This outline covers significant developments in federal income taxation along with a few other interesting or noteworthy tax topics arising during the preceding calendar year. It offers a selective treatment focusing on items likely to interest practitioners and advisors within a broad range of professional practices. It is not intended to provide comprehensive coverage. This year’s outline targets regular and reviewed decisions of the Tax Court, along with federal appellate cases. Other trial decisions from the Tax Court (including memorandum and summary opinions), district court, and claims court, as well as unreported appellate decisions receive limited attention due to their comparatively lesser impact on tax law development. Some significant administrative developments are also included, with a primary focus on guidance emerging from the 2017 Tax Cuts and Jobs Act. The legislation section provides an overview of significant provisions from the Act along with some relevant commentary.

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I. Gross income.

A. Timing.

1. Social Security benefits from other tax years paid in lump sum are taxable, Robbins v. Commissioner, TC Memo 2017-247.

Taxpayers received a lump sum benefit of nearly $60K in 2014, portions of which had accrued in two prior tax years. The Service treated about $32K of this benefit as taxable in 2014, although if the amounts had been received and reported in each of the attributed years, no tax would have been due in 2014. Section 86(e) provides an elective alternative method of computing the tax due from a lump sum benefit, which is based on taxing the marginal income effect from the year to which the benefit is otherwise attributable. However, these taxpayers failed to report the lump sum benefit at all, so of course they did not make the election! Without an election, tax is due on the lump sum benefit as though it was entirely attributed to the year of receipt. Unfortunately, as the Tax Court also noted, these taxpayers would have owed even more tax than under the proposed deficiency if they had made the election.

Comment: Tax is hard, as these pro se taxpayers probably learned. IRS Publication 915 includes a worksheet to help make these calculations.

2. Misappropriated funds were gross income, Sun v. Commissioner, 880 F.3d 173 (5th Cir. 2018).

Taxpayers sought review of an adverse decision by the Tax Court on the matter of whether their receipt of funds from a friend in China should be included in gross income. Taxpayer had received $19 million from a friend in China. They had an oral understanding that Taxpayer would invest these funds, but as is true with many oral agreements, the terms understood by both parties differed considerably. Taxpayer argued that this was a loan which he was bound to repay, and so it could not be included in gross income. The Tax Court disagreed, holding that although Taxpayer may have held the funds in trust to invest for his friend, the taxpayer misappropriated the funds for personal use. At such time, they became taxable as gross income. Taxpayer appealed, challenging this determination as well as a negligence penalty imposed.

Taxpayer argued that the Tax Court found that he had an obligation to return some money to his friend at some point. However, the Fifth Circuit noted that this finding was in the context of rejecting the characterization of the funds wired to him as a gift at the time of receipt. That finding is not inconsistent with the theory of misappropriation. Relying on James (SCT 1961), the Fifth Circuit applied the dichotomy between theft and a loan, finding here that there was no bona fide mutual obligation to repay when Taxpayer took the money and used it for personal purposes, likely gambling. A mere obligation to “return some money at some point” coupled even with some personal wealth from which repayment could be made was not sufficient to change misappropriation into a nontaxable transaction. Here, Taxpayer received economic value, the defining characteristic of income, when he took the funds for personal use. Moreover, this was never a loan, as there was no written loan agreement, no collateral, no agreement on the timing or amount of the payment – which would be expected where almost $20 million was involved. A mutual understanding that Taxpayer would return some money at some
point is simply not enough. When, as here, money is no longer being used for the benefit of the other person but is being diverted to personal use by another, that is taxable income.

Comment: This case provides helpful explanation of the underpinnings of treating misappropriation as a taxable event, despite some future expectations concerning repayment. The absence of some of the individual features commonly associated with a loan – including a formal agreement – are not always determinative. Informal relationships present opportunities not only for misunderstanding between the parties, but also tax consequences, as demonstrated here. Misusing funds held in trust presents tax risks that should not be ignored in any context.


Taxpayer, a founding executive in Monster, Inc., held significant shares in low-basis, high-value company stock. In 2007, he executed variable prepaid forward contracts (VPFCs) with two different banks. These VPFCs were designed to provide a valuation hedge for his shares without closing a sale on them. For example, in one of the VPFCs, Taxpayer received $50.9 million from Bank of America on September 11, 2007. In return, he pledged 1.7 million shares (worth $32.91/share or about $58 million) to secure his obligation to deliver up to 1.7 million shares between September 11 and 24, 2008. The number of shares actually delivered would depend on the stock price in 2008. If the price was less than $30.46, then the full number of shares would be delivered. If the price was more than $30.46, then a fraction of that number would be delivered. In effect, this meant that Bank of America bore some downside risk, and it would share in the upside potential based on the fraction of the shares in their agreement. Taxpayer retained the right to pay off Bank of America through a “cash equivalent” equal to 105 percent of the closing share price three days prior to delivery if he determined not to sell the stock. The other VPFC provided similar, though not identical, terms.

As 2008 unfolded, Taxpayer paid the banks to extend the contract dates for delivery of stock to satisfy his obligation (or cash settlement, if Taxpayer elected) until 2010. With the financial crisis underway, Monster stock had gone down in value to approximately $17 per share. Given his low basis in the stock and the obligation for the banks to accept downside risk through a payout exceeding then-current market value, Taxpayer would have had a large long-term capital gain if he had delivered the stock in 2008. However, Taxpayer had the good fortune of dying (!) in 2009. His estate settled his obligation by delivering Monster shares, which had a stepped-up basis under IRC § 1014(a)(1). It also got a very good deal from the banks. It received about $194 million in payments from the bank, paid about $12 million to extend the contract, and then used about $88 million worth of stock to satisfy its obligations under the contracts. Neither the Estate or the individual taxpayer paid any income taxes on the deal.

The Service determined a deficiency for the individual taxpayer’s 2008 return on the ground that the extension of the agreement caused the realization of income in that year. The Tax Court disagreed, holding in favor of Taxpayer. The receipt of cash in 2007 did not trigger any gain, as this was an “open” transaction. See Rev. Rul. 2003-7 (describing outcome under VPFC). When Taxpayer extended the contract in 2008, it held that there was no “disposition of property” under section 1001. The VPFCs were not property, as Taxpayer had only “obligations” under the contracts to either deliver shares or make a cash settlement payment in the future. Moreover, the open transaction doctrine continued to apply until the shares were later
sold by the Estate. The extension did not trigger some form of deemed sale, which would otherwise result in long-term capital gain.

The Second Circuit agreed with some aspects of this analysis, agreeing that there was no “property” involved in the extension of the contracts. However, it took a different view of an alternative argument: that the obligation to either deliver or pay a cash settlement was terminated when the contract was extended, thus triggering a short-term capital gain in 2008 under section 1234A. According to the Second Circuit, it was clear that extending the valuation date from 2008 to 2010 was significant. After all, Taxpayer paid $11 million for the privilege. However, it remanded to the Tax Court to determine whether this constituted a “termination” triggering gain under IRC § 1234A.

The Second Circuit also considered another novel argument under section 1259, which treats a taxpayer who enters into a forward contract to deliver stock at a “substantially fixed price” as having engaged in a constructive sale. Here, the Monster shares were trading at 17 only two months before the delivery dates would begin. Because the price was so far below the floor price of the contract (approximately $30), there would only be a “remote” chance that the price would recover by the delivery date. Accordingly, the Service argued that Taxpayer would have to deliver all the shares. This meant the amount of property to be delivered at settlement was “substantially fixed” for purposes of section 1059. The remoteness claim was buttressed by expert testimony using a probability analysis.

While this approach is novel, the Second Circuit agreed to approve it. A significant consideration was a desire to address the economic realities of these transactions. If, as Taxpayer argued here, an extension of a contract would not trigger gain recognition, a taxpayer may enter into a VPFC and continually extend it until his death, thereby avoiding all gains on the sale of the property. According to the court, “The Internal Revenue Code should not be readily construed to permit that result.” It also rejected the Tax Court’s position that, since Taxpayer had other shares (with possibly a different basis from the pledged shares), it was still uncertain which shares would be used to satisfy the delivery option. According to the Second Circuit, this might change the amount of gain, but it would not change the outcome of a realization event. Accordingly, it remanded to the Tax Court to determine the amount of both short-term and long-term capital gain in this context.

Comments: This case should not be read to mean that any extension of a VPFC is going to trigger gain recognition. The probabilistic analysis applicable here may not be satisfied in every case, particularly if the current price of the stock was not below the “floor” price. Moreover, I’m not persuaded by the tax avoidance rationale offered by the court. Every extension requires a transaction cost, which in turn triggers a taxable event for the counterparty. If a taxpayer holding appreciated property wants to pay someone else to bear risk on its behalf, it should get the benefit of this potentially costly bargain rather than converting the transaction into a constructive sale. The case leaves some unanswered questions. Query, what will be the appropriate tax treatment of the payments to extend? Are they effectively an investment in an option contract? How, if at all, will the short-term gains measured on an exchange affect the amount of long-term gains realized on a constructive sale? Does the focus on the value, rather than specific identity, of disposed-of shares affect the continued utility of this transaction? Those engaged in negotiating VPFCs should read this case carefully and consider how to best preserve the options that remain for deferring gain recognition under the open transaction doctrine.

These proposed regulations update existing regulations to take into account statutory changes in the 2017 Tax Act that affect the method of accounting for advance payments. The principal change is to remove Treas. Reg. 1.451-5 rules, which are now obsolete.

B. Exclusions/Deferral.


Taxpayer was an enrolled member of the Seneca nation, “the largest Indian Nation within the Iroquois Confederacy and the largest population of Indians in western New York.” She and her husband mined gravel from Seneca land, and when they filed their returns for 2008-10, they claimed that the income from those gravel sales were exempt from federal income taxes because it was from “Native American land not subject to federal income taxes.” They later based their positions on two treaties, one from 1794 and another from 1842.

The 1794 treaty promised that the United States would not “disturb the [Seneca] Nation … nor of their Indian friends residing thereon and united with them, in the free use and enjoyment” of Seneca lands. The 1842 Treaty protected the lands of the Seneca “from all taxes, and assessment for roads, highways, or any other purpose until such lands shall be sold….”

For the 2008-09 tax years, Taxpayers filed a petition in the Tax Court. For 2010, they paid the tax and filed suit in federal district court. The federal district court upheld the Taxpayer’s position in denying the Government’s motion to dismiss their claim, based on the view that the reference to “their Indian friends” in the 1794 treaty included individual rights for the Taxpayers. Moreover, it also relied on a rule of construction that required liberal interpretation in favor of the Indians. However, it rejected the 1842 treaty. Accordingly, this case presents an unusual situation where two trial courts get to analyze the same question for the same parties at the same time, albeit for different years.

The Tax Court rejected this reading of the 1794 treaty, choosing instead to recognize its protection as limited to the tribe itself, not individual members. A covenant not to “disturb” does not extend to an exemption of tax. Other precedents in the Court of Federal Claims take a similar position. Taxpayers argued that prior precedents involving wages are distinguishable, as their claim involves income arising from the land itself, but this was to no avail.

As for the 1842 Treaty, the Second Circuit had previously ruled that it protected the land only from real property taxes and did not confer an income tax exemption. Since the gravel was severed from the land, the income tax could be applied.

Comment: The basis for the opinion of the court remains controversial, as some judges concurred only in the result. Judge Foley dissented on the ground that “treaties should be construed liberally in favor of the Indians, with ambiguous provisions interpreted to their benefit.”


Taxpayer had formed a nonprofit corporation, the Association for Honest Attorneys, in Kansas in 2003. She obtained 501(c)(3) status with the IRS. During the 2010-12 tax years,
Taxpayer filed Form 990-N (e-Postcard) stating that it operated as tax exempt and that annual gross receipts were less than $50K. She did not file any forms relating to foundations. However, she disbursed considerable funds from the AHA checking account for purchases at department stores, grocery stores, gas stations, car repair shops, and home improvement stores. She also paid $2,200 to exhume her father’s remains and for DNA testing.

The Service proposed an assessment of excise taxes on “excess benefit transactions”, as it alleged that the transactions provided benefits with no consideration from a person in a position to exercise substantial influence over the organization. See IRC § 4958. The so-called “first-tier tax” is equal to 20 percent, with a second-tier tax of 200 percent if the transaction is not corrected within the taxable period. Both taxes are imposed on the disqualified person. The Tax Court agreed with the Service, finding that this was an applicable tax-exempt organization. Despite the fact that the Service had determined to revoke its tax-exempt status effective January 1, 2010, in a notice filed in 2015, the entity continued to claim it was tax exempt status during each of these years. Moreover, Taxpayer was a disqualified person, as she had exclusive authority over the entity’s checking account. Taxpayer’s evidence that the transactions were for legitimate entity purposes fell short, as her testimony was “vague, self-service, uncorroborated, and/or not credible in certain material respects” and her documentary evidence suffered from similar shortcomings.

Comment: These penalty taxes certainly make it expensive to abuse a nonprofit organization for one’s own benefit. And those prone to laugh at lawyer jokes may find her organization’s name to be a humorous punch line.


Taxpayers utilized a prepackaged plan to route funds from their family business through a Bermuda-based foreign sales corporation (FSC) that was owned by their Roth IRA. Taxpayers each made a $2000 initial contribution to the Roth in 1998, which was purportedly within their annual applicable limitations. These funds were used to purchase the FSC stock, which paid dividends totaling over $533K into the Roth. The Service challenged these dividends as excess contributions subject to excise tax. Moreover, since no excise tax returns had been filed, the statute of limitations had not begun to run on those taxes.

In a carefully written reviewed opinion, the Tax Court ruled in favor of the Service, determining that the Taxpayers individually, rather than their Roth IRAs, were the substantive owners of the FSC stock in this case. It relied on Ninth Circuit precedent (to which appeal would lie) on the parameters for economic substance, albeit with heavy reliance on the terms of the applicable statutes. Here, the Tax Court recognized that the applicable FSC statutes created a limited safe harbor from the transfer pricing rules in section 482, but only for the purpose of computing the taxable income of the FSC. It would not allow the underlying substance of ownership of the FSC to be exempted from scrutiny. While the FSC statutes allowed income to be assigned to the FSC, the real question was who actually owned and controlled the FSC? If Taxpayers, then the FSC made a contribution to their Roths, triggering the excise taxes. According to the court, that depended on the exposure to downside risks or upside benefits of ownership, keeping in mind that “[t]he high stakes in tax cases, and the high intelligence of tax lawyers, make[i] it impossible to have a simple checklist or rigid formula for determining whether a transaction is a sham.” [citation omitted]. Here, there was no downside risk for the
Roth. Moreover, the payment of commissions was all discretionary on behalf of the business with international sales. Thus, the taxpayers maintained their control over the deal.

The court also recognized that this case was different from the DISC cases, including the fact that the FSC regime did not involve an unrelated business income tax, only a corporate tax.

Comment: A vigorous dissent by Judge Holmes begins as follows: “In Summa Holdings... the Sixth Circuit – in the court of reversing our decision in a case nearly identical to this one -- warned that a court that construes the Tax Code against its language and in favor of judge-made doctrine acts like Caligula, who famously posted tax laws in fine print and so high that Romans could not read them. See Suet. Cal. 41. It is our custom to reconsider an issue when a circuit court reverses us. And today we have to choose either a well-reasoned opinion by a highly respected judge in America's heartland, or Caligula. We pick Caligula.” Ouch. When a statutory regime produces results that are too good to be true, there is immense pressure to find a way around “the high intelligence of tax lawyers.” But the question posed by the dissent is whether we do so without doing violence to the concept of the rule of law. See also Benenson, below.

4. Substance over form did not apply to make DISC commissions into excess Roth contributions, Benenson v. Commissioner, 887 F.3d 511 (1st Cir. 2018).

Taxpayers here used a DISC to channel commissions into their Roth IRAs. The Service challenged this arrangement, which involved an intermediary corporation, Summa Holdings, as involving excess contributions to a Roth, thereby triggering excise taxes. After an adverse Tax Court decision, Summa Holdings appealed to the Sixth Circuit, which reversed, upholding the Taxpayer position that it had used the DISC and Roth IRAs for purposes sanctioned by Congress, and that substance over form doctrine could not be used to upset those purposes.

Individual taxpayers affected by the adverse Tax Court ruling brought this appeal in the First Circuit, likewise arguing for reversal. Although the First Circuit refused to recognize claim or issue preclusion based on the result in Summa Holdings, it nonetheless made an independent determination in their favor. Since Congress is presumed to understand existing law when it enacts legislation, the court refused to conclude that the transaction used by the Taxpayers was outside the intent of the statute. Here, as the court stated, “We are inclined to accept the congressional sanctioned solution to a potential tax avoidance problem, rather than relying on a judicially crafted common law solution.” The court further observed:

Some may call the Benensons' transaction clever. Others may call it unseemly. The sole question presented to us is whether the Commissioner has the power to call it a violation of the Tax Code. We hold that he does not. The substance over form doctrine is not a smell test. It is, in this circuit, a tool of statutory interpretation. When, as here, we find that the transaction does not violate the plain intent of the relevant statutes, we can push the doctrine no further. In such circumstances, to the extent we accept “the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the court's.” Fabreeka Prod. Co. v. Comm'r, 294 F.2d 876, 879 (1st Cir. 1961).

Comment: Taxpayers dealing with substance/form challenges may find support in this case. However, a dissenting judge in Benenson was not convinced that the deferential approach to Congress should be followed here. As seen from Mazzei, above, the Tax Court also does not
seem to be quite so convinced on the matter. Expect to see this case, along with Summa, in further appellate argument. Judges will continue to wrestle with the rule of law considerations presented here, as well as the policy challenges that hard cases like these may present.

5. Distribution from IRA was taxable, not a settlement in divorce, Kirkpatrick v. Commissioner, TC Memo 2018-20.

Taxpayer and his spouse were engaged in divorce proceedings during the 2012-13 tax years. During those proceedings, a state court ordered him to transfer $100,000 into an IRA appropriately titled in his wife’s name “in a non-taxable transaction”. It also ordered that he pay her $40,000 for attorney fees.

During 2013, Taxpayer withdrew funds from his IRA accounts, deposited them in his checking account, and then wrote checks to his wife and to others on her behalf. He was over 59½ at the time of the withdrawals. Taxpayer and his spouse were still married in the year that the withdrawal occurred, so the couple filed a joint return. That return did not report the distribution as taxable. Their divorce was finalized in 2014. The record shows that Mrs. eventually “contributed” the funds to an IRA in her name.

On audit, the Taxpayer conceded that some of the funds distributed from the IRA were taxable and should have been reported. However, he claimed that the amounts ordered by the court should be covered by IRC 408(d)(6), which is an exception for transfers ordered pursuant to a divorce or separation instrument.

The Tax Court rejected the Taxpayer’s argument, finding that there was not a covered transfer of an IRA in this case. Instead, the Taxpayer received a taxable distribution. Following Tax Court precedent in Bunney v. Commissioner, 114 TC 259 (2000), there must be a transfer of the account, not a distribution. Thus, there must be a change in name or a trustee-to-trustee transfer, rather than cash flowing to the Taxpayer, as occurred here.

