rata share of the tested income of each con trolled foreign corporation with respect to which such shareholder is a United States shareholder for such taxable year of such United States shareholder (determined for each taxable year of such controlled foreign corporation which ends in or with such taxable year of such United States shareholder), over

(B) the aggregate of such shareholder's pro rata share of the tested loss of each controlled foreign corporation with respect to which such shareholder is a United States shareholder for such taxable year of such United States shareholder (determined for each taxable year of such controlled foreign corporation which ends in or with such taxable year of such United States shareholder).

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(c) Net CFC tested income. For purposes of this section—

(2) Tested income; tested loss.

For purposes of this section—

(A) Tested income. The term "tested income" means, with respect to any controlled foreign corporation for any taxable year of such controlled foreign corporation, the excess (if any) of—

(i) the gross income of such corporation determined without regard to—

(I) any item of income described in section 952(b),

(II) any gross income taken into account in determining the subpart F income of such corporation,

(III) any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4),

(IV) any dividend received from a related person (as defined in section 954(d)(3)), and

(V) any foreign oil and gas extraction income (as defined in section 907(c)(1)) of such corporation, over

(ii) the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).

(B) Tested loss.

(i) In general. The term "tested loss" means, with respect to any controlled foreign corporation for any taxable year of such controlled foreign corporation, the excess (if any) of the amount described in subparagraph (A)(ii) over the amount described in subparagraph (A)(i).

(ii) Coordination with subpart F to deny double benefit of losses. Section 952(c)(1)(A) shall be applied by increasing the earnings and profits of the controlled foreign corporation by the tested loss of such corporation.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(d) Qualified business asset investment. For purposes of this section—

(1) In general. The term “qualified business asset investment” means, with respect to any controlled foreign corporation for any taxable year, the average of such corporation's aggregate adjusted bases as of the close of each quarter of such taxable year in specified tangible property—

(A) used in a trade or business of the corporation, and

(B) of a type with respect to which a deduction is allowable under section 167.

(2) Specified tangible property.

(A) In general. The term “specified tangible property” means, except as provided in subparagraph (B) , any tangible property used in the production of tested income.

(B) Dual use property. In the case of property used both in the production of tested income and income which is not tested income, such property shall be treated as specified tangible property in the same proportion that the gross income described in subsection (c)(1)(A) produced with respect to such property bears to the total gross income produced with respect to such property.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

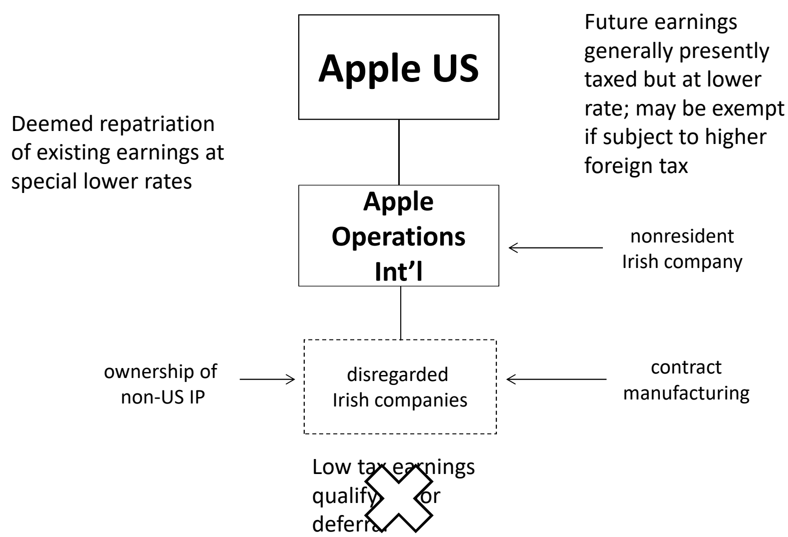
(f) Treatment as subpart F income for certain purposes.

(1) In general.

(A) Application. Except as provided in subparagraph (B), any global intangible low-taxed income included in gross income under subsection (a) shall be treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).

(B) Exception. The Secretary shall provide rules for the application of subparagraph (A) to other provisions of this title in any case in which the determination of subpart F income is required to be made at the level of the controlled foreign corporation.

APPLE



CALCULATING GILTI

1. Tested income is generally gross income not subject to other Subpart F treatment.
2. Subpart F income is excluded, as well as Subpart F income excluded under the high-tax exception.
3. Foreign oil and gas extraction income is excluded.
4. Tested income is reduced by allocable expenses, including taxes. A taxable loss can result.
5. For a given U.S. shareholder, "net CFC tested income" is the excess of tested income over tested loss for all applicable CFCs.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(c) Net CFC tested income. For purposes of this section—

(2) Tested income; tested loss.

For purposes of this section—

(A) Tested income. The term "tested income" means, with respect to any controlled foreign corporation for any taxable year of such controlled foreign corporation, the excess (if any) of—

(i) the gross income of such corporation determined without regard to—

(I) any item of income described in section 952(b),

(II) any gross income taken into account in determining the subpart F income of such corporation,

(III) any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4),

(IV) any dividend received from a related person (as defined in section 954(d)(3)), and

(V) any foreign oil and gas extraction income (as defined in section 907(c)(1)) of such corporation, over

(ii) the deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).

(B) Tested loss.

(i) In general. The term "tested loss" means, with respect to any controlled foreign corporation for any taxable year of such controlled foreign corporation, the excess (if any) of the amount described in subparagraph (A)(ii) over the amount described in subparagraph (A)(i).

(ii) Coordination with subpart F to deny double benefit of losses. Section 952(c)(1)(A) shall be applied by increasing the earnings and profits of the controlled foreign corporation by the tested loss of such corporation.

CALCULATING GILTI

1. GILTI is the excess of "net CFC tested income" over "net deemed tangible income return."
2. "Net deemed tangible income return" is 10% of "qualified business asset investment" ("QBAI") less interest expense.
3. QBAI is the average of the CFC's average adjusted basis of its "specified tangible property", i.e., depreciable tangible property used in a trade or business in the production of tested income.
4. Adjusted basis is determined using Section 168(g) ADS rules.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(b) Global intangible low-taxed income. For purposes of this section—

(1) In general. The term “global intangible low-taxed income” means, with respect to any United States shareholder for any taxable year of such United States shareholder, the excess (if any) of—

(A) such shareholder's net CFC tested income for such taxable year, over

(B) such shareholder's net deemed tangible income return for such taxable year.

