JCT-22-03-cover_Layout 1 5/31/22 9:33 AM Page 1

THOMSON REUTERS
CHECKPOINT™

May/June 2022

Corporate Taxation

Pass-Through Entity Taxation by the Forms

Assumed Contingent Liabilities in Asset Acquisitions

The Trust Fund Recovery Penalty

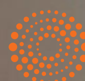
Research Credit Refund Claims

THOMSON REUTERS®

The most intelligent tax and accounting research platform ever.

See me in action at tax.tr.com/ai2021

© 2021 Thomson Reuters All_CPEdge_TR1206632-1/0820_MF



THOMSON REUTERS®

JCT-22-03-000-TOC.qxp_PTS-06-06-000-MH&TOC 6/1/22 10:51 AM Page 1

THOMSON REUTERS
CHECKPOINT™

Corporate Taxation

May/June 2022
Volume 49, Number 3

ARTICLES

PASS-THROUGH ENTITY TAXATION BY THE FORMS 3
JAMES R. HAMILL

ASSUMED CONTINGENT LIABILITIES IN ASSET ACQUISITIONS—NEW TAX COURT CASE 15
WILLIAM SKINNER

THE TRUST FUND RECOVERY PENALTY: WHO IS RESPONSIBLE TO PAY? 21
JULIET L. FINK

RESEARCH CREDIT REFUND CLAIMS—NEW IRS REQUIREMENTS 25
YAIR HOLTZMAN, SHARLENE SYLVIA, AND MICHAEL GANZ

COLUMNS

CORPORATE ORGANIZATIONS & REORGANIZATIONS 29
Administration's Subchapter C Proposals: Playing with the Control Test (and with Controlling Shareholders' Liability)
ROBERT RIZZI

RECENT DEVELOPMENTS 34
First Circuit Affirms $2,173,703 FBAR Penalty
Section 6426 Renewal Fuels Credit Reduces Taxpayer's Cost of Goods Sold
Taxpayers Failed to Qualify as Real Estate Professionals Under Section 469(c)(7)
Court Affirms Holding that Management Fees Paid to Shareholders Were Non-Deductible Disguised Dividends
Tax Court Misinterpreted the Meaning of "Grant" Under Tax Treaty
STEVEN I. KLEIN & STEPHEN R. LOONEY

IRS NEWS 44
IRS Provides Relief from Superfund Chemical Tax Deposit Failures
IRS Proposes Changes to Qualified Intermediary Agreement
IRS Responds to Reports of Information Return Destruction
Employee Retention Credit—Penalty Relief
Global Tax Chiefs Warn of Risks of Nonfungible Tokens
Employer Leave-Based Donations for Ukraine—IRS Guidance
TIGTA Audit on IRS Implementation of Partnership Audit Regime
IRS Sending Letters to Taxpayers with Qualified Opportunity Fund Investments

JCT-22-03-000-TOC.qxp_PTS-06-06-000-MH&TOC 6/1/22 10:51 AM Page 2

Corporate Taxation

Editor-in-Chief
Jerald David August
Fox Rothschild LLP
Philadelphia

Associate Editor
Joel D. Kuntz

Contributing Editors and Advisors

Robert S. Bernstein
Foley & Lardner LLP
Jacksonville, Florida

John A. Bogdanski
Lewis & Clark
Law School
Portland, Oregon

Joseph Calianno
Andersen
Washington, D.C.

David Friedel
PricewaterhouseCoopers LLP
Washington, D.C.

David P. Hariton
Sullivan & Cromwell
New York

Steven I. Klein
Sher Garner Cahill Richter
Klein & Hilbert L.L.C.
New Orleans, Louisiana

Stephen R. Looney
Dean, Mead, Egerton, Bloodworth,
Capouano & Bozarth, P.A.
Orlando, Florida

Todd Lowther
Shearman & Sterling LLP
Houston, Texas

Maura Ann McBreen
Baker & McKenzie LLP
Chicago

Joseph M. Pari
Weil, Gotshal & Manges LLP
Washington, D.C.

Robert A. Rizzi
Steptoe & Johnson LLP
Washington, D.C.

Jeanne Sullivan
KPMG LLP
Washington, D.C.

Editorial Staff

Managing Editor
Daniel E. Feld, J.D.
dan.feld@tr.com

Senior Graphic Designer
Christiane Bezerra

Desktop Artist
Vijay Jagdeo

Vice President, Editorial Knowledge Solutions
Nancy S. Hawkins, J.D.

Marketing Manager
Michele Henderlong

Subscriptions
(800) 431-9025

Please Visit Our Website
tax.thomsonreuters.com/CheckpointJournals

Corporate Taxation (ISSN 1534-715x) is published bi-monthly by Thomson Reuters/Tax & Accounting, P.O. Box 115008, Carrollton, TX 75011-5008. Subscriptions: $685 per year. Call: (800) 431-9025. Also available on the Internet on Thomson Reuters Checkpoint®; one-license user fee for one year: $590. Editorial inquiries: E-mail: scott.pierce@thomsonreuters.com.

© 2022 Thomson Reuters/Tax & Accounting. Thomson Reuters, Checkpoint, and the Kinesis logo are trademarks of Thomson Reuters and its affiliated companies. No part of this journal may be reproduced in any form—by microfilm, xerography, or otherwise—or incorporated into any information retrieval system without the written permission of the copyright owner. Requests to reproduce material contained in this publication should be addressed to Copyright Clearance Center, 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, FAX: (978) 646-8600. Requests to publish material or to incorporate material into computerized databases or any other electronic form, or for other than individual or internal distribution, should be addressed to Thomson Reuters, P.O. Box 115008, Carrollton, TX 75011-5008 or call (800) 431-9025.

POSTMASTER: Send address changes to Corporate Taxation, Thomson Reuters Tax & Accounting, P.O. Box 115008, Carrollton, TX 75011-5008. Periodicals postage paid at Hoboken, NJ, and at additional mailing offices. This publication is designed to provide accurate and authoritative information on the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If expert assistance is required, the services of a competent professional person should be sought.The views expressed in our columns may not be concurred in by editors or members of our editorial board.

Send correspondence relating to subscriptions and all other business matters to Thomson Reuters, P.O. Box 115008, Carrollton, TX 75011-5008 or call (800) 431-9025.

THOMSON REUTERS®

PASS-THROUGH ENTITY TAXATION BY THE FORMS

JAMES R. HAMILL

Introduction

Almost 90% of non-proprietorship businesses are organized as pass-through entities (PTEs). The prevalence of the C corporation form has steadily declined since the 1986 Tax Reform Act.

The growth in PTEs has not escaped the interest of the IRS. The IRS has announced plans to greatly increase the audits of partnerships. An IRS Large Business and International (LB&I) division compliance campaign will target reported partnership losses in excess of basis. The centralized partnership audit regime initiated in 2018 will facilitate the increased audit activity.[1]

The groundwork for enhanced audit activity is also found in new questions on PTE tax filings. The answers provided to these new questions may signal greater audit risk. If so, the preparer needs to consider that tax return question answers, even if seemingly innocuous, may later need to be defended.

The PTE filing is an information return to assist the PTE owners to report shares of income, gain, deduction, and loss of the entity. As Congress continues to enact legislation that differentially affects taxpayers of different types and income levels, the detail of information reporting in PTE returns has increased. This includes an increase in separately stated items as well as required or helpful supplemental information reporting.

The ability to prepare the PTE return depends on an understanding of why the forms request various types of information. It has therefore become difficult to prepare PTE tax returns without a detailed knowledge of Subchapter K and Subchapter S as well as general provisions of the tax law that apply at the PTE owner level. Preparers of the more than 9 million PTE returns have varying levels of knowledge and experience with these specific statutory provisions.

Many anti-abuse rules have been enacted to deal with sophisticated PTE taxpayers who may push the boundaries of the law. Tax return questions designed to target potential abuses apply equally to smaller and perhaps less sophisticated businesses and their preparers. What may have once been regarded as a simple act of tax compliance for the PTE is now inextricably tied to a complex system of laws.

The growth in PTEs requires tax professionals to devote increasing effort to keeping current with Subchapters K and S. There are many

The growth in pass-through entities (PTEs) requires tax professionals to devote increasing effort to keeping current with Subchapters K and S. This article uses the questions on Form 1065 and Form 1120S to identify the issues that the tax adviser should consider when both advising a PTE on transactional structures and in properly filing the entity tax return.

JAMES R. HAMILL, CPA, Ph.D., is Director of Tax Practice at Reynolds Hix & Co. in Albuquerque, New Mexico and Associate Professor of Accounting at Texas A&M University—Commerce.

JCT-22-03-003-Hamill.qxp_Article_Template_v1.2 6/1/22 8:48 AM Page 4

EXHIBIT 1
Specific PTE Questions

1	1065, page 1, Item K	Sections 465, 469 Groupings Done by Partnership
2	1065, page 2, Q6	COD event(s)
3	1065, page 2, Q10	Section 754 election
4	1065, page 3, Q11	Swap-and-drop (Section 1031)
5	1065, page 3, Q12	Drop-and-swap (Section 1031)
6	1065, page 3, Q24	Section 163(j) applicability
7	1065, page 3, Q25	QOF status
8	1065, K-1, Item I2	Partner is a retirement plan?
9	1065, K-1, Item J	Shares of Capital, P&L
10	1065, K-1, Item K	Shares of Debt (3 types)
11	1065, K-1, Item L	Tax basis capital reconciliation
12	1065, K-1, Item M	Contributed Section 704(c), in current year
13	1065, K-1, Item N	Unrecognized Section 704(c), aggregated
14	1065, K-1, Box 22	Check if > one Section 465 activity, statement attached
15	1065, K-1 Box 23	Check if > one Section 469 activity, statement attached
16	1120S, page 1, Item G	Designate if election year
17	1120S, page 1, Item J	Sections 465, 469 Groupings Done by Corporation
18	1120S, page 2, line 8	NUBIG calculation
19	1120S, page 2, line 10	Section 163(j) applicability
20	1120S, page 3, line 12	COD event(s) – non-SH debt
21	1120S, page 3, line 13	QSub termination or revocation
22	1120S, page 3, line 15	QOF status
23	1120S, page 5, M2	AAA, E&P, OAA reconciliation
24	1120S, K-1, Item 18	Check if > one Section 465 activity, statement attached
25	1120S, K-1, Item 19	Check if > one Section 469 activity, statement attached
26	1120S, K-1, Item H	Number of shares (units)
27	112S, K-1, Item I	Debt owed corporation-to-shareholder
28	1040, Sch E, basis schedule	Check if shareholder required to attach Form 7203: (4) scenarios
29	Tax Basis Capital – Partnership	How to – “transactional tax basis” reporting
30	S corporation qualification	Issues to identify before they become problems
31	Section 199A RPE Reporting Reg. 1.199A-6	How many businesses? SSTB for each business? QBI, by business? W2, UBIA, each by business? REIT Dividends?

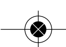
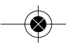


EXHIBIT 2

General Purpose of Items—Identified by Exhibit 1 Item Reference

1	If partnership aggregates, partners may not disaggregate. Try to segregate
2	Section 108 exclusions apply at partner level; allocation follows debt share
3	Useful if new client to determine history; once made binding on future years
4	Identifies possible problem with partnership's Section 1031 exchange
5	Identifies possible problem with identity of seller
6	Does Section 163(j) apply; if yes, added reporting complexity
7	GAO study notes concerns with eligibility
8	Possible UBTI for business income or debt-financed income
9	Identify shifts in interest (varying interest allocations); may be confusing to measure
10	Help with basis of interest; look for possible misclassification
11	Now required; not clear how to determine in some cases; problems with new clients
12	Identifies contributed property with BIG or BIL; not reverse Section 704(c)
13	Helps determine allocation efficacy; possible distribution triggers of Section 704(c)
14, 15	Partnership classification cannot be undone by partners
16	Should have 2553 already filed or attach with first return with a reasonable cause
17	If corporation aggregates, shareholders may not disaggregate; try to segregate
18	Hard to identify if no appraisal as going concern; AICPA SSTS No. 2 may help answer
19	Does Section 163(j) apply; if yes, added reporting complexity
20	Section 108 exclusions apply at corporate level
21	May identify a taxable transaction for the corporation
22	GAO study notes concerns with eligibility
23	PPP loan issue; impact on distribution treatment
24	Corporate classification cannot be undone by shareholders
25	Corporate classification cannot be undone by shareholders
26	Helps ensure proper allocations; assess conformity with single class of stock
27	Possible identification of debt-as-equity issue. Sections 385, 1361(c)(5); Reg 1.1361-1(l)
28	Distribution; debt repayment; sale/redemption of stock; loss pass-through
29	Generally tracks outside basis without debt shares
30	Can cause problems when shareholder(s) sell – more so than IRS challenge
31	Items that must be separately stated for all RPEs for Section 199A purposes



JCT-22-03-003-Hamill.qxp_Article_Template_v1.2 6/1/22 8:48 AM Page 6

ways to do this. This article will use the questions on the Form 1065 and Form 1120S to identify the issues that the tax adviser should consider when both advising a PTE on transactional structures and in properly filing the entity tax return.

Understanding why specific lines and questions exist can help understand key PTE tax items and identify planning opportunities for the owners of the entities. The forms themselves, and the required questions and supplemental schedules in particular, can be a training ground in the taxation of a PTE and its owners.

Exhibit 1 identifies key questions asked on the Forms 1065 and 1120S. The items are not exhaustive but represent the key issues that arise when preparing the typical PTE return. Exhibit 2 has a brief explanation of the purpose of each Exhibit 1 item. This article will expand upon that brief explanation. In doing so, the discussion may be useful to professionals preparing PTE returns, particularly younger professionals who may not be familiar with the history behind each information item.

Some items are specific to each distinct type of PTE. Other commonly required information disclosures are similar for both PTE forms. Exhibit 1 may be used to illustrate the overlap between the questions asked on Form 1065 and those on Form 1120S.

It is not possible to cover all issues that may arise in preparing a PTE return. For example, the scope and purpose of new K-2 and K-3 reporting, while important, is still evolving. This article ignores the detailed K-2 and K-3 reporting, as well as certain other items less frequently seen, to allow a more exhaustive focus on the most commonly encountered issues currently associated with domestic transactions.[2]

Partnership items—Form 1065

One of the first questions asked on page 1 of the Form 1065 is whether the partnership has aggregated activities for purposes of Section 465 (at-risk) or Section 469 (passive loss). A box is checked to indicate an entity-level aggregation for either purpose. The PTE box corresponds to similar questions asked on the partners' K-1 forms (boxes 22 and 23), which also require that a box be checked if aggregation has occurred. While answering this question does not require a detailed knowledge of either the at-risk or passive loss provisions, the preparer should consider the merits of entity-level aggregation. Partnership-level aggregation will be binding on the partners.

The Section 465 at-risk rules limit losses to the amount treated as being at risk with respect to each partner. While the loss limitation does not apply to the partnership itself, the decisions made by the partnership may affect the application of the rules to the partner.

Section 704(d) limits a partner's ability to claim a current year loss to the partner's basis in the partnership interest. Section 465(a) limits the partner's loss to amounts at risk with respect to each separate activity of the partnership. Section 469(a) limits a loss incurred from a trade or business activity in which the partner does not materially participate for the year.

Reg. 1.469-2T(d)(6) coordinates the operation of these three loss limitation rules, including the order in which they are applied. The Section 704(d) basis limitation, applied first, allows the partner to use the entire basis of the partnership interest without the need to trace that basis to a specific activity. In contrast, both Section 465 and Section 469 limit the loss on an activity-by-activity basis. This is why the Form 1065 asks whether the partnership has aggregated activities for purposes of either Section 465 or Section 469.[3]

The decision process involved in answering these aggregation questions can be complex. The activity definitions are different for each provision. Section 465(c)(2)(A) lists five activities that generally must be segregated. Section 465(c)(3)(B) then provides rules for aggregation of any non-listed activities.

Reg. 1.469-4(c) generally requires aggregation of operations that constitute an "appropriate economic unit" (AEU). Reg. 1.469-4(c)(2) identifies five factors to consider when aggregating operations under the AEU test. Reg. 1.469-4(d) prohibits aggregation of rental and non-rental operations, unless one is insignificant in relation to the other or the rental is to a trade or business in which the ownership of the rental and business operations is the same.

[1] The Treasury Inspector General for Tax Administration (TIGTA) issued a report (2022-30-020) on 3/17/2022 with results of early centralized audits. This report included recommendations for future audit activity.

[2] The K-2 and K-3 reporting is for items of international tax relevance. Who must file is still evolving, with IRS offering transitional relief (IR 2022-38) while addressing concerns of the complexity of these filings. The purpose of the new forms, however, is to standardize reporting of information previously reported in "white paper" attachments.

[3] Section 461(l)(1) limits aggregate business losses at the individual taxpayer level. The PTE has no role in this (final) limitation provision.

The Form 1065 does not ask about aggregation for purposes of the Section 1411 net investment income tax (NIIT), but Reg. 1.1411-5(b) defines income subject to the NIIT by reference to the passive activity classification. Therefore, the response to the Section 469 question applies equally to Section 1411.

The aggregation question on Form 1065, page 1, item K, which corresponds to the question for box 22 and box 23 of each partner's Schedule K-1, may appear innocuous because it simply involves checking, or not checking, a box. However, the decision process involved in the "box checking" response can be challenging and have significant implications for partners subject to the loss limitation provisions of either Section 465 or Section 469.

If a partnership aggregates operations into one activity for purposes of Section 469, the partner may not disaggregate that activity. The partner may further aggregate operations conducted through other PTEs or directly by the partner, but may not pull apart that which the partnership has bound together.[4] Where possible, the PTE should disaggregate operations. Each separate activity would require supplemental information disclosure so the PTE would need suitable records to allow disaggregation.

Interestingly, the Form 1065 does not ask if the partnership has aggregated trade or businesses for purposes of Section 199A (QBID). No aggregation is required for Section 199A, but a taxpayer may choose to aggregate subject to the requirements identified in Reg. 1.199A-4(b).

A "relevant pass-through entity" (RPE), which includes a partnership or an S corporation, may elect to aggregate trades or businesses.[5] An owner of the RPE is subject to a consistency rule that requires the owner to follow the RPE aggregation. As is true with Sections 465 and 469, the RPE owner may further aggregate subject to the requirements of Reg. 1.199A-4(b). The RPE is also subject to consistent reporting for aggregation done by a lower-tier RPE, but may add to the lower-tier entity's aggregated businesses. The RPE must attach a statement to each partner's K-1 form providing details of items reported by a lower-tier partnership.[6]

The RPE is required to report QBI, W-2 wages, and UBIA for each trade or business or aggregated trade or business. Qualified business income (QBI) forms the base for the allowed deduction. The W-2 wages and UBIA are relevant only for high-income owners. The RPE determines how many businesses it has and if any of those businesses are specified service trades or businesses (SSTBs).[7] If the RPE fails to satisfy its reporting obligation, the QBI, W-2 wages, and UBIA are presumed to be zero.[8]

Form 1065, page 2, question 6 asks if the partnership had a reduction in its debt resulting from a cancellation, reduction, or modification. Section 61(a)(11) defines gross income to include a cancellation of indebtedness (COD). Section 108 then provides options for the exclusion of COD income, including possible reduction in tax attributes that may lead to a deferral rather than a permanent income exclusion.

One of the first questions asked on Form 1065 is whether the partnership has aggregated activities for purposes of Section 465 (at-risk) or Section 469 (passive loss).

Under "aggregate" principles applicable to partnerships, the availability of the Section 108 exclusions is determined at the partner level.[9] The IRS would then expect to see any COD income resulting from question 6 reported by the partnership and allocated among the partners. This is so even if one or more partners might be eligible for a Section 108 exclusion provision. An affirmative question 6 response would also correspond to a Section 752(b) deemed distribution of money. Partner-level K-1 reporting more directly highlights that issue because the effect is partner specific.