The court also noted that, under the Supremacy Clause, the fact that the state court directed the transfer to be non-taxable did not make it so for federal tax purposes. However, it noted that it need not rule in that area as the state court merely directed that a non-taxable transfer be made, which Taxpayer did not do in this case.

Comment: An interest in an IRA is not the same as the money in the account. Care should be directed when effectuating divorce settlements to avoid these unintended consequences. And if you are the divorcing spouse filing a joint return with your husband in the midst of a rancorous divorce proceeding, beware about the potential for joint and several liability in that context. Query what consequences for Mrs. after she “contributed” the funds to the IRA in a subsequent year. Was that an excess contribution?

C. Characterization.

1. Damages from stray voltage tort claim against electric utility were business income and subject to self-employment tax, Allen v. United States, No 16-C-1412, 2018 WL 3717021 (E.D. Wis. Aug. 3, 2018).

Taxpayer is a dairy farmer in Wisconsin who successfully prosecuted a lawsuit against an electric utility company that alleged harm to his cattle business and dairy farm based on stray voltage. The suit claimed that Taxpayer experienced decreased milk production, injury and damage to his dairy herd, and lost profits and income due to stray voltage. Although he also
alleged damage to his property, he did not introduce any evidence on this point. A jury awarded $750K economic damages and $1 million in tort damages, plus interest. Taxpayer received $2.2 million and paid $1.2 million in fees and expenses to his attorneys. His lawyers advised him to seek the advice of a tax preparer, as the award was likely taxable.

Taxpayer did consult an accountant, but he ultimately refused to file the return because he disagreed with Taxpayer’s preferred reporting method, which included: 750K as Schedule F income, $519K interest as “capital gains” income on Schedule B, $548K in legal expenses as a farm expense on Schedule F. He omitted $1 million in tort damages and failed to include all the legal expenses in his return.

After audit, the Service increased his tax liability to treat all of the damages as farm income, took into account all fees and expenses as farm expenses, and imposed self-employment taxes on these amounts, along with accuracy penalties for failure to report the omitted tort damages.

Taxpayer paid the tax and filed a refund claim. The district court granted summary judgment in favor of the government. The award of interest was not properly treated as capital gain; instead it was ordinary income. Even if the award had been nontaxable personal injury damages, interest would still have been taxable under Tax Court precedent. Moreover, the court upheld the determination that the interest was subject to self-employment taxes. Here, the interest arose out of the damage award from losses incurred by his business. In support of his position, Taxpayer could only point to the absence of interest in the listing of examples of farm income in the instructions to Schedule F, but this was not sufficient authority for excluding the interest from the self-employment tax base.

As for the tort damages that taxpayer omitted from his return, there was no basis for an exclusion here. He did not submit evidence of any personal physical injury or any loss in the value of farm property, either of which might have given rise to a portion of the recovery being excludable. Moreover, taxpayer here was subject to the penalty. Not only did he fail to disclose his position on his return, but he deviated from the professional advice of his accountant without any showing of reasonable cause and good faith.

Comment: A hat tip to James A. Beavers in his Tax Adviser column published October 1, 2018, which highlighted this case. While the outcome here is predictable (apart from the inclusion of interest in the self-employment tax base), the case is useful in showing that the underlying claim might have generated more nontaxable income if the plaintiff’s lawyers had tax results in mind. The failure to present evidence on any loss in value for his property made it impossible to treat any of the recovery as a return of basis, which could have avoided some taxable income.


Taxpayers bought a home in 2005 in San Jose California for $695K, financed in part by nonrecourse debt. In 2010, they moved but decided to keep the house and rent it out to tenants. On their return filed in 2011, they valued the home at $590K for purposes of determining depreciation deductions allowable on their rental. Later, they would stipulate to a lower value of $495K at that time. Late in 2011, when the market had not recovered, they sold the house for $363K. Wells Fargo, their lender, approved the sale, and all proceeds went to Wells Fargo to pay down the loan and related closing costs on the sale.
Wells Fargo sent Taxpayers a 1099-C for $219K, the unpaid balance of their debt, which was cancelled on November 21, 2011. The title company handling their sale gave them a 1099-S reporting the $363K sales price for the house, showing a closing date of November 18, 2011. Mrs. Taxpayer was a lawyer “but had the misfortune of not taking even Intro Tax in law school”. She used TurboTax to prepare the return, and she reported a loss on the sale. As for the cancellation of indebtedness, she believed section 108(a)(1)(E), as amended in 2007, excluded “qualified principal residence indebtedness” in this case. The Service proposed a deficiency.

The Tax Court first noted that nonrecourse debt was involved here. California law restricts a lender’s remedies to the property, not to the debtor. It then turned to address the timing of the sale, agreeing with the Service that the sale and the cancellation of the debt occurred at the same time, not as separate events as argued by the taxpayer. Although there is case law supporting the proposition that nonrecourse debt can produce cancellation of indebtedness income, the best view is that the disposition of the underlying property triggers the inclusion of the debt into the amount realized from the property. Here, the sale was facilitated by the lender. Wells Fargo would not agree to the sale unless Taxpayers turned over the entire proceeds to them. Although Wells Fargo had to convey the deed of trust to allow the sale to close, and it couldn’t collect on the debt after it conveyed that deed, the entire transaction was a single taxable event.

The amount realized on the sale thus includes the full amount of the debt under established authority. Further, there is no cancellation of indebtedness here that would invoke section 108. The amount realized was $555,960, the amount of their nonrecourse debt outstanding at the time of the sale, not the $363K in cash paid over to Wells Fargo. (And it should be noted, closing costs paid by the seller should have reduced this amount, even if recourse debt were involved.) However, under the 1.165-9 regulations, the adjusted basis here for purposes of computing a loss is limited to the FMV at the time of conversion (less depreciation), but for purposes of determining gain, it would presumably be measured based on the original purchase price adjusted for depreciation taken. Here, while recognizing that these regulations present “the kind of conundrum only tax lawyers love”, the court concludes neither gain nor loss was incurred on the sale of their home.

The Tax Court left open for another day whether this home could be considered their personal residence if section 108 applied, noting that it was not obvious. In this case, the taxpayers avoided any penalties based on what the court characterized as “an honest misunderstanding of the law that was reasonable considering their lack of tax knowledge, the complexity of the issues, and the information returns they received.”

Comment: Frankly, I’m not sure that this case should have merited a full Tax Court opinion, as I viewed this law as settled. However, it may put to rest some older precedents that injected discharge of indebtedness into this context. Perhaps penalty avoidance is proper here, but my students would fail an examination question if they reported this transaction like the Taxpayers did in this case. Compare Hamilton, TC Memo 2018-62, in which accuracy penalties were applied to a taxpayer who wrongfully claimed he was covered by an insolvency exception based on excluding an account transferred to his adult son from his list of assets.

Taxpayer is a pharmaceutical scientist who co-invented “liquisolid technology”, which involves certain drug-delivery techniques meant to facilitate absorption of orally administered medication. The technology is potentially useful for many different drugs, but it cannot be commercially used without specialized work in connection with each specific drug. Therefore, practical formulation, testing, FDA approval, and marketing processes were required for each drug using the technology.

While Taxpayer had specialized knowledge to contribute to these activities, he could not develop drugs alone. Accordingly, he entered into a licensing agreement with a drug company (“Mutual”) in 1998, which provided a framework for licensing the liquisolid technology to Mutual, jointly identifying drugs to develop using that technology, and compensating Taxpayer through royalties based on the ultimate sales of those drugs. Their deal allowed Mutual to use the technology, but only in connection with drugs that the parties would unanimously select. Moreover, Mutual got the exclusive right to sell those drugs.

Following their agreement, Taxpayer and Mutual agreed to develop certain drugs. One of the most promising applications involved a blood-pressure drug, felodipine, resulting in an engagement letter in March of 2000 to undertake this work. Taxpayer completed the work to adapt the technology to this drug quickly -- sometime around May 2000 -- as he had already identified this drug as promising and had done some of the work beforehand. This drug ultimately received FDA approval. The drug was marketed with great success, generating $40 million in royalties paid to Taxpayer during 2007 and 2008, which Taxpayer reported as capital gains under section 1235.

Section 1235 allows capital gains treatment for “a transfer of property consisting of all substantial rights to a patent”. This treatment applies even when consideration is paid periodically or is contingent on productivity or use of the property. Regulations indicate that an actual patent is not required; a patentable product held as a trade secret can also qualify. Those eligible for capital gain treatment include the individual whose efforts created such property, or another who acquired an interest in such property prior to “actual reduction to practice” who is neither the creator’s employer or one related to the creator.

The Service argued that these royalties were ordinary income, not taxable gain, as there was not a transfer of “all substantial rights to a patent” as required under section 1235. The Tax Court agreed with the Service. Focusing on the 1998 license agreement, the Tax Court concluded that the agreement did not transfer rights to the formulation of any drug, as no such formulations existed. Tax Court found that the transfer of technology prior to the formulation did not extend to the liquisolid technology generally, but only the “rights to use the liquisolid technology … and to make and sell any ‘products containing the technology’”. The product using the technology, which generated the royalty, was not in existence when the Taxpayer entered into the agreement with the drug company that gave rise to the future payment of royalties. Moreover, the royalties were paid to Taxpayer and his co-inventor through their jointly held company, even though the co-inventor did not participate in developing the ultimate formulation of the patentable drug.

Taxpayer appealed to the Third Circuit. On appeal, he argued that the 1998 agreement also transferred complete and exclusive rights to all future drug formulations using the technology. Accordingly, when Taxpayer transferred the formulation, he was the holder of a patentable technology. Moreover, he received payments in consideration for that formulation.
Even though he transferred the actual formulation sometime in 2000 or 2001, the rights to the formulation were already transferred based on the 1998 agreement, which also gave him the royalty rights from the future sales of that product. According to the Taxpayer, the drug, not the liquisolid technology generally, was the source of the royalties. And it was perfectly proper for an inventor to assign a property right in an invention before he invents it; section 1235 does not prevent this from generating capital gains treatment.

The Third Circuit ruled against Taxpayer, but its decision was based on the doctrine of waiver. According to the majority, Taxpayer’s argument on appeal had been reformulated. He had failed to argue that the 1998 agreement transferred all substantial rights to the felodipine formulation in the Tax Court, and so this argument was waived on appeal. Moreover, the majority views section 1235 as inapplicable when there is a transfer of rights that had not been reduced to practice. A vigorous dissent disagreed on both points, alleging both factual and legal confusion by the majority.

Comment: This is a fascinating and difficult case, as evidenced by the vigorous disagreement and arguments in the Third Circuit opinion. I think the dissent may have the better position on the law of section 1235. If the majority’s formulation is correct in stating that the invention must be reduced to practice at the time of sale, then this substantially defeats the incentive structure contemplated by according capital gains treatment to those developing new technologies and to those who acquire them before they are reduced to practice. The dissent may also be correct on the doctrine of waiver, but that belies an even more important point: this case shows the importance of clarity in formulating and articulating arguments and supporting facts in the trial court. Some of the uncertainty may relate to the locus of the royalty in the agreements: one could not make the drug formulation without the liquisolid technology; that technology would only be monetized through a royalty on drugs developed after this technology. Query whether a more careful agreement could have navigated the section 1235 minefield more effectively. Which technology is really the source of the revenue? Could there be half a loaf, perhaps?


Taxpayer, an LLC, acquired a hotel property in 2005 for 13.8 million. After operating the property for just over a year (and carrying on a trade or business with it, rather than merely investing in it), Taxpayer reached an agreement to sell the property to a third party for $39 million, $9.7 million of which was paid immediately as a nonrefundable deposit that would otherwise be credited toward the purchase price at closing. Unfortunately, closing did not occur and in 2008, the buyer defaulted and forfeited the $9.7 million deposit.

The LLC reported the $9.7 million as a long-term capital gain. However, the IRS treated this amount as ordinary income. The Tax Court agreed with the IRS, ruling that the plain language of section 1234A requires this to be treated as ordinary income, not capital gain. The Eleventh Circuit agreed after de novo review.

Here, if the transaction had gone through, much of the gain realized would have been 1231 gain, as this property had been used in carrying on the trade or business of operating a hotel and restaurant. However, in this case, section 1234A states in relevant part: “Gain or loss attributable 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 ... shall be treated as gain or loss from the sale of a capital asset.” Unfortunately for the Taxpayer, section 1221 defines a capital asset in a manner that exclude those assets used in a trade or business. While section 1231 prescribes capital gains treatment in connection with a sale or exchange of business property, section 1221 precludes it in other contexts. Without the benefit of the special rule in section 1234A, capital gains treatment in this context is not allowed.

Taxpayer’s efforts to point to intellectual inconsistency in this outcome, including references to treatises and other academic writers, proved ineffectual in light of the plain language of the statute relied upon here. “[A]s a practical matter, conscientious adherence to the statutory text best ensures that citizens have fair notice of the rules that govern their conduct, incentivizes Congress to write clear laws, and keeps courts within their proper lane.” Further, “[n]ow it may well be, as CRI–Leslie asserts, that Congress really did mean for the amended Section 1234A to reach beyond “capital assets” as defined in Section 1221 to include Section-1231 property. Perhaps, that is, Congress just stubbed its toe between the hearing room and the House and Senate floors. Even so, it’s not our place or prerogative to bandage the resulting wound.”

Comment: The reliance on plain language here helps the Government. But note, there are limits to the reliance. As the court points out, “While “[t]here is an absurdity exception to the plain meaning rule,” it is necessarily “very narrow,” United States v. Nix, 438 F.3d 1284, 1286 (11th Cir. 2006), and applies only when a straightforward application of statutory text would compel a truly ridiculous—or to use Justice Story’s word, “monstrous”—outcome. We are not in that ballpark here....” (footnote omitted). Tension here is unlikely to be resolved anytime soon. Apparently, a passive investor will continue to come out better than a business operator in this context.

II. Deductions.

A. Charitable.

1. Trust’s charitable deduction for real property limited to adjusted basis, Green v. United States, 880 F.3d 519 (10th Cir. 2018).

A trust sought a charitable deduction for property donated in kind to churches. This trust has considerable income from ownership of Hobby Lobby retail stores. However, the trust had purchased the property years before, and it had appreciated considerably between the dates of purchase and the dates of contribution. The trust reported the gifts at fair market value, but on its original return, they applied a 30 percent limitation. On an amended return, the trust claimed that the 30 percent limitation was inapplicable, and thereby increased the amount of the deduction. The Service agreed that the applicable limitation was 50 percent, but it disallowed the refund claim on the basis that the deduction was limited to the adjusted basis of the real property contributed. The trust filed suit in the district court, which granted their refund claim. The Government appealed, and the Tenth Circuit reversed, upholding the Government’s position.

In this case, the Government took the position that the charitable deduction allowed by IRC § 642(c)(1), which allows a deduction for “any amount of the gross income”. Although the trust was flush with unrelated business taxable income from the Hobby Lobby operations, the court viewed the contribution as coming from a distinct source – the property itself. And since the amount of the deduction in the case of an estate or trust is limited to the “amount of the gross
income”, this presents a problem, since the property contained unrealized appreciation which had never been included in the gross income of the trust.

The Tenth Circuit viewed the “gross income” phrase as ambiguous, and in resolving the ambiguity, it resorted to the implementing regulation. Treas. Reg. § 1.642(c)-1(a) treats the gross income restriction as being measured in relation to the accumulated gross income not previously deducted. While this would allow a deduction to the extent that the trust property had been purchased with gross income, it did not resolve the question of whether unrealized appreciation was deductible. Two competing principles of interpretation could be invoked. On one hand, deductions are a matter of legislative grace, so that the taxpayer bears the burden of proving entitlement to the deduction. On the other hand, charitable deductions are sometimes viewed as an expression of “public policy” and therefore construed liberally.

It might be said that the Tenth Circuit gave “half a loaf” to each party. The liberal construction principle was invoked to allow the deduction for property if it was purchased with gross income, whether from the current year or from past accumulated income. However, the more restrictive principle was applied to limit the deduction amount in this case to the adjusted basis of the property (representing the purchase price) and disallowing the excess attributed to unrealized appreciation, which had not been taken into account in gross income. Although the Code embraces gains from “dealings in property” as a specifically enumerated item of gross income, the term “dealing” is restricted in the applicable regulations to “sale or exchange”, which had not occurred here.

Comment: The Tenth Circuit decision may be challenged by taxpayers in other circuits, who may wish to roll the dice that other judges will view the charitable deduction here with more liberality toward the trust or estate. After all, other taxpayers get to take deductions based on fair market value, rather than adjusted basis, in similar circumstances. Also note that the Tenth Circuit applied the variance doctrine to reject an argument based on section 512(b)(11) of the Code, which was not raised in the refund claim. It remains to be seen whether those or other arguments might be successful in another venue. For further analysis, see Philip Jones, 128 J. Tax’n 19 (April 2018).


Taxpayer, a partnership holding a long-term lease of an historic property, sought a charitable deduction for a conservation “façade” easement under section 170(h). The owner of the property, Economic Development Corporation, entered into an agreement with a qualified charity to protect the building’s façade. The Commissioner does not dispute that the fee owner is entitled to a deduction in connection with the contribution. However, he contends that the long-term lessee is not entitled to any such deduction, even though its rights in the property were indeed affected by the contribution.

In this context, although the lessee gave up contractual rights in connection with the easement, those rights were not a qualified real property interest that could give rise to a charitable deduction. Applying Massachusetts law, the Tax Court found that Taxpayer had at most an interest in the property for a term of years, which is personal property, rather than a form of fee ownership. Therefore, as lessee, the contractual rights that it may have had to contribute would be incapable of satisfying the statutory requirement for a perpetual restriction on the use of the buildings. Only the owner can satisfy this requirement. Arguments based on analogy to a
tenant in common or to equitable ownership proved unavailing. Even equitable ownership would not extend beyond the lease term, which is necessary to satisfy perpetuity requirements.

Comment: Taxpayer’s position is sensible from an economic perspective, as they truly gave up something in connection with the grant and their cooperation would presumably have been essential. However, the provision of tax benefits depends on the legal definition within the Code, which is not looking at the economics. Rather than looking to tax benefits to compensate for the loss of property rights, Taxpayer should have looked to contract for some sharing of the tax benefits available to the fee owner.


Taxpayer, a limited partnership, acquired a golf course and related land in South Carolina in 2002 for $2.4 million. The deed restricted its use to recreational facilities or open space for a period of 30 years. The golf course was not profitable, so the partnership closed it in 2006. It filed for Chapter 11 bankruptcy protection in March 2006, and in October 2006, it sought to invalidate the use restriction in the deed. That litigation eventually settled by granting the property owner’s association for a neighboring residential community an option to purchase the property, which it exercised in August 2007. However, prior to closing, Taxpayer granted a conservation easement covering 234 acres to the North American Land Trust, including the 27-hole golf course plus seven other acres of property. The use restrictions were “in perpetuity”, and they generally involved preserving the golf course for public use and, if it ceased operations, for other recreational purposes. Fees could be charged for access.