(2) Net deemed tangible income return. The term “net deemed tangible income return” means, with respect to any United States shareholder for any taxable year, the excess of—

(A) 10 percent of the aggregate of such shareholder's pro rata share of the qualified business asset investment of each controlled foreign corporation with respect to which such shareholder is a United States shareholder for such taxable year (determined for each taxable year of each such controlled foreign corporation which ends in or with such taxable year of such United States shareholder), over

(B) the amount of interest expense taken into account under subsection (c)(2)(A)(ii) in determining the shareholder's net CFC tested income for the taxable year to the extent the interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.

NEW SECTION 951A

§ 951A Global intangible low-taxed income included in gross income of United States shareholders.

(b) Global intangible low-taxed income. For purposes of this section—

(1) In general. The term “global intangible low-taxed income” means, with respect to any United States shareholder for any taxable year of such United States shareholder, the excess (if any) of—

(A) such shareholder's net CFC tested income for such taxable year, over

(B) such shareholder's net deemed tangible income return for such taxable year.

(2) Net deemed tangible income return. The term “net deemed tangible income return” means, with respect to any United States shareholder for any taxable year, the excess of—

(A) 10 percent of the aggregate of such shareholder's pro rata share of the qualified business asset investment of each controlled foreign corporation with respect to which such shareholder is a United States shareholder for such taxable year (determined for each taxable year of each such controlled foreign corporation which ends in or with such taxable year of such United States shareholder), over

(B) the amount of interest expense taken into account under subsection (c)(2)(A)(ii) in determining the shareholder's net CFC tested income for the taxable year to the extent the interest income attributable to such expense is not taken into account in determining such shareholder's net CFC tested income.

CALCULATING GILTI

1. GILTI indirect tax credit is 80% of attributable foreign income taxes, times the ratio of GILTI to tested income (Section 960(d)).
2. The GILTI tax credit is separately basketed and cannot be carried to other years.
3. Section 78 gross up is 100% of attributable foreign income taxes, times ratio of GILTI to tested income.
4. After deduction for 50% of sum of GILTI and Section 78 gross up, the GILTI inclusion is equal amount.

SECTION 960(d)

IRC § 960(d) Deemed paid credit for taxes properly attributable to tested income.

(1) In general.

For purposes of subpart A of this part, if any amount is includible in the gross income of a domestic corporation under section 951A, such domestic corporation shall be deemed to have paid foreign income taxes equal to 80 percent of the product of—

(A) such domestic corporation's inclusion percentage, multiplied by

(B) the aggregate tested foreign income taxes paid or accrued by controlled foreign corporations.

(2) Inclusion percentage.

For purposes of paragraph (1), the term “inclusion percentage” means, with respect to any domestic corporation, the ratio (expressed as a percentage) of—

(A) such corporation's global intangible low-taxed income (as defined in section 951A(b)), divided by

(B) the aggregate amount described in section 951A(c)(1)(A) with respect to such corporation.

(3) Tested foreign income taxes.

For purposes of paragraph (1), the term “tested foreign income taxes” means, with respect to any domestic corporation which is a United States shareholder of a controlled foreign corporation, the foreign income taxes paid or accrued by such foreign corporation which are properly attributable to the tested income of such foreign corporation taken into account by such domestic corporation under section 951A.

SECTION 904 BASKETING

IRC § 904(d) Separate application of section with respect to certain categories of income.

(1) In general.

The provisions of subsections (a), (b), and (c) and sections 902, 907, and 960 shall be applied separately with respect to—

(A) any amount includible in gross income under section 951A (other than passive category income)

(B) foreign branch income,

(C) passive category income, and

(D) general category income.

CARRYOVERS OF EXCESS CREDITS

IRC § 904(c) Carryback and carryover of excess tax paid.

Any amount by which all taxes paid or accrued to foreign countries or possessions of the United States for any taxable year for which the taxpayer chooses to have the benefits of this subpart exceed the limitation under subsection (a) shall be deemed taxes paid or accrued to foreign countries or possessions of the United States in the first preceding taxable year and in any of the first 10 succeeding taxable years, in that order and to the extent not deemed taxes paid or accrued in a prior taxable year, in the amount by which the limitation under subsection (a) for such preceding or succeeding taxable year exceeds the sum of the taxes paid or accrued to foreign countries or possessions of the United States for such preceding or succeeding taxable year and the amount of the taxes for any taxable year earlier than the current taxable year which shall be deemed to have been paid or accrued in such preceding or subsequent taxable year (whether or not the taxpayer chooses to have the benefits of this subpart with respect to such earlier taxable year). Such amount deemed paid or accrued in any year may be availed of only as a tax credit and not as a deduction and only if the taxpayer for such year chooses to have the benefits of this subpart as to taxes paid or accrued for that year to foreign countries or possessions of the United States. This subsection shall not apply to taxes paid or accrued with respect to amounts described in subsection (d)(1)(A).

SECTION 78 GROSSUP

§ 78 Gross up for deemed paid foreign tax credit.

If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under subsections (a), (b), and (d) of section 960 (determined without regard to the phrase "80 percent of" in subsection (d)(1) thereof) for such taxable year shall be treated for purposes of this title (other than sections 245 and 245A) as a dividend received by such domestic corporation from the foreign corporation.

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(a) Allowance of deduction.

(1) In general. In the case of a domestic corporation for any taxable year, there shall be allowed as a deduction an amount equal to the sum of—

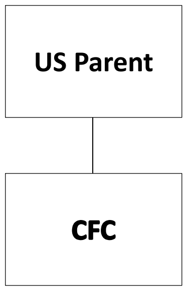
(A) 37.5 percent of the foreign-derived intangible income of such domestic corporation for such taxable year, plus

(B) 50 percent of—

(i) the global intangible low-taxed income amount (if any) which is included in the gross income of such domestic corporation under section 951A for such taxable year, and

(ii) the amount treated as a dividend received by such corporation under section 78 which is attributable to the amount described in clause (i).

CALCULATING GILTI



Country X manufacturing

US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1000 and "qualified business asset investment" ("QBAI") of $2,250. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $0, $100, or $200?