Form 1065, page 2, question 10 asks if the partnership is making, or has previously made, a Section 754 election to adjust tax basis in specified situations. If the response is "Yes," the partnership is then asked if an event occurred in the current year that would give rise to an adjustment under either Section 734 (partner-

[4] Reg. 1.469-4(d)(5)(i).

[5] Reg. 1.199A-4(b)(2)(ii).

[6] Reg. 1.199A-6(b)(3)(ii).

[7] See Reg. 1.199A-6(b)(2) for the RPE reporting obligations. An SSTB reports items in the same manner as a non-SSTB, but "threshold income" owners may be subject to a separate reduction in the allowed SSTB deduction imposed by the "applicable percentage."

[8] Reg. 1.199A-6(b)(3)(iii).

[9] Section 108(d)(6).

ship-level basis adjustment triggered by a distribution) or Section 743 (partner-specific adjustment triggered by a sale or exchange of an interest, including by the death of a partner). While the Section 743 adjustment does not affect the partnership itself, Reg. 1.743-1(j) imposes a reporting obligation on the partnership for the effects of the adjustment on the partner.

Question 10 highlights the need for the partnership to attach a required statement for each type of adjustment. Reg. 1.734-1(d) and Reg. 1.743-1(k)(1) include details required for each form of disclosure. The Section 734 adjustment occurs because of a partnership distribution so that the partnership is aware of the triggering event. The partnership's Section 743 reporting obligation is conditioned on the transferee partner informing the partnership of the transfer within 30 days.[10]

Form 1065 asks if the partnership had a reduction in its debt resulting from a cancellation, reduction, or modification.

A final part of question 10 asks if the partnership is required to record the effects of a substantial built-in loss adjustment under Sections 734(d) or 743(d). Both provisions require a mandatory adjustment when the result would be a negative adjustment in excess of $250,000.[11] This is a separate question because the adjustment occurs when no Section 754 election would otherwise mandate it. The partnership must record the negative adjustment but is not bound by the effects of a Section 754 election in future periods. The IRS would expect to see an explanatory statement if both 10a and 10b are marked "Yes," or if 10c is separately marked "Yes."

Form 1065, page 3, questions 11 and 12 highlight a potential qualification issue for a Section 1031 like-kind exchange. Question 11 asks about a "swap-and-drop" and question 12 about a "drop-and-swap." Section 1031 allows a deferral of gain when a taxpayer exchanges real property held for investment or trade or business use for real property of a like kind also to be held for investment or trade or business use. The partnership is generally the taxpayer seeking to qualify for nonrecognition relief.

Question 11 asks if the partnership distributed or transferred the replacement property acquired from a partnership-level exchange. Question 12 asks if the partnership distributed an undivided share in (to be relinquished) property to one or more partners. The question's response may identify an attempt to re-define the exchanging party. Partners often do not each want to complete a like-kind exchange, or may not want to continue as partners in exchange replacement property. A "drop-and-swap" is an approach commonly used to attempt to redefine the exchanging party.

As a simple example, consider a three-person partnership holding property valued at $3 million. Each member owns a one-third interest in all items. Members Alex and Barb want to continue as partners following an exchange while Member Carol wants to own exchange replacement property on her own.

The partnership might sell the relinquished property and exchange into two properties, one valued at $2 million and the other at $1 million. The partnership would then distribute the $1 million property, selected by Carol, in liquidation of Carol's interest.

Question 11 would highlight this transaction. The IRS could question whether the partnership satisfied the requisite motive to hold the replacement property for investment or business use and challenge the $1 million asset as qualified replacement property.[12] An alternative formulation of the exchange qualification issue would be if the partnership first distributed a fractional one-third ownership share to Carol, who then sold her fractional interest separately from the partnership. Carol would then contend that she may engage in an exchange separate from the partnership. Alex and Barb could remain in the partnership to complete a $2 million exchange.

Question 12 would identify this structure as well as other similarly motivated distributions of fractional ownership shares.[13] The IRS could challenge the qualification of the distributed property interest in Carol's hands (contending her motive is to exchange) or could contend that a sale of the entire property was effectively consummated by the partnership before the

[10] Reg. 1.743-1(k)(2).

[11] This may occur if the basis of partnership assets exceeds FMV by more than $250,000 or if a transferee would be allocated a loss of more than $250,000 from a hypothetical sale of partnership assets at FMV.

[12] See *Maloney*, 93 TC 89 (1989), as a possible defense against an IRS challenge.

[13] The partnership often liquidates by distributing fractional shares to all partners, who then contend Section 1031 is applied independently to each owner.

JCT-22-03-003-Hamill.qxp_Article_Template_v1.2 6/1/22 8:48 AM Page 9

distribution. The exchange would then fail if the partnership did not fully replace the relinquished property.[14] The IRS might also argue that the co-ownership arrangement following the distribution, and before the sale, was itself a partnership.[15]

Question 24 asks questions to determine if the partnership may be subject to reporting business interest expense for purposes of the Section 163(j) limitation. Where applicable, the partnership must then file Form 8990 (Limitation on Business Interest Expense Under Section 163(j)). Part II of this form identifies excess taxable income and excess business interest expense of a partnership, and Part III identifies the same information for S corporations. Schedule A and Schedule B are used to report partners and shareholders excess items and carryforward amounts. Schedules A and B of the Form 8990 will identify pass-through items of business interest expense, adjusted taxable income, business interest income, and carryforward items. All are required to determine the applicability of Section 163(j) limitations at the partner or shareholder level.

Question 25 first asks if the partnership intends to qualify as a "Qualified Opportunity Fund" (QOF) and, if so, if the Form 8996 (Qualified Opportunity Fund) is attached to the partnership return.[16] This form is used to self-certify the entity's status as a QOF and is filed each year to certify continued eligibility as a QOF.

A QOF must have 90% or more of its assets held in Qualified Opportunity Zone property.[17] The QOF tests twice a year, and the 90% test is satisfied if the average of qualifying assets satisfies the test. Thus, one computes the percentage for two separate six-month periods and then adds the percentages and divides by two to get the average.

This average is reported on line 14 of the Form 8996. Form 1065, question 25 asks for the amount from line 15 of the Form 8996. If the 90% test is satisfied, line 15 is zero. This line 15 amount is used to determine any potential penalty for the QOF's failure to satisfy the asset test. Entering zero on Form 1065, line 25 indicates that the QOF partnership is not subject to a penalty tax.

S corporation items—Form 1120S

Many of the Form 1120S questions directed to the entity are similar to those of the Form 1065. Exhibit 1 highlights the considerable overlap in the PTE form questions. The focus in this section will generally be on those questions that are specific to S corporations.

Page 1, item G asks if the year in question is the first year for which the S election is to be effective. This would generally mean that the election form, Form 2553 (Election by a Small Business Corporation), was filed by the 15th day of the third month of the current year. In that case, the box would be checked to indicate that the current year was the first year as an S corporation and no supporting documentation would be attached to the 1120S. If the election had not been timely filed, or was defective in some manner,[18] Rev. Proc. 2013-30 allows a qualifying entity to file the election with the current year tax return.[19]

Page 1, item J asks if the S corporation has aggregated activities for purposes of Section 465 or grouped activities for purposes of Section 469. These questions are asked for the same reasons as discussed earlier with respect to partnerships. Similar to the partnership, the shareholders' K-1 forms ask, in boxes 18 and 19, the same activity aggregation questions asked of the entity in Item J. Shareholders are subject to the same consistency rules that apply to partners.

Form 1065 questions highlight a potential qualification issue for a Section 1031 like-kind exchange.

As a Section 199A defined RPE, S corporations are subject to the same Section 199A reporting as detailed earlier for partnerships. S corporations are also subject to the same Sec-

[14] See *Court Holding Company*, 324 US 331 (1945), for the partnership-as-seller challenge. This case dealt with a corporation, but the application of step-transaction principles would be the same.

[15] See Rev. Proc. 2002-22, 2002-1 CB 733, for guidance in structuring co-ownership of real property to avoid partnership status. This guidance is intended for advance ruling purposes but may also be used for general guidance.

[16] A QOF may be a partnership or a corporation.

[17] Section 1400Z-2(d)(1).

[18] For example, not all affected shareholders may have consented, including those with community property rights under state law, or those who had disposed of their shares between the first day of the corporate tax year and the date the election was filed.

[19] Form 2553 requires a declaration that a reasonable cause exists for the late-filed election and a statement of the reasonable cause.

tion 163(j) reporting as discussed earlier for partnerships. Question 10 of Schedule B asks the same questions as previously noted for partnerships and may require the RPE to attach Form 8990 with the information discussed above in the partnership section.

Page 2 (Schedule B) question 12 asks for the corporation's net unrealized built-in gain (NUBIG) reduced by any previously recognized BIG. NUBIG must be computed for an S corporation that was previously a C corporation. Section 1374(c)(1) provides a general rule that the BIG tax does not apply to an entity that has always been an S corporation. However, this is modified by Section 1374(d)(8), which provides that if the S corporation acquired assets from a C corporation in a carryover basis transaction, the BIG tax applies to the extent of the excess of the FMV of the acquired assets over the tax basis to the S corporation at the date of acquisition.

There are two situations where this could occur. First, the S corporation acquires a C corporation in an asset acquisition that qualifies as a reorganization.[20] An acquisitive asset reorganization could include a "Type A",[21] a "Type C",[22] an acquisitive form of a "Type D,"[23] or a forward triangular merger.[24] Second, the S corporation acquires the stock of a C corporation and elects to treat the acquired entity as a qualified Subchapter S subsidiary (QSub).

Form 1065 asks questions to determine if the partnership may be subject to reporting business interest expense for purposes of the Section 163(j) limitation.

The QSub election will cause a deemed liquidation subject to Section 337 (liquidated C corporation) and Section 332 (parent S corporation).[25] No gain will generally be recognized by either party. The S corporation then acquires a carryover basis in the assets of the former C corporation.[26] A QSub election causes a deemed, rather than an actual, liquidation so the acquired entity will typically survive, but no longer as a C corporation, and will be deemed to be a division of the parent S corporation.

If there are multiple transactions that create NUBIG, the S corporation must separately report each "pool" of NUBIG. Section 1374(d)(7) limits the BIG exposure to five years. The instructions to the Form 1120S do not state that the NUBIG question can be disregarded after the five-year period has lapsed. However, it would seem pointless to continue to report the figure after the statutory recognition period had lapsed. The number would then be frozen as of the end of the recognition period and would potentially provide misleading information implying a continuing potential corporate-level tax exposure.

Question 12 asks if corporate third-party debt has been canceled, reduced, or forgiven. This is similar to the question asked on the partnership Form 1065. However, the S corporation follows an "entity" approach with respect to COD events. This means several things. Section 108(d)(7)(A) applies the COD exclusion provisions at the entity level. Any COD income excluded by Section 108 does not increase corporate reported income or the corporation's accumulated adjustments account (AAA). Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) would be filed by the entity to claim any exclusion.

Any attribute reduction mandated by Section 108(b) is applied at the entity level, with any Section 1366(d)(1) suspended loss for the year of the discharge treated as a net operating loss for purposes of the Section 108(b)(2)(A) attribute reduction.[27] Forgiveness of a Paycheck Protection Program (PPP) loan is ignored for purposes of question 12 and its attendant reporting because the income exclusion arises outside of Section 108.[28]

Question 13 asks if there was a termination of QSub status during the year, either by affirmative revocation of the election or by termination by failure to qualify. If "Yes" is checked, the corporation must also attach a statement to the return for the year of the termination or revocation, including the information required by Reg. 1.1361-5(a)(2). The effects of the termi-

[20] See the carryover basis rule of Section 358(a)(1), which applies when Section 361 protects the transferor corporation from recognition of gain on an asset transfer pursuant to a reorganization.

[21] Section 368(a)(1)(A).

[22] Section 368(a)(1)(C).

[23] Section 368(a)(1)(D).

[24] Section 368(a)(2)(D).

[25] Reg. 1.1361-4(a)(2).

[26] Section 334(b)(1).

[27] This provision states that the NOL is the first tax attribute to be reduced when a Section 108 exclusion applies.

[28] The 2020 Coronavirus Aid, Relief, and Economic Security Act (CARES Act) excludes PPP loan forgiveness from income.

JCT-22-03-003-Hamill.qxp_Article_Template_v1.2 6/1/22 8:48 AM Page 11

nation or revocation are set forth in Reg. 1.1361-5(b).

Question 15 asks if the entity is a QOF for the year and is attaching Form 8996 to certify its status as a QOF. Similar to a partnership, the corporation must (annually) provide the number from line 15 of the Form 8996, used to determine if a penalty may apply for noncompliance with the QOF asset test.

Schedule M-2 requires the corporation to provide a reconciliation of the AAA, earnings and profits (E&P), and other adjustments account (OAA) for the year.[29] Because S corporations do not generate E&P during S years, the E&P column reports only any beginning balance, reductions for distributions taxed as dividends under Section 1368(c)(2), and an ending balance.

PPP loans have created some confusion with respect to the determination of AAA and OAA. Tax-exempt income and expenses associated with tax-exempt income are included in OAA rather than AAA. If an S corporation with E&P distributes tax-exempt income, the distribution can become a dividend if AAA has been exhausted. Forgiveness of PPP loans creates tax-exempt income typically reported in OAA. However, the expenses paid by the PPP funds are deductible.[30]

An S corporation with E&P would increase the likelihood of a dividend distribution if deductible PPP-funded expenses reduce AAA rather than OAA. This AAA reduction would generally occur simply by following the M-2 schedule because AAA is reduced by line 21 ordinary income or loss. Line 21 would be expected to include any Section 162 expenses funded by PPP loan proceeds.

The Consolidated Appropriations Act (CAA) clarified both that Section 162 expenses funded by PPP loan proceeds could be deducted, and that the excluded forgiveness income would be treated as an item of tax-exempt income increasing the shareholder's basis. CAA was silent on the effect of the excluded income on AAA.

Reg. 1.1368-2(a)(2)(i) does not increase AAA for items of tax-exempt income. Similarly, Reg. 1.1368-2(a)(3)(i)(C)(2) does not decrease AAA for expenses associated with tax-exempt income. Arguably this would allow the full effects of the PPP loan transaction to be recorded in OAA. However, the mechanics of the M-2 schedule will reduce AAA for PPP funded items reported in line 21 income or loss.

The instructions to the 2021 1120-S clarify that the forgiven income should be included as part of the OAA, and that the expenses associated with that excluded income should also be part of OAA (and not AAA). The instructions state that if the expenses flow to the AAA (for example, through line 21 ordinary income or loss), the M-2 should reverse that AAA impact by including the expenses as line 3 other additions.

Many of the Form 1120S questions directed to the entity are similar to those of the Form 1065.

The net effect is that the exempt income and deductible expenses associated with the PPP funds all flow through OAA and there is no (net) effect on AAA. While this result is welcome, the M-2 reporting is complicated by PPP transactions.

Partner K-1 reporting

There is a mandated, or minimum, amount of information that must be provided to each partner on the K-1 schedule. However, understanding how partners use this information can be helpful in both properly completing the K-1 as well as identifying situations where supplemental information, even if not required, may be helpful to the partner. Certain information on the K-1 may also assist the IRS in identifying possible audit issues. It can be important for a preparer to know how all parties may use the information provided on the K-1.

Item J asks the partner's share of profit, loss, and capital, each reported for the beginning and the end of the year. Usually profit and loss percentages are stated in the partnership agreement as a single percentage. The agreement may prescribe changing percentages either due to attaining specified targets, or because of a major capital event. The agreement may also call for item allocations so that the partner's share of specific items is not the same. Allocations may also be required to attain "targeted" capital balances matching the hypothetical distributions following a hypothetical liquidation.

In each of these cases, it may not be clear what (single) percentage should be reported. Reasonable people may then disagree how to specify a single percentage on the K-1 schedule. The most important issue in such cases is

to be consistent in the approach taken from year to year.

IRS instructions explain capital percentages to be the percentage of assets to be received by the partner if the partnership were to liquidate. Many partnerships liquidate by Section 704(b) capital balances to comply with a regulatory safe harbor for tax allocations.[31]

crease partners' basis under Section 722 and deemed distributions decrease basis under Section 733.

The fourth step may require bifurcation of the nonrecourse debt share. Qualified nonrecourse debt is defined in Reg. 1.465-27 and serves to increase a partner's at-risk basis. Item K reports each partner's aggregate share of qualified nonrecourse debt. If the partnership reports more than one at-risk activity, an attachment to the partner's K-1 should identify the at-risk qualified debt shares activity-by-activity. Segregation into three categories of debt shares is necessary to allow the partner to compute at-risk basis for each activity. Segregation is not needed to determine the basis of the interest for other purposes.[33]

There is a mandated, or minimum, amount of information that must be provided to each partner on the K-1 schedule. However, understanding how partners use this information can be helpful in both properly completing the K-1 as well as identifying situations where supplemental information, even if not required, may be helpful to the partner.

Partnership K-1 capital must now be reported using transactional tax basis capital accounts. The tax basis capital will be less likely to represent rights to assets upon liquidation than Section 704(b) capital. However, many partnerships may simply report each partner's share of the capital to agree to the K-1 reported tax basis balances. If a partner has a negative capital, the share of capital should be reported as zero.[32] This will require a proportional adjustment to the capital percentages of those partners with positive capital accounts.

Item K requires reporting the partner's share of recourse liabilities, nonrecourse liabilities, and qualified nonrecourse liabilities. Completing this section may require four steps.

First, Reg. 1.752-1(a) is used to distinguish a recourse liability from a nonrecourse liability. Second, Reg. 1.752-2(a) determines partners' shares of recourse liabilities. Third, Reg. 1.752-3(a) determines partners' shares of nonrecourse liabilities. These three steps allow a determination of increases and decreases in partners' shares of partnership debt, based on classification of each debt instrument. These Section 752 debt shares then affect the basis of partners' interests based on deemed contributions and distributions under Sections 752(a) and (b) respectively. Deemed contributions in-

Item L requires a reconciliation of the partner's capital account from the beginning of the year to the end of the year. This capital must now be determined using the transactional tax basis method. In general, this method measures the basis of the partner's interest without regard to the share of partnership liabilities. However, there are situations where the transactional tax basis capital will not fully track the basis of the interest without regard to liabilities. In these situations, reasonable people may disagree on how transactional tax basis capital should be recorded. These topics are beyond the scope of this article.[34]

Item M asks if the partner has contributed property with a built-in gain or loss. Section 704(c) determines allocations with respect to built-in gains and losses. Item N asks for the partner's share of unrecognized Section 704(c) gain or loss at the beginning of the year and at

[29] One other classification, less commonly seen, is the shareholder's undistributed taxable income previously taxed. This relates to earnings prior to the 1982 Subchapter S Revision Act (P.L. 97-354).

[30] This result was confirmed by the 2021 Consolidated Appropriations Act (CAA).

[31] See, for example, the economic effect safe harbors of Reg. 1.704-1(b)(2)(ii)(b) and (d) and the deemed in accordance with the partners' interest safe harbor of Reg. 1.704-2(e).

[32] Because Section 752 debt shares are not included in capital accounts, it is possible to have both a negative tax basis capital balance and a positive basis in the interest. Section 704(b) capital balances may also be negative before liquidation, typically due to nonrecourse deductions that will be offset with a minimum gain chargeback.

[33] Losses are more likely to be limited by the at-risk basis than the Section 704(d) basis for two reasons. First, at-risk basis includes only qualified nonrecourse debt while Section 704(d) includes all (three) debt shares. Second, the loss limitation of Section 704(d) applies to the overall basis of the partner's interest. Section 465 limits losses to the at-risk basis of each identified activity.