However, the Service audited Taxpayer’s return and challenged the $15 million valuation placed on the easement. It also claimed that the easement did not satisfy the conservation requirements and that it lacked a perpetual time period as required by statute. The Tax Court ruled for the Service. Taxpayer appealed.

The Fifth Circuit concluded that the easement here met the requirement of being for conservation purposes. It preserved the land for outdoor recreation by the general public, even though it was a golf course that restricted access to those who paid fees for play. However, the Fifth Circuit concluded that the preservation requirement was not perpetual. Therefore, the deduction requirements are not satisfied.

Compliance with the conservation requirements is measured at the time of the contribution based on the restrictions applied by the donor. Therefore, facts that involved subsequent use by the property owners association could not be used to prove noncompliance in this case, where there was no evidence of collusion between them. Moreover, despite some conflicting language about public access in the deed itself, the court looked to the deed in its entirety and concluded that specific terms governing public access were entitled to greater weight than more general terms that could be read to restrict that access.

However, with regard to perpetuity, the Fifth Circuit found fault in a provision that addressed the possibility that the property could be condemned or otherwise cease compliant use – so-called “extinguishment” of the easement. Treas. Reg. 1.170A-14(g)(6) governs these extinguishment provisions, and the problem here surrounds the restriction in the provision that would remove the value of improvements on the property before calculating the pro rata share to which the donee would be entitled.
The Fifth Circuit also affirmed other aspects of the Tax Court’s opinion, including matters involving valuation and the gross valuation misstatement penalty.

Comment: In theory, it appears that the removal of improvements could exhaust the principal if those improvements were constructed after the donation. This ruling on the perpetuity requirement here may particularly interest those who draft extinguishment provisions.


Comment: Those in the charitable space or representing taxpayers who take charitable deductions will want to review these carefully. They cover topics including the contemporaneous written acknowledgement requirement, along with new requirements for a qualified appraisal and the meaning of a qualified appraiser. For a summary and further analysis, see J. Tax’n, October 2018, at 40.

B. Business.

1. Adjustments for unreasonable salaries disallowed and COGS upheld, Transupport, Inc. v. Commissioner, 883 F.3d 274 (1st Cir. 2018).

Although Taxpayer successfully avoided a fraud penalty in prior litigation, the Service sustained audit adjustments in both its cost of goods sold and its salary deductions in proceedings before the Tax Court. Taxpayer appealed.

Taxpayer operated a business that sold military equipment. Rather than using inventories, it used a “gross profit” method, in which it reported gross profits ranging from 31-39%. The IRS had previously audited Taxpayer and was aware of this method, but no adjustment was made. The methodology for reporting these percentages during the years at issue was not disclosed. Moreover, Taxpayer paid the founder’s sons over $500K in salaries over several years.

In 2007, the founder sought to sell the company. The company hired a consultant, who prepared a “Confidential Offering Memorandum” that revealed a 75% gross profit percentage and suggested that reasonable compensation for officers was closer to $50K. In other words, while the memo was supportive of a higher value for the company, it was not supportive of past tax treatments. Someone reported this to the Whistleblower office, and audit ensued.

The Tax Court upheld the audit adjustments and accuracy penalties, but it rejected fraud penalties. On appeal, the First Circuit upheld the Tax Court determinations. In doing so, it rejected Taxpayer’s claim that the court erred as a matter of law by refusing to consider the return on equity earned by the shareholders in determining that officer compensation was unreasonable. Based on a clear error standard of review, it upheld the Tax Court’s finding that the salary was unreasonable or that the COGS was lower than reported by Taxpayer. Moreover, it also upheld accuracy penalties as Taxpayer knew or should have known that the figures it provided to its accountant were incorrect. As for reasonable cause and good faith, the Tax Court may find this based on prior audit results, but it is not required to do so.

Comment: Life lesson here -- beware when preparing a “confidential offering memorandum” that essentially says the books have been cooked.
2. Deductions for marijuana business legal under state law disallowed, Alpenglow Botanicals, LLC v. United States, 894 F.3d 1187 (10th Cir. 2018).

Taxpayer, an LLC operating a marijuana business legally in Colorado, was audited for its 2010-2012 tax years. The Service disallowed its claimed business expense deductions under section 280E, resulting in deficiencies for both of its owners due to an increase in their share of pass-through income. Taxpayers paid the tax and filed suit in district court, which dismissed their claim (Rule 12(b)(6)), resulting in this appeal to the Tenth Circuit.

First, Taxpayers argued that the IRS could not deny a deduction under section 280E without a corresponding criminal conviction, and that even if it had this authority, it lacked the evidence to apply section 280E. The Tenth Circuit had no trouble rejecting these arguments. Tax law operates in a distinct realm from criminal law. The fact that the Justice Department issued memoranda during the Obama Administration (which have since been substantially rescinded) that decline to enforce federal drug laws did not bind the IRS from following the tax laws in this area. It was squarely within IRS authority to determine, as a civil tax law matter, whether taxpayers trafficked in a controlled substance, thereby suffering the disallowance of a deduction. Moreover, Taxpayers sought relief in refund litigation, which assigns a burden on the taxpayer to prove it was entitled to that refund. Taxpayer must prove error giving rise to an overpayment of tax; in this forum, the Government was not required to prove trafficking. Taxpayer failed to introduce any credible evidence that it was not trafficking in controlled substances.

Second, Taxpayer alleged that the denial of deductions in this context ran awry of the Sixteenth Amendment. Again, the Tenth Circuit gave no quarter to this argument. It pointed to Commissioner v. Sullivan (1958), in which the Supreme Court refused to deny deductions for ordinary and necessary business expenses to an illegal gambling business. In doing so, it placed the burden on Congress to deny a deduction for an illegal enterprise. Congress effectively took up that challenge through enacting section 280E; the Supreme Court would not ask Congress to do something unconstitutional; therefore, it must be constitutional. (Notably, the Taxpayers also tried to raise the denial of cost of goods sold offsets – remember, they are not deductions – but that was rejected under pleading rules.)

Finally, Taxpayer argued that the Eighth Amendment prohibition on excessive fines. Relying on its prior decision in Green Solution, 855 F.3d 1111 (10th Cir. 2017), the court rejected this argument, too. Disallowing deductions are not an exaction imposed as punishment. No one has a right to a deduction, as deductions are a matter of legislative grace.

Comment: The current state of legal conflict in this area needs to be resolved, one way or another, in the legislative branch. The court was asked to invoke a public policy exception, but it appropriately refused. In the interim, it appears that tax laws will continue to be enforced according to federal laws on controlled substances, regardless of state law treatments. Query whether states that have liberal marijuana laws will also alter their state income tax statutes to vary the measure of gross income from that reported on the federal return.


Taxpayer is a private country club operating as a section 501(c)(7) social club. While tax exempt income comes from member dues and expenditures on food and beverages, nonmember
income from rentals or from interest and dividends are unrelated business income, thereby taxable. Taxpayer held a series of nonmember events during the 2010-12 tax years that generated losses, which it used to offset otherwise taxable investment income. This was part of a streak of 13 years of loss-producing activity. The IRS disallowed the losses as not being incurred in a profit-seeking activity. The Tax Court agreed. (See TC Memo 2017-158). This appeal ensued.

The Sixth Circuit affirmed, but with some clarifications in the Tax Court rationale. For example, the Tax Court erroneously interpreted Supreme Court precedent in Portland Golf Club (1990) to require a showing of profitability. Instead, intention is sufficient. Moreover, it also rejected the application of factors from hobby losses (IRC § 183) in assessing the intent to profit, when many other courts had applied them by analogy. However, such errors were harmless. There was ample evidence here that the club failed to demonstrate a profit motive. It offered no evidence that their goal was to turn a profit. The court also upheld penalties in this context.

Comment: Those in social clubs may want to take note of this opinion.

4. Professional gambler may not deduct “track share” paid from all wagers, Lakhani, 731 Fed. Appx. 657 (9th Cir. 2018), affirming 142 T.C. No. 8 (2014).

   Taxpayer was a professional gambler who bet on horse races. He sought to avoid the deduction limitation in section 165(d), which allows losses from wagering transactions to be deductible only to the extent of gains from such transactions, by claiming that the so-called “takeout” calculated on each wager by the track and retained to offset its business costs was a separate trade or business expense associated with nongambling income. The Ninth Circuit found this distinction “unsound”. First, the “takeout” portion affected all wagers, not an expense that is separate and apart from the wager. Moreover, whenever a winning bettor received a payout, it would necessarily include the full amount of the wager plus a profit. On the other hand, a losing bettor would lose the entire amount. The “takeout” portion could not affect gains or losses. Finally, it followed the Tax Court’s prior opinion in Mayo, 136 TC No. 4 (2011), concluding that the more specific provision – 165(d) – governs over the more general provision in section 166.

Comment: Although this case resolves the matter for years prior to 2018, the Tax Cuts and Jobs act clarifies that professional gamblers now must treat their expenses as losses, thereby making them subject to section 165(d). Professional gamblers already had the odds against them – and the new tax legislation raises the stakes by further restricting their deductions. For additional analysis, including some case law with particular aspects of gambling income/expenses and some uncertainties, see Wei-Chih Chiang, Yingxu Kuang & Xiaobo Dong, “Tax reform law deals pro gamblers a losing hand, Journal of Accountancy, October 1, 2018.


   Taxpayer was an executive in a corporation that owned a majority interest in a Nevada LLC. That LLC participated in a scheme to defraud the Overseas Private Investment Corporation (OPIC) through obtaining loans to fund putative foreign business operations. Taxpayer as the corporate secretary of the LLC, and he also used the corporation to sponsor the loan. OPIC later discovered that the loans were fraudulent. Criminal proceedings emerged, and in 2011,
Taxpayer pled guilty to conspiracy to commit mail and wire fraud and money laundering. He was sentenced to 12-months imprisonment plus restitution of $750K, with forfeiture in lieu of restitution. There was no fine imposed. The restitution ordered represented Taxpayer’s share of the total restitution owed to OPIC, which was in turn based on its losses from the loan transactions.

In 2014, Taxpayer made four payments totaling $400K from IRAs and from an investment account. He initially claimed that these were tax payments, but he later changed that position to a claim that the payments represented miscellaneous itemized deductions as an employee business expense or as a loss on a transaction entered into for profit. A collection due process claim ensued, but the IRS sustained the proposed levy. Taxpayer then filed a petition in the Tax Court on the matter of the deductibility of the payments.

The Tax Court held that this taxpayer failed to prove that the expenses were attributable to the performance of services as an employee of the corporation in this case. Moreover, even if he was an employee, he failed to prove that these expenses were not entitled to reimbursement. If the restitution was in substance a repayment of the loan that GSP had obtained, the taxpayer is not entitled to a deduction for repayment of the loan to his employer. In that context, the taxpayer has a burden to show that there was a direct nexus between the purpose of the payment and taxpayer’s business or income producing activities. He failed on this point, and thus was not entitled to a deduction. Nor was he able to show a transaction entered into for profit. Any profits from the loans would have inured to the entities that took them, not to him directly. The court found it unnecessary to reach the question whether the deductibility of the payment violated any public policy, as these payments did not meet the threshold for deductibility.

Comment: *I suppose one life lesson here is not to defraud others, but if you do, then you should not use corporations to do the defrauding if you plan to get caught. Compare Cavaretta, TC Memo 2010-4, cited by Taxpayer, which allowed a dental practice deductions for repayment of false claims. Settlements of contract claims are ordinary and necessary in that context. Query whether his criminal defense team was keyed into tax issues in connection with sentencing. (A hat tip to Sebastian Murolo, who submitted this case to the Journal of Accountancy in November 2018.)*

6. Per diem rates for business travelers, Notice 2018-77

The Service has issued updated rates for business travel effective after October 1, 2018. This notice supersedes Notice 2017-54, which provides rates for the prior year.

7. Business meals may still be deductible!, Notice 2018-76, 2018-42 IRB

The TCJA created some uncertainty about the deductibility of business meals. Section 274 previously allowed deductions for entertainment expenses if “the taxpayer establishes that the item was directly related to, or in the case of an item directly preceding or following a substantial and bona fide business discussion …, that such item was associated with, the active conduct of the taxpayer’s trade or business….” See IRC § 274(a)(1)(A) (pre-TJCA). However, this language was stricken by the TJCA. Certain other restrictions also applied in pre-TJCA law. For example, in the case of meals and entertainment, only 50 percent deductibility was permitted (outside certain exceptions). See IRC § 274(n). Moreover, no deduction can be allowed for food or beverages unless the expenditure is not lavish or extravagant and the taxpayer or an employee
is present at the furnishing of food and beverages. See IRC § 274(k). These provisions remain after the TJCA was passed, except that the TJCA removed the 50 percent deduction discussion for entertainment, as such expenditures would no longer be deductible in any event.

Meals are sometimes referred to as a form of entertainment. Under prior law, it did not matter as both entertainment and business meals involved similar restrictions. After the TJCA, the extent to which business meals constitute “entertainment” is now a matter of some controversy, as no deduction is allowed for entertainment, but provisions governing business meals remain in place. Regulations under section 274 continue to define entertainment, and the TJCA did not change those regulations. So what is a taxpayer to do?

There is some indication in the legislative history that taxpayer may continue to deduct 50 percent of food and beverage expenses. The Notice provides interim guidance that taxpayers may continue to deduct 50 percent of an otherwise allowable business meal as long as certain conditions are met. Most of these are the same as prior law (e.g., ordinary and necessary, not lavish or extravagant, taxpayer present). However, these requirements also apply: “the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact”, and “in the case of food and beverages provided during or at an entertainment activity, the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately....”

Examples illustrate these requirements. Buying a hotdog and beverage for a client at a baseball game could be deductible, while the baseball ticket expenditure is not. Watching the game from a skybox where food and beverages is supplied as part of the facility would not satisfy the requirements for deductibility, unless the food tab is separately invoiced.

Comment: Proposed regulations to implement the guidance will follow. In the meantime, this transitional guidance is likely welcome news for taxpayers (and restaurants) with business meals. It remains to be seen what, if any, additional restrictions are imposed to ensure that the meal is a business meal and not entertainment.

8. Transitional guidance on new rules in sections 162(f) and 6050X, Notice 2018-23

The 2017 Tax Act provided additional restrictions on the deductibility of amounts paid to government to settle litigation under section 162(f). Section 162(f)(1) disallows deductions for certain amounts paid or incurred to, or at the direction of, government in relation to a violation of law. However, section 162(f)(2) allows deductions for amounts paid that satisfy certain additional requirements, which are designed to carve out payments in the form of restitution. For example, restitution for failure to pay any tax is treated as if the amount were tax. To help implement these provisions, the Act provided for new 6050X, which imposes information reporting requirements on government officials. This Notice provides transitional rules that will assist in the compliance with these new provisions. While the Notice does not suspend the restrictions in section 162(f), which are applicable to amounts paid or incurred after December 22, 2017, unless they were pursuant to a binding order or agreement entered into before that date, it does suspend the compliance obligations of government officials until no earlier than January 1, 2019, or such later date prescribed by regulations.

Section 163(j) has been amended by the 2017 Tax Act to further limit the deduction for business interest for taxable years beginning after December 31, 2017. Business interest is deductible to the extent it does not exceed the sum of (1) business interest income, (2) 30 percent of “adjusted taxable income”; and (3) floor plan financing interest. Certain taxpayers are not subject to the limitation, including certain trades or businesses (like farming, certain utilities, and certain real property businesses), as well as small businesses with gross receipts of less than $25 million. Amounts disallowed are to be carried forward.

This Notice outlines certain provisions in future regulations that will address uncertainties in the application of these new provisions, including the effect on interest carried forward from a prior year under the former provisions of section 163(j), the allocation of interest of a C corporation to business interest, and the treatment of consolidated groups.


The new deduction provision in section 199A, which replaces the section 199 deduction regime, has generated significant questions about how to implement this on 2018 returns. There proposed regulations, which run for 47 pages in the Federal Register, will give us something to study.

Comment: I believe a separate program is scheduled for these provisions.

C. Personal


FEMA announced federal disaster assistance for certain counties in Nebraska affected by storms, tornadoes, winds, and flooding on June 17 to July 1, 2018. This is significant for taxpayers seeking to deduct casualty losses, which are now restricted to federally-declared disasters.

2. Personal exemptions still treated as applicable for premium tax credits, shared responsibility, Notice 2018-84.

The 2017 Tax Act eliminated personal exemptions from the calculation of taxable income beginning in 2018. However, those exemptions remain important for purposes of administering certain provisions related to the Affordable Care Act. The Service released guidance as to how to interpret these rules in light of the new law. See also Notice 2018-70, which involves similar rules for determining a qualifying relative for purposes of the child credit and head of household filing status.

Comment: The Code is a tangled web. Cutting out one strand sometimes affects the integrity of the web.
3. Moving expense reimbursements for 2017 but received in 2018 may still be eligible for exclusion, Notice 2018-75.

Taxpayers who otherwise incurred deductible moving expenses in 2017 but who were reimbursed in 2018 may still exclude those amounts from gross income. Moreover, employers who pay an expense for moving an employee in 2017 during the 2018 taxable year do not create gross income for their employees.

Comment: This Notice clarifies that the timing of the suspension of the moving expense deduction will not affect moves in 2017.


Prior to the 2017 Tax Act, a taxpayer could obtain an unlimited itemized deduction for either charitable contributions or state and local taxes. There was little difference between the treatment of a deduction under section 164 or section 170 for this purpose. When states offered tax credits to incentivize certain charitable behavior, this raised a technical legal question that was addressed by Chief Counsel Advice memoranda in 2002 and 2004, and later in 2010. That advice indicated that either treatment was possible. After all, if a charitable deduction was taken, any tax credit would reduce the deduction taken for state and local taxes.

After the 2017 Tax Act imposed a $10,000 limitation on itemized deductions for state and local taxes under section 164(b)(6), the equivalent treatment for charitable contributions and tax payments has been removed. Some legislatures have considered new programs to enact credit programs for charitable contributions to the state for the purpose of allowing affected taxpayers to circumvent the deduction limitation. The Service initially addressed this issue in Notice 2018-54, but then proposed these regulations.

The new regulations require a reduction in the amount of any charitable deduction by the amount of any tax credit obtained. Likewise, if the taxpayer receives a deduction in excess of the amount of the contribution, the charitable deduction is reduced by the corresponding amount of the equivalent credit associated with the excess deduction. A de minimis rule is available to exclude credits that are 15 percent or less of the amount of the contribution.

Comment: This will prevent some abuses while allowing programs that incentivize contributions through tax credits (such as scholarship programs for underprivileged children) under the constraints of the de minimis rule. A separate information release, IR-2018-178 (Sept. 5, 2018), clarifies that this does not change the rules regarding business-related expenses, as long as they are otherwise ordinary and necessary business expenses. Also related to the matter of the state tax deduction, see IR-2017-210 (Dec. 27, 2017), which addresses the deductibility of tax payments in the 2017 tax year if those taxes have been assessed. Illustrations are included. It should also be noted that some states are litigating the constitutionality of this limitation. See New York v. Mnuchin, No 18-cv-6427 (S.D.N.Y.). My own view: this challenge raises a question whether the AGs from these states slept through Constitutional law when they were in school. But maybe these folks were only trying to make a political point. Loose claims about federalism and coercion are not likely to carry the day.
III. Tax Administration.