Tested income = $1000 - $0 = $1000

GILTI = $1000 – (10% * $2250) = $775

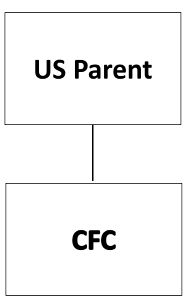
GILTI deduction =
50% * $775 = $387.5

Net GILTI inclusion = $387.5

US tax = $387.5 *21% = $81.375

Bottom line: $775 of GILTI taxed at 10.5% rate; remaining $225 qualifies for deferral/exemption.

CALCULATING GILTI



Country X manufacturing

US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1,000 and "qualified business asset investment" ("QBAI") of $2,250. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $0, $100, or $200?

Tested income = $1000 - $100 = $900

GILTI = $900 – (10% * $2250) = $675

GILTI tax credit =
80% * ($675/$900) * $100 = $60

Section 78 gross up = $75

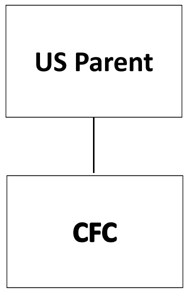
GILTI deduction =
50% * ($675 + $75) = $375

Net GILTI inclusion =
50% * ($675 + $75) = $375

US tax =
$375 * 21% - $60 = $18.75

Bottom line: worldwide tax rate = 11.9%

CALCULATING GILTI



Country X manufacturing

US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1,000 and "qualified business asset investment" ("QBAI") of $2,250. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $0, $100, or $200?

Tested income = $1000 - $200 = $800

GILTI = $800 – (10% * $2250) = $575

GILTI tax credit =
80% * ($575/$800) * $200 = $115

Section 78 gross up = $143.75

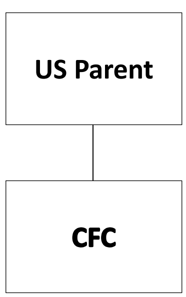
GILTI deduction =
50% * ($575 + $143.75) = $359.38

Net GILTI inclusion =
50% * ($575 + $143.75) = $359.38

US tax =
$359.38 * 21% - $115 = **$0 (negative)**

Bottom line: worldwide tax rate = 20% (all foreign).
Effective exemption from U.S. tax.

CALCULATING GILTI



Country X manufacturing

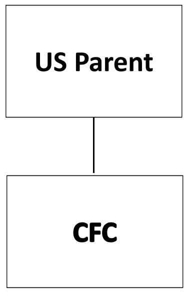
US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1000 and "qualified business asset investment" ("QBAI") of $2,250. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $0, $100, or $200?

How would these results differ if CFC instead had QBAI of $0 or $25,000?

If QBAI = $25,000, no GILTI. All income qualifies for U.S. deferral/exemption.

If QBAI = $0, more GILTI but U.S. tax still phases out once foreign tax rate equals 13.125%. See following example.

CALCULATING GILTI



Country X manufacturing

US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1,000 and "qualified business asset investment" ("QBAI") of $0. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $131.25?

Tested income = $1000 - $131.25 = $868.75

GILTI = $868.75 – (10% * $0) = $868.75

GILTI tax credit =
80% * ($868.75/$868.75) * $131.25 = $105

Section 78 gross up = $131.25

GILTI deduction =
50% * ($868.75 + $131.25) = $500

Net GILTI inclusion =
50% * ($868.75 + $131.25) = $500

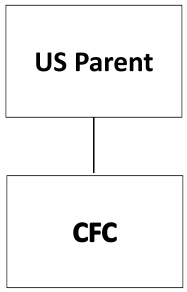
US tax =
$500 * 21% - $105 = **$0**

OPEN GILTI QUESTIONS

The GILTI calculations must be made at the shareholder level, not the CFC level, because they depend upon all CFCs owned by that shareholder. This raises a number of unresolved issues, including:

1. How is GILTI determined by related corporations?
2. How are expenses allocated against GILTI income for foreign tax credit purposes?
3. Do the grossed up income and taxes on GILTI income belong in the GILTI basket or the general limitation basket?

EXPENSE ALLOCATION AND APPORTIONMENT



Country X manufacturing

US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1,000 and “qualified business asset investment” (“QBAI”) of $0. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $131.25?

Tested income = $1000 - $131.25 = $868.75

GILTI = $868.75 – (10% * $0) = $868.75

GILTI tax credit =
80% * ($868.75/$868.75) * $131.25 = $105

Section 78 gross up = $131.25

GILTI deduction =
50% * ($868.75 + $131.25) = $500

Net GILTI inclusion =
50% * ($868.75 + $131.25) = $500

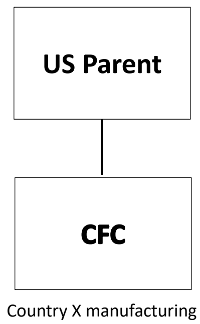
Tentative US tax = $500 * 21% = $105

Suppose in the previous example that expenses of $250 must be allocated and apportioned against GILTI. What is the foreign tax credit effect of this?

EXPENSE ALLOCATION AND APPORTIONMENT

Tentative US tax [21% * $500]	$105
Foreign-source income in GILTI basket [$500 - $250]	$250
Section 904 limitation:	
= US tax rate x Net GILTI income	
= 21% * $250	$52.5
Residual US tax	$52.5
Total worldwide tax	$18.375

BASKETING OF GROSS UP



US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1,000 and “qualified business asset investment” (“QBAI”) of $0. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $131.25?

Tested income = $1000 - $131.25 = $868.75

GILTI = $868.75 – (10% * $0) = $868.75

Section 78 gross up = $131.25

GILTI deduction =
50% * ($868.75 + $131.25) = $500

Net GILTI inclusion =
50% * ($868.75 + $131.25) = $500

Tentative US tax = $500 * 21% = $105

Suppose in the previous example that the Section 78 gross up is treated as general limitation income. What is the foreign tax credit effect of this?

BASKETING OF GROSS UP

Tentative US tax [21% * $500]	$105
GILTI basket:	
Allocable taxes: 80% * [$868.75/$1000) * $131.25 = $91.22	
Section 904 limit: 21% * [$500 - $131.25] = $77.44	
Allowable credit [excess of $13.78 lost]	$77.44
General limitation basket:	
Allocable taxes: [$131.25/$1000) * $131.25 = $17.23	
Section 904 limit: 21% * $131.25 = $27.56	
Allowable credit	$17.23
Residual US tax [$105 – ($77.44 + $17.23)]	$10.33
Total worldwide tax [$131.25 + $10.33]	$141.58

(Assumes GILTI deduction allocated entirely to GILTI basket.)