[34] See James R. Hamill, "The Mechanics of Maintaining Transactional Tax Basis Capital Accounts," *Practical Tax Strategies*, December 2021, Vol. 107, No. 6, pp. 4-19.

the end of the year. Item M is directed at a current year contribution of property by the K-1 partner. If Item M is checked "Yes," a statement must be attached to identify the item(s) contributed in that year. Item N is much broader, covering all unrecognized Section 704(c) gains and losses for the partner without regard to the year of origin.

Section 704(c) items are identified by differences between the Section 704(b) "book" and tax basis of the property. Section 704(c) items can arise from contributions of property by a partner with a built-in gain or loss (book value is determined by reference to FMV and tax value by the contributed tax basis),[35] or by Section 704(b) revaluations of partnership properties by events such as a contribution of money or property in exchange for an interest.[36] The revaluation creates a book-tax disparity and helps to identify built-in gains and losses at the time a new partner joins.[37] Allocations of gain and loss for these built-in items can be made only to the partners who were in the partnership when the book property revaluation occurred.

These allocations are referred to as "reverse" Section 704(c) allocations to distinguish them from those attributable to contributed property. Item M identifies only current year contributions that give rise to Section 704(c) items and will not identify revaluations. Item N shows an aggregated share of Section 704(c) items from all sources for all years.

Box 19 is supplemental information for distributions. Partners generally do not recognize gain from a partnership distribution unless they receive money in excess of the basis of their partnership interest.[38] Section 737 can cause a partner to recognize net pre-contribution gain to the extent the FMV of property and any money distributed to that partner exceeds the basis of the partner's interest. This anti-abuse provision prevents the partner from avoiding Section 704(c) gain by receiving other property while leaving behind the contributed property. It applies if the distribution occurs within seven years of the contribution of property with a built-in gain.[39]

The reporting of a partner's share of net unrecognized Section 704(c) gain in Item N can help the IRS (and the preparer) track the potential for Section 737 gain. Code "B" is used to identify distributions that result in the application of Section 737 at the partner level. Section 704(c)(1)(B) achieves a similar result when contributed Section 704(c) property is distributed to a partner other than the one who contributed the property. This provision also has a seven-year lookback period, but the gain is reported by the partnership itself and then allocated to the Section 704(c) partner. There is no need for a separate code in Box 19 because the Section 704(c) partner did not receive the distribution and the acceleration of the Section 704(c) gain is reported at the partnership level. Both Section 704(c)(1)(B) and Section 737 gain will reduce the affected partner's share of unrecognized Section 704(c) gain reported at Item N.[40]

Box 20, Code N, is used to report Section 163(j) interest items. Box 22 or box 23 is checked if the partner's K-1 reports the results of more than one activity for Section 465 (box 22) or Section 469 (box 23). If checked "Yes," a statement must be attached to show income or loss activity-by-activity.

Shareholder K-1 reporting

A shareholder's K-1 reporting has considerable overlap with the information provided on a partner's K-1. This is intuitive because they are both PTEs. Any reporting differences are caused by the use of the "aggregate" approach by the partnership and the "entity" approach by the S corporation.

Item G asks for the current year allocation percentage for the shareholder. S corporations allocate items by stock ownership. If ownership changes occur during the year the allocation will be per-share, per-day. The Item G response does not provide sufficient detail to determine if ownership changed during the year, but the preparer must consider any ownership changes in reporting allocation shares.

There are no allocations of Section 704(c) items in an S corporation because the corporation does not track gains and losses as specific to each owner (which is an aggregate concept). All S corporation items are allocated based on entity ownership even if attributable to contributed built-in gain or loss.

[35] Reg. 1.704-3(a)(3)(i).

[36] Reg. 1.704-3(a)(6)(i).

[37] Reg. 1.704-1(b)(2)(iv)(f)(5)(i). This is just one of the permitted revaluation events.

[38] Section 731(a)(1).

[39] Section 737(b)(1).

[40] Section 737(c)(2) makes adjustments to the contributed property to reduce the overall (and partner's) Section 704(c) unrecognized gain.

Item H asks the number of shares owned by the shareholder as of the beginning of the year and the end of the year. If ownership has changed, it would affect current year allocations. The IRS would also expect Form 7203 (basis tracking) to be required for the shareholder's return if any reduction in ownership resulted from a disposition of shares.

Form 7203 now standardizes reporting of stock and debt basis that was previously required but satisfied with preparer-generated "white paper" attachments. Form 7203 Part II, used to report shareholder debt basis, requires identifying each debt as a formal note or open account. Open account debt may be aggregated as a single loan if the year-end balances do not exceed $25,000.[41]

Schedule K-1, Item I asks for the loans outstanding from the shareholder, including beginning and ending balances. Reductions in loan balances would be another trigger for a Form 7203 filing requirement for the shareholder's return. If there is a pattern of no change to the beginning and ending loan balance, it may be more likely that the purported debt instrument would be challenged as an equity instrument. This could lead to a potential disqualifying second class of stock. It is best to ensure that all debt instruments either satisfy the Section 1361(c)(5) "straight-debt" safe harbor against classification as a second class of stock or at least may reasonably be respected as debt under the factor-test of Section 385.[42]

Item 16 provides information for items that would affect the shareholder's basis. As noted above, shareholders in S corporations may be subject to additional Form 7203 reporting of basis identified by an affirmative basis reporting response on Schedule E of the shareholder's tax return. Part II of Schedule E reports income or loss from an S corporation and line 28(e) has a box to check if a basis computation is required to be attached to the return.

Form 7203 is attached to the shareholder's return if any of four situations apply:

- An aggregate loss was reported for the tax year;
- A distribution was received from the corporation that was not classified as a dividend;
- Stock was disposed of during the year; or
- The corporation repaid shareholder debt.

The IRS advises that Form 7203 may be useful even if none of the four conditions apply so that basis may be tracked from year-to-year. The form tracks both stock basis (Part I) and debt basis (Part II).

Schedule K-1, items 18 and 19 ask whether the corporation is reporting more than one activity for Section 465 or Section 469. This response should be the same as items 22 and 23 on the partner's K-1. If a "Yes" response is given a statement must be attached to show income or loss activity-by-activity.

Conclusion

PTEs are currently the entity of choice for eligible businesses. Tax practitioners must be familiar with both compliance and consulting issues affecting PTEs. The IRS would be expected to focus future business audit activity on PTEs and has said as much.

The organization of the PTE tax forms, including the questions asked, has changed over the years. Much of the changes correspond with statutory or regulatory changes to the provisions affecting PTEs and their owners. Others appear to be targeted to highlight audit opportunities.

By understanding the PTE tax forms a practitioner can better understand these changes and identify both resulting tax risks and opportunities. This article takes a forms-based approach to comprehension of significant current issues in partnership and S corporation taxation. ■

[41] Reg. 1.1367-2(a)(2)(i).

[42] Reg. 1.1361-1(l)(4) could also be consulted to protect against a disqualifying second class of stock.

JCT-22-03-015-Skinner.qxp_Article_Template_v1.2 6/1/22 8:49 AM Page 15

ASSUMED CONTINGENT LIABILITIES IN ASSET ACQUISITIONS — NEW TAX COURT CASE

WILLIAM SKINNER

This article examines a Tax Court decision concerning the treatment to a seller of assets where the buyer assumes a contingent liability associated with the business.

Introduction

In *Hoops*,[1] the Tax Court recently addressed a longstanding, unanswered issue: what is the treatment to a seller of assets, where the buyer assumes a contingent liability associated with the business? While the treatment of such assumed obligations to the *purchaser* of assets is well known,[2] *Hoops* is one of the few cases that address the *seller*'s treatment. The last case to address this issue comprehensively arose prior to the Tax Reform Act of 1986 when old Section 337 allowed a C Corporation seller to dispose of assets without recognition of gain. A lot has changed since then.

The result in *Hoops* was that the seller was required to include the fair market value of deferred compensation liabilities in taxable proceeds without an offsetting deduction during the year at issue before the court.[3] The implications of this decision and such a mismatch in timing are significant for any asset sale involving assumed contingent liabilities, including actual asset sales, deemed asset sales by operation of Section 338(h)(10), or as will be seen in a recent Technical Advice Memorandum ("TAM"), internal transactions such as liquidations of insolvent subsidiaries.[4]

WILLIAM SKINNER is a partner in Fenwick & West LLP in Mountain View, California.

General background on assumed contingent liabilities

The treatment of contingent liabilities in acquisitions first requires a definition of the term "contingent liability." A "contingent liability" refers to an obligation that has not yet ripened into a deduction or basis for tax purposes under Section 461 or Section 1012 of the Code. Such a liability may be recognized by the parties to the transaction as having real economic value and also may be reflected in a reserve on the financial statements in accordance with generally accepted accounting principles.

However, under U.S. tax accounting rules, a liability of an accrual method taxpayer is only incurred as a deduction or capitalized cost if it satisfies the three-pronged all-events test of Section 461 and the regulations thereunder.[5] First, all facts must have occurred to cause the existence of the liability to be fixed. Second, the amount of the liability must be determinable with reasonable accuracy. Third, economic performance must have occurred with respect to the liability. Depending on the nature of the liability, economic performance may require, for example, that goods or services giving rise to the liability be delivered or in some cases, that payment be made to a third party.[6]

In addition to the three-pronged all-events test, other statutory provisions may defer accrued expenses from being taken into account as a deduction, such as Section 404(a)(5), the provision at issue in *Hoops.*

It is well-established that the purchaser of assets is required to capitalize assumed liabilities of the seller into the cost basis of the property acquired under Section 1012. This includes contingent liabilities of the business that are properly considered to have arisen prior to closing.[7]

Whether a contingent liability is a liability of the seller that must be capitalized or a liability of the buyer that may be deducted in the course of its post-closing operations is a fact-specific, case law inquiry. While the courts have considered a number of different factors, the Service has summarized the case law as providing that "capitalization is required where the events most crucial to creation of the obligation occur before the acquisition, while deduction is allowed where the events most crucial to creation of the obligation occur after the acquisition."[8]

On the seller side of the equation, there is a paucity of case law concerning the treatment of particular types of contingent liabilities or even laying out a basic framework for analysis. It is well settled that a seller must include in amount realized the amount of any indebtedness or liabilities assumed by the buyer to the extent those liabilities have given rise to a deduction or tax basis.[9] This treatment is self-evident: where the seller has achieved a tax benefit from the liability that benefit must be reversed out through gain or income when the liability is assumed; otherwise, the seller could achieve a different result by selling assets subject to a liability from selling assets for increased cash and using the cash to retire the liability.

With contingent liabilities, however, the treatment to the seller raises more difficult questions. On some level, a contingent obligation assumed by the buyer, particularly one reflected as a reserve on the financial statements, would seem to have economic value and cause the seller to receive a benefit as compared to selling the assets and retaining the liability. The assumption of such an obligation without an offsetting indemnity may in some cases reduce proceeds. However, from a tax accounting perspective, the liability has not yet, and may never, produce a tax benefit to the seller to be recaptured through additional gain.

The principles underlying Reg. 1.1001-2, as articulated in the bedrock cases of *Crane* and *Tufts*,[10] seem to be based on the seller recapturing a tax benefit of a prior loss or deduction that is then reversed out when the liability is discharged. If no deduction or expense for the liability has been taken by the seller, what tax benefit is the seller receiving when the liability is discharged? Moreover, if the seller is required to include the buyer's assumption of a contingent liability in proceeds, without being entitled to a deduction, the seller in some case is taxed on non-economic income. To the extent the correct answer is to treat the contingent liabilities both as proceeds and as an offsetting deduction, the issues of measuring the amount and timing of gain and offsetting deduction are difficult from both an economic and technical tax perspective.[11]

The fact pattern in *Hoops* required the court to provide partial answers in this difficult and long underexplored corner of M&A tax law. The Tax Court held that the taxpayer was required to increase gain by the estimated net

---

1 TCM 2022-9.

2 *See, e.g., Illinois Tool Works, Inc.*, 355 F.3d 997 (7th Cir., 2004), *aff'g* 117 T.C. 39 (2001); *Amergen Energy Co., LLC*, 779 F.3d 1368 (Fed Cir., 2015), *aff'g* 113 Fed. Cl. 52 (2013).

3 Left unaddressed by the Tax Court's decision is whether the seller might be permitted to claim a tax deduction when the buyer satisfies the assumed obligation in a later taxable year, and if so, on what basis.

4 See TAM 202116062 (4/23/2021), discussed below.

5 Reg. 1.461-1(a)(2). In *Amergen Energy Co., LLC*, 779 F.3d 1368 (Fed Cir., 2015), *aff'g* 113 Fed. Cl. 52 (2013), addressing nuclear decommissioning costs, the Court of Claims and Federal Circuit both held that the three-part test of Section 461(h) also applies to a liability incurred as part of the cost basis for acquisition of capital assets. Likewise, liabilities are only capitalized into the tax basis of inventory under Section 263A if they satisfy the three prongs of the all-events test. See Regs. 1.263A-1(c)(2)(ii) and 1.446-1(c)(1)(ii)(B).

6 *See* Reg. 1.461-4.

7 For example, see the cases cited in Footnote 2 above.

8 PLR 201036009 (9/10/2010).

9 Reg. 1.1001-2(a)(1); *Crane*, 331 U.S. 1 (1947). Compare Reg. 1.1001-2(a)(3) (providing that a liability incurred on acquisition of property is not included in amount realized when it is assumed or discharged, if the liability did not give rise to basis in the acquired property).

10 *Tufts*, 461 U.S. 300 (1983).

11 In *Hoops*, the liabilities represented deferred compensation payments that were fixed in fact and amount, but subject to payment on a deferred schedule. Even this relatively fixed liability raised measurement issues. The opinion states that the taxpayer in *Hoops* applied a 3% discount rate of the future payments to determine the amount of the liability. Was this the right discount rate to use? If the seller were subsequently permitted a deduction when the liability is satisfied how should the parties account for the difference between the discounted net present value and the ultimate amount paid? In the case of longer-term liabilities, such as for nuclear decommissioning, the timing and measurement issues may prove to be intractable.

present value of the compensation liability. At the same time, the court rejected the taxpayer's reliance on Reg. 1.461-4(d)(5), discussed below, to claim an offsetting deduction in the same amount for the deemed satisfaction of the liability. Left unanswered by the decision was when, if ever, and in what amount, would the seller be permitted to claim an offsetting deduction for the deferred compensation liabilities assumed and later satisfied by the buyer.

Detailed case discussion and analysis

The transaction at issue in *Hoops* was a sale of assets constituting a National Basketball Association (NBA) franchise subject to various liabilities. Among the liabilities assumed was approximately $12.6 million of deferred compensation owing to two players for past services. Payment of the amounts was deferred according to a fixed schedule set under the terms of NBA player contracts.

The partnership in *Hoops* was an accrual method taxpayer. It had accrued the compensation as an expense under the all-events test and economic performance had been met (i.e., the liability related to services rendered in the past), but the deduction for the liability was deferred under Section 404(a)(5). That section provides that deductions for deferred compensation are generally deductible only in the employer's taxable year in which, or with which, ends the taxable year in which the employee includes the amounts in taxable income.[12]

As a practical matter, this section often causes deductions for deferred compensation to be taken into account on the cash method—i.e., when payments to the employee are made. As a result, the deferred compensation to the players was not deductible in the year of sale of the business. The buyer assumed the liabilities, and on payment of compensation, would generally be entitled to take the expense into account as part of the capitalized cost of acquiring the assets.[13]

On its tax return as filed, the seller included the net present value of the deferred compensation liabilities as part of its amount realized on the sale of assets.[14] The seller did not claim any offsetting deduction. On the amended return that ended up presented to the Tax Court for decision, the seller claimed an offsetting deduction in reliance on Reg. 1.461-4(d)(5). In the alternative, the seller argued that it was erroneous to include the assumption of the liability in proceeds when it had not been taken into account as a deduction or as basis in any assets.

Issued in the early 1990s, Reg. 1.461-4(d)(5) provides for matching treatment of certain contingent liabilities that are assumed as part of the sale of a trade or business, providing that economic performance is considered to be satisfied as the liability is taken into account as proceeds.[15] Note that the regulation does not state ***when** the liability should be taken into account as additional proceeds*; it only provides that economic performance is deemed to be satisfied in the same year as the liability is included in proceeds, so that an offsetting deduction may be claimed.

The result in *Hoops* was that the seller was required to include the fair market value of deferred compensation liabilities in taxable proceeds without an offsetting deduction during the year at issue before the court.

Reg. 1.461-4(d)(5), in effect, establishes a matching concept and prevents a whipsaw that might otherwise arise if accrued, but unperformed, liabilities were required to be taken into account in taxable proceeds in advance of the deduction arising.[16] Further, if the seller actually liquidated following the sale of assets, or under Section 338 was deemed to liquidate, the

[12] Section 404(a)(5); Reg. 1.404(a)-12(b)(1).

[13] Under the case law discussed above, liabilities arising out of pre-closing performance of services have been required to be capitalized by the buyer of assets. *See David R. Webb Co.*, 708 F.2d 1254 (7th Cir., 1983), *aff'g* 77 T.C. 1134 (1981); *M. Buten & Sons, Inc.*, TCM 1972-44; TAM 9721002 (1/24/1997).

[14] The seller was a partnership for U.S. federal income tax purposes, and reported the gain as subject to Section 1231, presumably giving rise to long-term capital gains. By including the liability in proceeds, the partnership increased its Section 1231 gain. To the extent that the seller was entitled to claim a deduction for the liability, this increased Section 1231 gain would have been offset by ordinary compensation expense, producing a favorable character result for the seller.

[15] The regulation requires that the buyer "expressly assume" the liabilities as part of the acquisition. A purchase of shares with a Section 338 election or similar transaction has been treated as an "express assumption" of liabilities for this purpose. *See, e.g.*, TAM 202116012.

[16] This timing mismatch could be particularly acute in the case of long-term liabilities of the type that gave rise to the economic performance requirement in the first place. *See Ford Motor Co.*, 71 F.3d 209 (6th Cir., 1995), affg 102 T.C. 87 (1994); *Mooney Aircraft, Inc.*, 420 F.2d 400 (5th Cir., 1969).

JCT-22-03-015-Skinner.qxp_Article_Template_v1.2 6/1/22 8:49 AM Page 18

mismatch in timing could result in a permanent disallowance of the deduction. The regulation was intended in part to address these problems posed by the economic performance requirement.[17]

At the same time, however, Reg. 1.461-4(d)(5), by its literal terms, is limited to the economic performance requirement. Contingent liabilities that have not met the all-events test are not explicitly addressed. The portion of the regulation project from 1992 relating to "contingent liabilities" remains reserved for further guidance.[18]

In *Hoops*, the taxpayer, as noted above, relied on Reg. 1.461-4(d)(5) to permit the deferred compensation liabilities to be satisfied. The Tax Court rejected this position and held that Reg. 1.461-4(d)(5) only deemed economic performance to be satisfied. In the case of the compensation liabilities, it was not economic performance but rather Section 404(a)(5) that deferred the deduction. Although this led to an unfortunate whipsaw to the taxpayer, the court found that Reg. 1.461-4(d)(5) did not deem Section 404(a)(5) to be satisfied. The court also reasoned that such a result was required by the tax policies underlying Section 404(a)(5), which are discussed at length in the case.

The implications of *Hoops* and such a mismatch in timing are significant for any asset sale involving assumed contingent liabilities.

Alternatively, the taxpayer argued that, if the liabilities were not sufficiently ripe to be deductible, their assumption should not be included in gross proceeds. The Tax Court also rejected this position. On this point, the court stated that the parties agreed the players had performed the services, so that the taxpayer had an *obligation* to pay the compensation. Relying on *Commercial Security Bank*,[19] discussed at length below, the court held that this payment obligation was an assumed liability for purposes of Section 1001.

The court also rejected the taxpayer's arguments that the Section 1001 definition of "liability" should be consistent with that of other Code sections, such as Section 357(c), under which the case law has distinguished between deductible "liabilities" and unmatured "obligations."[20] Therefore, the partnership was left including the assumed liabilities in taxable proceeds without an offsetting deduction in the years before the court (or perhaps at any time).

