HOUSTON

47th Annual Tax & Business Planning Seminar

Wednesday, October 30, 2024

The Houstonian Hotel
111 N. Post Oak Lane
Houston, Texas 77024

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47th ANNUAL TAX AND BUSINESS PLANNING SEMINAR

OCTOBER 30, 2024

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47th Annual Tax and Business Planning Seminar
Houston, Texas

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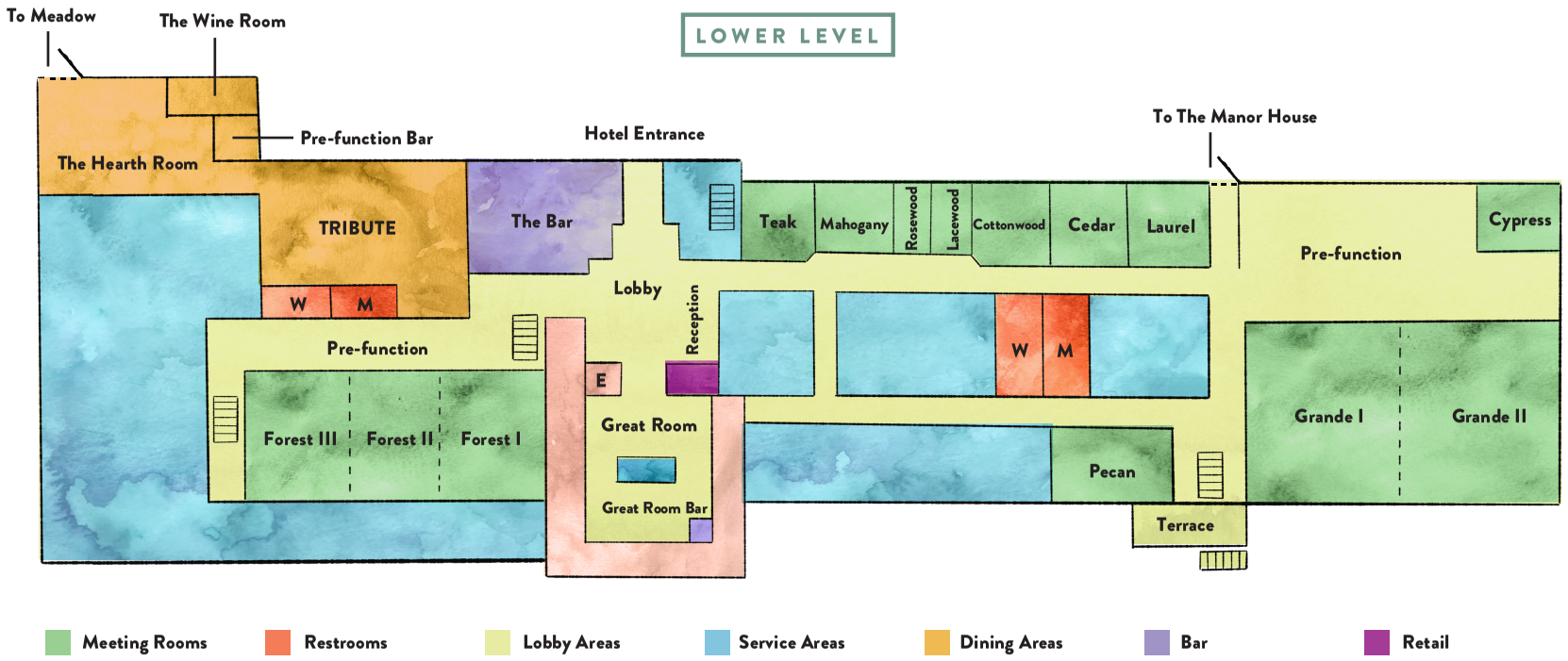
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Pre-function
Pre-function
Juniper
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Sequoia
Magnolia
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Willow
Camelia
Terrace
Hallway to Sleeping Rooms

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PRACTICE AREAS

ADMIRALTY AND ENERGY
Types of clients served:
- Offshore drilling and production companies
- Marine transportation companies
- Marine construction companies
- Dredging companies
- Inland barge lines
- Towing companies
- Shipping companies
- Commercial diving contractors
- Commercial fishing companies
- Cargo, hull, P&I and general liability underwriters

Experience includes:
- Litigation matters involving:
  - Asbestos
  - Cargo
  - Collision/Allisions
  - Contractual Defense and Indemnity
  - Exoneration from or Limitation of Liability
  - Longshore and Harbor Workers Compensation Act
  - Marine Construction
  - Marine Insurance
  - Personal Injury or Death
  - Pilotage
  - Salvage
  - Towage and Tugs

BANKRUPTCY, RESTRUCTURING, & CREDITOR RIGHTS
Types of clients served:
- Bankruptcy Trustees
- Lenders
- Creditors
- Debtors

Experience includes:
- In-Court and Out-of-Court Workouts
- Pre-filing negotiations and filing of Chapter 11 reorganization cases
- Pre-filing negotiations and filing of new Subchapter V, under Chapter 11 reorganization cases
- Filing of Chapter 7 cases for high-net worth individuals and businesses
- Financing and cash collateral disputes
- Bankruptcy litigation:
  - Contested bankruptcy 363 sales Fraudulent transfer and preferences
  - Breach of fiduciary duty, and similar disputes
  - oil, gas, and energy issues, including forward contract safe harbors in bankruptcy royalty recharacterization issues, treatment of plugging and abandonment liability,

BANKRUPTCY, RESTRUCTURING, & CREDITOR RIGHTS (continued)
  - disputes concerning statutory liens
  - Bankruptcy Code § 366 "utility" issues
  - Automatic Stay
- Proofs of claims, analysis of claims, and non-routine claim objections
- Collection of accounts and enforcement of judgments

COMMERCIAL LITIGATION
Types of clients served:
- Individuals
- Partnerships
- Corporations and other business entities

Experience includes litigation involving:
- Federal multi-district litigation
- Antitrust, securities and commodities
- Business fraud
- Contract disputes
- Professional liability defense
- Products liability
- Toxic tort defense
- Pension and health insurance benefits issues
- Labor and employment cases before administrative law judges, the NLRB, federal and state courts
- Energy and oil and gas
- Environmental
- Landowners in environmental and eminent domain cases
- Construction
- Lender liability
- Appeals
- Probate
- Arbitration, mediation and other alternative dispute resolution techniques

CONSTRUCTION LAW
Types of clients served:
- Prime or general contractors
- Subcontractors
- Suppliers
- Owners

Experience includes:
- Advising on all types of contracts
- Assistance with Contract drafting/negotiations
- Project troubleshooting
- Lien filing

CONSTRUCTION LAW (continued)

- Bond claims; preparation or defense
- Claim preparation; contract balance, change order/extra work, delay and inefficiency claims
- Litigation and arbitration involving:
  - Collection of contract balances
  - Terminations of work or contracts Extra work and disputed change orders Bid protests
  - Delay claims and defenses
  - Inefficiency claims and defenses
  - Defective work claims

Forums:

- Litigation in United States District Courts, the United States Court of Federal Claims, United States Courts of Appeal and state trial courts
- Arbitration hearings nationwide

CORPORATE, SECURITIES & FINANCE

Types of clients served:

- Entrepreneurs
- Privately-held (including family-owned) enterprises
- Professional practices
- Publicly-held corporations
- U.S. operations of international corporations
- Foreign and domestic banks and other financial institutions

Experience includes:

- General corporate representation
- Organization of new businesses
- Mergers, acquisitions and sales of businesses
- Preparation and negotiation of contracts
- Public and private offerings of debt and equity securities
- Leveraged buyouts
- Structured finance transactions, including asset securitizations
- Project finance
- Tender and exchange offers
- Loan documentation and debt restructuring (borrowers and lenders)
- Reorganizations and bankruptcy
- State and federal regulatory matters

DATA SECURITY & PRIVACY

Types of clients served:

- Entrepreneurs
- Domestic and Foreign Corporations
- Public and privately held enterprises
- Non

Experience includes:

- Creating and implementing data privacy policies and practices
- Creating and implementing data security policies and practices
- Responding to cybersecurity attacks, data breaches, and ransomware attacks
- Counseling client on cross-border data transfer requirements and global compliance obligations;
- Counseling clients on workplace privacy issues
- Developing and implementing training programs
- Assisting clients in conducting and responding to compliance audits
- Developing and implementing data privacy policies and programs
- Developing and implementing mobile and online privacy policies and programs
- Conducting M&A due diligence related to data privacy and security issues
- Developing and implementing HIPAA policies and programs
- Counseling clients on health care privacy issues.

EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION

Types of clients served:

- Employers of all sizes
- Professional practice groups
- Benefit consultants
- Individuals

Experience includes:

- Employee stock ownership plans
- Pension and profit-sharing plans 401(k) plans
- Welfare plans
- Executive compensation arrangements
- ERISA issues
- Administrative proceedings, audits and litigation initiated by the Department of Labor and the IRS

ENERGY

Types of clients served:

- Companies and individuals engaged in onshore and offshore exploration
- Production, marketing and transportation of oil, gas and other minerals
- Lending institutions

Experience includes:

- Energy-related asset sales and purchases
- Financing transactions
- Title opinions (Louisiana and Texas)
- All types of exploration and production contracts
- Litigation involving:
  - Oil and gas leases
  - Joint operating agreements
  - Condemnations
  - Natural gas contracts and transportation agreements
  - Farmout agreements
  - Drilling contracts
  - Issues before regulatory agencies such as the Texas Railroad Commission

ESTATE & INCOME TAX PLANNING & ESTATE ADMINISTRATION

Types of clients served:

- Individuals and families
- Business owners
- Estates, trusts and other fiduciaries
- Banks and Trust Companies

Experience includes:

- All aspects of estate planning
  - Wills
  - Powers of Attorney

ESTATE & INCOME TAX PLANNING & ESTATE ADMINISTRATION (continued)

- Health care directives
- Family limited partnerships
- Life insurance planning
- Trust planning and administration
- Gifts
- Charitable giving and charitable entities
- Estate administration and probate
- Buy-sell agreements
- Marital agreements
- Preparation and filing of estate, gift, generation-skipping transfer and inheritance tax returns Will contests and other disputes related to estates, trusts and fiduciaries
- Succession planning for business owners

EXEMPT ORGANIZATIONS

Types of clients served:

- Nonprofit hospitals
- Universities
- Private foundations
- Housing organizations
- Religious organizations
- Private equity funds
- Credit counseling agencies
- Arts organizations
- Community development corporations
- Governmental affiliates

Experience includes:

- Formation of new organizations
- Application for federal income tax exemption
- Negotiation of joint ventures
- Community benefit studies
- Nonprofit governance
- Executive compensation review
- Private use analysis
- Excess benefit and self-dealing analysis

FEDERAL WHITE COLLAR CRIMINAL DEFENSE

Types of clients served:

- Business entities
- Tax-exempt organizations
- Business Owners
- Corporate Executives
- Professional Service Providers
- High-Net-Worth-Individuals

Experience includes:

- Defending clients under investigation for suspected financial crimes
- Representation of clients concerning grand jury and administrative subpoenas for documents
- Representation of clients concerning grand jury and administrative subpoenas for testimony
- Defending clients in court proceedings against financial crime allegations
- Representing clients regarding the return of assets that were seized and/or are subject to forfeiture

IMMIGRATION

Types of clients served:

- U.S. Corporations seeking to hire foreign professionals and workers
- Entrepreneurs seeking to do business or invest in the U.S.
- U.S. operations of international companies seeking to transfer executives and managers

Experience includes:

- H1-B visas (Professionals)
- E visas (Investors/Treaty Traders)
- L visas (Intra-company transfers)
- O visas (Extraordinary ability)
- P visas (Athletes, Entertainers)
- Immigrant visas/permanent residence (green cards) for professionals, skilled workers, Executives, Managers, and Investors and their families
- Naturalization and citizenship Defense of removal matters

INTELLECTUAL PROPERTY

Type of clients served:

- Entrepreneurs
- Domestic and Foreign Corporations
- Public and privately held enterprises
- Individuals
- Inventors

Experience includes:

- PATENTS
- Patent Licensing
- Patent Infringement Litigation
- Clearance of design patents/industrial designs (through a network of associated attorneys)
- Prosecution of design patent/industrial design applications (through a network of associated attorneys)
- Employee Invention Assignment Agreements
- Product development and marketing agreements
- TRADEMARKS
- Clearance searches in the United States
- Clearance searches in foreign jurisdictions
- Prosecution of trademark applications in the United States
- Prosecution of trademark applications in foreign jurisdictions (through network of associated attorneys)
- Counseling on trademark protection strategies
- Counseling on trademark enforcement strategies
- Trademark rights enforcement
- Trademark licenses
- Trademark assignments
- Trademark oppositions, cancellations and other administrative proceedings in the United States
- Trademark oppositions, cancellations and other administrative proceedings in foreign jurisdictions (through network of associated attorneys)
- Trademark litigation in the United States
- Trademark litigation in foreign jurisdictions (through network of associated attorneys)
- COPYRIGHTS
- Ownership searches
- Prosecution of copyright applications in the United States
- Counseling on copyright issues

INTELLECTUAL PROPERTY (continued)

- Copyright enforcement
- Copyright licensing
- Copyright assignments
- Copyright litigation
- Digital Millennium Copyright Act Matters
- Employee work for hire and copyright assignment agreements
- Software Licensing
- Design and development agreements
- TRADE SECRETS
- Counseling on trade secret issues
- Employee trade secret policies and agreements
- Trade secret litigation
- RELATED MATTERS
- Acquisition and Divestiture of patents, trademarks, copyrights and domain names
- Acquisition and Divestiture of companies and divisions with substantial intellectual property
- Secrecy/Confidentiality agreements
- Software licenses and software maintenance agreements
- Software development agreements
- Distribution agreements (U.S. and international)
- Private label manufacturing agreements
- Consulting agreements
- Technical services agreements
- Engineering and design agreements
- Joint research and development agreement
- Joint venture agreements
- IT Services and maintenance agreements Internet privacy policies
- Website Terms of Use
- Electronic Signatures
- Electronic Contracts such as click-wrap agreements and online commerce agreements
- Product Endorsement Agreements
- Counsel on strategic intellectual property issues in product development and business growth

INTERNATIONAL

Types of clients served:

- Foreign and U.S. companies
- Foreign and U.S. individuals, estates and trusts

Experience for U.S. clients abroad includes:

- Disclosure of foreign financial accounts Tax ramifications of doing business in a foreign country
- Special tax or financing incentives for exporters
- Advantages of organizing foreign ventures as subsidiaries, branch offices, joint ventures with a foreign partner, or as licensing or distributorship agreements
- Remedies under foreign law when investments are threatened
- Patent or copyright protection
- Debt settlement
- Negotiation of contracts

Experience for foreign clients in the U.S. includes:

- Effect of federal and state tax laws on a U.S. venture or the repatriation of profits

INTERNATIONAL (continued)

- Acquisition of visas for non-U.S. employees who must be transferred to the U.S.
- Limitation of exposure to lawsuits and litigation
- Compliance with reporting obligations under federal and state law
- Representation in IRS audits
- Negotiation of contracts
- Protection of patents and other intellectual property

Individuals:

- Foreign trust planning for U.S. clients
- U.S. estate planning for foreign clients with U.S. assets

LABOR & EMPLOYMENT

Types of clients served:

- Private and public employers
- Union and non-union employers

Experience includes:

- Arbitrations and mediations
- Litigation involving labor and employee disputes, including discharge as well as civil rights claims
- Counseling employers on employee relations and compliance with labor laws
- Representation before governmental agencies such as the EEOC, NLRB and OSHA and state and federal courts
- Preparation and review of employee handbooks and establishing personnel policies and procedures
- Advice to employers on
  - Employment discrimination
  - Sexual harassment
  - Termination of employees
  - Civil rights
  - ADA, ADEA, FMLA
  - Negligence in the workplace
  - Worker's compensation
  - ERISA
  - WARN
  - Wages, overtime and other FLSA matters
  - Safety compliance
  - Confidentiality agreements and covenants not to compete
- Advice to employers on union issues
  - Fighting unionization and decertifying unions
  - Union organizing drives and elections
  - Strikes and picket line problems Unfair labor practices
  - Collective bargaining
  - Labor contract administration and interpretation
  - Filing litigation seeking to enjoin and seek damages for
    - Mass picketing and violence
    - Secondary boycotts

REAL ESTATE

Types of clients served:

- Corporations
- Partnerships
- Individuals
- Estates and Trusts

Experience includes:

- Commercial Leases: Landlord and Tenant representation
- Negotiation and drafting of real estate contracts
- Title and survey review and curative actions
- Closing agreements and documentation
- Development, financing, purchase and sale of
- Apartment complexes
- Shopping centers
- Office buildings
- Land for developments Corporate real estate and assets
- Advice to in-house corporate counsel on complex real estate issues
- Workouts and foreclosures
- Eminent domain and condemnation

TAX CONTROVERSY

Types of clients served:

- Business entities
- Tax-exempt organizations
- Individuals
- Estates, trusts and other fiduciaries

Experience includes:

- IRS audits
- IRS administrative appeals
- Prefiling advice
  - Disclosures and tax return positions
  - Amended returns and claims for refunds
- Tax litigation
  - Prepayment litigation in U.S. Tax Court
  - Refund litigation in U.S. District Court and Court of Federal Claims
  - Appeals to the U.S. Courts of Appeals and U.S. Supreme Court
- Criminal matters
  - Tax investigations by the IRS
  - Witnesses at grand jury proceedings
  - Investigations and litigation regarding financial crimes
- Recovery of attorney's fees from the U.S. government

TAX CONTROVERSY (continued)

- Damage claims for wrongful disclosure and wrongful collection
- State sales, property and franchise tax audits and litigation
- Jeopardy assessments
- Third party tax liability, including transferees and responsible persons
- Collection matters and offers in compromise
- Employment and excise taxes Income, estate, gift and trust taxation Responding to IRS summonses

TAX PLANNING

Types of clients served:

- Individuals
- Partnerships
- Corporations (closely-held and publicly-owned)
- Professional practices
- Estates, trusts and other fiduciaries
- Public charities
- Charitable funds
- Private foundations
- Investment funds
- Real estate investors and operators
- Financing transactions (e.g., leasing)

Experience includes:

- Capital gain and loss planning
- Taxation of settlements, workouts and bankruptcies
- Like-kind exchanges, passive activity loss implications and other real estate taxation
- Choice of entity, including partnerships, limited liability companies and S corporations
  - Tax planning for professional practices
  - Tax planning for charitable contributors
  - Planning for philanthropic organizations
  - Tax return disclosures and preparation advice
  - Consolidated return taxation
- Taxation of mergers and acquisitions
- Tax accounting issues
- Tax ruling requests
- Tax opinions
- State and local income, property, sales and use, and franchise tax planning
- Representation before the IRS and other governmental agencies

CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & AUGHTRY, P.C.
47th Houston Annual Tax and Business Planning Seminar

EVALUATION

Your comments and suggestions are valuable to us. Please complete this evaluation and place it on the on-site registration table as you exit the seminar.

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

	Knowledge of Subject Matter	Quality of Presentation	Content of Speech	Quality of Outline
LUNCHEON PRESENTATION				
Charles "Chuck" Rettig	_____	_____	_____	_____
1A. Keeping the Peace in the House of the Dragon: Tax and Business Considerations with Company Succession to Avoid an Intercompany Civil War				
Habeeb "Hobbs" Gnaim	_____	_____	_____	_____
1B. Pandora's Algorithm: The Promise and Perils of AI in Taxation				
Aly Dossa	_____	_____	_____	_____
Marcus Burnside	_____	_____	_____	_____
2A. JUDICIAL HIGHLIGHTS				
Alissa Gipson	_____	_____	_____	_____
Jonathan Stasney	_____	_____	_____	_____
2B. Foreign Entity, Asset and Transaction Reporting That You and Your Clients Need to Know About				
Sebastien N. Chain	_____	_____	_____	_____
J. Otto Timm	_____	_____	_____	_____
3A. The FAIR Tax				
George W. Connelly	_____	_____	_____	_____

3B. When a Nothing Turns Into a Something: Working with Disregarded Entities and Grantor Trusts in Estate Planning

Brett T. Berly _____ _____ _____ _____

Tyler Williams _____ _____ _____ _____

4A. Navigating the Corporate Transparency Act: Real-World Insights and Compliance Strategies

Jack Najarian _____ _____ _____ _____

Luz E. Villegas-Banuelos _____ _____ _____ _____

4B. Texas Sales and Use and Franchise Tax Updates

Bryan J. Dotson _____ _____ _____ _____

Quality of Meeting Space?_____ Quality of Food?_____ Convenience of Location?_____

Were prerequisites necessary or desirable for this course?_____

Were the objectives met?_____

How can we improve our seminars?_____

Please suggest future seminar topics that would interest you:

_____

Would you be interested in our attorneys presenting an in-house CPE program at your firm? YES NO

If yes, please list the topics that would interest you:_____

Would you like an attorney to call you in order to answer a specific question you have? _____

Other comments and suggestions are welcome:_____

Please take a moment to circle the information below that describes your situation:

- Size of Firm/Company: 1-9 10-24 25+
- Years Attending Chamberlain Hrdlicka Annual Seminars: 1-2 3-5 6-10 11+
- CLE and CPE Sources: HCTSCPA Seminars State Bar Seminars Tapes/Internet Other

_____
Please Print Your Name (Optional)

_____
Your Phone Number (Optional)

_____
E-Mail (Optional)

Chamberlain Hrdlicka
Attorneys at Law

BIOGRAPHIES

Charles "Chuck" Rettig

Chuck a Shareholder at Chamberlain Hrdlicka in the Firm's Tax Controversy & Litigation practice and other Tax and Trust & Estate practices, served as Commissioner of the Internal Revenue Service (IRS) from 2018 through 2022.

As a member of Chamberlain Hrdlicka's Tax Controversy & Litigation Practice, he draws on both his extensive background representing taxpayers and his deep knowledge of the IRS organization, operations and procedures in work for his clients. His practice focuses on tax, federal and state tax controversies and investigations, including sensitive issue examinations, administrative appeals, civil tax litigation, and representation in criminal tax investigations and prosecutions.

As IRS Commissioner, Chuck presided over the nation's tax system, which collected more than $4.9 trillion in tax revenue in FY22, representing about 96% of the total gross receipts of the United States. He managed an agency of about 83,000 employees and a budget of more than $14.1 billion. During his tenure, he focused on improving service to the nation's taxpayers, balancing appropriate enforcement of the nation's tax laws while respecting taxpayer rights, with a particular focus on traditionally underserved communities. In recognition of his leadership of the IRS, Chuck received the Alexander Hamilton Award from Treasury, the highest honor for individuals selected by the Secretary, whose performance and leadership demonstrate the highest standards of and dedication to public service benefiting our country.

Chuck came to the IRS from a background of defending tax papers in tax controversies, and he put those insights to use while at the IRS. He was often referred to as the "straight shooting" Commissioner, who worked closely with his Division Commissioners in Criminal Investigation, Large Business & International, Small Business/Self Employed, Wage & Investment, and Tax-Exempt & Government Entities to build new enforcement programs and decide how to allocate enforcement resources. A senior Senator on the U.S. Senate Finance Committee once stated, "Although we didn't always agree, Rettig called balls and strikes fairly."

Before heading to the IRS, Chuck spent 36 years with an esteemed tax law firm in Beverly Hills, California. Where he represented high-net worth individuals, businesses, and corporate taxpayers before the IRS, the Department of Justice Tax Division, federal and state courts and state taxing authorities. Significantly, he earned a reputation for helping his clients resolve disputes with taxing authorities. Although Chuck mounted vigorous defenses for clients and would go to court when necessary, he was adept at resolving matters without litigation, enabling his clients to move their businesses and lives forward as quickly as possible.

Chuck has been a featured speaker and panelist at hundreds of professional conferences throughout the U.S., in Europe and in Central America. Before joining the IRS, Chuck Retting was listed by Chambers USA as the only Eminent Practitioner in the category "Tax: Fraud – Nationwide." On multiple occasions, he was selected by his peers as the Tax "Lawyer of the Year" (Litigation and Controversy, Los Angeles) for Best Lawyers' and was included Nationwide in both "Litigation and Controversy – Tax" and "Tax Law" by Best Lawyers in America.

Chuck received a B.A. in Economics from the University of California at Los Angeles (UCLA), as well as a J.D. with honors from Pepperdine University School of Law and an LL.M. in taxation from the New York University School of Law.

1A: Keeping the Peace in the House of the Dragon: Tax and Business Consideration with Company Succession to Avoid an Intercompany Civil War

Habeeb “Hobbs” Gnaim

Hobbs Gnaim is a Shareholder with the law firm of Chamberlain Hrdlicka and serves as the Practice Chair of the Firm's Tax Planning & Business Transactions Group. Hobbs previously served on the Firm's Board of Directors and as Co-Head of the Firm's Recruiting Program.

Hobbs focuses his practice on tax and corporate matters, including the formation, governance, reorganization and internal restructuring of corporations, partnerships and limited liability companies to achieve tax and corporate objectives. Hobbs has significant experience in all aspects of structuring, negotiating and implementing business acquisitions and dispositions, corporate reorganizations, mergers, conversions, recapitalizations, deferred recognition transactions, admissions of and providing equity incentives for management and key employees, as well as choice of entity considerations, and state tax planning.

Hobbs also has significant experience in working with family-owned or closely-held businesses on the design and implementation of business succession plans or business separation matters. Hobbs' practice also includes consulting with families on the formation and governance of Family Limited Partnerships (FLPs) and similar holding company structures or vehicles to achieve planning objectives. He also advises individuals in personal divorce matters, along with their primary divorce counsel, on tax and corporate issues that arise with the division of complex marital estates involving substantial assets and entities.

Hobbs grew up in Pearland, Texas and has been with Chamberlain Hrdlicka since the beginning of his career as an attorney. He received his law degree from Southern Methodist University School of Law, and a Masters of Tax Law from Georgetown University Law Center.

For many years, Hobbs has been recognized by various publications or organizations, including the following:

- Winner, Lawyer of the Year, Annual M&A Atlas Awards held in New York City
- Finalist, Dealmaker of the Year, Texas Legal Awards by Texas Monthly
- Finalist, Legal Advisor of the Year, M&A Advisor Awards held in New York City
- Listed, Top 50: Americas M&A Lawyers by Global M&A Network
- Listed, Chambers USA: America's Leading Lawyers for Business (Tax) (multiple years)
- Listed, International Tax Review World Tax, Highly Regarded in General Corporate Tax
- Listed, Best Lawyers in America (multiple years)
- Recognized as a "Texas Super Lawyer" by Thomson Reuters (multiple years)
- Winner, Deal of the Year, Association of Corporate Growth Annual Deal of the Year Awards (multiple time winner in multiple years in various categories)
- Winner, Deal of the Year, Annual M&A Advisor Awards held in New York City (multiple time winner in various categories)

(Georgetown University Law Center, LL.M. in Taxation, with Distinction; Southern Methodist University School of Law, J.D.; University of St. Thomas, B.B.A. in Economics, *summa cum laude*).

1B: Pandora's Algorithm: The Promise and Perils of AI in Taxation

Aly Dossa

Aly Dossa is a shareholder and patent attorney with over twenty-three years of experience, specializing in intellectual property counseling and litigation for companies of all sizes, from startups to Fortune 100 corporations. He currently chairs both the Intellectual Property Practice and the Data Security & Privacy Practice at Chamberlain Hrdlicka, where he combines his deep legal knowledge and technical background to offer businesses strategic guidance in managing their most valuable assets.

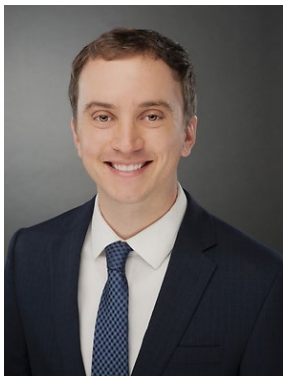
In his role as chair of the Intellectual Property Practice, Aly focuses on developing and executing global intellectual property strategies, including domestic and foreign patent prosecution and brand management. He has extensive experience drafting and negotiating licenses, providing non-infringement and invalidity opinions, and conducting due diligence for high-stakes transactions. Aly's expertise spans various industries, allowing him to craft innovative legal solutions that protect his clients' intellectual property and ensure long-term competitive advantages.

As chair of the Data Security & Privacy Practice, Aly helps clients navigate the complex and rapidly evolving regulatory landscape surrounding data privacy and cybersecurity. He advises on privacy compliance, cross-border data transfers, and incident response for data breaches, drawing on his certifications as a Certified Information Privacy Professional (CIPP/US) and Certified Information Privacy Manager (CIPM). Aly's in-depth understanding of data flows and security protocols enables him to provide forward-thinking legal strategies that mitigate risks while ensuring regulatory compliance across jurisdictions.

For several years, Aly has been included among *The Best Lawyers in America®*, by *Texas Monthly Magazine*, as a "Rising Star" and Houstonia Magazine as one of Houston's top lawyers.

(Queen's University, Canada, B.S., first class honors, Engineering Chemistry, 2001; Queen's University, Canada, B.S., with distinction, Computer Science, 2001; University of Houston Law Center, J.D., 2005)

Marcus Burnside



Marcus Burnside is an expert in intellectual property, data security and privacy law, and the complex legal challenges at the intersection of technology and law. With a deep understanding of both technical and legal domains, Marcus provides strategic guidance to clients navigating issues related to emerging technologies, data privacy, and intellectual property protection. His expertise includes advising on regulatory compliance, managing risks associated with artificial intelligence, and safeguarding sensitive data and intellectual property assets.

To that end, Marcus assists client with all aspects of obtaining patent, trademark, and copyright rights; enforcing trademark and copyright rights; enacting and maintaining organizational policies and practices relating to data privacy, cybersecurity, and artificial intelligence; and negotiating and managing both inbound and outbound contracts, particularly ones that implicate technology or data.

Marcus has earned a certification as a Certified Information Privacy Professional (CIPP/US) through the International Association of Privacy Professionals.

(University of Houston Law Center, J.D.; University of Houston, M.S., Electrical Engineering; University of Texas at Dallas, B.S., Mechanical Engineering)

2A: Judicial Highlights

Alissa Gipson

Alissa Gipson is an Associate in the Tax Controversy, International Tax, State and Local Tax and Tax Planning sections in the Houston office. Ms. Gipson's experience includes assisting clients with examinations and administrative appeals, state and local tax controversies, cross border civil and criminal tax matters, trust and estate matters, overseas tax effects, white-collar criminal defense and investigations, Affordable Care Act tax requirements and domestic and international tax planning matters.

Ms. Gipson is a member of the Firm's Diversity and Attorney Development Committee, Recruiting Committee and Pro Bono Committee. Ms. Gipson is also active in several community organizations, including as a member of the Steering Committee of the University of Houston Law Center's Black Law Alumni organization and a mentor with the University of Houston Law Center's Pipeline Program. She recently co-authored an article on Diversity, Inclusion and Retention in Law Firms for The Legal Intelligencer and has since presented the topic for a Thomson Reuters CLE and the Federal Bar Association's Section on Taxation.

(Texas A&M University, magna cum laude, President's Endowed Scholar, B.A. Business Honors and Marketing, 2011; University of Houston Law Center, J.D., 2016; University of Houston Law Center, LL.M., Taxation, 2017).

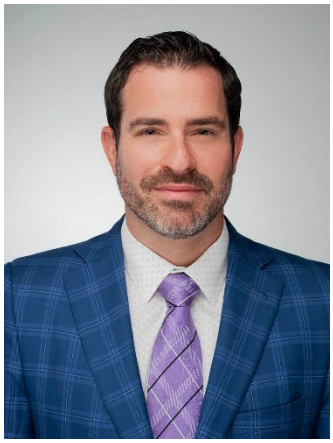
Jonathan Stasney

Jonathan Stasney is an associate in the Tax Controversy Practice Group. Prior to attending law school, Jonathan worked as a CPA in State and Local Tax at a Big Four accounting firm. He also was a tax analysist in the U.S. Tax Department at a multinational insurance underwriter.

(University of Houston Law Center, J.D. and L.L.M. in Taxation, 2023; Texas A&M University, Masters in Accounting, *cum laude*, 2014; Texas A&M University, B.S. in Accounting, cum laude, 2013)

2B: Foreign Entity, Asset and Transaction Reporting That You and Your Clients Need to Know About

Sebastien N. Chain



Sebastien Chain is a shareholder in the firm's Tax Controversy and International Tax sections. He concentrates his practice on federal and cross border civil and criminal tax matters, and represents clients at the examination level, administrative appeals, trial, and appeal. He also represents individuals and entities in domestic and international tax planning matters with particular emphasis on cross-border income and estate planning for high net worth dual resident families. Mr. Chain is also an active member of the Tax Sections of the American and Houston Bar Associations and has been named a Texas Rising Star since 2017.

(University of Texas at Austin, B.A., Honors, 2005; University of Houston Law Center, J.D., *cum laude*, 2010; Georgetown University Law Center, LL.M. Taxation, Honors, 2011)

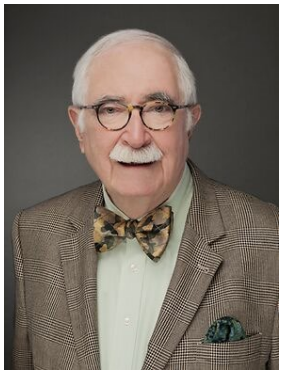
J. Otto Timm

Otto Timm is an associate attorney in the firm's Houston office and is a part of the International Tax and Tax Controversy practice groups. Otto assists international individuals and businesses with U.S. tax planning for a variety of issues, including U.S. taxation of inbound and outbound transactions, pre-immigration planning for U.S. income and estate taxes and pre-expatriation tax planning. Otto also assists individuals and businesses with U.S. tax compliance issues related to foreign assets and foreign companies.

(University of Houston Law Center, LL.M. in Taxation, 2020; Emory University School of Law, J.D., 2019; Pitzer College, B.A. in Anthropology, 2013)

3A: The FAIR Tax

George W. Connelly



George Connelly is recognized as one of the leading federal tax litigators in the United States. His practice focuses on IRS audit, collection and criminal matters including civil and criminal tax litigation matters, for clients including individuals, companies and estates. In a distinguished career spanning decades, he has achieved over 60 reported opinions in tax cases, and has received numerous honors and awards from governmental bodies and professional organizations.

George gained perspective and insight into the workings of the federal tax system as a lawyer with the Internal Revenue Service. In his 15-year career with the IRS, he established relationships that continue to the present day. George served at many levels, in the Office of Chief Counsel, as a Special Trial Attorney for the North-Atlantic Region in Buffalo, New York, and as the Legal advisor to the Buffalo, New York, District Director and the Buffalo Appeals Office for criminal, examination and collection divisions; and as the Tax Shelter Coordinator for nine years, from 1976 to 1985. George also served as an Instructor for the Chief Counsel's National Trial Attorney Training Program, lecturing on evidence and cross-examination; and as the Leader of Task Forces (1979, 1980) charged with the creation of the Regional Trial Attorney Training Program and the Redesign of the National Program.

In addition to serving as past Tax Controversy Practice Leader, George has assumed a leadership role within the Firm, participating for many years on the Business Development Committee and as Head of the Entry Level Recruiting Committee from 1999 - 2000 and 2003 - 2005, as well as participating on many other Firm committees.

(Northwestern University, J.D., 1971; Northwestern University, B.S., B.A., 1967)

3B: When a Nothing Turns Into a Something: Working with Disregarded Entities and Grantor Trusts in Estate Planning

Brett T. Berly

Brett Berly is a Shareholder in the Trusts & Estates Section of the law firm of Chamberlain, Hrdlicka, White, Williams & Aughtry, P.C. Brett's practice focuses on the representation of high net-worth individuals and fiduciaries of trusts and estates with respect to estate planning, probate, estate administration, and closely-held business planning and fiduciary litigation. While in law school, Brett was a recipient of the Marvin Key Collie Endowed Presidential Scholarship in Tax Law and worked as the Research Assistant for the distinguished Professor Stanley M. Johanson.

Brett is Board Certified in Estate Planning and Probate Law by the Texas Board of Legal Specialization and is a former member of that organization's Exam Commission. Brett serves on the Board of Directors of the Houston Estate and Financial Forum. He is also a Fellow of the Texas Bar Foundation and a member of the American Bar Association, Section of Real Property, Probate and Trust; the State Bar of Texas, Real Estate, Probate and Trusts Sections; the Houston Bar Association, Trusts and Estates Section; and the Houston Business and Estate Planning Counsel.

Brett has consistently been recognized as among the best in his field by Best Lawyers in America, Chambers USA: America's Leading Lawyers for Business, and Texas Super Lawyers.

Brett serves on the Advisory Board of Directors of Camp For All, an organization that provides a barrier-free camping experience for children with disabilities and illnesses, and is a past chairman of Camp For All's Young Professionals Board of Directors. Brett and his wife, Dawn, are also very active in Adoptive Families of Houston, which is focused on benefiting adoptive families and children through education, guidance and support by professionals and parents who have shared in the unique experience of adoption.

(University of Texas at Austin, B.A., with honors, 2001; University of Texas School of Law, J.D., with honors, 2005).

Tyler Williams

Tyler Williams is an associate in the Firm's Trusts & Estates section in the Houston office. His main focus is assisting high net worth clients with various aspects of estate, gift and generation-skipping tax planning. Additionally, Tyler's practice extends to probate and estate administration; and the preparation of federal gift and estate tax returns.

(South Texas College of Law Houston, J.D., Valedictorian, 2022; Texas A&M University, B.S., Industrial Distribution, 2011)

4A: Navigating the Corporate Transparency Act: Real-World Insights and Compliance Strategies

Jack Najarian

Jack Najarian is a shareholder in the Corporate, Securities & Finance practice group. Jack is dedicated to helping middle-market businesses, their owners, and high net worth individuals navigate a wide range of legal needs. With a focus on mergers and acquisitions, corporate law, business formation, commercial real estate transactions, and commercial leasing, among other areas, he brings a wealth of knowledge and experience to every client interaction.

Jack understands that every business and individual has unique legal needs, and he works closely with each of his clients to provide tailored legal solutions that help them achieve their goals while minimizing risk. Whether you are buying or selling a business or real estate, starting a new venture, or need legal advice on leasing, taxes, IP issues, employment matters, bankruptcy, or estate planning, Jack is able to help or work with a colleague to meet your needs.

Additionally, Jack hosts the Middle Market Dojo Podcast, where he interviews business leaders, entrepreneurs, and experts in various fields to share insights and best practices on navigating the middle market. Please don't hesitate to reach out if you'd like to discuss your legal needs or be a guest on the podcast.

(University of Illinois College of Law, J.D., *magna cum laude*, 2012; University of Houston Honors College, B.A. in Economics, Political Science, Classical Studies Minor, University Honors with Honors in Major, Class of 2009)

Luz E. Villegan-Bañuelos

Luz E. Villegas-Bañuelos is an associate in the International Tax practice in San Antonio. She assists multinational individuals and families with a wide range of international and U.S. tax law issues, including pre-immigration planning, expatriation, as well as international estate and tax planning. Luz assists a broad range of international clients with cross-border business and tax-related planning, tax compliance, and assists clients in disputes with different government taxing agencies including the Internal Revenue Service.

(University of San Diego School of Law, J.D., *magna cum laude*, 2019; Law degree from CETYS Universidad in Baja California, Mexico, with highest honors)

4B: Texas Sales and Use and Franchise Tax Updates

Bryan J. Dotson

Bryan Dotson is senior counsel in the Tax Controversy & Litigation practice. A talented litigator, Mr. Dotson has a proven track record of obtaining favorable results in disputes with taxing authorities at the state and federal levels. Mr. Dotson has the skillset, experience, and professionalism to successfully resolve a dispute with a taxing authority (federal, state, or local) of any type of tax (income, franchise, sales, etc.).

Mr. Dotson started his career at the Internal Revenue Service where his primary responsibility was to represent the IRS before the United States Tax Court. At the IRS, Mr. Dotson was regularly recognized for his trial work, receiving several awards and regularly serving as an instructor at various courses designed to train IRS attorneys on trial practice and procedure. His experience at the IRS covered every stage of the tax reporting and collecting process, from reviewing returns to collection alternatives and bankruptcy.

Mr. Dotson has handled matters in various areas including sales and use tax, state corporate income tax (including the Texas franchise and margin taxes), motor vehicle sales tax, oil and gas severance tax, insurance tax, motor fuels tax, mixed beverage tax, tobacco products tax, unclaimed property, tax credits/incentives, nexus disputes, audits, hearings, trials and appeals, tax collection cases, voluntary disclosure agreements, letter rulings, and open records requests.

(Texas Tech University, J.D., 2011; Texas Tech University, M.S., 2011; University of Houston, B.A., 2007)

A Look Inside IRS Operations

Predictions About the Future Based On a Behind the Scenes Look at the Past

Charles P. Rettig

Former Commissioner (2018-2022)
Internal Revenue Service

Chamberlain Hrdlicka
404.658.5446 310.503.1300
charles.rettig@chamberlainlaw.com
Houston ● Atlanta ● Philadelphia ● San Antonio ● Los Angeles
ChamberlainLaw.com

Overview

- Evolving role for the IRS in administering the tax law
- Structural headwinds for the IRS, particularly in the context of administering tax expenditure programs
- Legacy institutional challenges for the IRS
- The Inflation Reduction Act (IRA) as a watershed moment
- Challenges and opportunities going forward

Charles P. Rettig

Chamberlain Hrdlicka – Los Angeles, Houston, Atlanta, Philadelphia, San Antonio
***Former* Commissioner, Internal Revenue Service, Washington, D.C. (2018-2022)**

CHUCK RETTIG served as the 49th Commissioner of the IRS, presiding over the nation's tax system from 2018-2022, managing an agency of about 83,000 employees and an annual budget of more than $14.1 billion generating annual gross revenue in FY22 of approximately $4.9 trillion (representing more than 95% of the gross revenue of the United States). Throughout, Commissioner Rettig was focused on improving taxpayer services while balancing fair and impartial enforcement of the nation's tax laws.

During the COVID-19 pandemic, following a shutdown of more than 500 IRS facilities around the world and a transition into a more virtual operation, the IRS processed more than $1.5 trillion in record economic relief and individual refunds. As part of a larger outreach effort to reach underserved communities, the IRS has new, meaningful relationships with more than 18,000 community organizations and 13,000 public school districts. Simultaneously, IRS also aggressively pursued multi-lingual, multi-cultural efforts expanding outreach and assistance in multiple languages, including, for the first time, providing the Individual Income Tax Return, Form 1040 (tax years 2020–2022), in a language other than English (Spanish). Taxpayers can now also instruct the IRS to contact them in writing in a language other than English. Basic tax information is newly available in 20 languages on IRS.GOV. During FY22, there were more than 90 million visits to the non-English pages on IRS.gov, most of which did not previously exist.

Commissioner Rettig has represented the United States in foreign travels, including trips to Santiago, Chile and Paris, France. According to the Commissioner Engagement and Outreach Team, his strong support of the IRS workforce throughout his term resulted in visits to 65 PODs in 23 states and US territories, potentially engaging 48,487 IRS employees (directly and virtually) while he also engaged with more than 400,000 external stakeholders (based on information provided by event organizers) in presentations around the country.

Among numerous professional honors and lifetime achievement awards received during his career, Commissioner Rettig received the Alexander Hamilton Award from Treasury - the highest honor for individuals whose performance and leadership demonstrate the highest standards of and dedication to public service benefiting our country.

Charles P. Rettig

Chamberlain Hrdlicka – Los Angeles, Houston, Atlanta, Philadelphia, San Antonio
***Former* Commissioner, Internal Revenue Service, Washington, D.C. (2018-2022)**

Mr. Rettig is a Shareholder at Chamberlain Hrdlicka, based in Los Angeles, with offices in Houston, Atlanta, Philadelphia and San Antonio. For more than 36 years, before joining the IRS, Mr. Rettig represented thousands of individuals, businesses and corporate taxpayers before the IRS, the Department of Justice Tax Division, federal and state courts and state taxing authorities. As then stated in the Chambers USA: America's Leading Lawyers for Business, "According to peers, Charles Rettig . . . is 'phenomenal, just phenomenal.' Further, he "is regarded by market sources as a 'brilliant and gifted lawyer . . . a real star and a national leader'" who "enjoys a superb reputation and benefits from 'great presence.'" Chambers USA has further stated "Fantastic controversy tax lawyer" Charles Rettig is "knowledgeable and very intelligent . . .a force to be reckoned with . . .a driving force in policy making at the national level with great client skills when it comes to sensitive matters."

Mr. Rettig has held leadership roles in a number of professional organizations, most recently serving as Vice Chair-Administration, for the American Bar Association's Section of Taxation, Chair of the UCLA Annual Tax Controversy Institute for almost 20 years, and President of the American College of Tax Counsel. He was a member of the IRS Advisory Council (IRSAC) for three years beginning in 2008, and served as IRSAC's Chair from 2010 to 2011. He also served as Chair of the Taxation Section of the State Bar of California and has served on the advisory boards of both the CA Franchise Tax Board and the CA Board of Equalization. He is a Certified Specialist both in Taxation Law and in Estate Planning, Trust & Probate Law (The State Bar of California, Board of Legal Specialization) admitted to practice law in California, Hawai'i and Arizona (inactive).

Chuck Rettig was listed by Chambers USA as the only Eminent Practitioner in the Chambers Category "Tax: Fraud – Nationwide." He was selected by his peers as the 2016, 2017 and 2018 Tax "Lawyer of the Year" (Litigation and Controversy, Los Angeles) for Best Lawyers' and was included Nationwide in both "Litigation and Controversy – Tax" and "Tax Law" by Best Lawyers in America.

Chuck Rettig is a co-founder of the UCLA Extension VETS COUNT Scholarship Fund designed to provide scholarships for active duty and retired military personnel who are working to realize their career goals in tax, accounting, and wealth management.

"Rettig's Legacy: The Straight-Shooting COVID Commissioner"

- "**He was a cheerleader for the agency,** and for its employees. **He did a remarkable job connecting the IRS staff to their role as public servants and stuck to that message in a consistent, enthusiastic, and effective way.**
- He really made a **commitment to reaching out to underserved communities.**
- **The Commissioner was an effective defender of the IRS in front of Congress, a 'straight shooter' who at times could come off as aggressive.** You could tell he was a tax litigator – he'll come at you."
- "Rettig regularly pushed Congress to provide consistent, sufficient, long-term funding for the agency to modernize and perform all the tasks lawmakers demand of it. **And in the end, he got what he wanted and then some: nearly $80 billion extra to spend over 10 years. . . . He'll be leaving the new guy with an agency that will be much better positioned to start addressing some of the problems**.
- I think it's fair to say that **he was an honest broker**."
  - Tax Notes (November 11, 2022)

The *Privilege* of Tax Administration Belongs to Everyone

- "**Congress should start helping the IRS earn the trust and respect of the American people rather than attack it for political gain**. . . . I want Congress to be proud of the IRS. **I want the American people to be proud of the IRS.** I want tax professionals to be proud of the IRS."
  - Charles Rettig, Tax Notes (December 19, 2022)
- "The next IRS Commissioner must also demonstrate he can be a fair, consistent and impartial umpire for taxpayers, rather than reflexively pro-IRS. **While I did not always agree with former Commissioner Rettig, he was consistent and called balls and strikes the same for everyone."**
  - U.S. Senator Mike Crapo (R-Idaho), Ranking Member of the U.S. Senate Finance Committee, February 15, 2023)

IRS Implementation of *Numerous* Tax-Related Provisions
Seven Major Laws Enacted December 2017 – December 2022

- **TCJA - Tax Cuts and Jobs Act** (December 22, 2017)
- **SECURE -Setting Every Community Up for Retirement Enhancement Act of 2019** (December 20, 2019)
- **CARES - Coronavirus Aid, Relief, and Economic Security Act** (March 27, 2020)
- **CAA - Consolidated Appropriations Act of 2021** (December 27, 2020)
- **ARPA - American Rescue Plan Act of 2021** (March 11, 2021)
- **IRA22 - Inflation Reduction Act of 2022** (August 16, 2022)
- **SECURE 2.0 Act** (December 29, 2022)

Pre-IRA22 - Quick Look at IRS IT Operations

- **IRS maintains *two* Level 5 computing centers**
  - One of bigger **networks** in the world
  - Maintains 63 separate operating systems
    - Resilient duplication to assure performance
  - IRS has among the ***largest***
    - **Call centers** in the world
    - **Processing sites** in the world
    - **Collection processing systems** in the world
    - **Law firms** in the world

Pre-IRA22 - Quick Look at IRS IT Operations

- **Technological advances have helped**
  - **Advances haven't kept pace with the IRS' ever-increasing responsibilities and challenges**
  - IRS has been **unable to invest in new – spends to keep it going or builds new internally**
- **Significant O&M annual costs increase risks of failure year after year**
  - O&M costs often account for 70-80% of IT annual spend
  - As a result, without Modernization, the Operations Support budget is spent on O&M

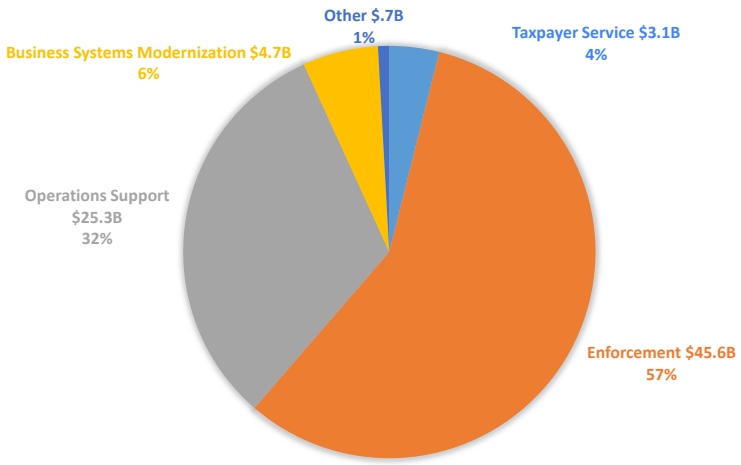
Inflation Reduction Act, Pub. L. No. 117-169

Enacted August 16, 2022, providing $79.6 billion in special 10-year IRS funding

- **$45.6 billion** for **TAX ENFORCEMENT** activities including hiring new examination agents, providing legal support and investing in "investigative technology," including to monitor and enforce taxes on digital assets such as cryptocurrency.
- **$25.3 billion** for **OPERATIONS SUPPORT**, including improved telecommunications and information technology, security, rent, facilities, printing, and postage
- **$3.2 billion** for **TAXPAYER SERVICES** including filing support and account services, pre-filing assistance and education
- **$4.8 billion** for **BUSINESS SYSTEMS MODERNIZATION** to upgrade systems used to administer taxpayer services, operations and cybersecurity

IRS Funding Under Inflation Reduction Act

(as originally enacted)



Inflation Reduction Act, Pub. L. No. 117-169

Baseline IRS Enforcement	2017	2018	2019	2020	2021	2022	2023	2020-2023 Average
(in $ billions)	$4.7	$4.7	$4.6	$4.8	$5.0	$5.4	$5.4	$4.9

- $45.6 billion for tax enforcement activities averaged over 10 years equates to annual additional enforcement spending of $4.6 billion per year, a 98% increase over the enacted average enforcement budget from FY 2017 through FY 2023
- Baseline amounts and averages do not take into account:
  - Inflation, including the 8.7% cost of living adjustment for FY 2023 alone
  - Increased IRS program responsibilities, *e.g.*, clean energy provisions enacted as part of the IRA

Fiscal Responsibility Act of 2023, Pub. L. No. 118-5

Debt ceiling legislation signed into law on June 3, 2023

- **Rescinds $1.4 billion in previously authorized FY 2023** funding for IRS "enforcement and related activities"
- Also understood to **repurpose an additional $20 billion in FY 2024 and FY 2025** IRS funding, haircutting the $79.6 billion in funding provided for by the IRA

Secretary Yellen's Directive to Commissioner Rettig re IRA Funding August 10, 2022

- Additional funding provided for by the IRA would, in part, be allocated to clearing the IRS's processing backlog, **improving customer service**, **overhauling technology**, and **hiring new employees to replace retiring workers**
- **DIRECTS that the increased funding resources -** including any new personnel or auditors that are hired -
  - **"SHALL NOT BE USED to INCREASE THE SHARE of AUDITED SMALL BUSINESS or HOUSEHOLDS BELOW THE $400,000 THRESHOLD** relative to historical levels."
  - **"ENFORCEMENT RESOURCES WILL FOCUS ON HIGH-END NONCOMPLIANCE . . .** to pursue a **robust attack** on the tax gap by targeting . . . **LARGE CORPORATIONS, HIGH-NET-WORTH INDIVIDUALS and COMPLEX PASS-THRU** Entities

IRS Strategic Operating Plan (April 6, 2023)

- **Plan includes 42 key initiatives, 190 key projects designed to help taxpayers, the tax community and the nation**
- **Organized around FIVE OBJECTIVES:**
  - **Dramatically Improve Services** to help taxpayers meet their obligations and receive the tax incentives for which they are eligible
  - **Quickly Resolve Taxpayer Issues** when they arise
  - **Focus on Expanded Enforcement**
    - On taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap
  - **Deliver Cutting-edge Technology**, data and analytics to operate more effectively
  - **Attract, Retain and Empower a Highly Skilled, Diverse Workforce** and develop a culture that is better equipped to deliver results for taxpayers.