A. Penalties.


Section 6751(b) provides: “No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate.” The Tax Court had previously ruled that a taxpayer may not raise the failure to comply with this provision in a preassessment deficiency proceeding. However, it has now changed course to follow the Second Circuit precedent in Chai v. Commissioner, 851 F.3d 190 (2d Cir. 2017), which viewed the requirement of written approval as an element of the penalty claim. The Tax Court also took the position that Chai only resolved the matter of the Commissioner’s burden of production regarding penalties, leaving to another day whether the Commissioner must also carry the burden of proof. (See note 14 of the Tax Court opinion.)

Comment: The Tax Court stated that it changed its position after Chai “in the interest of repose and uniformity on an issue that touches many cases before us.” It makes sense to resolve this matter earlier, rather than later, in the proceeding. However, the parameters of Graev will require additional regulation. See below.

2. Signature alone, not meaningful review, required to approve trust fund penalty, Blackburn v. Commissioner, 150 T.C. No. 9 (2018).

As noted above, in Graev v. Commissioner (2017), the Tax Court held that written approval required by IRC § 6751(b) is part of the Commissioner’s burden of production under section 7491(c) in penalty assessment. In this case, Taxpayer was assessed a trust fund recovery penalty. The Taxpayer’s only defense was that there was no “meaningful review” by a supervisor for assessing the penalty. The Tax Court rejected this argument, granting summary judgment to the Service. No more than a signature is required to satisfy the requirements of the statute in this context.

Comment: A contrary rule would require some form of additional evidence of consideration, thereby adding to the complexity of these determinations, particularly those that occurred prior to the announcement of such a rule. For another case interpreting the scope of Graev, see Dynamo Holdings, 150 T.C. No 10 (2018), which ruled that the Commissioner does not have the same burden of production regarding supervisory approval in partnership cases. Section 7491(c) applies only to individuals. See also Williams, 151 T.C. No 1 (2018), discussed in greater detail below, which ruled that there is no requirement of “supervisory approval” when the Tax Court imposes penalties on taxpayers who advance frivolous litigating positions.
3. Penalties for frivolous positions are not subject to the supervisory approval process, Williams v. Commissioner, 151 T.C. No. 1 (2018).

Taxpayer persisted in making frivolous arguments after warnings from the Tax Court. (E.g., “It is illegal to kidnap the Petitioner’s identity as a Constitutional Citizen by birth and move it to the District of Columbia without the Petitioner’s consent.”) Counsel for the government asked for sanctions under section 6673, which permits the Tax Court to impose a penalty of up to $25,000. The Tax Court imposed a penalty of $2000.

Taxpayer argued that this penalty was subject to the supervisory approval proof requirements discussed in Graev, supra. However, the Tax Court ruled that the penalties applicable in Graev involving the processes in section 6651(b) were distinct from the penalty imposed under section 6673. Since these two provisions could be reconciled with one another and the legislative history also supported keeping both penalty regimes intact, the Tax Court could be free to impose the penalty without involving supervisory review from the IRS. Only IRS determinations are subject to the penalty review process, not discretionary decisions by the Tax Court.

Comment: This taxpayer may be lucky his penalty was only $2,000. But his claim was sufficiently significant to generate a regular Tax Court decision.

4. Full payment rule bars refund claim based on partial payment of penalties, Larson v. United States, 888 F.3d 578 (2nd Cir. 2018).

Taxpayer was convicted of crimes related to organizing fraudulent tax shelters. The IRS assessed penalties of $67.6 million under section 6111(a), which subjected organizers and promoters who failed to register their tax shelters a penalty equal to 1 percent of aggregate investments in the tax shelter. Eight years after the IRS notified Taxpayer he was under investigation as an organizer, it informed him that penalties aggregating $160 million would be assessed. Even though Taxpayer was only one of several organizers, the penalties are joint and several liabilities of all the putative promoters.

Taxpayer filed an Appeal, and the Appeals Officer recognized that the penalty amount failed to account for amounts due (and perhaps paid) from other co-promoters. It reduced the assessed penalties to $67.6 million, and then informed him that he would have to pay this entire amount if he wanted to contest the assessment in court. Taxpayer paid only $1.4 million – an amount that supposedly reflected his pro rata share of the total penalties based on his production of the tax shelter investments – and filed a refund claim. The Service and later the Federal District Court rejected his claim under the full payment rule.

Taxpayer appealed. His arguments included: (1) the full payment rule applies only where Tax Court relief is available; (2) that the application here violates his Fifth Amendment right to due process; and (3) penalties are an excessive fine under the Eighth Amendment.

The Second Circuit affirmed. First, section 1346, which confers original jurisdiction on federal district courts, provides the only basis for federal jurisdiction here. The Tax Court did not have jurisdiction over these penalties. Although Taxpayer argued that the Flora rule, which originated from Supreme Court precedent in 1958, should only apply in the context where Tax Court review is also available, the Second Circuit disagreed. The full payment rule is rooted in the Government’s substantial interest in maintaining a smoothly functioning tax system. Although that may mean a hardship in some cases, the answer is a legislative, not a judicial, remedy.
Second, as to due process claims, other circuits had previously rejected similar arguments based on the application of the full payment rule. Moreover, Taxpayer got relief from administrative appeal – a reduction of nearly $100 million in penalties. As a result, the Second Circuit claimed the Taxpayer’s complaint was not procedural, but substantive. Congress simply did not provide for prepayment review in all cases, and due process does not require it, particularly in an area with a strong governmental interest in tax collection.

Finally, on the Eighth Amendment claim, the Second Circuit declined review as it lacked subject matter jurisdiction without full payment. The Second Circuit had little comfort for this aggrieved Taxpayer, other than “Tell it to the Congress”:

The notion that a taxpayer can be assessed a penalty of $61 million or more without any judicial review unless he first pays the penalty in full seems troubling, particularly where, as Larson alleges here, the taxpayer is unable to do so. But, “[w]hile the Flora rule may result in economic hardship in some cases, it is Congress’ responsibility to amend the law.”

Comment: Apparently the life of a tax shelter promoter (or even a putative one) is hard. Joint and several liabilities present real challenges for administration – the laws in many states preclude attempts to collect joint and several liability if the plaintiff has settled with one of the debtors without including the others. Query how other settlements could have affected the amount due if state law is applicable. The lack of access to judicial review in this context is troubling. Even tax shelter promoters should have their day in court, no? One wonders whether this category of taxpayers could generate sufficient interest for a rule change. Instead, the only review available without full payment comes at the hands of the agency imposing the penalty. An IRS Appeals Officer is not a full substitute for a federal district judge – and potential review by generalist judges on the court of appeals. But it apparently satisfies due process – a troubling result.

B. Whistleblowers.


Kasper detected what he believed was a longstanding failure by his employer to make required overtime payments to its employees. After his internal complaints were rebuffed, he decided to file Form 211, Application for Award for Original Information, on the basis that if the employer owed millions in unpaid overtime, it also owed millions in taxes that it had failed to pay over on such wages.

The Form 211 traveled around the IRS for a time, but eventually ended up on the desk of a “classifier” who performs a gatekeeping function to see which claims will be investigated. The classifier elected to deny the claim and not to forward it for investigation, as he viewed the overtime matter as involving a Department of Labor issue. The IRS prepared a denial letter to Kasper, but he denied receiving it. In the meantime, Kasper raised other issues with the IRS about the same employer, which were also rejected. Eventually, the employer filed for bankruptcy.

Kasper eventually received a copy of the 2009 letter the IRS prepared to deny his original claim, which was based on boilerplate reasons for denying a reward. After receipt of this copy, he chose to file a petition in the Tax Court to review the denial of his claim. In his petition, he claimed that the Service had filed proof of claim in bankruptcy involving $15 million in income,
FICA, FUTA and excise taxes. Later, the Service amended its proof of claim upped the ante to $3 billion, but all of this was for corporate income taxes, with nothing for FICA withholding taxes. According to the court, this was because “the target had not yet filed a return or provided information.” The Service eventually negotiated a closing agreement for $37.5 million, which included withholding taxes pursuant to section 1441 of the Code.

Kasper wanted a piece of the action as a reward for his information, but the Tax Court denied his claim. In doing so, it plowed some new ground in the Whistleblower area. First, it ruled that review of the denial of a claim is generally limited to the administrative record, although certain exceptions may be applied which are well-established in administrative law. (For example, when the agency failed to consider relevant factors, to include evidence in the record, or failed to take action, extraneous evidence can be considered.)

Second, it ruled that the standard of review to be applied is abuse of discretion, not de novo. Third, following the Chenery doctrine, a reviewing court must make its determination based solely on the grounds offered by the agency. It may not uphold the determinations based on what decisions the court surmises might have been made. Here, there was adequate evidence that the denial of the claim was based on the view that unpaid overtime was a Department of Labor issue, not a tax issue. Although Kasper had indeed raised suspicion over whether the enhanced bankruptcy claim had anything to do with his information, the Tax Court did not find that this was a basis for action. Unpaid wages do not generate employment tax obligations.

Comment: Whistleblowers and their counsel will welcome this guidance, even though they may wish for more generous terms in challenging denial of their claims.

C. Levy/Collection

1. Nursing home claim challenging scope of “economic hardship” exception to levy for unpaid withholding taxes mooted by ceasing operations, Lindsay Manor Nursing Home, Inc. v. Commissioner, 725 Fed. Appx 712 (10th Cir. 2018).

In TCM 2017-50, the Tax Court granted the IRS motion for summary judgment in a levy against a nursing home that had failed to pay over withholding taxes. In doing so, it rejected the Taxpayer’s argument that it would impose an economic hardship based on the levy, thereby accepting the IRS position that only an individual would be eligible to claim this form of relief. As it turned out, Taxpayer was not just in default on its obligations to the Government, but also to others. A third party creditor put Taxpayer into a receivership, and its nursing home operations were transferred to others. All this occurred before the final judgment was rendered by the Tax Court. Taxpayer asked that the decision be vacated, and the Tenth Circuit agreed: the case was moot because an actual case or controversy no longer exists.

Comment: I suspect that the assets were depleted, making a levy attempt ineffective. But query whether this also affected attempts to collect against responsible parties? It would have been nice to know if “economic hardship” could affect an entity like a nursing home, particularly when a levy might trigger liquidation (and displaced residents) instead of a transfer in ownership.
2. Commissioner abused his discretion in failing to consider proposed offer in compromise and claims of economic hardship in CDP hearing, Loveland v. Commissioner, 151 T.C. No. 7 (2018).

Taxpayers are husband and wife, a retired boilermaker and teacher, respectively. H had to leave his work due to a heart condition; W survived breast cancer. They lost their house during the great recession and housing crisis. They stopped paying taxes in the 2011-2014 tax years, with taxes in arrears of over $60K. In 2015, the Commissioner issued a notice of intent to levy. They entered into negotiations with a collections officer, making an offer in compromise. The collections officer rejected that offer. They appealed. They offered an installment agreement to the officer, but they were told no such agreement could be considered while the appeal was pending. So, they withdrew the appeal and continued negotiations, eventually agreeing to make voluntary payments of $800/month. They applied for a loan against their property so that they could make an additional payment of $11,500, bringing their total under $50K. But a federal tax lien was filed and their loan application was rejected. After the lien, they requested a hearing with Appeals, requesting that the lien be lifted as it prevented them from financing this payment. Appeals requested additional information, and Taxpayers requested that they review the prior offer in compromise and request for installment agreement at $800/month, which had previously been submitted. The Appeals officer declined to review the prior OIC and also rejected the installment agreement.

Taxpayers petitioned for review of the lien, and the Commissioner moved for dismissal on the ground that Taxpayers had not submitted requested paperwork. However, the Tax Court rejected this motion for summary judgment and instead ruled that the Commissioner had abused his discretion in failing to consider the OIC, financial documents filed with the proposed installment agreement, and the special circumstances surrounding the refusal to lift the tax lien in this case. Here, the record suggests that the Commissioner never considered the financial information that was recently submitted by the Taxpayer. Moreover, the taxpayer’s claims of economic hardship based on poor health were not properly considered.

Comment: Taxpayers here paint a sympathetic picture, which is reflected in the Tax Court’s decision. While paying one’s taxes is not optional, when calamity strikes it is understandable that the government may not always be first in line for attention. Tax Court judges are here to make sure that collection efforts address the reality of those calamities. “Telling it to the judge” in this case brought relief; the system ultimately worked, albeit not without difficulty for these taxpayers.

3. Notice of intent to levy may be sent to last known address on return, even if taxpayer resides in prison, Berkun v. Commissioner, 890 F.3d 1260 (11th Cir. 2018).

Taxpayer was imprisoned for various federal charges, including filing a false tax return. As part of his sentence, he was ordered to pay $390K in restitution to the IRS. In January 2013, Taxpayer sent a handwritten letter to an IRS agent that provided his Miami prison mailing address and requested that all notices be sent there. However, when he filed his 2012 return in April 2013 and his 2013 return in April 2014, he used another address – the home where he had lived with his girlfriend and their three children prior to his imprisonment. An IRS Revenue Officer was assigned to collect the restitution. He called the prison, but he could not reach Taxpayer. He then visited the home address on the return, but only left a
business card because no one was home. Taxpayer’s attorney eventually contacted the Revenue Officer and told him that Taxpayer would soon be released from prison to a halfway house.

On November 3, 2014, the Service issued a notice of intent to levy to collect the assessment. This notice was delivered to the address listed on his return (i.e., his girlfriend’s house). Taxpayer’s former girlfriend signed for the notice and returned the certified mail receipt on Taxpayer’s behalf. However, she also informed the Revenue Officer that Taxpayer no longer lived there. Taxpayer was soon released from custody and moved in with his mother.

The Revenue Officer eventually met with Taxpayer at his mother’s residence on November 20, 2014. He also delivered a notice of intent to levy showing that the balance, with interest, was now over $704K. On February 20, 2015 (within 90 days of their in-person meeting but long after the original notice had been delivered to the address on his return), Taxpayer submitted a Form 12153 request for a due process hearing. The Revenue Officer recorded the following entry in his file: “Appeal is timely because the taxpayer received the [NOIL] when I hand delivered it on 1/22/15 and the CDP was received on 2/20/2015.” Despite this view, the Appeals office ruled that the notice of appeal was untimely as the 30-day period for a CDP hearing had passed. Appeals granted a telephonic hearing, but thereafter issued an adverse decision. A Tax Court petition followed, but it was dismissed on the ground that the court lacked jurisdiction due to the untimely request for a CDP hearing. Taxpayer appealed.

The Eleventh Circuit affirmed, rejecting Taxpayer’s due process claim based on the IRS failure to mail a notice to him at his prison address. The relevant statutes and regulations here permit the IRS to mail to the taxpayer’s “last known address” and provide that this address is the one that appears on the most recently filed tax return. Unpublished case law in the circuit raises a plausible argument that notification at the prison is required when the Taxpayer is imprisoned for a criminal tax offense. Unfortunately for the taxpayer, this issue was not raised in the Tax Court, so it would not be taken up on appeal. Likewise, Taxpayer’s arguments based on the legislative history to section 6330 were rejected on the ground that they were not raised in the Tax Court.

Comment: This case may provide a roadmap for a future successful argument. It does strike one as unfair to permit a levy based on notice to an address where you are not living due to incarceration for a tax crime. The 30-day window is short, and the confusion here arguably did not give this taxpayer enough time to respond appropriately.

4. Check dishonored due to IRS levy on bank account prevents taxpayer from designating the tax year for a voluntary payment, Melaskey v. Commissioner, 151 T.C. Nos. 8 and 9 (2018).

Taxpayers had longstanding disputes with the IRS over collection matters extending back to the 1995 tax year. On January 27, 2011, they hand delivered a check for $18K, which represented a voluntary payment. They told the IRS agent that this should be applied to their liability associated with the 2009 tax year. The IRS admits that it got the check, and that it initially posted the payment against their 2009 liability on that date. However, that credit was reversed because the check bounced.

That check bounced because the IRS executed a levy against their bank account holding these funds before that check could clear. The IRS took the money and applied it against their 1995 tax liability. Adding insult to injury, they assessed a $360 penalty for writing a bad check. See IRC § 6657. The Notice of Levy sent to Taxpayers did not identify the 1995 tax year.
Instead, it listed years in the 2001-2009 range. Taxpayers asked for a CDP hearing, but the IRS determined that they had already had a CDP hearing for the 1995 tax year, as well as for 1996, 1999, and 2000-04. Further, the Settlement Officer determined that the funds obtained via levy procedures were not voluntary payments but instead could be applied by the IRS freely to any open tax year. Moreover, he also determined that a proposed installment agreement should be rejected.

Taxpayers filed suit in the Tax Court, arguing that their check was a voluntary payment that they were free to apply as they wished. First, the Tax Court determined that the levy and determination was subject to review for abuse of discretion. Taxpayers argued that a de novo review was appropriate for 2009, as they determined they had no liability (assuming the check had cleared). But the court rejected that view, finding that they had already had an opportunity to challenge the underlying tax for that year.

Applying that standard, a majority of the Tax Court held for the Service, finding no abuse of discretion here in applying the payment to the 1995 tax year. While taxpayers tend to prefer that their voluntary payments are applied to more recent tax years on account of the possibility that the ten-year statute of limitations on collection will run out, the Service is free to apply the proceeds of levy in a discretionary manner. Here, Taxpayers tendered a check. Acceptance of that check (without more) does not constitute an absolute payment. If the check is honored, the payment date relates back to the date the check is received. However, if the check is dishonored, there is no payment.

The Tax Court refused to create an equitable exception for this situation, as no caselaw supported it. Here, the Service had been chasing Taxpayers for 15 years on the 1995 liability. An OIC and an installment agreement had been executed for those years, but they were eventually terminated when Taxpayers failed to keep their obligations. According to the court, the IRS didn’t cause the check to bounce; the Taxpayers did so by “chronically” failing to pay taxes.

Further, the Tax Court ruled that it was not an abuse of discretion to reject Taxpayers’ claim for an installment agreement. The partial payment agreement proposed here was rejected in part because of consideration of a trust left to Mrs. Taxpayer by her late father. Interpreting Texas law, the trust could be distributed for the benefit of Mrs. Taxpayer, who was also the trustee. Applying Texas law, the Tax Court viewed it appropriate to consider these assets in rejecting the partial payment.

Comment: *A vigorous dissent by two judges saw these issues differently. A concurring opinion suggests just how much disagreement was present: “Many things said there [in the dissenting opinion] would justify lengthy rebuttal, had we but world enough and time.” Suffice it to say that the dissent had a different view of the equities due to this taxpayer, but their view did not carry the day. Life lesson here: perhaps get a certified check if the IRS is chasing you?*

D. Other.

1. Revised Guidance on Rulings, Rev. Procs. 2018-1 to 07, 2018-1 IRB.

   The Service began 2018 with a string of revenue procedures addressing the matter of guidance in the form of letter rulings, information letters, technical advice memoranda, as well as areas in which no guidance will be issued.
Comment: Ruling requests are not cheap. User fees now top out at $28,300 for a private letter ruling or closing agreement, with lower fees of $2,400 if a taxpayer has gross income under $250K and $7,600 for those with gross income of between $250K and $1 million. Some exceptions apply.