Both conclusions of the court—i.e., that Reg. 1.461-4(d)(5) did not permit an offsetting deduction and the deferred compensation obligation was properly included in proceeds prior to being deducted—raise interesting issues and implications for planning.

The deduction aspect—what is the scope of Reg. 1.461-4(d)(5)?

In the primary issue addressed in the opinion, the Tax Court held that Reg. 1.461-4(d)(5) was limited to deeming economic performance to be satisfied, and therefore, did not satisfy the requirements for deductibility under Section 404(a)(5). The court stressed that the policy of Section 404(a)(5) could be thwarted by any other interpretation.

The decision in *Hoops* reaches a similar result to the Service's position expressed in Technical Advice Memorandum("TAM") 8939002 (6/15/1989). The TAM, notably, involved a sale of assets under Section 337 prior to repeal of the *General Utilities* doctrine. In the TAM, the taxpayer sold all of its assets in a taxable transaction and then liquidated. Pre-1986 Tax Reform Act law (i.e., old Section 337) applied to provide non-recognition treatment to the taxpayer's gain realized on its sale of assets. Therefore, whether the liability assumed by the buyer was part of proceeds or not, such gain was not recognized by the corporate seller.

As part of the asset sale in liquidation of the seller, the buyer assumed the obligation to pay deferred compensation. Relying on *Commercial Security Bank*, the taxpayer argued that by accepting less proceeds, it had constructively satisfied the liabilities and therefore, was entitled to a deduction. The taxpayer also invoked the analysis of *James M. Pierce Corp.*,[21] arguing that it had secured a deduction apart from payment of the service providers by paying the buyer to assume the liability. The Service rejected both arguments, and in the TAM advised that Section 404(a)(5) conditions the deduction on income inclusion by the payee, not assumption or discharge of the liability of the payor.

[17] *See* T.D. 8408, 1992-1 C.B. 155, 160 (4/9/1992).

[18] *See* Reg. 1.461-4(j).

[19] 77 T.C. 145, 148–49 (1981).

[20] Specifically, the taxpayer cited *Focht*, 68 T.C. 223 (1977) (addressing assumption of payables of a cash method taxpayer in a Section 351 transaction) and Reg. 1.752-1(a)(4).

[21] 326 F.2d 67 (8th Cir., 1964).

The Tax Court in *Hoops*, as stated above, reached a similar result. Due to changes in law, however, the disallowance of the deduction in a case like *Hoops* potentially has a harsher result than was the case in TAM 8939002. The TAM involved an asset sale and liquidation prior to the 1986 Tax Reform Act, so that the gain on sale of assets was not recognized. Including the assumption of the liability in proceeds therefore did not increase the taxpayer's gain, nor did it result in the potential whipsaw present in *Hoops*. Notably also, the TAM was issued before Reg. 1.461-4(d)(5). It did not address whether Reg. 1.461-4(d)(5) could be extended to deem a deferred compensation liability to be satisfied.

As an interesting contrast to *Hoops*, in TAM 202116062, the Service recently ruled that Reg. 1.461-4(d)(5) applied to allow a corporation to deduct a lawsuit expense that was a so-called "payment liability" under Reg. 1.461-4(g). A payment liability is one where the deduction is deemed to arise as a payment is made to the party to whom the liability is owed.[22] In the TAM, the taxpayer's manufacturing subsidiary became involved in product liability litigation. The subsidiary reached a global settlement of product liability claims that satisfied the first two prongs of the all-events test. However, since litigation settlements generally are "payment liabilities," the economic performance requirement was not satisfied until the subsidiary paid the claimants the underlying settlement amounts.

In the TAM, the taxpayer converted its troubled subsidiary into an LLC, triggering a deemed liquidation for tax purposes. The TAM states that the subsidiary was insolvent and its liquidation was governed by Rev. Rul. 2003-125.[23] Accordingly, Parent was deemed to acquire all of the assets of the subsidiary in a taxable transaction.

The TAM held that the internal sale of the subsidiary's assets was a sale of a trade or business for purposes of Reg. 1.461-4(d)(5). Since the liability was deductible but for the economic performance requirement, the TAM concluded that it was also deemed deductible in the year of the liquidation.

Interestingly here, litigation expenses, like the deferred compensation liabilities at issue in *Hoops*, are only deductible as payment is made to the person to whom the liability is owed.[24] However, since the rule deferring the deduction until payment was a component of the economic performance requirement, rather than Section 404(a)(5), Reg. 1.461-4(d)(5) deemed the deduction to be available at the same time the liability was included in proceeds.

Should a contingent liability be included in amount realized in the year of sale?

As discussed above, the Tax Court in *Hoops* also concluded that the partnership was required to include the assumption of the deferred compensation liability in proceeds, despite not being allowed a deduction for that liability in the year before the court or in any prior year. The Tax Court's discussion of this issue is relatively brief. As noted above, the taxpayer's primary position was that it should be allowed an offsetting deduction under Reg. 1.461-4(d)(5, and the argument that the liability should not be included in proceeds was the alternative position.

Left unanswered by *Hoops* was when, if ever, and in what amount, would the seller be permitted to claim an offsetting deduction for the deferred compensation liabilities assumed and later satisfied by the buyer.

In holding that the liability was included in proceeds in the year of sale, the Tax Court cited *Commercial Security Bank* (authored by Judge Tannenwald), which in turn, cited *Crane*. On closer inspection, however, neither *Commercial Security Bank* nor *Crane* directly addressed the issue decided in *Hoops*.

In *Commercial Security Bank*, the court addressed a sale of assets by a cash method corporation, where the buyer assumed obligations under accrued interest payables and also acquired rights to accounts receivable. The asset sale was governed by old Section 337, so that no gain was recognized. However, under an exception to old Section 337, the seller was taxed on accrued income built into the accounts receivable.

The primary issue in the case was whether the seller was entitled to an offsetting deduction for the assumed accounts payable. Since

[22] See Reg. 1.461-4(g)(2)(i).

[23] Under Section 165(g)(3), but for the favorable ruling in the TAM, a worthless stock loss may also have been available. However, stock losses on consolidated subsidiaries may be partly or wholly eliminated under Reg. 1.1502-36. Also, if the subsidiary failed to satisfy the active gross receipts test of Section 165(g)(3)(B), the stock loss would have been a capital loss.

[24] Reg. 1.461-4(g)(2).

the transaction was governed by old Section 337, no gain would be recognized if the assumption of the payables was treated as additional amount realized on the asset sale.

In analyzing the issue, the Tax Court in *Commercial Security Bank* described the "accrued liabilities" as ones that were included in proceeds, stating: "[i]t is also beyond question (and petitioner does not argue otherwise) that the amount of the 'accrued business liabilities' would, but for the impact of Section 337, have been taken into account in computing Orem's gain or loss from the sale."[25] While this statement would seem to be fairly definitive, the issue of whether the unmatured cash method payables were included in proceeds was not directly presented to the court, as such treatment would not have changed the corporation's gain recognized on the sale.

Moreover, the Tax Court then went on to hold that by taking reduced cash proceeds as a result of the liability, the taxpayer constructively paid the liabilities and was entitled to a deduction. The court's holding, like Reg. 1.461-4(d)(5), thus achieved an equitable matching of the inclusion of the liabilities in proceeds and the allowance of the underlying deduction.

In *Hoops*, however, the Tax Court applied the *Commercial Security Bank* decision to include the amount of the deferred compensation liabilities in proceeds, but without allowing the offsetting deduction.

Conclusion

The treatment of assumed contingent obligations as proceeds before they have been taken into account as basis or a deduction can achieve inequitable results. Moreover, one important issue left unanswered by *Hoops*, as well as TAM 8939002, is whether the seller would be entitled to a deduction at a later point in time. Even if the seller were to be allowed a deduction for the payment of the liability in a later period, the utilization of that deduction may be limited. In *Hoops*, for example, the partnership might have dissolved after selling its assets, and thus not been in existence in a later year when the deduction for deferred compensation was available.

Moreover, under post-Tax Cuts and Jobs Act (TCJA) law, even if the seller remains in existence, Section 172 no longer permits carryback of net operating losses. Finally, in the case of contingent liabilities that are less measurable or longer term in nature, the timing issues from the inclusion of the obligations in proceeds in advance of a deduction are themselves acute.

Administratively, the IRS and Treasury have attempted to resolve some of these issues through Reg. 1.461-4(d)(5) and also through the private letter rulings under Section 468A addressing nuclear decommissioning costs.[26] However, the *Hoops* decision is a useful reminder that such administrative relief is imperfect and, in many cases, taxpayers confronting this issue will need to consider alternatives or self-help wherever it is available. ■

[25] 77 T.C. at 148-149.

[26] *See, e.g.*, PLR 202111007 (12/21/2020).

THE TRUST FUND RECOVERY PENALTY: WHO IS RESPONSIBLE TO PAY?

JULIET L. FINK

Introduction

Federal employment taxes arise under the Federal Insurance Contributions Act ("FICA') and the Federal Unemployment Tax Act ("FUTA"). FICA is comprised of Social Security and Medicare taxes (collectively "FICA taxes" or "payroll taxes"), and is imposed 50% on the employer and 50% on the employee (an equivalent tax is imposed on the self-employed).

The Internal Revenue Code (IRC) requires employers to collect and withhold income taxes together with their employees' share of FICA taxes from their employees' paychecks.[1] These taxes are referred to as trust fund taxes because employers hold their employees' money in trust until they make a federal tax deposit of those funds to the IRS. Conversely, only employers pay FUTA tax , which is not withheld from employees' wages.

Generally, employers must report wages, tips, and other compensation paid to an employee by filing the required form(s) with the IRS. Every quarter, employers must report all income taxes and FICA taxes withheld from employee wages by filing IRS Form 941 and make federal tax deposits ("FTD s") of income taxes withheld together with both the employer's and employee's portion of FICA taxes.

FUTA taxes are reported by filing Form 940. In addition, an employer may be required to file Form 943, if they are filing to report agricultural wages; Form 944, which is designed so the smallest employers (those whose annual liability for FICA taxes and withheld federal income taxes is $1,000 or less) will file and pay those taxes annually rather than quarterly; or Form 945, if they are filing to report backup withholding.

The failure to file these forms may result not only in liability to pay over all delinquent employment taxes but also the imposition of civil penalties and interest, and, in cases involving willful filing violations, may result in criminal prosecution.[2]

Enforcement

Civil and criminal employment tax enforcement is among the highest priorities of the Tax Division of the Department of Justice (the "Tax Division"). The Tax Division pursues civil litigation to enjoin employers who fail to comply with their

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty against every individual who is determined to be a "responsible person" of the employer. The overbreadth within which the IRS may determine individuals to be "responsible persons" should make employees cautious when taking on any accounting or banking responsibilities within their employment.

JULIET L. FINK is an associate at Kostelanetz & Fink, LLP in New York City. Her practice focuses on federal and state criminal and civil tax matters.

employment tax obligations and to collect outstanding amounts assessed against entities and responsible persons. The Tax Division also pursues criminal investigations and prosecutions against those individuals and entities who willfully fail to comply with their employment tax responsibilities, as well as those who aid and assist them in failing to meet those responsibilities.[3]

Employment tax fraud includes cases involving employee leasing, paying employees in cash, filing false payroll tax returns, failing to file payroll tax returns, and "pyramiding." Pyramiding occurs when a business withholds taxes from its employees, but intentionally fails to pay over those tax payments to the IRS; the individual then starts a new business and begins to accrue a new liability under the new entity.[4]

The Tax Division has increasingly emphasized its commitment to the criminal prosecution of employment tax evasion. Employers should therefore be mindful that the failure to comply with employment tax obligations is not always just a civil matter.

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty against every individual who is determined to be a "responsible person" of the employer, including certain shareholders, partners, members, managers, officers, and employees.

Trust Fund Recovery Penalty

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty ("TFRP") against every individual who is determined to be a "responsible person" of the employer, including certain shareholders, partners, members, managers, officers, and employees.[5] (While the TFRP most commonly applies to employment taxes, it also applies broadly to all taxes under the IRC where there is a withholding or collection obligation.)

The TFRP is not a penalty in the traditional sense in that it is not designed to be a penalty over and above the amount of unpaid taxes, rather it is a collection device to ensure that withheld taxes are properly remitted to the IRS—in essence, therefore, the TFRP is essentially a tax. Accordingly, it is the IRS's policy to assess the TFRP only in cases where the tax cannot be collected directly from the business entity.[6]

It is important to note that willfulness in the context of the TFRP does not require bad or malicious motive. Rather, willfulness means a deliberate, voluntary, conscious choice to prefer another creditor over that of the United States government. The reason for the failure to withhold or remit employment taxes is irrelevant to the imposition of the TFRP. (In addition to willfulness, the assessment of a TFRP requires an employer-employee relationship; if the employer can establish that the worker was in fact an independent contractor, and not an employee, the TFRP cannot be assessed.) The TFRP authorizes the IRS to essentially "pierce the corporate veil" and assess 100% personal liability against any individual it deems to be a "responsible person."

The amount of the TFRP is equal to the balance of unpaid trust fund taxes, which is the unpaid income taxes and employees' share of FICA taxes withheld. (It does not include the employer's share of FICA taxes.)

The liability for the TFRP is joint and several, and liability is not limited to *the most* responsible person. That means that *all persons* deemed a "responsible person" against whom the TFRP is assessed are liable for the full payment of taxes owed. However, the IRS may only collect the TFRP once for a business's unpaid payroll taxes.[7] Thus, if one responsible person pays the penalty in full, any other responsible persons need not pay that amount.

The investigation and assessment of the TFRP is the responsibility of the Collection Division of the IRS. A Revenue Officer will usually initiate the investigation by interviewing potential responsible persons.[8] After investigation of all potentially responsible persons and review of all pertinent documentation, including

[1] See generally IRC Section 3102; Section 3402.
[2] See IRC Section 6651(a)(1); Section 6656(a)-(b).
[3] See IRC Section 7201, Section 7202.
[4] See IRS CI Annual Report 2021 at p. 5.
[5] See generally IRC Section 6672.
[6] See IRM 5.17.7.1.9(2) (8/1/2010).
[7] See IRM 5.17.7.1.9 (8/1/2010); IRC Section 6672(d).
[8] See IRM 5.7.4.2.3 (6/29/2017).

banking and other business records, the Revenue Officer recommends whether to assert the TFRP against any of the potential responsible persons.[9] The penalty is then assessed and collected in the same manner as a tax.

Responsible person: who is liable?

The IRS casts a broad net when determining who constitutes a "responsible person." A "responsible person" is anyone who has the duty to perform and the power to direct the collecting, accounting, and paying of trust fund taxes, with the exception of voluntary, unpaid, honorary directors or trustees of tax-exempt organizations who do not participate in the day-to-day finances of the organization and do not have actual knowledge of the failure to pay over taxes.

A "responsible person" need not be the ultimate owner of the business. Any person who has the authority to sign checks, control finances, or had any other input in making the decision to pay other creditors while employment taxes remained unpaid, can be deemed a "responsible person."

Importantly, an employee may be deemed a "responsible person" if they were responsible for paying other creditors of the business even if they were not responsible for paying the business's employment taxes. Even those with no knowledge that the IRS is not being paid may be deemed a "responsible person" if the IRS determines that the person *should* have been aware of the outstanding taxes.

A responsible person can be any of the following:

- An officer or an employee of a corporation.
- A member or employee of a partnership.
- A corporate director or shareholder.
- A member of a board of trustees of a nonprofit organization.
- Another person with authority and control over funds to direct their disbursement.
- Another corporation or third-party payer.
- Payroll Service Providers (PSPs) or responsible parties within a PSP.
- Professional Employer Organizations (PEOs) or responsible parties within a PEO.
- Responsible parties within the common law employer (client of PSP/PEO).[10]

Put simply, a "responsible person" may be anyone, whether an insider or outsider to the business, with control or influence over the business's finances. While the Internal Revenue Manual (IRM) states that that control should be "significant," in practice, that is often not the case.[11] Further, a "responsible person" need not have exclusive control over the business's finances.

As illustrated by the list above, a business owner cannot avoid liability for the TFRP by simply delegating payroll responsibilities to a third-party, such as a payroll service provider. One must remember that more than one individual may be held personally liable for the TFRP. Accordingly, while a payroll service provider that failed to remit taxes on behalf of a business may be deemed a "responsible person," that does not mean that the business owner, bookkeeper, or other individuals are off the hook.

The IRS determines whether a person is a "responsible person" for purposes of employment taxes on a case-by-case basis. The determination of who is a "responsible person" is a question of fact. The IRS looks at the totality of circumstances to determine whether a person was authorized within a business to collect, account for, or remit taxes. Common factors considered include whether a person:

- Was an officer, director, or principal shareholder of the corporation, a partner in a partnership, or a member of an LLC.
- Had authority to sign checks.
- Controlled the financial affairs of the business.
- Determined which creditors were paid or exercised that authority.
- Managed payroll disbursements;
- Controlled the voting stock of a corporation.
- Signed the employment tax returns.[12]

The checklist above combines elements of "duty, status, and authority."[13] No single factor is determinative of whether or not a person is "responsible." However, the IRS considers the ability to sign checks and the actual signing of the business's checks to be an especially significant factor in concluding that an individual is a "responsible person" for purposes of the TFRP.[14] An employee who had signature authority on the business's bank account and who signed checks on behalf of the business is often deemed a "responsible person" for purposes of the TFRP. Conversely, if that employee merely had the authority to

Put simply, a "responsible person" may be anyone, whether an insider or outsider to the business, with control or influence over the business's finances.

[9] See IRM 5.7.4.5 (6/29/2017).
[10] See IRM 5.17.7.1.1(1) (7/18/2012); IRC Section 6671(b).
[11] See IRM 5.17.7.1.2(5) (8/1/2010).
[12] See IRM 5.17.7.1.2(4) (8/1/2010).
[13] *Gustin*, 876 F.2d 485, 491 (CA-5, 1989).
[14] See e.g. IRM 5.17.7.1.4 (8/1/2010).

JCT-22-03-021-Fink.qxp_Article_Template_v1.2 6/1/22 8:50 AM Page 24

sign checks, but he or she never actually exercised that authority, the IRS is unlikely to hold the employee responsible absent the existence of additional factors.

Limited exception when a business is under new management

There does exist a narrow *per se* exception to TFRP liability when a change in management of a business takes place. Specifically, a person is not personally liable if they become a "responsible person" when the business does not have the funds to pay an employment tax liability that arose under previous management and then uses funds acquired *after* becoming a "responsible person" to pay the operating expenses of the business.[15]

The reasoning behind this limited exception is that a person should not be liable for the TFRP if they had no personal fault in the failure to pay the taxes.[16] Accordingly, a person will be held liable to the extent that funds were available to pay employment taxes if, at the time the responsible person assumed control of the business, they failed to use those funds to pay the delinquent tax.

[15] See IRM 5.17.7.1.2(2) (8/1/2010).

[16] See *Slodov*, 436 U.S. 238, 254 (1978).

Conclusion

Many people will find it unfair that the TFRP can be assessed on a "responsible person" irrespective of whether or not they benefited from the failure to remit tax. This, of course, can place "responsible persons" in precarious situations where they have an inability to pay but nonetheless must make collection arrangements with the IRS.

The overbreadth within which the IRS may determine individuals to be "responsible persons" should make employees cautious when taking on any accounting or banking responsibilities within their employment. Merely having check signing authority can render an employee a "responsible person" if that business is failing to collect or remit employment taxes, irrespective of the employee's knowledge of that fact.