IRS Strategic Operating Plan (April 6, 2023)

Expanded Tax Enforcement Efforts -

- **Expand the Use of Data Analytics**
  - With more centralization of audit selection
- **Expand Large *Corporate* Enforcement**
- **Expand Large *Partnership* Enforcement**
  - 75 largest partnerships will be audited
  - Looking for discrepancies in balance sheets
- **Expand *High-Income and High Net Worth* Enforcement**
- **Expand Employment, Estate and Gift, and Excise Tax Enforcement**

IRS Agency-Wide Focus Areas

- Improved service
- Paperless
- Online account
- Technology modernization
- Data access and infrastructure improvements
- Human capital growth and improvements
- Growth and improvement in enforcement

Global High Wealth Program

- Business and financial enterprises controlled by individuals with assets or earnings in the tens of millions of dollars
- Unified, holistic look at the entire web of business entities controlled by a high wealth individual to better understand the entire economic picture of the entire and to assess the tax compliance of that overall enterprise
- Enterprise analysis of related trusts, private foundations, flow thru entities, real estate investments, privately held corporations, etc.
- Exam teams comprised of flow-through specialists, international examiners, economists to identify economic trends, appraisal experts to advise on valuation issues, and technical advisors to provide industry or specialized tax expertise
- Inter-operating division cooperation (i.e. TEGE / CI / SBSE)

REAL WORLD ENFORCEMENT CHALLENGES

- New and expanded paths for enforcement beyond traditional audits -
  - Examples of how current system presents resolution challenges, *e.g.*, transfer pricing, FTC redeterminations, valuation issues, basis
  - Expand Compliance Assurance Process (CAP), including for large partnerships
  - Implement industry, issue, and taxpayer-specific resolution programs

Improving Compliance Through Service and Certainty

- Improve compliance for all taxpayers
  - Better customer service
  - More opportunities for taxpayers to promptly and easily correct issues
  - Expanding tools to provide tax certainty, including adequate legal guidance
  - Appropriate enforcement

Selected Accomplishments Taxpayer Services

- **Modernizing IRS Information Technology Infrastructure –** Goal of reducing paper volume, increasing access to digital data and preparing our agency to manage digital data
  - **IRS Forms Online** - Implementing adaptive forms that are mobile, fillable and can be submitted directly to the IRS eventually converting all 1,400 forms available on IRS.gov
  - **Accelerate processing and resolution -** investing in developing machine learning capabilities to leverage the information IRS collects to better identify tax returns for compliance review
- **Enhancing Digital Services**
  - Digital options for taxpayers and tax professionals are fundamental to effective tax administration
  - Ability of taxpayers to transact much of their business with the IRS digitally
    - Including through their mobile devices
  - Online accounts, secure two-way communications, text chat, expanded ability to check the status of returns and payments, and more . . .
- **Taxpayer Digital Communications (TDC)** -Expand functionality to allow taxpayers to securely exchange digital information and messages with the IRS
- **In-Person Assistance –** Taxpayer Assistance Centers (TACs) – 360 around the country helped 900,000 taxpayers, many had special Saturday hours during filing season

Selected Accomplishments Taxpayer Services

- ***New* Taxpayer Experience Office**
  - **Customer call-back** on 70+% of toll-free lines
  - **Leveraged Available Resources**
    - Voice Bots – First 9 weeks, handled more than 1 million calls
    - Chat Bots – English and Spanish
    - Online live assistors
- ***Expanded* self-service options & taxpayer online account portal**
  - 120+ million sessions in FY21/FY22
  - On-line payment agreement
  - Request transcripts
  - Request identity protection pin
  - Update personal information
- **Significant focus on enhancing services to**
  - Lower income taxpayers
  - Underserved and diverse communities (ESL)

Selected Accomplishments Taxpayer Services

- **Enhanced safeguarding IRS Systems and Taxpayer Data**
  - ***Always* a top priority**
  - Protecting against more than 1.5 billion cyber attacks annually
- **Expanding Services to Diverse Communities**
  - **Expanding Multilingual Efforts** - Form 1040 in Spanish with a number of new offerings. Converted Form 1040 and its main schedules, as well as Form 1040 NR, Form 1040 SR, Form W-4 and six publications, into Spanish Braille, text, audio and large print
    - New Form 9000, Alternative Media Preference, allows taxpayers to request receipt of IRS notices in Braille, large print, audio, or text, and can be filed alone or with the 1040
  - **Mississippi Delta Outreach Initiative -** Educating taxpayers in Louisiana and Mississippi about child-related tax credits, partnered with local churches, reached 1.4 million students
  - **Puerto Rico Hiring Initiative** - In FY2022, the IRS embarked on a significant expansion of IRS operations in Puerto Rico, to better serve Spanish-speaking taxpayers in the United States and provide an economic boost to a high-poverty area
  - **Mississippi Delta Hiring Initiative -** In November 2021, IRS started an innovative pilot program to help people in communities across America rise out of poverty by pursuing a career at the IRS as contact representatives, individual taxpayer assistant specialists and compliance personnel. We started in the Mississippi Delta region, an area of the country that currently has the highest rate of poverty (19.58%) in the United States

Selected Accomplishments Taxpayer Services

- ***New* Virtual Service Tools**
  - Large file transfers, electronic signatures, electronic submission of authorization forms
- **QR codes added on improved landing pages of IRS.gov**
- **Created Multilingual Initiative (MLI) -** Expanded language channels
- **Created Lifting Communities Up Initiative**
  - Recruiting and expanding IRS facilities in underserved communities
- **Expanded Social Media**
  - 1.5 million followers on LinkedIn, Facebook, Twitter, etc.

IRS COMPLIANCE Strategies

- **Since the IRA22 funds are phased in over a 10-year horizon, Treasury has stated that the overall IRS workforce should grow each year by no more than a "manageable 15%"**
- **Efforts to address more sophisticated forms of tax avoidance**
  - Through a combination of technology, improved data analytic approaches, AI, and hiring and training a workforce dedicated to complex enforcement activities
- **Efforts to hire specialized enforcement staff**
  - Treasury has stated that audit rates will not rise relative to recent years for those earning less than $400,000 in actual income
- **Enhanced focus on large corporations, large partnerships, pass thru and high income closely held entities**

Enforcement Focus Areas

- **INCREASED AUDITS** for **large corporations, partnerships and high wealth individuals**
- **INCREASED COVERAGE** of **specific issues**
- **CHANGES TO CASE SELECTION AND USE OF DATA ANALYTICS to identify issues and indicators of noncompliance**
- **IMPROVED REPORTING including form changes**
- **INCREASED OPPORTUNITIES FOR LEGAL CERTAINTY** and **ACCESS TO ISSUE RESOLUTION PROGRAMS**
- **MODERNIZED TECHNOLOGY** and **METHODS OF ENGAGEMENT**
- **INCREASED STAFFING**

IRS COMPLIANCE Strategies

- **Ongoing but *enhanced* focus on**
  - **Offshore noncompliance**
  - **High-Wealth/High Income**
  - **High Income Non-Filers** (High priority beginning with tax year 2016)
  - **Virtual currency transactions**
  - Abusive Tax Shelters
    - **Syndicated Conservation Easements**
    - **Micro-Captive Insurance Shelters**
  - **Employee Retention Credit (ERC) Claims**
    - As of May 31, 2024, CI has initiated 450 investigations involving more than $6.97 billion of potentially fraudulent ERCs in tax years 2020-2023.
  - **Monetized Installment Sales**

IRS COMPLIANCE Strategies

- **Ongoing but enhanced focus on**
  - **Virtual Currency Fraud.** In March 2022, the IRS's Office of Fraud Enforcement (OFE) and CI partnered to launch the IRS **Chain-analysis Learning Academy** providing IRS employees extensive on-demand virtual currency training and certification on topics ranging from tracing digital assets to basis computation and tax treatment of virtual currency, non-fungible tokens and other digital assets
  - **Maltese Pension Plans -** Taxpayer claims no income from gains and distributions based on a reading of the U.S.-Malta treaty.
  - **Certain Charitable Remainder Annuity Trusts (CRATs)**
    - IRS concerned with an "improper" step-up in basis that allows taxpayers to improperly eliminate gain on the sale of property

IRS COMPLIANCE Strategies

- **Ongoing but enhanced focus on**
  - **Business Aircraft** - Emphasis on qualified business use, personal use, and fringe benefit inclusion usage by large corporations, large partnerships, and high-income taxpayers.
  - **Puerto Rico Act 22, Individual Investors Act** (01/16/2024) **-** addresses taxpayers who claimed benefits through Puerto Rico Act 22, "Act to Promote the Relocation of Individual Investors to Puerto Rico," without meeting the requirements of IRC Section 937, Residence and Source Rules Involving Possessions and may be excluding income subject to US tax on a filed US income tax return or failing to file and report income subject to US tax. This campaign will also address those individuals who have met the requirements of IRC Section 937 but may be erroneously reporting US source income as Puerto Rico source income in order to avoid US taxation.

High-Income Efforts of the IRS

- **Increased capacity** as part of the IRA Funding – 300 employees in GHW
- **High Income Filers Initiative** – LB&I and SB/SE effort to maintain compliance efforts in the area of high-income taxpayers – Use the most appropriate treatment stream
- **Global High Wealth** – LB&I program since 2009 – Enterprise approach looks at the complete financial picture of high wealth individuals and the enterprises they control – Based on income or assets, wealthiest taxpayers
- **High Income Non-filer (Collections)** – initiative to step up efforts to address non-filers who have high incomes through enhanced notices (QR codes)

High-Income Efforts of the IRS

- **Increasing coordination between IRS Divisions -** LB&I, SB/SE, TE/GE
  - Collaboration involves not only traditional individual Exam functions as well as the *related* tax-exempt entities and estate & gift returns
- **Improving specialized training and audit processes** to ensure that IRS employees have the right training and can approach these exams in a way that is most appropriate (i.e., enterprise vs. single issue)
- **Increasing focus** on the non-compliant and reduce touches on the compliant
- **Increased use of data analytics**

Wealth Squad IDRs

- The IRS has somewhat standardized their information requests in these matters by seeking everything imaginable with respect to the taxpayer under examination and all related entities, including
  - Org charts, financial statements, tax workpapers, asset transfers by sale or charitable contribution, organizational documents for all related entities, offshore or coss-border financial transactions, estate planning documents, etc.
- Detailed responses to detailed requests for information often generate additional detailed requests for information

IRS Announcement IR-2023-166, Sept. 8, 2023

- **IRS ANNOUNCES *NEW COMPLIANCE EFFORTS***
  - **FOCUSED on INCREASING SCRUTINY on HIGH-INCOME, PARTNERSHIPS, CORPORATIONS and PROMOTERS ABUSING TAX RULES on the BOOKS** (IR-2023-166, Sept. 8, 2023)
  - **IRS will focus on High Net Worth Collections**
    - IRS is pursuing 1,600 high-income, high-wealth individuals who have either not filed their taxes or failed to pay recognized tax debt. As of October 2023, the IRS has collected ***$160 million dollars in 100*** of these already assigned 1,600 cases.
  - **New Large Partnership Initiative**
    - Identified partnerships with assets > $10 billion for audit
    - *75 largest partnerships* will be audited
    - Greater focus on partnerships with assets > $10 million
    - Looking for discrepancies in balance sheets
  - **More Money to be Allocated to "Emerging" Issues**

IRS Announcement IR-2023-166 (Cont'd)

- **Expanded work on digital assets**
  - Continuing the **IRS Virtual Currency Compliance Campaign**
    - Responds to potential *"75% non-compliance rate"*
  - August 25, 2023: IRS Proposed regulations to create new information reporting requirements for brokers
  - John Doe summons efforts continue
- **IRS increased audits of potential high income non-filers in 2024**
- **More Scrutiny on FBAR**
  - IRS has identified "hundreds of possible FBAR non-filers"
  - Account balances in the millions
- **More Scrutiny of Labor Subcontracting Arrangements**
  - Construction contractors pay subcontracting fees to "shell" companies with "no legitimate business relationship" to the contractor
  - Funds eventually flow back to the construction contractor

Selected Additional IRS Announcements

- **IRS ORDERS IMMEDIATE STOP TO NEW EMPLOYEE RETENTION CREDIT** processing amid surge of questionable claims; concerns from tax pros (IR-2023-169, Sept. 14, 2023)
- **IRS LOOKS TO HIRE 3,700 EMPLOYEES NATIONWIDE TO HELP EXPAND COMPLIANCE** for **large corporations and complex partnerships**; experienced accountants encouraged to apply for Revenue Agent positions (IR-2023-172, Sept. 15, 2023)
- **IRS TO ESTABLISH SPECIAL PASS-THROUGH ORGANIZATION TO HELP WITH HIGH-INCOME COMPLIANCE EFFORTS,** new workgroup to blend current employees and new hires to focus on complex partnerships, other key areas (IR-2023-176, Sept. 20, 2023)
- **IRS DELIVERS NEW CAPABILITIES TO TAX PRO ACCOUNT,** latest expansion part of effort to improve technology, tools to help tax professionals serve clients (IR-2023- 182, Sept. 29, 2023)

Selected Additional IRS Announcements

- **IRS launches new initiatives to pursue high-income, high-wealth individuals who do not pay overdue tax bills and complex partnerships and *"is now taking swift and aggressive action."*** (IR-2023-194, Oct. 20, 2023)
  - **Large foreign-owned corporations transfer pricing initiative** - The IRS is sending compliance alerts to approximately 150 subsidiaries of large foreign corporations to reiterate their U.S. tax obligations and incentivize self-correction.
  - **Expansion of the Large Corporate Compliance program** - LB&I is expanding the program by starting an additional 60 audits of the largest corporate taxpayers selected using a combination of artificial intelligence and subject matter expertise in areas such as cross-border issues and corporate planning and transactions.
  - **Cracking down on abuse of repealed corporate tax break** - Following the 2017 repeal of a provision of the code that provided a deduction for producing goods in the U.S., the IRS received hundreds of claims collectively seeking more than $6 billion in refunds, with a significant portion of filers claiming the deduction for the first time.
  - **Prioritization of high-income cases** - The IRS has been ramping up efforts to pursue about 1,600 high-income, high-wealth individuals who have either not filed their taxes or failed to pay recognized tax debt and has already collected $122 million dollars in 100 of these already assigned 1,600 cases.

Selected Additional IRS Announcements

- **IRS begins audits of corporate jet usage; part of larger effort to ensure high-income groups don't fly under the radar on tax** responsibilities (IR-2024-46, Feb. 21, 2024)
- **IRS announces new steps to combat abusive use of partnerships; agency's focus intensifies as new guidance closes loopholes worth tens of billions** (IR-2024-166, June 17, 2024)
  - New IRS, Treasury guidance focuses on **"basis shifting" transactions** used by partnerships
  - **New Associate Chief Counsel Office focused exclusively on partnerships, S-corporations, trusts and estates.**
- **IRS tops $1 billion in past-due taxes collected from millionaires; compliance efforts continue involving high-wealth groups, corporations, partnerships** (IR-2024-185, July 11, 2024)

Selected Additional IRS Announcements

- **U.S. Department of the Treasury, IRS announce $1.3 billion recovered from high-income, high-wealth individuals under Inflation Reduction Act initiatives** (IR-2024-233, Sept. 6, 2024)
  - February 2024 launched an initiative focused on identified high-income, high-wealth non-filers - In the first six months of this initiative, nearly 21,000 of these individuals filed returns and paid more than $172 million in taxes.
  - Fall 2023 launched an initiative to pursue high-income, high-wealth individuals who have failed to pay recognized tax debt - concentrated on taxpayers with more than $1 million in income and more than $250,000 in recognized tax debt. After successfully collecting $38 million from more than 175 high-income, high-wealth individuals in 2022, the IRS expanded this effort to around 1,600 additional high-income, high-wealth individuals. Nearly 80% of these individuals have made payments totaling more than $1.1 billion. This is an additional $100 million just since July, when Treasury and IRS announced reaching the $1 billion milestone.

IRS COMPLIANCE Strategies

- **Enhanced coordination with the Whistleblower Office** - Since 2007, IRS has paid out more than 2,500 awards totaling more than $1.05 billion
- **International Tax Compliance** –
  - **Joint Chiefs of Global Tax Enforcement (J5)** organization to combat transnational tax crime through increased information gathering, intelligence sharing, joint investigative activity and capacity building with partner countries' tax agencies.
  - **Transfer Pricing** - Centralized efforts of LB&I's Transfer Pricing Risk Assessment (TPRA) team continue to guide case selection to the appropriate treatment stream
- **National Coordinated Investigations Unit (NCIU)** – In FY22, IRS-CI used data analytics to identify multiple new unique data sets that identified more than 10,000 taxpayers that potentially committed a criminal or civil violation of the tax code

IRS COMPLIANCE Strategies

- **Exam Case Selection**
  - During FY22, the IRS began using a predictive model to automate the identification of issues for the Discriminant Index Function inventory and grading cases for the Tax Compliance Officer inventories
  - The IRS SB/SE division incorporated FinCEN data into the **Compliance Data Warehouse (CDW),** which allows for in-depth data analytics for both the Bank Secrecy Act program and the Foreign Bank and Financial Accounts (FBAR) program
  - In collaboration with Research, Applied Analytics and Statistics (RAAS), SB/SE will analyze the data to enhance current case selection and identification methods
- **Improvements in Data-Driven Decision-Making**
  - In FY22, the IRS deployed the Enterprise Data Platform (EDP), which is a scalable platform to support data analytics for numerous business and information technology operations services, connecting data providers with data consumers
  - The EDP is a component-based open architecture that delivers universal data access for authorized users and systems at the enterprise level. It comprises three main components: the Universal Data Hub, Data Access Services and Analytical Tools and Services

IRS COMPLIANCE Strategies

- **CI Advanced Analytics & Innovation (AAI)**
  - To become the trusted "go to" source within CI for case generation, data analytics expertise, and challenge resolution through innovation and data management and governance
  - AAI is designed to provide high-quality support in managing and engaging data analytics, making data-driven decisions, measuring and monitoring CI's impact on compliance, implementation of ideas, and investigative support.
- **Cyber Crimes**
  - The CI Cyber Crimes unit collaborates with other federal law enforcement agencies to identify the movement of criminally derived profits utilizing virtual currency and the Dark Web
- **Advanced Collaboration Data Center (ACDC)**
  - Expand sophisticated collaboration techniques from high profile cyber investigations - a national government-wide collaboration - bring together data, technology, and specialized personnel from across Treasury and government
- **Data Management Working Group (DMWG)**
  - Formed in FY22, the DMWG is a collaborative working group consisting of CI's Cyber division along with AAI and Field and International Operations
  - The DMWG will drive recommendations to support a comprehensive management strategy to facilitate CI's data management (acquisition, validation, cleaning, updates, etc.) and governance

Pre-IRA22 - Selected IRS Compliance Accomplishments

- **Recent Criminal Investigations involving sophisticated *cyber* tools**
  - **Kleptocapture Task Force – I**nter agency law enforcement task force dedicated to enforcing sweeping sanctions - ongoing investigations involving Russian oligarchs and those who are involved with or assist in Russia's invasion of Ukraine
  - **Historical Takedown of Child Exploitation site operating in the Dark Net**
    - 337 arrests in 38 countries
    - Rescue of 23 actively exploited minors residing in the US, Spain and the UK
  - **Historical Takedown of Terrorism Financing sites**
    - **Global disruption** of three cyber-enabled terrorist financing campaigns involving the
      - al-Qassam Brigades (Hamas's military wing)
      - al-Qaeda
      - Islamic State of Iraq and the Levant (ISIS)
  - ***Largest cryptocurrency seizure ever recorded* for the federal government**
    - Valued at more than *$3.6 billion* re an alleged conspiracy to launder cryptocurrency stolen during a 2016 hack of Bitfinex, a virtual currency exchange

IRS Operations - Data Book

- **Gross collections - $4.9 trillion FY22** (FY21 was $4.1 trillion; FY23 was $4.7 trillion)
  - **Individual Income Tax, Employment Taxes, and Estate and Trust Income Tax**
- **Form 1040 Processed – 160.6 million FY22**; 163 million FY23
- **Form 1040 Refunds – 237.8 million totaling $511.9 billion FY22**; 121 million totaling $461 billion in FY23
  - Includes overpayment refunds, refunds resulting from examinations, refundable tax credits, etc.
  - **E-Filed** – 93.8% (150.6 million) in FY22; 90.7% (147.9 million) in FY23
  - **Paid Preparers** – 85.9 million in FY22; 84.0 million in FY23
  - **Paper Filed** – 9.9 million in FY22; 15.2 million in FY23
  - **Free File** – 3.3 million in FY22; 2.9 million in FY23
- **Corporate Returns Processed** – 2.2 million in FY22; 1.56 million in FY23
  - **S Corp** – 5.5 million in FY22; 5.3 million in FY23
- **Partnership Returns Processed** – 4.5 million in FY22; 4.5 million in FY23
- **Estate Tax Returns Processed** – 2.973 million in FY22; 2.778 million in FY23

THANK YOU!

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Keeping the Peace in the House of the Dragon: Tax and Business Considerations with Company Succession to Avoid an Intercompany Civil War

Presented by
Habeeb (Hobbs) Gnaim
Shareholder and Practice Group Leader,
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Chamberlain, Hrdlicka, White, Williams & Aughtry, P.C.

Annual Tax & Business Planning Seminar
October 30, 2024

Chamberlain Hrdlicka
Attorneys at Law

Overview

- Importance of Company Succession Planning.
- Events Leading into a Business Transition.
- Challenges or Hurdles Faced with Company Succession.
- Coordinating Company Succession Goals with Estate Planning Goals (i.e., managing estate tax exposure).
- Common Situations or Fact Patterns.
- Methods to Transition the Company.
- Buy-Sell Agreements (or Similar Agreements).

3

4

I'm the eldest boy!
[LAUGHS]
[LAUGHS]
[LAUGHS]

5

I'm gonna set aside several hundred
thousand dollars and I'm going to
dedicate it to destroying your life.

6

Fact Pattern for this Presentation

- OpCo is an operating business that is organized as a Texas corporation, which was initially treated as a C-Corporation for federal income tax purposes, but later made an S-Corporation election, which occurred over 5 years ago. OpCo was founded many years ago by Viserys Targaryen while Viserys was married to Aemma. Although all of the issued stock in OpCo was issued to, and titled in, Viserys' name, ownership of OpCo was the community property of both Viserys and Aemma. Sadly, Aemma died years ago, and Viserys has since married Alicent. Although Viserys' ownership of OpCo is now his separate property, he is willing to treat such ownership interest as community property to facilitate estate planning and company succession planning goals. OpCo has steadily grown over the years to a current value of $50 million.

Fact Pattern for this Presentation (cont'd)

- Viserys and Aemma had one child together, a daughter named Rhaenyra, who is heavily involved in the business, respected by OpCo employees and is viewed as a leader. Viserys and Alicent have 4 children together, Aegon (a son), Aemond (a son), Halaena (a daughter) and Daeron (a son). All children are over the age of 21. Aegon, Aemond and Halaena are involved in the business, but Daeron is not. Daeron lives in Austin and his current occupation is singing live music in the various bars and restaurants in Austin. Aegon and Aemond are both viewed as hot tempered, and although they are involved in the business, they both have not spent enough time growing into leadership roles, are not respected by OpCo's employees and are not viewed as leaders. Halaena, on the other hand, is viewed as kind and well respected by OpCo's employees, and while she doesn't have the same level of experience in the business as Rhaenyra, she is slowing growing into a leadership role within OpCo.

Fact Pattern for this Presentation (cont'd)

- Following Viserys' marriage to Alicent, OpCo stopped leasing its facility and instead purchased its own facility in LandCo, which is organized as a Texas LLC and is treated as a disregarded entity for federal income tax purposes. All of the ownership interests of LandCo are issued to, and titled in, Viserys' name, but are the community property of both Viserys and Alicent. OpCo pays monthly rent to LandCo for OpCo's use of the facility.
- While Viserys is open to hearing offers from potential purchasers for OpCo (and wants to stay ready for an exit), Viserys is more focused on keeping and growing OpCo within the family and focusing on transitioning the business to the next generation of owners.
- Viserys and Alicent have a total net worth of approximately $75 million, but recall that $50 Million is attributed to OpCo, which is Viserys' separate property, while the remaining $25 Million is attributed to LandCo and a mixture of cash and investment accounts (stocks, bonds, investment portfolio, etc.) held with a financial institution that Viserys and Alicent work with. Both Viserys and Alicent are concerned about their estate tax exposure.

Challenges of Implementing Company Succession Goals

- **Estate planning documents are outdated or non-existent and/or are not coordinated with company governance documents.**
  - Wills vs. Revocable Trusts.
  - Wills typically go through probate, which is a public process and can be lengthy.
  - Revocable trusts provide more privacy and avoids probate.
  - Are estate planning document coordinated with company governance documents.
  - Are there any children's trusts in existence?
  - Have the parents used any of their existing lifetime exemption amounts?
  - Is there sufficient liquidity to pay estate tax exposure without selling OpCo?
- **Current exemption amounts are scheduled to expire:**
  - 2024: $13,610,000. The amount is being increased to $13,990,000 in 2025.
  - TCJA expires January 1, 2026, and lifetime exemption reverts back to pre-TCJA levels, which is expected to approximately $7,000,000 per individual.

Challenges of Implementing Company Succession Goals

- **Current company structure is not conducive to company succession planning (the shoe does not fit). In other words, we know what we want the final puzzle to look like, but we do not have the needed puzzle pieces.**
  - Single entity vs. multiple entities.
    - Are there voting and non-voting equity interests authorized?
    - Manager-managed vs. Member-managed LLCs
  - Do the business entities have updated minute books in place?
    - Are the minute books non-existent?
    - Perhaps the minute books exist, but are missing one or more needed company documents.
  - Federal income tax reporting status of the business entities.
    - Can a family limited partnership ("FLP") be implemented?
    - Challenges between C corporation, S corporations, partnerships and disregarded entities ("DREs").
- **Waited too long (net worth is high, and it's difficult to fit an elephant through a keyhole).**
  - Even with the challenges mentioned above, it was easier to address such challenges when the parents had a smaller net worth.

Scenario 1

- **Facts:** Viserys is getting older, but still wants to stay involved with the day-to-to day operations of OpCo. However, Viserys is concerned that if something unexpected should occur to him, such as a sudden death or permanent disability/incapacitation (for purposes of this discussion, "Incapacitation" or "Incapacitated"), there is no organized company succession plan in place, and Alicent does not want to be left with the burden of having voting control over OpCo. Further, Viserys and Alicent have been told that they are over-exposed to the federal estate tax, but neither of them have used any portion of the lifetime estate and gift exemption amounts.
- **Goals/Objectives**:
  - Have an organized company succession plan in place upon the death or Incapacitation of Viserys.
  - Reduce estate tax exposure.

Scenario 1 (cont'd)

- **Possible Solutions**:
  - Viserys and Alicent will update their estate planning documents to include:
    - Convert Viserys' interest in OpCo to community property.
      - Alternatively, Viserys can keep his ownership as separate property and utilize some of Alicent's lifetime exemption with her consent.
    - Establish a revocable trust as will substitutes.
    - Establish irrevocable trusts for the benefit of their children ("Children's Trusts"), which are treated as Intentionally Defective Grantor Trusts ("IDGTs").
  - Recapitalize OpCo's stock to create 1% voting shares and 99% non-voting shares.
  - LandCo undergoes similar recapitalization for its ownership interests using the same 1% voting and 99% non-voting ratios.
    - Although interests in LandCo may not be transferred at this time, the structure is in place.

Scenario 1 (cont'd)

- **Possible Solutions (cont'd)**:
  - Viserys will transfer non-voting shares of OpCo to Children's Trusts, which is intended to pull value out of the estates of Viserys and Alicent (and reduce estate tax exposure) without giving up voting control.
  - For now, Viserys and Alicent will hold off on transferring non-voting units in LandCo or any of their other assets to the Children's Trusts, but it's something to consider in future years, as they continue to monitor their estate tax exposure and the constantly changing tax laws.

Scenario 1 (cont'd)

- **Possible Solutions (cont'd)**:
  - Viserys will transfer non-voting ownership interests in both OpCo and LandCo to their Revocable Trust.
  - However, Viserys and Alicent shall also establish a separate Voting Trust and all voting ownership interests in both OpCo and LandCo will be transferred to such Voting Trust, which shall provide:
    - While both Viserys and Alicent are still alive and not Incapacitated, Viserys shall serve as sole trustee of the Voting Trust (allows Viserys to maintain control over the voting ownership interests of OpCo and LandCo).
    - Upon either the death or Incapacitation of Alicent, if Viserys is still alive (and not Incapacitated), Viserys shall continue serving as the sole trustee of the Voting Trust, and thus continue having control over the voting ownership of the OpCo and LandCo
    - Upon either the death or Incapacitation of Viserys, if Alicent is still alive, Rhaenyra shall become the sole Trustee of the Voting Trust, but all assets of the Voting Trusts shall continue to be for the benefit for Alicent while she's alive.
    - Upon the death of both Viserys and Alicent, Rhaenyra shall continue to be the sole Trustee of the Voting Trust, but the assets of the Voting Trust (which are just the voting ownership interests of OpCo and LandCo) shall be for the benefit of all children equally.

Scenario 1 (cont'd)

- **Possible Solutions (cont'd)**:
  - Children's Trusts:
    - Protection of trust assets from creditors or divorce.
    - Pass down assets to next generation while avoiding estate tax.
    - This is done by designating the grantor's children as lifetime beneficiaries, but not giving full ownership to the trust assets. Thus, the trust assets are not included in the children's estates.
  - IDGTs:
    - Drafted with a purposeful defect (such as the power to substitute trust assets).
    - Grantor is treated as "owner" for federal income tax purposes, but not estate tax purposes.
    - Grantor pays all federal income tax attributable to the IDGT, decreasing their estate.
      - This is a tax-free gift to the trust every year.
  - If the grantor is concerned about paying the IDGT's federal income taxes, the IDGT's grantor trust status can be shut off.
    - Note that this shut off is permanent (i.e., cannot be turned back on).
  - OpCo and LandCo enter into Buy-Sell Agreements with their respective owners that provide for, among other things, the following:
    - Transfer restrictions to protect OpCo's S-Corporation status.
    - Restriction on transfers without the approval of the Board and certain owner voting threshold.
    - All owners that are trust owners must qualify as a certain type of trust (a "Qualifying Trust").

Recapitalizations and Share Exchanges

- What is a recapitalization and why is it needed?
  - The myth of majority ownership.
  - What constitutes management control vs. total control over a business entity?
  - Multiple classes of ownership commonly used where a family treats children equally, but not all children are involved in the business.
- Typically done to change the capital stock structure from one class of common stock to Class A Voting common stock and Class B Nonvoting common stock.
  - Allows shareholders to gift and/or sell shares to family members without giving up control. Also, allows parent to eventually transfer voting control to selected family members that are most qualified to manage the business.
- Must be careful when an S-Corporation undergoes a recapitalization.
  - Only difference can be voting rights with multiple classes of stock.
- A share exchange is similar to a recapitalization but is used in situations where a corporation already maintains Class A Voting Stock and Class B Nonvoting stock.
- Similar recapitalizations can be done with LLCs and Limited Partnerships
  - Typically, easier to do with LLCs and LPs.

Gifting vs. Sale of OpCo Stock

- As noted above in the Possible Solutions section, Viserys will transfer non-voting stock in OpCo to the Children's Trusts, but such transfer can be either in the form of a gift or in the form of a sale, both of which are intended to pull value out of the estates of Viserys and Alicent while the parents are still living (instead of waiting at death).
- Gift of ownership interests in entities is typically the easiest path.
  - Future appreciation in, and distributions from, the OpCo shares that were gifted to the Children's Trusts will not be included in Viserys' estate.
  - Typically, gifts of ownership interests in appreciating entities are more tax efficient gifts than gifting cash.
- But….the *Powell* case risks now lurk around with tradition gifts of ownership interests in entities.
  - Most Parents desire to retain ownership in the entities, especially voting control over such entities. This raises the "Powell Case Conundrum."
- *Estate of Nancy H. Powell vs. Commissioner*.
  - gifts of ownership interests where the transferor keeps certain rights or control after the transfer are at risk of being included in the transferor's estate.
  - Related Section 2036 risks.
  - Although *Powell* had unique facts, it could apply to situations when ownership is transferred by parents to children, while the parents maintain ownership in such entity.
  - Further, under Section 2035, amounts transferred within three years of the transferor's death are included in the gross estate.

Selling Ownership Interests in Lieu of Gifting

- An alternative to gifting ownership interests in an entity to the Childrens' Trusts is for Viserys to instead sell nonvoting stock to the Children's Trusts. Although the IRS has not acquiesced, a purchase and sale transaction, if structured and documented properly, should not come within the purview of the Powell case.
  - Sale transaction made by grantors to IDGTs are tax-free to the grantors.
  - If Viserys sells non-voting stock in OpCo to the Children's Trusts, it would be non-taxable to Viserys.
  - If the Children's Trusts were not IDGTs, the sales would be taxable to Viserys
- Further Consideration
  - IDGT can pay the purchase price in cash, with a note or both.
  - Could result in parents keeping more lifetime exemption.
  - Don't over leverage the purchase trust.
  - Important to set reasonable interest rate no less than the applicable AFR.
  - Payments on note should be made in accordance with its terms.
  - Many planners have concerns that a death during the term of the note could result in capital gains, because the death may cause the IDGT to no longer qualify as an IDGT.

S-Corporation Limitations

- Since OpCo is taxed as an S-Corporation, the parties involved must take special care to ensure that OpCo's S-election is not involuntarily terminated due to impermissible shareholders.
- Other than voting differences, voting and non-voting stock must have identical rights such as pro rata distributions and allocations of profits/losses.
- Buy-Sell Agreement should contain provisions to protect the S election.
- FLPs cannot be used as part of the planning because impermissible shareholder.
- Make sure all trusts qualify as shareholders.
  - If ESBTs or QSSTs receive S corporation stock, make sure such trusts make timely elections with IRS.
  - If an IDGT receive S corporation stock, but later the IDGT feature is shut off where such trust is responsible for its own taxes, then a timely election with IRS must be made.
  - If a trust shareholder of an S corporation fails to qualify in the future as a permissible S corporation shareholder, the Buy-Sell Agreements needs to address that scenario.

Buy-Sell Agreements: Overview

- What is a "Shareholders Agreement" or "Buy-Sell Agreement"?
- Customized document that is typically different for every client. Should be tailored to the needs and circumstances of the business and the owners.
- Important to update the agreement when provisions are outdated or circumstances change.
- Consider a pre-negotiated purchase agreement.

Buy-Sell Agreements: General Provisions

- Restrictions on transfer provisions
- Rights of first refusal
- Rights upon death or disability of an owner
- Rights upon divorce of an owner
  - Community property or separate property state
- Rights upon bankruptcy of an owner
- Rights upon termination of employment
- Right to buy-out owner for any reason upon threshold vote
- Default owners (ownership subject to being seized or involuntary transfer)
- Deadlock provisions or push-pull provisions
- Minimum tax distributions
- Drag-along rights and Tag-along rights
- Restrictive covenants (confidentiality, non-competition, non-solicitation)
- Pre-negotiated purchase agreement

Buy-Sell Agreements: Transfer Provisions

- Important to accurately define important terms such as:
  - Permitted Transfer
    - Example definition using HOD Characters: "Permitted Transfer" Subject to the terms and conditions set forth in [Articles/Sections _____ and _____,] all or any portion of the Units of a Member may be Transferred at any time to: (a) any Person with the prior written consent and approval of the Board of Managers and a Required Interest, (b) Viserys, (c) Alicent, (d) any Descendants of Viserys or Alicent, (e) a Qualifying Trust, or (f) if such transferring Member is a Qualifying Trust, the Beneficiary or Beneficiaries.
  - Beneficiary
    - Example definition: "Beneficiaries" mean those persons to whom the trustee of a trust is required to or may currently exercise its discretion to distribute income and/or principal from such trust.

Buy-Sell Agreements: Transfer Provisions (Cont'd)

- Descendants
  - Example definition: "Descendant" means the lineal blood descendants of any degree of the ancestor designated; provided, however, such references shall include, with respect to any provision of this Agreement, descendants who have been conceived at any specific point in time relevant to such provision and who thereafter survive birth; provided further that a child adopted prior to attaining age nineteen (19) and such adopted child's lineal descendants by blood or adoption shall be considered under this Agreement as lineal blood descendants of the adopting parent or parents and of anyone who is by blood or adoption a lineal ancestor of the adopting parent or of either of the adopting parents.
- Qualifying Trust
  - Example definition using HOD Characters: "Qualifying Trust" means a trust of which (a) Viserys, (b) Alicent, and/or (c) any Descendants of Viserys or Alicent constitute all of the Beneficiaries thereof.
- Should the definition of Qualifying Trust include spouses or spousal benefit trusts?
- Who is permitted to the trustee of a Qualifying Trust?

Buy-Sell Agreements: Structuring the Buyout

- Generally, the company has the first option to redeem and buy-back the ownership interests from the owner.
  - Should the buy-back be mandatory or optional?
- Then, the remaining owners have the option to purchase the ownership interest.
  - Again, consideration should be given whether to make this mandatory or optional.
  - If there are multiple classes of stock, consider restricting certain classes of stock from purchasing the ownership interest.
  - Reclassification event: If there's voting and nonvoting shares, and an unexpected event occurs where there's no voting shares left, what happens? This unforeseen situation should be addressed.

Buy-Sell Agreements: Calculating the Purchase Price

- Common ways to calculate the purchase price:
  - A mutually agreed specific dollar amount per share, unit or percentage. Be wary of these as they tend to get outdated.
    - Option to use specific price, but then defer to valuation if specific price is not updated annually.
  - A price per share, unit or percentage based upon a calculation. Be wary of formulaic approaches becoming outdated over time.
  - An appraised value approach (qualified third party valuations are recommended). Most popular approach.
- Different calculations may be used for different buy-out situations.
  - Lower price upon certain buyout event such as termination for cause. Be wary that different pricing mechanics may lead to enforceability issues.

Buy-Sell Agreements: Payment Terms and Funding Mechanisms

- Should you pay the purchase price entirely up front or pay the balance of the purchase price over time via promissory note?
  - What interest rate should be used? AFR?
- If the owner is deceased, businesses often require the use of life insurance to fund some, if not all, of the purchase price.

Voting Trust vs. Directed Trust

- As previously noted, a separate Voting Trust will hold all of the voting ownership interests of OpCo and LandCo. The Trustee of the Voting Trust essentially controls the Voting Trust, and thus controls the voting rights of such voting ownership interests.
- A Revocable Trust with a directed trust feature removes one or more powers that the Trustee would normally have.
  - For example, Viserys could include all of the voting and non-voting ownership interests of OpCo and LandCo in one revocable trust of which Halaena is the Trustee.
  - Viserys could implement a directed trust feature in the Revocable Trust that grants Rhaenyra the power to control the vote on behalf of the voting ownership interests in OpCo and LandCo as Trust Director.
- However, a trust with a directed feature that gives a child power over voting interests can pose issues when representing both parents.
- What if Rhaenyra predeceases Viserys? Is there a back-up?
  - Halaena?

Scenario 1(b) (Slight Twist of the Facts on IDGTs)

- **Facts:** Same Facts as Scenario 1, but Viserys and Alicent made gifts of OpCo stock to the Children's Trusts back in 2012 before the *Powell* decision was issue. Viserys and Alicent still have lifetime exemption left, and want to transfer more OpCo stock to the Children's Trusts because OpCo continues to grow in value, but they are concerned about the Powell case risks. To complicate matters, Viserys and Alicent revoked the power that made the IDGTs defective back in 2017, and thus the Children's Trusts are no longer IDGTs.
- **Goals/Objectives**: Same goals as Scenario 1: Have an organized company succession plan/solution in place upon the death or Incapacitation of Viserys, and reduce estate tax exposure.
- **Possible Solutions**:
  - Viserys and Alicent establish new Children's Trusts as IDGTs.
  - Viserys and Alicent sell OpCo stock to the new IDGTs.
    - Funding of Trusts, timing of sale/purchase of OpCo stock, and payment of purchase price needs to be determined.
  - If Viserys and Alicent are concerned about complexity and administrative burden of having too many trusts, they can look into merging the two sets of trusts together late (each case is different and dependent on the facts).

Scenario 1(c) (Slight Twist on the Trusts)

- **Facts:** Same background of Scenario 1. Viserys and Alicent transferred stock in OpCo and LandCo to the Children's Trusts long. Viserys and Alicent are now both deceased. Rhaenyra has had voting control over OpCo and LandCo through the Voting Trust and the business has thrived under Rhaenyra's leadership. However, Daeron, who remains as a musician in Austin has disdain for his family's wealth and wants to give the assets of his trust to charity. The language of the Children's Trusts, while well written, did provide some flexibility to the children to transfer/distribute assets out of the trusts. Daeron, now the trustee of his trust, transfers and distributes his trust's ownership interests in OpCo and LandCo to himself, and then donates/transfers such ownership interests in both entities to a charity.
- **Goals/Objectives**: Have an organized company succession plan in place.
- **Possible Solutions**:
  - Perhaps the trust for Daeron should have had a Co-Trustee to help avoid this situation.
  - Enforce the Buy-Sell Agreement that was entered into when the Children's Trusts first became owners of OpCo and LandCo.
  - But….did such Buy-Sell Agreement have the needed, comprehensive provisions?

Scenario 1(c) (Slight Twist on the Trusts) (cont'd)

- **Possible Solutions (cont'd)**:
  - S-Corporation Example: "Qualifying Trust" means a trust (i) of which Viserys, Alicent, and/or any Descendants of Viserys or Alicent constitute all of the Beneficiaries thereof, *and (ii) during the periods in which the Company is an S-Corporation, is a trust that is permitted as a shareholder of an S-Corporation within the meaning of Code Section 1361(c)(2)*.
  - A trust that qualified as a member of the Targaryen Family Group at the time it received Shares will fail to qualify as a member of the Targaryen Family Group if, at any time, such trust no longer meets the definition of a Qualifying Trust. In the event that a trust holding any Shares fails to qualify as a member of the Targaryen Family Group ("*Disqualifying Event*"), such trust shall Transfer all of its Shares to a qualifying member of the Targaryen Family Group in a Permitted Transfer within 60 Business Days of the date of the Disqualifying Event, but such Transfer shall be effective immediately prior to Disqualifying Event; provided, that if such trust fails to Transfer all of its Shares as required by this Section [__], a Breach Event shall be deemed to have occurred, and such trust shall be deemed to be a Breach Shareholder and shall be subject to Section [__]. Notwithstanding the foregoing, during the periods in which the Corporation is an S-Corporation, if a trust owning Shares no longer meets the definition of a Qualifying Trust because such trust is no longer permitted as a shareholder of an S-Corporation within the meaning of Code Section 1361(c), such trust shall be deemed to have violated the covenants and provisions of Section [__] and shall be subject to the obligations of a Breach Shareholder pursuant to the provisions of Section [__].

Scenario 1(d) (Slight Twist on the Facts Involving the Children) (cont'd)

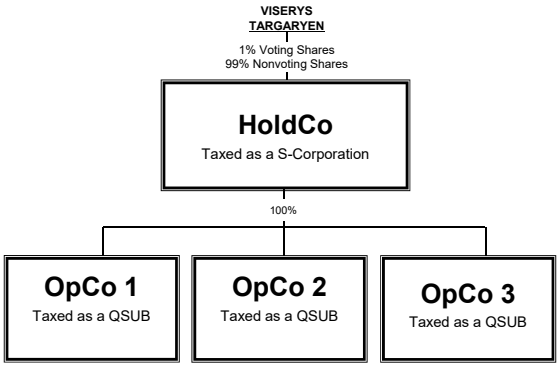
- **Facts:** Same Facts as Scenario 1. Viserys and Alicent are convinced that Rhaenyra is the right person to be Trustee of the Voting Trust, but they are concerned about Rhaenyra possible abusing her powers. They want her to have enough control over OpCo and LandCo to enable her to manage and operate the business, but total unfettered control.
- **Goals/Objectives**: Have an organized company succession plan in place.
- **Possible Solutions**:
  - Include provisions in the Buy-Sell Agreement:
    - Certain transactions or actions cannot be done without the agreement of one more sibling or a certain threshold vote of the non-voting owners, such as:
      - Sale of the company
      - Amendment or restatement of the entity's governing documents.
      - Any merger, conversion, exchange of ownership or any type of reorganization.
      - Issuing new ownership interests.
      - Admitting new owners.
      - Incur certain levels of debt outside of the ordinary course of business.
    - Set limits on salaries paid to Rhaenyra and others.
    - Allow non-nonvoting owners to have seat(s) on the Board.

Scenario 2 (Succession Planning with Multiple Entities)

- **Facts:** Same facts as Scenario 1, but the business is not limited to one business entity. Instead, Viserys owns three business entities: OpCo1, OpCo2, and OpCo 3. Each is owned 100% by Viserys and each is an S corporation. Viserys likes the solutions discussed in Scenario one, but is concerned on how to accomplish the same thing for multiple entities.
- **Goals/Objectives**: Same goals as Scenario 1: Have an organized company succession plan/solution in place upon the death or Incapacitation of Viserys, and reduce estate tax exposure.
- **Possible Solutions**:
  - Viserys shall form new corporation ("HoldCo"), which elects to be an S-Corporation.
    - HoldCo is authorized to issue 1% voting and 99% non-voting shares.
  - Viserys shall contribute/transfer his ownership in OpCo 1, OpCo 2 and OpCo 3 to HoldCo, and a QSUB election is made for all three entities. Treated as "D" reorganization under Section 368(a)(1)(D).
  - Use same solutions as Scenario 1 for HoldCo.

Scenario 2 (cont'd)

- Illustration of organizational structure post-reorganization:



Scenario 2 (cont'd)

- **Related Issues and Decisions**:
  - If Viserys' ownership in OpCo1, OpCo2, and OpCo 3 are his separate property, is Viserys converting separate property to community property because he's exchange ownership in pre-existing entities for ownership in the new holding company post-marriage.
  - Should Viserys form the new holding company as an S corporation or an LLC?
    - LLC can make an S election and be part of the "D" reorganization.
    - LLC has charging order protections, which a corporation does not have.