BASKETING OF GROSS UP

Tentative US tax [21% * $500]	$105
GILTI basket:	
Allocable taxes: 80% * [$868.75/$1000) * $131.25 = $91.22	
Section 904 limit: 21% * [$500 - $65.23] = $91.22	
Allowable credit [excess of $13.78 lost]	$91.22
General limitation basket:	
Allocable taxes: [$131.25/$1000) * $131.25 = $17.23	
Section 904 limit: 21% * $65.23 = $13.78	
Allowable credit	$13.78
Residual US tax [excess general limitation credits of $3.45]	$0
Total worldwide tax	$131.25

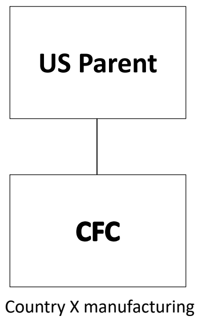
(Assumes GILTI deduction allocated ratably to baskets.)

BASKETING OF GROSS UP

Tentative US tax [21% * $500]	$105
GILTI basket:	
Allocable taxes: 80% * [$1000/$1000) * $131.25 = $105	
Section 904 limit: 21% * [$500 - $131.25] = $77.44	
Allowable credit [excess of $13.78 lost]	$77.44
General limitation basket:	
Allocable taxes: [$0/$1000) * $131.25 = $0	
Section 904 limit: 21% * $131.25 = $27.56	
Allowable credit	$0
Residual US tax [$105 – $77.44]	$27.56
Total worldwide tax [$131.25 + $27.56]	$158.81

(Assumes no foreign taxes allocable to general limitation basket.)

CALCULATING GILTI



US Parent wholly owns CFC, which conducts an active manufacturing business in Country X. CFC has income before Country X income taxes of $1000 and “qualified business asset investment” (“QBAI”) of $2,250. CFC does not make any distributions during the year. What are the U.S. tax results to US Parent, assuming that CFC alternatively pays Country X income taxes of $0, $100, or $200?

What are the results if CFC makes a distribution of the earnings in a later year?

The portion of the earnings attributable to GILTI is exempt as previously taxed income (PTI) under Section 959.

The portion of the earnings qualifying for deferral is generally exempt under new dividends-received deduction of Section 245A.

EXEMPT DIVIDENDS

MOVE TO PARTIAL EXEMPTION SYSTEM

1. The 2017 tax act establishes a 100-percent dividends received deduction (“participation DRD”) for foreign-source portion of dividends received from specified 10-percent owned foreign corporations by domestic corporations that are 10-percent “U.S. shareholders” of such foreign corporations within the meaning of Section 951(b). See new IRC § 245A.
2. No foreign tax credit or deduction is allowed for any taxes, including withholding taxes, paid or accrued with respect to a dividend qualifying for the participation DRD.
3. Participation DRDs are subject to a one-year holding period requirement. See new IRC § 246(c)(5).
4. Section 956, however, can still apply to these earnings if investment in U.S. property prior to distribution.

NEW SECTION 245A

§ 245A Deduction for foreign source-portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations.

(a) In general. In the case of any dividend received from a specified 10-percent owned foreign corporation by a domestic corporation which is a United States shareholder with respect to such foreign corporation, there shall be allowed as a deduction an amount equal to the foreign-source portion of such dividend.

Note that Section 245A only applies to domestic C corps.

NEW SECTION 245A

§ 245A Deduction for foreign source-portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations.

(b) Specified 10-percent owned foreign corporation. For purposes of this section—

(1) In general. The term "specified 10-percent owned foreign corporation" means any foreign corporation with respect to which any domestic corporation is a United States shareholder with respect to such corporation.

(2) Exclusion of passive foreign investment companies. Such term shall not include any corporation which is a passive foreign investment company (as defined in section 1297) with respect to the shareholder and which is not a controlled foreign corporation.

NEW SECTION 245A

§ 245A Deduction for foreign source-portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations.

(d) Disallowance of foreign tax credit, etc.

(1) In general. No credit shall be allowed under section 901 for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under this section.

(2) Denial of deduction. No deduction shall be allowed under this chapter for any tax for which credit is not allowable under section 901 by reason of paragraph (1) (determined by treating the taxpayer as having elected the benefits of subpart A of part III of subchapter N).

EXCEPTION FOR HYBRID DIVIDENDS

§ 245A Deduction for foreign source-portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations.

(e) Special rules for hybrid dividends.

(1) In general.

Subsection (a) shall not apply to any dividend received by a United States shareholder from a controlled foreign corporation if the dividend is a hybrid dividend.

(4) Hybrid dividend.

The term "hybrid dividend" means an amount received from a controlled foreign corporation—

(A) for which a deduction would be allowed under subsection (a) but for this subsection, and

(B) for which the controlled foreign corporation received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.

IMPACT ON OTHER REPATRIATION RULES

1. Section 956 can still apply to deferred earnings if there is an investment in U.S. property prior to distribution (triggering associated Section 960 indirect credits for C corporations).
2. The Section 367(b) repatriation rules are rendered much less important.
3. Are the Section 909 foreign tax credit splitting rules now overkill?

FOREIGN DERIVED INTANGIBLE INCOME

FOREIGN-DERIVED INTANGIBLE INCOME

US Corp

US manufacturing for export

Based on the incentives found in the 2017 tax act, US Corp sets up a new manufacturing facility in the United States. For 2018, it earns $1,000 of "deduction eligible income," of which $200 is attributable to the sale of property to non-U.S. persons for foreign use. Assume its QBAI is $2,500. How much can US Corp benefit from the new deduction for "foreign-derived intangible income" ("FDII")? *See* IRC § 250.

FDII RULES: INCENTIVE FOR STAYING IN THE US

1. The 2017 tax act establishes a 37.5 percent deduction for "foreign-derived intangible income" earned by domestic C corporations, reducing effective tax rate to 13.125 percent (same as minimum foreign tax rate when GILTI fully offset by foreign tax credits).
2. There are serious concerns as to whether this provision violates U.S. trade law obligations (under the rules of the World Trade Organization): there are rules against export-contingent income tax incentives.

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(a) Allowance of deduction.