Of course, business owners must be cognizant of the importance of timely paying employment taxes, even when circumstances might suggest holding off until other critical expenses are paid. A business may be struggling and the owner, in good conscience, may opt to pay payroll or suppliers rather than taxes in an effort to keep the business afloat on the theory that the taxes can be paid at a later time. However, that decision could lead not just to civil liability but might also result in a criminal investigation despite the business owner's good intentions. ■

JCT-22-03-025-Holtzman.qxp_Article_Template_v1.2 6/1/22 8:50 AM Page 25

RESEARCH CREDIT REFUND CLAIMS—NEW IRS REQUIREMENTS

YAIR HOLTZMAN, SHARLENE SYLVIA, AND MICHAEL GANZ

A new IRS Chief Counsel Memorandum sets forth additional detailed information that will be required when claiming valid research credit refunds.

In an IRS Chief Counsel Memorandum, No. 20214101F, released on 10/15/2021, the IRS notified taxpayers of additional detailed information that will be required when claiming valid research credit refunds. Treasury Regulations require that for a refund claim to be valid, it must set forth sufficient facts to apprise the IRS of the basis of the claim. The Chief Counsel Memorandum is intended to improve tax administration efficiency by providing taxpayers with clear instructions to claim the credit and by reducing the number of disputed claims.

Each year, the IRS receives thousands of research credit refund claims for amounts in the hundreds of millions of dollars from corporations, businesses, and individual taxpayers. Claims for the research credit are currently examined in a substantial number of cases and consume significant resources for both the IRS and taxpayers.

The new requirements

The new requirements are aimed at expediting IRS decisions on which claims can be immediately paid, and which will require further examination. Under the new guidelines, for a research credit refund claim to be considered valid, the taxpayer must:

- Identify all the business components to which the research credit claim relates for that year.
- For each business component: (1) identify all research activities performed; (2) identify all individuals who performed each research activity; and (3) identify all the information each individual sought to discover.
- Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year.

Code Section 41 allows taxpayers a credit against income taxes that is a portion of the increased expenses incurred and attributable to qualified research activities (QRAs). To be considered a QRA, Section 41 requires the analysis to be broken down by each of the taxpayer's identified business components. Each business component must individually meet a statutory four-part test. Therefore, identification of each business component to which the

YAIR HOLTZMAN, CPA, MBA, MS, CGMA, CPD, is a partner at Anchin, Block & Anchin LLP in New York, where he is Practice Leader of the firm's Research & Development (R&D) Tax Credits Group, Life Sciences Industry Group, and Chemicals and Energy Industry Group, as well as Co-Practice Leader of the Tax Credits & Incentives Group. SHARLENE SYLVIA, CPA, MST, is a senior manager at Anchin and MICHAEL GANZ is a tax manager at Anchin.

JCT-22-03-025-Holtzman.qxp_Article_Template_v1.2 6/1/22 8:50 AM Page 26

Section 41 research credit relates is a basic requirement and is why this information must be included in a refund claim for the claim to meet the IRS specificity requirement.

While it might be expected that the taxpayer identifies primary business components related to its current year claim, requesting information on all business components appears overly burdensome to most practitioners, along with the additional information being requested. For taxpayers with extensive research operations, spanning multiple locations and/or departments, complying with the new information requirements may prove very difficult, because they may account for project costs by department or cost center rather than by specific business components. The taxpayer's cost to identify, quantify, and detail every business component with specific information will reduce, and in some cases may even eliminate, the value of the research credit.

From the newly issued memorandum, once a business component is identified, the taxpayer must also demonstrate that it engaged in research. To determine whether there is qualified research as defined under Section 41, identifying who performed the research and the information that each individual who performed the research sought to discover is essential.

The new requirements are aimed at expediting IRS decisions on which claims can be immediately paid, and which will require further examination.

The memorandum argues that without this specificity in the claim for refund, it is impossible to make a determination whether the taxpayer engaged in QRAs for the refund claim year. Thus, this information also must be included in a refund claim for the claim to meet the new IRS specificity requirement. The requirement is also ambiguous, because not all employees who perform QRAs will be conducting research—direct support or supervision of qualified research is also eligible for the research credit under Section 41.

The IRS justification for the new requirement is that having this specific information allows the IRS to determine if a refund should be paid immediately based on the information provided or if an examination should be conducted to verify the taxpayer's entitlement to the refund. The IRS will provide a grace period up until 1/10/2022 before requiring the inclusion of this information with timely filed Section 41 R&D tax credit claims for refund.

Expenses attributed to qualified research activities that may be deemed qualified research expenses (QREs) generally include:

- Total wages paid or incurred to an employee for engaging in (directly, supervising, or supporting) qualified research activities;
- The cost of supplies used in qualified research activities; and
- 65% of any amounts paid to any non-employee to perform qualified research.

Importantly, the taxpayer must also provide a declaration signed under the penalty of perjury, verifying that the facts provided are accurate. In most cases, the taxpayer's signature on Forms 1040X or 1120X will suffice.

Additionally, the taxpayer should provide the facts in a written statement, rather than through the production of documents. However, if a taxpayer provides documents, including for example a completed R&D tax credit study, the taxpayer must specify the exact page(s) that supports each specific fact. Merely providing documents will not suffice to meet the taxpayer's obligation.

Here again practitioners are claiming foul by the IRS, for placing additional burdens on the taxpayer in the form of signature and documentation. There is also ambiguity in the written statement requirement because it is not clearly defined.

Finally, the refund claim must be filed within the period of limitations stated in Section 6511. Typically, taxpayers must file a valid claim within three years of the date their return was filed or two years from the time the tax was paid, whichever period expires later.

Interim guidance

On 1/3/2022, the IRS issued interim guidance and frequently asked questions to assist taxpayers in complying with its controversial memo.

Enforcement for these requirements began on 1/10/2022, start of a one-year transition period through 1/9/2023, where taxpayers will have 45 days to perfect their claim if any information is deemed missing or insufficient by the IRS. This is an increase from 30 days in the initial October 2021 memorandum. Any timely filed claims that are determined to be insufficient during the transition period will still be considered timely if perfected during this 45-day period.

Taxpayers will be notified that additional information is required with Letter 6428, Claim for Credit for Increasing Research Activities—Additional Information Required. The 45-day period to perfect the claim will start from the date the letter is issued. In the case that sufficient information is not received to perfect the claim, taxpayers will be issued Letter 6430, No Consideration, Section 41 Claim. The IRS indicates that all returns will be checked for the new refund claim required information, and that it may therefore take up to six months from receipt for the IRS to process these claims.

The IRS also provided additional guidance on its submission requirements, clarifying that taxpayers may group together employees who sought to discover the same information for a business component and describe what they collectively sought to discover. These employees may be identified by job title or position, rather than individual employee names. However, the taxpayer may be asked to provide the specific employee names after IRS review of the claim. Finally, taxpayers who used statistical sampling to determine their research credit refund claim, in accordance with Revenue Procedure 2011-42, will only need to provide information related to the projects contained in the sample.

Recent court cases

Some practitioners and legal experts have brought forth the somewhat controversial theory that the IRS Chief Counsel Memorandum was issued in response to a string of taxpayer victories in recent court cases involving refund claims and documentation requirements. If so, this may be perceived as a way to enforce their requirements without having court case precedent, and actually despite recent court decisions.

In *Harper*,[1] the owner of a military construction company filed amended returns for 2008 and 2010 to claim R&D tax credits in those years. The existing specificity requirement stated that a claim for refund "must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis." The IRS denied the taxpayer's claims and the district court upheld that Harper failed to establish grounds for the claims or to present facts to justify its R&D tax credits, essentially presenting only two Form 1040X attachments.

On appeal, however, the Ninth Circuit Court of Appeals reversed the prior decisions and determined that the government had waived its specificity requirement by conducting a four-year audit examination. According to the Court of Appeals, although the IRS is entitled to require taxpayers to provide information in a certain form, it may also seek the required information by investigation. The court determined that the IRS had waived its specificity requirement by accepting Harper's tax forms and substantively examining his specific claims without asking for additional information.

More recently, in two separate 2021 decisions, taxpayers received favorable court rulings. In both the *Premier Tech*[2] and *Intermountain Electronics*[3]. cases, the IRS tried to disallow research credit refund claims on procedural grounds, rather than by litigating whether the asserted research activities meet Section 41 requirements. The government made motions to dismiss based on its assertion that the taxpayers' administrative claims lacked specificity. In other words, the IRS could not determine why the taxpayers were entitled to their refund claims. The taxpayers argued that attachment of Form 6765 was sufficient to disclose the nature of their claims.

In the *Premier Tech* case, the court ruled in favor of the taxpayer, stating that the IRS could not now change its own rules and say that the amended return and research claim form were inadequate. In the *Intermountain Electronics* case, similar to the *Harper* case, the court ruled that the IRS's extensive five-year audit proved the validity of the taxpayer's claim and constituted a waiver of the specificity requirement. The government had a partial victory, subsequently arguing that Intermountain "failed to state a claim," but the court provided Intermountain with an opportunity to replead with sufficient facts and evidence.

The new requirements disproportionately burden small and medium businesses that more commonly file an amended return, compared to much larger, well-established companies.

Conclusion—adding burdens to taxpayers

The research credit has always been a complex and somewhat subjective area of law, involving the application of a four-part test, numerous potential exclusions, and a variety of cal-

[1] *Harper*, 127 AFTR2d 2021-1027 (CA-9, 2021).
[2] *Premier Tech, Inc.*, 128 AFTR2d 2021-5220 (DC UT, 2021).
[3] *Intermountain Electronics, Inc.*, 128 AFTR2d 2021-5240 (DC UT, 2021).

culation methods, all of which need to be accurately evaluated and applied to determine each taxpayer's sustainable claim in any given tax year. By forcing taxpayers to provide more information to evaluate their research credit claims, the newly released specificity requirements appear only to increase the burdensome nature of making the claims themselves, which discounts the value of research credits to taxpayers. The new IRS requirements disproportionately burden small and medium businesses that more commonly file an amended return, compared to much larger, well-established companies.

It is important to keep in mind that being issued in the form of a memorandum rather than being published, these new requirements are considered "private guidance," and therefore are technically not binding on the IRS. It remains to be seen whether or not the IRS will further change the language and publish these new requirements in the form of a Revenue Ruling or Revenue Procedure in the Internal Revenue Bulletin. ■

ADMINISTRATION'S SUBCHAPTER C PROPOSALS: PLAYING WITH THE CONTROL TEST (AND WITH CONTROLLING SHAREHOLDERS' LIABILITY)

ROBERT RIZZI

Introduction

The Biden Administration has released a number of wide-ranging proposals for changes to the Code, many of which, such as a plan for a corporate minimum tax, have received widespread publicity.[1] Less well-publicized, but of interest to corporate tax practitioners, are proposals to change long-standing rules for subchapter C corporations.[2] These proposals, like many of the other initiatives, face well-known political obstacles,[3] and may well not see the light of day in any viable tax reform legislation. However, the nature of Treasury tax proposals is that, once on the table, the provisions can take on a life of their own and are revived periodically, perhaps as last-minute add-ons to "score" additional revenue, for tax legislation that may succeed in getting enacted.

Indeed, in the case of one of the proposals, concerning changes to the control test under Section 368(c), the current provision of the Treasury Department proposals traces back to a similar change first advanced in the Clinton administration.[4] The details of the control test proposal, as well as another change to the Code proposed by the Biden administration, involving "controlling" shareholders, are the topics of this column.

Control under Section 368(c)

For purposes of most corporate tax provisions related to reorganizations and similar transactions that include a "control" requirement, the term is defined as ownership of stock possessing at least 80% of the total combined voting power of all classes of voting stock and at least 80% ownership of the total number of shares of each class of outstanding nonvoting stock of the corporation.[5] This control test is both venerable and pervasive in subchapter C.[6] Thus, the test is used not only for purposes of determining control for "B," certain "C,"[7] and both types of subsidiary merger reorganizations,[8] and for spin-offs under Section 355,[9] but it is also used for determining whether a transfer of property to a corporation in exchange for stock qualifies for tax-free treatment under Section 351.[10]

While there are a number of uncertainties with the current control test — for example, the meaning of "total combined voting power" and "stock entitled to vote," to say nothing of "owns" — generally one looks to the power of stockholders to elect directors,[11] so by counting the members of the board, voting power can generally be determined quite readily, even with respect to complex, multi-class, equity structures.

It bears noting that the bright-line aspects of the control test that allow transactions to qualify for tax-free treatment also allow taxpayers to "bust" such qualification in order to avoid the application of Section 351 or certain provisions of Section 368(a).[12] This violation of the control test can cause a given exchange transaction to be intentionally taxable (for example, in order to obtain a basis step-up or to use expiring losses).[13]

ROBERT RIZZI is a tax partner at Steptoe and Johnson LLP in Washington and New York.

While there are certain aspects of the control test that seem peculiar or perhaps antiquated — including the notion of counting the number of shares of nonvoting stock in the second part of the test — a myriad of transactions depend upon the certainty that the current control test provides, both for tax-free and taxable treatment.

In contrast with the bright-line standard in Section 368(c), a very different test applies for purposes of determining whether a corporation is a member of an "affiliated group" of corporations for purposes of Section 1504(a)(1) of the Code. For various reasons, the "affiliation" test, which has a function similar to that of the control test, turns on both vote and value.[14] Specifically, Section 1504(a)(2) requires ownership of stock that possesses at least 80% of the total voting power of the stock of the corporation and that has a value of at least 80% of the total value of the stock of the corporation.[15]

This discrepancy between the two tests is one of the targets of the proposals for reform. It can easily be argued that the rationale for each test is fundamentally different, and it could also be argued that, if the control test for purposes of Section 368(c) is to be changed, it does not automatically have to conform to the affiliation test under Section 1504(a)(2), but the Biden administration proposals assume that the two tests should be consistent.

During the Clinton administration, when the change to the control test under Section 368(c) was proposed, Treasury was aware of certain highly structured transactions that were based upon an exploitation of the test.[16] Perhaps the most well-known of these is the transaction that became the basis for the *Tribune Company* case in the Tax Court.[17] In that case, not one but two "controlled" merger subsidiaries were formed, one of which was largely used as an intermediary for a transfer of dominion over more than one billion dollars of cash to the "selling" corporation.[18]

Although that case was not finally decided until 2006, the structure of the transaction was relatively well-known during the time that the proposed changes were being considered. A number of other, similar alleged manipulations were described by the Treasury and the Joint Committee using multi-class stock arrangements, many of which were characterized as "sale-like."

As was the case during the Clinton administration, the current Treasury Department rationale for the change in the control test is lacking in detail, but focuses on the perceived opportunities for abusive transactions:

> The control test under Section 368(c) creates potential for taxpayers to improperly achieve desired tax outcomes through structured transactions. By carefully allocating voting power among the shares of a corporation, taxpayers

[1] For a good summary, see Bonner, "Biden Proposes Higher Corporate Tax Rate, 20% Billionaire Minimum Tax," J. Accountancy, 3/28/2022. For the Treasury Department summary, see General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, March 2022 (referred to as the "2022 Greenbook"); see also earlier proposals in General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, May 2021 (referred to as the "2021 Greenbook").

[2] See 2022 Greenbook, p. 13; 2021 Greenbook, pp. 97-99.

[3] Rappeport, "Biden Proposes a Tax on Billionaires as He Looks to Fund His Economic Agenda," New York Times, 3/28/2022 ("It is unclear whether any of the proposals will be able to gain enough support in Congress to become law. Previous efforts to raise taxes on the wealthy and corporations have run into resistance from moderate Democrats, including Senators Joe Manchin III of West Virginia and Kyrsten Sinema of Arizona").

[4] See Administration's Fiscal Year 2000 Budget Proposals, discussed extensively in New York State Bar Association Tax Section Report No. 958, submitted 7/8/1999 ("New York Bar Report"). See also Joint Comm. Staff Description of Treasury's Revenue Proposals, p. 220 (2/22/1999); and American Bar Ass'n, Tax Section, "Comments on Proposed Section 368(e) Definition of Corporate Control," 83 Tax Notes 1357 (5/31/1999).

[5] Section 368(c). See Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 3.07[1], discussed in connection with exchanges under Section 351 ("Section 368(c) is one of the original 'control' tests under the Code").

[6] Id. ("Importantly, the value of the transferee's stock is not relevant at all for purposes of control under § 368(c)—only voting power of voting shares and, if there are other, nonvoting, classes of stock, the number of those nonvoting shares is taken into account under this venerable standard.")

[7] A so-called "parenthetical 'C' reorganization": "the acquisition by one corporation, in exchange solely for all or a part of its voting stock (*or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation*), of substantially all of the properties of another corporation, * * *." (Emphasis added.)

[8] For example, in a forward triangular merger under Section 368(a)(2)(D), the parent corporation must control the acquiring corporation that has in turn acquired the assets of the target. "D" reorganizations have different control tests, depending upon whether the transaction is a "divisive" or "acquisitive" one. See Sections 368(a)(1)(D), 368(a)(2)(H) ("the term 'control' has the meaning given such term by Section 304(c)").

[9] Under the "control requirement" in Section 355(a)(1)(D).

[10] Section 351(a) ("No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 368(c)) of the corporation.")

[11] See, e.g., Rev. Rul. 66-339, 1966-2 CB 274; Rev. Rul. 69-126, 1969-1 CB 218.

[12] For example, by leaving outstanding a share of nonvoting stock in someone's hands when the voting stock is all acquired in a transaction that would otherwise qualify under Section 368(a)(1)(B). See Ltr. Rul. 8822062 (The exchange intentionally failed to qualify as a reverse subsidiary merger, as follows: "Prior to the consummation of the mergers described above, Company A will issue and Company B will purchase one share of Company A non-voting preferred stock for cash. After consummation of the merger of Sub A into Company A, the preferred stock issued to Company B will remain outstanding stock of company A held by Company B").

can manipulate the Section 368(c) control test in order to qualify or not qualify, as desired, a transaction as tax-free. For example, a taxpayer may structure a transaction in this manner to avoid tax-free treatment in order to recognize a loss. In addition, the absence of a value component under this standard allows corporations to retain control of a corporation but to "sell" a significant amount of the value of the corporation tax-free. A uniform ownership test for corporate transactions would reduce the complexity currently caused by these inconsistent tests.[19]

As indicated, the Biden administration proposal would conform the control test under Section 368(c) with the affiliation test under Section 1504(a)(2). Therefore, "control" would be defined as the ownership of at least 80% of the total voting power and at least 80% of the total value of stock of a corporation.[20]

The details of the proposal are not spelled out in the summary of the current Treasury tax plan. However, it is possible to glean some suggestions from the proposal that was made during the Clinton administration.[21] Indeed, the explanation in 1999 of why the change was needed, as summarized in the New York Bar Report, was similar to the current argument: because the current control test was "too easily manipulated" by allocating voting power among the shares of a corporation and that the absence of a value component "enables corporations to retain technical control of the corporation" while selling a significant amount or substantially all of its value.[22] Much of the analysis in the 1999 New York Bar Report will be relevant, if the proposed legislation goes forward.

The problems with value

By including the value of the issuer's stock in the determination of control, the current proposal invites potential uncertainty concerning whether, especially in a situation involving an issuer with a multi-class capital structure, the control test has been met. This uncertainty is certainly problematic when taxpayers are trying to determine whether, in a close case, a particular subsidiary is included within an affiliated group. When that uncertainty is translated into tax-free qualification of a reorganization, spinoff, or Section 351 exchange, however, the consequences could be more dire.

The problems created by using the value of stock, especially relative value of various classes of stock, in determining basic tax outcomes, have been highlighted, for example, in the rules under Section 382, concerning limitations on the use of net operating losses after a "change in control."[23] Under Section 382(g), the event that impacts the utility of corporate NOLs is a shift of the loss corporation's stock ownership over a three-year period, determined exclusively by value.[24] As the treatise states, however, "Using value rather than number of shares to determine changes of ownership [under Section 382] practically ensures disputes about control premiums, blockage discounts, and minority interest discounts, especially in close cases."[25]

The regulations under Section 382(g) provide limited guidance on how such value is determined in a multi-class situation.[26] Similar

[13] Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders (WG&L), ¶ 3.09 n. 252 ("The origin of the term "bust" in connection with transactions that intentionally do not qualify under § 351 is uncertain." Citing, e.g., Thigpen, "Unanticipated Bandage for a Busted Section 351 Exchange," KPMG publication (2001); Fisher, "The Conversion of Ordinary Income to Capital Gain by Intentionally Avoiding Section 351 of the Internal Revenue Code of 1954," 32 Mo. L. Rev. 422 (1967)).