Scenario 3 (Succession Planning With Spousal Involvement)

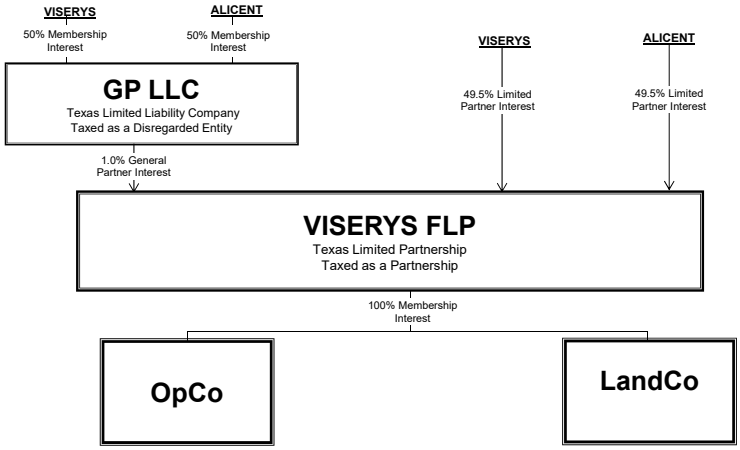
- **Facts:** Same facts as Scenario 1, but Alicent is involved in the business. If something unexpected should occur to Viserys, such as a sudden death or permanent disability/incapacitation, Viserys wants Alicent to continue being part of the overall management of OpCo, but Viserys is also wary/concerned that Alicent will favor her children, despite that Rhaenyra being the most qualified to run the business
- **Goals/Objectives**: Same goals as Scenario 1: Have an organized company succession plan/solution in place upon the death or Incapacitation of Viserys, and reduce estate tax exposure.
- **Possible Solutions**:
  - Voting Trust can provide that upon the death of Incapacitation of Viserys, both Alicent and Rhaenyra will serve as Co-Trustees over the Voting Trust.
  - If Viserys is concerned that Alicent will be unhappy with Rhaenyra being a Co-Trustee over the Trust, Viserys can amend the governance documents of OpCo to (i) make Rhaenyra a member of the board of directors, and she cannot be removed unless for cause, and (ii) OpCo cannot take certain action (such as selling the company, taking on significant debt, reorganizing, etc.) without unanimous approval of the board of directors. Thus, Rhaenyra has a blocking/veto vote.

Scenario 4 (Succession Planning For Larger Net Worth Individuals)

- **Facts:** Same facts as Scenario 1, but Viserys and Alicent have a larger net worth than $75M (as indicated in the initial facts above), because they have accumulated more assets (such as commercial real estate). Their net worth now stands at $95M. Even if all non-voting stock in OpCo is transferred to the Children's Trusts, Viserys and Alicent still are exposed to the estate tax.
- **Goals/Objectives**: Same goals as Scenario 1, but estate tax exposure is more challenging because more wealth is outside of OpCo.
- **Possible Solutions**:
  - Creation of a FLP, where long-term assets of Viserys and Alicent are contributed/transferred, such as their ownership in LandCo, commercial properties and their investment accounts.
  - After creation of the FLP, Viserys and Alicent shall transfer portions of their limited partner interests to the Children's Trusts.

Scenario 4 (cont'd)

- Illustration of FLP structure:



Scenario 4 (cont'd)

- **Related Issues and Decisions**:
  - *Powell* case/Section 2036 risks apply, but are even more risky with FLPs than operating entities. *Powell* was an FLP case.
  - How are the commercial properties held within FLP structure?
    - Typically, do not recommend mixing risky assets (e.g., commercial real estate) with non-risky assets (e.g., cash and investment accounts).
    - For example, LandCo would be held in a separate LLC under the FLP to contain all of its liabilities.
    - Viserys and Alicent should consider transferring the other commercial properties to LandCo or new formed LLCs under the FLP.
  - Viserys and Alicent should keep some level of wealth outside of the FLP.
    - No set amount and all clients are different, but enough to cover day-to-day living expenses.
    - FLP is not a personal piggy bank.

Family Limited Partnerships

- Some clients are in a rush to form their FLPs and make transfers of assets to them.
  - It is recommended to space out the steps to decrease audit risks.
  - Ideally, an FLP or its partnership interests are not valued immediately after FLP formation.
  - Sales intended to prevent *Powell* issues need to be spaced out from gifts.
    - Most helpful to do in separate tax years.
- Personal use assets should not go in the FLP.
  - e.g., vacation homes and ranches.
  - If the client really wants these in the FLP, there must be leases or rent paid for personal use.
- FLPs typically do not have separate voting and non-voting interests.
  - Instead have general partner ("GP") interests and limited partner interests.
  - Common to use an LLC or corporation as GP for liability protection.
  - Succession planning as described in Scenario 1 should be considered here.
  - Consider transferring ownership interest in GP to Rhaenyra to alleviate Powell/2036 risks.

Scenario 5 (Succession Planning with FLPs)

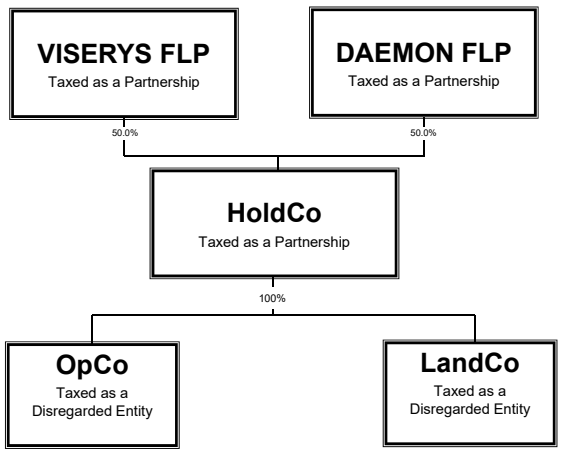
- **Facts:** Same facts as Scenario 4, but Viserys and Alicent forgot to put in a big asset of theirs, which is a commercial property worth $10M into the FLP. They now want to put such commercial property into the FLP, but the Children's Trusts do not have enough value or cash within in them to make matching contributions.
- **Goals/Objectives**: Same as above for Scenario 3, but they want that other commercial property in to the FLP.
- **Possible Solutions**:
  - Viserys and Alicent can still contribute the commercial property into the FLP, but since the Children's Trusts will not make matching contribution, their ownership will be diluted.
  - A a valuation will be needed to come up with the new ownership interests considering the dilution.

Scenario 6 (Succession Planning Involving Multiple Families)

- **Facts:** Same facts as Scenario 1, but OpCo is taxed as a partnership for federal income tax purposes (Form 1065 filer) and is owned 50% by Viserys and 50% by Viserys' brother, Daemon. LandCo, also a partnership for federal income tax purposes, is owned 50% by Viserys and 50% by Daemon. Viserys and Daemon have always had an understanding if one died, the owner would control the companies without the interference of the deceased owner's family, but none of this has ever been reduced to writing.
- **Goals/Objectives**: Same goals as Scenario 1, but more concern about succession now that there are two families involved.
- **Possible Solutions**:
  - Viserys and Daemon form a new holding company ("HoldCo"), which is structured as a new Texas limited liability company that is taxed as a partnership for federal income tax purposes (Form 1065 filer), and simultaneously, Viserys and Daemon contribute/transfer their respective 50% ownership interest in both OpCo and LandCo to HoldCo, which results in HoldCo being the 100% owner of both OpCo and LandCo.
  - Soon after, Viserys and Daemon each establish their own FLP, and each of them transfer/contribute their 50% ownership interest in HoldCo to their respective FLPs.
  - Results in Holdco being owned 50/50 by the two FLPs.

Scenario 6 (cont'd)

- Illustration of HoldCo structure:



Scenario 6 (cont'd)

- **Possible Solutions (cont'd):**
  - HoldCo shall enter into a new Buy-Sell Agreement with the Viserys FLP and the Daemon FLP, which shall (among other things) provide for the following:
    - Ownership of HoldCo shall always be owned by the Viserys FLP and the Daemon FLP, which locks-in ownership among only two owners. This facilitates governance and company succession.
    - Each of the Viserys FLP and the Daemon FLP have a right to appoint one Manager to the Board of Managers.
    - The Viserys FLP must always be completely owned by Viserys, Alicent and their descendants (or trusts for such parties). Similar restriction for the Daemon FLP.
    - An alternative is requiring the Viserys FLP to be under the control of Viserys, Alicent and their descendants (or trusts for such parties). Similar for the Daemon FLP.

Scenario 6 (cont'd)

- **Possible Solutions (cont'd):**
  - Upon the death of Incapacitation of Viserys, the Viserys FLP's ownership in Newco is converted from voting to non-voting, and the Viserys FLP loses its right to have a Manager on HoldCo's Board of Managers. The intention here is to honor the deal that Viserys had with Daemon. Similar provisions would be inserted for Daemon.
  - However, upon the death of Incapacitation of both Viserys and Daemon, whichever FLP lost its voting rights and board seat, would regain both rights to put both FLPs back on equal footing.
    - Alternative: Let's assume that Daemon has children, but none of them are involved in the business, nor qualified to work in the business. Also, Daemon likes Rhaenyra and thinks she is a good leader within the business. Daemon is also ok with Rhaenyra taking over for Viserys one day. Accordingly, the Buy-Sell Agreement can provide that the Viserys FLP will not lose its voting rights or board seat as long as Viserys or Rhaenyra is alive and not Incapacitated.

Scenario 6 (cont'd)

- **Related Issues and Decisions**:
  - Since the Viserys FLP and the Daemon FLP are 50/50 owners in HoldCo, the families are concerned about getting into voting deadlocks. Consider a push-pull provision.
  - In lieu of a push-pull provision, should there be an option to force a dissolution of HoldCo where the assets of the FLPs are partitioned? This is possible, but partitions tend to be messy because difficult to split up assets, employees, etc. Further, who gets the intellectual property assets/rights such as the name/brand of the company?
  - If one of the families is concerned about losing their voting rights and board seat (such as Daemon because he has no successor such as Rhaenyra), consider including a put right for the family that loses its voting right and a board right, which will require HoldCo to buy-out such FLP.

Scenario 7 (Succession Planning Involving All Children)

- **Facts:** Same facts as Scenario 1, but there are only three children, which are from only the marriage of Viserys and Alicent. All three children are involved in the business and viewed as leaders. Viserys and Alicent do not want to choose one of their children to have managing/voting control over OpCo, and thus have decided to have voting control over OpCo distributed evenly among the three children after the death or Incapacitation of both Viserys and Alicent.
- **Goals/Objectives:** Same as Scenario 1, but there is concern about what happens when one of their children dies? Do the deceased child's voting rights pass to their heirs, and do such heirs interfere with the management of OpCo by the surviving siblings?
- **Possible Solutions**:
  - OpCo and its owners enter into a Buy-Sell Agreement providing that the death or incapacitation of a child will cause that child's voting interest to convert to non-voting.
    - Allows surviving children to manage OpCo without interference of the deceased child's family/heirs.
    - Keeping equity with deceased child's family/heirs.
    - After death of last child, all interests return to voting interests.

Scenario 7 (cont'd)

- **Related Issues and Decisions:**
  - What if a child, child's trust or family/heirs argues that they are not bound by the Buy-Sell Agreement?
  - Perhaps they did not sign the Buy-Sell Agreement because they received their ownership interest in OpCo pursuant to Viserys' and Alicent's estate planning documents. They were not original signatories to the Buy-Sell Agreement.
  - Consider including in the estate planning documents the requirement that receipt of any ownership interests requires the signing the Buy-Sell Agreement and other governing documents of OpCo..
    - Consider include a buy-sell right within the trust agreement or estate planning documents.
      - Important that intended recipient still receive value.

Scenario 8 (Succession Planning Involving Employees)

- **Facts:** Same facts as Scenario 1, but OpCo has two long-time employees that are important to the success of OpCo. Their CFO, named Larys Strong, and their top salesperson, named Criston Cole. Viserys and Alicent are concerned that Larys and Criston will be unhappy if ownership is transferred to the Children's Trusts, while Larys and Criston continue to have no ownership. To combat this risk, Viserys wants OpCo to provide some kind of ownership or incentive to Larys and Criston so that they have some skin the game.
- **Goals/Objectives:** To give skin the game and to incentivize Larys and Criston so that they remain as long-term employees of OpCo.
- **Possible Solutions**:
  - Transfer non-voting stock to Larys and Criston.
  - Have OpCo provide some kind of non-equity incentive, such as phantom stock plan, Transaction Bonus Agreement or Incentive Compensation Agreement.

Scenario 8 (cont'd)

- **Related Issues and Decisions:**
  - If OpCo chooses to issue stock to Larys and Criston, they will be taxed on the value of these interests and OpCo will owe payroll tax.
  - If OpCo sells stock to Larys and Criston, they may not want to pay for their stock and may need to finance the purchase.
  - Alternatives to stock ownership:
    - Phantom Stock Plans - Incentive received from various events, including:
      - Sale of the company.
      - Retirement, death or Incapacitation.
      - Distribution equivalent right.
      - Performance of the Company.
        - Caution: May not be best if the metrics in calculating the incentive is dependent on productivity of the plan participants. In this case, such metrics would be different between Larys, who is a CFO, versus, Criston, who is a salesperson.
    - Plan participants are not real owners, which is beneficial to the company for various reasons.
  - Transaction bonus agreements.
    - Similar to Phantom Stock Plans, but more personalized for each employees.
  - Consider restrictive covenant agreements.

Scenario 9 (Succession Planning Involving Spouses of Children)

- **Facts:** Same facts as Scenario 1, but the business is not limited to one business entity. Instead, there are OpCo1, OpCo2, and OpCo 3. Also, both Rhaenyra and Halaena are both married. Rhaenyra's husband is named Laenor, and Laenor works for OpCo2. Halaena's husband is named Jason, and he works for OpCo3. OpCo 1, OpCo 2 and OpCo 3 are all DREs and held under OpCo Holdings, LLC, a Texas limited liability company ("OpCo Holdings"). In this scenario, Viserys wholly owns OpCo Holdings, similar to his ownership in OpCo in the previous scenarios.
- **Goals/Objectives:** Viserys may want to include Laenor and Jason in OpCo 2 and OpCo 3, respectively, because they are family. However, Laenor and Jason may not have what it takes to step into leadership roles.
- **Possible Solutions**:
  - Viserys could provide Laenor and Jason with profits interests in OpCo 2 and OpCo 3, respectively.
  - As discussed in the previous scenario, Viserys could issue or sell ownership interests to Laenor and Jason, implement a phantom stock plan or enter a transaction bonus agreement with them.

Scenario 9 (cont'd)

- **Related Issues and Decisions:**
  - Viserys should be aware of potential vertical slice issues under Section 2701 related to issued profits interests to relatives. When applicable, Section 2701 can require a significantly higher value to the transferred interest and can cause major issues with gift and estate tax planning for business owners
  - A Buy-Sell Agreement should be entered into with spouses of children to provide the company with options if the situation encounters issues.
    - Allows the company to buy-back ownership from the spouses.
    - Restrictive covenants should be considered (non-competition, non-solicitation, confidentiality).

Scenario 10 (Succession Planning with Minor Children)

- **Facts:** Same facts as Scenario 1, but all of the children are still minors. Viserys is concerned that if something unexpected should occur to him, such as a sudden death or Incapacitation, there is nobody to run the business. Again, Alicent does not want to be left with the burden of having voting control over OpCo.
- **Goals/Objectives:** Same goals as Scenario 1.
- **Possible Solutions**:
  - Estate planning documents of Viserys and Alicent are more important because the children are minors. Particularly, appointment of trustees of the trusts – in particular, the Voting Trust.
    - Consider appointing trusted employee of OpCo.
    - Alicent can serve as co-trustee alongside a long-time employee.
  - Have Trustee of the Voting Trust encourage the appointment of an independent board. If Alicent does not want the burden of running OpCo, perhaps she can be Trustee of the Voting Trust and appoint an independent board to help manage OpCo or explore sale of OpCo.
  - Appoint institution as Trustee.
    - Typically, a tougher situation because clients don't want institutions making company's decisions. On the flip side, many intuitions don't want to e int eh role of managing a business.

Scenario 11 (Succession Planning For S-Corporations with Leftover E&P)

- **Facts:** Viserys holds his operating business and all real estate in one entity, OpCo, which is taxed as an S-Corporation. OpCo was previously taxed as a C-Corporation many years ago and still has left over accumulated earnings and profits ("E&P"). OpCo later sells its operating business, but keeps the real estate, which OpCo now leases to third parties to generate income.
- **Goals/Objectives:** Same as Scenario 1, but Viserys want to avoid an involuntary termination of OpCo's S-Corporation status. If an S-Corporation with accumulated E&P at the close of three consecutive years has at least 25% passive income for those three years, then the S-election will terminate
- **Possible Solutions**:
  - Implement another active business in OpCo.
  - Purge OpCo's accumulated E&P.

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Pandora's Algorithm: The Promise and Perils of AI in Taxation

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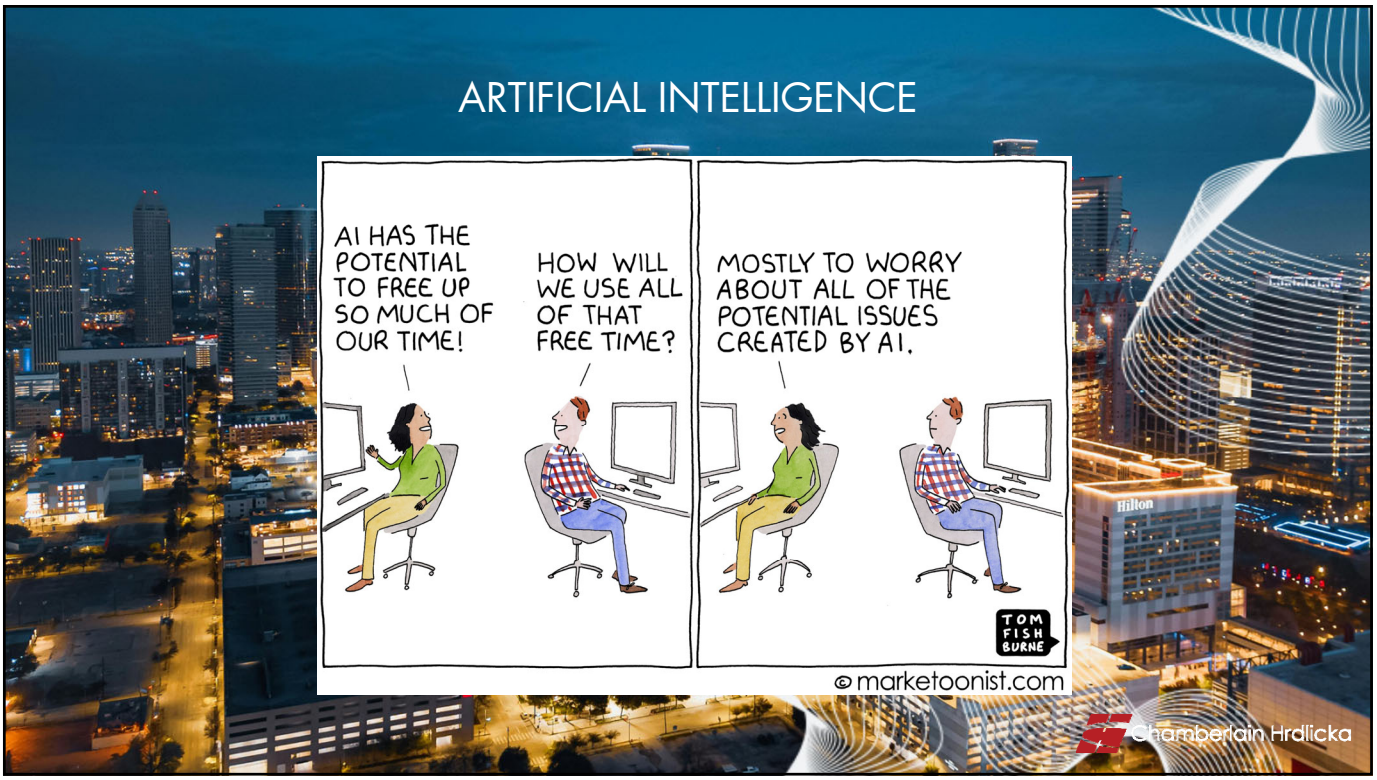

What is AI?

- There is no commonly accepted definition
- Definitions vary widely and often cover technologies that many do not consider to be "AI"

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AI Definition - 15 USC 9401

- The term ''artificial intelligence'' means a machine-based system that can, for a given set of human-defined objectives, make predictions, recommendations or decisions influencing real or virtual environments. Artificial intelligence systems use machine and human based inputs to— (A) perceive real and virtual environments; (B) abstract such perceptions into models through analysis in an automated manner; and (C) use model inference to formulate options for information or action.

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AI Definition – Financial Institution 1

> Any tool (including but not limited to those available via APIs, websites, search engines, chatbots, AI models, use of open Source Code, or as product feature), wherein such tool is machine-trained or uses artificial intelligence and is able to generate content, such as, but not limited to, source code, images, text, videos, voices and inferences. Examples include, but are not limited to, ChatGPT, Stable Diffusion, LLaMA, Bard, etc.

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AI Definition – Financial Institution 2

> "AI Tool" means an engineered or machine-based system that is designed to, or can, for a given set of objectives or inputs, generate outputs such as content, predictions, recommendations, or decisions influencing real or virtual environments (and includes, without limitation, generative AI tools and large language models).

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REGULATIONS

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US AI LAWS, REGULATIONS, IMPLEMENTATION

- Executive Order 14110 -Executive Order on Safe, Secure, and Trustworthy Development and Use of Artificial Intelligence (October 30, 2023)
- Utah AI Policy Act - Effective May 1, 2024
- Colorado AI Act – Effective February 1, 2026
- Formal Opinion 512 on Generative Artificial Intelligence Tools (American Bar Association)
- IRS is starting to use AI to detect tax fraud

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Utah AI Policy Act

- "Generative artificial intelligence" means an artificial system that: (i) is trained on data; (ii) interacts with a person using text, audio, or visual communication; and (iii) generates non-scripted outputs similar to outputs created by a human, with limited or no human oversight.
- Applies to individuals in "regulated occupations" (an occupation regulated by the Department of Commerce that requires a person to obtain a license or state certification to practice the occupation)
- The general consensus is that accounts and attorneys are included under "regulated occupations"
- Companies using generative AI are required to disclose its use to their customer and companies are liable for generative AI outputs.

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Colorado AI Act

- "Artificial Intelligence System" means any machine-based system that, for any explicit or implicit objective, infers from the inputs the system receives hot to generate outputs, including content, decisions, prediction, or recommendations, that can influence physical or virtual environments.
- Covers both "developers" (entities that make and sell AI Systems) and "deployers" (entities that use AI Systems)
- Deployers need to provide appropriate consumer notification of the use of AI Systems
- Deployers need to have internal written policies related to their use of AI Systems

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ENFORCEMENT ENTITIES

- Federal Trade Commission (FTC)
- Internal Revenue Service (IRS)
- Securities and Exchange Commission (SEC)
- Health and Human Services (HHS)
- Department of Labor (DOL)
- Consumer Financial Protection Bureau (CFPB)
- State Attorneys General (and other state entities)
- Private Causes of Action

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Texas AG Enforcement

- Texas AG asserted that Pieces Technology, Inc. (Pieces) misled its customers about the accuracy of its AI products.
- Per the Texas AG – "Pieces developed a series of metrics to claim that its healthcare AI products were "highly accurate," including advertising and marketing the accuracy of its products and services by claiming an error rate or "severe hallucination rate" of "<1 per 100,000."
- Per the settlement – "Pieces has agreed to accurately disclose the extent of its products' accuracy. Pieces has also agreed to ensure that the hospital staff using its generative AI products to treat patients understand the extent to which they should or should not rely on its products."

Source: https://www.texasattorneygeneral.gov/news/releases/attorney-general-ken-paxton-reaches-settlement-first-its-kind-healthcare-generative-ai-investigation

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FTC Enforcement

- FTC commenced "Operation AI Comply" in September 2024
- FTC sued DoNotPay over its use of "Robot Lawyer"
- FTC sued Ascend Ecomn over its false claims related to improving e-commerce businesses using their AI tools
- FTC sued Rytr over using AI tools to generate fake consumer reviews

Source: https://www.ftc.gov/news-events/news/press-releases/2024/09/ftc-announces-crackdown-deceptive-ai-claims-schemes

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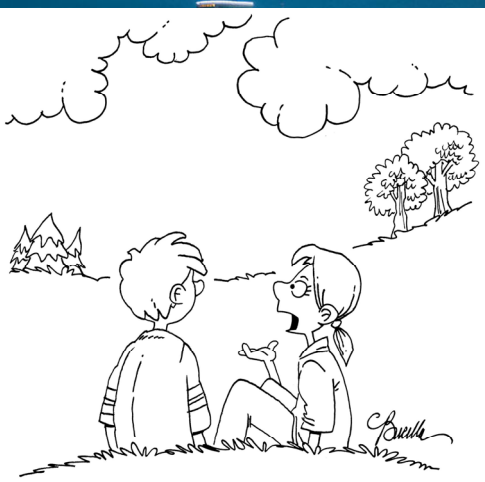
VENDOR RISK



"Which one stores our computer data-the cloud that looks like a kitty or the one that looks like a pony?"

CartoonStock.com

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KEY ISSUES

- Who are your vendors?
- What agreements do you have with your vendors?
- What data do they store and where do they store it?
- What happens if there is a breach?
- What agreements do you have with your customers about use of their data?
- What are they allowed to do with "your" data (which often includes your customer's data)?

COMMON PROBLEM - ONLY REVIEWING COMMERCIAL TERMS AND NOT PERFORMING TECHNICAL DUE DILIGENCE ON VENDORS

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AI RISKS AND UNKNOWNS

- Understanding how AI works
- Quality issues
- Entities are using AI without any established policies (e.g., using AI to analyze confidential information)
- Uncertain legal landscape with respect to use and enforcement
  - IP issues (inputs, generated models, and output)
  - Liability
- AI change outpacing policy development and implementation

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QUESTIONS?
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JUDICIAL HIGHLIGHTS

A timely review of the past year's most significant court decisions on federal and state tax issues[1]

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[1] All credit for this outline goes to Bruce A. McGovern, Professor of Law and Director of the Tax Clinic at South Texas College of Law Houston, Cassady V. ("Cass") Brewer, Associate Dean and Professor of Law at Georgia State University College of Law, and James M. Delaney, Centennial Distinguished Professor of Law at the University of Wyoming College of Law who graciously agreed to our sharing their work with you.

I. BUSINESS INCOME AND DEDUCTIONS

A. Income

1. The *Moore* we read this decision by the U.S. Supreme Court about phantom income, realization, and the Constitution, the less we think it decides — but the clear winner is the government. Moore v. United States, 144 S. Ct. 1680 (6/20/24). Put simply (and perhaps pejoratively), the issue in this U.S. Supreme Court case is whether the Constitution permits federal taxation of phantom income (i.e., gross income without the actual receipt of cash or other property). The unsurprising answer: Yes, the Constitution permits federal taxation of phantom income. (*Silly us. We didn't think the matter was open to question, but what do we know?)* Nevertheless, this case garnered much attention and made its way to the U.S. Supreme Court because of (i) the unique tax provision in question and (ii) the taxpayer's novel argument: that *realization* is a Constitutional prerequisite to federal income taxation. We elaborate below.

The facts: The taxpayers, a married couple, invested $40,000 in 2006 to acquire stock in a non-U.S. corporation conducting business in India. The taxpayers owned 13 percent of the corporation's outstanding stock. The taxpayers' investment was profitable. By 2017, the taxpayers' share of the foreign corporation's undistributed earnings and profits was approximately $508,000. Also in 2017, as part of the Tax Cuts and Jobs Act, Congress added the Mandatory Repatriation Tax ("MRT") to subpart F of the Code. *See* IRC § 965(a)(1), (c), (d). Subpart F applies to "controlled foreign corporations," commonly referred to as CFCs. Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017). In the Court's words, the MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." 144 S. Ct. at 1686. Put differently, and subject to conditions and limitations not applicable to the taxpayers in this case, the MRT effectuates a deemed repatriation (in tax parlance, "phantom income") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the MRT, subpart F mainly applied to passive income.[2] Thus, after certain adjustments, the MRT required the taxpayers to report $132,512 of undistributed income in 2017 from their shareholdings in a foreign corporation, resulting in a *whopping* $14,729 federal income tax liability with respect to their shares.[3] The taxpayers paid the tax and then sued for a refund on the grounds that the MRT is unconstitutional. The U.S. District Court held for the government, the U.S. Court of Appeals for the Ninth Circuit affirmed the district court, and the Supreme Court granted certiorari.

The arguments. The taxpayers argued that the MRT is prohibited under Article I, §§ 8 & 9 and the Sixteenth Amendment of the Constitution because it taxes (via a deemed repatriation) *unrealized* income from their shares of the foreign corporation in which they invested. According

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[2] The MRT was enacted in 2017 to correct a perceived abuse by taxing United States shareholders on their share of post-1986 accumulated but undistributed trade or business income of "controlled foreign corporations" (as defined) even though a dividend had not been declared. Otherwise, if the income earned by the foreign corporation was never repatriated, it remained indefinitely untaxed by the U.S. The MRT also operates prospectively after 2017 with respect to "global intangible low-taxed income" (a/k/a "GILTI") See IRC § 951A.

[3] The amount of tax was inconsequential to the taxpayers; however, the taxpayers' refund suit was used as a litigation vehicle for other interested parties seeking to foreclose the possible enactment of a U.S. wealth tax.

to the taxpayers, the MRT thus is an unconstitutional "direct" tax. The Court elaborated on the taxpayers' argument as follows:

> Article I of the Constitution affords Congress broad "Power To lay and collect Taxes, Duties, Imposts and Excises." Art. I, §8, cl. 1. That power includes "two great classes of" taxes—direct taxes and indirect taxes.
>
> Generally speaking, direct taxes are those taxes imposed on persons or property. As a practical matter, however, Congress has rarely enacted direct taxes because the Constitution requires that direct taxes be apportioned among the States. To be apportioned, direct taxes must be imposed "in Proportion to the Census of Enumeration." U.S. Const., Art. I, §9, cl. 4; see also §2, cl. 3. In other words, direct taxes must be apportioned among the States according to each State's population.
>
> * * * *
>
> By contrast, indirect taxes are the familiar federal taxes imposed on activities or transactions. That category of taxes includes duties, imposts, and excise taxes, as well as income taxes. U.S. Const., Art. I, §8, cl. 1; Amdt. 16. Under the Constitution, indirect taxes must "be uniform throughout the United States." Art. I, §8, cl. 1. A "tax is uniform when it operates with the same force and effect in every place where the subject of it is found."
>
> Because income taxes are indirect taxes, they are permitted under Article I, §8 without apportionment.

144 S. Ct. at 1687-1688 (*case citations omitted)*.

The taxpayers reasoned that the MRT is an impermissible direct (not indirect) tax by relying on the Court's 1920 decision in *Eisner v. Macomber*, 252 U.S. 189 (1920). *Eisner v. Macomber* famously held, now codified in § 305, that a pro rata stock dividend does not give rise to gross income. The Court's opinion in *Eisner v. Macomber* stated in dicta as partial support for its holding that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." 252 U.S. 219. The taxpayers latched onto this language from *Eisner v. Macomber* to support their position that the MRT is unconstitutional, arguing their phantom income in 2017 from their shares in the foreign corporation was unrealized "capital." Therefore, according to the taxpayers, the MRT is either (i) an unconstitutional direct tax (because it is not apportioned among the states) or (ii) is an unconstitutional indirect tax because *Eisner v. Macomber* requires realization, whereas the taxpayers' shares in the foreign corporation represented capital.

The government argued in response that the MRT is a permissible indirect tax under a long line of cases decided after *Eisner v. Macomber*, including cases upholding the constitutionality of pass-through tax treatment within subpart F, subchapter K (partnerships), and subchapter S (S corporations). As readers understand, so-called phantom income (gross income without an actual distribution of cash or property) under subpart F, subchapter K, and subchapter S is commonplace. Moreover, the government argued that neither *Eisner v. Macomber* nor any other authority constitutionally requires realization as a prerequisite to federal income taxation. The District Court and the Ninth Circuit agreed with the government, but the Supreme Court granted certiorari to hear the taxpayers' argument that realization is a constitutional prerequisite to federal income taxation. Yet, as discussed below, we still do not know the answer to the taxpayers' realization argument.

The Court's messy (non?) decision: By a 7-2 vote, the Supreme Court upheld the constitutionality of the MRT as applied to the taxpayers in this case, but the Court did so without explicitly ruling whether realization is constitutionally required. How did the Supreme Court get there without addressing the realization question? Well, as we said, the opinion in *Moore* is messy. Justice Kavanaugh wrote the Court's majority opinion. The reasoning among the majority, however, varied.

- Four justices (Roberts, Sotomayor, Kagan, and Jackson) joined in Justice Kavanaugh's majority opinion. Summarizing the Court's decision, Justice Kavanaugh wrote:

  > [W]e emphasize that our holding today is narrow. It is limited to: (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders, (iv) when the entity itself has not been taxed on that income. In other words, our holding applies when Congress treats the entity as a pass-through.
  >
  > * * * *
  >
  > The [taxpayers] argue that realization is a constitutional requirement; the Government argues that it is not. To decide this case, we need not resolve that disagreement over realization.
  >
  > Those are potential issues for another day, and we do not address or resolve any of those issues here. As to the [taxpayers'] case, Congress has long taxed shareholders of an entity on the entity's undistributed income, and it did the same with the MRT. This Court has long upheld taxes of that kind, and we do the same today with the MRT. We affirm the judgment of the U.S. Court of Appeals for the Ninth Circuit.

144 S. Ct. at 1696-1697.

- Justice Jackson agreed with the majority but would have gone further than the Court was willing, writing in a separate, concurring opinion: "[B]oth before and after the Sixteenth Amendment was adopted, the term 'income' was widely recognized as flexible enough to include both realized and *unrealized* gains." 144 S. Ct. at 1698 (emphasis added).
- Justices Barrett and Alito disagreed with Justice Kavanaugh's opinion, including his reasoning and interpretation of precedent; however, they nevertheless concurred in the result in favor of the government, stating:

  > Congress's power to attribute the income of closely held corporations to their shareholders is a difficult question — and unfortunately, the parties barely addressed it. Without focused briefing on the attribution question,[4] I would not resolve it. Subpart F and the MRT *may or may not be constitutional*, nonarbitrary attributions of closely held foreign corporations' income to their shareholders. In this litigation, however, the [taxpayers] have conceded that subpart F is constitutional. And I agree with the Court that subpart F is not meaningfully different from the MRT in how it attributes corporate income to shareholders. Taxpayers generally bear the burden to show they are entitled to a refund. Given the [taxpayers'] concession, they have not met that burden here. For that reason, I concur in the Court's judgment affirming the judgment below.

144 S. Ct. at 1709.

The dissent: Justices Thomas and Gorsuch disagreed with both the majority and concurring opinions. Justice Thomas authored a 33-page dissenting opinion. The dissent goes deep into the history behind the adoption of the U.S. Constitution as well as the Sixteenth Amendment (which we leave to our readers' discretion) to support the conclusion that realization is indeed a constitutional prerequisite to federal income taxation. Justice Thomas wrote:

> The Court today upholds the MRT, but not because it endorses the Ninth Circuit's erroneous view that "realization of income is not a constitutional requirement." The majority acknowledges that the Sixteenth Amendment draws a distinction between income and its source. And, it does not dispute that realization is what distinguishes

[4] We feel compelled to point out that over 50 briefs were filed with the Court by the parties and amici curiae.

> income from property. Those premises are sufficient to establish that realization is a constitutional requirement. Sixteenth Amendment "income" is only realized income. We should not have hesitated to say so in this case. I respectfully dissent.

144 S. Ct. at 1727 (case citations omitted).

Comment: What are the broader implications of the Supreme Court's decision in *Moore*? Other than upholding the constitutionality of the deemed repatriation, pass-through aspect of the MRT (including, perhaps, pass-through taxation within subchapter K, subchapter S, and other provisions of subpart F), we think the answer is "None." The Court did not decide if realization is constitutionally required, and the differing opinions, especially the concurring and dissenting opinions, invite such challenges in the future. Thus, in our view, *Moore* raises far more questions than it answers and provides fertile ground for challenging the constitutionality of phantom income (i.e., "unrealized" income) outside the context of subpart F, subchapter K, and subchapter S. Justice Kavanaugh admitted as much in a footnote: "[O]ur analysis today does not address the distinct issues that would be raised by (i) an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income; (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation."

For example, what about the Court's decision in *Commissioner v. Tufts*, 461 U.S. 300 (1983), which sanctions the determination of amount realized and gain on the disposition of property encumbered by a nonrecourse liability by taking into account the entire outstanding principal balance of the debt notwithstanding the property's lower fair market value? *See also* § 7701(g). Is unrealized *Tufts* gain unconstitutional? What about the taxation of built-in gain and passive investment income of subchapter S corporations? Sections 1374 and 1375 impose federal income taxes on the S corporation itself even though S corporation's shareholders also pay federal income tax on their allocable shares of such income. *See* §§ 1366, 1374, 1375. Are sections 1374 and 1375 taxes "on both the entity and the shareholders" as described by Justice Kavanaugh in the above-quoted footnote? Finally, what about the federal estate tax, which taxes the unrealized but appreciated value of a decedent's property (and grants a corresponding basis step-up)? *See* §§ 1014, 2001. Is the estate tax a questionable "wealth tax" as footnoted by Justice Kavanaugh? The Court upheld the constitutionality of the federal estate tax over 100 years ago in *New York Trust Company v. Eisner*, 256 U.S. 345 (1921), but does *Moore* change the analysis? We're certain there are numerous other examples of the taxation of "unrealized" appreciation.

B. Miscellaneous Deductions

1. Eleventh Circuit affirms Tax Court in denying a deduction for "legal fees" determined to be related to criminal charges arising out of inappropriate personal activities. Anderson v. Commissioner, 133 A.F.T.R. 2d 2024-1551 (10th Cir. 5/17/24), *aff'g*, T.C. Memo. 2023-42 (3/28/23). The taxpayer in this case, a doctor who researched gene therapy, was arrested on allegations of sexually abusing the minor daughter of his research assistant. He was convicted in California state court and sentenced to prison. The IRS disallowed deductions for legal fees on the taxpayers' (husband's and wife's) federal income tax returns for 2013 and 2014 and issued a notice of deficiency for those years. The taxpayers responded by filing a petition in the Tax Court and argued that the legal fees were deductible as ordinary and necessary business expenses under § 162. The Tax Court (Judge Paris) disallowed the taxpayers' legal expense deductions for 2013 ($292,175) and disallowed $65,120 of the $68,120 in deductions for 2014. The Tax Court allowed the taxpayer to deduct $3,000 of the 2014 legal fees (plus an additional $10,000 not previously claimed) because those fees had been paid for an investigation related to his trade or business.

On appeal, in an order and judgment by Judge Tymkovich, the U.S. Court of Appeals for the Eleventh Circuit agreed with the Tax Court's analysis. The taxpayers asserted that they had paid the legal fees, at least in part, for an investigation of the doctor's former colleague, who allegedly had filed false accusations of molestation against the doctor in an effort to steal his intellectual property. In both the Tax Court and on appeal, the taxpayers argued that the Tax Court misapplied the Supreme Court's decision in *Commissioner v. Tellier*, 383 U.S. 687 (1966). In *Tellier*, the

petitioner was in the securities business and was found guilty of securities fraud. Mr. Tellier sought to deduct his legal fees as a business expense and the IRS disallowed the deduction "on the ground of tax fraud." *Tellier*, 383 U.S., at 690. The IRS conceded in *Tellier* that the legal fees were business expenses but argued that the deductions should be disallowed as a public policy exception to § 162, which authorizes a deduction for ordinary and necessary business expenses. *Id.* The Supreme Court disagreed and held that public policy does not prohibit a deduction of legal fees related to criminal activity so long as the legal fees are an ordinary and necessary expense of the taxpayer's trade or business. *Id.* at 694-95. The Eleventh Circuit in this case distinguished *Tellier* and reasoned that the issue in this case was not whether the taxpayers' deductions were disallowed by public policy, but rather whether legal fees paid by the taxpayers were actual business expenses. Pursuant to the U.S. Supreme Court's decision in *United States v. Gilmore*, 372 U.S. 39, 48-49 (1963), the deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim has a sufficient connection to the taxpayer's business or income-producing activities. Under *Gilmore*, "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test." *Id.* at 49. Here, the Eleventh Circuit agreed with the Tax Court's reasoning that the taxpayer was charged with sexual abuse of a minor that was alleged to have occurred at the taxpayer's home. Those activities were personal in nature and did not involve or arise out of the taxpayer's gene therapy business. Rather, the expenses the taxpayer attempted to deduct were primarily related to his ineffective assistance of counsel claim in his criminal case and a later proceeding in which he filed a state habeas corpus petition seeking his release from prison. The Eleventh Circuit adopted the Tax Court's reasoning that the criminal charges did not involve the taxpayer's gene therapy business or any other activity for the production or collection of income. The connection between the taxpayer's criminal proceedings and his occupation was merely tangential. Further, any economic loss to the taxpayer's business following the conviction was a collateral consequence of the criminal case and not the origin of the claimed expenses. The court therefore affirmed the Tax Court's disallowance of the majority of the taxpayer's legal expense deductions in 2013 and 2014.

II. INVESTMENT GAIN AND INCOME

A. Gains and Losses

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

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

The Tax Court (Judge Lauber) ruled in favor of the government. The taxpayer's argument, the court stated, had no legal basis. The court observed that "[t]he doctrine of estoppel can be invoked against the United States only in the rarest of circumstances." Further, the "unclean hands" principle, the court concluded, did not apply because that principle withholds equitable relief from a party who has acted improperly, and the government in this case was not seeking equitable relief but rather was seeking to recover taxes due from the taxpayer under the Internal Revenue Code. Further, the court reasoned, the annual accounting principle "dictates that a taxpayer's income for a particular year be calculated on the basis of events occurring during that year." Although Congress has allowed corporations to carry capital losses both forward and back under § 1212(a)(1), it has chosen to allow individual taxpayers to carry capital losses realized in 2020 only forward, which means that losses the taxpayer might have realized in 2020 are irrelevant in determining his liabilities for 2013-2017.

III. COMPENSATION ISSUES

A. Qualified Deferred Compensation Plans

B. Individual Retirement Accounts

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

- In January 2015 (and thereafter, as noted below), PBSM did not provide UBS with the value of Caan's hedge fund interest for the year ended 2014. In this regard, the UBS IRA custodial agreement provided as follows: "The Client acknowledges, understands and agrees that if the Custodian does not receive a fair market value as of the preceding December 31, the Custodian shall distribute the Investment to the Client and issue an IRS Form 1099-R for the last available value of the Investment."
- In March and August of 2015, UBS sent PBSM letters requesting the hedge fund interest's fair market value as of December 31, 2014. UBS received no response from PBSM with respect to either letter.
- Meanwhile in June of 2015, Caan's personal financial advisor at UBS, Michael Margiotta, moved to Merrill Lynch.
- UBS alerted PBSM again in October 2015 that unless corrective action was taken it would resign as IRA custodian of the hedge fund interest effective November 23, 2015, and distribute the interest to Caan. UBS received no response from PBSM with respect to the October letter.
- Also in October of 2015, Margiotta convinced Caan to transfer the assets in his two UBS IRAs to a rollover IRA at Merrill Lynch. Caan signed the necessary paperwork, and then UBS transferred the assets, except for the illiquid hedge fund interest, to Caan's Merrill

Lynch rollover IRA. The interest in the hedge fund was not transferred because the National Securities Clearing Corporation system normally used for IRA-to-IRA transfers does not accommodate unregistered securities and other nontraditional IRA assets.

- In December 2015, UBS notified PBSM of its resignation as IRA custodian and the corresponding distribution of the hedge fund interest to Caan effective as of November 25, 2015. UBS's December letter to PBSM stated that Caan had sixty days from November 25, 2015, to rollover the hedge fund interest into another IRA. UBS's December letter advised PBSM and Caan to contact the hedge fund itself to re-register the interest into Caan's name or have it registered in the name of another IRA custodian.
- Later (presumably early in 2016), in accordance with the IRA custodial agreement, UBS issued Mr. Caan (via PBSM) a 2015 Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reflecting the November 25, 2015, IRA distribution of $1,910,903, the hedge fund interest's reportable year-end value for 2013.
- PBSM and Merrill Lynch did not discover until October 2016 that the hedge fund interest had not been transferred to Caan's Merrill Lynch rollover IRA.
- In December 2016, PBSM and Merrill Lynch instructed the hedge fund itself (which handled transfers and redemptions of partnership interests in the fund) to liquidate Caan's interest for cash and transfer the cash to Caan's Merrill Lynch rollover IRA.
- Then, in 2017, three separate cash transfers totaling $1,532,605.46 then were made from the hedge fund to Caan's Merrill Lynch rollover IRA.

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

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

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

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

With respect to the estate's argument that UBS's 2015 Form 1099-R erroneously reported a distribution to Caan of $1,910,903, Judge Copeland *partially* agreed. Judge Copeland reasoned that, as discussed above, UBS did in fact distribute the hedge fund interest to Caan on November 25, 2015; however, the value of the distribution for income tax purposes was $1,548,010, not the $1,910,903 value reported by UBS and not the $1,532,605.46 in cash proceeds resulting from the liquidation of the interest in 2017. Judge Copeland based his decision on the IRS's position that the hedge fund's 2014 ending capital account for Caan's partnership interest was $1,548,010 (presumably, a booked-to-market value). Moreover, Caan's estate had not proposed or proven any other value. Thus, Judge Copeland set the amount of Caan's 2015 taxable distribution from his UBS IRA at $1,548,010.

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

2. Honey, I shrunk the IRAs! Being incarcerated is bad enough without learning that your wife has depleted your IRAs and other accounts and filed for divorce and that the IRS seeks to collect tax on the withdrawals Balint v. Commissioner, T.C. Memo. 2023-

118 (9/25/23). The taxpayer was incarcerated from late 2013 through January 6, 2015. While incarcerated, he wrote a letter to his wife that stated:

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

His attorney, Glenn Abbott, then prepared a proposed power of attorney for the taxpayer's signature. The power of attorney was broadly worded and gave his wife "full power and authority to perform any act, power, or duty that I may now or hereafter have and to exercise any right that I now have or may hereafter acquire." It specifically authorized her to withdraw money from financial and retirement accounts, to make gifts of his property, and to engage in acts that otherwise would constitute prohibited self-dealing. Pursuant to this authority, his wife withdrew large amounts of money from the taxpayer's IRAs and his pension and annuity accounts and transferred the money from the couple's joint checking account into her own separate bank account. She used the funds to move from their residence in Florida to Kentucky, to renovate a house there, and to pay living expenses and care for her ailing mother. She then initiated a proceeding for divorce. After the taxpayer was released from prison in early 2015, he filed a federal income tax return for 2014 with the filing status of married filing separately on which he reported all withdrawals from the accounts, including those taken by his wife, as income because he received information returns (presumably Forms 1099-R) that reported the withdrawals as taxable to him. When he could not pay the balance due, the IRS issued a final notice of intent to levy, in response to which the taxpayer requested a collection due process (CDP) hearing. The IRS Settlement Officer who conducted the CDP hearing issued a notice of determination sustaining the proposed levy, and the taxpayer then filed a petition in the U.S. Tax Court. While the taxpayer's case in the Tax Court was pending, the taxpayer filed his own action for divorce and the state court issued an order in which it concluded that his wife should be liable for tax on the amounts she withdrew because the taxpayer did not benefit from the withdrawals and they were made without his knowledge or consent.

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

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

No gross income from the disputed withdrawals. The taxpayer argued that he should not have to include approximately $159,811 that his wife had withdrawn from his IRAs and life insurance policy. The Tax Court held that these distributions were not includible in the taxpayer's gross income under § 408(d)(1), which provides that the "payee or distributee" must include in gross income in the manner provided under § 72 any amount paid or distributed out of an individual retirement plan. The court reasoned that the taxpayer was not a payee or distributee within the meaning of § 408(d)(1) because he had not authorized the withdrawals and did not benefit from them. Although the power of attorney signed by the taxpayer was broadly worded and gave his

wife authority to make gifts of his property and to engage in acts that otherwise would be prohibited self-dealing, the court interpreted the power of attorney as limiting her authority to actions undertaken for the purpose of financial or estate planning for the taxpayer's benefit or for qualifying for public assistance for which the taxpayer might be eligible. The relevant language in the power of attorney, the court concluded,

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

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

IV. PERSONAL INCOME AND DEDUCTIONS

A. Deductions and Credits for Personal Expenses

1. A nonresident alien is entitled to a personal exemption deduction in 2018 through 2025, but the amount of the deduction is zero under the 2017 Tax Cuts and Jobs Act. Bell v. United States, 169 Fed. Cl. 466 (1/25/24). The taxpayer in this case, Mr. Cecil Bell, was a Jamaican citizen and a nonresident alien of the United States.[5] The Court of Federal Claims, in an opinion by Judge Horn, held that, although the taxpayer was entitled to one deduction of the "exemption amount" under § 151(a) and § 151(b), the exemption amount was zero pursuant to § 151(d)(5), as applicable during the years 2018 through 2025. The effect of this holding is that the taxpayer did not receive any reduction in income or the refund he requested.

Section 151(a) and (b) authorize a deduction equal to the "exemption amount" for a taxpayer. The 2017 Tax Cuts and Jobs Act, § 11041, amended Code § 151(d) by adding § 151(d)(5). Section 151(d)(5)(A) reduces the exemption amount to zero for taxable years beginning after 2017 and before 2026. The intended effect of this amendment was to eliminate the deduction for personal exemptions authorized by § 151(a).

The arguments in this case primarily revolve around the specific wording of §§ 151(d)(5)(B) and 873(a)-(b). Section 151(d)(5)(B) provides:

> For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph A shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.

Section 873(a) provides that deductions are allowed for a nonresident alien individual only to the extent they are connected with income that is effectively connected with the conduct of a trade or business in the United States. Despite this general rule, § 873(b) provides that certain deductions

[5] The taxpayer was represented by the Low Income Taxpayer Clinic at Syracuse University College of Law.

are allowed for a nonresident alien individual *whether or not* they are connected with income with income that is effectively connected with the conduct of a trade or business in the United States. Pursuant to § 873(b)(3), one of these deductions is "the deduction for personal exemptions allowed by section 151 …"

The taxpayer filed an amended return for 2018 on which he claimed a personal exemption deduction and a refund of $415. The taxpayer argued that, despite Congress's reduction of the exemption amount to zero for 2018, he was entitled to a personal exemption deduction under § 873(b)(3). The taxpayer focused on the language in § 151(d)(5)(B) providing that the reduction of the exemption amount to zero "shall not be taken into account in determining whether…a taxpayer is entitled to a deduction, under this section." The taxpayer asserted that this language, in conjunction with the language of § 873(b)(3), which provides that a nonresident alien individual is allowed "the deduction for personal exemptions allowed by section 151 …," entitles a nonresident alien to a personal exemption deduction. In sum, taxpayer asserted that Congress suspended a U.S. citizen's right to personal exemption deduction while, at the same time, preserving a nonresident alien taxpayer's entitlement to the same deduction.