(1) In general. In the case of a domestic corporation for any taxable year, there shall be allowed as a deduction an amount equal to the sum of—

(A) 37.5 percent of the foreign-derived intangible income of such domestic corporation for such taxable year, plus

(B) 50 percent of—

(i) the global intangible low-taxed income amount (if any) which is included in the gross income of such domestic corporation under section 951A for such taxable year, and

(ii) the amount treated as a dividend received by such corporation under section 78 which is attributable to the amount described in clause (i).

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(b) Foreign-derived intangible income.

For purposes of this section—

(1) In general. The foreign-derived intangible income of any domestic corporation is the amount which bears the same ratio to the deemed intangible income of such corporation as—

(A) the foreign-derived deduction eligible income of such corporation, bears to

(B) the deduction eligible income of such corporation.

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(b) Foreign-derived intangible income.

For purposes of this section—

(2) Deemed intangible income. For purposes of this subsection—

(A) In general. The term “deemed intangible income” means the excess (if any) of—

(i) the deduction eligible income of the domestic corporation, over

(ii) the deemed tangible income return of the corporation.

(B) Deemed tangible income return. The term “deemed tangible income return” means, with respect to any corporation, an amount equal to 10 percent of the corporation's qualified business asset investment (as defined in section 951A(d), determined by substituting “deduction eligible income” for “tested income” in paragraph (2) thereof and without regard to whether the corporation is a controlled foreign corporation).

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(b) Foreign-derived intangible income.

For purposes of this section—

(3) Deduction eligible income.

(A) In general. The term "deduction eligible income" means, with respect to any domestic corporation, the excess (if any) of—

(i) gross income of such corporation determined without regard to—

(I) any amount included in the gross income of such corporation under section 951(a)(1),

(II) the global intangible low-taxed income included in the gross income of such corporation under section 951A,

(III) any financial services income (as defined in section 904(d)(2)(D)) of such corporation,

(IV) any dividend received from a corporation which is a controlled foreign corporation of such domestic corporation,

(V) any domestic oil and gas extraction income of such corporation, and

(VI) any foreign branch income (as defined in section 904(d)(2)(J)), over

(ii) the deductions (including taxes) properly allocable to such gross income.

(B) Domestic oil and gas extraction income. For purposes of subparagraph (A), the term "domestic oil and gas extraction income" means income described in section 907(c)(1), determined by substituting "within the United States" for "without the United States".

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(b) Foreign-derived intangible income.

For purposes of this section—

(4) Foreign-derived deduction eligible income. The term "foreign-derived deduction eligible income" means, with respect to any taxpayer for any taxable year, any deduction eligible income of such taxpayer which is derived in connection with—

(A) property—

(i) which is sold by the taxpayer to any person who is not a United States person, and

(ii) which the taxpayer establishes to the satisfaction of the Secretary is for a foreign use, or

(B) services provided by the taxpayer which the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.

NEW SECTION 250

§ 250 Foreign-derived intangible income and global intangible low-taxed income.

(b) Foreign-derived intangible income.

For purposes of this section—

(5) Rules relating to foreign use property or services. For purposes of this subsection—

(A) Foreign use. The term "foreign use" means any use, consumption, or disposition which is not within the United States.

(B) Property or services provided to domestic intermediaries.—

(i) Property. If a taxpayer sells property to another person (other than a related party) for further manufacture or other modification within the United States, such property shall not be treated as sold for a foreign use even if such other person subsequently uses such property for a foreign use.

(ii) Services. If a taxpayer provides services to another person (other than a related party) located within the United States, such services shall not be treated as described in paragraph (4)(B) even if such other person uses such services in providing services which are so described.

(C) Special rules with respect to related party transactions.—

(i) Sales to related parties. If property is sold to a related party who is not a United States person, such sale shall not be treated as for a foreign use unless—

(I) such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is an unrelated party who is not a United States person, and

(II) the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use.

For purposes of this clause, a sale of property shall be treated as a sale of each of the components thereof.

(ii) Service provided to related parties. If a service is provided to a related party who is not located in the United States, such service shall not be treated described in subparagraph (A)(ii) unless the taxpayer established to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.

FOREIGN-DERIVED INTANGIBLE INCOME

US Corp

US manufacturing for export

Based on the incentives found in the 2017 tax act, US Corp sets up a new manufacturing facility in the United States. For 2018, it earns $1,000 of "deduction eligible income," of which $200 is attributable to the sale of property to non-U.S. persons for foreign use. Assume its QBAI is $2,500. How much can US Corp benefit from the new deduction for "foreign-derived intangible income" ("FDII")? *See* IRC § 250.

Deemed intangible income = $1000 – (10% x $2,500) = $750

Foreign-derived intangible income = $750 x ($200/$1000) = $150

FDII deduction = 37.5% x $150 = $56.25

Net FDII inclusion = $150 - $56.25 = $93.75

At 21% corporate rate, FDII effective tax rate = 13.125%

US tax = 21% x $943.75 = $198.19

= 21% x $850 + 13.125% x $150

IMPACT ON INDIVIDUALS

2017 TAX ACT: WHAT ABOUT INDIVIDUALS?

1. The international provisions of the 2017 tax act were written with large C corporations in mind. Their impact on individual taxpayers is less clear.
2. Individual U.S. shareholders of CFCs are generally subject to the deemed repatriation transitional rules of Section 965; the application of the lower 8 and 15.5 percent rates is not entirely clear. Notice 2018-26 provides that qualifying taxpayers may make an election under Section 962 to obtain such rates.

2017 TAX ACT: WHAT ABOUT INDIVIDUALS?

1. Individuals can be subject to present taxation of GILTI income, but the 50-percent deduction does not apply. It is unclear whether individuals can obtain the deduction by making a Section 962 election.
2. The dividends-received deduction of new Section 245A does not apply to individuals, so double taxation is still a concern with individually owned corporate structures.
3. Individuals could alternatively hold CFCs through U.S. C corporations to obtain the GILTI deduction and qualified dividend treatment on distributions from the C corp.
4. Individuals are not allowed the FDII deduction. The existing IC-DISC rules of Sections 991-997, which can effectively allow individuals a lower rate of tax on certain export transactions, were retained in the 2017 tax act.

SECTION 962

1. Under Section 962, individuals can elect to be taxed on Subpart F income at corporate rates, and claim available Section 960 indirect credits.
2. Upon an actual distribution of the earnings, PTI treatment does not apply to the extent the earnings exceed the U.S. corporate tax imposed.
3. The election has the effect of allowing possible reduction or elimination of present Subpart F taxation, at the cost of an eventual double tax.
4. Under the 2017 tax act, including the reduction of the U.S. corporate rate, this election may be more useful.