[14] As noted in the New York Bar Report, the "affiliation" test in Section 1504 was added to the Code in 1984, and the 1984 change replaced a test similar to the current control test under Section 368(c). See New York Bar Report, p. 5. The Report posits a range of distinctions between the two tests as well as the implications of such variations.

[15] Section 1504(a)(4).

[16] There was also substantial commentary around the same time, especially regarding the importance of the control test in spinoffs, e.g., Willens, "New IRS Ruling Focuses Attention on 'Control' in Section 355 Transactions," 89 J. Tax'n, July 1998; Sheppard, "Retained Value in Spinoffs and Other Questions," 65 Tax Notes 398, 10/24/1994.

[17] *Tribune Company (as successor to Times Mirror Company)*, 125 TC 110, Tax Ct Rep (CCH) 56151, Tax Ct Rep Dec (RIA) 125.8, 2005 WL 2364801, Docket No. 17443-02 (filed 9/27/2005).

[18] Summarized in Rizzi, "Tribune Company Case and the Deconstruction of the Reorganization Rules," Corp. Tax. (WG&L), Mar/Apr 2006. This transaction was also summarized, without naming a taxpayer, in the New York Bar Report, pp. 4-5.

[19] 2022 Greenbook p. 19.

[20] The proposal would be effective for transactions occurring after 12/31/2022.

[21] Thus, for example, it was assumed that "stock" for purposes of the control test would not include "pure preferred" stock that satisfied the requirements of Section 1504(a)(4). Presumably, this carveout would also apply under the current proposals.

[22] See New York Bar Report, pp. 2-3.

[23] Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 14.43.

[24] Section 382(k)(6)(C) provides that all determinations of the percentage of stock held by any shareholder are to be made on the basis of the value, rather than on the number of shares.

[25] Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 14.43 n. 186. But see Reg. 1.382-2(a)(3)(i) (all shares with the same material rights have the same value (e.g., no control premiums or blockage discounts)). See also Bennett, "Valuing Stock for Ownership Changes," 83 Taxes 7, June 2005.

[26] See Regs 1.382-2(a)(3)(i):

> The determination of the percentage of stock of any corporation owned by any person shall be made on the basis of the relative fair market value of the stock owned by such person to the total fair market value of the outstanding stock of the corporation. Solely for purposes of determining the percentage of stock owned by a person, each share of all the outstanding shares of stock that have the same material terms is treated as having the same value. Thus, for example, a control premium or blockage discount is disregarded in determining the percentage of stock owned by any person.

JCT-22-03-029-Rizzi.qxp_Column_Template_v1.2 6/1/22 8:51 AM Page 32

concerns can be predicted under the proposed changes under Section 368(c).

Imposing liability on "controlling" shareholders

Another change affecting C corporations proposed by the Biden administration would impose liability for corporate-level taxes on certain "controlling" shareholders.[27] Although targeted at a relatively narrow class of corporations and corresponding shareholders, and focusing on a specific type of transaction deemed "abusive," this aspect of the Biden administration's subchapter C proposals is a significant departure from past practice. The proposal has its own independent "control" test and would impact closely held companies engaged in M&A transactions.

The proposal would add a new Section to the Code to create direct exposure on shareholders who sell the stock of an "applicable C corporation."[28] Potential secondary liability would be limited only by the amount of the sales proceeds received by the shareholders, and would disregard state corporate and liability law. For purposes of the proposal, an "applicable C corporation" would include any C corporation two-thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold.[29]

The proposal would only impose this exposure upon shareholders who, directly or indirectly, dispose of a "controlling interest" in the stock of the applicable C corporation within a 12-month period in exchange for consideration other than the stock of an acquiring corporation. Controlling interest is defined as at least 50%; the proposal is not specific as to whether this definition includes both vote and value, but presumably it would. Moreover, the secondary liability would arise only after the applicable C corporation had been assessed income taxes, as well as interest and penalties, with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of and after the corporation did not pay those amounts within 180 days after assessment.[30] The proposal would also amend the Code to provide that the amount for which the selling shareholder was secondarily liable would constitute a deficiency that was governed by general procedural notice and demand rules, but with an additional year added to the statute of limitations.[31]This "controlling shareholder" proposal obviously provides a significant expansion of potential shareholder liability, thus "piercing the corporate veil" in a limited set of circumstances.

The rationale for this proposal is quite clearly tied to so-called intermediary, or "Midco," transactions that have bedeviled the Treasury for a number of years, notwithstanding court victories and other steps to stamp out these transactions.[32]Midco transactions generally involve a sale of a corporation's stock to a specially designated corporation (commonly, "Midco") and a sale of the target assets to a different person or entity. The intent of such Midco transactions is to try to provide the selling shareholders with capital gains treatment with respect to the sale of their shares, and to give the buyer of the target business a step-up in the basis of the assets, all hopefully without the significant corporate-level tax that would otherwise have been imposed if the target had completed the transaction as an asset sale and if the cash proceeds had been distributed to the target shareholders.[33]

However, if the IRS does determine that there is significant corporate tax liability from the typical Midco transaction, most likely the corporate intermediary is without significant assets, since the cash from the transaction has been disbursed. The proposal aims to remedy this practical problem, by imposing a new form of expanded liability.

Conclusions

The effort to prevent taxpayers from "manipulating" transactions by using the venerable control test in Section 368(c) to effect "deemed sales" has

[27] 2022 Greenbook pp. 74-75. This provision was also included in the 2021 Greenbook, pp. 97-88.

[28] 2022 Greenbook p. 74.

[29] Id.

[30] The proposal would not apply with respect to certain dispositions, for example (1) the stock of a C corporation or real estate investment trust with shares traded on an established securities market, (2) the shares of a publicly traded regulated investment company, or (3) to an acquirer whose stock or securities are publicly traded, or is consolidated for financial reporting purposes with a public issuer of stock or securities.

[31] The proposal would not limit the government's ability to pursue any cause of action available under current law against any person. The proposed changes above would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after 4/10/2013, i.e., with a retrospective effective date.

[32] Hill and Nessler, "MIDCO Transactions and the Expanding Universe of Transferee Liability," NY Tax Club paper, 4/20/2016.

[33] See Rizzi, "Midco Transactions and Shareholder-Level Liability," Corp. Tax'n (WG&L), Sep/Oct 2012.

spurred the Treasury once again to revisit the issues first raised more than 20 years ago. The leap to determining that the preferable test is the one used to determine affiliation under Section 1504(a)(2), however, is perhaps less clear. As noted above, the purposes of the two tests are different. Moreover, because the addition of the value hurdle will add uncertainty, the ability to plan may be jeopardized. On the other hand, taxpayers may be able to take advantage of the "whipsaw" potential for such transactions, which is always a potential side-effect of uncertainty in subchapter C.[34]

Similarly, eliminating liability protection for shareholders of certain C corporations through the proposal in the Treasury list, although targeted towards a specific kind of transaction — the Midco variety — risks undercutting some basic principles, and, as a corollary, double taxation of transactions that involve transfers between corporations and shareholders. ■

[34] See, e.g., "anti-Hendler" provisions of Section 357. Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L) ¶ 3.06[1].

FIRST CIRCUIT AFFIRMS $2,173,703 FBAR PENALTY

STEVEN I. KLEIN AND ST.EPHEN R. LOONEY

In *Toth*,[1] the First Circuit Court of Appeals affirmed the summary judgment decision of the District Court holding that Monica Toth was liable for an FBAR penalty in the amount of $2,173,703, plus $826,469.56 in late fees and $137,925.92 in interest.

Facts

Monica Toth is a U.S. citizen who maintained an account with Union Bank of Switzerland (UBS) since 1999. Although Congress passed the Bank Secrecy Act (the "Act") in 1970,[2] provisions of which required U.S. citizens and residents to file reports and keep records of certain relationships with foreign financial agencies,[3] she first filed a report of Foreign Bank and Financial Accounts (FBAR) with the IRS disclosing her Swiss UBS account in 2010.

Toth's FBAR precipitated an IRS audit the next year, and pursuant to the audit the IRS filed delinquent FBAR forms on her behalf for the audit period 2005-2009. As a result of the audit, the IRS also determined that Toth's failure to file an FBAR was willful for the 2007 calendar year. This led the IRS to assess a civil penalty against Toth in an amount equal to $2,173,703, which was one-half the amount in her Swiss UBS account at the time of the violations, the maximum amount of penalty under the Act.

Toth did not pay the penalty, leading the government to file a civil suit against her in the District Court of Massachusetts on 9/16/2015. Toth was unrepresented during a significant portion of this prolonged litigation, which ultimately culminated in a final judgement on 9/16/2020, referred to as Toth IV.[4]

During the prolonged litigation, Toth consistently failed to respond to the Government's discovery requests. On 10/15/2018 the District Court granted the Government's motion for sanctions under Federal Rule of Civil Procedure 37, and ordered as a sanction that several facts be taken as established, including that she violated the Act willfully (Toth II).[5] After that holding Toth hired a lawyer.

Ultimately, the District Court granted the Government's motion for summary judgment in Toth IV, reaffirming its determination that Toth willfully violated the Act, rejecting her arguments that the size of the penalty violated the existing Treasury regulations and also the U.S. Constitution's Excessive Fines and Due Process Clauses.

Analysis

Under 31 U.S.C. section 5314(a), U.S. citizens or residents are required to keep records, and file reports when the person makes a transaction or maintains a relation for any person with a foreign financial agency. Under Treasury regulations promulgated to implement the Act, an individual is required to file an FBAR with the IRS for each calendar year that individual has more than $10,000 in a foreign bank account.[6]

STEVEN I. KLEIN is a member of Sher Garner Cahill Richter Klein & Hilbert, L.L.C., a professional limited liability company in New Orleans, is a member of the Advisory Board of this Journal, and is a Past Chair of the American Bar Association Tax Section[esq]s S Corporations Committee.

STEPHEN R. LOONEY is a shareholder and chairman of the tax department of the Orlando, Florida firm of Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A., is a member of the Advisory Board of this Journal, and is a Past Chair of the American Bar Association Tax Section[esq]s S Corporations Committee. *The information contained in this article is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor. This article represents the views and opinions of the authors only and does not necessarily represent the views or professional advice of Sher Garner Cahill Richter Klein & Hilbert, L.L.C. or Dean, Mead, Egerton, Bloodworth, Capouano & Bozarth, P.A.*

If an individual fails to file an FBAR, 31 U.S.C. section 5321(a)(5)(B) authorizes the IRS to impose a civil penalty of up to $10,000 for each violation. However, if the person willfully violates the reporting requirement, under 31 U.S.C. section 5321(a)(5)(C) the maximum penalty is increased to the greater of (1) $100,000, or (2) 50% of the amount determined under subparagraph (D). Under 31 U.S.C. section 5321(a)(5)(D), if the violation involves a failure to report the existence of an account or any identifying information required to be provided with respect to an account, the amount is the balance in the account at the time of the violation.

Under the regulation in effect at the time the IRS assessed the penalty against Toth, the pertinent regulation provided that the maximum penalty for a willful failure to file an FBAR was $100,000 (the "2012 Regulations").[7]

Court sanction

Toth challenged the District Court's sanction order that it be taken as a fact that she "willfully failed to file an FBAR" for the 2007 calendar year. She contended that this was particularly harsh and was tantamount to a default judgment.

The court reviewed the District Court's choice of sanction for an abuse of discretion. The court stated that it would consider both (1) substantive factors – the severity of the violation, the legitimacy of the party's excuse, repetition of violations, the deliberateness of the misconduct, mitigating excuses, prejudice to the other side and the operations of the court, and the adequacy of lesser sanctions, and (2) procedural factors – whether the offending party was given sufficient notice and opportunity to explain its noncompliance or argue for a lesser penalty, to make this determination.

The court agreed that Toth's violations of the District Court's discovery orders were severe, repeated, and deliberate. The court found that the District Court repeatedly gave her second chances and warned her she could face sanctions by continuing to fail to meet its deadlines, including the sanction of accepting certain facts as established, such as she acted willfully in failing to file an FBAR. Thus, the court could not find that the District Court abused its discretion in selecting the sanction it chose.

The 2012 Regulations

Toth contended that the 2012 Regulations imposed a maximum penalty of $100,000 for a willful failure to file an FBAR and that the IRS was therefore precluded from assessing a greater amount.

The 2012 Regulation was originally promulgated in 1987. However, the statute was amended after the 1987 regulation became final to provide for the increased amount. Nevertheless, Toth contended that the 1987 regulation remained operative and placed a ceiling of $100,000 on the maximum penalty.

The court rejected this argument and held in accordance with every other court considering the issues,[8] that the regulation did not limit the penalty amount to $100,000 because the statutory amendments superseded the regulation.

The court found that the statute in question did not, in any clear way, confer the power on Treasury to establish a ceiling on the maximum penalty that would be lower than the maximum penalty allowed by statute. Further, the regulation was promulgated under 31 U.S.C. section 5314(b)(5), which is merely a grant of general authority that provides that Treasury may prescribe regulations necessary to carry out the Act's reporting requirements for foreign accounts. The court also noted that another statutory provision expressly confers authority on the Treasury to set by regulation the maximum size of transactions that must be reported under the Act.

Finally, the court stated that the regulation was promulgated as an interpretive rule. As such, the regulation is properly understood to be clarifying, rather than substantive. The court referred to the regulation as a parroting regulation. Thus, when Congress amended 31 U.S.C. section 5314(a)(5)(C)-(D) to permit the IRS to impose a penalty in excess of $100,000, the 1987 regulation was superseded because the regulation was merely a regulation parrot-

1 129 AFTR 2d 2022-1646 (CA-1, 4/29/2022).
2 P. L. 91-508, 84 Stat. 1114.
3 31 U.S.C. section 5314(a).
4 126 AFTR 2d 2020-6065 (D. Mass., 9/16/2020).
5 122 AFTR 2018-6280 (D. Mass., 10/15/2018).
6 31 CFR sections 1010.350(a), 1010.306(c).
7 31 CFR section 1010.820(g)(2)(2012).
8 Citing, *Kahn*, 5 F. 4th 167, 175, 128 AFTR 2d 2021-5197 (CA-2, 2021); *Horowitz*, 978 F. 3d 80, 90-91, 126 AFTR 2d 2020-6556 (CA-4, 2020); *Rum*, 995 F. 3d 882, 892, 127 AFTR 2d 2021-1765 (CA-11, 2021); *Norman*, 942 F. 3d 1111, 1117, 124 AFTR 2d 2019-6595 (Fed. Cir., 2019).

ing a then operative statutory maximum and could have no effect once a new statutory maximum was set.

Constitutional arguments

Toth claimed that the $2,173,703 penalty for failing to file an FBAR violated the Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution, providing that "[e]xcessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishment inflicted."[9]

The court first stated that only monetary penalties that function as "punishment for some offense" are encompassed within the clause "excessive fines imposed."[10] The court explained that there is no per se rule that the Excessive Fines Clause only applies to a criminal prosecution; what matters is whether the penalty, even if only a civil one, is punishment. Thus, the court is required to explore whether the penalty serves remedial purposes, as opposed to retributive or deterrent purposes.

The court distinguished the FBAR penalty from other penalties that are the subject of other cases, because the FBAR penalty is not tied to any criminal sanction. Additionally, the court found that the penalty served the remedial purpose of reimbursing the government. The court stated:

> Here there was such a fraud and loss. Indeed, Congress authorized the imposition of a penalty of this size for willfully failing to comply with the Act's reporting requirements to address the fact that "[i]t has been estimated that hundreds of millions in tax revenues [were] lost" due to the secret use of foreign financial accounts – which Congress characterized as the "largest single tax loophole permitted by American law," and that it was very difficult for law enforcement to police the use of these accounts, causing costly investigations to stretch on for years ….

(citation omitted).

The court also compared the FBAR to tax penalties and cases that make clear that a tax penalty for failing to file taxes can exceed the amount owed in taxes without thereby constituting punishment.[11] Finally, the court also rejected Toth's argument that the fact that 31 U.S.C. section 5321(a)(5) provides for different maximum penalties depending on willfulness of the violation necessarily reveals that a deterrent or retributive purpose underlies the provision. The court found that other statutes that focus on culpability (e.g., civil tax fraud penalty), have not been found to render an otherwise remedial penalty punitive.

Thus, for all of the foregoing reasons, the court concluded that the civil penalty imposed under 31 U.S.C. section 5321(a)(5)(C)-(D) is not a "fine," and as such, the Excessive Fines Clause does not apply to it.

The court also rejected Toth's argument that the FBAR penalty violated her rights under the Due Process Clause of the Fifth Amendment. Toth relied on *BMW of North America, Inc.*,[12] a case involving punitive damages awarded by a jury. The court noted that in *Sony BMG Music Entertainment v. Tenenbaum*,[13] the First Circuit held that *BMW* does not apply to cases that involve a penalty set by statute. Therefore, the court rejected an argument based on *BMW*, and stated that Toth's attempt to shift her argument to fit within the *Sony* framework was a new argument that could not be made on brief. Accordingly, the court held that she waived any argument that the FBAR penalty assessed against her violated her due process rights. ■

SECTION 6426 RENEWABLE FUELS CREDIT REDUCES TAXPAYER'S COST OF GOODS SOLD

In *Delek US Holdings, Inc.*,[14] the Sixth Circuit Court of Appeals affirmed the decision of the district court, holding that the Section 6426 tax credit claimed by Delek against its Section 4081(a)(1)(A) excise tax, also reduced its cost of goods sold, and denied taxpayer's refund claim based on its claimed increase to cost of goods sold.

Facts

Delek is a fuel producer subject to federal excise taxes under Section 4081. In 2010 and 2011, Delek claimed over $64 million in credits under Section 6426 against its Section 4081 federal excise taxes. In computing its federal income taxes, Delek subtracted the claimed fuel mixture credits from its costs of goods sold. However, in 2015 it determined that the Section 6426 credit should

[9] U.S. Const. Amend VIII.
[10] Citing *United States v. Bajakajian*, 524 US 321, 327-28 (1998).
[11] Citing *Helviering v. Mitchell*, 303 US 391, 20 AFTR 796 (1938); *McNichols*, 13 F. 3d 432, 73 AFTR 2d 94-618 (CA-1, 1993).
[12] 517 US 559 (1996).
[13] 719 F. 3d 67 (CA-1, 2013).
[14] 129 AFTR 2d 2022-1566 (CA-6, 4/22/2022), *aff'g.* 515 F. Supp. 3d 812, 127 AFTR 2d 2021-641 (M.D. Tenn, 2021).

not reduce its cost of goods sold because the credit was a payment of the excise tax.

Therefore, it filed amended returns for 2010 and 2011 claiming a refund on the basis that the Section 6426 credits were payments in satisfaction, but not in reduction, of its federal excise tax, and therefore it erred in reducing its cost of goods sold by the amount of the Section 6426 credits. After the IRS denied Delek's refund claim, it filed a refund action in the district court, which denied Delek's refund claim.

Analysis

Section 4081(a)(1) imposes an excise tax per gallon on (1) the removal of a taxable fuel from any refinery, (2) the removal of a taxable fuel from any terminal, (3) the entry into the U.S. of any taxable fuel for consumption, use, or warehousing, and (4) certain sales of taxable fuel.

Section 6426(a)(1) allows as a *credit* against tax imposed by Section 4081 an amount equal to the sum of the credits under subsections (b) [alcohol fuel mixture credit], (c) [biodiesel mixture credit], and (e) [alternative fuel mixture credit].