The government responded that the language in § 151(d)(5)(B), which provides that the reduction of the exemption amount to zero is not taken into account in determining whether a taxpayer is entitled to a deduction under § 151, "applies when there is a Code section that asks whether someone would be eligible for a deduction under § 151, and then grants some other tax status or benefit on the basis of eligibility." For example, the parties agreed that a taxpayer's right to the child tax credit under § 24 or head of household filing status under § 2 is preserved because the personal exemption deduction remains in effect for purposes of determining the benefits under these provisions. The government disagreed, however, that § 151(d)(5)(B), in conjunction with § 873(b)(3), allows a nonresident alien to take a personal exemption deduction in 2018 through 2025.

The court agreed with the government. Judge Horn reasoned that the issue is whether the language of § 151(d)(5)(B) in conjunction with § 873(b)(3) allows a nonresident alien to ignore the reduction of the exemption amount to zero. Persuaded by the government's reading of the statutes, Judge Horn reasoned that

> the plain language of … § 151(d)(5) establishes two separate concepts: (1) the process of determining whether a taxpayer's deduction is "allowed," "allowable," or is "entitled to," and (2) the actual exemption amount.

According to the court, the language of § 151(d)(5)(B) providing that the reduction of the exemption amount to zero is not taken into account in determining whether a taxpayer is entitled to a deduction under § 151 simply means that, in determining whether a deduction is allowed (or not) or whether a taxpayer is entitled to a deduction (or not), the reduction of the exemption amount to zero is not taken into consideration. In reaching this conclusion, the court reasoned that the taxpayer's theory that nonresident aliens are treated differently under the statute than U.S. citizens would create an unintended discriminatory effect against U.S. citizens and in favor of nonresident aliens. Judge Horn observed that, if Congress had intended such a distinction, it surely would added explicit language to the statute and Congress had not done so. The court concluded that, like a U.S. citizen, the taxpayer was entitled to one personal exemption deduction and that the deduction was equal to the exemption amount of zero.

V. CORPORATIONS

A. Miscellaneous Corporate Issues

1. Much ado about nothing . . . or an open can of worms full of you know what flung against a fan?!?! A U.S. corporation with a tax year straddling the effective date of the TCJA was entitled to a deduction under § 245A for a deemed dividend from a CFC the U.S. corporation was required to include in income under § 78. Varian Medical Systems Inc. v. Commissioner, 163 T.C. No. 4 (8/26/24). Candidly, we are not sure if this reviewed case of

first impression from the Tax Court is a yawner or a gobsmacker. Only time will tell. The taxpayer took advantage of *both* § 78 *and* § 245A for its 2018 tax year due to conflicting effective date language in the 2017 Tax Cuts and Jobs Act (TCJA). Except in circumstances almost identical to this case (where a multinational corporate taxpayer's taxable year straddles the enactment of the TCJA), taking advantage of both § 78 and § 245A is expressly prohibited. *See* IRC § 78. *Yes, we told you the case has extremely narrow application, but that's not really the important part, so keep reading.* The Tax Court's precedential opinion does not entirely settle the case, but it does resolve competing cross-motions for summary judgment filed by the taxpayer and the IRS.

Broader implications of the case. On one hand, the Tax Court addressed an unusually narrow set of facts, largely ruling in favor of a clever multinational corporate taxpayer who for *one taxable year* took advantage of a known, limited-time loophole: a mismatch in the TCJA's effective date provisions concerning § 78 and § 245A. On the other hand, the Tax Court reached its decision by completely disregarding a Treasury regulation that purported to close the loophole. The Treasury regulation sought to close the loophole retroactively as had been proposed in technical corrections legislation that our dysfunctional Congress drafted but never passed. The authors believe that the Tax Court, as explained in a well-written opinion by Judge Toro, reached the correct result, especially considering the straightforward but conflicting effective date language in the relevant statutes. Nevertheless, the real significance of the case is the Tax Court's willingness to completely disregard the loophole-closing Treasury regulation on point. Going forward, it seems clear that the Tax Court (and other federal courts as well) will exercise independent judgment when evaluating government agency interpretations of statutes. Thus, the Tax Court no longer will defer to Treasury's admittedly self-interested interpretation of ambiguous, or arguably ambiguous, Code provisions. Instead, interpretative (as opposed to legislative) Treasury regulations and other administrative guidance not satisfying the new *Loper Bright* "best interpretation" standard adopted by the U.S. Supreme Court may be disregarded or invalidated. We elaborate below.

Factual Background. The taxpayer was the parent company of a consolidated group of medical device and software manufacturers headquartered in the U.S. The taxpayer also operated internationally, including through controlled foreign corporation ("CFC") subsidiaries within the meaning of subpart F of the Code. *See* IRC § 957.[6] The taxpayer and its CFC subsidiaries previously had adopted a fiscal (as opposed to a calendar) taxable year for federal income tax purposes. The taxpayer's fiscal taxable year in this case ran from September 30, 2017, through September 28, 2018 (the "2018 tax year"). The TCJA was enacted late in 2017. Thus, the taxpayer's 2018 tax year straddled the enactment of the TCJA. Reading between the lines, we believe that for its 2018 tax year the taxpayer was subject to the § 965 "Mandatory Repatriation Tax" ("MRT") enacted by the TCJA as part of Congress's overhaul of subpart F of the Code.[7]

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[6] Under § 957(a), a CFC generally is a non-U.S. corporation if, on any day during the corporation's taxable year, "United States shareholders" own stock possessing more than 50 percent of either the total voting power of all classes of stock entitled to vote or the total value of the corporation's stock. Pursuant to § 957(b), a "United States shareholder" is a "United States person" (see § 7701(a)(30)) who owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote (before 2018) or 10 percent or more of the total value of shares of all classes of stock of the foreign corporation (after 2017).

[7] We previously summarized the MRT in connection with our discussion of SCOTUS's decision in Moore v. United States, 602 U.S. ___ (6/20/2024). The MRT imposes "a one-time pass-through tax" that is "backward-looking" on the accumulated but undistributed income of "American-controlled foreign corporations." *Moore*, 144 S. Ct. at 1686. Put differently, the MRT effectuates a deemed repatriation (in corporate tax parlance, "deemed dividend") of earnings and profits to U.S. shareholders holding 10 percent or more of the controlled foreign corporation's stock. Longstanding provisions of subpart F have operated the same way for decades, but before the TCJA-enacted MRT, subpart F mainly applied to passive income. The MRT was enacted in 2017 to correct a perceived abuse by taxing U.S. shareholders on their share of post-1986 accumulated but undistributed trade or business income of "controlled foreign corporations" (as defined) even though a dividend had not been declared. Otherwise, if the income earned by the foreign corporation

Accordingly, the taxpayer was keen to ameliorate the adverse impact of the MRT. Regardless, the taxpayer's international operations via its CFC subsidiaries for its 2018 tax year permitted the taxpayer to claim approximately $161 million in § 901 foreign tax credits. Those claimed foreign tax credits in turn implicated § 78 (deemed dividends relating to claimed foreign tax credits) and § 245A (deduction relating to dividends received from specified 10-percent owned foreign corporations).

Legal Background. As noted above, § 245A was enacted at the end of 2017 as part of the TCJA's extensive revisions to subpart F of the Code. Generally, § 245A grants a dividends-received deduction ("DRD") to a domestic corporation that is a United States shareholder with respect to any "specified 10-percent owned foreign corporation" for any dividend received from the foreign corporation. *See* § 245A(a). Importantly, § 245A became effective for "distributions made after December 31, 2017." Thus, § 245A applied to any dividends received by the taxpayer from its CFC subsidiaries on or after January 1, 2018. The dividends-received deduction authorized by § 245A eliminates U.S. taxation of distributions (or deemed distributions) of untaxed foreign-source income. Contrastingly, § 78 has been a part of the Code since 1962. Section 78 was enacted to achieve tax parity between U.S. corporations operating internationally through foreign branches vis-a-vis those operating through CFCs. Section 78 achieves this tax parity by "grossing up" a U.S. corporate CFC shareholder's dividends received by the amount of foreign taxes imposed on the foreign earnings and deemed paid and claimed by the U.S. corporate shareholder as a foreign tax credit under § 960. For example, if the U.S. corporate shareholder receives a dividend of $70 from a CFC and the CFC has paid $30 in foreign taxes for which the U.S. corporate shareholder claims a foreign tax credit under § 960, then, under § 78, the U.S. corporate shareholder would be treated as receiving a dividend of $100 ($70 + $30) and would claim a foreign tax credit of $30 against the corporation's U.S. tax liability.[8] In this example, § 78 treats the $30 of foreign tax deemed paid as a dividend received by the U.S. corporate shareholder. This gross-up of the dividend is designed to prevent the U.S. corporate shareholder from effectively obtaining both a deduction and a credit for foreign tax deemed paid. The deemed dividend under § 78, however, has never been eligible for the normal § 245 DRD and, except as applied in this case, was not supposed to be eligible for the § 245A DRD. (The normal § 245 DRD was not relevant to this case.) Specifically, before the TCJA, § 78 stated that the foreign taxes deemed paid by the U.S. corporate shareholder "shall be treated for purposes of this title (*other than section 245*) as a dividend received by such domestic corporation from the foreign corporation." *See* IRC § 78 (2016) (emphasis added). Therefore, in connection with enacting new § 245A, the TCJA amended the above-quoted parenthetical in § 78 to add a cross-reference to § 245A as follows: "(other than sections 245 *and 245A*)." *See* § 78 (2024) (emphasis added). Nonetheless amended § 78's effective date provision under the TCJA — and here's the big "*Oops*" at the crux of the case — states that the revised statute applies for "taxable years of foreign corporations beginning after December 31, 2017, and . . . taxable years of United States shareholders in which or with which such taxable years of foreign corporations end." TCJA § 14301(d), 131 Stat. at 2225. As noted above, then, § 245A applies to "distributions made after December 31, 2017." Thus, as Judge Toro put it in the Tax Court's opinion, the TCJA's mismatched effective date language left a narrow "gap" during which both § 78 and § 245A theoretically could apply to taxpayers with a fiscal year straddling the enactment of TCJA. 163 T.C. at ___. As a result, a U.S. corporation exploiting this gap could claim a foreign tax credit for foreign taxes actually paid by the foreign corporation

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was never repatriated, it remained indefinitely untaxed by the U.S. The MRT also operates prospectively after 2017 with respect to "global intangible low-taxed income" (a/k/a "GILTI") *See* IRC § 951A.

[8] Stating the obvious, perhaps, we have greatly oversimplified the tax analysis pertaining to foreign tax credits and subpart F of the Code, including the deemed dividend, increase to taxable income, the § 245A DRD, and the tax parity achieved by § 78. Judge Toro's opinion, however, provides a helpful but also somewhat simplified illustration at 163 T.C. ___ -___. We commend it to readers curious about the interrelationship between subpart F, foreign tax credits, § 78, and § 245A.

paying the dividend (and deemed paid by the U.S. corporation receiving the dividend) and simultaneously deduct the dividend received, i.e., the U.S. corporation effectively receives both a tax-free dividend and a foreign tax credit.

Treasury's Attempted "Gap" Fix. Treasury, the IRS, and Congress were well aware of this unintended "gap" in the TCJA's mismatched effective date language concerning §§ 78 and 245A. On January 2, 2019, the House Ways and Means Committee published a *Tax Technical and Clerical Corrections Act Discussion Draft* that would have retroactively closed the "gap" as of the enactment of the TCJA. The proposed fix, however, was never passed by Congress. Regardless, Treasury published on June 21, 2019, a revised, interpretative regulation under § 78 that disallowed the § 245A deduction for the deemed dividend engineered by § 78. The revised regulation under § 78 purported to be retroactively effective to § 78 deemed dividends occurring on or after January 1, 2018, despite the contrary effective date language (as quoted above) in the TCJA regarding amended § 78. *See* Reg. 1.78-1 (stating in part and emphasis added: "A section 78 dividend is treated as a dividend for all purposes of the Code, except that it is not treated as a dividend for purposes of sections 245 *or 245A* . . . .").

The Arguments. Because the case has such narrow applicability regarding potentially affected taxpayers, we have minimized our discussion of the taxpayer's and the IRS's arguments regarding whether §§ 78 and 245A could apply to the taxpayer's 2018 fiscal tax year. Essentially, the taxpayer relied on the plain language of the statutes, including the TCJA effective date provisions, while the IRS was left to make the following unsuccessful "should be" arguments:

- § 245A should be read to apply, even for the "gap" period, only to dividends *actually* received rather than deemed § 78 dividends;
- § 275(a)(4) (disallowing a deduction for foreign or territorial taxes for which tax credits are claimed) and § 261 (referencing Code §§ 262 through 280H, which consist of a long list of prohibited deductions for specified items such as personal expenses, capital expenditures, entertainment expenses, etc.) should be read broadly (*somehow?*) to disallow the taxpayer's § 245A DRD for the "gap" period; and
- allowing a DRD under § 245A for a § 78 deemed dividend only within the "gap" period should be considered absurd and contrary to congressional policy and intent.

None of the foregoing arguments were found persuasive by the Tax Court. If you are incurably curious and must understand why the Tax Court rejected the above IRS arguments, read Judge Toro's opinion.

Here's the "Beef"—Impact of Loper Bright on Treasury Regulations. Finally, the IRS argued that Reg. § 1.78-1 (as cited and quoted above) closed the effective date "gap" retroactive to January 1, 2018. Judge Toro wrote in response to this argument:

> The rule adopted by the revised regulations essentially gives one of the TCJA's amendments to section 78 an earlier effective date than provided for in the TCJA to prevent taxpayers like Varian from deducting section 78 dividends. But, as we have already observed, the plain text of the statutes provides for the deduction. As the Supreme Court has said, "self-serving regulations never 'justify departing from the statute's clear text.'"

163 T.C. at ___. The IRS argued in response that its interpretation of §§ 78 and 245A, as reflected in Reg. § 1.78-1, nevertheless should be considered "permissible" and entitled to deference. 163 T.C. at ___. Judge Toro disagreed, though, based upon the U.S. Supreme Court's recent *Loper Bright* decision overturning so-called "*Chevron* deference" previously granted by the courts to administrative interpretations of statutes and promulgation of interpretative regulations. *See Loper Bright Enterprises v. Raimonda*, 603 U.S. ___ (2024), *overruling in part Chevron, U.S.A., Inc. v. Natural Resources Council, Inc.*, 467 U.S. 837 (1984). Instead, Judge Toro flatly refused to apply Reg. § 1.78-1 to close the "gap" against the taxpayer in this case, concluding:

> As the Supreme Court observed in *Loper Bright*, "statutes, no matter how impenetrable, do—in fact, must—have a single, best meaning. That is the whole point of having written statutes; 'every statute's meaning is fixed at the time of enactment.' And, in cases involving ambiguity, "instead of declaring a particular party's reading 'permissible' . . . , courts [must] use every tool at their disposal to determine the best reading of the statute and resolve the ambiguity." Put another way, "in an agency case as in any other . . . even if some judges might (or might not) consider the statute ambiguous, there is a best reading all the same—the reading the court would have reached if no agency were involved."
>
> In short, "[i]n the business of statutory interpretation, if it is not the best, it is not permissible." And, as we have shown above, the best (indeed the unambiguous) reading of the provisions at issue here permits [the taxpayer's] deduction.

163 T.C. at ___.

The IRS's Consolation Prize. Although the Tax Court rejected the IRS's arguments that § 245A should not apply to a § 78 deemed dividend arising within the "gap" period created by the TCJA's relevant effective date provisions, the Tax Court did embrace the IRS's argument relating to the determination of the taxpayer's allowed foreign tax credits. As mentioned above, the taxpayer claimed roughly $161 million in foreign tax credits for its 2018 tax year. The IRS's position was that, if the Tax Court determined the taxpayer could take the § 245A DRD attributable to the § 78 deemed dividend for its 2018 tax year, then the taxpayer's claimed foreign tax credits must be reduced under § 245A(d)(1). Section 245A(d)(1) provides: "No credit shall be allowed under section 901 [(foreign taxes)] for any taxes paid or accrued (or treated as paid or accrued) with respect to any dividend for which a deduction is allowed under this section." The taxpayer contended that § 245A(d)(1) was not relevant to a § 78 deemed dividend but was only meant to apply to foreign taxes paid *on* a dividend (whether actual or deemed). The taxpayer paid $0 foreign taxes "on" its § 78 deemed dividend for 2018. Judge Toro, however, was not persuaded by the taxpayer's argument. Instead, Judge Toro adopted the IRS's position that the phrase "with respect to" in § 245A(d)(1) should be read broadly to mean "concerning" or "related to," not simply "on." Therefore, because the taxpayer's § 78 deemed dividend unquestionably relates to the foreign tax credits claimed by the taxpayer, the § 245A(d)(1) limitation applies. Further, because the amount of the § 78 deemed dividend "represents the share of a foreign corporation's earnings that were paid out to a foreign country as tax," Judge Toro likewise adopted the IRS's proposed formula for calculating the § 245A(d)(1) disallowance of a portion of the taxpayer's otherwise allowable foreign tax credits for its 2018 tax year. The formula considers the taxpayer's § 78 deemed dividend and the taxpayer's § 965 subpart F income to reduce the taxpayers claimed § 901 foreign tax credits for its "gap"-controlled 2018 taxable year as follows:

$$\text{Disallowed Foreign Tax Credit} = \text{Deemed Paid Foreign Tax Credit} \times \left(\frac{\text{Section 78 gross-up}}{\text{Net section 965 inclusion + section 78 gross-up}} \right)$$

The same analysis would apply if a U.S. corporation included in income its share of subpart F income of a CFC under the general subpart F inclusion rule of § 951(a) rather than an amount calculated pursuant to the MRT of § 965.

Comment: Kudos if you have read the foregoing summary and fully appreciate the somewhat disguised significance of the Tax Court's recent decision in *Varian Medical Systems*. Query whether we will begin referring to the "*Varian* test" for Treasury regulations or the "*Varian* formula" where § 245A(d)(1) applies to "gap"-controlled taxable years of multinational corporate taxpayers. One author guesses that the *Varian* formula or some variation thereof will appear in future Treasury regulations interpreting § 245A(d)(1). Of course, the opportunity to apply § 245A,

including subsection (d)(1), in the context of a § 78 deemed dividend is limited (at least according to the Tax Court) to those multinational U.S. corporate taxpayers with CFC subsidiaries claiming foreign tax credits within a fiscal taxable year that straddled the enactment of the TCJA. In any event, we strongly suspect other taxpayers will be emboldened by the Tax Court's pronouncement in *Varian Medical Systems* that interpretive (as opposed to legislative) Treasury regulations must satisfy the new *Loper Bright* "best interpretation" standard adopted by SCOTUS. *Let the games (a/k/a litigation) begin . . . .*

- The authors understand that other corporations with tax years that straddle the effective date of the TCJA are now examining their eligibility to deduct under § 245A the deemed dividend required by § 78. For example, the Tax Court recently entered an order granting the motion for partial summary judgment filed by Sysco Corporation on the basis that the court's opinion in *Varian Medical* fully resolved Sysco's eligibility for a deduction under § 245A for the deemed dividend required by § 78. *Sysco Corporation v. Commissioner*, No. 5728-23 (9/13/24).

VI. TAX SHELTERS

A. Charitable Giving

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

New "2.5 times" proportionate outside basis rule will limit the charitable deduction for conservation contributions by pass-through entities. New § 170(h)(7)(A) generally provides that a contribution by a partnership is not treated as a qualified conservation contribution (and therefore no deduction is allowed)—whether via a direct contribution or as an allocable share from a lower-tier partnership—if the amount of the contribution exceeds "2.5 times the sum of each partner's relevant basis" in the partnership. The term "relevant basis" is defined by new § 170(h)(7)(B)(i) to mean that portion of a partner's "modified basis" which is allocable (under rules similar to those used under § 755) to the real property comprising the qualified conservation contribution. "Modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752. Thus, reading between the lines and subject to further guidance, relevant basis appears to equate to an investor's cash investment (a/k/a initial tax and book capital account) in a syndicated conservation easement partnership. Many syndicated conservation easement partnerships claim that investors may secure a charitable deduction that is five times their cash investment. New § 170(h)(7)(A) thus limits the charitable deduction to "2.5 times" an investor's cash contribution, making a syndicated conservation easement much less attractive. New § 170(h)(7) also contains three exceptions: (i) partnerships making conservation easement contributions after a three-year holding period applicable at the partnership- and partner-level, including through tiered partnerships; (ii) "family partnerships" (as defined) making conservation easement contributions; and (iii) partnerships making conservation easement contributions relating to historic structures. *See* IRC §§ 170(f)(19), 170(h)(7)(C)-(E). Moreover, new § 170(h)(7)(F) authorizes Treasury to issue regulations applying similar rules to S corporations and other pass-through entities. Related provisions of the legislation make dovetailing amendments to (i) § 170(f) (charitable contribution substantiation and reporting

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

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

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

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

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

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

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

b. Final regulations on the disallowance of deductions for conservation easements by partnerships and S corporations. T.D. 9999, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 89 F.R. 54284 (6/28/24). The Treasury Department and the IRS have finalized proposed regulations[9] under amended Code § 170(h)(7) and the related information reporting rule of Code § 170(f)(19). The final regulations apply to partnerships and S corporations that claim qualified conservation contributions and partners and shareholders to whom the contribution deduction is allocated. The final regulations provide guidance on the statutory disallowance rule of § 170(h)(7), definitions of terms, methods of calculating the "relevant basis" of a partner or an S corporation shareholder, three statutory exceptions, as well as other reporting requirements. The final regulations apply to qualified conservation contributions by pass-through entities (partnerships and S corporations). They do not apply to contributions by individuals or C corporations.

General rules. In general, under § 170(h)(7)(A), a contribution by a partnership (or S corporation) is not treated as a qualified conservation contribution if the amount of the contribution exceeds "2.5 times the sum of each partner's [or S corporation shareholder's] relevant basis" in the partnership or S corporation. Thus, if the amount of a contribution by a partnership or S corporation exceeds this limit, then no deduction is allowed. There are three statutory exceptions to this disallowance rule. One exception applies to contributions made three or more years after the later of (i) the last date on which the pass-through entity acquired any interest in the real property with respect to which the contribution is made or (ii) the last date on which any owner or upper tier pass-through entity acquired an interest in the pass-through entity that made the contribution. See § 170(h)(7)(C). The second exception is for contributions by family partnerships. See § 170(h)(7)(D). The third exception is for contributions to preserve certified historic structures. See § 170(h)(7)(E).

Relevant basis, modified basis. As discussed above, no deduction is allowed for a conservation contribution by a partnership or S corporation if the amount of the contribution exceeds 2.5 times the sum of each partner's or S corporation shareholder's relevant basis. The term "relevant basis" means the portion of a partner's "modified basis" in the partnership which is allocable (under rules similar to those of § 755) to the portion of the real property with respect to which the contribution is made. IRC § 170(h)(7)(B)(i). The term "modified basis" (defined in § 170(h)(7)(B)(ii)) essentially refers to a partner's outside basis exclusive of the partner's share of partnership liabilities under § 752.

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[9] REG–112916–23, Statutory Disallowance of Deductions for Certain Qualified Conservation Contributions Made by Partnerships and S Corporations, 88 F.R. 80910 (11/20/23).

Ultimate members. The final regulations use the term "ultimate member" and apply the statutory limit with reference to the relevant basis of a partnership's or S corporation's ultimate members. Specifically, the final regulations provide that no deduction is allowed for a conservation easement contribution by a partnership or S corporation if

> the amount of the qualified conservation contribution exceeds 2.5 times the sum of each of the contributing partnership's or contributing S corporation's ultimate member's relevant basis ….

Reg. § 1.170A-14(j)(2)(i). For this purpose, an "ultimate member" is any partner or S corporation shareholder that (i) is not itself a partnership or S corporation, and (ii) receives a distributive share or pro rata share, directly or indirectly, of a qualified conservation contribution. Reg. § 1.170A-14(j)(3)(x). Thus,

> ultimate members will either be partners holding a direct interest in a partnership, which may be the contributing partnership or an upper-tier partnership, or shareholders holding a direct interest in an S corporation, which may be the contributing S corporation or an upper-tier S corporation. Upper-tier S corporations and upper-tier partnerships themselves are not considered ultimate members.

Reg. § 1.170A-14(j)(3)(x). The regulations thus contemplate that a partnership or S corporation must identify its ultimate members and determine the sum of the relevant basis of each of those ultimate members.

Rules for tiered entities. The final regulations provide rules for tiered entities (partnerships and S corporations). Under these rules, an allocated portion (i.e., distributive share) of the contribution deduction received by an upper-tier entity is disallowed if either (i) the contribution is a disallowed contribution with respect to the entity (partnership or S corporation) that allocated the deduction to the upper-tier entity (partnership or S Corporation), or (ii) the allocated portion exceeds 2.5 times the sum of the upper-tier entity's ultimate member's relevant basis. Reg. § 1.170A-14(j)(2)(ii). In general, if a contribution deduction is disallowed for a lower-tier entity, then that contribution deduction is also disallowed for the upper tier entity that owns an interest in the lower-tier entity. However, if a contribution deduction is allowed for a lower-tier entity, then the same analysis moves to the next higher tier to determine once again whether the upper-tier entity has a disallowed amount. The test keeps getting reapplied at each tier up the entity chain.

Examples. The final regulations contain numerous complex examples that illustrate the application of the rules described above. While it is beyond the scope of this outline to review each of the examples, the following examples from Reg. § 1.170A-14(j)(6) illustrate the basic rules:

Example 1: Disallowed qualified conservation contribution.

(A) Facts. A, an individual, and B, a C corporation, form AB Partnership, a partnership for Federal income tax purposes. AB Partnership acquires real property. Two years later, AB Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. AB Partnership allocates the contribution equally to A and B. A's relevant basis is $30X, and B's relevant basis is $8X.

(B) Analysis. A and B are the ultimate members of AB Partnership because they each receive a distributive share of the qualified conservation contribution and are not partnerships or S corporations. The claimed amount of AB Partnership's qualified conservation contribution is $100X, which exceeds 2.5 times the sum of A's and B's relevant bases, which is $95X ($95X = 2.5 x (A's $30X relevant basis + B's $8X relevant basis)). Therefore, AB Partnership's contribution is a disallowed qualified conservation contribution. No person may claim any deduction with respect to this contribution, even though A's $50X distributive share of the contribution does not exceed 2.5 times A's $30X relevant basis.

Example 3: Tiered partnerships

(A) Facts. Individuals E and F form UTP Partnership, a partnership for Federal income tax purposes. UTP Partnership and G, a C corporation, form LTP Partnership, a partnership for Federal income tax purposes. LTP Partnership acquires real property. Two years later, LTP Partnership makes a qualified conservation contribution with respect to the property and claims a contribution of $100X on its return. LTP Partnership allocates the contribution $5X to G and $95X to UTP Partnership. UTP Partnership allocates its $95X portion of the contribution $45X to E and $50X to F. G's relevant basis is $10X, E's relevant basis is $11X, and F's relevant basis is $21X.

(B) Analysis for LTP Partnership. The ultimate members of LTP Partnership are G, E, and F because they each receive a distributive share of the qualified conservation contribution and are not a partnership or S corporation. Because UTP Partnership is a partnership, it is not an ultimate member of LTP Partnership, even though it receives a distributive share of the qualified conservation contribution. The amount of LTP Partnership's qualified conservation contribution is $100X, which does not exceed 2.5 times the sum of each of the ultimate member's relevant basis, which is $105X ($105X = 2.5 x (G's $10X relevant basis + E's $11X relevant basis + F's $21X relevant basis)). Therefore, LTP Partnership's contribution is not a disallowed qualified conservation contribution (that is, is not disallowed by section 170(h)(7) and this paragraph (j)) with respect to LTP Partnership and G.

(C) Analysis for UTP Partnership. Because UTP Partnership receives an allocated portion, UTP Partnership must apply this paragraph (j) and paragraphs (k) through (m) of this section to determine whether its allocated portion is a disallowed qualified conservation contribution. The ultimate members of UTP Partnership are E and F because they each receive a distributive share of UTP Partnership's allocated portion and are not partnerships or S corporations. The amount of UTP Partnership's allocated portion of LTP Partnership's qualified conservation contribution is $95X, which exceeds 2.5 times the sum of E's and F's relevant bases, which is $80X ($80X = 2.5 x (E's $11X relevant basis + F's $21X relevant basis)). Therefore, UTP Partnership's allocated portion of LTP Partnership's contribution is a disallowed qualified conservation contribution with respect to UTP Partnership, E, and F. No partner of UTP Partnership may claim any deduction with respect to this contribution, even though F's $50X distributive share of the contribution does not exceed 2.5 times F's $21X relevant basis. This does not affect the determination that G's distributive share of the contribution is not a disallowed qualified conservation contribution.

VII. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

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

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

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

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

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

approval of the *initial determination* of the assessment of the penalty and therefore requires supervisory approval before the IRS formally communicates the penalty to the taxpayer. According to the Ninth Circuit, "[t]he problem with Taxpayer's and the Tax Court's interpretation is that it has no basis in the text of the statute." The court acknowledged the legislative history of § 6751(b), which indicates that Congress enacted the provision to prevent IRS revenue agents from threatening penalties as a means of encouraging taxpayers to settle. But the text of the statute as written, concluded the Ninth Circuit, does not support the interpretation of the statute advanced by the Tax Court and the taxpayer. The court summarized its holding as follows:

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

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

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

> In my view, then, the statute means what it says: a supervisor must personally approve the "initial determination" of a penalty by a subordinate, or else no penalty can be assessed based on that determination, whether the proposed penalty is objected to or not. 26 U.S.C. §§ 6751(b)(1). That meaning is consistent with Congress's purpose of preventing threatened penalties never approved by supervisory personnel from being used as a "bargaining chip" by lower-level staff, S. Rep. No. 105-174, at 65 (1998); see *Chai v. Commissioner*, 851 F.3d 190, 219 (2d Cir. 2017), which is exactly what happened here.

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

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

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

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

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

Facts of this case. In the current case, *Kroner v. Commissioner*, the taxpayer failed to report as income just under $25 million in cash transfers from a former business partner. The IRS audited and, at a meeting with the taxpayer's representatives on August 6, 2012, provided the taxpayer with a letter (Letter 915) and revenue agent's report proposing to increase his income by the cash he had received and to impose just under $2 million in accuracy-related penalties under § 6662. The letter asked the taxpayer to indicate whether he agreed or disagreed with the proposed changes and provided him with certain options if he disagreed, such as providing additional information, discussing the report with the examining agent or the agent's supervisor, or requesting a conference with the IRS Appeals Office. The letter also stated that, if the taxpayer took none of these steps, the IRS would issue a notice of deficiency. The IRS later issued a formal 30-day letter (Letter 950) dated October 31, 2012, and an updated examination report. The 30-day letter provided the taxpayer with the same options as the previous letter if he disagreed with the proposed adjustments and stated that, if the taxpayer took no action, the IRS would issue a notice of deficiency. The 30-day letter was signed by the examining agent's supervisor. On that same day, the supervisor also signed a Civil Penalty Approval Form approving the accuracy-related penalties. The IRS subsequently issued a notice of deficiency and, in response, the taxpayer filed a timely petition in the U.S. Tax Court.

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

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

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

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

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

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

Finally, the court reviewed the Second Circuit's decision in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), in which the court had interpreted § 6751(b) in light of Congress's purpose in enacting the provision, which, according to the Second Circuit, was to prevent IRS agents from threatening unjustified penalties to encourage taxpayers to settle. According to the Eleventh Circuit, the *Chai* decision did not take into account the full purpose of § 6751(b). The purpose of the statute, the court reasoned, was not only to prevent unjustified threats of penalties, but also to ensure that only accurate and appropriate penalties are imposed. There is no need for supervisory approval to occur at any specific time before the assessment of penalties, the court explained, to ensure that penalties are accurate and appropriate and therefore carry out this aspect of Congress's purpose in enacting the statute. Further, the Eleventh Circuit concluded, there is no need for a pre-assessment deadline for supervisory approval to reduce the use of penalties as a bargaining chip by IRS agents. This is so, according to the court, because negotiations over penalties occur even after a penalty is assessed, such as in administrative proceedings after the IRS issues a notice of federal tax lien or a notice of levy. (This latter point by the court seems to us to be a stretch. Although it is possible to have penalties reduced or eliminated post-assessment, such post-assessment review does not meaningfully reduce the threat of penalties by IRS agents to encourage settlement at the examination stage.)

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

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

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

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

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

The Tax Court's prior decisions have focused on what constitutes the *initial determination* of the penalty in question. These decisions have concluded that the initial determination of a penalty occurs in the document through which the IRS Examination Division notifies the taxpayer in writing that the examination is complete and it has made a decision to assert penalties. *See, e.g.*, *Belair Woods, LLC v. Commissioner*, 154 T.C. 1 (2020); *Beland v. Commissioner*, 156 T.C. 80 (2021). Accordingly, if the IRS notifies the taxpayer that it intends to assert penalties in a document such as a revenue agent's report, and if the IRS fails to secure the required supervisory approval before that notification occurs, then § 6751(b)(1) precludes the IRS from asserting the penalty. In this case, the Tax Court held, the IRS had failed to comply with § 6751(b)(1) because the Form 4549 the revenue agent presented to the taxpayer in prison was the initial determination of the penalties, and the IRS had not secured the required supervisory approval before the agent presented the form to the taxpayer.

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

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

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

> We are persuaded by the Second Circuit's reasoning and hold that with respect to civil penalties, the requirements of § 6751(b)(1) are met so long as written

supervisory approval of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

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

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

The Tax Court. The Tax Court has taken an expansive view of § 6751(b)(1) regarding what constitutes the *initial determination* of the penalty in question. In a series of cases beginning with *Graev v. Commissioner*, 149 T.C. 485 (2017), the Tax Court reversed its earlier position that supervisory approval need only occur before assessment of the penalties subject to § 6751(b)(1). Instead, the Tax Court in *Graev* accepted the Second Circuit's interpretation of § 6751(b)(1) as set forth in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017): "that § 6751(b)(1) requires written approval of the initial penalty determination no later than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty." Then, in subsequent cases, the Tax Court has gone further, generally holding that:

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

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

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

- As mentioned above, the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017), *aff'g in part and rev'g in part*, T.C. Memo 2015-42, held that, for penalties subject to deficiency procedures (like the § 6662 accuracy-related penalties) "§ 6751(b)(1) requires written approval of the initial penalty determination no later

than the date the IRS issues the notice of deficiency (or files an answer or amended answer) asserting such penalty."

- The Ninth Circuit in *Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), held that for an "assessable penalty" not requiring a deficiency procedure (like the penalty imposed by § 6707A for failure to disclose a reportable transaction) the § 6751(b)(1) supervisory approval requirement applies "before the assessment of the penalty or, if earlier, before the relevant supervisor loses discretion whether to approve the penalty assessment."
- The Eleventh Circuit in *Kroner v. Commissioner*, 48 F. 4th 1272 (11th Cir. 2022), *rev'g*, T.C. Memo. 2020-73, held that, for penalties subject to deficiency procedures, the IRS may comply with § 6751(b)(1) by obtaining supervisory approval at any time, even just before assessment. Writing in reversal of the Tax Court, the Eleventh Circuit stated: "The 'initial' determination may differ depending on the process the IRS uses to assess a penalty…But we are confident that the term 'initial determination of such assessment' has nothing to do with communication and everything to do with the formal process of calculating and recording an obligation on the IRS's books."
- The Tenth Circuit, in an unpublished opinion, *Minemyer v. Commissioner*, 131 A.F.T.R.2d 2023-364 (10th Cir. 2023), *aff'g in part and rev'g in part*, T.C. Memo. 2020-99 (2020), aligned itself with the Second Circuit by holding in a case concerning penalties subject to deficiency procedures that "the requirements of § 6751(b)(1) are met so long as written supervisory of an initial determination of an assessment is obtained on or before the date the IRS issues a notice of deficiency.

The Facts in Kraske. The Tax Court in *Kraske v. Commissioner*, 161 T.C. No. 7 (10/26/23), a case appealable to the Ninth Circuit, signaled that it may be reconsidering its expansive interpretation of § 6751(b)(1) and backing off its view that supervisory approval must come on or before the IRS "formally communicates" proposed penalties to a taxpayer. On June 2, 2014, the examining agent within the IRS's Small Business and Self-Employed Division sent the taxpayer in *Kraske* a Letter 692 (15-day letter) proposing in part the imposition of accuracy-related penalties under § 6662. The 15-day letter further advised that if the taxpayer did not respond within 15 days, a notice of deficiency would be issued. Almost a month after the deadline passed for responding to the 15-day letter, the taxpayer on July 16, 2014, mailed the IRS examining agent a letter disagreeing with the examining agent's proposed tax adjustments and penalties. Coincidentally, on that same day, July 16, 2024, the examining agent, not having received a response to the 15-day letter from the taxpayer after having been promised it several times, closed the case as unagreed and forwarded it to the agent's group manager, who was the agent's immediate supervisor. On July 21, 2014, the group manager reviewed the case, signed approval forms regarding the agent's assertion of accuracy-related penalties under § 6662, and approved the case for closure. The case was then forwarded to Appeals on July 24, 2014, immediately after the IRS received on that date the taxpayer's July 16, 2014, letter objecting to the proposed tax adjustments and penalties. IRS Appeals received the case on August 12, 2014, and after the taxpayer and Appeals were unable to settle matters, a notice of deficiency was issued to the taxpayer on July 28, 2015. Before the Tax Court, the taxpayer argued that imposition of any accuracy-related penalty under § 6662 was improper because the IRS had not timely obtained supervisory approval under § 6751(b)(1).

The Tax Court's Opinion in Kraske. In an opinion written by Judge Gale, the Tax Court acknowledged that under the court's holding in *Clay v. Commissioner*, 152 T.C. 23 (2019), *aff'd on other grounds*, 990 F.3d 1296 (11th Cir. 2021), *cert. denied*, 142 S. Ct. 342 (2021), the supervisory approval obtained in *Kraske* would be considered untimely under § 6751(b)(1) because it came after a "formal communication" (i.e., the 15-day letter) of the proposed penalties was sent to the taxpayer. Judge Gale noted, however, that because the case was appealable to the Ninth Circuit, the Ninth Circuit's decision in *Laidlaw's Harley Davidson Sales, Inc. v.*

Commissioner, 29 F.4th 1066 (9th Cir. 2022), *rev'g*, 154 T.C. 68 (2020), must be considered. As noted above, *Laidlaw's Harely Davidson Sales, Inc.* concerned an "assessable penalty," not a penalty subject to deficiency procedures as in *Kraske*. Arguably, then, *Laidlaw's Harley Davidson Sales, Inc.* was distinguishable, and the Tax Court was not necessarily bound to follow it under a strict application of *Golsen v. Commissioner*, 54 T.C. 742, 756-57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971) (holding that "better judicial administration...requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone)." Judge Gale also noted, though, that the so-called *Golson* doctrine allows the Tax Court to examine not just the narrow holding of a binding Circuit Court decision, but also the underlying rationale of the decision. On this basis, Judge Gale determined that the *Golson* doctrine should apply in *Kraske*, resulting in the Tax Court ruling in favor of the government and against the taxpayer. Judge Gale wrote:

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

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

> When the supervisor approved the penalties on July 21, 2014, it was more than a month past the deadline for [the taxpayer] to respond to the 15-day letter, and the [examining agent] had not received a written request for Appeals' consideration from him. Although [the taxpayer] had mailed such a request on July 16, 2014, it was not received by the [examining agent] until July 24, 2014--three days after written supervisory approval had been given. The case was not received by Appeals until August 12, 2014--over three weeks after supervisory approval had been given. Thus, the [examining agent's] immediate supervisor retained discretion to approve or to withhold approval of the penalties when she did so on July 21 because the case had not yet been transferred to Appeals (at which time the Small Business and Self-Employed Division's jurisdiction over the case, and the supervisor's discretion, may have terminated).

2. What's the point of a penalty if the IRS is precluded from collecting it? The Tax Court has held that there is no statutory authority for the IRS to assess penalties imposed by § 6038(b) for failure to file information returns with respect to foreign business entities and that the IRS therefore cannot proceed to collect the penalties through a levy. Farhy v. Commissioner, 160 T.C. No. 6 (4/3/23). Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls (defined in § 6038(e)(2) as owning more than 50 percent of all classes of stock, measure by vote or value). The form prescribed for providing this information is Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations. Section 6038(b)(1) imposes a penalty of $10,000 for each annual accounting period for which a person fails to provide the required information. In addition, § 6038(b)(2) imposes a continuation penalty of $10,000 for each 30-day period that the failure continues up to a maximum continuation penalty of $50,000 per annual accounting period. In this case, the taxpayer was required to file Form 5471 for several years with respect to two wholly-owned corporations organized in Belize but failed to do so. The IRS assessed a penalty under § 6038(b)(1) of $10,000 and a continuation penalty of $50,000 for each of the years in issue. In response to a notice of levy, the taxpayer requested a collection due process (CDP) hearing. In the CDP hearing, the taxpayer argued that the IRS had no legal authority

to assess § 6038 penalties. Following the CDP hearing, the IRS issued a notice of determination upholding the proposed collection action and the taxpayer challenged this determination by filing a petition in the Tax Court. The Tax Court (Judge Marvel) agreed with the taxpayer and held that there is no statutory authority for the IRS to assess § 6038 penalties. The IRS argued that § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title" authorizes assessment of penalties imposed by § 6038. The court disagreed, however, and reasoned that the term "assessable penalties" in § 6201(a) does not automatically apply to all penalties in the Code. The court observed that (1) §§ 6671(a) and 6665(a)(1) provide that penalties imposed by specified Code sections shall be assessed and collected in the same manner as taxes and (2) Code sections other than those specified by §§ 6671(a) and 6665(a)(1) commonly provide that the penalty is a tax or assessable penalty for purposes of collection or are expressly covered by (or contain a cross-reference to) one of the specified Code sections. In contrast, the court explained, § 6038 is not one of the Code sections specified by §§ 6671(a) and 6665(a)(1) and contains only a cross-reference to a criminal penalty provision. The court also rejected the IRS's argument that § 6038 penalties are "taxes" within the meaning of § 6201(a) and therefore subject to assessment. In short the court held, although § 6038(b) provides penalties for failure to provide the information required by § 6038(a), there is no statutory authority for assessment of those penalties and the IRS therefore is unable to collect those penalties through a levy.

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

- The court's decision is appealable to the U.S. Court of Appeals for the D.C. Circuit.

a. The Tax Court has again held that the IRS lacks authority to assess penalties under § 6038(b) and has held that penalties imposed by § 6677 for failure to file information returns regarding foreign trusts are not fines and therefore do not violate the Excessive Fines clause of the Eighth Amendment. Mukhi v. Commissioner, 162 T.C. No. 8 (4/8/24). The taxpayer in this case held controlling interests in a foreign trust and a foreign corporation. The taxpayer failed to comply with three reporting requirements:

- Section 6038(a) requires every United States person to provide information with respect to any foreign business entity the person controls (defined in § 6038(e)(2) as owning more than 50 percent of all classes of stock, measure by vote or value). The form prescribed for providing this information is Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations.
- Section 6048(a) requires written notice to the IRS of either the creation of a foreign trust by a United States person or the transfer of money or property to a foreign trust by a United States person. The form prescribed for complying with § 6048(a) is Forms 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.
- Section 6048(b) requires every United States person to provide information with respect to any foreign trust of which the person is treated as the owner. The form prescribed for complying with § 6048(b) is Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.

As previously discussed in connection with the *Farhy* decision, § 6038(b) imposes significant penalties for failure to file Form 5471 to provide information with respect to any foreign business entity the person controls. In addition, § 6677(a)-(b) imposes penalties for failure to file an information return disclosing ownership of a foreign trust (Form 3520-A). For returns required to be filed after December 31, 2009, the penalty is the greater of $10,000 or 5 percent of the gross value of the portion of the trust assets that a United States person is treated as owning. Section

6677(a) imposes penalties for failure to file an information return disclosing the transfer of money or property to a trust (Form 3520). For returns required to be filed after December 31, 2009, the penalty is the greater of $10,000 or 35 percent of the money or property transferred to the foreign trust.

The IRS assessed approximately $5 million in penalties for the taxpayer's failure to file Form 3520, $5.9 million in penalties for failure to file Form 3520-A, and $120,000 in penalties for failure to file Form 5471.

After the IRS issued a final notice of intent to levy and a notice of federal tax lien, the taxpayer requested a collection due process (CDP) hearing. Based on the IRS's estimate of the taxpayer's reasonable collection potential, the Settlement Officer who conducted the CDP hearing rejected the taxpayer's alternative requests for an installment agreement or an offer-in-compromise. The Settlement Officer issued a notice of determination sustaining the collection action and the taxpayer responded by filing a petition in the Tax Court.

In the Tax Court, the taxpayer argued principally that (1) the IRS had violated his Fifth Amendment due process rights because the Settlement Officer was not independent, (2) the Settlement Officer had abused his discretion in rejecting the taxpayer's offer-in-compromise, and (3) the foreign reporting penalties imposed by §§ 6038(b) and 6677 violate the Excessive Fines Clause of the Eighth Amendment. The Tax Court (Judge Greaves) efficiently disposed of the taxpayer's first two arguments and, because they are highly fact-specific, this discussion will not address those arguments. The significance of the Tax Court's opinion is its holding regarding the third argument.

Section 6038(b) penalties. The Tax Court declined to address whether the penalties imposed by § 6038(b) for failure to timely file Form 5471 violated the Excessive Fines clause of the Eighth Amendment because the court had previously concluded in *Farhy* that the IRS lacks the authority to assess the penalties imposed by § 6038(b). Because the IRS is precluded, in the Tax Court's view, from assessing the penalties, it is precluded from collecting them through a lien or levy. The court declined to reconsider its decision in *Farhy*. The court noted that its decision in *Farhy* was on appeal to the D.C. Circuit and reasoned that, even if the D.C. Circuit reversed the Tax Court's decision in *Farhy*, the holding of the D.C. Circuit would not be binding in this case because any appeal in the current case would be heard by the Eighth Circuit. *See Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The Tax Court then granted summary judgment to the taxpayer and held that the IRS was precluded from collecting the penalties imposed by § 6038(b).

Section 6677 penalties. The Tax Court held that the penalties imposed by § 6677 are not fines and therefore do not violate the Excessive Fines Clause of the Eighth Amendment. In its prior decisions, including its decision in *Thompson v. Commissioner*, 148 T.C. 59, 66 (2017), the Tax Court held that the purpose of civil tax penalties and additions to tax is to encourage voluntary compliance and that such penalties or additions therefore are not punitive. Similarly, the court noted, the U.S. Court of Appeals for the First Circuit concluded in *United States v. Toth*, 33 F.4th 1, 19 (1st Cir. 2022), that penalties for failure to file a Foreign Bank Account Report (FBAR) are not fines. The Eighth Circuit, the court noted, has not ruled on whether the penalties imposed by § 6677 are fines. Because the penalties imposed by § 6677 are civil penalties designed to encourage voluntary compliance, the court held, they are not fines and therefore do not violate the Excessive Fines Clause of the Eighth Amendment. Further, the court held, even if the penalties imposed by § 6677 are fines, they do not violate the Eighth Amendment because they are not excessive. The court reasoned that, under the U.S. Supreme Court's decision in *United States v. Bajakajian*, 524 U.S. 321 (1998):

> To pass the constitutional proportionality inquiry under the Excessive Fines Clause, the amount of the forfeiture or fine must bear some relationship to the gravity of the offense that it is designed to punish. See *Bajakajian*, 524 U.S. at 334. A fine

> violates the Excessive Fines Clause if "the amount of the forfeiture is grossly disproportional to the gravity of the defendant's offense." *Id*. at 337

The court noted that it had consistently concluded that penalties similar to the penalties imposed by § 6677 are not disproportionate. Accordingly, the court held, even if the penalties imposed by § 6677 are fines, they do not violate the Eighth Amendment.

b. The Tax Court got it wrong, says the D.C. Circuit. Despite the absence of explicit language authorizing the assessment of penalties imposed by § 6038(b), the text, structure, and function of § 6038(b) indicate that the penalties it imposes are assessable. Farhy v. Commissioner, 100 F.4th 223 (D.C. Cir. 5/3/24), *rev'g* 160 T.C. No. 6 (4/3/23). In an opinion by Judge Pillard, the U.S. Court of Appeals for the D.C. Circuit has reversed the Tax Court and held that statutory authority exists for the assessment of penalties imposed by § 6038(b) and that the IRS therefore is able to collect those penalties through its administrative collection powers, such as a levy. The court first rejected the parties' competing readings of § 6201(a), which authorizes the Secretary of the Treasury to make the "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties) imposed by this title." The IRS argued that § 6201(a) authorizes the assessment of all taxes and penalties unless the Code expressly requires a different process for a given exaction. The taxpayer argued that § 6201(a) authorizes the assessment of a penalty only if the penalty is explicitly characterized as a "tax" or designated as assessable. The court declined to adopt either interpretation of § 6201(a) and instead based its holding on the text, structure, and function of the specific provision at issue, § 6038(b). The court placed primary emphasis on the history and legislative purpose underlying § 6038(b). Congress enacted § 6038 in 1960. As originally enacted, the penalty for failure to file the required informational return regarding a foreign corporation was a 10-percent reduction in the U.S. taxpayer's foreign tax credit. Congress amended § 6038 in the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III, § 338, 96 Stat. 324, 631, commonly known as TEFRA. The 1982 amendments moved the 10-percent reduction of a taxpayer's foreign tax credit to current § 6038(c) and amended § 6038(b) to impose a new, fixed-dollar penalty for failure to file the required informational return. Amended § 6038(c)(3) coordinates the two penalties by providing that the § 6038(c) reduction of a taxpayer's foreign tax credit is reduced by any fixed-dollar penalty imposed by § 6038(b). These changes, the court observed, were intended to bolster and streamline enforcement of the penalty. The parties in this case agreed that the penalty imposed by § 6038(c) is assessable because a reduction of a taxpayer's foreign tax credit has the effect of increasing a taxpayer's tax liability, and § 6201(a) authorizes the assessment of all taxes imposed by the Internal Revenue Code. The remaining question was whether authority exists for the IRS to assess the penalty imposed by § 6038(b). The court emphasized that Congress's purpose in amending § 6038 in 1982 to add the fixed-dollar penalty currently provided by § 6038(b) was to streamline collection of the penalty. Under the interpretation of § 6038 advanced by the taxpayer, the IRS can assess and therefore collect through its administrative collection powers the penalty imposed by § 6038(c) (the 10-percent reduction in a taxpayer's foreign tax credit) but must instead enforce the fixed-dollar penalty imposed by § 6038(b) by bringing legal action against the taxpayer in a United States District Court. Such an interpretation, the court concluded, does not make sense:

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

The court also reasoned that the availability of a reasonable cause defense to the penalty imposed by § 6038(b) suggests that the penalty is assessable. A taxpayer can avoid the penalty imposed by § 6038(b) by showing reasonable cause for the noncompliance. See I.R.C. § 6038(c)(4); Reg. § 1.6038-2(k)(3)(ii). Section 6038(c)(4)(B), the court reasoned, "expressly treats the reasonable cause showing for failure to file the relevant informational returns as within the purview of the

Service." Further, the court observed, "[i]f the subsection (b) penalty were not assessable, there would be no post-assessment administrative process in which the taxpayer could make a reasonable cause showing to the Secretary." The express contemplation of § 6038 that the Secretary of the Treasury will determine the availability of a reasonable cause defense to the penalties imposed by § 6038 supports treating the penalties imposed by both § 6038(b) and § 6038(c) as assessable. Finally, the court, observed, interpreting the § 6038(b) penalty as not being assessable and therefore collectible only through an action in U.S. District Court and the § 6038(c) penalty as being assessable and collectible through the IRS's administrative collection powers with judicial review of the collection process (following a collection due process hearing) in the Tax Court could lead to inconsistent holdings in the two courts for the same taxpayer and would raise other potential issues:

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

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

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

The IRS audited the taxpayer and ultimately issued two notices of deficiency, one for 2004 through 2008 and another for 2019 through 2014. The IRS asserted that, of the $26 million contributed to the taxpayer's IRA, $25.1 million was attributable to his relinquishment of his rights in the non-ESOP deferred compensation plans, which were not eligible for treatment as a tax-free rollover. The IRS's position in the notices of deficiency was that this $25.1 million was an "excess contribution" subject to the 6% excise tax of § 4973(a). Further, under § 4973(b)(2), the excise tax continues to apply for future years until the original excess contribution is distributed to the taxpayer and included in income. Therefore, according to the IRS, the taxpayer owed for the years involved an excise tax in the aggregate amount of approximately $8.5 million. In response to the notices of deficiency, the taxpayer petitioned the Tax Court. He subsequently filed an amended petition in which he argued that the 6% excise tax imposed by § 4973(a) is a penalty subject to the supervisory approval requirement of § 6751(b)(1) and that the IRS was precluded from assessing the penalty because it had failed to comply with the supervisory approval requirement. In the Tax Court, the IRS moved for partial summary judgment and argued that the exaction imposed by § 4973(a) is a "tax" and not a "penalty" and that the supervisory approval requirement of § 6751(b)(1) therefore did not apply.