SECTION 962

§ 962 Election by individuals to be subject to tax at corporate rates.

(a) General rule.

Under regulations prescribed by the Secretary, in the case of a United States shareholder who is an individual and who elects to have the provisions of this section apply for the taxable year—

(1) the tax imposed under this chapter on amounts which are included in his gross income under section 951(a) shall (in lieu of the tax determined under sections 1 and 55) be an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation, and

(2) for purposes of applying the provisions of section 960 (relating to foreign tax credit) such amounts shall be treated as if they were received by a domestic corporation.

SECTION 962

§ 962 Election by individuals to be subject to tax at corporate rates.

(d) Special rule for actual distributions.

The earnings and profits of a foreign corporation attributable to amounts which were included in the gross income of a United States shareholder under section 951(a) and with respect to which an election under this section applied shall, when such earnings and profits are distributed, notwithstanding the provisions of section 959(a)(1), be included in gross income to the extent that such earnings and profits so distributed exceed the amount of tax paid under this chapter on the amounts to which such election applied.

SECTION 962

US individual

CFC

$100 FPHC income
$10 foreign tax

Result without Section 962 election:

$90 Subpart F income taxed currently as ordinary income; no credit for foreign taxes paid by CFC.

US tax = $90 * 37% = $33.3

Total tax = $43.3

SECTION 962

US individual

CFC

$100 FPHC income
$10 foreign tax

Unclear whether all Section 962(d) distributions can be qualified dividends or whether treaty country corporation required (issue pending before Tax Court).

Result with Section 962 election:

$100 Subpart F income (ordinary); taxed at corporate rates with credit for foreign tax.

Current US tax = $11

Total current tax = $21

<u>Plus</u> second US tax on inclusion/distribution of $79 after-tax earnings (when applicable):

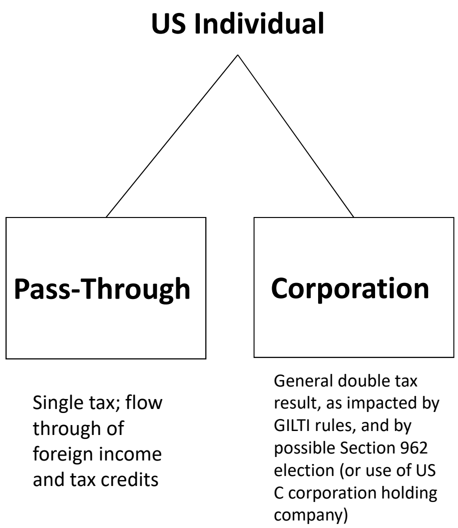
If ordinary:

$79 * 37% = $29.23 (total tax $50.23)

If qualified dividend:

$79 * 20% = $15.8 (total tax $36.8)

PASS-THROUGH OR CORPORATE TREATMENT?



Under the 2017 tax act, individuals need to compare the overall tax cost of pass-through treatment with the result under the modified Subpart F rules.

INTERNATIONAL RESTRUCTURINGS

INTERNATIONAL RESTRUCTURINGS

1. Repeal of Section 367(a) active trade or business exception.
2. Revised loss recapture rules (new Section 91).
3. Provisions to discourage new corporate inversions.

ACTIVE TRADE OR BUSINESS EXCEPTION (PRIOR LAW)

IRC § 367(a)(3) Exception for transfers of certain property used in th[illegible]ctive co[illegible]t of a trade or business.

(A) In general. Excep[illegible]d in regulations prescribed by the S[illegible]raph (1) shall not apply to any property t[illegible]ed [illegible]gn corporation for use by such foreign [illegible]rporation [illegible] the active conduct of a trade or business outside of the United States.

The active trade or business exception was repealed by the 2017 tax act.

SECTION 367(d) DEEMED ROYALTY

IRC § 367(d) Special rules relating to transfers of intangibles.

(1) In general.

Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361 —

(A) subsection (a) shall not apply to the transfer of such property, and

(B) the provisions of this subsection shall apply to such transfer.

(2) Transfer of intangibles treated as transfer pursuant to sale of contingent payments.

(A) In general. If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received—

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

SECTION 936(h)(3)(B) DEFINITION OF INTANGIBLE PROPERTY

IRC § 936(h)(3)(B) Intangible property.

The term “intangible property” means any—

(i) patent, invention, formula, process, design, pattern, or know-how;

(ii) copyright, literary, musical, or artistic composition;

(iii) trademark, trade name, or brand name;

(iv) franchise, license, or contract;

(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data;

(vi) any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) or its employment; or

(vii) any other item the value or potential value of which is not attributable to tangible property or the services of any individual.

Note: (vi) and (vii) added by 2017 tax act

SUPERROYALTY

IRC § 367(d) Special rules relating to transfers of intangibles.

(1) In general.

Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361 —

(A) subsection (a) shall not apply to the transfer of such property, and

(B) the provisions of this subsection shall apply to such transfer.

(2) Transfer of intangibles treated as transfer pursuant to sale of contingent payments.

(A) In general. If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received—

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

SECTION 91

§ 91 Certain foreign branch losses transferred to specified 10-percent owned foreign corporations.

(a) In general. If a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of section 367(a)(3)(C), as in effect before the date of the enactment of the Tax Cuts and Jobs Act) to a specified 10-percent owned foreign corporation (as defined in section 245A) with respect to which it is a United States shareholder after such transfer, such domestic corporation shall include in gross income for the taxable year which includes such transfer an amount equal to the transferred loss amount with respect to such transfer.

SECTION 91

§ 91 Certain foreign branch losses transferred to specified 10-percent owned foreign corporations.

(b) Transferred loss amount.

For purposes of this section, the term “transferred loss amount” means, with respect to any transfer of substantially all of the assets of a foreign branch, the excess (if any) of—

(1) the sum of losses—

(A) which were incurred by the foreign branch after December 31, 2017, and before the transfer, and

(B) with respect to which a deduction was allowed to the taxpayer, over

(2) the sum of—

(A) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and

(B) any amount which is recognized under section 904(f)(3) on account of the transfer.