Section 6427(e)(1) provides that the Secretary shall pay (without interest) an amount equal to the respective alcohol fuel mixture credit, biodiesel mixture credit, and alternative fuel mixture credit, to the person earning such credits. However, Section 6427(e)(3) provides that no amount is payable under Sections 6427(e)(1) and (2) with respect to any mixture with respect to which an amount is *allowed* as a credit under Section 6426.

The court framed the issue positing that by accepting the Section 6426 credit, did Delek pay a lesser amount in fuel excise tax. The court found that the text of Section 6426 plainly says yes, and that was decisive.

The court said the first step in its analysis was to define the term "credit." While Section 6426 does not define the term, the court found that the dictionary meaning of "credit" as well as case law interpreting the term was that a credit takes away from a total tax liability or an amount otherwise due, and therefore reduces that liability. The court stated that under the statutory text, the Section 6426 credit reduces the producer's entire Section 4081 excise tax liability. The court cited to *Sunoco, Inc.,*[15] where the court also determined that Section 6426(a)(1) *reduces* the taxpayer's overall excise tax liability. Therefore, by reducing Delek's excise tax liability, the credit also reduced its cost of goods sold.

The court rejected several arguments made by Delek. One argument was that Sections 6426 and 6427(e) offered it two options. In this respect, it argued that it could effectively forego the credit and pay the full amount of its Section 4081 excise tax liability without reduction for the credit. It could then claim a refund under Section 6427(e) for the full amount of the Section 6426 credit. Delek premised its argument on the use of the term "allowed" in Section 6427(e)(3). In this respect Section 6427(e)(3) reduces the amount of the refund under Section 6427(e)(1) and (2) by the "amount allowed as a credit under Section 6426."

Delek argued that the term *allowed* refers to a deduction or credit which is actually taken on a return and results in a reduction of a taxpayer's income tax.[16] In contrast, the Code also uses the term *allowable*, which usually means that a credit simply qualifies under a specific Code section.[17] Because Section 6427(e) uses the term "allowed," Delek argued that the Section 6426 credit preempts Section 6427(e)(1) and (2) direct payments only insofar as the taxpayer chooses to take the Section 6426 credit.

The court rejected this argument. The court reasoned that Section 6426 states that the mixtures credit "*shall* be allowed… as a credit against the tax imposed by Section 4081." By using the term "shall," Congress requires taxpayers to actually take the mixtures credit. Therefore, since producers cannot receive any Section 6427(e) payments that overlap with the mixtures credit, they must wait until their excise tax liability reaches zero before they can seek a payment under Section 6427(e).

Delek also tried to analogize to other types of credits under the Code. For example, Delek argued that Section 31(a)(1), which credits amounts withheld as tax under chapter 24 (Collection of Income Tax at Source) and requires taxpayers to prepay their income tax by withholding, actually pays (without reducing) income tax liability and that the fuel mixtures credit operates in the same way.

The court found that Section 31(a)(1) is an exception, not the rule. It cited Section 6211(b)(1), which clarifies that a taxpayer's liability is calculated "without regard to the credit

[15] 908 F. 3d 710, 122 AFTR 2d 2018-6529 *(CA-Fed. Cir., 2018).*
[16] Citing *Lenz*, 101 TC 260, 265 (1993).
[17] Id.

EXHIBIT 1
Time Logs—Hours Worked on Properties

	2013	2014	2013	2014
Flagler Beach	254.20	77.50	202.25	26.40
Palm Coast	222.00	2.50	203.05	0.00
Total Time	476.20	80.20	405.50	26.40

under Section 31." According to the court, Congress went out of its way to clarify the special nature of the credit for wages withheld at the source. The court further noted that the Section 31 credit is housed under subpart C (Refundable credits) of part IV of the Code's first chapter. It stated that subpart C credits are unlike other credits in part IV because they do not *reduce* taxpayer liabilities. Rather, as Section 6401(b)(1) explains, subpart C credits go toward overpayment, while other part IV credits are calculated into the liability itself. Thus, the court found that the fuel mixtures credit did not fit into this exception.

Delek also argued that legislative history supported its interpretation. The court simply responded that when the statutory text of the provision being parsed is clear, there is no need or warrant to explore legislative history.[18] Thus, relying solely on the text of Section 6426, the court concluded that Delek paid a reduced excise tax liability and was not entitled to a refund based on an increase to its cost of goods sold. ■

TAXPAYERS FAILED TO QUALIFY AS REAL ESTATE PROFESSIONALS UNDER SECTION 469(c)(7)

In *Sezonov*,[19] the Tax Court held that neither Christian Sezonov nor his wife Francine qualified as real estate professionals under Section 469(c)(7), because neither taxpayer individually performed more than 750 hours of services during any tax year in real property trades or business in which the taxpayer materially participated.

[18] Citing *In re Comshare Inc. Sec. Litig.*, 183 F. 3d 542, 549 (CA-6, 1999).

[19] TCM 2022-40.

Facts

In 2013 and 2014 the Sezonovs were married and resided in Ohio. Christian was the sole member of Design Build Service, LLC (DBS), which operated a wholesale HVAC business.

In 2013 DBS purchased two properties in Florida. One property was located in Palm Coast and was purchased in April 2013. After acquiring the property, DBS leased it to the prior owner for approximately two months. After the former owner vacated the Palm Coast property it was cleaned and furnished and DBS leased the property to a tenant for a one-year term beginning in September or October 2013.

The second property located in Flagler Beach was purchased on 11/11/2013. DBS made improvements and repairs to this property so that it could be leased for short-term (one month) vacation rentals. The property was first made available for lease in December 2013 and was first rented in January 2014.

The Sezonovs advertised the rental properties and communicated with prospective renters via email. Francine was responsible for day-to-day management of the properties. In between rentals, Francine would travel to Florida to clean and prepare the Flagler Beach property for its next rental or hire a cleaner to do so on her behalf. Christian assisted in responding to emails and also performed maintenance and repairs on the properties.

The Sezonovs did not maintain contemporaneous records of the hours they worked on the Florida properties. However, Francine later prepared time logs based on the rental agreements and their email correspondence with renters. The time logs are summarized in Exhibit 1.

The Sezonovs reported the rental activity of DBS on Schedule E of their joint income tax returns for 2013 and 2014. Their Schedule Es reported loss deductions for the Florida rental

properties. They did not make an election to aggregate their rental activities under Section 469(c)(7)(A). On audit, the IRS disallowed the Schedule E loss deductions claimed by the Sezonovs.

Analysis

Section 469 generally provides that a taxpayer may not deduct the net losses from the taxpayer's passive activities against their non-passive income. A passive activity is an activity which involves the conduct of any trade or business in which the taxpayer does not materially participate. Except as provided in Section 469(c)(7), a rental activity is treated as a passive activity.

Under Section 469(c)(7), the per se classification of rental activity as a passive activity does not apply to the rental real estate activity of a taxpayer who qualifies as a real estate professional for the taxable year. A taxpayer qualifies as a real estate professional for a taxable year if:

- More than one-half of the personal services performed in trades or businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
- The taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.[20]

In the case of a joint return, at least one spouse must separately satisfy the real estate professional qualification requirements.

If the taxpayer qualifies as a real estate professional, the rental activity is treated as a trade or business subject to the material participation requirements of Section 469(c)(1) rather than as per se passive.[21]

The court stated that in assessing a taxpayer's material participation, it treats each interest in real estate as a discrete real estate activity unless the taxpayer makes an election to treat all such activities as a single activity. However, in determining whether the 750-hour requirement is satisfied, all of the taxpayer's real property trade or business activity is taken into account.[22]

The court questioned the time logs constructed by Francine and commented that the time estimates appeared excessive in several respects. However, even accepting the time logs as credible and accurate in all respects, the court stated that they did not establish that either taxpayer met the definition of a real estate professional within the meaning of Section 469(c)(7).

In each of 2013 and 2014, according to the time logs, neither taxpayer spent at least 750 hours in real estate activities. Because neither taxpayer met the 750-hour requirement for either year, neither qualified as a real estate professional. Therefore, the court held that the Florida real estate rental activities were passive activities regardless of whether the taxpayers materially participated in those activities and the losses were properly classified by the IRS as passive activity losses. ■

COURT AFFIRMS HOLDING THAT MANAGEMENT FEES PAID TO SHAREHOLDERS WERE NON-DEDUCTIBLE DISGUISED DIVIDENDS

In *Aspro, Inc.*[23] the Eighth Circuit Court of Appeals affirmed the holding of the Tax Court that management fees that Aspro, Inc. paid to its three shareholders were disguised dividends not deductible as ordinary and necessary business expenses.

Facts

Aspro, Inc. (Aspro) is an asphalt-paving company based in Waterloo, Iowa. During 2012-2014 its stock was held by three shareholders, Milton Dakovich, its President, owning 20%, and Jackson Enterprises Corp. (JEC) and Manett's Enterprises, Ltd. (Manett's), each owning 40%.

Aspro did not pay any dividends since the 1970s. However, over a 20-year period, in every year save 2010, it paid management fees to its shareholders. The management fees were paid to the shareholders in approximate proportions to their share ownership and were paid at year-end in a lump sum payment. Further, there was no written management services agreement or other documentation of a management service relationship between Aspro and any shareholder, and no evidence that any shareholder billed Aspro for these services.

[20] Section 469(c)(7)(B).

[21] Section 469(c)(7)(A)(i); see also *Aragona Trust*, 142 TC 165, 171(2014).

[22] Citing *Almquist*, TCM 2014-40 at 11.

[23] 129 AFTR 2d 2022-1581 *(CA-8, 4/26/2022), aff'g, TCM 2021-8 (2021).*

Dakovich served as the President of Aspro and was paid a salary and bonus. However, in connection with the payment of the year-end management fee, at trial he was unable to explain what he did to earn the management fee.

On audit the IRS disallowed deduction of the management fees paid to Dakovich, JEC, and Manett's on the ground that Aspro failed to establish that the payments were made for ordinary and necessary business purposes. The Tax Court sustained the Commissioner's determination, holding that the claimed amounts were not paid as compensation for services but were disguised distributions of corporate earnings.

Expert testimony

At trial, the Tax Court excluded the testimony of two expert witnesses offered by Aspro. On appeal, Aspro contended that the Tax Court abused its discretion by excluding the testimony of its experts.

One expert was Gale Peterson, Jr. Peterson worked for Aspro and was a contractor in the highway-construction industry. In Peterson's report he opined that based on his personal experience working for Aspro and the reputation of the shareholders in the industry, the services they provided to Aspro were valuable.

Under the Federal Rules of Evidence, expert testimony is admissible only when the expert's specialized knowledge helps the trier of fact to understand the evidence or to determine a fact in issue.[24] The expert's specialized knowledge must be based on sufficient facts or data, be the product of reliable principles and methods, and demonstrate that the expert reliably applied the principles and methods to the facts of the case.[25]

The court found that the Tax Court did not abuse its discretion in excluding Peterson's testimony. In this respect, it agreed that Peterson did not employ the same level of intellectual rigor that characterized the practice of an expert in the field, and that his expert-witness testimony was not helpful as required by Rule 702.

The other expert offered by Aspro was William Kenedy, a CPA specializing in business valuation. The Tax Court found that Kenedy did not articulate what principles and methods he used, if any, to conclude that valuable services were provided. Among others, Kenedy admitted that his findings were based on a lack of documentation and lack of scientific method to assess the value of the services. Thus, the court agreed with the Tax Court's assessment that the opinions offered by Kenedy were based on personal belief rather than an expert analysis and were properly excludible.

Service Fees as Deductible Compensation Section 162(a) allows as a deduction the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. A deduction may be made for salary if it is both (1) reasonable, and (2) in fact payment purely for services.[26] Compensation paid by a corporation to shareholders is closely scrutinized to make sure the payments are not disguised distributions.[27]

Analyzing whether any portion of the management fees paid to JEC and Manett's were deductible, the court noted the following. Aspro did not present evidence showing what like enterprises under like circumstances would ordinarily pay for like management services, a factor for deducting compensation for personal services provided under Reg. 1.162-7(b)(3). Also, Aspro did not produce any written management services agreement with JEC or Manett's or any other documentation of the service relationship with these entities.

Rather, facts and circumstances indicated that the payments were disguised dividends. In this respect, Aspro had not made a dividend distribution since the 1970s, which absence itself was an indication that some of the purported compensation really represented a distribution of profits. The management fees were roughly proportional to stock ownership, 43% to each of JEC and Manett's in 2012, 46% in 2013 and 44% in 2014. Further, the management fees had little relationship to services performed and were paid in a lump sum at the end of the year despite the fact that Aspro claimed the services were performed throughout the year. Additionally, Aspro had very little income after taking a deduction for the management fees. Thus, the court concluded that the Tax Court did not err in concluding that the

[24] Fed. R. Evid. 702(a).

[25] Id at 702(b)-(d).

[26] *David E. Watson, P.C.*, 668 F. 3d 1008,1018, 109 AFTR 2d 2012-1059 (CA-8, 2012).

[27] *Heil Beaty Supplies, Inc.*, 199 F. 2d 193, 194. 42 AFTR 678 (CA-8, 1952).

management fees paid to JEC and Manett's were non deductible because Aspro did not prove that the fees were both reasonable and purely for services.

The court separately analyzed the management fees paid to Dakovich, who was Aspro's President and also received substantial payments of salary and bonus for each year 2012-2014, in addition to the management fees. The court noted that Aspro did not present any evidence showing what similar companies under like circumstances would pay as management fees (over and above salary and bonus) to an employee like Dakovich for the same type of management services. Further, Aspro did not quantify the value of any such management services.

The court also cited to the findings of the Commissioner's expert, an expert in valuing compensation arrangements. He concluded that Dakovich's salary and bonus exceeded the industry average and median by a substantial margin, and that management fees in addition to the salary and bonus were not reasonable. Further, the court noted that when the excess compensation determined by the Commissioner's expert was added to Dakovich's management fees, Dakovich's share of management fees was 22%, approximating his share ownership.

Elucidating many of the same factors that the court noted in its discussion of the management fees paid to JEC and Manett's, the court held that the Tax Court did not err in finding that Aspro did not establish that management fees paid to Dakovich were reasonable. The court concluded the payments made to Dakovich were a disguised distribution and not payments purely for services.

Observation The result in *Aspro* is not surprising. In fact, based on the court's description, *Aspro* is practically a blueprint of no-nos in trying to structure deductible payments for services rendered by shareholders.

Among other bad facts:

1. Prolonged history of no dividend distributions;
2. Elimination of any significant amount of taxable income;
3. Year-end lump sum distribution of purported service payments;
4. No management services agreement;
5. No written documentation of services provided;
6. No evidence of value of services provided;
7. No consultation with consultants having expertise in establishing a compensation plan; and
8. Failure to properly utilize experts to establish that compensation for services were in line with industry average for similar companies.

Thus, *Aspro* emphasizes the risks inherent in a haphazard approach to compensation planning. ■

TAX COURT MISINTERPRETED THE MEANING OF "GRANT" UNDER TAX TREATY

In *Baturin*,[28] the Fourth Circuit Court of Appeals reversed the decision of the Tax Court, holding that a Russian scientist was the recipient of compensation and not a "grant," which made the amount taxable under the United States-Russia Tax Treaty.[29] The court held that the Tax Court misinterpreted the term "grant" as used in the Treaty and remanded the case to determine whether Dr. Baturin's relationship with the lab where he provided services was a "grant" within the meaning elucidated by the Fourth Circuit.

Facts

During 2010 and 2011 Dr. Vitaly Baturin, a Russian national, held a J-1 visa as a researcher sponsored by Jefferson Lab, a Department of Energy Facility in Newport News, Virginia. Jefferson Lab operates a particle accelerator, which smashes particles together to help researchers learn about the structure of the universe. Dr. Baturin's work at Jefferson Lab involved a detector that would enable researchers to see what happens at the subatomic level inside the accelerator.

During 2010 and 2011 Dr. Baturin received Form W-2s from Jefferson Lab reporting "wages, tips, [or] other compensation" paid to Dr. Baturin in the amounts of $76,729 and $79,061, respectively. Dr. Baturin filed a Form 1040-NR (nonresident) income tax return with the IRS for each year and claimed that the Jefferson Lab payments to him were exempt under the Treaty. In 2014 the IRS issued a no-

[28] 129 AFTR 2d 2022-1399 (CA-4, 4/6/2022).

[29] Convention Between the United States of America and the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, 6/17/1992, T.I.A.S. No. 93-1216, S. Treaty Doc. No. 102-39.

tice of deficiency to Dr. Baturin stating that the payments from Jefferson Lab were taxable and claiming he owed $22,229 in income taxes.

Tax Court

In the Tax Court Dr. Baturin argued that the payments from Jefferson Lab were excludable under Art. 18(1) of the Treaty as a grant, allowance, or other similar payments from a scientific organization. The Tax Court held that although Art. 14 of the Treaty allows a Contracting State to tax the income derived by a resident of the other Contracting State with respect to employment exercised in the Contracting State, the payments from Jefferson Lab were covered under Art. 18(1) and constituted an exempt grant. In this respect, the Tax Court determined that wages may be eligible for exemption so long as they are similar to a grant or allowance.

Analysis

Arts. 14(1) and 18(1) of the Treaty provide respectively, in pertinent part:

> Subject to the provisions of Article 15 (Directors' Fees), 16 (Government Service), and 17 (Pensions), salaries, wages, and other similar remuneration derived by a resident of a Contracting State [i.e., the United States or Russia] in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.
>
> Art. 14(1) (Emphasis added.)
>
> An individual who is a resident of a Contracting State at the beginning of his visit to the other Contracting State and who is temporarily present in that other State for the primary purpose of: … (c) studying or doing research as a recipient of a grant, allowance, or other similar payments from a …scientific … organization, shall be exempt from tax by that other State … with respect to the grant, allowance, or other similar payments.
>
> Art. 18(1)

The court stated that the Treaty does not define what differentiates "salaries, wages, and other similar remuneration" in Art. 14 from a "grant, allowance, or other similar payments" in Art. 18. However, the court found that the items covered by Art. 14 and Art. 18 are mutually exclusive. Thus, a payment cannot be wages, et al, and at the same time excludable as a grant or similar allowance.

The court noted that some guidance to the interpretation of these provisions is provided under Art. 3(2) of the Treaty which provides:

> As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities agree to common meaning pursuant to [an inapplicable section], have the meaning which it has under the laws of the State concerning the taxes to which this Convention applies.
>
> (Emphasis added)

Thus, the court turned to the laws of the United States to distinguish the relevant terms. The court found the closest U.S. tax analogue is Section 117, which exempts from taxation as a qualified scholarship any amount received by an individual as a scholarship or fellowship grant. In addressing what may qualify as a fellowship grant under Section 117, Reg. 1.117-4(c) specifically excludes amounts paid as compensation for services or primarily for the benefit of the grantor as follows:

> (c) Amounts paid as compensation for services or primarily for the benefit of the grantor.
>
> (1) Except as provided in [inapplicable], any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.
>
> (2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.
>
> However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of Section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefits to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

The court noted that the Section 117 regulations were interpreted and upheld by the Supreme Court in *Bingler v. Johnson.*[30] There, the Supreme Court found that a tuition program provided to Westinghouse Electric engineers paying them tuition remuneration for post-graduate studies on the condition that they return to the employ of Westinghouse for a period of two years was not excludable be-

[30] 394 U.S. 741, 23 AFTR 2d 69-1212 (1969).

cause the definitions supplied by the regulations comported with the ordinary understanding of scholarships and fellowships as relatively disinterested no-strings educational grants, with no requirement of any substantial quid pro quo from the recipients.

The court found that the distinction drawn by the Section 117 regulations and *Bingler* parallels the Treaty's distinction between taxable "salaries, wages, and other similar remuneration" and an excluded "grant, allowance or other similar payment." Therefore, because the Treaty directs the court to U.S. law and because of the parallels between the *Bingler* framework and the Treaty's structure, the court determined that Section 117 and its implementing regulations supply the principles to distinguish taxable compensation from tax-exempt grants under the Treaty.