IV. Tax Litigation & Procedure

A. Motions and Processes.

1. Self-serving, uncorroborated affidavit may prevent summary judgment against a taxpayer in levy action, United States v. Stein, 881 F.3d 853 (11th Cir. 2018).

In 2015, the Government sued Taxpayer (Estelle Stein), for outstanding tax assessments for the 1996, 1999, 2000, 2001, and 2002 tax years, alleging that she owed over $220K plus additional fees and penalties. It moved for summary judgment based on copies of her federal tax returns, transcripts of her accounts, and the affidavit of an IRS officer. Mrs. Stein responded with an affidavit of her own, stating that “to the best of her recollection” she had paid the taxes and penalties owed, including particular assertions about each of the tax years. For example, she alleged that an accountant had prepared the returns after the death of her husband, who had otherwise been responsible for their taxes. She also alleged admitted errors by the IRS in applying some of her payments. Mrs. Stein was never deposed.

The district court granted summary judgment to the Government, stating that the evidence submitted by the Government created a presumption that its assessments were correct. Taxpayer’s uncorroborated affidavit did not create a genuine dispute as to any material fact that would prevent summary judgment from being granted. Taxpayer appealed, and a three-judge panel of the Eleventh Circuit affirmed based on its 1985 decision in Mays v. United States, 763 F.3d 1295. Rehearing en banc was granted, and the full court ruled that Mays is overruled “to the extent it suggests that self-serving and uncorroborated statements in a taxpayer’s affidavit cannot create an issue of material fact with respect to the correctness of the government’s assessments.” It remanded the case to the original panel for additional determinations.

Comment: This is important precedent that respects the important role of trial as opposed to a comparatively cold determination based on documentary evidence. The court made it clear that Rule 56 does not require corroborating evidence to support the affidavit, but it left open the question of whether an affidavit alone could overcome the presumption of correctness that attaches to the government’s determinations in all cases. Facts and circumstances still matter; the court also cautioned that this ruling may not extend to a refund claim, where the taxpayer must prove entitlement to the refund. See note 2, p. 858. The concurring opinion of Judge Pryor is worth reading on the matter of the historical importance of a jury trial to vindicate citizen rights in the American system of justice.

2. Taxpayer effort to challenge Notice of Deficiency based on IRM deemed invalid, Muncy v. Commissioner, 890 F.3d 724 (8th Cir. 2018).

Taxpayer appealed the adverse judgment of the Tax Court finding a deficiency on the basis that the Notice of Deficiency was signed by one other than those listed in the appropriate section of the Internal Revenue Manual. Delegation Order 4-8, which is incorporated in the
Internal Revenue Manual, authorized certain employees to sign and send Notices of Deficiency. The IRS employee who signed Taxpayer’s Notice of Deficiency was not on that list. However, the Eighth Circuit noted that the signer had a supervisory position over those specified on the list. The Manual provides that “Authority shall be delegated directly to the lowest level expected to take final action.” This means that all in the intervening supervisory chain have the authority, too.

Comment: You can’t blame the Taxpayer for trying, but it is rare to get traction from the IRM.


Taxpayer here claimed a $500 million deduction for worthless stock, which the government contested. It based this deduction in part on the valuation opinion of DLA Piper. The DLA Piper study included footnote references to certain documents on which it relied to support its opinion, including two memoranda that Taxpayer claimed were covered by the attorney-client privilege. The court agreed that privilege attached to the two documents. However, it also concluded that Taxpayer had waived the privilege by disclosing those documents to DLA Piper and submitting the valuation study as evidence in support of their deduction. As the court noted, “In order for the IRS or any other reader to evaluate the DLA Piper opinion, the materials on which the opinion were based become discoverable. Otherwise, the IRS … would be forced to simply accept the opinion without access to the foundation material….”

Comment: This case illustrates the importance of disclosures by experts on the materials on which they rely, which here became the basis for requesting the memoranda at issue. It also presents a cautionary tale for taxpayers seeking to protect otherwise privileged documents. What you disclose to an expert will likely come out, one way or another, if you choose to use the expert’s work product to support your claim.

4. Appellate window closes and cannot be extended by successive motions to vacate Tax Court decision, Annamalai v. Commissioner, 884 F.3d 530 (5th Cir. 2018).

Taxpayers had an adverse decision in the Tax Court on July 13, 2016. They filed a motion to vacate that decision, which was subsequently denied. They filed another motion to vacate the Tax Court’s decision, which did not raise new grounds or arguments. The Tax Court denied this motion to vacate on December 22, 2016. The Taxpayers filed a notice of appeal on March 15, 2017, which was 83 days after the adverse ruling on the second motion to vacate, but 117 days after the ruling on the first motion to vacate. Was this timely?

The Fifth Circuit concluded that it was not timely. Section 7483 requires that notice of appeal must be filed with the clerk of the Tax Court within 90 days after the decision is entered. See also FRAP 13(a)(1)(A). This is an absolute, jurisdictional requirement. Following unpublished decisions in the Tenth Circuit, the Fifth Circuit held that successive motions do not interrupt the running of the time for appeal. Case dismissed.

Comment: This still leaves open the question of whether the time should run – but it signals that there are limits on the use of motions to delay the window for appeal. Tarry at your peril.
5. Closing agreement did not bar recalculation of tax liability, Estate of Duncan v. Commissioner, 890 F.3d 192 (5th Cir. 2018).

Mr. and Mrs. Duncan entered into Son of Boss transactions in 1999 and 2000 through a partnership, RCD Investments. RCD Investments also claimed large bad-debt deductions, which generated a NOL in 2001 that produced a large refund for 1996 through a loss carryback. Mr. Duncan died in 2003, leaving an estate worth over $8 million. The Estate and Mrs. Duncan sought to take advantage of offers for Son of Boss participants, and so they executed a closing agreement that required them to “concede all claimed benefits and attributes from the [Son of Boss] transaction” and pay a penalty on any deficiency. The original Form 4549 prepared showed no deficiency for the Son of Boss transaction, as all deficiencies were attributed to the bad debt deduction. However, the Service later determined that this Form 4549 was incorrect, and that the Duncans owed over $3 million in combined tax liabilities, penalties, and interest. Mrs. offered $40K as an offer in compromise, justifying this modest amount because she was 91 years old and had only about $500K in assets. The Service rejected this offer.

Tax Court litigation ensued, with the Tax Court ruling in favor of the Commissioner. Taxpayers appealed. The Fifth Circuit upheld the Tax Court. First, it agreed that the closing agreement, as a contract between the IRS and the taxpayer, did not bar the assessment in this case. Although Taxpayer objected that the Service improperly recalculated their liability after the closing agreement, the Fifth Circuit ruled that the language in the closing agreement only provided that the Taxpayer conceded the treatment of any tax attributes from the Son of Boss transaction and consented to collection. It did not specify a certain amount of tax due.

Moreover, the Commissioner did not abuse his discretion by failing to accept the offer in compromise. The Fifth Circuit rejected Taxpayer’s arguments that the Service erred by failing to hire experts to value their property in assessing collection potential. Moreover, Taxpayer could not claim reliance on the Internal Revenue Manual to challenge IRS collection practices. Here, the Service had a claim against Mr.’s estate, particularly, his trustee, for nonpayment of the tax. It claimed assets had been dissipated, and that those dissipated assets also justified a refusal to accept an offer from Mrs.

Comment: This case should be required reading for those serving in a fiduciary capacity. First, an executor who fails to pay attention to potential tax liability may face personal liability. Second, caution is in order in basing a liability assessment on a closing agreement. Here, the language of the agreement apparently gave the Service flexibility to redetermine liability – probably not something the executor thought about when making distributions. Fiduciaries, beware.

6. Party has 60 days to file a notice of appeal whenever the United States is a party, United States v. Conner, __ F.3d __, 2018 WL 5118641 (5th Cir. Oct. 22, 2018).

The Fifth Circuit has ruled that FRCP Rule 4(a)(1) provides a 60 day limitations period in all cases in which the United States is a party, even a civil contempt order. In this case of first impression, Taxpayer failed to comply with an IRS summons. The federal district court issued a contempt citation, and Taxpayer appealed to the Fifth Circuit. Unfortunately, he waited until day 43 to file his notice of appeal. At issue here is whether a 30 day limit applicable in other cases should be applied, despite the fact that the government was a party to the underlying litigation giving rise to the contempt citation. The Fifth Circuit initially dismissed the appeal, but on a motion for rehearing en banc, it treated the motion as a motion to reconsider its ruling.
The Fifth Circuit changed course, noting that under its 1999 decision in *Brumfield*, the determination of whether the 60-day rule was invoked depended on an analysis of the government’s interest in the particular matter. However, Rule 4 has been amended in 2011 to enhance the focus on the party, rather than the interest in the issue being litigated. Moreover, other circuits have abandoned this more granular examination in favor of the clarity of the 60-day rule.

Comment: Taxpayer gets his day in appellate court and other litigants get the clarity of a 60 day window.

7. Tax Court lacks jurisdiction over redetermination of wage amounts to S corporation shareholder for FICA tax purposes, Martin S. Azarian, PA v. Commissioner, 897 F.3d 943 (8th Cir. 2018).

S Corporation petitioned the Tax Court for relief from a determination that it owed additional employment taxes on distribution from its solely-owned S corporation. Its sole shareholder performed services for the S corporation, which paid him from $32,5000 to $40,000 in wages. However, it also paid dividends each year in addition to the salary amounts. The Service did not challenge Taxpayer’s characterization of its shareholder as an employee, but it argued that “reasonable compensation” was $125K annually, requiring additional FICA taxes for both employer and employee and a penalty assessment for the understatement.

The Tax Court dismissed Taxpayer’s complaint for want of jurisdiction. This appeal followed. The Eighth Circuit agreed that there was no jurisdiction here under section 7436(a)(1), which states in part that jurisdiction is proper if “there is an actual controversy involving a determination by the Secretary as part of an examination that ... one or more individuals performing services ... are employees ... for purposes of subtitle C....” Here, the Service did not contest the shareholder-payee’s status as an employee; it only challenged the amount he was paid as employee compensation. The court rejected Taxpayer’s argument that, by recharacterizing some of the payments from a dividend to a wage, the Service determined that Taxpayer was an employee with regard to some of the putative dividend payments.

Comment: Those seeking to challenge these “unreasonable compensation” issues in which an S corporation pays too little apparently must therefore pay the tax and sue for a refund. In contrast, if Taxpayer had reported no wages but only dividends, there would be a determination about employee status and jurisdiction in the Tax Court to challenge that determination.

B. Statutes of Limitations.


Section 6038D of the Code imposes new reporting requirements on certain “specified foreign financial assets” effective for tax years beginning after March 18, 2010. Taxpayer in this case filed tax returns for 2006-2009 but failed to report income from a foreign account. The Service issued a John Doe summons to the foreign institution, which was resolved and produced information about the account in 2010. More than three years later, in 2014, the Service issued a notice of deficiency for these tax years. Taxpayer concedes that he had a “specified foreign financial asset” under section 6038D but challenged the assessment as barred by the statute of limitations.
The three-year period for assessment under section 6501 is suspended beginning six months after the service of a John Doe summons and ending with its resolution. See IRC § 7609(e)(2). Moreover, section 6501(e)(1)(A)(ii) provides for a six-year limitations period if the taxpayer omits income attributable to a specified foreign asset under section 6038D which is greater than $5,000. This provision was added at the same time as 6038D – after the years at issue for this taxpayer. Relying on the plain language of the statute, the Tax Court ruled that the six-year period was not applicable in this case because it related to assets for which a reporting requirement had not been imposed. Accordingly, the Tax Court granted summary judgment in favor of the Taxpayer.

2. PFIC gains are not part of gross income for purposes of measuring six-year limit on omitted income, Toso v. Commissioner, 151 T.C. No. 4 (2018).

Taxpayers had foreign accounts with UBS AG in the 2006-2008 tax years. After a John Doe summons was issued to UBS AG, Taxpayers filed amended returns for those tax years that included additional taxable income relating to investments held in the UBS AG account.

On January 6, 2015, the Service issued a notice of deficiency for the 2006-2008 tax years. It made two types of adjustments: first, it treated long-term capital gains reported on the amended returns as gains from sales of stocks in PFICs (see IRC § 1297). Second, it assessed negligence penalties based on the original returns rather than the amended returns. Taxpayers filed suit in the Tax Court, alleging that the deficiencies were time barred. Alternatively, they claimed that PFIC losses should be offset against gains for tax purposes.

The Tax Court first had to unpack the statute of limitations applicable in this case, which in turn depended on the role of PFIC income. Section 1291(a) provides that a gain on the sale of a PFIC (unless taxpayer elections are made that are not applicable here) is allocated ratably to each day that the taxpayer held the stock. That which is applicable to the current taxable year is deemed ordinary income, which is thereby taxed as gross income. However, the portion allocated to prior-year holding periods do not increase current-year gross income. Instead, they become the foundation for a separate tax calculation, which includes the application of the highest ordinary income tax for that prior tax year to the ratable share of gain and computing an interest charge on that amount. The sum of these products is then added to the Taxpayer’s current tax liability.

The Service argued that despite section 1291, all PFIC gains should be included in determining whether Taxpayer omitted more than 25 percent of reported gross income, thereby triggering the six-year statute of limitations under section 6501(e)(1)(A)(i). The Tax Court rejected this argument, choosing instead to base their decision on the language of section 1291. If that language produced an undesirable policy outcome, that claim is for the legislature, not the court.

Based on that ruling, the 2006 tax year was governed by the extended statute of limitations (based on counting six years from the date of filing the amended return), but the 2007 and 2008 years were not (as only the three year period applied). Thus, Taxpayer gained a partial victory.

On the deficiency from 2006, Taxpayer also argued that it should be allowed to offset PFIC losses against PFIC gains in determining the net tax position. The Tax Court rejected this argument. While PFIC gains are characterized as ordinary income, PFIC losses are characterized as either long-term or short-term capital losses. Section 1211(b) permits capital losses to be offset against capital gains, but section 1291 specifically treats PFIC gains as ordinary, not
capital. Accordingly, section 1291 does not govern losing PFIC positions, which are instead evaluated under the unfavorable capital loss limitation provisions.

Comment: This is a useful case in exploring the mechanics of section 1291 and its relationship to the extended limitations period. Taxpayers with foreign passive investment company positions should take note: the government is your partner in all winning positions, but you are disadvantaged with capital losses in losing ones. Of course, for taxpayers with undisclosed foreign accounts, the PFIC rules may be the least of your worries.


In this case, a divided Tax Court upheld the taxpayer’s position that they had filed a valid return and they were entitled to summary judgment based on the statute of limitations. By way of background, residents of the Virgin Islands file returns with the Virgin Islands Bureau of Internal Revenue (VIBIR) instead of the IRS. Beneficial tax treatment is accorded to income sourced in VI. However, they owe taxes to the US Treasury on income earned outside of the VI. For filing purposes, VI residents use the same form 1040, but they must also file a Form 8689, which allocates income taxes due to the Virgin Islands and any amounts due to the IRS. Moreover, the VI authorities share at least some information from the Form 1040 with the U.S. Treasury when a bona fide resident also has taxes withheld and remitted to the U.S. Treasury. While regulations under section 932 issued in 2008 treat a return filed in the VI by an individual who claims to be a bona fide resident as a valid US income tax return based on routine sharing of information, the years at issue here predate those regulations. Thus, the court’s analysis had to rest on past jurisprudence.

In this case, the IRS received information from the timely filed 2003 and 2004 returns that Taxpayers filed. They used this information to create a transcript of account for these taxpayers. Eventually, the IRS selected their returns for audit based on this information. The IRS took their time, however, and they proposed deficiencies in September 2009 for both the 2003 and 2004 tax years. Taxpayers asserted that the statute of limitations had run on both years. These taxpayers claimed that they had a good faith belief that they were bona fide residents in the years at issue. Moreover, they also claimed that even if they were not bona fide residents, their federal return had been filed based on the sharing of information from VIBIR to the Treasury.

A majority of the Tax Court agreed with Taxpayers that the information sharing here satisfied the requirements for filing a return. Applying the common law features for a return in Beard v. Commissioner, the majority concluded that even though not all the schedules were shared with the Treasury, it was sufficient to verify the amount of income and taxes due. In many other cases, missing schedules did not prevent the return from being valid. The IRS used the information on the return to create a statement of account, and when they did not have the information, they put in zero. This is exactly what would have happened if the Taxpayers had submitted a federal return to the IRS with zeros in it – as the IRS would later advise in a Notice to Taxpayers. Such a position would be sufficient to start the limitations period.

Moreover, it was really a “return” that was filed. A taxpayer who files a fraudulent return with VIBIR commits a federal tax crime, not a territorial crime. If those documents are returns for purposes of putting a taxpayer in jail, why not make them the basis for triggering the statute of limitations? The Forms transmitted to the IRS did not contain the signatures of the taxpayers,
which is otherwise required to satisfy the jurat requirement. However, the majority pointed to some cases in which missing or photocopied signatures were sufficient.

The court sums up their ruling as follows: “To sum it up, the IRS failed to promulgate mandatory regulations under section 932, failed to tell taxpayers that they should file protective zero returns, and failed to send the Coffeys a notice of deficiency within three years of receiving the cover-over documents. And, only a few short years later, the IRS finally did promulgate regulations that adopt precisely the position that the Coffeys took about how to start the statute of limitations. Despite all this, the Commissioner tells us that the Coffeys lose—though one is left to wonder how the current regulation is valid if the Commissioner is correct that filing anything other than a zero return with the IRS would be inadequate under the Code.”

Comment: This case illustrates the outsized role that procedural formality sometimes plays in tax law. While the opinion of the court would leave open the possibility that the Service could still challenge whether the taxpayer was a bona fide resident of the VI, a concurring judge joined by six others took the position that this case should end the matter, and that the taxpayer deserved repose in this case based on its efforts to file. The concurring opinion included a citation to New Capital Fire, TC Memo 2017-177 (holding statute of limitations applied based on filing corporate tax return by successor corporation, even though IRS argued that putative F reorganization was invalid and therefore no return had been filed for predecessor). Four judges dissented to this taxpayer victory in Hulett, leaving some room for doubt. For additional discussion of the validity of a return without a “wet ink signature”, see in re Harold, 2018 WL 4026991 (E.D. Mich. Aug. 20, 2018) (agreeing with Hulett and citing other relevant authority).

4. A day late means no jurisdiction, Duggan v. Commissioner, 879 F.3d 1029 (9th Cir. 2018).

Taxpayer received notices of determination proposing collection for unpaid taxes. Both notices informed him that he could file a petition in the Tax Court to challenge the determination, but that the time for filing is limited to the “30-day period beginning after the date of this letter.” Taxpayer erroneously assumed that the first day after the letter dated January 7, 2015 was day zero, and he therefore mailed his petition thirty-one days later on February 7, 2015. But that was a day late. It deprived the Tax Court of jurisdiction. Although equitable tolling sometimes applies to deadlines that are not jurisdiction, that was not the case here.