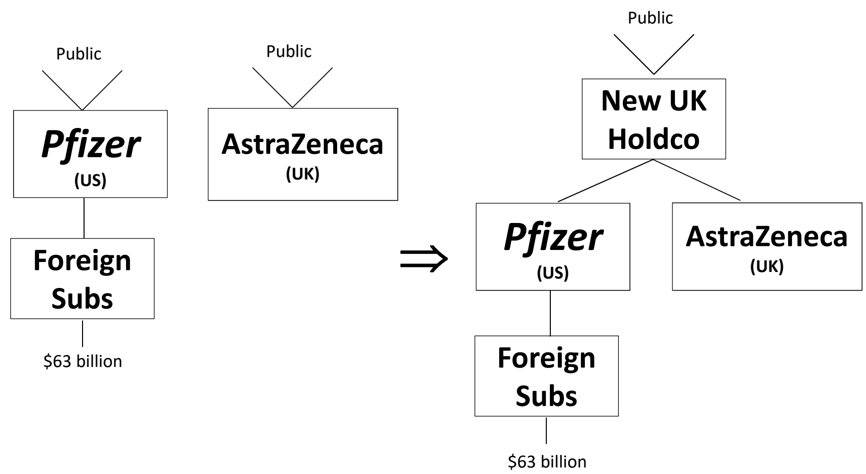
(c) Reduction for recognized gains.

The transferred loss amount shall be reduced (but not below zero) by the amount of gain recognized by the taxpayer on account of the transfer (other than amounts taken into account under subsection (b)(2)(B)).

EXAMPLE OF RECENT INVERSION TRANSACTIONS

- Pfizer, the U.S. pharmaceutical company, had accumulated at least $63 billion in offshore cash.
- In 2014, Pfizer proposed an acquisition of AstraZeneca, a U.K. company, in an “inversion” transaction designed (among other things) to allow Pfizer to access this cash.
- This transaction did not go forward, but Pfizer later announced an inversion transaction with Allergan, an Irish company that itself inverted some time ago.
- This transaction was scuttled after temporary regulations issued in April 2016 because Allergan was a “serial inverter”.

PROPOSED TRANSACTION STRUCTURE



In the proposed transaction, Pfizer would have become a subsidiary of a new U.K. holding company.

2017 TAX ACT

How does the 2017 tax act attempt to discourage inversion transactions?

1. General changes to international tax rules.
2. Increase of Section 4985 excise tax rate from 15 to 20 percent.
3. Stricter application of the BEAT (new IRC § 59A) to new 60/80% inversions.
4. Elimination of qualified dividend treatment for dividends paid by foreign parents after new 60/80% inversions. *See* IRC § 1(h)(11)(C)(iii)(II).
5. Recoupment of Section 965 benefit if new 60/80% inversion in next 10 years (i.e., taxing deemed Section 965 inclusion at former 35 percent corporate rate). *See* IRC § 965(l).

BASE EROSION PAYMENTS

IRC § 59A(d) Base erosion payment.

For purposes of this section—

(1) In general.

The term 'base erosion payment' means any amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer and with respect to which a deduction is allowable under this chapter.

* * *

(4) Certain payments to expatriated entities.

(A) In general. Such term shall also include any amount paid or accrued by the taxpayer with respect to a person described in subparagraph (B) which results in a reduction of the gross receipts of the taxpayer.

(B) Person described. A person is described in this subparagraph if such person is a—

(i) surrogate foreign corporation which is a related party of the taxpayer, but only if such person first became a surrogate foreign corporation after November 9, 2017, or

(ii) foreign person which is a member of the same expanded affiliated group as the surrogate foreign corporation.

(C) Definitions. For purposes of this paragraph—

(i) Surrogate foreign corporation. The term 'surrogate foreign corporation' has the meaning given such term by section 7874(a)(2)(B) but does not include a foreign corporation treated as a domestic corporation under section 7874(b).

(ii) Expanded affiliated group. The term 'expanded affiliated group' has the meaning given such term by section 7874(c)(1).

QUALIFIED FOREIGN CORPORATIONS

IRC § 1(h)(11) Dividends taxed as net capital gain.

* * *

(C) Qualified foreign corporations.

(i) In general. Except as otherwise provided in this paragraph, the term "qualified foreign corporation" means any foreign corporation if—

(I) such corporation is incorporated in a possession of the United States, or

(II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.

(ii) Dividends on stock readily tradable on United States securities market. A foreign corporation not otherwise treated as a qualified foreign corporation under clause (i) shall be so treated with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.

(iii) Exclusion of dividends of certain foreign corporations. Such term shall not include—

(i) any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297), and

(II) any corporation which first becomes a surrogate foreign corporation (as defined in section 7874(a)(2)(B) after the date of enactment of this subclause, other than a foreign corporation which is treated as a domestic corporation under section 7874(b).

(iv) Coordination with foreign tax credit limitation. Rules similar to the rules of section 904(b)(2)(B) shall apply with respect to the dividend rate differential under this paragraph.

NEW SECTION 965

§ 965 Treatment of deferred foreign income upon transition to participation exemption system of taxation.

(l) Recapture for expatriated entities.

(1) In general. If a deduction is allowed under subsection (c) to a United States shareholder and such shareholder first becomes an expatriated entity at any time during the 10-year period beginning on the date of the enactment of the Tax Cuts and Jobs Act (with respect to a surrogate foreign corporation which first becomes a surrogate foreign corporation during such period), then—

(A) the tax imposed by this chapter shall be increased for the first taxable year in which such taxpayer becomes an expatriated entity by an amount equal to 35 percent of the amount of the deduction allowed under subsection (c), and

(B) no credits shall be allowed against the increase in tax under subparagraph (A).

(2) Expatriated entity. For purposes of this subsection, the term "expatriated entity" has the same meaning given such term under section 7874(a)(2), except that such term shall not include an entity if the surrogate foreign corporation with respect to the entity is treated as a domestic corporation under section 7874(b).

(3) Surrogate foreign corporation. For purposes of this subsection, the term "surrogate foreign corporation" has the meaning given such term in section 7874(a)(2)(B).

OTHER IMPACTS ON INTERNATIONAL RESTRUCTURINGS

1. Effect of GILTI rules on Section 338 elections and "check and sell" transactions.
2. Effect on Section 901(m) "covered asset acquisition" rules (now arguably overkill).