The court also found significant that the Treaty differed from the prior Convention with the Union of Soviet Socialist Republics on matters of taxation.[31] That treaty provided for a two-year exemption of personal service income earned by researchers. The court noted that before the Senate ratified the new Treaty, the Assistant Secretary for Tax Policy testified to the Senate Foreign Relations Committee that although "[s]pecial tax relief applies to grants … received by … researchers … the new treaty does not preserve [the two-year exemption] … it is not the policy of … either of the two countries to provide special exemptions of the compensation earned by … researchers."[32]

The court concluded that because the Tax Court did not have the benefit of the court's decision when it heard testimony and decided the case, the record was not entirely clear as to the specifics of Dr. Baturin's relationship with Jefferson Lab. Accordingly, it remanded the case to the Tax Court to determine what Jefferson Lab gained from having Dr. Baturin on staff. The court suggested that the Tax Court might address the following:

If not Dr. Baturin, would Jefferson Lab have hired someone else to work on upgrading the detector? Did the projects he worked on predate and/or post-date his tenure at Jefferson Lab or were they dependent on his presence? Did Jefferson Lab retain any rights to the product of his research? How much discretion did Dr. Baturin have to direct day-to-day performance of his work? In short, was there a substantial quid pro quo here? ■

[31] Convention with the Union of Soviet Socialist Republics on Matters of Taxation, U.S. – U.S.S.R., 6/20/1973, 27 U.S.T. 3

[32] See Tax Conventions with the Russian Federation, Treaty Doc. 102-39..., Before the Sen. Foreign Relations Comm., 103 Cong, S. Hrg. 103-335 at 26 (1993) (Statement of Leslie B. Samuels, Assistant Sec'y for Tax Policy, Treasury Dept.).

JCT-22-03-044-IRS.qxp_Column_Template_v1.2 6/1/22 10:50 AM Page 44

IRS PROVIDES RELIEF FROM SUPERFUND CHEMICAL TAX DEPOSIT FAILURES

In Notice 2022-15, 2022-18 IRB 1043, the IRS has provided failure to deposit penalty relief for Superfund chemical tax deposits for the rest of calendar year 2022 and the first quarter of calendar year 2023.

The Infrastructure Investment and Jobs Act (IIJA; P.L. 117-58, 11/15/2021) reinstated the excise taxes imposed by Code Section 4661 and Code Section 4671 (the Superfund chemical taxes) with certain modifications. The IIJA requires taxpayers subject to the Superfund chemical taxes to make deposits of these taxes semi-monthly beginning 7/1/2022.

The tax deposit for each semi-monthly period should be at least 95% of the net tax liability incurred during the tax period unless a deposit safe harbor applies. The IRS may withdraw a taxpayer's right to use the deposit safe harbor if the taxpayer fails to make required deposits. (Reg. 40.6302(c)-1(b))

Section 6656 imposes a penalty for failure to make timely deposits of taxes, including Superfund chemical taxes (failure to deposit penalties). A taxpayer may avoid these penalties by showing that such failure is due to reasonable cause and not willful neglect.

Superfund chemical taxes are reported on Form 6627, Environmental Taxes, which is attached to the taxpayer's Form 720, Quarterly Excise Tax Return.

In Notice 2021-66, 2021-52 IRB 901, the IRS provided initial guidance related to the Superfund chemical taxes and requested comments on whether issues related to the reinstated Superfund chemical taxes required clarification or additional guidance. One of the comments the IRS received requested relief from failure to deposit penalties.

In response to the comment, the IRS has issued Notice 2022-15, which provides relief from failure to deposit penalties for taxpayers required to deposit Superfund chemical taxes. This relief covers:

- The third and fourth calendar quarters of 2022, and
- The first calendar quarter of 2023 (collectively the "covered period").

Notice 2022-15 also provides that during the first, second, and third calendar quarters of 2023, the IRS will not withdraw a taxpayer's right to use the deposit safe harbor rules for failure to make required deposits of Superfund chemical taxes if certain requirements are met.

For semi-monthly periods in the covered period, a taxpayer owing Superfund chemical taxes will have satisfied the reasonable cause standard to avoid a penalty for failure to deposit Superfund chemical taxes if:

- The taxpayer makes timely deposits of applicable Superfund chemical taxes, even if the deposit amounts are computed incorrectly, and
- The amount of any underpayment of the applicable Superfund chemical taxes for each calendar quarter is paid in full by the due date for filing the Form 720 return for that quarter. ■

IRS PROPOSES CHANGES TO QUALIFIED INTERMEDIARY AGREEMENT

The IRS has proposed changes to portions of the 2017 qualified intermediary (QI) withholding agreement (QI agreement) that apply to a QI effecting the transfer of an interest in a publicly traded partnership (PTP) or receiving a distribution from a PTP on behalf of a foreign account holder of the QI. (Notice 2022-23, 2022-20 IRB 1062)

A QI is a foreign financial institution (or foreign branch of a U.S. financial institution) that enters into a QI agreement with the IRS to report and withhold taxes from payments made to their account holders. Under the QI agreement, a QI is entitled to follow certain simplified withholding and reporting rules. The current QI agreement (2017 QI agreement) expires on 12/31/2022. (Rev. Proc. 2017-15, 2017-3 IRB 437)

Under Code Section 1446(a), a PTP must pay a withholding tax on any portion of the partnership's "effectively connected taxable income" that is allocated to a foreign partner. Generally, a PTP's "effectively connected taxable income" is any income that is effectively connected to the conduct of a U.S. trade or business.

Under Section 1446(f), a partner who transfers an interest in a PTP must withhold 10% of the amount realized on the disposition of that interest if any portion of the gain would be treated as effectively connected with the conduct of a U.S. trade or business. If the partner/transferee fails to withhold any amount required to be withheld, the partnership must deduct and withhold from distributions to the transferee the amount the transferee failed to withhold (plus interest).

Proposed changes to 2017 QI agreement. Under the 2017 QI agreement, a QI is not permitted to act as a QI with respect to an amount subject to withholding under Section 1446(a) on a PTP distribution received on behalf of an account holder. The proposed modifications in Notice 2022-23 would extend the scope of the QI agreement to include withholding required under Section 1446(a) and Section 1446(f). (Notice 2022-23, section 4)

According to the notice, the IRS anticipates that these proposed changes to the 2017 QI agreement, subject to modifications based on comments the IRS receives, would be included in a revenue procedure containing a new QI agreement. The new QI agreement would apply on or after 1/1/2023.

Notice 2022-23:

- Highlights the IRS's proposed changes to the QI agreement (Notice 2022-23, section 3);
- Contains the text of the proposed changes to the QI agreement (Notice 2022-23, section 4); and
- Provides information on how to submit comments on the proposed changes (Notice 2022-23, section 5).

IRS RESPONDS TO REPORTS OF INFORMATION RETURN DESTRUCTION

In May 2022, the IRS issued a statement responding to an audit report from the Treasury Inspector General for Tax Administration (TIGTA) saying the agency destroyed millions of information returns because of a processing backlog. (IRS Statement on Information Returns (5/13/2022))

The IRS stated the following:

> "We processed 3.2 billion information returns in 2020. Information returns are not tax returns, and they are documents submitted to the IRS by third-party payors, not taxpayers. 99% of the information returns we used were matched to corresponding tax returns and processed. The remaining 1% of those documents were destroyed due to a software limitation and to make room for new documents relevant to the pending 2021 filing season."

Claiming that there were no negative taxpayer consequences as a result of this action, the IRS noted that taxpayers or payers have not been and will not be subject to penalties resulting from this action.

The IRS stated that this situation reflects the significant issues posed by antiquated IRS technology. In 2020, the IRS prioritized the processing of backlogged tax returns to get taxpayers their refunds and support other COVID-related relief over inputting the less than 1% of information documents—mostly Form 1099s—that were submitted on paper.

System constraints, according to the IRS, require the IRS to process these paper forms by the end of the calendar year in which they were received. This meant that these returns could no longer be processed once filing season 2021 began. The IRS pointed out that not processing these information returns did not impact original return filing by taxpayers in any way as taxpayers received their own copy to use in filing an accurate return.

The IRS noted that it processed all paper information returns received in 2021 and planned to process those received in 2022. ■

EMPLOYEE RETENTION CREDIT—PENALTY RELIEF

The IRS, in a news release, reminded employers of penalty relief related to claims for the Employee Retention Credit (ERTC) (IR 2022-89, 04/18/2022)

Treasury and the IRS have received requests from taxpayers and their advisors for relief

from penalties arising when additional income tax is owed because the deduction for qualified wages is reduced by the amount of a retroactively claimed ERTC, but the taxpayer is unable to pay the additional income tax because the ERTC refund payment has not yet been received.

According to the news release, Treasury and the IRS are aware that this situation may arise, in part, due to the IRS's backlog in processing adjusted employment tax returns (e.g., Form 941-X) on which the taxpayers claim ERTC retroactively. Based on applicable law, IRS guidance provides that an employer must reduce its income tax deduction for the ERTC qualified wages by the amount of the ERTC for the tax year in which such wages were paid or incurred. Taxpayers that claimed the ERTC retroactively and filed an amended income tax return reducing their deduction for the ERTC qualified wages paid or incurred in the tax year for which the ERTC is retroactively claimed have an increased income tax liability, but may not yet have received their ERTC refund.

The news release reminds taxpayers that, consistent with the relief from penalties for failure to timely pay noted in Notice 2021-49, they may be eligible for relief from penalties for failing to pay their taxes if they can show reasonable cause and not willful neglect for the failure to pay.

In general, taxpayers may also qualify for administrative relief from penalties for failing to pay on time under the IRS's First Time Penalty Abatement program if the taxpayer:

- Did not previously have to file a return or had no penalties for the three prior tax years;
- Filed all currently required returns or filed an extension of time to file; and
- Paid, or arranged to pay, any tax due.

The IRS suggests that for general information on penalty relief, taxpayers and tax practitioners should visit the Penalty Relief page on irs.gov.

GLOBAL TAX CHIEFS WARN OF RISKS OF NONFUNGIBLE TOKENS

In a news release, the Joint Chiefs of Global Tax Enforcement (J5), including the IRS, announced the release of an intelligence bulletin, warning banks, law enforcement personnel, and private citizens of some of the dangers when dealing with nonfungible tokens (NFTs). (J5 news release, 4/28/2022). The document, called the "J5 NFT Marketplace Red Flag Indicators," is the first of its kind from the J5. It lists items that should draw concern when one is dealing with NFTs or planning to purchase one.

The document is not meant to be an all-inclusive list of risks associated with NFTs, but rather a list of best practices from the five countries in the J5 from their dealings with NFTs in various investigations.

According to the J5, while the majority of cryptocurrency owners and those purchasing NFTs are doing so for righteous reasons, criminals look for any way to exploit new technologies. Cryptocurrencies and NFTs are not immune. The purpose of the J5 document is to provide insight to banks, law enforcement partners, and private industry regarding potential red flags in NFT marketplaces. The J5 seeks to continuously improve fraud detection measures in place to detect and prevent criminal activity.

The J5 notes that NFTs can be anything digital including drawings, music, or anything that can be seen as art. They have been described as an evolution of fine art collecting, only digital.

The J5 recognizes that data available to NFT marketplaces can provide additional and valuable perspectives in combatting fraud. A list of possible account or transaction attributes are included in the J5 document that may provide these insights. The J5 stated that it is likely that any single indicator in isolation will not be a definitive indication of fraud, but a compound set of risk indications, after following a "business as usual" process, may provide insights into potential fraud.

The J5 includes the Australian Taxation Office (ATO), the Canada Revenue Agency (CRA), the Dutch Fiscal Information and Investigation Service (FIOD), Her Majesty's Revenue and Customs (HMRC) from ■

EMPLOYER LEAVE-BASED DONATIONS FOR UKRAINE—IRS GUIDANCE

In Notice 2022-28, 2022-23 IRB xxx, the IRS stated that employer leave-based donation payments by an employer before 1/1/2023 to Section 170(c) organizations to aid victims of Russia's invasion of Ukraine will not be treated as gross income or wages of the employer's employees.

JCT-22-03-044-IRS.qxp_Column_Template_v1.2 6/1/22 10:50 AM Page 47

Under an employer leave-based donation program, an employee can elect to forgo vacation, sick, or personal leave in exchange for the employer's making cash payments to charitable organizations described in Section 170(c) ("Section 170(c) organizations"). Cash payments made by an employer to Section 170(c) organizations under an employer leave-based donation program are referred to as "employer leave-based donation payments."

The notice specifically provides that employer leave-based donation payments made by an employer before 1/1/2023 to Section 170(c) organizations to aid victims of the invasion of Ukraine by Russian forces beginning on 2/24/2022 (qualified employer leave-based donation payments) will not be treated as gross income or wages (or compensation, as applicable) of the employer's employees.

Similarly, employees who elect or who have an opportunity to elect to forgo leave that funds the qualified employer leave-based donation payments will not be treated as having constructively received gross income or wages (or compensation, as applicable).

Employers should not include the amount of qualified employer leave-based donation payments in Box 1, 3 (if applicable), or 5 of an electing employee's Form W-2.

Electing employees are not eligible to claim a charitable contribution deduction under Section 170 for the value of the forgone leave that funds qualified employer leave-based donation payments.

An employer may deduct qualified employer leave-based donation payments under the rules of Section 170 or Section 162 if the employer otherwise meets the respective requirements of either section.

The IRS stated that this new guidance in Notice 2022-28 is similar to the guidance provided in Notice 2001-69, 2001-2 CB 491, as modified and superseded by Notice 2003-1, 2003-1 CB 257, regarding charitable relief following the 9/11/2001 terrorist attacks. ■

TIGTA AUDIT ON IRS IMPLEMENTATION OF PARTNERSHIP AUDIT REGIME

The Treasury Inspector General for Tax Administration (TIGTA) has published an audit initiated to determine whether the IRS adequately implemented changes to partnership audit rules pursuant to the Bipartisan Budget Act of 2015 (BBA). (TIGTA Audit Report No. 2022-30-020, 3/17/2022)

In November 2015, section 1101 of BBA repealed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership procedures and replaced them with a new centralized partnership audit regime. By the beginning of Fiscal Year 2018, the IRS started to examine partnership returns using the new centralized partnership audit regime procedures. This TIGTA audit was initiated to determine whether the IRS adequately implemented the changes to the partnership audit rules as specified in section 1101 of BBA.

TIGTA's review of the initial examination efforts under the centralized partnership audit regime rules found that as of the end of Fiscal Year 2021, the IRS has completed a total of 480 examinations. These examinations include returns filed for Tax Years 2016 through 2019. The IRS closed 376 (approximately 78%) of these partnership returns as a no-change. TIGTA stated that this rate is high in comparison to the average no-change rate of 50% for all partnership returns for the same tax years, closed as of 9/30/2020.

IRS management agreed with TIGTA that the no-change rate is high and believes that it is too early in the process to analyze and form conclusions about the no-change rate. However, the IRS also confirmed that it has not determined acceptable rates or ranges they would use to measure closure types for examinations.

According to TIGTA, the IRS does not establish goals based on audit procedures such as the centralized partnership audit regime. However, the centralized partnership audit regime provides a centralized method of examining items of a partnership that should limit the burden on the IRS in both the examination and judiciary process. Therefore, TIGTA stated that the IRS should measure whether partnership examinations performed after the centralized partnership audit regime was in place are taking less overall resources to complete and administer in comparison to pre-centralized partnership audit regime results. By not having these targets, the IRS cannot measure the effectiveness of the new audit rules on taxpayer compliance.

The IRS has developed a manual compliance monitoring process to confirm adjustments to partners' returns when a partnership

JCT-22-03-044-IRS.qxp_Column_Template_v1.2 6/1/22 10:50 AM Page 48

makes a push-out election. However, TIGTA believes that the process is not fully systemic, and that without a proper systemic monitoring process, the underreporting or nonreporting of adjustments may only be detected through a cumbersome time-intensive manual process.

TIGTA recommendations. TIGTA recommended that the IRS address the centralized partnership audit regime examination no-change rates, establish goals and measures that address the expected outcomes from the implementation of the centralized partnership audit regime, and implement a fully systemic method to monitor and verify that push-outs are properly reported on partners' returns.

The IRS agreed with one recommendation and plans to request the development of a systemic method to verify push-outs. The IRS disagreed with two recommendations. TIGTA believes that these recommendations will help the IRS address factors contributing to high no-change rates and establish goals and measurements based on the expected outcomes from the implementation of the centralized partnership audit regime.

The TIGTA audit report is available on the TIGTA website (treasury.gov/tigta). ■

IRS SENDING LETTERS TO TAXPAYERS WITH QUALIFIED OPPORTUNITY FUND INVESTMENTS

The IRS announced in a news release that taxpayers who may need to take additional actions related to Qualified Opportunity Funds (QOFs) began to receive letters in the mail in April 2022. (IR 2022-79, 4/12/2022)

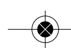
Taxpayers who attached Form 8996, Qualified Opportunity Fund, to their return may receive Letter 6501, Qualified Opportunity Fund (QOF) Investment Standard. This letter lets taxpayers know that information needed to support the annual certification of investment standard is missing or invalid, or the calculation is not supported by the amounts reported. If the taxpayers intend to maintain their certification as a QOF, they may need to take additional action to meet the annual self-certification of the investment standard requirement.

To correct the annual maintenance certification of the investment standard, these taxpayers should file an amended return or an administrative adjustment request (AAR). If an entity that receives the letter fails to act, the IRS may refer its tax account for examination. Investors who made an election to defer tax on eligible gains invested in that entity may also be subject to examination.

Additionally, taxpayers may receive Letter 6502, Reporting Qualified Opportunity Fund (QOF) Investments, or Letter 6503, Annual Reporting of Qualified Opportunity Fund (QOF) Investments. These letters notify taxpayers that they may not have properly followed the instructions for Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, since it appears that information is missing or invalid or that they may not have properly followed the requirements to maintain their qualifying investment in a QOF with the filing of the form.

If these taxpayers intend to maintain a qualifying investment in a QOF, they can file an amended return or an AAR with a properly completed Form 8997 attached. Failure to act will mean those who received the letter may not have a qualifying investment in a QOF and the IRS may refer their tax accounts for examination. This may result in letter recipients owing taxes, interest, and penalties on gains not properly deferred. ■

JCT-22-03-coverads.qxp_Layout 1 5/31/22 1:04 PM Page 3



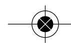
Be the forward-thinking firm

Between ever-changing customer needs, economic uncertainty, and constant regulatory reform, the tax and accounting profession is not the same as it used to be. Delivering high-value advisory services is critical to attract and retain clients. So how do you put advisory services at the center of your client relationships?

With **Thomson Reuters® Practice Forward**, you'll have the tools you need to build a scalable advisory services model that will impress your clients and boost revenue potential.

Learn how to get started at **tax.tr.com/practice-forward** or call **+1 800 968 8900**.

© 2020 Thomson Reuters TR1316956/11-20



THOMSON REUTERS
ONESOURCE™

Simple, fast, and accurate sales tax.

Thomson Reuters ONESOURCE™ Determination delivers real-time sales and use tax and VAT calculations with a platform designed for the ever-changing, cloud-driven future of tax.

Find trusted answers for today's needs and tomorrow's unknowns with ONESOURCE.

- Built-in tax content with rates for more than 16,000 jurisdictions and 8,000 product categories, saving you time and resources
- Seamless integration with your existing business systems
- Implemented by a team of experts

Want to learn more about the benefits of ONESOURCE Determination?

Contact us at **+1 800 865 5257**
or visit **tax.tr.com/indirecttax.**

THOMSON REUTERS®

© 2020 Thomson Reuters TR987785/2-20