Comment: Square corners are required when dealing with the Government. See also Cunningham v. Commissioner, 716 Fed. Appx. 182 (4th Cir. 2018) (rejecting equitable tolling based on similar miscalculation as alternative basis for relief).

5. A week late means no jurisdiction, even if the IRS told you differently, Nauflett v. Commissioner, 892 F.3d 649 (4th Cir. 2018).

Taxpayer sought relief from unpaid tax liabilities based on a claim she was an innocent spouse. The IRS denied her claim by issuing a letter dated June 17, 2015, which stated that if she disagreed with the determination, you “must file your petition within 90 days from the date of this letter….T]he IRS cannot change the time period.”

Taxpayer contacted the IRS person listed on the letter and the Taxpayer Advocate Service. According to Taxpayer, both informed her that she could file by September 22, 2015.
However, after filing on that date, the Service moved to dismiss for lack of jurisdiction, and that motion was granted.

On appeal, the Fourth Circuit agreed with the Tax Court that the 90 day rule in section 6015(e)(1)(A) is jurisdictional, agreeing with prior decisions in the Second and Third circuits on this question. Not even a misrepresentation by the IRS can confer jurisdiction if it is otherwise lacking.

*Comment:* Those representing taxpayers with innocent spouse claims, take note of this jurisdictional bar. Without funds to pay the tax and to seek a refund, having this avenue shut off may work an injustice to some taxpayers.

6. Amended return for later year did not provide refund claim for prior year in Claims Court, Stephens v. United States, 884 F.3d 1151 (Fed. Cir. 2018).

Taxpayers had passive activity losses disallowed in their 1995 and 1996 tax years. Those years remained open until the audit of an S Corporation that affected their returns was completed. A final notice of deficiency was sent in 2008, and Taxpayers paid the taxes proposed by the IRS on January 6, 2010. The limitations period for a refund claim on those taxes paid expired on January 6, 2012. See IRC § 6511(a). No refund claim for those tax years was ever formally filed. However, Taxpayers filed an amended return for the 1997 tax year, which included a claim to carry over the passive activity losses disallowed in 1995 and 1996. Unfortunately, by the time that 1997 amended return was filed, that tax year was closed. Although Taxpayers had executed an extension for the 1997 year until June 30, 2008, they filed their amended return in 2009, over a year late.

The Service rejected the refund claim for 1997 as untimely. It also rejected additional claims raised by the Taxpayers that mitigation provisions (IRC §§ 1311 ff.) and equitable recoupment permitted recovery. Claims court litigation followed, which ultimately resulted in the Taxpayer’s claims being dismissed. This appeal followed.

The Federal Circuit upheld the dismissal. First, the 1997 amended return could not reasonably be viewed as a timely refund claim for the 1995 and 1996 years, which were still open. In order for sovereign immunity to be waived in the matter of a tax refund claim, the jurisdictional requirements of section 7422 must be met. This includes a “claim for refund or credit … duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.” Here, the 1997 return did not set forth in sufficient detail the nature of the claim for refund in a manner that would permit appropriate investigation by the Government. Instead, they agreed that the passive losses in 1995 and 1996 carried over to 1997. The 1997 taxes were at issue, and these were time-barred.

Taxpayers also sought relief, despite the time-bar in this case, based on mitigation provisions. However, those provisions are not a broad license for courts to address inequity, but instead require specific conditions to be met. Taxpayers did not meet them. Neither were they entitled to equitable recoupment.

*Comment:* This case shows that extreme care should be taken whenever tax years are extended. These Taxpayers did extend the 1997 tax year, but their extension was not long enough to match the formal claim they filed. As a result, they likely overpaid their taxes. Those interested in mitigation and equitable recoupment remedies may also profit from studying this case. This is
another example of a case in which long delays attended the audit of a pass-through entity, in this case an S corporation. Is justice delayed justice denied?

**C. Attorney fees, costs, and damages.**

1. **Section 7430 award based on changed position over tax exempt status denied,**

   *Friends of Benedictines in Holy Land, Inc v. Commissioner, 150 T.C. No. 5 (2018).*

   Friends of the Benedictines (“Friends”) submitted a Form 1023 in 2012 seeking exempt status under section 501(c)(3). More than a year later, no action was taken. The IRS informed counsel for Friends that its exemption was still being processed and would not give a date certain for a determination. On September 20, 2013, Friends filed suit in the Tax Court seeking a declaratory judgment of its tax-exempt status. On Sunday, September 22, 2013, the IRS issued a determination letter recognizing Friends as a tax-exempt organization effective on March 14, 2012. On December 31, 2013, the Tax Court entered a stipulated decision declaring the Friends’ exempt status.

   In January 2014, Friends filed a motion for costs under section 7430, which included legal bills for work performed during the period September 9, 2013 and January 29, 2014. This motion was later clarified to extend to both administrative costs as well as the related litigation costs associated with the stipulated conclusion of their case along with the work on the motion for costs. “To recover costs, the taxpayer must establish that (1) it is the prevailing party, (2) it did not unreasonably protract the proceedings, (3) the amount of the costs requested is reasonable, and (4) it exhausted the administrative remedies available.” Here, the government conceded the second and fourth requirements. But all four must be satisfied, and there is a separate inquiry for both administrative and judicial proceedings.

   The Tax Court first rejected the Service’s argument that an application for tax-exempt status was akin to a PLR request, and therefore not an administrative proceeding eligible for costs. While a PLR is entirely discretionary, a denial of tax-exempt status may be challenged in court. It then considered the Service’s alternative argument that Taxpayer was not a prevailing party because the Government did not take a position on its ruling request. (Of course, the Government’s failure to act was the basis for incurring costs in this case!) However, in other case law involving the Government’s failure to issue tax refunds, courts would not permit a failure to act to become a basis for determining the government’s position. Accordingly, administrative costs could not be awarded here.

   On the matter of litigation costs, the Government conceded its case in the answer to Taxpayer’s petition. Although Taxpayer had a favorable district court precedent, which had required the Government to pay costs when it forced the taxpayer to file a lawsuit in order to get the Government to change its position after a contrary administrative ruling (remarkably similar to the present case), the Tax Court rejected this precedent as inconsistent with the bifurcated approach adopted here, which evaluates the question of fees on the basis of conduct after the Taxpayer (or here, aspiring tax-exempt organization) files a petition.

   **Comment:** The result here may be unsatisfying, but it appears to be grounded in the statute as written. The court itself recognizes that there may be a “gap in coverage in circumstances such as this one, [but] it is not our place to provide a remedy.” We can either hope for the IRS to be run properly or change the statute to empower judicial review with costs and fees to the tax-exempt organization when government conduct does not measure up.
2. Taxpayers could not recover damages for alleged negligent assessment, Goldberg v. United States, 881 F.3d 529 (7th Cir. 2018).

Taxpayers reached a civil settlement with the IRS over taxes they allegedly failed to pay in connection with partnership income in 1994. The Service had initiated a criminal investigation that had touched upon this partnership, which apparently triggered this settlement. Nearly ten years later, Taxpayers filed suit to obtain relief from this settlement. They first claimed that they were entitled to relief from the statute of limitations on account of the “informal claim doctrine”. They also sought damages for behavior by the IRS that they alleged violated section 7433. The district court dismissed this suit as failing to state a claim upon which relief could be granted. On appeal, the Seventh Circuit affirmed and provided additional guidance on both legal claims raised by Taxpayers.

First, Taxpayers here failed to file a formal refund claim with the Service within the applicable limitations period. Accordingly, they also failed to follow administrative processes in seeking a refund. However, they argued that their suit in the district court should be evaluated under the “informal claim doctrine”. The court rejected this claim. The “informal claim doctrine” does allow a claim that was deficient in some way to be cured after the limitations period had expired through filing a later conforming complaint. However, the informal claim must give the Commissioner some notice that fairly advises the Service of the nature of that claim. Moreover, the subsequent claim must effectively perfect the original claim by filling in missing information. Taxpayers here did neither of these things. They did not file an informal refund claim, and they never did file a perfecting claim with the Service. Indeed, their pleadings suggested that the could file claims if they were needed, but they did not in fact file them. Taxpayers could not use this doctrine to circumvent the otherwise-applicable refund processes.

Second, Taxpayers could not use section 7433 to create an alternative remedy for the failure to following the processes for refund claims in section 7422. Section 7433 allows damages actions for recklessly, intentionally, or negligently disregarding the Code or Regulations in matters that relate to collection, but not assessment of tax. The Seventh Circuit followed other circuits in upholding this distinction. To allow damage claims in this context would not only violate the terms of the statute, which is limited to matters “in connection with any collection”, but it would also circumvent the otherwise applicable processes governing tax refunds. The court also pointed to legislative history, which showed that the Conference Committee removed the word “determination” and included “collection” in its place. “Legislative history does not come much clearer than that.”

Comment: Taxpayers here may have felt aggrieved that they settled what might have been a time-barred claim. But of course, that view on the time bar was likely informed by whether a determination of fraud could be made to extend the limitations period. Would you want to roll those dice (and risk fraud penalties to boot) or settle? The court’s view of legislative history here is worth noting: even skeptics of the utility of committee reports as a “gloss” on legislation should recognize that when language changes, there is likely an intention to change the meaning of the statute. This informs textual interpretation by judges, which is at the core of their function, rather than drawing upon a staffer’s interpretive insights.
3. Damages for emotional distress allowed against IRS for violating bankruptcy stay, Hunsaker v. United States, 902 F.3d 963 (9th Cir. 2018).

Taxpayers filed for Chapter 13 bankruptcy. Thereafter, the IRS sent four notices to them demanding payment and threatening a levy on their social security benefits. Taxpayers brought an action for damages, claiming that the IRS violated the automatic stay under section 362(k) of the Bankruptcy Code. At trial, the bankruptcy court awarded them damages of $4000 for emotional distress. The federal district court reversed, concluding that sovereign immunity protected the government from an award of damages. Taxpayers appealed.

The Ninth Circuit reversed. Section 362(k) establishes these consequences for violating the stay: “an individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys’ fees, and, in appropriate circumstances, may recover punitive damages.” Other precedent in the Ninth Circuit holds that actual damages can include emotional distress. Here, the Ninth Circuit focused on the plain meaning of 11 USC § 106(a), which waives sovereign immunity for “an order or judgment awarding a monetary recovery, but not including an award of punitive damages.” According to the court, this is a plain and unambiguous waiver. It rejected a more restrictive interpretation of monetary recovery as implausible as it would render part of the statute meaningless, and it also rejected the First Circuit’s ruling in In re Rivera Torres (2005) to the contrary.

Comment: The circuit split on this issue remains unresolved. Of course, these damages may be taxable income, as they are not excludable under section 104 unless Taxpayers incurred medical expenses to treat their emotional distress. Query whether the Government will offset their prior tax claims by the amount due, and then send them another bill for taxes due on the $4K they are deemed to receive! But recovering something is still better than nothing – unless they incurred significant attorney fees to collect it, which may well be nondeductible miscellaneous itemized deductions!

D. Tax Crimes.


Marinello was convicted of a felony involving 26 USC § 7212(a), which entails one who “corruptly or by threats of force (including any threatening letter communication) endeavors to intimidate or impede any officer or employee of the United States acting in an official capacity under this title [known as the “officer clause”], or in any other way corruptly … endeavors to obstruct or impede, the due administration of this title…. [known as the “omnibus clause”]. Marinello’s conduct here was charged under the “omnibus clause”, and its application was challenged in this litigation.

Marinello had been indicted in 2012 with several felony tax violations, including a violation of the omnibus clause. The Government claimed that he had, among other things, failed to maintain corporate books and records, failed to provide his accountants with accurate information, hiding income, and paying his employees in cash, as a predicate for the omnibus clause violations. However, all these activities preceded his awareness of a particular IRS action or investigation against him (although, in fact, he had been under criminal tax investigation at the time). After conviction, he raised this issue in the Second Circuit, which ruled that a defendant
did not require an awareness of an action or investigation to be convicted. The Supreme Court granted certiorari, which reversed.

The Supreme Court took a restrained approach to interpreting the scope of this statute. Finding that a broad interpretation would risk the lack of fair warning and related unfairness that counseled restraint in a similar statutory context, the Court rejected the government’s interpretation. For example, it noted that a person who pays a babysitter $41 a week in cash without withholding or who leaves a large tip could be caught up in a felony violation of this provision. The mere requirement of showing one acts “corruptly” did not save this provision, as corruptly merely means for the purpose of obtaining an unlawful advantage. Moreover, prosecutorial discretion is not an adequate basis to narrow the potential scope of this provision. It is not appropriate to entrust freedom to the discretion of policemen, prosecutors, and juries.

Accordingly, the majority required prosecutors to show a nexus between the conduct and a particular administrative proceeding involving the taxpayer. They also clarified that not every activity carried out by IRS employees would constitute an administrative proceeding.

A vigorous dissent by Justices Thomas and Alito took the majority to task. They focused on the bad acts of Marinello, including destroying business records and taking money from his company to pay personal expenses. The statute allowed the prosecution, and it was up to Congress to narrow it. “[L]enity-sounding concerns” invoked by the majority were not sufficient to overcome the plain meaning of this statute. It also cast aspersion on the limitations imposed by the majority, which they suggested also raised considerable problems of vagueness.

Comment: The majority’s approach is taxpayer-friendly, although the dissent is likely correct that we will see more litigation to clarify the parameters that the majority imposed on the statute.

V. International.


   Partnership that owned two CFCs that had guaranteed loans made to a United States person petitioned the Tax Court to challenge the IRS determination that the partnership, as a shareholder of the CFC had ordinary income from the CFC on account of the guarantee. The Tax Court upheld the IRS position, upholding that the Treasury Regulations under section 956 under the doctrine of Chevron deference. Although the CFC might have otherwise been entitled to defer accumulated income, the shareholder is required to included certain amounts under section 951, including the amount of U.S. property held by the shareholder. Section 956 and its underlying regulations treat as US property a guarantee by the CFC of the U.S. shareholder’s debt in the amount of the shareholder’s pro rata share of average US property held by CFC during the taxable year. This was true even where more than one CFC had guaranteed the debt. Moreover, the income included was properly taxed as ordinary income rather than qualified dividend income. The court rejected Taxpayer’s argument that an earlier tax court decision on the matter of characterization (Rodriguez, 2011), was restricted to the context of an actual investment in real or tangible US property, not a deemed investment resulting in a deemed distribution.

Comment: This issue is on appeal to the Third Circuit. Challenging regulations is hard, even when the taxpayer has a credible claim that the regulations can produce absurd results.

After Taxpayer’s victory in the Tax Court on proposed deficiencies of over $500 and $800 million, respectively, for two tax years, the Service appealed to the Eighth Circuit.

This case involves transfer pricing issues arising from the manufacture and sale of medical devices. The Service argued that Taxpayer was shifting too much profit to Puerto Rico in order to reduce its U.S. tax burdens. In the 2002 tax year, Taxpayer and the Service entered into a Memorandum of Understanding that based future profit allocations on certain stated royalty rates. However, by 2005, the Service and the Taxpayer could no longer agree that this method clearly reflected income. Accordingly, the Service used a comparable profits method and the Taxpayer used the comparable uncontrolled transactions (“CUT”) method.

Taxpayer filed suit in the Tax Court challenging the Service’s method, and the court agreed that the Service approach was arbitrary, capricious, and unreasonable. However, instead of adopting the CUT method used by the Taxpayer, the court engaged in its own analysis, which resulted in some adjustments to the Taxpayer approach.

The Eighth Circuit vacated the Tax Court opinion on this issue and remanded for further factfinding. In effect, the Eighth Circuit required the court to make additional findings as required in the transfer pricing regulations. In particular, it cast doubt on the use of a settlement in a licensing dispute between Taxpayer and a third party to determine a comparable transaction. Among other things, the settlement involved a lump sum, which might have affected the comparability with ongoing transactions. Moreover, it also did not take into account potential differences in the intangibles involved in the settlement.

Comment: While a big disappointment to Taxpayer, the Taxpayer lives to fight another day. The concurring opinion by Judge Shepherd is particularly insightful, as it identifies some particular problems in the settlement environment that may affect comparability, including the effects of litigation hazards on the agreed-upon price.


The DC Circuit invalidated certain regulations under IRC § 883, which involved a claim for tax exemption by a foreign corporation. Although the IRS was successful in the Tax Court, the Circuit Court reversed, finding after de novo review of the record, the regulations in this case were not a reasonable interpretation of section 883. Section 883(c)(1) states in relevant part that a tax exemption for foreign shippers “shall not apply to any foreign corporation if 50 percent or more of the value of the stock of such corporation is owned by individuals who are not residents of [a country granting a reciprocal tax exemption].” At issue here was the method of proof of ownership when bearer shares are used. According to the Circuit Court, the regulations erred by creating an insurmountable burden of proof in which no amount of relevant evidence could be used to establish ownership of bearer shares. Moreover the regulations did not treat bearer shares consistently, which was viewed as “the last straw needed to break this camel’s back.”
Comment: This was a substantial taxpayer win on an issue that provides an uphill battle due to the Chevron framework. Notably, the author of this taxpayer-friendly opinion is Merrick Garland.


Taxpayers, who are residents of Florida, held stock in CFCs based on Hong Kong and later in Cyprus through a wholly-owned S corporation, Hopper US. The Hong Kong CFC, Memcorp HK, sold some of its business operations in 2007, leaving it with significant cash. Taxpayers hoped that it could be distributed to them in the form of a qualified dividend taxed at preferential rates. However, section 1(h)(11)(B)(i)(II) required Memcorp HK to be a “qualified foreign corporation” in order to achieve those preferential rates. Otherwise, ordinary income rates would apply. A “qualified foreign corporation” must either be incorporated in a possession of the US or in a country with a comprehensive tax treaty with the US. Hong Kong satisfied neither of these requirements. Hong Kong has a tax system that is independent from the People’s Republic of China and no treaty with the US, although China has such a treaty.

In mid-2008, Memcorp HK paid an $18 million dividend to Hopper US. This amount was based on the sum of the amounts that had previously been included in Taxpayer’s income under subpart F. See IRC § 951(a). Taxpayers had elected to be taxed on corporate rates on these distributions, see IRC § 962, and pursuant to a special rule, they were permitted to exclude the tax assessed on previous E&P. In this case, that tax amounted to about $6 million, so the net effect was a taxable dividend of $12 million. Taxpayers conceded that they failed to include this net amount in their gross income for 2008.

For later distributions, Taxpayers sought to change the residency of Memcorp HK by transferring all its shares to a Cyprus CFC, which then filed Form 8832 to treat it as a disregarded entity. In effect, Memcorp HK was treated as undergoing an F reorganization (a change in form or place of incorporation). The Cyprus CFC thus obtained all of its assets, including cash.