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

B. Statutory Notice of Deficiency

1. Ever heard of a 424-day letter? Well, now you have in this case of first impression from the Tax Court. Dodson v. Commissioner, 162 T.C. No. 1 (1/3/24). The taxpayers in this case received a notice of deficiency dated October 7, *2021* ("first 90-day letter"). The first 90-day letter specified December 5, *2022*, as the last day for filing a petition in the Tax Court. (FYI, December 5, 2022, is 424 days after October 7, 2021.) Promptly realizing its mistake, on October 8, 2021, the IRS sent the taxpayers a "corrected" notice of deficiency ("second 90-day letter") substantially the same as the first 90-day letter but specifying January 6, *2022*, as the last day for filing a petition in the Tax Court. A cover sheet to the second 90-day letter stated: "PREVIOUS NOTICE SENT WITH INCORRECT DATE. CORRECTED NOTICE WITH CORRECT DATES." The taxpayers stated that they did not receive the second 90-day letter. The taxpayers also produced tracking information from the USPS indicating that the second 90-day letter left a distribution center near the taxpayers' address but did not show delivery. On March 3, 2022, 147 days after October 7, 2021, the taxpayers filed a petition in the Tax Court disputing the adjustments proposed by the IRS in the first 90-day letter. The IRS moved to dismiss the taxpayers' petition on the grounds that it was untimely because it was filed beyond the 90-day period specified in § 6213(a) (which was the date reflected in the IRS's corrected, second 90-day letter). The

taxpayers, however, argued that their petition in response to the IRS's first 90-day letter was timely because, as the last sentence of § 6213(a) states: "Any petition filed with the Tax Court on or before the last date specified for filing such petition by the Secretary in the notice of deficiency shall be treated as timely filed." In a case of first impression, the Tax Court (Judge Marvel) agreed with the taxpayers. Judge Marvel reasoned that the above-quoted last sentence of § 6213(a) controlled in this case, especially because the IRS did not rescind the first 90-day letter as permitted by § 6212(d). Section 6212(d) permits the IRS to rescind a notice of deficiency mailed to a taxpayer if the taxpayer consents on a properly executed Form 8626 (Agreement to Rescind Notice of Deficiency) or other acceptable document reflecting an agreement to rescind between the IRS and the taxpayer. *See also* Rev. Proc. 98-54, 1998-2 C.B. 529 at 530 (§ 5.07). Judge Marvel further determined that the second 90-day letter sent by the IRS was insufficient to unilaterally rescind the first 90-day letter. Moreover, the Tenth Circuit, to which an appeal from the Tax Court would lie in this case, has stated: "[I]f a notice indicates a petition date that is more than 90 days after the date of mailing, that date controls." *Smith v. Commissioner*, 275 F.3rd 912 at 916 (10th Cir. 2001). Judge Marvel rejected the IRS's argument that the 90-day period set forth in § 6213(a) nevertheless should apply because the date in the first 90-day letter was an "obvious mistake." The IRS's argument relied in part upon two prior decisions in which the 90-day period in § 6213(a) was enforced even though the notice of deficiency completely omitted a date by which a petition in the Tax Court was required to be filed. *See Smith v. Commissioner*, 114 T.C. 489 (2000), *aff'd* 275 F.3rd 912 (10th Cir. 2001) (notice of deficiency was valid despite failure to specify last date to file a petition in Tax Court); *Rochelle v. Commissioner*, 116 T.C. 356 (2001) (petition filed 143 days after mailing of notice of deficiency was untimely despite failure of notice to specify last date to file a petition in Tax Court). Judge Marvel distinguished *Smith* and *Rochelle* because those cases dealt with circumstances where no filing date for a Tax Court petition was specified, not a situation like the present case in which the specified filing date incorrectly extended beyond the 90-day period of § 6213(a). Judge Marvel reasoned that the IRS's argument "attempts to create uncertainty about the meaning of the last sentence of section 6213(a) where there is none." Anticipating a future case, perhaps, Judge Marvel also wrote: "This is not a case where a taxpayer petitions us for redetermination of a deficiency in a notice that purports to correct a prior notice of deficiency, a circumstance for which we express no view on the application of the last sentence of section 6213(a)."

C. Statute of Limitations

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

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

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

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

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

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

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

The court concluded that the provision's text did not indicate that the 90-day period specified in § 6213(a) is jurisdictional. The language Congress used, the court reasoned, does not link the 90-day deadline to the Tax Court's jurisdiction. The statute provides that the Tax Court has no jurisdiction to enjoin actions or order a refund if the taxpayer's petition is not timely filed, which indicates that "Congress knew how to limit the scope of the Tax Court's jurisdiction." But the provision does not similarly limit the Tax Court's jurisdiction to review petitions that are not timely filed. Further, according to the court, neither the context of the statute nor the court's own precedent interpreting § 6213(a) indicates that the 90-day period is jurisdictional.

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

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

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

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

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

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

c. The Tax Court will not follow the Third Circuit's decision in *Culp* in cases appealable to the Tenth Circuit. Nguyen v. Commissioner, T.C. Memo 2023-151 (12/20/23). In a case decided after the Third Circuit issued its decision in *Culp v. Commissioner*, 75 F.4th 196 (3d Cir. 7/19/23), the Tax Court refused to apply equitable tolling in a case appealable to the Tenth Circuit. Briefly, the taxpayer's Tax Court petition arrived one day after the 90-day

period of § 6213(a) had expired. Moreover, the "timely-mailed, timely-filed" rule of § 7502 did not apply because the taxpayer used FedEx Ground instead of one of the other FedEx delivery services permitted under § 7502 pursuant to Notice 2016-30, 2016-18 I.R.B. 676. The Tax Court (Judge Lauber) refused to apply equitable tolling principles and dismissed the taxpayer's petition for lack of jurisdiction, stating in footnote 2 of the opinion:

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

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

- IRS Appeals has authority under § 6320 to hold CDP hearings and issue a notice of determination even when a taxpayer files a request after the 30-day period of § 6320(a)(3)(B).
- The Regulations under § 6320 do not preclude the application of the doctrine of equitable tolling with respect to the 30-day period.
- The 30-day period is subject to equitable tolling where the circumstances so warrant.

- *Kennedy v. Commissioner*, 116 T.C. 255 (2001), is overruled to the extent that it holds that IRS Appeals is not authorized under § 6320(a)(3)(B) to waive the 30-day period and issue a notice of determination (instead of a decision letter after a CDP equivalent hearing) where circumstances warrant application of the doctrine of equitable tolling.

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

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

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

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

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

4. The Tax Court declined to give *Chevron* deference to Treasury regulations and held that the taxpayers' petition was timely filed by virtue of § 7508A(d), which provides a mandatory extension for federally declared disasters. Abdo v. Commissioner, 162 T.C. No. 7 (4/2/24). In this case, the IRS issued a notice of deficiency indicating that March 2, 2020, was the last day for filing a petition in the Tax Court. The taxpayers, however, mailed their petition on March 17, 2020. On March 31, 2020, under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, the President issued a major disaster declaration with respect to the State of Ohio as a result of the COVID-19 pandemic. The declaration provided that the disaster conditions began on January 20, 2020. The IRS moved to dismiss on the basis that the taxpayers had filed their petition after the March 2 deadline. The taxpayers argued that § 7508A(d), which provides a mandatory 60-day extension of specified tax related deadlines by reason of a federally declared disaster, extended the time within which they could file their petition and that their petition was timely filed. Ultimately, the parties' dispute narrowly focused on the proper interpretation of § 7508A(d) and whether Reg. § 301.7508A-1(g)(1) and (2) provide a valid construction of the statute. It is important for readers to note that the analysis in the opinion is based on the Code and Regulations in effect on March 17, 2020. In a reviewed opinion (13-2-0) by Judge Marshall, the Tax Court held that the taxpayers had timely filed their petition.

Pursuant to § 7508A(a), the IRS has discretion to postpone certain tax-related deadlines for up to one year for taxpayers determined to be affected by a federally declared disaster. In contrast, § 7508A(d) provides a mandatory 60-day extension of specified tax related deadlines by reason of a federally declared disaster. In June of 2021, Treasury and the IRS issued final regulations under § 7508A(d). Under these regulations, taxpayers whose principal residence is located in a disaster area are entitled to a mandatory 60-day postponement period in relation to certain time sensitive acts. Reg. § 301.7508A-1(g)(1). Time sensitive acts are "acts determined to be postponed by the Secretary's exercise of authority under section 7508A(a) or (b)." Reg. § 301.7508A-1(g)(2). In other words, the regulations provide that § 7508A(d) extends a deadline only if the IRS has exercised its discretionary authority to extend the deadline. Because the IRS had not exercised its discretionary authority to extend the deadline for filing Tax Court petitions as a result of the Ohio disaster declaration, the IRS argued that § 7508A(d) did not operate to extend the deadline for the taxpayers to file their petition. The IRS contended that the final regulations applied to the case and the regulations were entitled to deference under *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837 (1984).

Chevron Analysis. Under *Chevron*, when a court reviews an agency's construction of a statute, there are two questions. First, whether Congress has directly spoken on the precise question at issue. *Chevron*, 467 U.S. at 842-843. If Congress' intent is clear, courts and agencies must give effect to the unambiguous intent of Congress. *Id.* If the court determines that Congress has not directly addressed the precise question at issue, the court does not impose its own construction on the statute. *Id.* Second, if the statute is silent or ambiguous with respect to an issue, the court must ask whether the agency's interpretation is based on a permissible construction of the statute. *Id.* However, a court must defer to the agency's interpretation unless it is "arbitrary, capricious or manifestly contrary to the statute." *Id.* at 843-44. With respect to the first question, the Tax Court considered the plain language of both § 7508A(a) and § 7508A(d). The court agreed with the taxpayer's argument that § 7508A(d) is not ambiguous in its provision of a self-executing postponement period. In contrast, the court observed, the language in § 7508A(a) is discretionary. The language of § 7508A(d), the court reasoned, provides that a specifically defined period *"shall be disregarded"* in a defined manner. The court concluded that § 7508A(d) provides for a mandatory extension period for filing a Tax Court petition.

Deference to Treas. Regulation §301.7508A-1(g)(1) and (2). Having concluded under the *Chevron* analysis that § 7508A(d) was unambiguous and that the court did not have to accord *Chevron* deference to the regulations, the court also concluded that Reg. § 301.7508A-1(g)(1) and (2) were invalid. The regulations were invalid to the extent that these two subsections limit the non-pension-related "time sensitive acts that are postponed for the mandatory 60-day

postponement period…[to] the acts determined to be postponed by the Secretary's exercise of authority under 7508(a)." In so holding, the court stated that the regulation, promulgated after the petition in this case was filed, cannot change the result dictated by an unambiguous statute.

Follow-Up Based on the Supreme Court's Decision in Loper. On June 28, 2024, in *Loper Bright Enterprises v. Raimondo*, 2024 WL 3208360, the United States Supreme Court addressed the question of whether *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*., 467 U.S. 837, should be overruled or clarified. In *Loper,* the Supreme Court held that *Chevron* deference, as determined under the two-step analysis described above, cannot be reconciled with the Administrative Procedure Act. The Supreme Court, therefore, overruled *Chevron*. While in *Abdo*, the Tax Court applied the two-part *Chevron* analysis, the Tax Court did not accord *Chevron* deference to the Treasury's regulations. Anticipating the possibility that *Chevron* could be overruled, in his concurring opinion, Judge Buch noted that the continued viability of Chevron was in question. Further, regardless of whether the Supreme Court overruled *Chevron*, the concurrence notes that the Tax Court would reach the same conclusion in this case. Therefore, the holding in *Abdo* here should not be impacted by the Supreme Court's decision in *Loper*.

D. Innocent Spouse

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

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

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

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

Tax Court's analysis. In a unanimous, reviewed opinion by Judge Toro, the Tax Court concluded that the blog posts were "newly discovered evidence" within the meaning of § 6015(e)(7). The court began with the language of the statute and concluded that § 6015 does not

define the term "newly discovered evidence." Accordingly, the court reasoned, "[w]e must therefore discern the ordinary meaning of that phrase in 2019." The court turned to the dictionary definition of the phrase "*newly discovered*" and concluded that the ordinary meaning of the phrase as of 2019 "was 'recently obtained sight or knowledge of for the first time.'" The court concluded that the blog posts the IRS sought to introduce into evidence were "newly discovered evidence" because the IRS had first discovered them by searching the internet after the taxpayer had filed her petition in the Tax Court. In reaching this conclusion, the court rejected the taxpayer's argument that § 6015(e)(7)(B) should be read to incorporate an additional limitation similar to that in Federal Rule of Civil Procedure (FRCP) 60(b)(2). Rule 60(b)(2) provides that a court can relieve a party from a final judgement, order, or proceeding on the basis of "newly discovered evidence *that, with reasonable diligence, could not have been discovered in time to move for a new trial.*" (emphasis added). The taxpayer argued that the IRS could have discovered the blog posts that existed before September 8, 2020, once she had submitted her administrative request for innocent spouse relief on that date and that they therefore should not be considered "newly discovered evidence." The court rejected this argument. The court reasoned that Congress had not included a reasonable diligence standard in the language of § 6015(e)(7)(B) and, in fact, the statute's use of the phrase "*any* additional newly discovered evidence" counseled against reading such a limitation into the statute. The court also observed that the statute's specification that the Tax Court's standard of review of an IRS determination concerning innocent spouse relief is de novo (rather than an abuse-of-discretion standard) supported "the conclusion that evidence unknown to a participant in the innocent spouse administrative proceeding should be admissible if that participant (now a party in our Court) offers it in the proceedings before us." Finally, the court noted that § 6015(e)(7) applies in a context entirely different from that of FRCP 60(b)(2). When a party moves for relief from a judgment under FRCP 60(b)(2), both parties have had an opportunity to conduct discovery and introduce evidence at trial. In contrast, "in the context of section 6015(e)(7), the Court considers a case for the first time following a relatively limited administrative proceeding." Accordingly, the court concluded that the blog posts offered into evidence by the IRS were admissible.

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

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

spouse relief had to be excluded from evidence as inadmissible hearsay, and (2) whether the taxpayer was entitled to innocent spouse relief under § 6015(f).

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

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

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

Eligibility for innocent spouse relief under § 6015(f). Section 4.01 of Rev. Proc. 2013-34, 2013-2 C.B. 297, sets forth seven threshold requirements that apply to all requests for equitable relief under § 6015(f). The parties agreed that the taxpayer satisfied the threshold requirements. Section 4.02 of Rev. Proc. 2013-34 sets forth the conditions under which the IRS will make streamlined determinations granting equitable relief under § 6015(f). A streamlined determination is available if (1) the requesting spouse is no longer married to the non-requesting spouse, (2) the requesting spouse would suffer economic hardship if relief were not granted, and (3) in underpayment cases such as this one, the requesting spouse "did not know or have reason to know that the non-requesting spouse would not or could not pay the underpayment of tax reported on the joint income tax return." The IRS asserted that the taxpayer had not established that she would suffer economic hardship if relief were not granted, and the court agreed. The court reviewed her sources of income and her assets, including a house in an affluent suburb of San Francisco and a vacation home near ski resorts in Lake Tahoe, and concluded that she had not established that she would suffer economic hardship if relief were not granted. Accordingly, the court concluded that she was not eligible for a streamlined determination without reaching the question of whether she knew or had reason to know that the non-requesting spouse would not pay the underpayment of tax. Section 4.03 of Rev. Proc. 2013-34 provides a nonexclusive list of factors for consideration in determining whether a spouse who does not qualify for streamlined relief is nevertheless relieved under § 6015(f) of federal income tax liability resulting from the filing of a joint return. Although Rev. Proc. 2013-34 lists seven equitable factors, the only factors in dispute were whether the taxpayer would suffer economic hardship absent relief, whether she knew or had reason to know that her former husband would not or could not pay the income tax liabilities, and whether she significantly benefited from the underpayment of tax. The court concluded that the taxpayer had not established that she would suffer economic hardship if relief were not granted and that, even if the taxpayer knew or had reason to know that her former husband would not or could not pay

the income tax liabilities, this factor was outweighed by the significant benefit to her of the unpaid tax liabilities. In reaching the conclusion that the taxpayer had significantly benefitted from the underpayment of tax, the court took into account her purchase of a luxury vehicle (a 2013 Land Rover), several vacations she took with her daughters to New York, Europe, and Napa Valley, and her blog posts about a green Dior bag she purchased for her daughter's 18th birthday as well as several designer bags she owned herself and about paying a business coach $220 an hour for private sessions.

E. Miscellaneous

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

Facts: The background of the case is complicated, involving multiple parties entering numerous contracts and related financial transactions across tax years 2006 through 2011. The essential facts, though, concern 2011 and are as follows. The taxpayer, GSS Holdings (Liberty) Inc. was a member of a limited liability company treated as a partnership for federal income tax purposes. Under a contract originally executed by the LLC-partnership in 2006 but amended and closed in 2011, the LLC-partnership was compelled for financial and regulatory reasons to dispose of certain assets. The assets consisted of (i) a promissory note with a par value and basis higher than the note's fair market value plus (ii) cash that the LLC-partnership had to "rebate" to compensate the buyer for acquiring the devalued promissory note at its par value (instead of its fair market value). The total loss suffered by the LLC-partnership from the transaction with the buyer was approximately $22.5 million. The loss was allocated entirely to the taxpayer via the LLC-partnership. On the one hand, in the view of the IRS (and as originally reported by the LLC-partnership on its 2011 Form 1065), the loss derived from a § 165 sale or exchange of a capital asset (the promissory note, coupled with the rebate of cash) and because the loss arose from a sale or exchange with a related party, the loss must be disallowed under § 707(b)(1). On the other hand, in the view of the taxpayer (and as subsequently reported on an amended return and refund claim filed in 2013), the loss was ordinary and stemmed solely from the cash that the LLC-partnership had to "rebate" to the buyer in a transaction separate and distinct from the disposition of the promissory note. Thus, the fundamental dispute was whether the transaction with the buyer consisted of one sale of assets (a promissory note and the cash rebate) resulting in a disallowed capital loss or, instead, two separate transactions: a sale of the promissory note at par value (no gain or loss) and a separate, independent § 165 ordinary loss "rebate" of cash to the buyer. (Again, we could spend pages explaining the entire factual background and the reasons that the promissory note was acquired from the LLC-partnership by the buyer at its par value along with cash "rebated" to the buyer, but suffice it to say that the case involves complex financial transactions and relationships that are not critical to the appeals court's reversal of the lower court.)

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

substance as well as the step transaction doctrine mandated sale or exchange treatment as argued by the IRS.

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

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

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

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

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

VIII. WITHHOLDING AND EXCISE TAXES

A. Self-employment Taxes

1. "Sticks and stones may break my bones but …" calling someone a limited partner in a state-law limited partnership does not necessarily exempt that person from self-employment tax on their distributive share of partnership income. Soroban Capital Partners LP v. Commissioner, 161 T.C. No. 12 (11/28/23). The petitioner in this case, Soroban Capital Partners LP (Soroban), is a limited partnership that, for the years in question, was subject to the former TEFRA unified audit and litigation procedures. Soroban had one general partner (a limited liability company) and three individual limited partners, Messrs. Mandelblatt, Kapadia, and Friedman. On its partnership tax returns for 2016 and 2017, Soroban included in net earnings from self-employment the guaranteed payments received by the three limited partners and the general partner's distributive share of the partnership's ordinary business income. On the other hand, Soroban excluded from net earnings from self-employment the limited partners' distributive shares of the partnership's ordinary business income. Following an audit, the IRS issued Notices of Final Partnership Administrative Adjustment for 2016 and 2017 in which the IRS proposed increasing net earnings from self-employment by the limited partners' distributive shares of the partnership's ordinary business income. On behalf of the partnership, the general partner filed a petition in the

Tax Court challenging this adjustment. In the Tax Court, Soroban filed a motion for summary judgment asking the court to determine as a matter of law that the limited partners' shares of the partnership's ordinary business income were excluded from net earnings from self-employment or, alternatively, that any inquiry into the roles of the limited partners in the partnership's business did not concern a partnership matter and therefore could not be resolved in this TEFRA partnership-level proceeding. The government filed a motion for partial summary judgment asking the court to determine as a matter of law that an inquiry into the limited partners' roles could be determined in this partnership-level proceeding. The Tax Court (Judge Buch) denied Soroban's motion and granted the government's motion. Under § 1402(a), a partner's distributive share of partnership income generally is treated as net earnings from self-employment, but § 1402(a)(13) excludes from this treatment "the distributive share of any item of income or loss of a limited partner, as such …" (other than guaranteed payments for services). The court reviewed the legislative history of § 1402(a)(13) and the government's issuance of proposed regulations in 1997 that sought to define the scope of this limited partner exception and that led to a congressional moratorium on the issuance of regulations. The court also reviewed prior judicial interpretation of the limited partner exception in § 1402(a)(13), including the court's prior decision in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011). In *Renkemeyer*, the court held that partners in a law firm organized as a limited liability partnership were subject to self-employment tax on their distributive shares of partnership income because that income was derived from legal services performed by the partners in their capacity as partners, and therefore "they were not acting as investors in the law firm." The Tax Court had not previously addressed whether a limited partner in a state law limited partnership is automatically a "limited partner, as such" within the meaning of § 1402(a)(13) or instead must satisfy a functional analysis test like the one applied in *Renkemeyer* to be entitled to the limited partner exception. The partnership, Soroban, argued that, because Soroban was a state law limited partnership and its Limited Partnership Agreement identified Messrs. Mandelblatt, Kapadia, and Friedman as limited partners, § 1402(a)(13) was satisfied. The court, however, disagreed and concluded that "[a] functional analysis test should be applied when determining whether the limited partner exception under section 1402(a)(13) applies to limited partners in state law limited partnerships." Because this test requires analysis of the functions and roles of the limited partners, which are factual determinations, the court denied the partnership's motion for summary judgment. The court also held that this examination of the roles of the limited partners is a partnership item that the court had jurisdiction to determine in this TEFRA partnership-level proceeding.

IX. TRUSTS, ESTATES & GIFTS

A. Gross Estate

1. Case results in a clear split between Eighth and Eleventh Circuits concerning inclusion of corporate-owned life insurance proceeds in estate tax value of closely-held stock. Connelly v. United States, 70 F.4th 412 (8th Cir. 6/2/23). In this federal estate tax case, the U.S. Court of Appeals for the Eighth Circuit had to decide whether corporate-owned life insurance proceeds were includable in the estate tax value of a deceased shareholder's redeemed shares or should be excluded from such value as the Eleventh Circuit had held in *Estate of Blount v. Commissioner*, 428 F.3rd 1338 (11th Cir. 2005). Two brothers owned all 500 outstanding shares of stock of Crown C Corporation ("Crown"), a building-materials company located in St. Louis. One brother owned a majority (385.9 shares or 77.18%) of Crown's outstanding stock, while the other brother owned a minority (114.1 shares or 22.82%) of Crown's outstanding stock. Crown and the two brothers had entered into a stock purchase agreement that would take effect upon the death of either brother. Under the agreement, the surviving brother had an option to purchase the deceased brother's shares, or if the surviving brother declined the option, the corporation, Crown, was obligated to redeem the deceased brother's shares. The agreement set the price for the decedent's shares via either (i) a contemporaneous "Certificate of Agreed Value" executed between the brothers each year or (ii) an appraisal process if the brothers failed to execute a "Certificate of Agreed Value" for the relevant year. Furthermore, Crown owned separate $3.5

million insurance policies on the life of each brother to facilitate a redemption of stock upon the death of either brother. When the brother owning the majority of Crown's shares died in 2013, the surviving brother's and Crown's rights under the stock purchase agreement were triggered. No "Certificate of Agreed Value" had been executed between the brothers for 2013 (or, for that matter, ever), and the surviving brother declined to exercise his purchase option. Therefore, Crown proceeded to redeem the deceased brother's shares (385.9 shares or 77.18%) for $3 million, funded by the $3.5 million corporate-owned life insurance policy on the decedent's life, with Crown retaining the $500,000 excess of life insurance proceeds over the redemption price. Rather than the redemption price being set by the agreement itself, however, the deceased brother's son and the surviving brother, as executor of the deceased brother's estate, had agreed to the $3 million value for the deceased brother's shares as part of an "amicable and expeditious" settlement of several estate-administrative matters. Not surprisingly, the decedent's estate reported the value of the redeemed stock at $3 million for federal estate tax purposes. On audit, the IRS challenged the reported $3 million estate tax value of the decedent's shares, arguing that Crown's overall fair market value, including the $3.5 million in life insurance proceeds, was $6.86 million ($3.36 million exclusive of the $3.5 million in life insurance proceeds). The IRS further argued that the higher company-level value informs the estate tax value of the decedent's stock, not merely the $3 million redemption price agreed to by the decedent's son and the surviving brother. The IRS (supported by expert testimony) thus set the value of the deceased brother's shares at about $5.3 million (77.17% x $6.86 million) and assessed a $1 million estate tax deficiency against the decedent's estate. The estate paid the deficiency and filed a refund suit in U.S. District Court, where the lower court held for the IRS. The estate then appealed to the Eighth Circuit.

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

The Eighth Circuit's Opinion. The Eighth Circuit rejected both arguments by the estate and accepted the IRS's position that Crown's overall fair market value upon the decedent's death was $6.86 million, resulting in the deceased brother's shares being valued at approximately $5.3 million for estate tax purposes, inclusive of the $3.5 million of corporate-owned life insurance proceeds. In an opinion by Chief Judge Smith, the Eighth Circuit reasoned that the estate's first argument concerning § 2703 was flawed because the stock purchase agreement did not contain a fixed price or formula to set the value of the deceased brother's shares for estate tax purposes. Courts, including the Eleventh Circuit in *Blount*, have recognized that, under Reg. § 20.2031-2(h), a stock purchase agreement must contain a fixed or determinable price if it is to be binding for

estate tax valuation purposes. Reg. § 20.2031-1(h) provides in part that "[l]ittle weight will be accorded a price" in an agreement where the decedent was "free to dispose of" stock at any price during the decedent's lifetime. Section 2703 was enacted against the backdrop of Reg. § 20-2031-2(h), and thus the courts have applied the two in tandem to control the determination of value for estate tax purposes. Chief Judge Smith thus concluded that the stock purchase agreement at issue in Connelly v. United States could not establish the estate tax value of the decedent's shares under § 2703 or Reg. § 20.2023-2(h) because, in the absence of a pre-determined and binding "Certificate of Agreed Value" or a compulsory appraisal, the agreement had no fixed or determinable method for setting the stock's redemption price as of the decedent's death. The Eighth Circuit also declined to adopt the estate's second argument that *Blount* controlled to exclude the $3.5 million of corporate-owned life insurance proceeds from the determination of the estate tax value of the deceased brother's shares. Chief Judge Smith cited as support both the general willing buyer/willing seller rule of Reg. § 20.2031-2(a) and the more specific rule of Reg. § 20.2031-2(f)(2), which states that in valuing shares of a closely-held corporation for estate tax purposes "consideration shall also be given to nonoperating assets, including proceeds of life insurance policies payable to or for the benefit of the company." Chief Judge Smith emphasized this latter point by noting that the $500,000 of excess life insurance proceeds not used to redeem the decedent's shares benefitted Crown and augmented its overall fair market value. Chief Judge Smith wrote further:

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

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

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

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

a. It's (Unbelievably?) Unanimous! SCOTUS resolves the conflict by affirming *Connelly* (8th Circuit) and implicitly overruling *Estate of Blount* (11th Circuit). Connelly v. United States, 144 S. Ct. 1406 (6/6/24), *aff'g* 70 F.4th 412 (8th Cir. 6/2/23). After the

Eighth Circuit's decision in *Connelly*, the Supreme Court of the United States granted certiorari. Oral arguments were heard on March 27, 2024. The Supreme Court, in an incredibly swift decision by today's standards, unanimously upheld the Eighth Circuit's opinion in favor of the IRS and against the estate. The Court rejected the estate's arguments—which were substantially the same as before the Eighth Circuit—and agreed with the IRS that the federal estate tax value of the deceased brother's shares in Crown must consider the life insurance proceeds payable to the company. The Supreme Court thus determined that Crown's overall fair market value upon the decedent's death was $6.86 million, resulting in the deceased brother's shares being valued at approximately $5.3 million for estate tax purposes, inclusive of the $3.5 million of corporate-owned life insurance proceeds. The Court declined to rule, as the Eleventh Circuit did in *Estate of Blount*, that Crown's obligation to redeem the decedent's shares should be treated as an offsetting liability for federal estate tax purposes. Justice Thomas wrote the unanimous opinion of the Court, reasoning as follows:

> An obligation to redeem shares at fair market value does not offset the value of life-insurance proceeds set aside for the redemption because a share redemption at fair market value does not affect any shareholder's economic interest. A simple example proves the point. Consider a corporation with one asset—$10 million in cash—and two shareholders, A and B, who own 80 and 20 shares respectively. Each individual share is worth $100,000 ($10 million ÷ 100 shares). So, A's shares are worth $8 million (80 shares x $100,000) and B's shares are worth $2 million (20 shares x $100,000). To redeem B's shares at fair market value, the corporation would thus have to pay B $2 million. After the redemption, A would be the sole shareholder in a corporation worth $8 million and with 80 outstanding shares. A's shares would still be worth $100,000 each ($8 million ÷ 80 shares). Economically, the redemption would have no impact on either shareholder. The value of the shareholders' interests after the redemption—A's 80 shares and B's $2 million in cash—would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.

144 S. Ct. at 1411-1412. Importantly, however, Justice Thomas clarified in a footnote that the Court's holding in *Connelly* does not mean a redemption obligation can never decrease a corporation's value for estate tax purposes. "A redemption obligation could, for instance, require a corporation to liquidate operating assets to pay for the shares, thereby decreasing its future earning capacity. We simply reject [the estate's] position that all redemption obligations reduce a corporation's net value. Because that is all this case requires, we decide no more." 144 S. Ct. at 1413 note 2.

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1. **U.S. Residents Investing in Potential PFIC & Reporting Requirements for Newly Formed Foreign Partnership Using Check the Box (CTB) Election.**
2. **Reporting Requirements for Treaty Dual-Resident Individual Owning Foreign Corporations Through a MX *Fideicomiso*.**
3. **Tracking and Utilizing Previously Taxed E&P (PTEP) of a CFC When a 962 Election Is in Effect.**
4. **Conversion of a Foreign Corporation to a Partnership to Avoid PFIC Status & Applicable Reporting Requirements.**
5. **Reorganization of a U.S. Resident's Foreign Corporations—Avoiding a Taxable Exchange & Applicable Reporting Requirements.**

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Case Study 1

- **U.S. Residents Investing in Potential PFIC**
- **Reporting Requirements for Newly Formed Foreign Partnership Using Check the Box (CTB) Election.**

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Case Study 1. – Background

Investment. Clients (one MX resident and one US resident) propose to invest in a private *sociedades cotizadas de inversión en el mercado inmobiliario* in Spain (the "SOCIMI"), which is similar to a US REIT. The SOCIMI holds 100% of the outstanding shares in various Spanish SA de CVs (the "Spanish HoldCos"). The Spanish HoldCos collectively own all of the outstanding shares in various Spanish Sociedad Limitada companies (the "Spanish PropertyCos"), which each hold a separate piece of real estate that each Spanish PropertyCo actively manages and leases to unrelated tenants.

Assets and Income of the Spanish PropertyCos. Each Spanish PropertyCo is engaged in the active conduct of leasing and marketing the pieces of property held by those companies. Each of the Spanish PropertyCos has been fully funded and has used its capital to acquire or develop rental real estate. Neither the SOCIMI, the Spanish HoldCos nor the Spanish PropertyCos are holding a significant amount of cash or securities in anticipation of future real estate investments.

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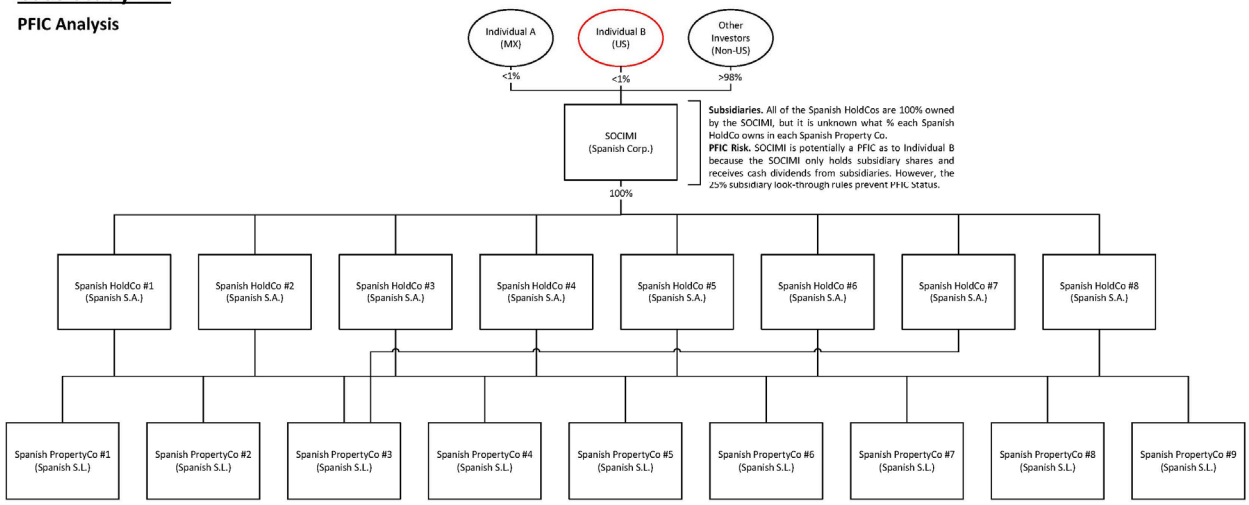
Case Study 1.A

PFIC Analysis



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Case Study 1.A – PFIC Analysis

PFIC Classification of the SOCIMI. The SOCIMI has the potential to be a PFIC with regard to Individual B because it is not a CFC with regard to Individual B (and the CFC overlap rule is therefore inapplicable). However, the SOCIMI will not be a PFIC to Individual B because the SOCIMI will not meet the "50% passive-asset test" ***or*** the "75% passive-income test." Based on the conclusion that the SOCIMI should not be classified as a PFIC, the subsidiary Spanish HoldCos and Spanish PropertyCos should also not be PFICs with regard to the US investor (Individual B) due to the PFIC attribution rules of §1298. Individual B can receive dividends at qualified dividend rate (max 23.8%).

- **Assets and Income of the Spanish PropertyCos.** The property management companies are engaged in the active conduct of a real estate leasing business. Therefore, the assets, rental income and future sales proceeds produced by these companies should generally be considered non-passive.
- **Attribution of Spanish PropertyCo Income and Assets to the SOCIMI.** The PFIC rules contain a "look-through" rule that applies when a company owns, directly or indirectly, 25% or more of a subsidiary company. The look-through rule states that the parent company will be treated as owning a proportional amount of the assets and income of its 25% subsidiaries for purposes of determining whether the parent company is a PFIC under the 50% passive-asset test and the 75% passive-income test. The SOCIMI owns 100% of each of its direct subsidiaries and all of the Spanish PropertyCos are 100% owned by some combination of the direct subsidiaries of the SOCIMI. Therefore the Spanish PropertyCos are considered 100% indirectly owned by the SOCIMI under Treas. Reg. 1.1297-2(b)(1), and the 25% look-through subsidiary rules will apply to treat the SOCIMI as the owner of all income and assets of the Spanish PropertyCos.
- **SOCIMI Not Considered a PFIC.** Treating the assets and income of the Spanish PropertyCos as its own, the SOCIMI must pass the 75% passive-income and 50% passive-asset value tests under §1297 to avoid PFIC status. So long as (*a*) the combined value of all business assets (including rental real estate) of the Spanish PropertyCos exceeds 50% of the combined total asset value of the SOCIMI and its subsidiaries (including the Spanish PropertyCos) and (*b*) the combined gross business income of all Spanish PropertyCos exceeds 25% of the combined gross income of the SOCIMI and its subsidiaries (including the Spanish PropertyCos), the SOCIMI should not be classified as a PFIC under IRC §1297.
- **SOCIMI Subsidiaries Not Considered PFICS.** If the SOCIMI is not a PFIC due to the 25% subsidiary look-through rules, the subsidiary Spanish HoldCos should also not be PFICS with regard to the US investor. For purposes of the PFIC rules, a US shareholder that owns shares in a foreign corporation that is not a PFIC is only treated as an indirect owner of the foreign corporation's subsidiaries if the US shareholder owns, directly or indirectly, 50% or more of the foreign corporation. §1298(a)(2)(A) states, "[i]f 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning [a proportional amount of] the stock owned directly or indirectly by or for such corporation." Under §1298(a)(2)(B), if the corporation is a PFIC, the 50% requirement does not apply and the U.S. shareholder is treated as owning a proportional share of the corporation's subsidiaries regardless of his percentage of ownership in the parent corporation.

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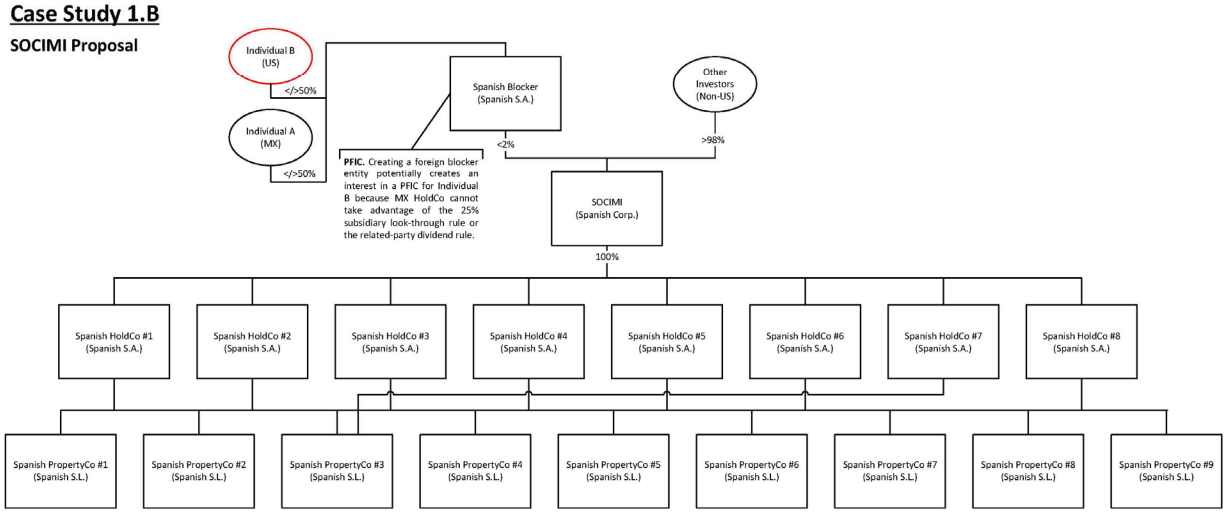
Case Study 1.B

SOCIMI Proposal



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Case Study 1.B – SOCIMI Proposal

SOCIMI Proposal. The SOCIMI proposed that Clients (Individual A & B) make their investment through a Spanish blocker corporation (the "Spanish Blocker") due to ES tax efficiency considerations (accumulation and deferral of dividend income).

Issues. For Individual B, the use of the Spanish Blocker would not be more efficient from a US tax perspective because Spanish Blocker would likely be a PFIC (or a CFC).

PFIC Status. If the US investor owns ≤50% of the Spanish Blocker, the Spanish Blocker is a PFIC because it earns only passive income (dividends), and its only asset is a passive asset (i.e., one that produces passive income, such as stock in a company). The US shareholder would get the benefit of deferral on dividend income because he would not be taxed on dividends paid to the Spanish Blocker. When the Spanish Blocker pays a dividend, however, the portion of the dividend that exceeds 125% of the average dividends paid in the prior 3 years is treated as an excess distribution. Under the excess distribution regime, the US shareholders must allocate the excess distribution across the holding period of their stock, determine how much is included in each tax year, and then apply the highest rate of tax for that year (37% since 2018). In addition, the PFIC tax computed for each year is subject to a punitive interest charge, which is computed from the day the tax would have been due for a prior tax year through the date of the distribution. The part of the dividend that is not an excess distribution is taxed as ordinary income. Gain from the sale of a PFIC is also subject to the excess distribution regime, and capital losses are disallowed.

CFC Status. If the US shareholder owns more than 50% of the shares in the Spanish Blocker, the company would be a CFC. Dividends paid to Spanish Blocker would qualify as Subpart F income, on which the US shareholder would annually recognize his proportional share of earnings and profits regardless of whether those amounts are distributed. Subpart F income would be included as ordinary income subject to marginal US income tax rates (max 37%). The US shareholder would also have to recognize the 3.8% NIIT when there is an actual dividend. Alternatively, Individual B could make an election to include the NIIT at the same time as the Subpart F income, resulting in a total tax rate of 40.8%. The US shareholder can claim an FTC, but there are timing issues with claiming the FTC in the same tax year.

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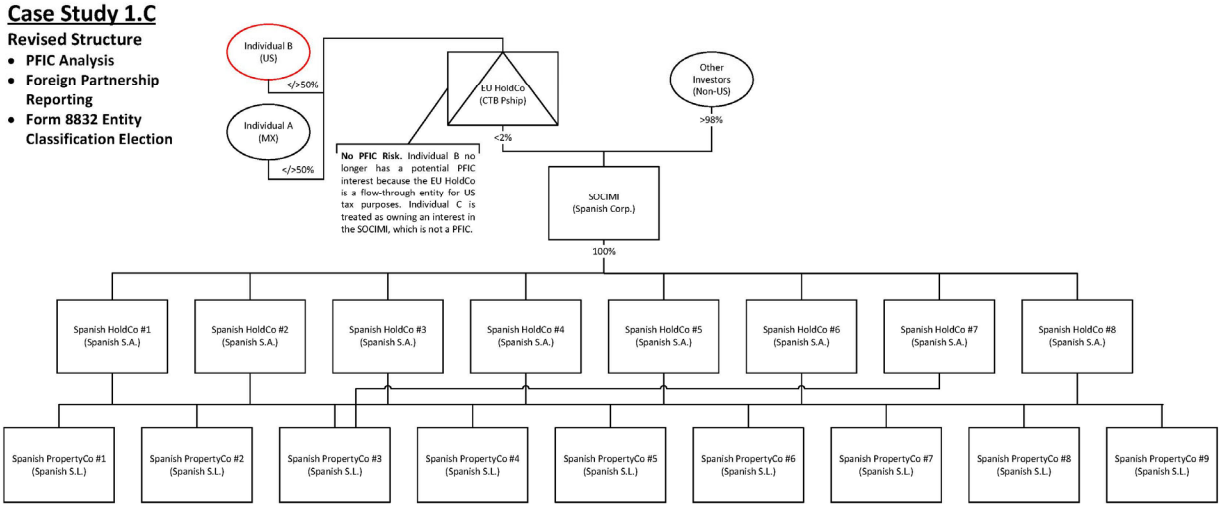
Case Study 1.C

Revised Structure

- **PFIC Analysis**
- **Foreign Partnership Reporting**
- **Form 8832 Entity Classification Election**



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Case Study 1.C – Revised Structure

Use of Pass-through Entity. Individuals A & B could instead invest in the SOCIMI through a hybrid entity in a European jurisdiction that is an eligible foreign corporation for purposes of the CTB election regulations (the "EU HoldCo"). The EU HoldCo can make a CTB election to be treated as a partnership for US tax purposes, while the EU HoldCo continues to be treated as a taxable corporation for ES tax purposes.

PFIC Analysis. Under the attribution rules of §1298, Individual B will be treated as owning a proportional amount the SOCIMI shares owned by EU HoldCo, but the SOCIMI will not be a PFIC with regard to Individual B for the same reasons discussed above.

Qualified Dividend Treatment. Given that the PFIC and CFC rules do not apply, the SOCIMI is classified as a qualified foreign corporation (QFC) because there is a comprehensive income tax treaty between the US and Spain. Dividends from a QFC are subject to the lower long term capital gains (LTCG) rate of 20% plus the 3.8% net investment income tax (NIIT) for a total tax rate of 23.8%. In addition, to the extent there is any Spanish withholding tax, the US investor can claim a foreign tax credit (FTC) for this amount against his 20% LTCG tax (the FTC generally only applies to income taxes and US courts have determined, in almost all cases, the NIIT is not an income tax).

Use of Form 8832 (Entity Classification Election) to make CTB Election. For the EU Holdco to be treated as a partnership for U.S. federal income tax purposes, the EU Holdco will need to file a valid Form 8832 making an initial entity classification electing to be treated as a partnership for US income tax purposes. Individual B will be required to attach the Form 8832 to his income tax return for the tax year.

Form 8865 Filing Requirements. Individual B will be required to file Form 8865 to disclose his partnership interest in the EU HoldCo under the following filing categories:

- **Category 1 Filer.** If Individual B controls (owns >50%) of the EU HoldCo, he will need to file as a category 1 filer.
- **Category 2 Filer.** Individual B is a 10% or greater owner of an interest in the EU HoldCo. If the EU Holdco is controlled (>50% owned) by US persons owning at least a 10% interest (i.e., Individual B), Individual B will be a category 2 filer.
- **Category 3 Filer.** Individual B will have to make a direct §721 contribution to the EU HoldCo in exchange for an interest in the partnership, and he will hold greater than a 10% interest in EU HoldCo thereafter. Therefore, Individual B is a category 3 filers.
- **Category 4 Filer.** Individual B has acquired a new greater than 10% interest in the EU Holdco. Therefore, Individual B had a "reportable event" and must file as a category 4 filer.

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Case Study 2

- **Reporting Requirements for Treaty Dual-Resident Individual**
- **Reporting Foreign Corporations Owned Through a Fideicomiso.**

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Case Study 2 – Background

Presence in the United States. Client (Individual A) met the substantial presence test for the tax year and did not qualify for the closer connection exception. Individual A is a citizen and resident of Mexico for MX tax purposes. Individual A has a permanent residence in Mexico and has a center of vital interests in Mexico. Therefore, Individual A may claim the closer connection exception under Article 4 of the US-MX income tax treaty to be treated as nonresident alien for purposes of calculating her US income tax liability (but not for foreign asset reporting purposes).

Foreign Assets. Individual A and her siblings (Individuals B & C) are equal 1/3 beneficiaries of a MX *fideicomiso* (the "Fideicomiso") created by their father (individual D). The Fideicomiso was funded with minority interests (ranging from 1%-50%) in Individual D's various MX corporations (the "Tier 1 Companies"). The Fideicomiso is under the complete control of Individual A and her siblings and effectively serves as their nominee. Individual D has no rights to the Fideicomiso assets and has no powers over the Fideicomiso. Several of the Tier 1 Companies own interests (ranging from 1%-100%) in subsidiary MX corporations (the "Tier 2 Companies").

Issue. Client must determine what, if any, US reporting obligations she has with regard to the Tier 1 Companies and the Tier 2 Companies.