TRANSFER PRICING

TRANSFER PRICING

1. The 2017 tax act adds a new third sentence to Section 482.
2. It requires transfer pricing determinations to be made on an aggregate basis and taking into account realistic alternatives.
3. This change is consistent with recent IRS regulations and with government positions taken (so far unsuccessfully) in recent transfer pricing litigation (e.g., *Amazon* and *Medtronic*).

SECTION 482

IRC § 482. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible. For purposes of this section, the Secretary shall require the valuation of transfers of intangible property (including intangible property transferred along with other property or services) on an aggregate basis or the valuation of such a transfer on the basis of the most realistic alternatives to such a transfer, if the Secretary determines that such basis is the most reliable means of valuation of such transfers.

(New last sentence added by 2017 tax act; equivalent language added to Section 367(d).)

SOURCE OF PRODUCTION INCOME

SOURCE OF PRODUCTION INCOME

1. The 2017 tax act adds a new last sentence to Section 863(b), requiring that the sale of inventory property produced by the taxpayer be sourced entirely by where the production activities occur.
2. Among other things, this eliminates the potential for sourcing a portion of the income as attributable to the sales function, and thus foreign source, assuming foreign title passage. Formerly, an arbitrary 50 percent allocation to the sales function was generally possible under the “export source rule.”
3. Consider also the effect on inbound branch structures.

SECTION 863(b)

IRC § 863(b) Income partly from within and partly from without the United States.

In the case of gross income derived from sources partly within and partly without the United States, the taxable income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income; and the portion of such taxable income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Secretary. Gains, profits, and income—

(1) from services rendered partly within and partly without the United States,

(2) from the sale or exchange of inventory property (within the meaning of section 865(i)(1)) produced (in whole or in part) by the taxpayer within and sold or exchanged without the United States, or produced (in whole or in part) by the taxpayer without and sold or exchanged within the United States, or

(3) derived from the purchase of inventory property (within the meaning of section 865(i)(1)) within a possession of the United States and its sale or exchange within the United States,

shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits, and income from the sale or exchange of inventory property described in paragraph (2) shall be allocated and apportioned between sources within and without the United States solely on the basis of the production activities with respect to the property.

(New last sentence added by 2017 tax act.)

International Agreements and the TCJA

TAX TREATIES

- BEAT taxes - US subsidiaries that make deductible payments to a related foreign party, notwithstanding that the payments are arm's-length.
  - The tax is, at least arguably, an indirect withholding tax on interest, royalties and other payments to the foreign related party.
    - Articles 11 (interest), 12 (royalties) and 21 (other income) generally eliminate US withholding taxes on payments of interest, royalties and other income (see US Model Treaty (2016)).
    - The savings clause in US tax treaties (see Article 1 paragraph 4 of the US Model Treaty (2016)) provides –

      "Except to the extent provided in paragraph 5 of this Article, this Convention shall not affect the taxation by a Contracting State of its residents…and its citizens."
    - None of the exceptions listed in paragraph 5 exempt Articles 11, 12 or 21 from the savings clause.
    - Because the tax is imposed directly on US residents, it should not violate US tax treaties given the broad blanket authority the US has with respect to the taxation of its residents.

TAX TREATIES

- BEAT might also be viewed as violating Article 24, the non-discrimination article in US tax treaties, because the tax is not imposed when such deductible payments are made to a domestic related party.
  - Article 24 is one of the exceptions listed in paragraph 5 of Article 1 of US tax treaties and as a consequence, it is not subject to the savings clause.
  - Deduction provision. Paragraph 4 of Article 24 of the US Model Treaty (2016) provides in part –

    "…interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting States shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned Contracting State".
  - Technically, the BEAT does not eliminate the deduction a domestic corporation may claim for payments made to a foreign related party - it reduces the benefit by subjecting such deductions to the 10% BEAT.

TAX TREATIES

- Foreign controlled enterprise provision. Paragraph 5 of Article 24 of the US Model Treaty (2016) provides –

  "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned Contracting State are or may be subjected."
  - The BEAT also applies to payments by a domestic corporation to its CFC and therefore arguably subjecting domestic corporations to the same BEAT tax, but such arrangements are avoided due to potentially adverse tax consequences – can theoretical arrangements be relied upon to demonstrate that the BEAT tax is not more burdensome on foreign controlled enterprises?
  - US treaties and foreign law have allowed foreign companies to strip earnings out of US affiliates without recognizing offsetting income – the BEAT tax is justifiable under such arrangements.
  - Earnings stripping arrangements should be eliminated as BEPS is implemented and US treaties renegotiated to include STR, notional deductions and other US Model Treaty (2016) provisions.
  - BEAT however, would continue to apply and may result in double taxation given a credit for the tax is unlikely to be available to foreign companies.
  - The future status of BEAT under US tax treaties is not clear.

WORLD TRADE ORGANIZATION

- The Subsidies and Countervailing Measures Agreement ("Agreement") prohibits a WTO member from providing certain subsidies to the member's residents.
  - A *subsidy* is defined to include the non-collection or forgiveness of taxes.
  - A *prohibited subsidy* includes a subsidy that is contingent, in law or in fact, upon export performance.
  - If a subsidy is *specific* (subsidy benefits are limited to certain persons) and it has an *adverse effect* (it is prejudice to the interests of another member), the affected member is entitled to file a formal compliant with the WTO and may unilaterally, impose retaliatory sanctions.

WORLD TRADE ORGANIZATION

- FDII appears to be a prohibited subsidy because it provides for the non-collection of taxes otherwise due on income from exports.
- It should also be a prohibited subsidy because it is contingent, in law or in fact, upon income from exports.
- Finally, it is specific because it benefits US domestic corporations and it has an adverse effect on a resident corporation of a WTO member because the resident corporation is required to compete with subsidized US corporations.
- As a consequence, FDII should be found to violate the Agreement and result in retaliatory sanctions.

OECD

- The EU has asked the OECD to determine whether FDII and other provisions in the TCJA are "harmful tax practices".
- Harmful tax practices is one of the 4 minimum standards that 102 countries (including the US) agreed to as part of the BEPS initiative.
  - It prohibits, among other things, bestowing patent box regime benefits on income derived from an intangible developed in another country.
  - FDII may be in conflict with this requirement because there is no requirement that development of an intangible generating FDII occur in the US.
- Given the current administration's position on the WTO, the EU may prefer to address issues regarding FDII through the OECD if possible, (or it might just be waiting for a favorable opinion from the OECD to further strengthen its position before proceeding to the WTO).

THE END