On March 24, 2009, after the reorganization, the Cyprus CFC paid a cash dividend of $57 million to its US shareholder, Hopper US. In addition, the Service alleged that the Cyprus CFC also provided a constructive dividend of $21 million to Taxpayers based on the amount of an account receivable from Hopper US that it had owed to Memcorp HK. The Cyprus CFC chose to cancel this debt in March 2009, thereby inuring to the benefit of Taxpayers as US shareholders of Hopper US.

The Tax Court first addressed the $12 million dividend in 2008. Taxpayer argued that this was from a “notional” domestic corporation, as they had elected to be taxed as a corporation under section 962, and the operation of section 962(d) effectively treats the distribution as coming from a domestic corporation. The Tax Court did not buy this. Although Bittker and Lokken describe the effect of section 962(d) as effectively treating the distribution as though it came through a domestic corporation due to the tax exclusion for the income previously taxed to the shareholders, the Tax Court found no support for this in the actual statutes governing the receipt of a qualified dividend. Section 962(d) expressly states that it involves previously taxed E&P of a foreign corporation, not a “notional domestic corporation”. Moreover, the legislative history was deemed unhelpful on this point, as it long predated the more recent concept of the qualified dividend eligible for preferential rates.
As for the $2009 distribution of $57 million, Taxpayer sought summary judgment that the Cyprus CFC was a Cypriot corporation under the applicable Treaty. However, the Service contested whether it was eligible, as the treaty required not only residence but also negated those corporations in which “a principal purpose” was obtaining benefits under the treaty. Although Taxpayers argued that an “act of state” doctrine applied in this case based on the certificates issued by the Cypriot authorities, that was not dispositive as an act of state. The mere action by an administrative authority in interpreting the treaty does not insulate the treaty from interpretation by a US court. This issue is headed for further factfinding.

Finally, as for the cancellation of the account receivable that Hopper US had owed to Memcorp HK, the Tax Court ruled that this was indeed a constructive dividend to Taxpayers, an “economic benefit without expectation of repayment.” By cancelling indebtedness from Hopper US, Memcorp (now through the Cyprus CFC) made a distribution to Hopper in the amount of the debt. That distribution will be treated as a dividend to the extent of its E&P. Here, Taxpayers conceded that the Cyprus CFC had ample E&P to cover this constructive dividend. Additional complexities are also presented here due to the deemed inclusion of CFC income under section 956 when a CFC makes an investment in US property, which affects the incremental change in that investment. However, that did not affect the constructive dividend amount in 2009, although the matter of whether it is a qualified dividend remains yet to be determined.

Comment: This is a tough case to unravel, as it touches upon various complexities in the international regime. But it rewards those who stay engaged through that difficulty. The constructive dividend issue presents additional complexity, which is not yet addressed in this decision: could the IRS view this as cancellation of indebtedness income, which might generate a less favorable result than a qualified dividend (if, indeed, that is later determined based on Cypriot residency)?

5. Taxpayer working under “personal services agreement” for U.S. State Department is not eligible for section 911 exclusion, O’Kagu v. Commissioner, 151 T.C. No. 6 (2018).

Taxpayer worked as a technician under a personal services agreement in Germany. He alleged that he was not an employee of the US Government, as he is excluded from certain perquisites ordinarily afforded to government employees. He also relies on 22 USC § 2669, which governs the use of funds by the Secretary of State, allows him/her to “employ individuals or organizations, by contract, for services abroad, and individuals employed by contract to perform such services shall not by virtue of such employment be considered to be employees of the United States Government for purposes of any law administered by the Office of Personnel Management…”

Unfortunately for Taxpayer, the DC Circuit has treated this clause as confirming that personal services agreements do make the participants employees for other purposes, including for example statutory protections under the ADEA. Moreover, the Tax Court pointed out that section 911 is not a “law administered by” the OPM. Consequently, due to the nature of his employment, he is not eligible for the section 911 exclusion.

Comment: This will clarify the law for others in these contractual arrangements with US government agencies who are serving abroad.

Taxpayers participated in a visitor program sponsored by the State Department, in which full-time students pursuing post-secondary study are allowed to work in the United States during their summer vacations. Participants obtain a “J Visa”, which indicates that by coming here, they have no intention of abandoning their country of residence. They worked in various jobs, and they sought to deduct travel expenses and certain other expenses associated with their participation in the program. All participants were full-time students; none had a trade or business in their home country although one did pay his mother to help maintain the family home in which he lived.

Taxpayers argued that they were “away from home” for purposes of section 162, that their employment was temporary, and that business exigencies required them to incur these expenditures. However, the Tax Court rejected these arguments, finding that they were not away from home in pursuit of a trade or business because they had no business reason to maintain a separate residence away from their principal place of employment, which they had none. Here, they could not claim that their personal residence in their home country was their home. Moreover, the decision to incur the claimed expenditures were for personal reasons, not because of the exigencies of their trade or business.

The DC Circuit affirmed, finding that these expenditures are nondeductible personal living and family expenses under section 262, not deductible under section 162. Even if they were “ordinary and necessary” and they were “away from home” because of temporary employment, they cannot meet the requirement that the expenditures were in pursuit of a trade or business. If instead their employers required them to travel or live temporarily at some place, the exigencies requirement would be satisfied. Instead, they had no trade or business to be away from. Their decision to travel to obtain their jobs was personal, not driven by the exigencies of an existing trade or business. Maintaining an abode for immigration purposes is not the same as being engaged in a trade or business.

Comment: Those interested in reviewing the significant case law interpreting this statute will profit from reviewing this case.


The international provisions of the Tax Cuts and Jobs act of 2017 (Pub. L. No. 115-97) have wrought significant changes in the regime covering the tax treatment of investing abroad, as well as the matter of treating foreign investment in the United States. While the details of these provisions are outside the scope of this program, you should be aware that the IRS has invested significant time during the past year in providing guidance in this area of the tax law. BNA has produced a “Guidance Timeline” covering various forms of guidance issued in connection with this new legislation. This is a good source for winnowing out the various guidance projects relevant in this area.
VI. Corporations.

1. Loans to S corporation through related entities did not increase shareholder basis for loss purposes, Hargis v. Koskinen, 893 F.3d 540 (8th Cir. 2018).

The Eighth Circuit has affirmed the Tax Court in disallowing pass-through losses from S corporations operating nursing homes in 2009-10 on the ground that Taxpayers lacked adequate basis to absorb these losses. See IRC § 1366(d). Taxpayer husband argued that the S corporations borrowed from commercial lenders and from others to finance their operations when revenues were insufficient. Although none of the loans were directly from him, Taxpayer signed them either as co-obligor or guarantor. Relying on a flexible view of the transactions under the “economic outlay” doctrine, Taxpayer argued that the substance of these transactions involved loans to him, and that he made an actual economic outlay for the loans. This failed on many levels.

First, one of the lenders was a pass-through entity controlled by his wife. But this was not sufficient under applicable case law. Second, neither co-obligor nor guarantor status created an outlay here. Although Taxpayer tried to rely on Selfe, the Tax Court had found no convincing evidence that the lenders looked at him as the primary obligor. The court also rejected loss claims from wife in this case, finding that she had failed to prove that she had adequate basis to absorb the losses.

Comment: While regulations clarify the requirements for shareholder loans that increase basis, they case provides yet another cautionary tale about the adverse tax consequences from a poorly structured loan transaction if a pass-through loss is the desired outcome.

2. Transferee liability based on Arizona UFTA in corporate sale, Slone v. Commissioner, 896 F.3d 1083 (9th Cir. 2018).

These taxpayers engaged in a “Fortrend” transaction, which has become quite a familiar fact pattern in generating transferee liability litigation. Significantly, the Ninth Circuit reversed the Tax Court in finding that the Taxpayers had no actual or constructive knowledge of a tax avoidance scheme, which ultimately left their corporation without funds to pay its $15.3 million tax liability. Looking to the substance of the transaction, the Ninth Circuit rejected the form-bound approach adopted by the Tax Court, choosing instead to rely on foundations for suspicion in the structure of the transaction. Despite ample basis for suspicion, Taxpayer’s leaders and advisers failed to asked pertinent questions. For example, their accountant indicated that the purchaser could pay a premium price (i.e., more than the net assets after satisfying tax liabilities) because of its ability to “resolve liabilities at the corporate level.” But no one asked how that was so, other than an inquiry by counsel to which the purchaser replied that it was a proprietary secret. Even if Taxpayers lacked actual notice, they had constructive knowledge. Willful blindness cannot be used as a defense in this context.

Comment: This is yet another taxpayer loss in this area. These cases have required many hours of attorney time – and likely some losses to the Treasury to the extent not all of these schemes have been detected. It should be noted that Taxpayer sought advice from counsel about transferee liability. Apparently, that advice turned out to be wrong.
3. Economic benefits flowing from corporate payment of shareholder life insurance premiums may not be taxable, Machacek v. Commissioner, __ F.3d __, 2018 WL 4939080 (6th Cir. 2018), reversing TC Memo 2016-55.

Husband and wife owned an S corporation, which in 2005 paid a $100K premium on a life insurance policy on Husband’s life. This was a “split dollar” policy that was not owned by Husband. The S corporation deducted the $100K premium and the Taxpayers did not include it in their income. After audit, the Tax Court correctly held that no deduction was allowed, thereby increasing Taxpayer’s income for 2005. However, at issue here was the Tax Court’s treatment of the increases in value that accompanied the split-dollar policy. The Tax Court had determined that it was taxable to Husband, but the Sixth Circuit reversed and remanded for additional consideration of the split-dollar regulations.

Here, the policy did not qualify under the so-called “traditional” split dollar regulations in Treas. Reg. 1.61-22. But it qualified as a “compensatory” agreement, since the arrangement was in connection with the performance of services, was not part of a group-term life policy, the employer pays the premiums, and in this case, the employee has an interest in the cash value of the contract. Although separate rules apply to a “shareholder” agreement, the parties apparently conceded that those rules were not applicable here.

In a split-dollar policy of any kind, the non-owner must take into account “the full value of all economic benefits.” Treas. Reg. § 1.61-22(d)(1). The regulations state the “depending on the relationship between the owner and non-owner, the economic benefits may constitute a payment of compensation, a distribution under section 301, a contribution to capital, a gift, or a transfer having a different tax character.” Id.

However, the nature of those benefits in an S corporation context is far from clear. Relying on a provision in the regulations, Taxpayers argued that the economic benefits here should be treated as a distribution of property. See Treas. Reg. § 1.301-1(q)(1)(i). Because it is an S corporation, 301(c) would apply and the distribution would be treated as a return of capital.

The Service and the Tax Court had focused on the fact that this policy involved a compensatory arrangement, which in their view made the economic benefits taxable as a form of compensation. However, the Sixth Circuit found fault in this analysis, as it failed to take into account the provision of Treas. Reg. § 1.301-1(q)(1)(i), which dictates treatment as a property distribution. It reversed and remanded – presumably for proceedings to ensure that the return of capital treatment claimed by Taxpayer would be proper.

Comment: This is a complicated area. The Sixth Circuit points out that when these regulations were promulgated in 2003, commentators were concerned about their scope. This specialized area of S Corporation ownership may highlight the need for additional regulatory guidance. Indeed, new regulations may be needed to overcome the Sixth Circuit’s view in this case. Note to government: If you write the regulations, you must follow the regulations.


Exelon was drawn into the SILO (sale-in, lease-out) tax strategy by its accountants, who proposed a like-kind exchange plan to offset considerable gains from the sale of power plants. The plan they executed collapsed under the weight of substance over form analysis in the Tax Court (147 TC No. 9 (2016)), which found that Exelon failed to acquire a genuine interest in property it acquired in the SILO transaction, and therefore it did not qualify for like kind
exchange treatment under section 1031. The Seventh Circuit affirmed, generally agreeing with the Tax Court analysis. “Ownership for tax purposes is not determined by legal title.” Instead, the taxpayer “must bear the benefits and burdens of ownership.” Here, there was no such benefits or burdens. During the operational period, the leases were “triple net”. And at the lease end, the Tax Court correctly applied a “reasonable likelihood” test that purchase options would be exercised.

Comment: Given the magic of compound interest, that will be a big tax bill to pay. Those interested in substance/form considerations will want to review this case, which among other things, rejects the Taxpayer’s “economic compulsion” standard in determining whether a “reasonable likelihood” of exercising the option would exist.

VII. Partnerships.

1. Withholding tax applicable to foreign partners is a partnership item, triggering Tax Court jurisdiction, YA Global Investments, LP v. Commissioner, 151 T.C. No. 2 (2018).

   Partnership had both foreign and domestic partners. During 2006-10, it filed Form 1065 reporting portfolio income from investments. However, the Service argued that the partnership was a dealer in securities under section 476, which was thereby engaged in a trade or business. As a consequence, the partnership would be required to withhold taxes under section 1446 on effectively connected income attributed to the U.S. Notices of deficiency based on the failure to withhold under section 1446, along with related penalties, were issued for 2006-2009.

   Partnership’s TMP sought to redetermine the notice of deficiency and to dismiss the case based on lack of jurisdiction on the theory that the withholding liability was not a partnership item that could be determined in this proceeding. The Tax Court ruled in favor of jurisdiction, concluding that the partnership is indeed liable for a failure to withhold under section 1446. Section 1461 provides that “every person required to deduct and withhold any tax … is hereby made liable for such tax.” Penalties related to the partnership adjustment are statutorily included as being properly within the Tax Court’s jurisdiction.

   Comment: This case shows the importance of carefully reading the Code in determining what is a partnership liability and what is a separate liability for a partner. The withholding tax imposed on international partners reflects a policy choice to deputize the partnership and impose liability when it fails to withhold. Note that here, Taxpayer argued for investor status rather than trade or business status (and vice versa for the IRS) due to the particular application of withholding rules affecting the partnership. Chasing foreign partners can be challenging for the tax collector if the withholding regime is not functioning properly!

2. Representing entity as a partnership precluded later attempt to treat as disregarded entity or qualified joint venture, Argosy Technologies, LLC v. Commissioner, TC Memo 2018-35.

   Husband and wife jointly operated business through an LLC. The Service attempted to levy against them to collect unpaid taxes, which apparently included penalties for late filing of Form 1065 with regard to the LLC. The form that they did file listed both husband and wife as owning 100 percent of the entity. However, in a collection due process hearing that challenged
the underlying liability, Husband argued that they could not be liable for penalties for failing to file a partnership return because it was a single-member LLC. Appeals denied relief, leading to this litigation in the Tax Court.

The Tax Court ruled against the Taxpayers, finding that they could not change the representation made on their returns. There was no evidence here of an election pursuant to section 761(f), which would have allowed them to simply report on two schedule Cs (or Fs, if that was the case).

Comment: Frankly, I would have overlooked this case but for a clever column by Kevin R. Sell in the October 1, 2018 Tax Adviser, “Filing ‘optional’ partnership return costly.” The section 761(f) election should be considered by those couples operating businesses together.


Taxpayer claimed pass-through losses from an LLC taxed as a partnership during the 1998 to 1999 tax years. However, Taxpayer did not actually take the steps to become a member of the LLC, including signing the operating agreement. Moreover, Taxpayer never made the required capital contribution to the LLC. In 2005, the Tax Matters partner of the LLC was indicted for tax crimes related to the LLC and its returns, and in 2008 he was convicted. On November 9, 2009, the Service issued a notice that they were beginning administrative proceedings concerning an audit of the partnership tax returns. Taxpayer also received this notice. By 2014, the Service had issued FPAAs adjusting the 1998 and 1999 tax returns, thereby affecting pass-through losses claimed by Taxpayer. Taxpayer submitted a deposit to cover putative liabilities, and then filed a complained in district court seeking to adjust the partnership items and requesting a refund of their deposit.

One issue before the district court was the matter of whether the assessment of taxes was barred by the statute of limitations. The Service alleged that the limitations period was unlimited, as the Taxpayer filed a fraudulent return. Section 6501(a) provides a default three-year limitations period for the assessment and collection of tax. However, other Code provisions create exceptions to this default rule. In particular, section 6501(c) provides that no limitations period applies to a fraudulent return.

Taxpayer here claimed that section 6229, which is part of TEFRA, creates a separate and distinct limitations period for partnership assessments. Section 6229(c) creates a six year period for partners who participated in the preparation of a false or fraudulent return. Taxpayer thus claimed that assessment occurred beyond the limitations period here, even if Taxpayer was deemed to be participating.

The Service took a different view, in that section 6229 did not provide an independent statute of limitations. Instead, it provides minimum terms for assessment that should be read in conjunction with the rules in section 6501, including the unlimited period for limitations in the event of fraud. The Tenth Circuit agreed with the district court to follow the Service’s view here, and in doing so, it follows the decisions of other circuits hearing the matter, as well as the Tax Court.

Comment: This outcome ensures that participants in fraudulent partnership returns do not skate on their personal tax liabilities. But it also allows the Service to draw out the process of
examination. *Query, is it fair to allow fifteen years for an adjustment to flow through to the partner, when the government knew about potential fraud nearly ten years before?*


A partnership of single-member LLCs, which were otherwise disregarded entities, was subjected to TEFRA partnership proceedings before the Tax Court, which included adjustments and penalties. The partnership appealed on the grounds that the Tax Court had erred in rejecting its claim that it was a small partnership exempt from TEFRA audit and litigation proceedings (see IRC § 6231(a)(1)(B)), which would therefore have deprived the Tax Court of jurisdiction.

The DC Circuit upheld the Tax Court’s position, ruling that the Service appropriately followed regulations that treated a partnership with a “pass through partner” as ineligible for the small partnership exemption. (See Treas. Reg. § 301.6231(a)(1)-1(a)(2)). According to the DC Circuit, the check-the-box regulations merely determine the tax consequences for a particular entity, and they do not determine who holds a partnership interest for TEFRA purposes. Here, the owners were LLCs, not the individuals who owned the LLCs. Further, LLCs are “pass-through” partners for purposes of determining the scope of the TEFRA exception. The Service was given some deference in interpreting its own regulations for this purpose, including its position in Rev. Rul. 2004-88 and its own litigating position in this case. Taxpayer also lost its bid to challenge penalties, as the Circuit Court held that these claims were waived as they were not properly raised in the partnership level proceedings.

Comment: *This outcome strikes me as contestable, particularly to the extent that the IRS is given deference in interpreting its own regulation as a litigating position. Shouldn’t the courts have the power to interpret the regulatory language independently? Here, the taxpayer was assigned a heavy burden in determining that there was a compelling reason to contravene the IRS position.*

5. Carried interest regulations are coming soon to implement new section 1061, Notice 2018-18.

Much hand-wringing has occurred over the potential for certain partners to obtain capital gain treatment on the disposition of their partnership interests. The 2017 Tax Act added section 1061, which requires an “applicable partnership interest” (i.e., one acquired in connection with the performance of substantial services) to satisfy a three-year holding period requirement in order to obtain long-term capital gain treatment. However, an interest held by a “corporation” is excluded from the definition of an applicable interest. See IRC § 1061(c)(4)(A). This Notice clarifies that taxpayers may not use S corporations to hold partnership interests in order to circumvent the three-year rule.