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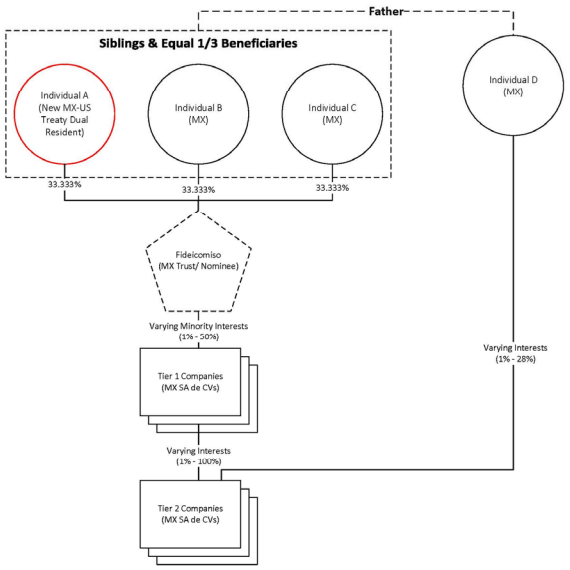
Case Study 2

- **Form 5471 Reporting Obligations**
- **Change In Resident Status for US Reporting Purposes**



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Case Study 2 – U.S. Reporting

Form 5471 Reporting (Category 3). Generally, U.S. residents (and treaty dual-residents) are required to file Form 5471 as category 3 filers if they obtain an initial or additional 10% ownership interest in a foreign corporation (direct, indirect or constructive) or dispose of an interest

- **New U.S. Residents.** A person who becomes a U.S. resident while meeting the above 10% stock ownership requirement, above, with respect to a foreign corporation must generally file Form 5471 as a category 3 filer. Although treaty dual-residents may be nonresident aliens for purposes of computing U.S. income tax liability, they are U.S. residents for all other tax purposes, including Form 5471 filing requirements. *See* Reg. 301.7701(b)-7(a)(3).
- **Constructive Ownership Rules (§6046).** For category 3 purposes, the constructive ownership rules under §6046 apply to treat Individual A as the owner of all shares held directly or indirectly by her father and her siblings. Consequently, Individual A must file Form 5471 for each of the Tier 1 and Tier 2 companies in which her father and the Fideicomiso hold a combined interest that is equal to or greater than 10% in the year she became a U.S. resident (even if she is not a U.S. resident for purposes of calculating her U.S. income tax liability).

  Example: Even if Individual A only holds a 5% indirect interest in a foreign corporation, she would still be a category 3 filer because she constructively owns 15% of that company through her siblings.

Case Study 2 – U.S. Reporting

Form 5471 Reporting (Category 4). Individual A is not a category 4 filer. A U.S. person has control of a foreign corporation (cat. 4 filer) if, at any time during that person's tax year, she owns stock possessing:

- **More than 50% of the total combined voting power** of all classes of stock of the foreign corporation entitled to vote, or
- **More than 50% of the total value** of shares of all classes of stock of the foreign corporation. A person in control of a corporation that, in turn, owns more than 50% of the combined voting power, or the value, of all classes of stock of another corporation is also treated as being in control of such other corporation. Individual A is not attributed her siblings shares, so she does not control any companies.
- **Reg. 1.6038-2(c) attribution:** Normal §318(a) attribution rules applies, except:
  - (1) No downward attribution to pass-through entities/ trusts/ estates.
  - (2) no downward attribution of shares held by controlling shareholders to the corporation.
  - (3) If **10 percent or more** in value of the stock in a corporation is owned, directly or indirectly, by or for any person, § 318(a)(2)(C) shall apply: proportional attribution of corporation's shares in subsidiaries.
- **Note:** Under these rules, Individual A could be a category 4 filer for any foreign corporation her father owned >50% of, even though that corporation would not be a CFC under the Section 958(b) attribution rules.

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Case Study 3

- **Effect of a 962 Election (or Lack Thereof) on GILTI Tax**
- **Tracking and Utilizing Previously Taxed E&P (PTEP) of a CFC**

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Case Study 3 – Background

Presence in the United States. Client (Individual A) is a US lawful permanent resident (Green Card holder) and has been a US resident for US federal income tax purposes for several years. Individual A is also a citizen and resident of Mexico for MX tax purposes. Individual A is not claiming the closer connection exception under Article 4 of the US-MX income tax treaty.

Foreign Assets. Individual A owns 99.99% of the outstanding shares in his MX corporation ("F Co"). F Co is a CFC as to Individual A and Individual A must (absent an election) include all of F Co's Subpart F income and GILITI for the accounting period ending on or during his tax year in his gross income for that tax year. F Co does not generate Subpart F income but does generate a substantial amount of GILTI. The GILTI generated by F Co is subject to 30% MX income tax.

Issue. In prior tax years, Individual A failed to make a 962 election or a high-tax exclusion (HTE) election. Subsequently, Individual A made 962 elections for his tax years, but overstated the amount of PTEP generated during those years. Consequently, Individual A is at risk of underreporting the amount of taxable dividend income he will receive from F Co in the current tax year.

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Case Study 3 - Section 962 Elections

##########
SSN: #########

FOR THE YEAR ENDED DECEMBER 31, 2021

ELECTION BY AN INDIVIDUAL SHAREHOLDER OF A CONTROLLED FOREIGN CORPORATION TO BE TAXED AT A CORPORATE RATE PURSUANT TO IRC SEC. 962

HEREBY ELECTS PURSUANT TO IRC SEC. 962 TO BE TREATED AS A DOMESTIC CORPORATION FOR PURPOSES OF BEING TAXED ON ALL AMOUNTS WHICH ARE INCLUDIBLE IN GROSS INCOME FOR SUCH TAX YEAR UNDER IRC SEC. 951(A) PURSUANT TO REG. SEC. 1.962-2(B). THE FOLLOWING INFORMATION IS PROVIDED PERTAINING TO THE CONTROLLED FOREIGN CORPORATIONS (CFC) FOR WHICH THE TAXPAYER IS EITHER DIRECTLY OR INDIRECTLY A QUALIFIED U.S. SHAREHOLDER:

NAME OF CFC: ##########

ADDRESS OF CFC: ##########

GLOBAL INTANGIBLE LOW-TAXED INCOME (IRC. SEC. 951(A):	$ 372,868
SUBPART F INCOME	$ -
CORPORATIONS EARNINGS & PROFITS	$ 467,405
SHAREHOLDERS PRO RATA SHARE OF E & P (REG. SEC. 1.964-1(A)):	$ 467,354
CORPORATIONS FOREIGN TAXES PAID	$ 232,813
FOREIGN TAXES PAID ON SHARE OF EARNINGS AND PROFITS:	$ 232,730
AMOUNT OF DISTRIBUTIONS RECEIVED BY SHAREHOLDER:	$ 216,730

Section 962 Election (GILTI Inclusion)

GILTI	$ 372,868
Section 78 inclusion	230,435
Section 250 deduction (50%)	(301,677)
Adjusted GILTI	301,677
Subpart F Income	-
Federal Taxable Income	301,677
Tentative US Federal Income Tax (21%)	63,352
Foreign Tax Credit (up to 80%)	(63,352)
Total Section 962 US Federal Tax	-

##########
SSN: #########

FOR THE YEAR ENDED DECEMBER 31, 2021

REG. 1.962-2(b)(4). DISTRIBUTIONS OF IRC. SEC. 962 EARNINGS AND PROFITS

The taxpayer received distributions from Section 962 earnings and profits as follows:

Corporate Name	Total Distribution	Excludable	Taxable
##########	$ 216,730	$ 216,730	-

Case Study 3 - Section 962 Elections and HTE Elections

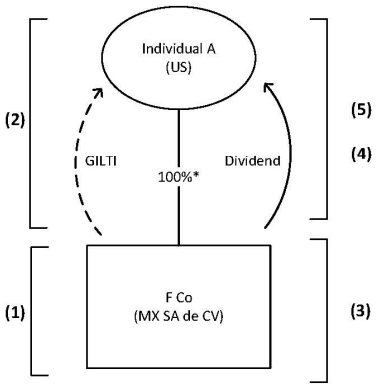
Comparison of MX Entity Planning Options – CFC Example with 30% Effective MX Tax Rate

	Partnership / Disregarded Entity	CFC without Section 962 or HTE election	CFC with Section 962 election
GILTI Income	100	100	100
Less: MX Tax	30	30	30
After MX Tax Income	70	70	70
US Tax Liability	37	25.9	10.5
Less: FTC	30	0	24
US Cash Tax	7	25.9	- 0 -
Total Cash Tax	37	55.9	30
Total Pre-Distribution After Tax Profit	63	44.1	70
US and MX Tax on Future Distributions	0 US Tax 7 MX withholding tax*	2.66 US NIIT 7 MX withholding tax*	16.66 US Tax 7 MX withholding tax*
Total After Tax Profit	63	34.44	53.34

*MX withholding tax will be imposed on post-2013 profits paid to shareholders and should qualify for a foreign tax credit in the US, but there are timing issues to consider.

Case Study 3.A

Year 1 (No 962 Election)



(1) GILTI Earned by F Co. 100x of income Subject to normal MX income tax (30x).

(2) GILTI Tax Pre-Dividend.
- 70x of after-MX tax GILTI subject to US income tax at ordinary marginal tax rates (25.9x).
- No foreign tax credit. Effective 55.9% tax rate on GILTI pre distribution.

(3) Future F Co Dividends.
- Potential 70x cash dividend.
- 10% MX withholding tax under income tax treaty (7x).

(4) Future F Co Dividends.
- 70x distribution is 951A PTEP.
- 70x PTEP remains subject to 3.8% Net Investment Income Tax (NIIT) (2.66x) on dividend income.

(5) After-Tax Profit. Only 34.44x of profit on 70x dividend (49%).

*Disregards obligatory second owner under MX corporate law holding 1% as nominee.

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YEAR 1

SCHEDULE J (Form 5471)
(Rev. December 2020)
Department of the Treasury
Internal Revenue Service

Accumulated Earnings & Profits (E&P) of Controlled Foreign Corporation

▶ Attach to Form 5471.
▶ Go to *www.irs.gov/Form5471* for instructions and the latest information.

OMB No. 1545-0123

Name of person filing Form 5471: Individual A — **Identifying number**

Name of foreign corporation: F Co — EIN (if any) — **Reference ID number** (see instructions)

a Separate Category (Enter code—see instructions.) ▶ GEN
b If code 901j is entered on line a, enter the country code for the sanctioned country (see instructions) ▶

Part I Accumulated E&P of Controlled Foreign Corporation

☐ Check the box if person filing return does not have all U.S. shareholders' information to complete an amount in column (e) (see instructions).

Important: Enter amounts in functional currency.

		(a) Post-2017 E&P Not Previously Taxed (post-2017 section 959(c)(3) balance)	(b) Post-1986 Undistributed Earnings (post-1986 and pre-2018 section 959(c)(3) balance)	(c) Pre-1987 E&P Not Previously Taxed (pre-1987 section 959(c)(3) balance)	(d) Hovering Deficit and Deduction for Suspended Taxes	(e) Previously Taxed E&P (see instructions) (i) Reclassified section 965(a) PTEP	(e) (ii) Reclassified section 965(b) PTEP
1a	Balance at beginning of year (as reported on prior year Schedule J)						
b	Beginning balance adjustments (attach statement)						
c	Adjusted beginning balance (combine lines 1a and 1b)						
2a	Reduction for taxes unsuspended under anti-splitter rules						
b	Disallowed deduction for taxes suspended under anti-splitter rules						
3	Current year E&P (or deficit in E&P) (enter amount from applicable line 5c of Schedule H)	70x					
4	E&P attributable to distributions of previously taxed E&P from lower-tier foreign corporation						
5a	E&P carried over in nonrecognition transaction						
b	Reclassify deficit in E&P as hovering deficit after nonrecognition transaction						
6	Other adjustments (attach statement)						
7	Total current and accumulated E&P (combine lines 1c through 6)	70x					
8	Amounts reclassified to section 959(c)(2) E&P from section 959(c)(3) E&P	(70x)					
9	Actual distributions						
10	Amounts reclassified to section 959(c)(1) E&P from section 959(c)(2) E&P						
11	Amounts included as earnings invested in U.S. property and reclassified to section 959(c)(1) E&P (see instructions)						
12	Other adjustments (attach statement)						
13	Hovering deficit offset of undistributed post-transaction E&P (see instructions)						
14	Balance at beginning of next year (combine lines 7 through 13)						

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. — Schedule J (Form 5471) (Rev. 12-2020)

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Schedule J (Form 5471) (Rev. 12-2020) — Page 2

Part I Accumulated E&P of Controlled Foreign Corporation *(continued)*

	(e) Previously Taxed E&P (see instructions) (iii) General section 959(c)(1) PTEP	(iv) Reclassified section 951A PTEP	(v) Reclassified section 245A(d) PTEP	(vi) Section 965(a) PTEP	(vii) Section 965(b) PTEP
1a					
b					
c					
2a					
b					
3					
4					
5a					
b					
6					
7					
8					
9					
10					
11					
12					
13					
14					

	(e) Previously Taxed E&P (see instructions) (viii) Section 951A PTEP	(ix) Section 245A(d) PTEP	(x) Section 951(a)(1)(A) PTEP	(f) Total Section 964(a) E&P (combine columns (a), (b), (c), and (e)(i) through (e)(x))
1a				
b				
c				
2a				
b				
3				
4				
5a				
b				
6				
7				70x
8	70x			
9				
10				
11				
12				
13				
14	70x			70x

Schedule J (Form 5471) (Rev. 12-2020)

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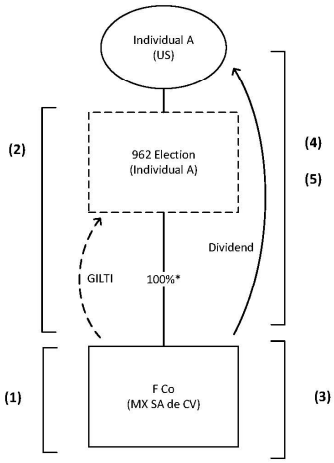
Case Study 3.B

Year 2 (962 Election)



(1) GILTI Earned by F Co.
100x of income Subject to normal MX income tax (30x).

(2) GILTI Tax Pre-Dividend.
- 70x of after-MX tax GILTI subject to US income tax at corporate 21% rate, less 50% deduction under Section 245 (10.5x).
- Foreign tax credit on MX tax (24x) allowed. Effective 30% tax rate on GILTI pre distribution to A.

(3) Future F Co Dividends.
Potential 70x cash dividend.
10% MX withholding tax under income tax treaty (7x).

(4) F Co Dividends.
- 70x distribution no longer consists of 951A PTEP because no tax was actually paid by A.
- 70x remains subject to 3.8% NIIT and 20% (15% at lower bracket) qualified dividend tax for a combined (16.66x) tax on F Co dividends.

(5) After-Tax Profit. 53.34x of profit on 70x dividend (76.2%).

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YEAR 2

SCHEDULE J (Form 5471)
(Rev. December 2020)
Department of the Treasury
Internal Revenue Service

Accumulated Earnings & Profits (E&P) of Controlled Foreign Corporation

▶ Attach to Form 5471.
▶ Go to *www.irs.gov/Form5471* for instructions and the latest information.

OMB No. 1545-0123

Name of person filing Form 5471: Individual A — **Identifying number**

Name of foreign corporation: F Co — EIN (if any) — **Reference ID number** (see instructions)

a Separate Category (Enter code—see instructions.) ▶ GEN
b If code 901j is entered on line a, enter the country code for the sanctioned country (see instructions) ▶

Part I Accumulated E&P of Controlled Foreign Corporation

☐ Check the box if person filing return does not have all U.S. shareholders' information to complete an amount in column (e) (see instructions).

Important: Enter amounts in functional currency.

		(a) Post-2017 E&P Not Previously Taxed (post-2017 section 959(c)(3) balance)	(b) Post-1986 Undistributed Earnings (post-1986 and pre-2018 section 964(c)(3) balance)	(c) Pre-1987 E&P Not Previously Taxed (pre-1987 section 959(c)(3) balance)	(d) Hovering Deficit and Deduction for Suspended Taxes	(e) Previously Taxed E&P (see instructions)	
						(i) Reclassified section 965(a) PTEP	(ii) Reclassified section 965(b) PTEP
1a	Balance at beginning of year (as reported on prior year Schedule J)						
b	Beginning balance adjustments (attach statement)						
c	Adjusted beginning balance (combine lines 1a and 1b)						
2a	Reduction for taxes unsuspended under anti-splitter rules						
b	Disallowed deduction for taxes suspended under anti-splitter rules						
3	Current year E&P (or deficit in E&P) (enter amount from applicable line 5c of Schedule H)	70x					
4	E&P attributable to distributions of previously taxed E&P from lower-tier foreign corporation						
5a	E&P carried over in nonrecognition transaction						
b	Reclassify deficit in E&P as hovering deficit after nonrecognition transaction						
6	Other adjustments (attach statement)						
7	Total current and accumulated E&P (combine lines 1c through 6)	70x					
8	Amounts reclassified to section 959(c)(2) E&P from section 959(c)(3) E&P						
9	Actual distributions						
10	Amounts reclassified to section 959(c)(1) E&P from section 959(c)(2) E&P						
11	Amounts included as earnings invested in U.S. property and reclassified to section 959(c)(1) E&P (see instructions)						
12	Other adjustments (attach statement)						
13	Hovering deficit offset of undistributed post-transaction E&P (see instructions)						
14	Balance at beginning of next year (combine lines 7 through 13)	70x					

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. — Schedule J (Form 5471) (Rev. 12-2020)

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Schedule J (Form 5471) (Rev. 12-2020) Page 2

Part I Accumulated E&P of Controlled Foreign Corporation *(continued)*

	(e) Previously Taxed E&P (see instructions)				
	(iii) General section 959(c)(1) PTEP	(iv) Reclassified section 951A PTEP	(v) Reclassified section 245A(d) PTEP	(vi) Section 965(a) PTEP	(vii) Section 965(b) PTEP
1a					
b					
c					
2a					
b					
3					
4					
5a					
b					
6					
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10					
11					
12					
13					
14					

	(e) Previously Taxed E&P (see instructions)			(f)
	(viii) Section 951A PTEP	(ix) Section 245A(d) PTEP	(x) Section 951(a)(1)(A) PTEP	Total Section 964(a) E&P (combine columns (a), (b), (c), and (e)(i) through (e)(x))
1a	70x			70x
b				
c	70x			70x
2a				
b				
3				
4				
5a				
b				
6				
7				70x
8				
9				
10				
11				
12				
13				
14	70x			140x

Schedule J (Form 5471) (Rev. 12-2020)

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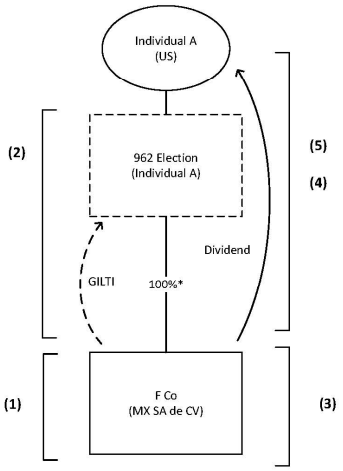
Case Study 3.C

Year 3 (962 Election with PTEP)



(1) GILTI Earned by F Co.
100x of income not subject MX income tax due to net loss importation or other deductions: (0x).

(2) GILTI Tax Pre-Dividend.
- 100x of GILTI subject to US income tax at corporate 21% rate, less 50% deduction under Section 245: (10.5x).
- No foreign tax credits available on MX tax, so Individual A pays 10.5x tax on GILIT. Effective 10.5% tax rate on GILTI pre distribution to Individual A.

(3) Future F Co Dividends.
- Potential 100x cash dividend.
- 10% MX withholding tax under income tax treaty: (7x).

(4) F Co Dividends.
- 100x distribution no longer consists of 951A PTEP because no tax was actually paid by A.
- 100x remains subject to 3.8% NIIT: (3.8x)
- 89.5x remains subject to 20% qualified dividend tax: (17.9x).
- Combined tax on F Co dividend: (21.7x)

(5) After-Tax Profit. 67.8x of profit on 100x dividend (67.8%).

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YEAR 3

SCHEDULE J (Form 5471) (Rev. December 2020)
Department of the Treasury Internal Revenue Service

Accumulated Earnings & Profits (E&P) of Controlled Foreign Corporation

▶ Attach to Form 5471.
▶ Go to *www.irs.gov/Form5471* for instructions and the latest information.

OMB No. 1545-0123

Name of person filing Form 5471: Individual A — Identifying number:
Name of foreign corporation: F Co — EIN (if any): — Reference ID number (see instructions):

a Separate Category (Enter code—see instructions.) ▶ GEN
b If code 901j is entered on line a, enter the country code for the sanctioned country (see instructions) ▶

Part I Accumulated E&P of Controlled Foreign Corporation

☐ Check the box if person filing return does not have all U.S. shareholders' information to complete an amount in column (e) (see instructions).

Important: Enter amounts in functional currency.

		(a) Post-2017 E&P Not Previously Taxed (post-2017 section 959(c)(3) balance)	(b) Post-1986 Undistributed Earnings (post-1986 and pre-2018 section 959(c)(3) balance)	(c) Pre-1987 E&P Not Previously Taxed (pre-1987 section 959(c)(3) balance)	(d) Hovering Deficit and Deduction for Suspended Taxes	(e) Previously Taxed E&P (see instructions) (i) Reclassified section 965(a) PTEP	(e) (ii) Reclassified section 965(b) PTEP
1a	Balance at beginning of year (as reported on prior year Schedule J)	70x					
b	Beginning balance adjustments (attach statement)						
c	Adjusted beginning balance (combine lines 1a and 1b)	70x					
2a	Reduction for taxes unsuspended under anti-splitter rules						
b	Disallowed deduction for taxes suspended under anti-splitter rules						
3	Current year E&P (or deficit in E&P) (enter amount from applicable line 5c of Schedule H)	100x					
4	E&P attributable to distributions of previously taxed E&P from lower-tier foreign corporation						
5a	E&P carried over in nonrecognition transaction						
b	Reclassify deficit in E&P as hovering deficit after nonrecognition transaction						
6	Other adjustments (attach statement)						
7	Total current and accumulated E&P (combine lines 1c through 6)	170x					
8	Amounts reclassified to section 959(c)(2) E&P from section 959(c)(3) E&P	(10.5x)					
9	Actual distributions	(159.5x)					
10	Amounts reclassified to section 959(c)(1) E&P from section 959(c)(2) E&P						
11	Amounts included as earnings invested in U.S. property and reclassified to section 959(c)(1) E&P (see instructions)						
12	Other adjustments (attach statement)						
13	Hovering deficit offset of undistributed post-transaction E&P (see instructions)						
14	Balance at beginning of next year (combine lines 7 through 13)						

For Paperwork Reduction Act Notice, see the Instructions for Form 5471. — Schedule J (Form 5471) (Rev. 12-2020)

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Schedule J (Form 5471) (Rev. 12-2020) — Page 2

Part I Accumulated E&P of Controlled Foreign Corporation *(continued)*

	(e) Previously Taxed E&P (see instructions) (iii) General section 959(c)(1) PTEP	(iv) Reclassified section 951A PTEP	(v) Reclassified section 245A(d) PTEP	(vi) Section 965(a) PTEP	(vii) Section 965(b) PTEP
1a					
b					
c					
2a					
b					
3					
4					
5a					
b					
6					
7					
8					
9					
10					
11					
12					
13					
14					

	(e) Previously Taxed E&P (see instructions) (viii) Section 951A PTEP	(ix) Section 245A(d) PTEP	(x) Section 951(a)(1)(A) PTEP	(f) Total Section 964(a) E&P (combine columns (a), (b), (c), and (e)(i) through (e)(x))
1a	70x			140x
b				
c	70x			140x
2a				
b				
3				
4				
5a				
b				
6				
7				100x
8	10.5x			
9	(80.5x)			(240x)
10				
11				
12				
13				
14				

Schedule J (Form 5471) (Rev. 12-2020)

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Case Study 3.

Utilizing PTEP From Years With No 962 Election. Following A's 962 election, none of the GILTI generated by F Co will result in any actual U.S. tax for A. All of A's potential tax liability for the reduced 21% tax on GILTI pursuant to the 962 election will be eliminated by the deemed 50% foreign-derived intangible income deduction under IRC §250(a)(1)(B) and the deemed paid credit under §960(d) equal to 80% of the foreign taxes imposed on the CFC's tested income times the shareholder's percentage of net tested income included in income under §951A (i.e., GILITI). Here, A would have a deemed paid foreign tax credit of 24x (80% of the 30x MX tax paid on GILTI) and would pay no U.S. income tax on his GILTI inclusion for the current year.

- **Taxable 962 E&P (Reg. 1.962-3(b)(1)).** There are two categories of § 962 E&P: (i) excludible 962 E&P; and (ii) taxable 962 E&P. A CFC's excludible 962 E&P is the amount of income tax previously paid on amounts the U.S. taxpayer included in gross income under §951 & §951A. Any other §962 E&P in excess of income tax previously paid by the U.S. Shareholder is taxable 962 E&P.
- **PTEP Ordering Rules.** 962 E&P is treated as PTEP for purposes of the ordering rules, falling within §959(c)(1) or §959(c)(2) E&P (Subpart F income and GILTI). 962 PTEP is only distributed after any PTEP in the relevant account that is not 962 E&P. 962 E&P is distributed first from excludible 962 E&P and then from taxable 962 E&P.

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Case Study 3

Retroactive Form 962 Election. Although the PTEP from tax years prior to the 962-election years can still be distributed tax-free, Individual A can achieve the optimal tax result by filing qualified amended returns and making retroactive 962 elections (or HTE elections) for the years in which he did not originally make the election.

- **Authority.** Preamble to §962 regulation amendments (T.D. 9901 (July 9, 2020)) announced that IRS is studying the issue of an individual's ability to make a §962 election on an amended return. Pending additional guidance, for the 2018 and subsequent taxable years, individuals may elect §962 treatment on an original or amended tax return. However, the interests of the government must not be prejudiced, consistent with §9100 (e.g., the election cannot create an additional liability for a tax year that cannot be assessed because it is barred by the statute of limitations). The GILTI HTE election can also be made on an amended return, provided the amended return is filed within 24 months of the unextended due date of the original return and other requirements are met. *See* Reg. §1.951A-2(c)(7)(viii)(C). Relief for earlier tax years may be obtained through a PLR.
- **Tax Consequences.** The retroactive 962 elections will result in a refund for the prior years but will eliminate any §951A (GILTI) PTEP generated in prior years and future distributions will be taxable dividends rather than tax-free distributions of PTEP. Ultimately, the 76.2% (or 67.8%) after-tax profit on the dividends paid from GILTI earned by F Co under the 962 election is still preferable to the 49.2% after-tax profit that Individual A would receive otherwise.

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Case Study 4

- **Conversion of a Foreign Corporation to a Partnership to Avoid PFIC Status**
- **Reporting Requirements for Newly Formed Foreign Partnership**

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Case Study 4 – Background

Presence in the United States. Clients (Individuals C-I) are members of the same extended family. Individuals H & I are brothers and their children (Individuals C-G) are cousins. Individuals A-G own shares in a MX corporation ("F Co"). Individuals A & B are unrelated to any other owners of F Co. Individuals A, B, C & D are nonresident aliens while Individuals E, F, G, H & I are US residents for federal income tax purposes. ***Note:*** In actuality the facts were more complicated due to Individual H & I also holding potential *usufructo* rights to the F Co shares.

Foreign Assets. F Co is a dormant foreign corporation with no assets, no income, no expenses and no current activities. Clients decide to utilize F Co to purchase a warehouse located in Mexico (the "Property"). F Co enters into a tentative agreement to purchase the Property and will begin making installment payments on the purchase during the current tax year. Once the Property is acquired F Co will actively manage and maintain the Property and lease it to unrelated tenants.

Issue. To fund the purchase of the Property, the F Co shareholders will need to contribute large sums of cash in the current tax year. However, F Co is not likely to acquire the Property until at least next year and may not begin leasing operations until the subsequent year. Thus, there is a risk that F Co will be classified as a PFIC.

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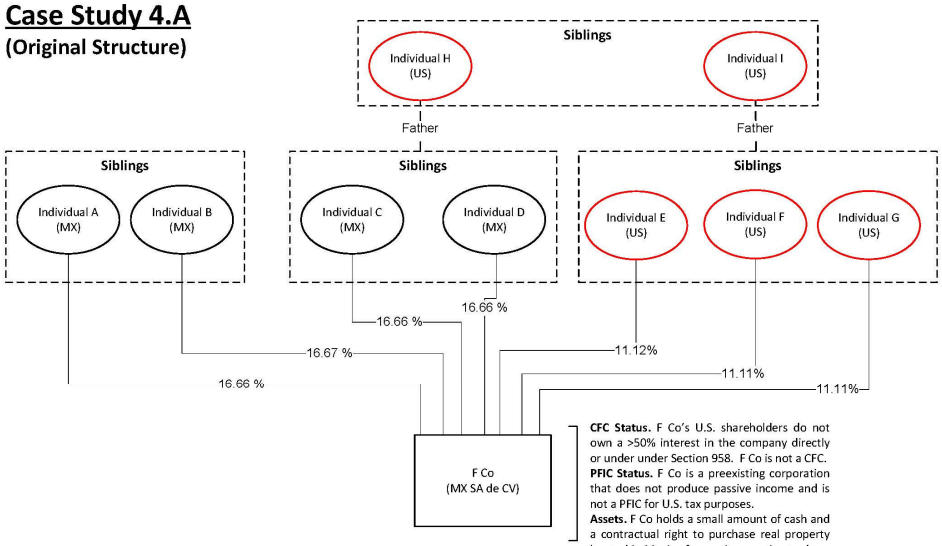
Case Study 4.A
(Original Structure)



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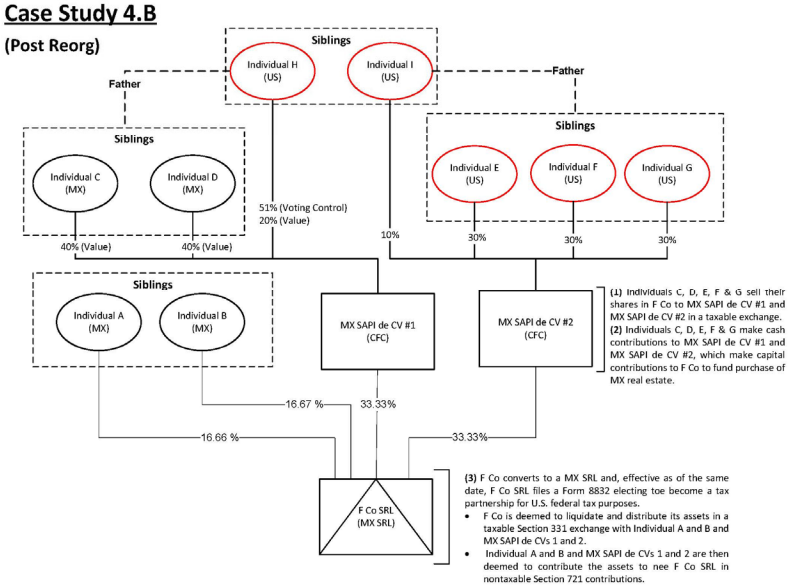
Case Study 4.B
(Post Reorg)



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Case Study 4 – U.S. Reporting

Original Structure. F Co has the potential to become a PFIC as to its U.S. Shareholders upon funding of F Co with cash for the future acquisition of the MX real estate by F Co.

- **PFIC Tax.** F Co would be reportable on Form 8621 and would be subject to "PFIC Taint." Once a foreign entity is classified as a PFIC, it will remain a PFIC subject to taxation under IRC §1297. Once distributions were made to the MX SAPI de CVs, the U.S.

Post Reorg & Entity Election. The U.S. shareholder of F Co now have a reportable interest in F Co SRL (a foreign partnership).

- **Form 8865.** Individuals E, F, G, H & I are all category 2 filers for F Co SRL.
  - **Category 2 Filers.** Under the constructive ownership rules of §267(b), (c) each former U.S. shareholder of F Co remains a 10% or greater owner of an interest in F Co SRL and F Co SRL is controlled by U.S. persons owning at least a 10% interest.
  - **Category 3 Filers.** Because Individuals E, F, G, H & I did not make direct contributions to the partnership, they are not category 3 filers.
- **Form 926.** The U.S. Shareholders must report cash contributions to the MX SAPI de CVs on Form 926.
- **Form 8832.** The indirect U.S. owners of F Co SRL will need to attach copies of the Form 8832 to their U.S. income tax returns for the year.

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Case Study 5

- **Avoiding a Taxable Exchange During Reorganization of a U.S. Resident's Foreign Corporations**
- **Special Filing and Reporting Requirements Triggered by the Reorganization**

Case Study 5 – Background

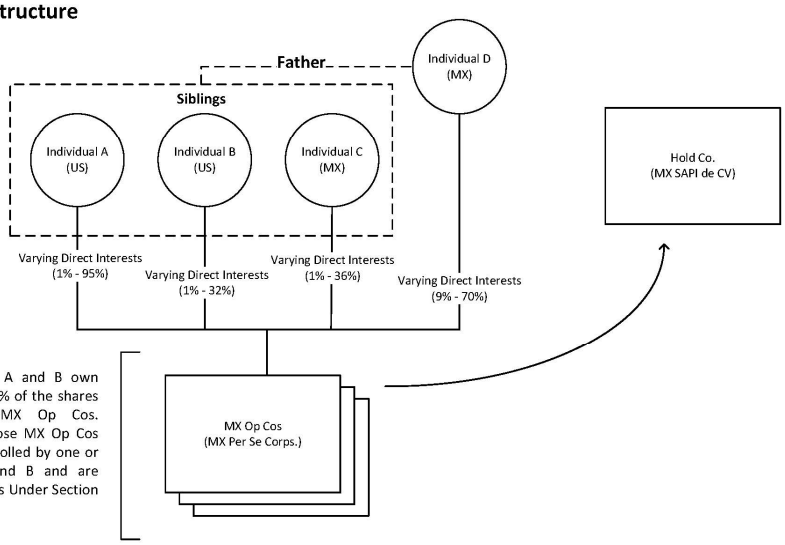
Presence in the United States. Client (Individuals A & B) are US lawful permanent residents (Green Card holders) and are US resident for US federal income tax purposes. Their sister (Individual C) and their father (Individual D) are citizens and residents of Mexico and are not US resident aliens.

Foreign Assets. Individuals A and B each own varying interests in their family business's operating companies (the "MX Op Cos"). Individual A and Individual B are US Shareholders (>10% owners) of several MX Op Cos that are CFCs. In an effort to consolidate ownership of the MX Op Cos and facilitate succession planning for Individual D, Individuals A, B, C & D will contribute their shares in the MX Op Cos and cash to a newly formed MX holding company ("Hold Co.") in a transaction that qualifies as a tax-free Section 351 exchange for US income tax purposes (the "Reorganization").

Issue. Under the general rule of Section 367(a), when a US person contributes property to a foreign corporation in an otherwise valid Section 351 exchange, the foreign corporation is not treated as a corporation and the exchange is taxable. Consequently, Individuals A & B must qualify for an exception to Section 367(a) and fulfill the necessary reporting requirements for the Reorganization to avoid recognizing taxable gains.

Case Study 5.A

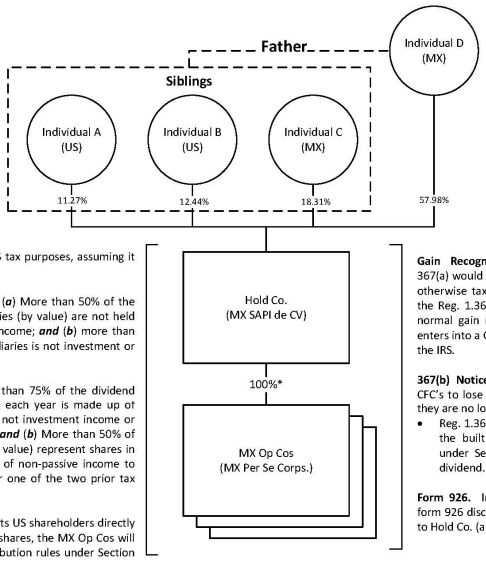
Original Structure



CFC Status. A and B own more than 10% of the shares in Several MX Op Cos. Several of those MX Op Cos are also controlled by one or both of A and B and are therefore CFCs Under Section 957 .

Case Study 5.B

(Post Reorganization)



PFIC Status. Hold Co. will not be a PFIC for US tax purposes, assuming it passes ***either*** of the following tests:

- **Look-through Test for 25% Subsidiaries.** (***a***) More than 50% of the combined assets of all subsidiary companies (by value) are not held for investment or production of passive income; ***and*** (***b***) more than 75% of the combined income of all subsidiaries is not investment or other passive income.
- **Related Party Dividend Test.** (***a***) more than 75% of the dividend income received from subsidiaries during each year is made up of income earned by the subsidiaries that is not investment income or other passive income to the subsidiaries; ***and*** (***b***) More than 50% of the shares in all subsidiary companies (by value) represent shares in companies that paid dividends consisting of non-passive income to Hold Co. in either the current tax year or one of the two prior tax years.

So long as Hold Co. is not a PFIC and none of its US shareholders directly or indirectly own 50% or more of all Hold Co. shares, the MX Op Cos will not be considered PFICs due shareholder attribution rules under Section 1298(a)(2).

Gain Recognition Agreement. Typically, Section 367(a) would require A and B to recognize gain on an otherwise tax-free Section 351 exchange. However, the Reg. 1.367(a)-3(b) provides an exception to the normal gain recognition rule if the U.S. transferor enters into a Gain Recognition Agreement (GRA) with the IRS.

367(b) Notice. The 351 exchange causes all prior CFC's to lose CFC status under Section 957 because they are no longer controlled by U.S. Shareholders.

- Reg. 1.367(b)-4(b) requires A and B to recognize the built in gain on their former CFC shares under Section 1248 in the form of a deemed dividend.

Form 926. Individual A and Individual B must file form 926 disclosing the FMV of all assets transferred to Hold Co. (a foreign corporation).

*Disregards obligatory second owner under MX corporate law holding 1% as nominee.

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Appendix

I. U.S.-Resident Status and Applicable Reporting Obligations.
II. Reporting Foreign Companies (CFCs, PFICs, Etc.).
III. Tracking and Utilizing Previously Taxed E&P (PTEP).
IV. GILTI, Section 962 Elections and the HTE Election.
V. Reporting Reorganizations of Foreign Companies.

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I. U.S.-Resident Status and Applicable Reporting Obligations.

- **Taxation of U.S. Residents.** U.S. Residents are subject to U.S. income tax on their worldwide income and must report most worldwide assets (e.g., foreign bank accounts, financial assets and companies).
- **"U.S. Resident" Defined.**
  - **Immigration Status.** U.S. citizens & Persons lawfully admitted for Permanent Residence ("Green Card" test).
  - **Substantial Presence Test.** Must (a) be present >31 days during current year; and (b) Must have at least 183 days of presence under the following formula: (i) days present in the current year; plus (ii) 1/3 of days in the preceding year; plus (iii) 1/6 of days in 2nd preceding year.
  - **Closer Connection Exception.** If a present <183 days during current year, have tax home in foreign country and have closer connection to such foreign country.
  - **Treaty Tiebreaker Exception.** Dual-resident taxpayer may escape U.S.-resident status for income tax (but not reporting) purposes if they meet the treaty tiebreaker test (i.e., permanent home and center of vital interests in a treaty country).
- **First Year Election to be Treated as a Resident.**
- **Election to Treat Non-resident Alien Spouse as a U.S. person.**
- **Residency Termination Date.** Termination date is last day of presence in subsequent tax year.

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I. U.S.-Resident Status and Applicable Reporting Obligations.

- **U.S. Estate & Gift Taxes.** For U.S. estate and gift tax purposes, a "resident" is one who was domiciled in the United States at the time of transfer. Decedent is a decedent, who, at the time of his death, had his domicile in the United States. Treas. Reg. 20.0-1(b). A resident is an individual who has his domicile in the United States at the time of his gift. Treas. Reg. 25.2501-1(b). If not a resident, then classified as a nonresident, noncitizen.
- **Domicile.** "A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to charge domicile effect such a change unless accompanied by actual removal." Treas. Reg. Secs. 20.0-1(b), 25.2501-1(b).
- **Facts & Circumstances Test.** Domicile test is based on all relevant facts and circumstances, including but not limited to: U.S. immigration status and citizenship in other countries; statements of intent (in visa applications, tax returns, will, etc.); length of time in U.S.; location of business interests and assets; location of family members; lifestyle in the U.S. and abroad; and social and cultural ties.
- **Estate/ Gift Tax Treaties.** May resolve issues of domicile and provide relief from double taxation.

I. U.S.-Resident Status and Applicable Reporting Obligations.

Effectively Connected Income (ECI). Nonresident aliens are still subject to U.S. income tax on ECI of their U.S. trade or business.

- **Services Income.** Income derived form services performed in the United States is considered ECI.
- **Foreign Partnerships.** If a foreign partnership engages in a U.S. trade or business, the individual partners are also considered engaged in that same trade or business. Any nonresident partners will be subject to U.S. taxation on ECI under §871(b).
- **Foreign Corporations.** Foreign corporations engaged in a U.S. trade or business are subject to U.S. taxation of ECI of the U.S. trade or business.
  - **Form 1120F.** If Form 1120F is not timely filed, the IRS may deny all deductions and credits otherwise available to offset U.S. income for the year.
  - **Branch Profits Tax.** Foreign corporations engaged in a trade or business through a U.S. branch are subject to an annual tax on a "deemed dividend equivalent" from the U.S. branch office.
  - **Income Tax Treaties.** In certain circumstances, an applicable bilateral income tax treaty may alter the analysis of whether a foreign corporation is subject to U.S. income tax.

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I. U.S.-Resident Status and Applicable Reporting Obligations.

- **Nonresident Alien Withholding Obligations.** Nonresident aliens with no ECI of a U.S. trade or business are still subject to applicable U.S. withholding taxes on payment from U.S. payors.
  - **Chapter 3/ Chapter 4 Withholding (Forms 1042, 1042-S, 1042-T, FATCA).** Fixed, determinable, annual or periodic (FDAP) income payed to a nonresident aliens must be withheld by the U.S. payor/ withholding agent at a rate of 30%. Withheld amounts must be remitted to the IRS within a specified time period. Failure to withhold and remit payments to the IRS in a timely manner results in penalties.
  - **Foreign Investment in Real Property Tax Act (FIRPTA).** The disposition of a U.S. Real Property Interest (USRPI) by a foreign person is subject to 15% income tax withholding under §1445.
    - **Exception.** There is a general exception for non-recognition transactions (e.g., 351 exchanges and nontaxable corporate reorganizations), so long as the appropriate certificate is obtained from the IRS or a copy of the appropriate notice is filed with the IRS within 20 days of the transaction.
  - **Treaty Provisions.** Various income tax treaty articles provide relief from withholding taxes imposed by the U.S. However, it is still necessary for the U.S. withholding agent to file the appropriate returns to disclose the foreign payee's exemption from withholding.

I. U.S.-Resident Status and Applicable Reporting Obligations.

Form 3520. Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts (IRC §§ 6039F, 6048(a), 6677).

Form 3520A. Annual Report of Foreign Trust with a U.S. Owner (IRC § 6048, 6677).

Form 8938. Statement of Specified Foreign Financial Assets (IRC § 6038D).

Form 2555. Foreign Earned Income (IRC § 911).

Form 1116. Foreign Tax Credit (IRC §§ 901-909).

Form 8833. Treaty-Based Return Position Disclosure Under § 6114 or 7701(b) (IRC §§ 6114 & 6712).

II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

Controlled Foreign Corporations (CFCs) and other Foreign Corporations. U.S. residents that are "U.S. Shareholders" of a CFC are subject to the Subpart F and GILTI anti-deferral regimes. The U.S. Shareholder recognizes her proportional share of Subpart F income and GILTI (taxable at ordinary income rates) generated by the CFC during the CFC's annual accounting period ending prior to or on the last day of the U.S. Shareholder's current tax year.

- **U.S. Shareholder.** U.S. person who owns 10% of a foreign corporation (based on the constructive ownership rules of §958). However, U.S. Shareholders are only taxed based on direct and indirect ownership in CFCs
- **CFC.** A foreign corporation is a CFC if more than 50% of its shares, by vote or value, are owned by U.S. Shareholders (based on the constructive ownership rules of §958).

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II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

Form 5471. Information Return of U.S. Persons With Respect to Certain Foreign Corporations.

- **Category 1 Filers.** Several types, but generally category 1a filers are U.S. Shareholders of a CFC or a corporation of which a domestic corporation is a U.S. Shareholder.
- **Category 2 Filers.** Generally, directors or officers of the corporation that obtain a 10% interest in the corporation's stock, by value, or obtain a smaller interest that brings their total interest in the corporation to more than 10%. The constructive ownership rules of §6046 apply.
- **Category 3 Filers (*Check for §367(a) and Form 926*).** Generally, all U.S. persons who obtain a 10% interest in the corporation's stock, by value, or obtain a smaller interest that brings their total interest in the corporation to more than 10%. Category 3 also includes a person who becomes a U.S. person while owning at least 10 % of the corporation's stock and a person who makes a disposition of stock that reduces the person's shareholdings below 10%, by vote and by value. The constructive ownership rules of §6046 apply.
- **Category 4 filers.** U.S. persons who control a foreign corporation (i.e., own more than 50% of the corporation based on §6038(e)(2) attribution rules).
- **Category 5 filers.** Any person who is a U.S. Shareholder of a CFC at any time during the CFC's taxable year and also has this status on the last day of that year on which the corporation was a CFC.

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II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

Passive Foreign Investment Companies (PFICs).

- **Form 8621 (Information Return by a Shareholder of a PFIC or Qualified Electing Fund (QEF)).** Generally, a U.S. person that is a direct or indirect shareholder of a PFIC must file Form 8621 for each tax year under the following five (5) circumstances: (1) The U.S. Person receives certain direct or indirect distributions from a PFIC; (2) Recognizes gain on a direct or indirect disposition of PFIC stock; (3) Is reporting information with respect to a QEF or §1296 mark-to-market election; (4) Is making an election reportable in Part II of the form; or (5) Is required to file an annual report as a U.S. person owning shares in a PFIC.
- **Indirect Ownership (§1298(a)(2)).** While U.S. partners of a partnership are treated as owning their proportional share of foreign corporations owned by partnerships, only U.S. shareholders owning 50% or more of the stock of a foreign corporation will be treated as indirectly owning a proportional share of foreign corporations owned by the corporation. However, this 50% ownership threshold does not apply if the corporation is a PFIC.
- **Additional PFIC Tax (§1291).** "Excess distributions" from PFICs (which include the disposition of PFIC shares) are allocated ratably across the shareholder's entire holding period of the PFIC stock and the tax on the distribution is increased by the "deferred tax amount." For amounts allocated to prior tax years, shareholders will also incur tax plus interest at the applicable rates and method under §6621. *See* Prop. Reg. 1.1291-4(d).

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II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

PFIC Status (§1297). Generally, under §1297(a) the term "passive foreign investment company" means any foreign corporation that meets one of two definitions:

- **Income Test.** 75% or more of the gross income of such corporation for the taxable year is passive income; or
- **Asset Test.** The average percentage of assets held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50%.

Exceptions. There are a number of exceptions that apply to the PFIC tests under §1297. Some of the most common exceptions include:

- **Look-through Test for 25% Subsidiaries.** Tested foreign corporations can look through to their proportional share of the assets and income of subsidiaries they own 25% or more of the shares of when determining the tested foreign corporations PFIC status under §1297.
- **Related Party Dividend Rule.** Dividends received from related parties are treated as made up of passive or non-passive income earned in proportion to the passive and non-passive income earned by the subsidiary. Likewise the value of subsidiary stock shall be considered non-passive assets to the extent those shares paid dividends consisting of non-passive income in either the current tax year or one of the two prior tax years.

PFIC Taint. Once a foreign entity is classified as a PFIC, it will remain a PFIC subject to taxation under IRC §1297 unless it elects to become a QEF or makes a "purging election". However, both will trigger tax consequences.

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II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

Form 8865. Return of U.S. Persons With Respect to Certain Foreign Partnerships. For these purposes, the constructive ownership rules of §267(b),(c) apply.

- **Category 1 Filers.** Any U.S. person who controlled the foreign partnership at any time during the partnership's tax year. Control of a partnership is ownership of more than a 50% interest in the partnership. Category 1 filers also include U.S. transferors who must report certain information on contributions of built-in gain property to the partnership under §721(c).
- **Category 2 Filers.** A Category 2 filer is a U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons each owning at least a 10% interest.
- **Category 3 Filers.** U.S. persons who contributed property to the foreign partnership for an interest in the partnership if that person either: (***1***) owned directly or constructively at least a 10% interest in the foreign partnership immediately after the contribution; or (***2***) made contributions in excess of $100,000 (includes the value of any other property contributed to the partnership by related persons) during the 12-month period ending on the date of transfer.

II. Reporting Foreign Companies (CFCs, PFICs, Etc.).

- **Category 4 Filers (Form 8865 – Foreign Partnerships).** A Category 4 filer is a U.S. person that had a reportable event under §6046A during that person's tax year:
  - **Acquisitions.** Partnership acquisitions are reportable events if: (***1***) The person didn't own a 10% or greater direct interest in the partnership and, as a result of the acquisition, the person owns a 10% or greater direct interest in the partnership; or (***2***) Compared to the person's direct interest when the person last had a reportable event, after the acquisition the person's direct interest has increased by at least a 10% interest.
  - **Dispositions.** Partnership dispositions are reportable events if: (***1***) The person owned a 10% or greater direct interest in the partnership before the disposition and, as a result of the disposition, the person owns less than a 10% direct interest; or (***2***) Compared to the person's direct interest when the person last had a reportable event, after the disposition the person's direct interest has decreased by at least a 10% interest.
  - **Changes in Proportional Interests.** A U.S. person has a reportable event if compared to the person's direct proportional interest the last time the person had a reportable event, the person's direct proportional interest has increased or decreased by at least the equivalent of a 10% interest in the partnership.

III. Tracking and Utilizing PTEP.

Form 5471, Schedule J. Schedule J is used to report and track a CFC's accumulated E&P in its functional currency, computed under §964(a) and 986(b). E&P of a CFC that is taxable to the U.S. shareholders is sorted into several categories, including 951(a) PTEP (Subpart F income) and 951A PTEP (GILTI). PTEP carries over from year to year and needs to be entered consistently.

- **Distributions of PTEP (§959(a)).** Distributions of PTEP, either directly or through a chain of ownership, are not again included in the U.S. Shareholders gross income. However, the applicable pool of PTEP is reduced by the amount of the distribution. PTEP is still subject to the 3.8% Net Investment Income Tax (NIIT).
- **U.S. Shareholder Basis in CFC Shares (§961(a); Reg. 1.961-1(a)).** The basis of a U.S. Shareholder's stock in a CFC (or the intermediary company through which the U.S. shareholder indirectly owns a CFC) is increased, as of the last day of the CFC's accounting period, by the amount of PTEP actually included in the gross income of the U.S. Shareholder. The U.S. Shareholder's adjusted basis in the stock is reduced by the excluded amount of the PTEP distribution received as of the time such person receives the distribution. If the tax-free distribution exceeds the adjusted basis of the stock the excess amount is treated as gain from the sale or exchange of property.
- **IRS Guidance On Midyear Basis Step-up.** The language of Reg. 1.961-1(a) creates a potential timing issue for midyear distributions. In PLR 202304008 and AM 2023-002 the IRS allowed share basis to increase as Subpart F income is realized throughout the year rather than the last day of the year.

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IV. GILTI, Section 962 Elections and the HTE Election.

962 Elections. A 962 election must be made by the shareholder desiring to make the election by filing a statement with his return for each taxable year for which the election is made.

- **Retroactive Elections.** Pending further guidance from Treasury and the IRS, U.S. shareholders are permitted to make a Section 962 election on an amended return, provided the interests of the U.S. government are not prejudiced by the delay (i.e., the delay does not result in benefits beyond what a timely 962 election would have resulted in). *See* Reg. 301.9100-3(c).

HTE. There is a "high-tax exclusion" for Subpart F income and GILTI that would otherwise be currently taxable to a U.S. Shareholder of a CFC.

- **High-Taxed Income.** U.S. Shareholders of a CFC may only elect to exclude an "item of income" that is subject to a foreign tax rate equal to at least 90% of the highest U.S. corporate tax rate of 21% (i.e., 18.9%).
- **Effect on GILTI.** Income excluded from Subpart F income under the HTE is also excluded from GILTI. To be excluded from GILTI taxation, an item of income must be subject to a foreign tax rate of at least 18.9%, regardless of what U.S. tax rate would otherwise be applicable to GILTI.
- **Election Requirement.** To claim the HTE, the controlling United States Shareholders of a CFC must make an election under §954(b)(4) by filing an election statement with their income tax returns, annually.

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V. Reporting Reorganizations of Foreign Companies.

Transfers of Property to Foreign Corporations (§367). §367(a) generally functions to turn of the tax-free exchange rules for corporate organization and reorganizations under the IRC when there is a transfer of property to a foreign corporation by a United States Person.

- **Gain Recognition Agreements.** Only a limited set of corporate reorganizations can avoid the rules of §367(a). However, Reg. 1.367(a)-3(b) provides a general exception to the normal gain recognition rule if the U.S. transferor enters into a Gain Recognition Agreement (GRA) with the IRS. Under the GRA, the U.S. shareholder must agree to recognize gain upon the occurrence of certain triggering events within a period of 5 years, must comply with certain annual filing requirements and must file the GRA with the tax return for the year in which the transfer occurs.
- **§367(b) Notice (Reg. 1.367(b)-4(b)).** If a foreign corporation acquires the stock of a foreign corporation in a §351 exchange or the stock or assets of a foreign corporation in a tax-free reorganization described in §368(a)(1) then an exchanging shareholder must recognize a deemed dividend equal to the built-in gain attributable to the stock and provide a notice statement filed with its U.S. income tax return if two conditions are met:
  - **(1)** Immediately before the exchange, the exchanging shareholder is either a U.S. Shareholder of the foreign acquired corporation or the exchanging shareholder is a foreign corporation with a 10% U.S. shareholder under §958; and
  - **(2)** Immediately after the exchange, the stock received is not stock in a controlled foreign corporation (CFC) of which the exchanging shareholder is 10% shareholder under §958, or the transferee foreign corporation or the foreign acquired corporation is not a CFC of which the exchanging shareholder is a 10% shareholder under §958 and the exchange is not of type specifically exempted by the Regulations.

V. Reporting Reorganizations of Foreign Companies.

Form 8832. Entity Classification Elections (or "check the box" elections) must be attaches to the entity's tax return or the tax returns of its U.S. owners.

Section 368 and Section 351 Statements. Any U.S. corporation a party to a Section 368 reorganization or a Section 351 exchange must file the appropriate statement for the relevant tax year. U.S. transferors must also file Section 351 Statements.

The FAIR Tax

George W. Connelly
ATBPS Conference
October 30, 2024

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What is the FAIR Tax?

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Why are we discussing it now?

- Thomas Hobbs – 17th Century
- Mike Huckabee – "Biblical"
- Proposed Since 1874, every year since 1999
- H.R. 25 (2023)
- Project 2025

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HISTORY(Part 1)

Before 1913

- Civil War – Income tax which expired in 1872
- 1884 – Enacted again but held unconstitutional in 1885
- Corporate income tax – upheld as Excise tax
- 1887-1913 – Tariffs as major source of revenue

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HISTORY Since 1913(Part 2)

What happened in1913?

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HISTORY(Part 3)

The Federal Tax System Since1913

- 1913 – What happened?
- Originally income tax of 1-7% applied to 400,000 citizens
- Corporate and individual income tax
- Social Security and Medicare
- Excise taxes
- Tariffs
- Estate and gift taxes

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Who Pays Federal Taxes Now?

2021 Figures:

- Top 1% - 45.78% of Federal Income Taxes
- Top 5% - 65.64%
- Top 10% - 75.81 %
- Bottom 50% - 2.34%

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Who wants the FAIR Tax?

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FAIR TAX PROPOSALS

- Coverage
- Rates

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H.R. 25

118th CONGRESS
1st Session

To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States.

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H.R. 25 (continued)

IN THE HOUSE OF REPRESENTATIVES

January 9, 2023

Mr. Carter of Georgia (for himself, Mr. Clyde, Mr. Duncan, Mrs. Cammack, Mr. Perry, Mr. Good of Virginia, Mr. Massie, Mr. Norman, Mr. Posey, Mr. Palmer, Mr. Banks, and Mr. Loudermilk) introduced the following bill; which was referred to the Committee on Ways and Means.

H.R. 25 (continued)

A BILL

To promote freedom, fairness, and economic opportunity by repealing the income tax and other taxes, abolishing the Internal Revenue Service, and enacting a national sales tax to be administered primarily by the States.

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TITLE 1 – REPEAL OF THE INCOME TAX, PAYROLL TAXES, AND ESTATE AND GIFT TAXES

SEC. 101 INCOME TAXES REPEALED

Subtitle A of the Internal Revenue Code of 1986 (relating to income taxes and self-employment taxes) is repealed.

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SEC. 102 PAYROLL TAXES REPEALED

(a) IN GENERAL - Subtitle C of the Internal Revenue Code of 1986 (relating to payroll taxes and withholding of income taxes) is repealed.

(b) FUNDING OF SOCIAL SECURITY – For funding of the Social Security Trust Funds from general revenue, Section 201 of the Social security Act (42 U.S.C. 401).

SEC. 103 - ESTATE AND GIFT TAXES REPEALED

Subtitle B of the Internal Revenue Code of 1986 (relating to estate and gift taxes) is repealed.

SEC. 101. IMPOSITION OF SALES TAX.

"(a) In General.--There is hereby imposed a tax on the use or consumption in the United States of taxable property or services.

"(b) Rate.– "(1) FOR 2025.--In the calendar year 2025, the rate of tax is 23 percent of the gross payments for the taxable property or service.

"(2) For years after 2025.--For years after the calendar year 2025, the rate of tax is the combined Federal tax rate percentage (as defined in paragraph (3)) of the gross payments for the taxable property or service.

"(d) LIABILITY FOR TAX

"(1) IN GENERAL – The person using or consuming taxable property or services in the United States is liable for the tax imposed by this section, except as provided in paragraph (2) of this sub-section.

"(d) LIABILITY FOR TAX

"(2) EXCEPTION WHERE TAX PAID TO SELLER. A person using or consuming a taxable property or service in the United States is not liable for the tax imposed by this section if the person pays the tax to a person selling the taxable property

"(c) INVESTMENT PURPOSES. For purposes of this section, the term "purchased for an investment purpose" means property purchased exclusively for purposes of appreciation or the production of income but not entailing more than minor personal efforts.

SEC. 103 RULES RELATING TO COLLECTION AND REMITTANCE OF TAX.

"(a) LIABILITY FOR COLLECTION AND REMITTANCE OF THE TAX. - Except as provided otherwise by the section, any tax imposed by this subtitle shall be collected and remitted by the seller of taxable property or services (including financial intermediation services).

"(b) TAX TO BE REMITTED BY PURCHASER IN CERTAIN CIRCUSTANCES.

"(1) IN GENERAL – In the case of taxable property or services purchased outside of the United States and imported into the United States for use or consumption in the United States, the purchaser shall remit the tax imposed by Section 101.

"(2) CERTAIN WAGES OR SALARY – In the case of wages or salary paid by a taxable employer which are taxable services, the employer shall remit the tax imposed by Section 101.

Proposed Coverage

- What will be taxed?

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Proposed Coverage

- What will be exempt?

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Consumption Tax Rates

What rate is needed to replace all the federal taxes?

- 2005 – Treasury 34%
- 2005 – Bush Panel 34-38%
- Governor Norquist – 30%
- Brookings Institute – 60%

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Consumption Tax Rates

- H.R. 25 – 23%
- Is it really 30%
- On top of state sales tax rates

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Proposed Coverage

- Who will collect it?

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Proposed Coverage

Who will administer the FAIR Tax?

- Collected by state agencies
- States keep .025% of collections
- If state declines, U.S. Treasury
- Five states do not have sales tax
- Federal and state sales tax rates may differ

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Proposed Coverage

- What about states without a sales tax?

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Proposed Coverage

- What about the IRS?

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Proposed Coverage

- Can it be abolished?

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Proposed Rates

- Rebates for low income citizens?

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Problems

- Double taxation on seniors and retirees
- Double costs of compliance for business
- No third party withholding or reporting
- No "definitions" or "rules"
- Assumes no tax avoidance or evasions
- Creating exemptions

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WHEN A NOTHING TURNS INTO A SOMETHING:
WORKING WITH DISREGARDED ENTITIES AND GRANTOR TRUSTS IN ESTATE PLANNING

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October 30, 2024

When a Nothing Turns Into a Something:
Working with Disregarded Entities and Grantor Trusts in Estate Planning

I. Introduction: Disregarded entities and grantor trusts have developed into fundamental building blocks of modern estate plans due to the simplicity, flexibility, and other advantages they provide clients. Notwithstanding their widespread use, many common misconceptions and potential pitfalls may be present when the entity or trust loses its status as a disregarded entity or grantor trust. The goal of this paper is to identify and present solutions to these issues.

II. Discussion on Disregarded Entities ("DREs")

a. What is a DRE?

i. A DRE is an entity with a single owner that has not elected to be classified a corporation. Treas. Regs. §§ 301.7701-1(a), -2(c)(2).

1. The existence of the entity is ignored and is a "tax nothing" for federal income tax purposes. The single owner includes the entity's tax obligations on such owner's income tax return.

2. It is a separate legal entity for state law purposes. This separation provides limited business liability and creditor protection for the owner.

ii. Unique features of DREs

1. Assets and liabilities are treated as those of the owner for federal income tax purposes.

2. DRE reports on the same fiscal year as the single owner.

3. The owner does not have a separate tax basis in the DRE interest or in the assets of the DRE.

iii. Common types of DREs

1. Single-Member Limited Liability Company ("SMLLC"): A SMLLC is the "typical" DRE – a limited liability company with only one owner.

2. Qualified Subchapter S Subsidiary ("QSub"): A QSub is a subsidiary of an S Corporation where the parent S Corporation owns 100% of the stock.

3. Single-Member Real Estate Investment Trusts

4. Grantor Trusts: While not entities, grantor trusts are disregarded for income tax purposes, and all of the trust's income, deductions, and credits are reported on the grantor's personal income tax return.

iv. Check-the-Box regulations

1. The Check-the-Box ("CTB") system allows eligible entities to choose their classification and tax treatment for *federal tax purposes.*

2. Initial domestic entity classification under Treas. Regs. §§ 301.7701-1, -2, -3:

a. An eligible entity may elect to be taxed as a corporation, partnership, or disregarded entity based upon the number of owners of such entity.

b. If an entity is operating under its default classification, then no election is necessary.

3. Eligible Entities
    a. An eligible entity is generally a business entity that is not automatically classified as a corporation under Treas. Reg. § 301.7701-2(b) (i.e., not a "per se" corporation).
        i. A business entity refers to any entity recognized for federal tax purposes that is not properly classified as a trust or does not receive special treatment under the Internal Revenue Code. Treas. Reg. § 301.7701-2(a) (i.e., Real Estate Mortgage Investment Conduits).
        ii. A business entity is classified as a "per se" corporation if, for example: (i) it is organized under a federal or state statute; (ii) it is an insurance company; (iii) it constitutes one of the foreign business entities enumerated in the regulations, and (iv) it satisfies certain other requirements listed in the regulations. Treas. Reg. § 301.7701-2(b)(8).
4. Default tax classifications
    a. Single owner: Disregarded entity – One may use the CTB regulations to treat the entity as either a C Corporation or an S Corporation rather than a DRE.
    b. More than one owner: Partnership – One may use the CTB regulations to treat the entity as either a DRE (in specific circumstances as discussed later), a C Corporation, or an S Corporation rather than as a partnership.
    c. Corporation: C Corporation – One may use the CTB regulations to treat the entity as an S Corporation.
5. Making the Election
    a. There are three general requirements to make a CTB election. Treas. Reg. § 301.7701-3(c):
        i. File a Form 8832;
        ii. Ensure that such Form 8832 is signed by each owner-member or authorized officer, manager, or member; and
        iii. 60 months have passed from the effective date of any prior election that has been made to change the classification of the entity.
    b. The election under the CTB regulations is effective as of the date specified on the Form 8832.
    c. A Form 8832 must be attached to the entity's federal tax or information return (or, if none, then to the return of the owner) for the tax year when the election is made.
    d. A timely filed election is effective not more than 75 days prior to the date of the election, nor later than 12 months after the date of the election.
        i. Relief: Rev. Proc. 2009-41 provides for automatic remediation for late elections under certain circumstances within 3 years and 75 days of the desired effective date. If one does not fit within this category of relief, further relief may be requested under I.R.C.

§ 9100 if the taxpayer can show that they acted reasonably and in good faith, and granting the relief will not prejudice the interests of the government. Treas. Reg. § 301.9100-3(a).

6. Considerations for making a CTB election
    a. Different tax regime/consequences apply to the separate entity classifications:
        i. Single (flow-through) v. Double Taxation: Flow-through taxation (S Corporations, partnerships, LLCs) allows business income to be taxed only once, at the owner's level, while double taxation (C Corporations) occurs when a corporation's income is taxed at both the corporate level and again when distributed to shareholders as dividends.
        ii. Applicable income tax rates (10-37% if taxed on individual level, or 21% for corporations).
        iii. Employment taxes v. self-employment taxes; net investment income tax, etc.
        iv. Available deductions.
        v. Treatment of allocations of debt and transfers of property.
        vi. Business termination implications.
    b. A DRE may remain regarded in certain situations:
        i. Employment taxes: Owners are subject to tax on net earnings from self-employment in the same manner as a sole proprietorship, and, as a statutory employer, certain DREs are liable for employment taxes attributable to the DRE. Treas. Reg. § 301.7701-2(c)(2)(iv).
        ii. Excise taxes. Treas. Reg. 301.7701-2(c)(2)(v). (e.g., tax imposed by Chapters 31-36, 38, 39, and 49 of the I.R.C., registration under I.R.C. §§ 4101, 4222 and 4412, etc.).
        iii. FBAR reporting requirements. Treas. Reg. § 301.7701-2(c)(2)(ii).
        iv. Gift, estate, and GST tax valuation.
    c. Non-tax considerations:
        i. Liability/creditor protection and anonymity.
        ii. Ease of management and administration, including incapacity planning.
        iii. Estate planning and succession considerations.

v. DRE Filing and Reporting
    1. Activities of a DRE owned by an individual should be reported on Schedule C, E, or F of the individual's Form 1040.
    2. Activities of a DRE owned by a corporation should be reported as a branch or division of the owner-corporation's income tax return.

3. Activities of a DRE downed by a partnership should be reported as operations of the owner-partnership's income tax return.
    a. When a partner is a DRE, the partnership must provide the beneficial owner's entity type for reporting purposes.
    b. Similarly, if the partnership interest is owned by tiered DREs, the partnership must report the information pertaining to the DRE, which is the legal owner of the partnership interest.

vi. DREs and Taxpayer Identification Numbers ("TIN")
1. DREs generally use the Social Security Number, or TIN, of the owner; except that a TIN may separately be required for the DRE when:
    a. It is necessary for normal business operations, such as opening bank accounts, obtaining insurance, etc., or if it is required by a state law;
    b. The entity has employees; or
    c. The entity has excise tax liabilities accruing after 1/1/2008 or employment tax liabilities accruing after 1/1/2009.
2. For W-9 purposes (identification for payment as an independent contractor), for SMLLCs that are DREs, the Social Security Number of the owner (or TIN it has one) should be used. If the DRE is classified as a corporation or partnership, then the entity's TIN should be used.

vii. Classification change upon the change in ownership of an entity. Treas. Reg. § 301.7701-3(f).
1. Corporation
    a. Corporation classification is not affected by a change in the number of stockholders of the entity.
    b. A corporation may only be taxed as a C Corporation or an S Corporation, and may not be taxed as a DRE or a partnership.
2. Entity taxed as a partnership
    a. If the membership of the partnership is reduced to a single owner, then the entity defaults to a DRE.
    b. A state law partnership or a multimember LLC may only be taxed as a partnership, a C Corporation, or an S Corporation if the membership is not reduced to a single member.
3. Single member entity
    a. If the membership of an entity with a single owner, which is taxed as a DRE is increased to more than one member, the entity will then be taxed as a partnership.

viii. Entity change consequences (not mere change in ownership). Treas. Reg. § 301.7701-3(g):
1. Partnership to a Corporation: The partnership is deemed to contribute all of its assets and liabilities to the corporation in exchange for stock of the corporation,

and immediately thereafter, the partnership liquidates by distributing the stock to its partners.

2. Corporation to Partnership: The corporation is deemed to distribute all of its assets and liabilities to its shareholders in a liquidation event. The shareholders immediately thereafter contribute the assets and liabilities to a new partnership.
3. Corporation to a DRE: The corporation is deemed to distribute all of its assets to its single owner in a liquidation event.
4. DRE to Corporation: The owner of the DRE is deemed to contribute all of the assets and liabilities of the DRE to the corporation in exchange for stock of the corporation.
5. DRE to Partnership: The owner(s) are treated as contributing their respective interests in the assets to the partnership in exchange for ownership interests in the partnership. Rev. Rul. 99-5.
6. Partnership to DRE: If the assets of a partnership are sold to one partner, such that that partner now owns 100% of the partnership, the partnership terminates. Treas. Reg. § 1.708-1(b)(1); Rev. Rul. 99-6.

ix. An entity with more than one legal owner, such as a partnership or LLC, may be a disregarded entity for federal income tax purposes.

1. Rev. Rul. 2004-77: a partnership was owned by a corporation and an LLC wholly-owned by the corporation. Although they were partners under local law, because one of these partners, the LLC, was a disregarded entity as to the other partner, the corporation was treated as owning the entire partnership for income tax purposes.
2. Other examples
   a. Individual and a defective trust in a partnership in which the individual is the deemed owner for federal income tax purposes.
   b. Family limited partnership ("FLP") which owns 100% of an LLC.
   c. FLP with LLC general partner, if 100% of the LLC is owned by an individual and the remaining limited partner interest is owned by the same individual.

x. DREs in community property states

1. Husband and Wife may treat any *qualified entity* as either: (i) a disregarded entity or (ii) a partnership for federal income tax purposes.
2. Rev. Proc. 2002-69
   a. A business entity is a *qualified entity* if:
      i. The business is wholly owned by the Husband and Wife as community property under the laws of a state, foreign country, or a possession of the United States;
      ii. No person other than one or both spouses would be considered an owner for federal tax purposes; and

iii. The business entity is not treated as a corporation under Treas. Reg. § 301-7701-2.

b. If the spouses treat the entity as a partnership for federal tax purposes and file appropriate partnership returns, the IRS will accept the position that the entity is a partnership for federal tax purposes.

c. It is required that the entity be wholly owned by the spouses as community property of a state and be treated as owned only by the spouses for federal tax purposes.

3. Practical tip: Establishing an FLP with Husband and Wife

   a. Generally speaking, when establishing an FLP for a Husband and Wife in a community property jurisdiction, the main entity ("LP") is classified as a partnership and the 1% general partner LLC is classified as a DRE.

   b. For purposes of filing the LP tax return, although the general partner is a DRE, we suggest still filing a Form 1065 for the LP to begin a history of reporting for the entity.

4. If Husband and Wife (or just Husband/Wife in a community property state) own 100% of an entity that is disregarded for federal income tax purposes, what happens to the DRE upon the death of the first spouse to die ("deceased spouse")?

   a. Does the entity remain disregarded?

   b. If the deceased spouse's interest in the entity passes to someone other than the surviving spouse, is there an automatic basis adjustment in assets of the DRE (which would now be taxed as a partnership) under I.R.C. § 1014 or must a § 754 election be made?

   c. Outright distribution v. distribution in trust for surviving spouse:

      i. Outright distribution: Upon the death of the deceased spouse, the deceased spouse's interest is temporarily held in his/her estate. During this period of administration, the entity has multiple owners and can no longer be taxed as a DRE; however, upon the interest being transferred to the surviving spouse, the entity is again owned wholly by one individual and may revert to DRE status.

      ii. Distribution in trust: The entity no longer is wholly owned by one taxpayer, and thus will be taxed as a partnership if no election is made otherwise (to be taxed as a corporation).

5. § 754 election

   a. Although upon the death of a deceased spouse, the outside basis of such spouse's interest in a partnership will receive a basis adjustment, the inside basis of the property of the partnership does not receive a similar basis adjustment. An election under I.R.C. § 754 allows the partnership to also adjust the inside basis of partnership property, aligning the inside basis of the partnership assets with the outside basis of the deceased partner.

      i. Inside basis: The partnership's adjusted tax basis in the assets or property of the partnership.

ii. Outside basis: The basis in which each individual partner has in such partner's partnership interest.

b. Requirements of an I.R.C. § 754 election – Treas. Reg. § 1.754-1: no particular form is required to be filed, rather the election must be in writing and:

i. Include the name and address of the partnership making the election;

ii. Be signed by any one of the partners; and

iii. Contain a declaration that the partnership elects to apply the provisions of I.R.C. §§ 734(b) and 743(b).

c. Any such election must be filed with the partnership return during the tax year in which the transfer or distribution occurs.

6. Revenue Ruling 99-5, Situation 1: The IRS provides guidance on the federal income tax treatment when a disregarded SMLLC becomes a partnership.

a. A 50% interest in an LLC/DRE owned by A was purchased by B. A and B are treated as each contributing their 50% interests of the DRE assets to a new partnership in exchange for interests in such partnership.

i. A's basis in the partnership is equal to A's basis in A's 50% share of the assets of the DRE.

ii. B's basis is the purchase price.

b. This revenue ruling does not address the consequences of the death of a DRE owner or a transfer at death of an interest in a community property DRE.

7. Pierre v. Commissioner, 133 TC 24 (2009)

a. In *Pierre*, the Tax Court discussed the issue of whether the CTB regulations that classify a DRE as an entity separate from its owner for *federal tax purposes* applies to determine how a *donor* must be taxed for federal gift tax purposes with respect to a gift transfer of an ownership interest in an LLC.

b. A gift of an interest in an SMLLC, which was disregarded for federal tax purposes, was a gift of an interest in the entity rather than a gift of the underlying assets.

c. Discounts for lack of marketability and control were applicable because the donor had no rights or interest in the underlying assets.

d. The Tax Court's view is that the CTB regulations apply to *classify* entities for income tax purposes but the state property rights control for federal gift tax purposes.

e. *Will this rationale also control for estate tax purposes?* This is to be determined. In many situations, the estate tax regime and gift tax regime closely resemble one another. By this logic, it follows that, in a jurisdiction that recognizes the entity separate and apart from its members, at the deceased spouse's death, the interest transferred at such spouse's death is

the membership interest in the entity rather than the underlying assets. With this in mind, lack of marketability and control discounts should be applied because a willing buyer would not purchase a fractionalized interest in an entity at 100 cents on the dollar.

8. DRE and Marital Property. What if a client has established and transferred assets to a DRE prior to marriage?
    a. Inception of title applies at the time the DRE is formed. The client's ownership interest in the entity is separate property if acquired prior to marriage.
    b. Partnership distributions will generally be community property.
    c. Advantages.
        i. Ownership interest is easily traced as a client's separate property using date on formation documents filed with the Secretary of State.
        ii. Income generated by the assets of the entity may be accumulated inside the entity without creating a comingling problem.
        iii. To the extent the entity owns real estate in a state other than the spouse's state of residence, the transfer to an entity will also help to eliminate the need for probate in such state at the spouse's death.
        iv. Possibility for estate/gift tax discounts on transfers of interests.
        v. Provides protection from liabilities related to assets held in the DRE.
    d. Caution regarding mineral interests.
        i. As a general rule, royalties received from separate property mineral interests constitute the separate property of an owner spouse.
        ii. A common planning tool is for the owner spouse to contribute her separate property mineral interests into an LLC treated as a DRE for asset protection, management consolidation, and preservation of a separate estate.
        iii. Notwithstanding these benefits, it is important to remember that under Texas law, income from separate property is community property absent a valid pre-/post-martial agreement to the contrary. In the context of an LLC, non-liquidating distributions to the LLC owner is considered to be income/community property.
        iv. Thus, while the receipt of mineral royalties would have been characterized as separate property had the owner continued to own same directly, the same royalties received by and then distributed out of an LLC to its sole owner will likely be considered to be community property.
9. DRE and Qualified Subchapter S Trust ("QSST")
    a. An issue arises in a community property state where one spouse is the income beneficiary of a QSST. QSSTs (as explained later) require that all

income be distributed annually to the income beneficiary. While distributions from a trust are often separate property, this income may become commingled with community property after distribution from the QSST and lose its separate property status.

b. A possible solution is avoid actual income distributions from a QSST is to have a SMLLC which is classified as a DRE be the sole owner of the QSST assets. Because the SMLLC is a DRE, the income will ultimately be reported on the income beneficiary's Form 1040. However, since the income is earned in the SMLLC and may not actually be distributed to its owner (the QSST), there is an argument that this income may be retained in the SMLLC, so that the "income" to be distributed by the QSST to the income beneficiary is zero, and any distributions from the SMLLC to the QSST and from the QSST to the income beneficiary could be limited to the amount necessary to pay the resulting income tax.

III. Grantor Trusts

a. Tax classifications of Trusts

i. Non-grantor trusts

1. Simple trusts: Income is taxed to the beneficiaries upon distribution. To be a simple trust, such trust:

a. Must distribute income earned on trust assets to the trust beneficiaries annually;

b. Make no distributions of principal; and

c. Make no distributions to charity.

2. Complex trusts: Income may be taxed to the beneficiaries upon distribution, or taxed to the trust if retained within the trust. Alternatively, complex trusts:

a. The trustee may have discretion whether to make distributions of trust income. It may distribute some or all of the income, or retain all income within the trust.

b. May make discretionary distributions of principal.

c. May make charitable contributions if authorized by the trust instrument.

3. Note: A trust may be simple one year, then complex the next.

ii. Grantor Trusts

1. A Grantor Trust is a trust in which the grantor (or another person) retains certain powers or interests in the trust that cause the income to be taxed to the grantor (or other person) individually rather than to the trust or to the trust beneficiaries.

2. If a trust in considered to be a Grantor Trust, all income, gains, and deductions are reported on the grantor's personal income tax return, regardless of whether such income is distributed or retained within the trust.

iii. Subchapter S Trust (QSST or ESBT)

1. Qualified Subchapter S Trust ("QSST"): A trust designed to hold stock in an S Corporation, while ensuring that the trust does not disqualify such S Corporation election.
    a. Requirements of a QSST. I.R.C. § 1361(d):
        i. The trust must have only one income beneficiary;
        ii. All income must be distributed annually to the income beneficiary;
        iii. The income beneficiary must be a U.S. citizen or resident;
        iv. No distributions of trust corpus may be made to anyone other than the income beneficiary;
        v. The income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust; and
        vi. Upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary.
    b. All income from the S Corporation flows through to the beneficiary and is reported on his or her personal tax return.
    c. A beneficiary of a QSST is treated as the owner of that portion of the trust which consists of stock in an S Corporation. I.R.C. §§ 1361(d)(1)(B) and (c)(2)(A)(i). Therefore, such trust is treated as a grantor trust under I.R.C. § 678(a) as of the effective date of the corporation's S election. Treas. Reg. § 1.1361-1(j)(6)(i).
    d. The trust's current income beneficiary must elect QSST status under I.R.C. § 1361(d)(2) within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. Treas. Reg. § 1.1361-1(j)(6)(iii)(A).
2. Electing Small Business Trust ("ESBT"): A trust designed to hold stock in an S Corporation, which may have more than one beneficiary.
    a. Requirements of an ESBT. I.R.C. § 1361(e):
        i. All beneficiaries of the trust must be individuals, estates, or charitable organizations that qualify as eligible shareholders of S corporations.
        ii. The trustee must make an election to treat the trust as an ESBT.
        iii. Generally, such election must be filed by the Trustee within two months and 16 days of the date the S Corporation stock is transferred to the trust. Treas. Reg. § 1.1361-1(m)(2)(iii).
    b. An ESBT is bifurcated into an S portion and a non-S portion. Income attributable to the S portion is taxed to the trust and is subject to tax on ordinary income at the highest marginal rate applicable to trusts and net capital gains are taxed at the maximum capital gains rate.

iv. Charitable Trusts.

1. The IRS defines a charitable trust as a trust all of the unexpired interests of which are devoted to one or more charitable purposes, and for which a charitable contribution deduction was allowed.
2. Charitable trusts are not treated as charitable organizations, and are thus not tax exempt. Rather, the trust is subject to the excise tax on its investment income under the rules that apply to taxable foundations.

b. Principals of Trust Taxation

i. Taxable Income: Taxable income of a trust is gross income less deductions, determined similarly to individuals with certain exceptions. I.R.C. § 642(b).

1. Gross income of a trust includes gains derived from property, interest, rents, royalties…etc. I.R.C. § 61(a).
2. Deductions include administrative expenses (trustee fees and other administrative costs incurred in managing the trust), charitable contributions, and distributable net income (discussed in (b)(iii) below).
3. Trusts are also allowed exemptions – complex trusts may claim a $100 exemption, while simple trusts may claim a $300 exemption. I.R.C. § 642(b).

ii. Fiduciary Accounting Income ("FAI"): The term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. I.R.C. § 643(b).

iii. Distributable Net Income ("DNI"): DNI generally means the amount of income from a trust or estate that is available for distribution to beneficiaries, which determines the amount deductible for both the trust and its beneficiaries. I.R.C. § 643(a). Details regarding the calculation of DNI are beyond the scope of this outline; however, capital gains are generally not included in DNI (subject to certain exceptions in Treas. Reg. § 1.643(a)-3(b).

c. Grantor Trusts

i. The "Grantor Trust" rules are found in Subpart E of Subchapter J of the I.R.C.

ii. If a trust meets the requirements of I.R.C. §§ 671 – 679, then the grantor (or another person) will be treated as the owner of all or a portion of the trust.

1. I.R.C. § 673: Reversionary interests (greater than 5% of the value of the relevant portion of the trust has a reversionary interest in either the corpus or the income therefrom).
2. I.R.C. § 674: Power to control the beneficial enjoyment.
3. I.R.C. § 675: Administrative powers (i.e., power to sell, borrow, or loan trust property without commercially reasonable terms).
4. I.R.C. § 676: Power to revoke.
5. I.R.C. § 677: Income for the benefit of the grantor.
6. I.R.C. § 678: Person other than the grantor treated as a substantial owner.
7. I.R.C. § 679: Foreign trusts having one or more United States beneficiaries.

iii. Partial grantor trusts: A trust may be a grantor trust as to all or a portion of the trust. For example: (i) only as to income, meaning that the taxable income will be taxable to the grantor individually, (ii) only as to principal, meaning that capital gains may be taxable to the grantor, (iii) as to both income and principal, meaning both income and capital gains will be taxable to the grantor (iv) as to specific property of the trust, or (v) as to a fractional or pecuniary portion of the trust.

iv. Who is the Grantor(s)?

1. The settlor of the trust is often referred to as the grantor.
2. A deemed owner for income tax purposes is also referred to as the grantor.
    a. A grantor includes a person who creates a trust and/or a person who, directly or indirectly makes a gratuitous transfer to a trust. Treas. Reg. § 1.672-2(e)(1). A gratuitous transfer typically includes a transfer made to a trust for less than full fair market value of the transferred property.
3. Multiple grantors: More than one individual may be a deemed owner over a portion of the trust, and, therefore, each is taxed on some but not all of the trust income.
    a. If a trust has more than one contributor, each is a deemed owner in proportion to the value of property such individual contributed to fund the trust.
    b. Crummey powers. A beneficiary may be given the right to vest a portion of a trust's principal for a specific period of time. During this withdrawal period, the beneficiary may be treated as the owner of the portion of the trust over which he or she has the right of withdrawal. PLR 200022035.
    c. 5 and 5 power. A beneficiary may be given the power to withdraw up to the greater of $5,000 or 5% of the trust assets each year. The IRS has ruled that the beneficiary will be treated as the owner under I.R.C. § 678(a)(1) until the power is exercised, released, or lapses. If the power is not exercised, the beneficiary is treated as if he or she released a power to withdraw and will be treated as the owner under I.R.C. § 678(a)(2). Each year of a lapsed power will result in the beneficiary's owning an increased percentage of the trust's corpus. PLR 9541029.

v. Grantor Trust reporting requirements

1. TIN: Reporting requirements for grantor trusts generally depend upon the existence and number of deemed owners. In determining this, a Husband and Wife may generally be treated as a single grantor. Treas. Reg. § 1.671-4(b)(8).
    a. Generally, a trust must use an employer identification number. However, Treas. Reg. § 301.6109-1(a)(2) provides that a trust that is treated as owned by one grantor or one other person, and that reports under Treas. Reg. § 1.671-4(b)(2)(i)(A) need not obtain a TIN.
        i. Practice note: If the grantor trust is irrevocable, we suggest receiving a TIN regardless of whether one is required because chances are the trust will need one in the future to open a bank account, etc.

2. Wholly-Owned Grantor Trust traditional reporting method: Form 1041 is filed for the trust.
    a. The activity of the trust is shown on a statement/attachment providing (i) the grantor's name, social security number and address; (ii) that the income of the trust is taxable to the grantor; and (iii) any deductions or credits that apply to the income.
    b. A TIN is required.
3. Wholly-Owned Grantor Trust Alternative Method #1 (Treas. Reg. § 1.671-4(b)(2)(i)(A)): The trustee does not file a Form 1041, but instead takes steps to facilitate the grantor's tax reporting.
    a. The trustee provides the grantor's name and other identifying information to all payors, and provides to the grantor a statement that:
        i. Informs the grantor that the information on the statement must be included in computing the grantor's taxable income and credits;
        ii. Sets out all items of income, deductions and credits for the taxable year;
        iii. Identifies the payor of each item of income;
        iv. Provides the grantor with the information necessary to take the items into account in computing the grantor's taxable income; and
        v. Informs the grantor that the items of income, deduction, and credit must be included in computing taxable income. Treas. Reg. § 1.671-4(b)(2)(ii)(A).
    b. The trustee must also (i) obtain a W-9 from the grantor, and (ii) provide the trust's Forms 1099 to the grantor to attach to the grantor's individual income tax return.
    c. No TIN is required.
4. Wholly-Owned Grantor Trust Alternative Method #2 (Treas. Reg. § 1.671-4(b)(2)(i)(B):
    a. The trustee receives Forms 1099 from payors listing the trust as payee.
    b. The trustee must file Forms 1099 with the IRS showing the income or proceeds received by the trust during the year and showing the trust as the payor and the grantor as payee.
    c. If income is reported to the trust through a form other than a 1099, the trustee must furnish an informational statement to the grantor similar to in Alternative Method #1.
    d. Trust TIN is required.

vi. Sale to Intentionally Defective Grantor Trust ("IDGT")

1. A common method of utilizing grantor trusts in estate planning is to sell partnership interests to an IDGT.

a. First, an irrevocable trust is established where the grantor retains a power over the trust which causes him/her to be liable for the income tax consequences of the trust.

b. The trust is then funded with cash, which will be used as collateral. The general rule of thumb is that the trust should own cash equal to at least 1/9 of the amount of assets it intends to purchase.

c. Next, the trust purchases limited partner interests in return for a secured promissory note.

d. Because the grantor is treated as the owner of the trust, such sale is ignored for federal income tax purposes. Rev. Rul. 85-13.

2. Benefits of sale to an IDGT

a. Allows the grantor to transfer limited partner interests without using a significant amount of the transferor/grantor's available gift or estate tax exemption amount.

b. The grantor will continue to pay the income tax on the earnings of the trust, allowing the trust principal to grow. Such payments are not considered to be gifts made by the grantor to the trust.

c. The grantor retains an income stream with the interest payments made by the trust.

d. Grantor may retain the power to "repurchase" any appreciated property at fair market value. The asset may then be included in the grantor's gross estate upon death and the basis of the asset will be adjusted to its fair market value at the date of death.

3. Disadvantages of sale to an IDGT

a. If the transferred interest does not appreciate at a rate greater than the interest on the note, it may not successfully decrease the transferor's gross estate for federal estate tax purposes.

b. If the sales price is determined to be less than the fair market value of the interest transferred, the IRS could attempt to re-characterize the sale to the IDGT as a gift (or part gift) with a retained income interest, exposing the transaction to I.R.C. § 2036.

c. These transactions are susceptible to revaluation of assets in an audit.

d. Post-Death Considerations

i. I.R.C. § 645 election. If an election under I.R.C. § 645(a) is made, a qualified revocable trust may be treated as part of a decedent's estate for federal income tax purposes.

1. A qualified revocable trust ("QRT") is defined as any trust (or portion thereof) which was treated under I.R.C. § 676 as owned by the decedent by reason of a power of the decedent to revoke or reacquire the trust assets held by the decedent. I.R.C. § 645(b)(1).

a. If the decedent's power to revoke a trust is exercisable only with the approval or consent of a nonadverse party or with the approval or consent of the decedent's spouse, such trust is a QRT. Treas. Reg. § 1.645-1(b)(1).

However, a trust treated as owned by the decedent solely by reason of a power held by a nonadverse party or the decedent's spouse is not.

2. Filing the election. A Form 8855 must be filed no later than a properly filed Form 1041 (including extensions) for the estate. Treas. Regs. §§ 1.645-1(c)(1), (2).
    a. If an executor is appointed to administer the estate, the executor and trustees of each QRT must join in the election.
    b. If no executor is appointed, then the trustee of the QRT completes the Form 8855. If more than one QRT joins the election, the trustees of each QRT must appoint one QRT as the filing QRT whose trustee is responsible for filing Form 1041 for the joined QRTs. Treas. Reg. § 1.645-1(c)(2)(D)(2).
    c. If an executor is appointed after the trustee of a QRT has made an I.R.C. § 645 election, then a revised Form 8855 is required to be filed within 90 days of appointment. Treas. Reg. § 1.645-1(g)(1). However, if the executor does not agree with the election made, and a revised Form 8855 is not filed, then the election period is treated to have terminated the day before the executor's appointment.

ii. Outstanding promissory note. What happens if a note payable by an IDGT remains outstanding when the grantor spouse dies?
    1. The IRS holds that the grantor trust springs into existence as a separate taxpayer, so it is clear that the trust assets are deemed to be transferred to a new taxpayer, but it is not clear as to what type of transfer it is. Rev. Rul. 57-51.
    2. Possible outcomes
        a. The transfer is a deemed testamentary transfer by the deceased grantor, and thus is a bequest or devise which applies to cause the tax basis to be adjusted to the date of death value under I.R.C. § 1014.
            i. Generally, the basis of property in the hands of a person acquiring property from a decedent is the fair market value of property on the date of the decedent's death. I.R.C. § 1014(a).
            ii. Furthermore, property acquired by bequest, devise or inheritance, or by the decedent's estate is considered to have been acquired from the decedent. I.R.C. § 1014(b)(1).
                1. Since the grantor was a deemed owner of the trust property during the grantor's life, would assets received from a grantor trust upon the death of the grantor be considered acquired by a decedent, and thus receive a basis adjustment?
                2. The IRS closed this possibility in Rev. Rul. 2023-2. There the IRS clarified that an I.R.C. § 1014 basis adjustment does not apply to assets of an irrevocable grantor trust not included in a deceased grantor's gross estate.

b. The transfer is considered to be a sale by the deceased grantor to the trust at the grantor's death, with the assets receiving a cost basis under I.R.C. § 1012 equal to the deemed the purchase price. This does not seem to be the position taken by the IRS. *See* PLR 200434012.

c. The transfer is considered to be a gift by the deceased grantor to the trust on death, with the assets receiving a carry-over basis under I.R.C. § 1015, increased by any amount of gain, or decreased by any amount of loss, recognized to the deceased grantor upon such transfer.

3. Income Tax Consequences: (1) the promissory note would be includable in the deceased grantor's gross estate and receive a § 1014(a) basis adjustment, (2) the asset sold to the IDGT would be out of the deceased grantor's estate but would not receive a basis adjustment, and (3) gain may be recognized to the extent the outstanding balance of the note exceeds the fair market value of the note at the deceased grantor's death.

   a. Possible Solutions:

      i. Hold the note in a revocable trust

         1. Structure the note to be held in a revocable trust with provisions that automatically transfer it to the surviving spouse.

         2. This strategy is complex, but it could ensure the continuation of grantor trust status because the surviving spouse steps into the original grantor's shoes automatically.

      ii. Hold the note in an LLC treated as a DRE[1]

         1. Have the IDGT contribute its assets and debt to an LLC, and the grantor simultaneously contributes the promissory note to the same LLC.

         2. Because the trust and grantor are considered the same taxpayer, the LLC is disregarded for income tax purposes.

         3. The LLC, then will own an asset that has a debt liability, and also own the right to receive the debt. When one has a debt but also owns the right to be paid on such debt, the debt should be extinguished without tax ramifications.

         4. Upon the death of the grantor, the grantor trust becomes a non-grantor trust, converting the DRE to a partnership. Under Rev. Rul. 99-5, a deemed transfer of 50% of the LLC to the IDGT occurs, which then converts the DRE to a partnership. This conversion is treated as in acquisition of the LLC by the members and a contribution of such assets to a new partnership. If the conversion is treated this way, then the estate may not

[1] The authors would like to acknowledge Mr. Paul Lee and his extensive article: *Goblins Lamentation List: Unscrambling "Installment Obligations"* for developing this possible solution.

own 50% of the partnership, but is instead deemed to own 50% of the assets, which are simultaneously contributed to the partnership at death. If this is true, then the estate may be entitled to a basis adjustment under I.R.C. § 1014(a).

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Navigating the Corporate Transparency Act

Real-World Insights and Compliance

31 U.S. § 5336; 31 CFR 1010.380

By Jack A. Najarian and Luz Villegas-Banuelos

Chamberlain Hrdlicka
Attorneys at Law

Objective and Purpose of the Corporate Transparency Act

Prevent Illicit Activities

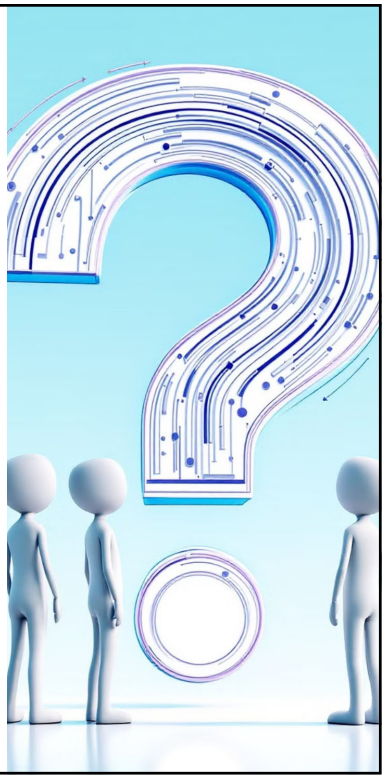
The Corporate Transparency Act aims to prevent money laundering, terrorist financing, and other illicit activities that can occur when individuals hide their identities behind anonymous companies.

Make Investigating Companies Easier

Law enforcement agencies will now have a readily available database of pertinent information about a legal entity, the persons behind the entity, and their contact information.

Takeaways

1. No, this just does not apply to big companies.
2. It may be unconstitutional, but do you want to be wrong? Failing to comply with the Act can result in significant penalties, including monetary fines and imprisonment.
3. The guidance and regulations leave a lot to figure out.



The Extremely Way Too Short Summary of the Act

Starting January 1, 2024, a legal entity must disclose to FinCEN certain information about those persons who own 25% or more of that entity or persons that exercise substantial control over that entity (i.e. CEO, CFO, CLO and COO), unless it qualifies for an exemption.

Exempt entities are generally speaking those entities that are already reporting its ownership/responsible persons to the federal government or an entity that employs more than 20 employees on a full-time basis in the US, filed in previous year tax returns demonstrating more than $5,000,000 in gross receipts or sales, and has an operating presence at a physical office in the U.S.

Penalties for Non-Compliance

Who is responsible?

The Company.

The person causing the willful violation or a senior officer of the reporting company may be held liable.

*This arguably can include the Company Applicant (i.e. company's lawyers or accountants).

Monetary Penalties and Imprisonment

Penalties may consist of (a) a civil penalty of not more than $500 per day that the violation continues, (b) a fine of not more than $10,000 *and/or* (c) imprisonment for not more than 2 years.

Curing Inaccurate Information

Inaccurate information may be corrected by submitting a corrected report within 90 days after submitting the inaccurate report, unless the individual submitted the inaccurate report with knowledge of its inaccuracy and does so with the intent of evading reporting requirements.

Literature is calling this a "safe harbor."

Breaking Down the Law - Deadlines and Updates

- 90 days to file report after SOS confirms entity is formed, for any company formed during 2024. For companies formed on or after January 1, 2025, will only have 30 days to complete the report.
- If ***any*** changes, Company has 30 days to update report (transfers, M&A, death, etc.).
- Companies formed prior to January 1, 2024, have one year to comply (i.e. 12/31/24).

Breaking Down the Law - Reporting Companies

Which Companies Must Report?

A **"reporting company"** is defined as a corporation, limited liability company, or other similar entity that is created by filing a document with a secretary of state or similar office under the law of a state, Indian tribe or a foreign country.

What's reported?

- Corporate information;
- Beneficial Owners/Responsible Persons; and
- Company Applicants.

FinCEN's commentary in the first final rule indicates that the filing obligation and certification of accuracy is on the reporting company itself, and the individual submitting the report would be doing so on the reporting company's behalf.

How to Report?

Reporting will be made online at the FinCEN website: https://www.fincen.gov/boi. The portal for submitting information is still being built, but the proposed form can be found on the website.

Breaking Down the Law - Foreign Companies

Foreign reporting companies are entities (including corporations and limited liability companies) formed under the law of a foreign country that have registered to do business in the United States by the filing of a document with a secretary of state or any similar office.

Breaking Down the Law - Notable Exemptions

1. Publicly Traded Companies
2. Certain Tax Exempt Organizations
3. Certain Financial Institutions (Banks, etc.)
4. Insurance Companies and Producers
5. Public Accounting Firms
6. Pooled Investment Vehicles
7. Inactive Entities Before 2020
8. Others…

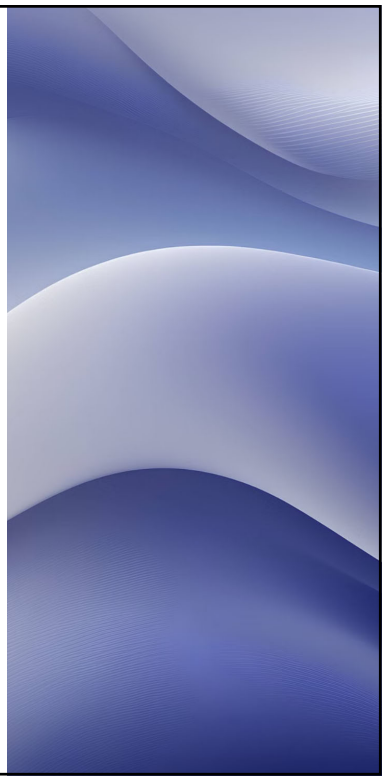
Breaking Down the Law - Large Company Exemption

Operating entities that:

1. Employ more than 20 employees on a full-time basis in the U.S.;
2. Filed in previous year tax returns demonstrating more than $5,000,000 in gross receipts or sales; and
3. Has an operating presence at a physical office in the U.S.

Breaking Down the Law - Subsidiary Exemption

Subsidiaries that are controlled or wholly owned, directly or indirectly, by certain exempt entities	Partially owned by one or more exempt entities and is also partially owned by one or more non-exempt entities
EXEMPT	NOT EXEMPT Report up to Exempt Entity



Breaking Down the Law - Public Accounting Firm Exemption

Any public accounting firm registered in accordance with section 102 of the Sarbanes-Oxley Act of 2002.

The Sarbanes-Oxley Act requires public accounting firms to register with the Public Company Accounting Oversight Board (PCAOB) to prepare or issue an audit report for a U.S. public company or a broker-dealer, or to play a substantial role in those audits.

Thus, not all accounting firms are exempt companies, and may need to file a BOI report if they don't qualify for another exemption.

Breaking Down the Law - Defining Beneficial Owner

Beneficial Owner - any individual who, directly or indirectly (a) exercises "substantial control" over the entity; or (b) owns or controls not less than 25 percent of the ownership interests of the entity.

Breaking Down the Law - Defining Beneficial Owner - 25% Ownership Interest

The regulations make specific point to say that "ownership interest" means all types of equity or quasi-equity, including:

- convertible instruments;
- profits interests;
- put, call, straddle or other option; or
- any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership.

Generally speaking, the calculation should be made on a fully diluted basis. The regulations provide some specific formulas. But, in short, the regulations indicate, when in doubt, if the facts and circumstances indicate who owns/controls more than 25% of the company, you should disclose this person as a beneficial owner.