Comment: *I think my former tax professor, Douglas A. Kahn, had the carried interest question right in his paper, “The Fallacious Objections to the Tax Treatment of Carried Interest”, 20 Fl. Tax Rev. 319-34 (2017) (with co-author J.H. Kahn). But Congress thought otherwise. This appears to close a loophole, in that a hybrid-pass-through like an S corporation would otherwise allow the holding period rule to be circumvented. But query whether this change can be made*
without Congress. Will this notice be upheld if challenged in litigation? After all, S corporations are corporations, too.

6. Other Complexities: Partnership audit rules.
Those who engage in businesses through partnerships and LLCs taxed as partnerships under Subchapter K should be aware that a new partnership audit regime was enacted in section 1101 of the Bipartisan Budget Act of 2015 legislation. It is becoming effective this year, and final regulations governing the ability to elect out of this regime were published on January 2, 2018. See TD 9829, 83 Fed. Reg. 24 (2018). This regime may change the way you think about partnership investments. Rather than a pass-through entity with the owner being taxable on his/her pro rata share of income, the new regime creates the potential for the partnership to be liable for tax bills attributed to prior taxable years. This means a potential shift in liability from former partners to current partners. The omnibus spending bill that was signed by President Trump (Pub. L. No. 115-141 (March 23, 2018) includes additional provisions affecting this audit regime, which also deserve attention.

Comment: This item deserves a separate program on its own.


A. Introduction.
While tax legislation that tweaks at the margin is quite common, legislation that reflects significant and sweeping policy changes is comparatively rare. The Tax Cuts and Jobs Act (Pub. L. No 115-97, December 22, 2017)\(^1\) falls into this rare category. By reducing rates and providing significant new incentives designed to stimulate capital investment in the United States, the Act signals growth and opportunity in the private sector. There is much to like for businesses and investors. Below I highlight some key areas of the Act, focusing primarily on domestic business and personal provisions that are particularly noteworthy for general practice.

B. Rate Reductions.

1. Individual Overview:
   a. Ordinary Income: Married Filing Jointly

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $19,050</td>
<td>10% of the taxable income</td>
</tr>
<tr>
<td>Over $19,050 but not over $77,400</td>
<td>$1,905 plus 12% of the excess over $19,050</td>
</tr>
<tr>
<td>Over $77,400 but not over $165,000</td>
<td>$8,907 plus 22% of the excess over $77,400</td>
</tr>
<tr>
<td>Over $165,000 but not over $315,000</td>
<td>$28,179 plus 24% of the excess over $165,000</td>
</tr>
<tr>
<td>Over $315,000 but not over $400,000</td>
<td>$64,179 plus 32% of the excess over $315,000</td>
</tr>
</tbody>
</table>

\(^1\) This legislation is formally designated as “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018”.

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b. Ordinary Income: Unmarried

Not over $9,525 10% of the 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 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000 $32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000 $45,689.50 plus 35% of the excess over $200,000
Over $500,000 $150,689.50 plus 37% of the excess over $500,000

c. Capital Gains/Qualified Dividends: Maintain prior rates.

i. 0 percent below $77,200 married/$38,600 single.

ii. 15 percent $77,200-$479,000 married/$38,600-$425,800 single.

iii. 20 percent for excess above $479,000 married/$425,800 single.

iv. Net investment income (NII) tax of 3.8% may also apply based on modified AGI of $250,000 (married) and $200,000 (single).

d. AMT: Exemptions raised to $109,400 married/$70,300 single.
Unfortunately, the AMT was not eliminated – but with the removal of miscellaneous itemized deductions from the regular tax (see below), it may not affect as many taxpayers as in prior years.

e. Note: Rates reflect potential marriage penalty for those in the highest income tax brackets.

i. Two singles earning $500K each will pay a total of $301,379, but a married couple earning $1 million will pay $309,379, or $8,000 more.

ii. Capital gain differentials also allow singles to have proportionally more income taxed at lower rates.

iii. NII impact also favors singles; so does AMT exemption amount.

iv. But demographics can still produce a bonus in some cases: e.g., a married couple with one earner at $600,000 will pay $161,379, while single earner at that level would pay $187,689.50!

f. Brackets are indexed for inflation based on a new methodology. The “Chained Consumer Price Index for All Urban Consumers” (C-CPI-U) will likely produce smaller inflation adjustments going forward because the methodology takes into account changes in purchasing decisions as price levels increase.

g. Changes to the tax base (such as the new deduction under section 199A) may also affect average tax rates.
h. Change in scope of capital assets. Section 1221(a)(3), as amended, excludes self-created intangibles (such as patents, inventions, formulas) from treatment as capital assets. (But note: section 1235 still allows a patent to be taxed at the lowest applicable capital gain rate. The characterization issue may still affect the ability to utilize capital losses, and thus remains significant.)

2. Corporations.
   a. The story here is simpler: we went from graduated rates from 15 to 35 percent (or a flat rate of 35 percent for a PSC) to a single flat rate of 21 percent.
      i. That translates to a tax increase for the lowest-earning corporations, as those with taxable income of $50,000 or less had a tax rate of 15 percent.
      ii. For all others, this is a big rate cut.
   b. For corporate dividends, the deductions available under IRC § 243 are likewise reduced.
      i. Those entitled to a 70 percent deduction are now entitled to 50 percent.
      ii. Those entitled to a 80 percent deduction are now entitled to 65 percent.
   c. Corporate AMT is also repealed.
   d. As we will explore below, this overall rate deduction makes the corporation much more attractive than before.
   e. Lowering the tax rate also makes it possible for the US to compete more effectively for global investment.

3. Economic effects from lower rates.
   a. Will lower tax rates incentivize earning?
   b. Will higher after-tax returns affect wage growth and capital decisions?
   c. Will economic growth (caused by 1 and 2, above) offset (to some extent) tax collections?
   d. Private actors will control a greater dollar volume of economic decisions than under prior law. But note, without offsetting cuts to government spending, the current scope of government influence in our economy is staying the same – and it is still growing over time. JCT projects significant growth in deficits – but these projections came from the same people who told us the Affordable Care Act would be reducing our deficits.
   e. The reconciliation process means we have a temporary fix – reversion to prior law after 2025 for most provisions. Query what effects this instability will have on future tax years.
C. Shrinking the Tax Base: Enhanced Business Deductions.

1. Capital investments.
   a. Section 179 Expansion. Smaller businesses will benefit from the expanded parameters of section 179 expensing.
      i. $1 million vs. $510K in expense limits.
      ii. $2.5 million vs. $2.03M phaseout.
      iii. Both amounts are permanent and adjusted for inflation, ending longtime temporary adjustments with dubious incentive effects due to the timing of statutory extensions near year-end.
      iv. The scope of eligible property was also expanded to include certain kinds of real estate investment, including certain improvements to the interior portions of nonresidential real property plus roofs, HVAC, fire and alarm systems, and security systems for nonresidential real property. Some of those items were eligible for bonus depreciation under prior law.

   b. Bonus Depreciation. There are many details, but here are some relevant highlights.
      i. For qualified new assets placed in service after 9/27/17 and before year-end in 2023, 100% depreciation is available, up from 50% in 2017. (A transition rule allows a taxpayer to elect 50% for 2018 instead of 100%.)
      ii. Bonus amount phases out annually thereafter in 20% increments, expiring altogether for property placed in service after 12/31/26.
      iii. The acquisition date and placed in service date matter in terms of eligibility. Some complexities lurk here which merit attention, particularly the options for bonus depreciation and recovery periods.
      iv. New or used assets may be eligible.
      v. Farm property gets some beneficial treatments if placed in service after 12/31/17. Certain types of new property can be recovered over 5 years (instead of 7) and the recovery method is the 200% declining balance method (instead of 150%) under prior law.

   c. Note that the timing of tax benefits from enhanced depreciation or section 179 deductions may be affected by other provisions discussed below, including interest deduction limitations and restrictions on NOLs. These benefits thus may only become fully effective in the current year for the most profitable firms.

2. Deduction for “qualified business income” (New section 199A).
a. Perhaps the most intriguing manner for shrinking the tax base (and thus lowering effective rates) is the new deduction allowable to taxpayers engaged in a trade or business other than that of an employee.
   i. Section 199A allows a deduction of up to 20 percent of domestic qualified business income earned from a partnership, S corporation, or sole proprietorship.
   ii. As explored below, restrictions on this deduction are phased in – making it widely available for lower-income taxpayers, but more limited for those with higher levels of business income.
   iii. Section 199A replaced the “domestic production activity” deduction previously available in section 199, which is now repealed.

b. Complexities abound in this new code provision. However, some key concepts are illustrated below.

c. “Qualified business income” includes the combined items of income, gain, deduction, and loss that are effectively connected with U.S. trades or businesses.
   i. Certain items are excluded, including capital gain/loss, certain dividends, investment income not allocable to the trade or business, and publicly traded partnership income.
   ii. For partnerships and S corporations, qualified business income is allocated to each partner/owner.
   iii. Qualified business income also excludes compensation for services, including guaranteed payments to partners.
      i. An S corporation that pays a salary to the shareholder/employee thus creates a source of income that is not qualified business income in the hands of the shareholder/employee.
      ii. A partnership that pays a guaranteed payment for services (and which cannot otherwise treat a partner as an employee) will thus also create a source of income that is not qualified business income in the hands of the employee.
   iv. Qualified business income is combined for all trades or businesses of each taxpayer.
      i. If there is a net loss, it is carried forward to a succeeding year.
      ii. Thus, the deduction will be available only for profitable businesses, measured over a time period beginning in 2018 and going forward.
      iii. But note: if limitations apply, they are applicable to each separate trade or business. Complexity lurks here.

d. Taxpayers with qualified business income who have taxable income below a “threshold amount” avoid certain restrictions that may otherwise apply. These “threshold amounts” are as follows:
i. Unmarried or married filing separately: $157,500

ii. Married: $315,000.

iii. Such amounts are indexed for inflation in future years.

e. Limitations: The potential deduction of 20 percent of net qualified business income can be further limited as follows for taxpayers having taxable income that exceeds the applicable threshold amount.

i. The allowable deduction may not exceed the greater of:

   i. 50% of W-2 wages allocable to qualified business income or

   ii. 25% of such W-2 wages plus 2.5% of the unadjusted basis of all qualified property.

   1. Qualified property is tangible, depreciable property that is still held by the taxpayer on the later of ten years after it was first placed in service or in which depreciation deductions are still being taken.

   2. This rule thus requires acquisition and use of tangible assets or significant use of employees rather than partners or owners.

ii. “Specified service businesses” face an additional limitation that excludes their income from “qualified business income” if the allocable share goes to a taxpayer whose taxable income exceeds the threshold amount.

   i. Affected businesses are defined in section 1202(e)(3)(A) of the Code. Section 1202 generally provides an exclusion for gains on the sale of qualified small business stock. Section (e)(3)(A) excludes any trade or business other than: “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”.

   ii. Section 199A(d)(2) provides that a “specified service business” includes all of those described above, except for engineering and architecture.

   iii. Moreover, the term “employees” is redefined to include “owners or employees”, thus including a partner or other owner who may not be an employee of the firm.

   iv. Disfavored businesses also include “investing and investment management, trading, or dealing in securities.”

iii. The bad news: no special deduction for the owners of these disfavored firms if the owner is highly successful, as defined by
earning more than the threshold amount plus $50K (single) or $100K (joint), with a partial phase-out deduction in between).

iv. The good news: owners of service businesses can still get the entire deduction if they do not make more than the threshold amount. This could include a lower-earning partner in an otherwise highly successful firm, or a higher-earning partner who files jointly with a spouse that has a qualified business with losses that will reduce their taxable income below the joint threshold amount.

v. Outcomes will vary based on the tax situation of each owner. There are other complexities here yet to be considered for pass-through businesses and for taxpayers with multiple qualified trades or businesses. Like old section 199, this is not a step toward simplicity.

vi. This provision terminates for taxable years beginning after December 31, 2025.

D. Expanding the Tax Base: Restricting Business Deductions.

1. Business Interest.

a. Section 163(j) is amended to restrict the available deductions for business interest for all forms of businesses. If applicable, this restriction will be restricted to 30 percent of the taxpayer’s “adjusted taxable income” plus certain floor plan financing interest for taxpayers with motor vehicle inventories.

i. Adjusted taxable income generally means taxable income adjusted for these items:

ii. Add back any deductions or losses not allocable to a trade or business;

iii. Deduct any income or gain not allocable to a trade or business (note that income earned as an employee does not count as trade or business income);

iv. Deduct net business interest (i.e., business interest paid less business interest income)

v. Add back any section 199A deductions for owners of pass-through entities

vi. Beginning in 2022, deduct the allowable deduction for depreciation, amortization, or depletion.

b. Exemptions:

i. Covered small businesses (i.e., those with $25M or less in average annual gross receipts over the past three year period) are exempt.

ii. Electing farming businesses.

iii. Electing “real property trade or business” (which includes development, redevelopment, rental, etc.)

iv. But note: electing businesses face restrictions on depreciation options, which may reduce the attractiveness of the election.

c. Complexities exist for pass-through entities, with the deduction limitation first computed at the entity level, and then again at the partner level. Excess deductions are carried forward by the taxpayer, requiring the taxpayer to track
the excess deduction and use it to offset income in the future generated by the entity in excess of its interest expenses.

d. Implications for highly leveraged business models (not otherwise exempt):
   i. Leverage becomes more expensive.
   ii. Will firms operating in partnership form shift the manner of compensating capital providers to avoid these rules? And will anti-abuse rules stop these clever approaches?

2. Excess Business Losses
   a. Section 461(l) provides a restriction applicable to taxpayers other than a C corporation: “excess business losses” are disallowed in the current year and must be carried forward as an NOL in succeeding taxable years.
   b. Excess business losses are defined as the net losses attributable to all taxpayer’s trade or businesses plus $250,000 or $500,000 (joint return).
   c. Passive loss limitations still apply, and complexities will abound in figuring out how to work through the interrelationships between excess business losses, passive losses, and future NOL deductions.
   d. Query: will these loss restrictions counsel start-up investors to consider C corporations despite the inability to obtain pass-through deductions for their initial losses? Note the possibility of section 1202 stock benefits here.

3. Net Operating Losses
   a. Carry forward, not back (with exception for farm businesses). (§ 172)
   b. Deduction limited to 80 percent of future income, potentially causing additional deferral in realizing tax benefits for past losses.

4. Entertainment and Meals.
   a. Disallowance of deductions for entertainment (including meals) will make it more expensive to entertain. (But see Notice 2018-75 – some business meals that are not entertainment may continue to be deductible, albeit at the 50 percent rate applicable prior to the 2017 Act.)
   b. Disallowed deductions will particularly affect those who engage in business as a sole proprietor or through a pass-through entity, where rate reductions don’t offset increases in taxable income.
   c. But note: effects on corporate entertainment should be minimal given significant offsetting rate reductions in section 11. To illustrate:
      i. True cost of $100 in entertainment expenses in 2017, when 50 percent is deductible under section 274(n): $50/1 (deductible portion) plus $50/(1-.35) (nondeductible portion)= $126.92. (Note: the cost of the nondeductible portion is the pretax cost of earning that amount, computed by dividing the nondeductible portion by 1-tax rate.)
      ii. After-tax cost of $100 entertainment in 2018, when no deduction is allowed: $100/(1-.21)= $126.58.
5. **Local Lobbying.**  
   a. Section 162(e)(2) and (e)(7), authorizing local lobbying expenses (including tribal governments) are both stricken effective in 2018.
   b. This puts local lobbying on the same ground as other lobbying – it must be paid with after-tax dollars.
   c. Again, corporate businesses will find at their true costs of lobbying are lower than pass-through or proprietorships that face comparatively modest cuts in their income tax rates.
   d. Example: corporate cost of $100 in local lobbying = $100/(1-.21)= 126.58; proprietor’s cost of $100 in local lobbying = 100/(1-.37)=158.73. Both compare to $100 in deductible costs in 2017, prior to this change.

6. **Sexual harassment settlements.**  
   a. The “me too” movement is catching up with taxpayers who engage in settlements for sexual harassments or abuse.
   b. Although such payments have, in the past, generated “ordinary and necessary” trade or business deductions in the past, the new provision (§ 162(q)) restricts deductions if a settlement is subject to a nondisclosure agreement.
   c. Choose: if confidentiality is good for business, continue with nondisclosure and pay marginally more for the privilege.
   d. Here, too, corporate taxpayers will see a lesser impact than passthrough business owners and proprietors who continue to be subject to higher tax rates. (See the computations for local lobbying, above, for an illustration.)
   e. One unanticipated wrinkle: section 162(q) does not distinguish between the perpetrator and the victim. Does that mean the victim cannot deduct costs if the settlement is private? A legislative fix may be needed.

E. **Other significant provisions affecting individual taxpayers.**  
   1. **Increasing standard deduction.**  
      a. Married filing joint raised from $12,700 in 2017 to $24,000 in 2018.
      b. Single raised from $6,350 in 2017 to $12,000 in 2018.
      c. Higher standard deduction may benefit some taxpayers, who may otherwise feel effects from restrictions on itemized deductions.
      d. But note: loss of personal exemptions may make some taxpayers worse off – particularly those with older dependents who are not eligible for child credits.

   2. **Eliminating personal exemptions.**  
      a. The personal exemption deduction of $4050 in 2017 (for those within AGI limitations) is eliminated for 2018.
      b. Consider: Family of four with $12,700 standard deduction and $16,200 in personal exemptions could shelter $28,900 from tax in 2017, but only $24,000 in 2018 if they use the standard deduction. (But note: increased child tax credits may apply to offset this difference.)
      c. Note discussion above about the need to have a notional personal exemption to administer certain provisions in the ACA as well as filing status, etc. See Notices 2018-84, 2018-70, discussed supra.
3. Eliminate Pease Amendment.
   a. This deduction limitation (§ 68) was a stealth tax increase on higher-income individuals.
   b. Note that other restrictions on itemized deductions (see below) potentially impact a broad range of taxpayers.

4. Restrictions on Itemized Deductions.
   a. State and local tax deduction capped at $10K (§ 164). See
   b. Home mortgage interest base capped at $750K (down from $1M); no home equity deduction (§ 163).
   c. No miscellaneous itemized deduction (§ 67). Note hardships for:
      i. Employee business expenses. (Ask for your employer to pay some expenses instead of a raise?!?)
      ii. Investor expenses.
      iii. Litigation expenses not connected with a trade or business or otherwise deductible “above the line” in § 62(a)(20).
      iv. Deductions associated with money-losing hobbies (§ 183).

5. Expanded child tax credit benefits.
   a. Amount of credit is increased from $1000 to $2000 from 2018 to 2025. (§ 24(h)(1)). However, the refundable portion of the credit is limited to $1400.
   b. Phase-out increased from $110,000 AGI (married filing joint in 2017) to $400,000 (married filing joint) and from $75,000 (single in 2017) or $55,000 (married filing joint) to $200,000 in 2018 (other than married filing joint)
   c. Families with qualifying children (not yet 17 by end of tax year and US citizen, national, or resident with a TIN) will see a significant opportunity to reap additional tax benefits from these credits.
   d. Note that a credit of $500 may be available for nonqualifying children who are dependents, which is also more generous than prior law.