Breaking Down the Law - Substantial Control

"Substantial Control" is defined as:

- Service as a senior officer of a reporting company (president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function);
- Authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body) of a reporting company;
- Having direction, determination, or decision of, or substantial influence over, important matters of a reporting company; or
- Any other form of substantial control over the reporting company not specifically listed.

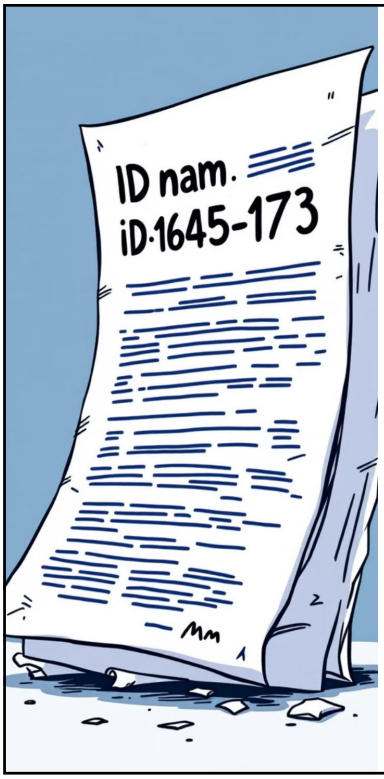
Breaking Down the Law - Reporting Requirements

Each reporting company is required to submit a report to FinCEN that discloses the following:

1. Full legal name and DBA names of the reporting company;
2. Address of principal place of business;
3. Jurisdiction of formation; and
4. EIN.

Each beneficial owner and each company applicant has to disclose the following:

1. Full Legal Name;
2. Date of Birth;
3. Current Residential Address (or business address if company applicant is an entity); and
4. Unique identifying number from a passport, government identification document or a driver's license (along with a scanned image of such document).



FinCEN Identifier

A FinCEN ID is a unique identifying number issued to an individual by FinCEN. Although there is no requirement to obtain a FinCEN ID, doing so can simplify the reporting process.

An individual beneficial owner or company applicant's FinCEN ID can be reported instead of required information about that individual on the reporting company's Beneficial Ownership Information Report (BOIR) submitted to FinCEN.

Any individual can obtain a FinCEN ID through the FinCEN website.

Filing Information

1. * Type of filing:
   - a. Initial report ☐
   - b. Correct prior report ☐
   - c. Update prior report ☐
   - d. Newly exempt entity ☐

   Reporting Company information associated with most recent report, if any:

   - e. Legal name
   - f. Tax Identification type
   - g. Tax Identification number
   - h. Country/Jurisdiction *(if foreign tax ID only)*

2. Date prepared *(auto-filled when form is finalized)*

Beneficial Ownership Information Report

Home | Reporting Company | Company Applicant(s) | Beneficial Owner(s)

Part I. Reporting Company Information

3. Request to receive FinCEN Identifier (FinCEN ID) ☐
4. Foreign pooled investment vehicle ☐

Full legal name and alternate name(s):

5. * Reporting Company legal name
6. Alternate name (e.g. trade name, DBA) (+) (-)

Form of identification:

7. * Tax Identification type
8. * Tax Identification number
9. Country/Jurisdiction *(if foreign tax ID only)*

Jurisdiction of formation or first registration:

10. * a. Country/Jurisdiction of formation

Domestic Reporting Company:

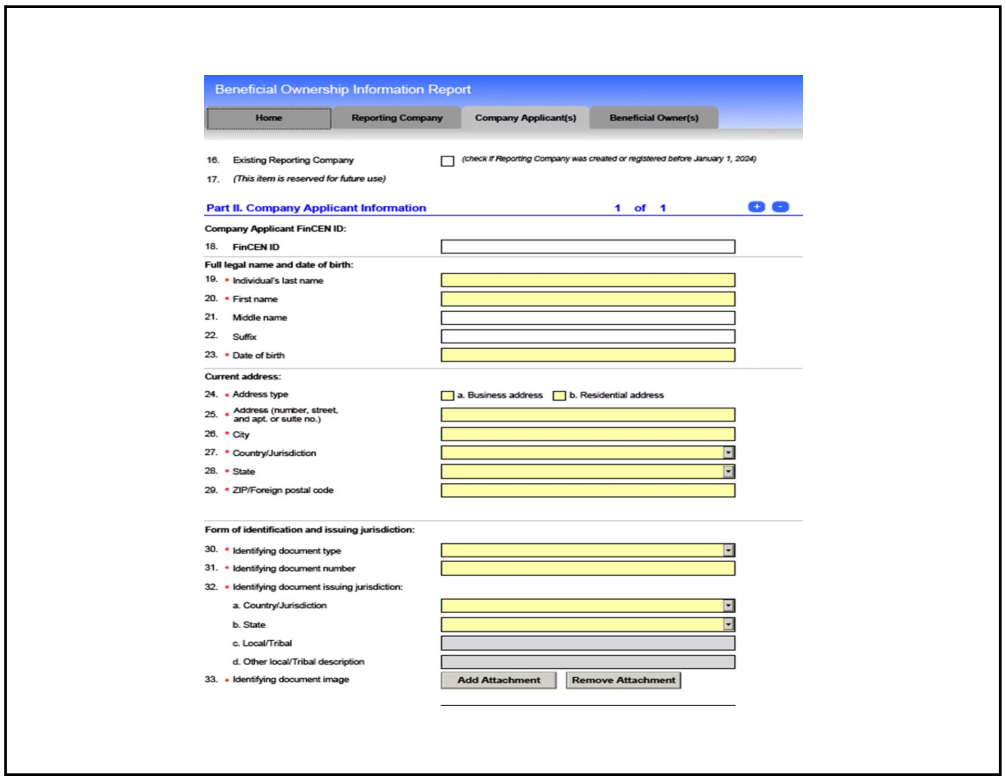
- b. State of formation
- c. Tribal jurisdiction of formation
- d. Name of the other Tribe

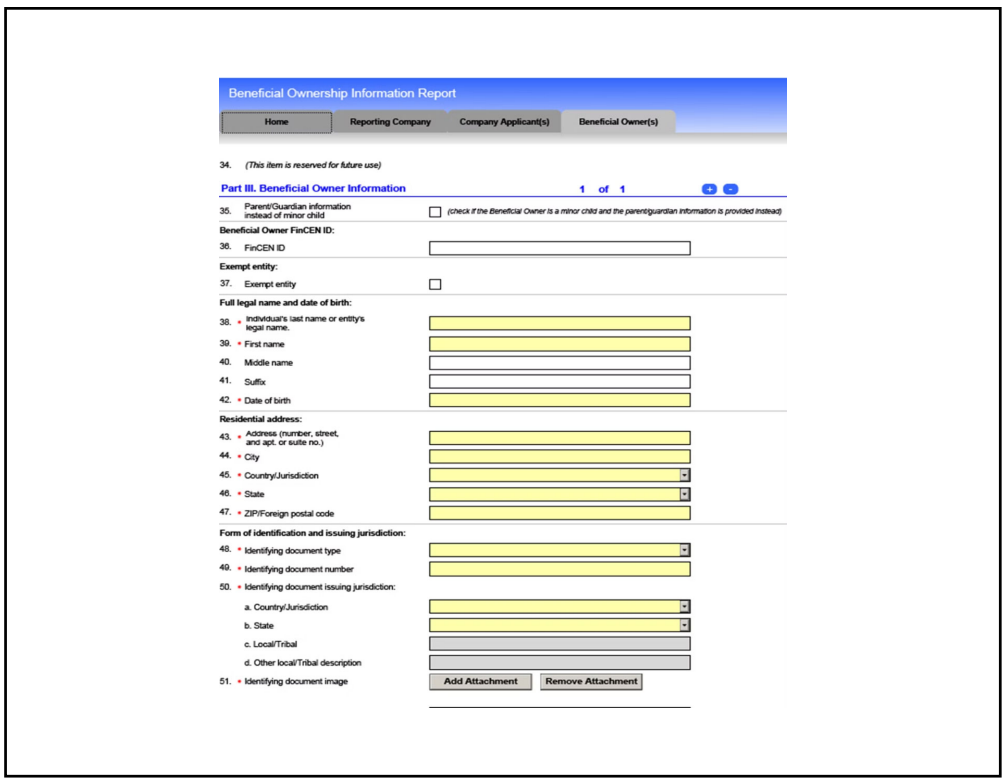
Foreign Reporting Company:

- e. State of first registration
- f. Tribal jurisdiction of first registration
- g. Name of the other Tribe

Current U.S. Address:

11. * Address (number, street, and apt. or suite no.)
12. * City
13. * U.S. or U.S. Territory
14. * State
15. * ZIP Code


Beneficial Ownership Information Report
Home
Reporting Company
Company Applicant(s)
Beneficial Owner(s)
16. Existing Reporting Company
(check if Reporting Company was created or registered before January 1, 2024)
17. (This item is reserved for future use)
Part II. Company Applicant Information
1 of 1
Company Applicant FinCEN ID:
18. FinCEN ID
Full legal name and date of birth:
19. * Individual's last name
20. * First name
21. Middle name
22. Suffix
23. * Date of birth
Current address:
24. * Address type
a. Business address
b. Residential address
25. * Address (number, street, and apt. or suite no.)
26. * City
27. * Country/Jurisdiction
28. * State
29. * ZIP/Foreign postal code
Form of identification and issuing jurisdiction:
30. * Identifying document type
31. * Identifying document number
32. * Identifying document issuing jurisdiction:
a. Country/Jurisdiction
b. State
c. Local/Tribal
d. Other local/Tribal description
33. * Identifying document image
Add Attachment
Remove Attachment


Beneficial Ownership Information Report
Home
Reporting Company
Company Applicant(s)
Beneficial Owner(s)
34. (This item is reserved for future use)
Part III. Beneficial Owner Information
1 of 1
35. Parent/Guardian information instead of minor child
(check if the Beneficial Owner is a minor child and the parent/guardian information is provided instead)
Beneficial Owner FinCEN ID:
36. FinCEN ID
Exempt entity:
37. Exempt entity
Full legal name and date of birth:
38. * Individual's last name or entity's legal name.
39. * First name
40. Middle name
41. Suffix
42. * Date of birth
Residential address:
43. * Address (number, street, and apt. or suite no.)
44. * City
45. * Country/Jurisdiction
46. * State
47. * ZIP/Foreign postal code
Form of identification and issuing jurisdiction:
48. * Identifying document type
49. * Identifying document number
50. * Identifying document issuing jurisdiction:
a. Country/Jurisdiction
b. State
c. Local/Tribal
d. Other local/Tribal description
51. * Identifying document image
Add Attachment
Remove Attachment

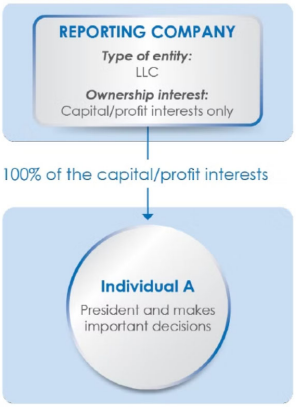
Who will have access to this information?

BOI is generally confidential and may not be disclosed except as authorized under the CTA and the Final Access Rule.

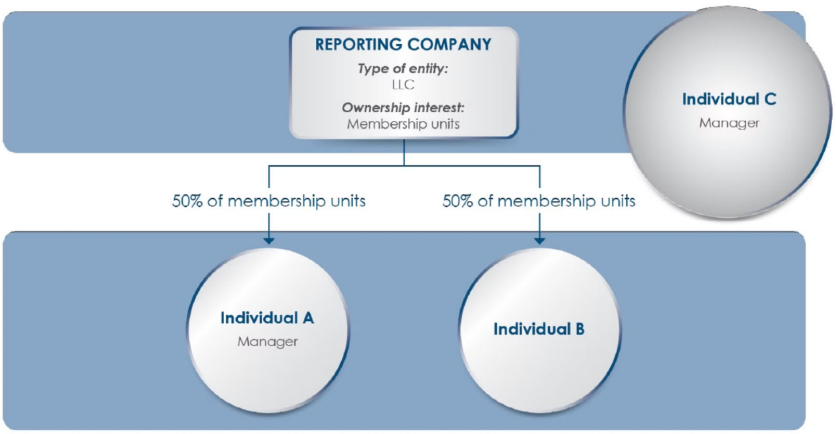
Under the Final Access Rule, the CTA provides access to BOI to if they meet specific requirements:

1. Federal agencies engaged in national security, intelligence, or law enforcement activity
2. State, local, and Tribal law enforcement agencies with court authorization
3. Foreign law enforcement agencies, judges, prosecutors, and other authorities that meet specific criteria
4. Financial institutions with customer due diligence requirements and regulators supervising those financial institutions, and
5. Certain US Treasury Department officers and employees.

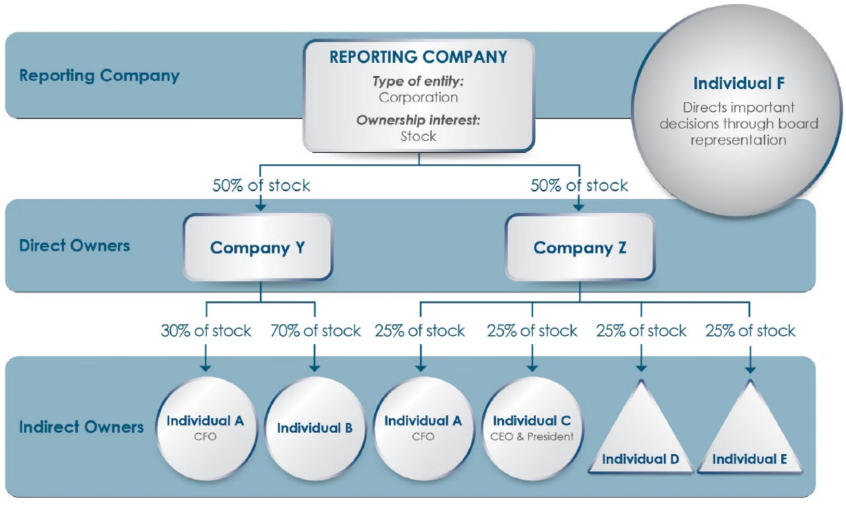
Example #1 - Single Owner Company Where Owner Operates Company



Example #2 - 50/50 Ownership with 3rd Party Manager



Example #3 - Lots of Owners

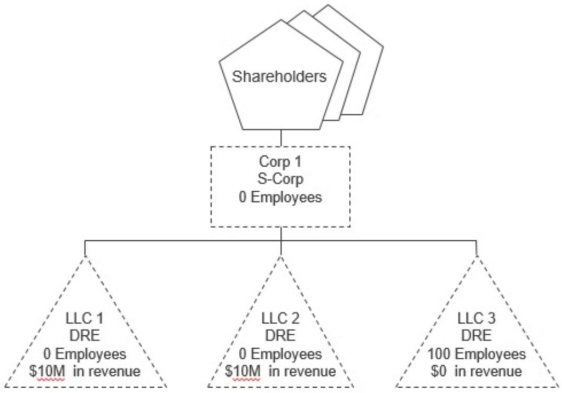


Example #4 - Large Company Exemption

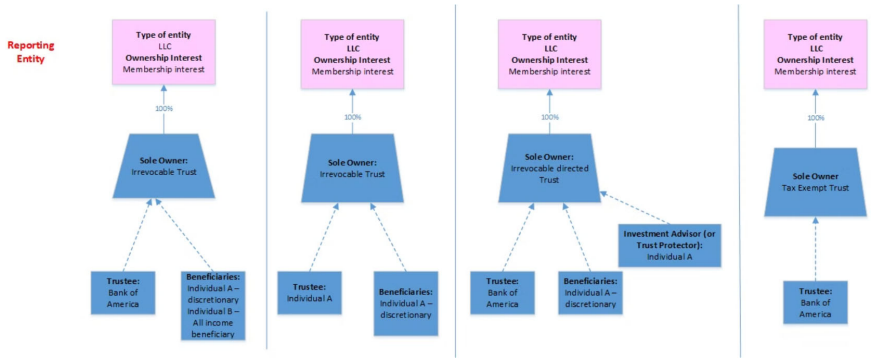
Operating entities that:

1. Employ more than 20 employees on a full-time basis in the U.S.;
2. Filed in previous year tax returns demonstrating more than $5,000,000 in gross receipts or sales; and
3. Has an operating presence at a physical office in the U.S.

Example #4 - Large Operating Company Exemption



Example #5 - Trusts



Breaking Down the Law - Company Applicants

→ If you assist a client in forming an entity, you are a Company Applicant

A "Company Applicant" is an is an individual who files an application/document to form an entity. In the reporting form, you can list up to two Company Applicants. Entities formed prior to January 1, 2024, won't have a Company Applicant.

"In many cases, company applicants may be employed by a business formation service or law firm. For example, there may be an attorney primarily responsible for overseeing the preparation and filing of incorporation documents and a paralegal who directly files them with a state office to create the reporting company. In this example, this reporting company would report two company applicants—the attorney and the paralegal—but additional individuals who may be indirectly involved in the filing would not need to be reported."

Odds And Ends We're Running Into

1. What if you cannot get an EIN by the deadline?
2. How should community property laws be considered?
3. How active will enforcement be?
4. If I dissolve the entity this year do I need to file?
5. Is it worth paying a professional to do this? Do I really need to have a lawyer do this? Can or should accountants help clients comply?
6. The grieving process
7. Our sense is FinCEN is going to be disappointed. What will it do to get people to comply?
8. The end of form and figure it out later.

CTA - Constitutional?

A U.S. District Court judge in Alabama has ruled the Corporate Transparency Act (CTA) unconstitutional. ***National Small Business United v. Yellen***, No. 5:22-cv-1448-LCB (N.D. Ala. 3/1/24)

The Government argued that the CTA is within Congress' broad powers to regulate commerce, oversee foreign affairs and national security, and impose taxes and related regulations.

The court did not agree, the Court determined that "the CTA exceeds the Constitution's limits on the legislative branch and lacks a sufficient nexus to any enumerated power to be a necessary or proper means of achieving Congress' policy goals, the Plaintiffs are entitled to judgment as a matter of law."

The Government has filed a notice of appeal.

What does this mean?

Thanks for attending!

PART 1. COMPTROLLER OF PUBLIC ACCOUNTS

CHAPTER 3. TAX ADMINISTRATION

SUBCHAPTER O. STATE AND LOCAL SALES AND USE TAXES

34 TAC §3.330

The Comptroller of Public Accounts proposes amendments to §3.330, concerning data processing services. The comptroller amends this section to clarify existing definitions; to add new definitions; to list examples of services that are included in and excluded from taxable data processing services; to describe data processing that is not taxable; to explain the incidence of the tax; and to update provisions related to the collection of local sales and use taxes on data processing services. The amendments implement language in Senate Bill 153, 87th Legislature, 2021 regarding payment processing. Other revisions improve the clarity and readability of the section.

Subsection (a) provides definitions. The comptroller amends the general definition of "data processing service" in paragraph (1) to list the operative words included as examples of "data processing service" in Tax Code, §151.0035(a)(1) ("Data Processing Service"). The comptroller moves and amends existing language regarding examples to subsection (b). The comptroller deletes existing language regarding internet access services as they are no longer taxable.

The comptroller adds new subparagraph (A) listing services that are specifically included in data processing service under Tax Code, §151.0035.

The comptroller adds new subparagraph (B) listing services that are specifically excluded from data processing service under Tax Code, §151.0035, including services added by Senate Bill 153.

The comptroller adds new subparagraph (C) to exclude some data processing that might otherwise be included in "data processing service" as described in Tax Code, §151.0035. The comptroller adds subparagraph (C) under its exclusive jurisdiction to interpret taxable services, as provided in Tax Code, §151.0101(b) ("Taxable Services").

Subparagraph (C) provides that a data processing service will not be taxable if it is sold for a single charge with another service, the data processing service does not have a separate value, and the data processing service is ancillary to the other service.

New subparagraph (C)(i) provides that if the data processing service is sold for a single charge with another service that does not have a separate value, and the other service is ancillary to the data processing service, the entire charge will be taxable as a data processing service.

New subparagraph (C)(ii) provides that if the data processing service has a separate value and is sold or purchased for a single charge with a nontaxable related service, subsection (e) applies.

New subparagraph (C)(iii) identifies factors that the comptroller may consider in determining whether the data processing service has a "separate value." The "separate value" requirement is drawn from *Rylander v. San Antonio SMSA Ltd. P'ship.* 11 S.W.3d 484, 488 (Tex. App.--Austin 2000, no pet.). The opinion uses the "separate value" concept in evaluating whether services could be segregated for taxation purposes.

The "separate value" requirement of subparagraph (C)(iii) is also consistent with the comptroller's longstanding rule, retained in subsection (e)(3), which provides for the segregation of nontaxable and taxable services sold or purchased for a single charge.

The comptroller explains the "ancillary" requirement in new subparagraph (C)(iv). The requirement is similar to the current provision that excludes data processing service if it "facilitates the performance" of another service. But subparagraph (C)(iv) identifies specific factors, which are not in the current rule.

The test for determining whether a data processing service is "ancillary" to a nontaxable service is not an essence of the transaction test. The essence of the transaction test attempts to determine what the buyer ultimately wants. *Combs v. Chevron, Inc.,* 319 S.W.3d 836, 843 (Tex. App.--Austin 2010, pet. denied) ("underlying goal"). The buyer will never want the manipulation of data for its own sake. The buyer will always want the manipulation of data as the means to achieve an end. Therefore, the identification of the "underlying goal" of the buyer, or the essence of the transaction, is not the appropriate test for data processing services. *See also,* Hellerstein & Hellerstein, State Taxation §12.08 (3rd ed. 2020) (the primary purpose test is "folly").

In determining whether a data processing service is "ancillary" to a nontaxable service, the comptroller will focus on what the seller is doing, and not what the buyer wants. The repetitive or routine manipulation of data by the seller is a factor suggesting that the activity is not ancillary and should be taxable as a data processing service, while the manipulation of data that depends on the external knowledge and discretionary judgment of the service provider suggests that the activity is ancillary and should not be taxable as a data processing service.

For example, the insertion of data into form title or loan documents for a client would ordinarily be a taxable data processing service. The primary service is the compilation, retrieval, and accurate manipulation of the data into the forms, even though there may be an element of independent judgement in correctly entering the data. However, the preparation of a title opinion would not ordinarily be a taxable data processing service. The primary service is the application of legal knowledge and judgement to a set of facts, even though there may be elements of data processing. The "ultimate goal" of the preparation of loan documents and the preparation of title opinions may be the same - to close a real estate deal. But one service is a taxable data processing service because it requires the repeated application of the same process to different data, albeit with skill and expertise; and the other service is not a taxable data processing service because it produces a solitary result based on legal principles. These examples are illustrated in the recent opinion in *Hegar v. Black, Mann, & Graham, L.L.P.,* No. 03-20-00391-CV, 2022 WL 567853 (Tex. App.--Austin Feb. 25, 2022, no pet.).

The comptroller amends current paragraph (2) to delete the definition of "internet" as that term is already defined in Tax Code, §151.00393 (Internet). The comptroller adds a new definition of "downstream payment processor" based on the language in Senate Bill 153 that incorporates the definition in 7 TAC §33.4(c) (Payment Processors) as that provision existed on January 1, 2021.

The comptroller amends paragraph (3) to delete the definition of "internet access services" as the statutory reference to that definition is now listed in subsection (a)(1)(B)(i) and a separate definition is no longer necessary. The comptroller adds a new definition of "point of sale payment processor" based on the lan-

guage in Senate Bill 153 that incorporates the definition in 7 TAC §33.4(d) as that provision existed on January 1, 2021.

The comptroller adds new paragraph (4) to add a definition of "settling of an electronic payment transaction" based on the language in Senate Bill 153.

The comptroller moves the existing text of current subsection (b) to amended subsection (c)(2), with changes. Amended subsection (b) text provides examples that apply the definition of "data processing service."

The comptroller adds new paragraphs (1)-(3) to restate text from current subsection (a)(1) that payroll services, business accounting, and the preparation of financial statements are data processing services.

The comptroller adds new paragraph (4) based on the holding in *Hegar v. Black, Mann, & Graham, L.L.P.,* No. 03-20-00391-CV, 2022 WL 567853 (Tex. App.--Austin Feb. 25, 2022, no pet.), which held the preparation of form title or loan documents is taxable data processing.

The comptroller adds new paragraph (5) to clarify that marketplace providers may provide data processing services to their customers if they enter, retrieve, search, manipulate, and store data or information in the course of their business.

The comptroller adds new paragraph (6) to clarify that internet hosting as defined by Tax Code, §151.108 (Internet Hosting) is taxable data processing.

The comptroller adds new paragraph (7) to clarify that video streaming subscriptions are taxable cable television services under Tax Code, §151.0033 ("Cable Television Service"). See also §3.313 of this title (relating to Cable Television Service and Bundle Cable Service).

The comptroller adds new paragraph (8) to clarify that streaming video gaming subscriptions are taxable amusement services as set forth in Tax Code, §151.0028 ("Amusement Services") and in STAR Accession No. 201405957L (May 28, 2014), and are not taxable data processing services.

The comptroller adds new paragraph (9) to provide that the compilation of nontaxable opinion polls and survey information as described by §3.342 of this title (relating to Information Services), is not taxable data processing if the data processing is ancillary to the acquisition of the information and the service provider's expertise is not managing data, such as in an inventory management service.

The comptroller adds new paragraph (10) to provide that the compilation of nontaxable information derived from laboratory, medical, or exploratory testing or experimentation as described by §3.342 of this title is not taxable data processing if the data processing is ancillary to the provision of the information.

The comptroller adds new paragraphs (11) and (12) to add examples from Comptroller's Decision No. 116,834 (2022) regarding the taxability of computerized three-dimensional rendering, website design, website development, search engine optimization, social media marketing, and lead generation.

The comptroller moves current subsection (c) to amended subsection (d), with changes. New subsection (c) is titled "Imposition of tax, permits."

The comptroller adds new paragraph (1) to provide that the use of data processing service is subject to state sales and use tax and that local sales and use tax may also be imposed.

The comptroller adds new paragraph (2) that contains language moved from current subsection (b) and restates that providers of data processing services must obtain a Texas sales and use tax permit. The paragraph includes the permitting safe harbor for small remote sellers as set forth in §3.286(b)(2) of this title (relating to Seller's and Purchaser's Responsibilities).

The comptroller adds new paragraph (3) that contains language moved from current subsection (a)(1) stating that a data processing service is taxable regardless of the ownership of the computer or whether that data is provided by the customer or the customer's authorized designee.

The comptroller adds new paragraph (4) to restate the language from current subsection (b) which exempts 20% of the amount charged for data processing services from sales and use tax based on Tax Code, §151.351 (Information Services and Data Processing Services).

The comptroller amends relettered subsection (d), formerly subsection (c), to update the storage medium used in the example from a magnetic tape to a Universal Serial Bus (USB) drive.

The comptroller amends relettered subsection (e), formerly subsection (d). The substantive effect of subsection (e) is the same as former subsection (d). However, the term "unrelated service" is replaced by the term "nontaxable related service" to conform to the ordinary usage of the terms. Subsection (e) applies when multiple services are sold or purchased for a single charge. Because the services are sold or purchased for a single charge, the services are in some manner going to be "related," as that term is ordinarily used, even if they are also distinct. When services are related by a common charge, and the services are each also commonly provided on a stand-alone basis, and the performances are distinct and identifiable, then the single charge may be segregated under the conditions described in subsection (e).

The comptroller reletters subsection (f), formerly subsection (e).

The comptroller amends relettered subsection (g), formerly subsection (f) and retitles it "Determining the incidence of the tax (service benefit rule)". The comptroller moves current text in subsection (g) regarding local taxes to relettered subsection (h), with changes.

The comptroller amends paragraph (1) to restate the statutory definition of "use" in Tax Code, §151.011 ("Use" and "Storage"). The comptroller deletes the current presumption language in paragraph (1) regarding a separate, identifiable segment of a customer's business. The current presumption language is replaced by the presumption in paragraph (2) that more closely follows the statutory presumption in Tax Code, §151.104(a) (Sale for Storage, Use, or Consumption Presumed).

The comptroller amends paragraph (2) to restate statutory language in Tax Code, §151.104(a) regarding presumption of use in Texas. The comptroller moves language in current paragraph (2) regarding business conducted both inside and outside the state to amended paragraph (3) and moves language regarding multi-state customers' method of allocation to new paragraph (6).

The comptroller amends paragraph (3) and adds clauses (i)-(ii) to restate statutory language in Tax Code, §151.104 and §151.330 (Interstate Shipments, Common Carriers, and Services Across State Lines). The comptroller moves language in current paragraph (3) regarding a multi-state customer providing an exemption certificate to new paragraph (6).

The comptroller amends paragraph (4) to restate statutory language in Tax Code, §151.101 (Imposition of Use Tax) and to be consistent with the interpretation of statute in Comptroller's Decision No. 116,293 (2022). The comptroller deletes language in current paragraph (4) regarding identifiable segments of a business as the revised subsection follows the statutory guidelines more closely.

The comptroller amends paragraph (5) to restate statutory language in Tax Code, §151.303(c) (Previously Taxed Items: Use Tax Exemption or Credit) and §3.338 of this title (relating to Multistate Tax Credit and Allowance of Credit for Tax Paid to Suppliers). The comptroller deletes language in current paragraph (5) regarding services that cannot be assigned to an identifiable segment of a business, as the revised subsection follows the statutory guidelines more closely.

The comptroller adds new paragraph (6) to restate moved language from current paragraph (3) regarding multi-state customers issuing exemption certificates, with non-substantive changes to improve readability.

The comptroller adds new paragraph (7) to restate language from paragraph (2) regarding a multistate customer's use of any reasonable method for allocation which is supported by business records.

The comptroller adds new clause (i) to restate moved language from current paragraph (2) regarding the method used for business records to allocate a data processing service used both within and outside Texas.

The comptroller adds new clause (ii) to add language regarding the good faith acceptance of an exemption certificate as set forth in §3.287 of this title (relating to Exemption Certificates).

The comptroller amends relettered subsection (h), formerly (g) regarding Local Taxes.

The comptroller amends paragraph (1) to provide general guidance on the consummation of sale for local sales tax and directs taxpayers to §3.334 of this title (relating to Local Sales and Use Taxes) and deletes the existing language.

The comptroller amends paragraph (2) to provide general guidance on determining local use tax and directs taxpayers to §3.334 of this title and to delete language that is now located in §3.334 of this title.

Language in former subparagraph (A) remains as new paragraph (3). The comptroller deletes subparagraph (B) as that language is now located in new subsection (g)(6).

The comptroller adds subsection (i) to restate former subsection (h) and to make minor changes for readability.

The comptroller adds new paragraphs (1) and (2) to clarify when a customer is responsible to report use tax due on the purchase of taxable data processing services under Tax Code, §151.101.

Tetyana Melnyk, Director of Revenue Estimating Division, has determined that during the first five years that the proposed amended rule is in effect, the rule: will not create or eliminate a government program; will not require the creation or elimination of employee positions; will not require an increase or decrease in future legislative appropriations to the agency; will not require an increase or decrease in fees paid to the agency; will not increase or decrease the number of individuals subject to the rule's applicability; and will not positively or adversely affect this state's economy.

Ms. Melnyk also has determined that the proposed amended rule would benefit the public by conforming the rule to current statute and improving readability. This rule is proposed under Tax Code, Title 2, and does not require a statement of fiscal implications for small businesses or rural communities. The proposed amended rule would have no significant fiscal impact on the state government, units of local government, or individuals. There would be no anticipated significant anticipated economic cost to the public.

You may submit comments on the proposal to Jenny Burleson, Director, Tax Policy Division, P.O. Box 13528, Austin, Texas 78711-3528 or to the email address: tp.rule.comments@cpa.texas.gov. The comptroller must receive your comments no later than 30 days from the date of publication of the proposal in the *Texas Register.*

The comptroller proposes the amendments under Tax Code, §111.002 (Comptroller's Rules; Compliance; Forfeiture), which provide the comptroller with the authority to prescribe, adopt, and enforce rules relating to the administration and enforcement of provisions of Tax Code, Title 2 (State Taxation), and taxes, fees, or other charges or refunds which the comptroller administers under other law.

The amendments implement Tax Code, §§151.0035 ("Data Processing Services"), 151.0101 (Taxable Services), 151.105 (Importation for Storage, Use, or Consumption Presumed), 151.330 (Interstate Shipments, Common Carriers, and Services Across State Lines), 151.351 (Information Services and Data Processing Services), 321.203 (Consummation of Sale), and 321.205 (Use Tax).

§3.330. Data Processing Services.

(a) Definitions. The following words and terms, when used in this section, shall have the following meanings, unless the context clearly indicates otherwise.

(1) Data processing service--the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information. [~~services - the processing of information for the purpose of compiling and producing records of transactions, maintaining information, and entering and retrieving information. It specifically includes word processing, payroll and business accounting, and computerized data and information storage or manipulation. The charge for data processing services is taxable regardless of the ownership of the computer. Examples of data processing services include entering inventory control data for a company, maintaining records of employee work time, filing payroll tax returns, preparing W-2 forms, and computing and preparing payroll checks. Data processing does not include the use of a computer by a provider of other services when the computer is used to facilitate the performance of the service or the application of the knowledge of the physical sciences, accounting principles, and tax laws, e.g., the use of a computer to provide interpretive or enhancement geophysical services or the use of a computer by a CPA firm, enrolled agent, or bookkeeping firm to produce a financial report, prepare federal income tax, state franchise or sales tax returns, or charges for temporary secretarial personnel who as part of their function use word processing equipment. Data processing services does not include Internet access services or data processing services provided in conjunction with and incidental to the provision of Internet access service when billed as a single charge.~~]

(A) Data processing service includes:

(i) word processing;

(ii) payroll and business accounting data production;

(iii) the performance of a totalizator service with the use of computational equipment required by Occupations Code, Subtitle A-1, Title 13, (Texas Racing Act); and

(iv) the use of a computer or computer time for data processing whether the processing is performed by the provider of the computer or computer time or by the purchaser or other beneficiary of the service.

(B) Data processing services do not include:

(i) Internet access service as defined by Tax Code, §151.00394 (Internet access service);

(ii) the transcription of medical dictation by a medical transcriptionist;

(iii) the display of a classified advertisement, banner advertisement, vertical advertisement, or link on an Internet website owned by another person;

(iv) services exclusively to encrypt electronic payment information for acceptance onto a payment card network that allows a person to accept a specific brand of debit or credit card by routing information and data to settle an electronic payment transaction, in order to comply with standards set by the Payment Card Industry Security Standards Council; or

(v) settling of an electronic payment transaction by:

(I) a downstream payment processor or point of sale payment processor or point of sale payment processor that routes electronic payment information to an entity described in subclause (II) or (III) of this clause;

(II) a federally insured financial institution, as defined by Finance Code, §201.101 (Definitions), that is organized under the laws of Texas, another state, or the United States, or an affiliate of the institution;

(III) a payment card network that allows a person to accept a specific brand of debit or credit card by routing information and data to settle an electronic payment transaction;

(IV) a person who has entered into a sponsorship agreement with an entity described in subclause (II) for the purpose of processing that entity's electronic payment transactions through a payment card network; or

(V) a person who is engaged in the business of money transmission and required to obtain a license under Finance Code, §152.101 (Money Transmission License Required).

(C) Under its exclusive jurisdiction to interpret taxable services, the comptroller excludes from the definition of "data processing service" data processing that is sold for a single charge with another service if the data processing service does not have a separate value, and the data processing service is ancillary to the other service. The burden is on the taxpayer to demonstrate that the data processing service does not have a separate value and is ancillary to the other service.

(i) If the data processing service is sold for a single charge with another service that does not have a separate value, and the other service is ancillary to the data processing service, the entire charge will be taxable as a data processing service.

(ii) If the data processing service is sold for a single charge with another service that has a separate value, subsection (e) of this section applies.

(iii) In determining whether the data processing service and the other service have separate values, the comptroller will consider whether the services are distinct and identifiable and whether each service is of a type that is commonly provided on a stand-alone basis or commonly provided as an additional service for a greater single charge.

(iv) In determining whether the data processing service is ancillary to another service, or conversely, whether the other service is ancillary to the data processing service, the comptroller may consider the extent to which the service provider exercises discretion or judgment in individual applications of the processed data based on knowledge of the physical sciences, accounting principles, law, or other fields of study. The repetitive or routine manipulation of data by the seller is a factor suggesting that the data processing activity is not ancillary to another service and should be taxable as a data processing service. The manipulation of data that depends on the external knowledge and discretionary judgment of the service provider in individual applications suggests that the data processing activity is ancillary to another service and should not be taxable as a data processing service. The provider's skill, experience, or expertise, in processing data or information is not a factor. Other factors may be considered, and the weight of the factors may vary from case to case. The evaluation is based on what the service provider is doing, not on what the customer wants.

(2) Downstream payment processor--A payment processor that acts as an intermediary between a consumer-facing entity that has incurred an outstanding money transmission obligation to a consumer, and the consumer's designated recipient. [~~Internet - collectively the myriad of computer and telecommunications facilities, including equipment and operating software, that comprise the interconnected worldwide network of networks that employ the Transmission Control Protocol/Internet Protocol, or any predecessor or successor protocols to the protocol, to communicate information of all kinds by wire or radio.~~]

(3) Point of sale payment processor--A payment processor that receives funds from a consumer on behalf of a consumer-facing entity that either sells goods or services other than money services or accepts charitable donations. [~~Internet access service - a service that enables users to access content, information, electronic mail, or other services offered over the Internet and may also include access to proprietary content, information, and other services as part of a package of services offered to consumers. Internet access service does not include any other taxable service, unless the taxable service is provided in conjunction with and is merely incidental to the provision of Internet access service. Individuals providing Internet access should refer to §3.366 of this title (relating to Internet Access Services).~~]

(4) Settling of an electronic payment transaction--The authorization, clearing, or funding of a payment made by credit card, debit card, gift card, stored value card, electronic check, virtual currency, loyalty program currency such as points or miles, or a similar method. The term does not include charges by a marketplace provider, as that term is defined by Tax Code, §151.0242 (Marketplace Providers and Marketplace Sellers).

(b) Examples of services that are and are not taxable data processing services. [~~Hold permits. All providers of data processing services must obtain Texas sales and use tax permits and collect tax on charges for data processing services, or accept properly completed resale, exemption, or direct pay permit certificates in lieu of collecting tax. See §3.285 of this title (relating to Resale Certificate; Sales for Resale); §3.287 of this title (relating to Exemption Certificates); §3.288 of this title (relating to Direct Payment Procedures and Qualifications). Effective October 1, 1999, 20% of the total amount charged for data~~

~~processing services is exempted from tax. The exemption applies to services performed on or after October 1, 1999. The exemption does not apply to services performed before the effective date and billed or paid for after the effective date of the exemption.~~]

(1) Payroll services, such as maintaining records of employee work time, computing and preparing payroll checks, filing payroll tax returns, and completing pre-printed employee-related forms such as W-2s, are taxable data processing because they involve the routine and repeated simultaneous application of the same process to different data. The service provider's skill, experience, or expertise with payroll documents is not determinative.

(2) The production of business accounting data, such as inventory reports, is taxable data processing because it involves the routine and repeated simultaneous application of the same process to different data. The service provider's skill, experience, or expertise with business reports is not determinative.

(3) The preparation of financial statements kept in accordance with generally accepted accounting principles, is not included in taxable data processing, even though it has elements of data processing, because the categorization and characterization of the data is variable and depends upon the discretion and certified opinion of an accounting professional.

(4) The insertion of data into form title or loan documents for a client is taxable data processing because it involves the repeated application of the same process to different data. The service provider's skill or experience with title or loan documents is not determinative. The preparation of a title opinion is not included in taxable data processing, even though it has elements of data processing, because the result is solitary and depends upon the opinion or skills of a legal professional.

(5) Marketplace provider services may be included in taxable data processing services when they involve the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information provided by the purchaser or the purchaser's designee. For example, services to store product listings and photographs, maintain records of transactions, and to compile analytics are taxable data processing services.

(6) Internet hosting, as defined by Tax Code, §151.108 (Internet Hosting), is included in taxable data processing services when the user stores data on the service provider's hardware, or processes data on software that is owned, licensed, or leased by the user or provider. An example is the provision of servers and operating systems that are used by a customer to store software applications and content that can be accessed by the customer's customers.

(7) Streaming video subscriptions are taxable as a cable television service but not as data processing services. See also §3.313 of this title (relating to Cable Television Service and Bundle Cable Service).

(8) Streaming video game subscriptions are taxable as an amusement service but not as data processing services. See also §3.298 of this title (relating to Amusement Services).

(9) The compilation of information that the service provider acquires from unrelated third parties through nontaxable opinion polls and surveys as described by §3.342 of this title (relating to Information Services) is not a taxable data processing service if the data processing is ancillary to the main service of data acquisition and the data processing does not have a separate value. However, if the service provider acquires and compiles data from the customer or the customer's designees, and the service provider's expertise is in managing the data, such as in inventory management, the main service is data processing and the service is taxable.

(10) The compilation of nontaxable information primarily derived from the service provider's laboratory, medical, or exploratory testing or experimentation or any similar method of direct scientific observation of physical phenomena as described by §3.342 of this title (relating to Information Services) is not a taxable data processing service if the data processing is ancillary to the main service and the data processing does not have a separate value. Examples may be geophysical surveys, polygraph tests, and the recording and tracking of vital signs in a medical treatment.

(11) Computerized three-dimensional rendering that is created using customer provided data is taxable data processing as it requires the computerized entry, retrieval, search, compilation, manipulation, or storage of data or information.

(12) Website design, website development, search engine optimization, social media marketing, and lead generation are taxable data processing when they involve the storage, manipulation, compilation, and entry of data.

(c) Imposition of tax, permits.

(1) State sales and use tax and any applicable local sales and use tax are imposed on each sale or use of a data processing service in Texas.

(2) Except for small remote sellers described in §3.286(b)(2)(B) of this title (relating to Seller's and Purchaser's Responsibilities), a seller of data processing services must obtain a Texas sales and use tax permit and collect and remit tax on charges for data processing services, or accept properly completed resale, exemption, or direct pay permit certificates in lieu of collecting tax. See §3.285 of this title (relating to Resale Certificate; Sales for Resale); §3.287 of this title (relating to Exemption Certificates); §3.288 of this title (relating to Direct Payment Procedures and Qualifications).

(3) A charge for data processing services is taxable regardless of the ownership of the computer or whether the data is provided by the customer or the customer's authorized designee.

(4) Twenty percent of the total amount charged for data processing services is exempted from tax. If the data processing service is also taxable as another type of taxable service other than an information service, the twenty percent exemption does not apply.

(d) [~~(c)~~] Resale certificates.

(1) Providers of data processing services may issue a resale certificate in lieu of tax to suppliers of tangible personal property only if care, custody, and control of the property is transferred to the client. For example, a service provider purchases a Universal Serial Bus (USB) drive [~~magnetic tape~~] to transfer the results of data processing services to customers. The USB drive [~~tape~~] is transferred to the customer, and the customer owns and uses the USB drive [~~tape~~] to review the results of the data processing service. The service provider may purchase the USB drive [~~tape~~] tax free by issuing a resale certificate. Tax is due on the total amount charged the customer, including amounts for the USB drive [~~tape~~] and for the services.

(2) A resale certificate may be issued for a service if the buyer intends to transfer the service as an integral part of taxable services. A service will be considered an integral part of a taxable service if the service purchased is essential to the performance of the taxable service and without which the taxable service could not be rendered.

(3) A resale certificate may be issued for a taxable service if the buyer intends to incorporate the service into tangible personal

property which will be resold. If the entire service is not incorporated into the tangible personal property, it will be presumed the service is subject to tax and the service will only be exempt to the extent the buyer can establish the portion of the service actually incorporated into the tangible personal property. If the buyer does not intend to incorporate the entire service into the tangible personal property, no resale certificate may be issued, but credit may be claimed at the time of sale of the tangible personal property to the extent the service was actually incorporated into the tangible personal property.

(e) [~~(d)~~] Nontaxable related [~~Unrelated~~] services.

(1) A service will be considered as a nontaxable related service [~~unrelated~~] if:

(A) it is neither a data processing service, nor a service taxed under other provisions of the Tax Code, Chapter 151;

(B) each of the services provided are [~~it is~~] of a type which are [~~is~~] commonly provided on a stand-alone basis; and

(C) the performance of the service is distinct and identifiable. Examples of such a service would be consultation, development of and preparation of feasibility studies, design and development, or training.

(2) Where nontaxable related [~~unrelated~~] services and taxable services are sold or purchased for a single charge and the portion relating to taxable services represents more than 5.0% of the total charge, the total charge is presumed to be taxable. The presumption may be overcome by the data processing service provider at the time the transaction occurs by separately stating to the customer a reasonable charge for the taxable services. However, if the charge for the taxable portion of the services is not separately stated at the time of the transaction, the service provider or the purchaser may later establish for the comptroller, through documentary evidence, the percentage of the total charge that relates to nontaxable related [~~unrelated~~] services. The service provider's books must support the apportionment between exempt and nonexempt activities based on the cost of providing the service or on a comparison to the normal charge for each service when [~~if~~] provided alone. If the charge for exempt services is unreasonable when the overall transaction is reviewed considering the cost of providing the service or a comparable charge made in the industry for each service, the comptroller will adjust the charges and assess additional tax, penalty, and interest on the taxable services.

(3) Charges for services or expenses directly related to and incurred while providing the taxable service are taxable and may not be separated for the purpose of excluding these charges from the tax base. Examples would be charges for meals, telephone calls, hotel rooms, or airplane tickets.

(f) [~~(e) Service benefit location.~~] If both the data processing service provider and the customer are located in Texas, Texas tax is due.

[~~(f) Service benefit location--multi-state customer.~~]

(g) Determining the incidence of the tax.

(1) With respect to a taxable service, "use" means the derivation in Texas of direct or indirect benefit from the service. [~~To the extent a data processing service is used to support a separate, identifiable segment of a customer's business (other than general administration or operation of the business) the service is presumed to be used at the location where that part of the business is conducted.~~]

(2) The sale of a data processing service that is delivered in Texas is presumed to be a sale for storage, use, or consumption in Texas until the contrary is established. [~~If that part of the business is conducted at locations both within and outside the state, the service is not taxable to the extent it is used outside Texas. A multi-state customer may use any reasonable method for allocation which is supported by business records.~~]

(3) A data processing service performed in Texas is subject to Texas sales tax unless an exemption applies. [~~A multi-state customer purchasing data processing services for the benefit of both in-state and out-of-state locations is responsible for issuing to the data processing service provider an exemption certificate asserting a multi-state benefit, and for reporting and paying the tax on that portion of the data processing charge which will benefit the Texas location. A data processing service provider that accepts such a certificate in good faith is relieved of responsibility for collecting and remitting tax on transactions to which the certificate relates.~~]

(A) A data processing service performed in Texas for use entirely outside of Texas is exempt from sales tax.

(B) A data processing service performed in Texas for use both within and outside of Texas is exempt to the extent that the service is used outside Texas.

(4) A data processing service performed outside of Texas is subject to Texas use tax to the extent that the service is for use in Texas, unless an exemption applies. [~~The customer's books must support the assignment of the service to an identifiable segment of the business, the determination of the location or locations of the use of the service, and the allocation of the taxable charge to Texas.~~]

(5) A purchaser of a data processing service performed outside of Texas for use in Texas may claim a credit for a similar tax paid in another state if that state provides a similar credit for a taxpayer in Texas. [~~To the extent the use of the service cannot be assigned to an identifiable segment of a customer's business, the service is presumed to be used to support the administration or operation of the customer's business generally. The service is presumed to be used at the customer's principal place of business. The principal place of business means the place from which the trade or business is directed or managed.~~]

(6) A purchaser asserting the use of a data processing service at business locations in multiple states may issue to the service provider a form promulgated by the comptroller, or a substantially similar document that asserts a concurrent multi-state business use and represents that the purchaser will report and pay the state and local tax on the portion that is taxable and is not exempt.

(A) The multi-state purchaser may use a reasonable and consistent method supported by its business records to allocate the service between jurisdictions.

(B) A service provider that accepts a multi-state use certificate in good faith is relieved of responsibility for collecting and remitting Texas state and local sales and use taxes on transactions subject to the certificate.

(h) [~~(g)~~] Local taxes.

(1) Local sales tax is due in a local jurisdiction where the sale is consummated. The sale may be consummated at a place of business of the seller where the order is received, a place of business of the seller where the order is fulfilled, or at the location to which the service is delivered. See §3.334 of this title (relating to Local Sales and Use Taxes). [~~For local sales tax purposes, city, county, transit authority, and/or special purpose district sales taxes are due if the data processing service provider has only one place of business (the location where clients request service) within the boundaries of a local taxing entity. Local sales tax must be collected based upon the tax rate at that location, except that no MTA or CTD sales tax is due on services provided~~

~~at a location outside the boundaries of the transit area. In the case of multiple locations, if an order for service is placed at one location but the service is provided at another location, the place of business from which the service is provided will determine to which local taxing entity the tax is allocated.~~]

(2) Local use tax may also be due in a local jurisdiction where a direct or indirect benefit from the service is derived if the 2.0% local tax cap has not been exceeded. See also §3.334 of this title. [~~For the purposes of the local use tax, if a place of business is outside the boundaries of a local taxing entity, the data processing service provider will be required to collect local use tax if the client is within the local taxing entity and the service provider has representation in the local taxing entity as outlined in §3.286 of this title (relating to Seller's and Purchaser's Responsibilities). Even if the service provider is not required to collect local use tax, the client is still liable for the tax if the service is performed or a benefit is derived from the service within the boundaries of a local taxing entity.~~]

(3) [~~(A)~~] An in-state customer purchasing data processing services for the benefit of locations in more than one local taxing entity is responsible for issuing to the data processing service provider an exemption certificate claiming a multi-city benefit and for determining the extent of benefit for each entity. The local use tax for each entity must be reported, allocated, and paid by the customer. A data processing service provider that accepts in good faith an exemption certificate claiming a multi-city benefit is relieved of responsibility for collecting and remitting local tax on transactions to which the certificate relates.

[~~(B) A multi-state customer purchasing data processing services for the benefit of both in-state and out-of-state locations is responsible for issuing an exemption certificate and for reporting and paying local tax as provided by subsection (f)(3) and (4) of this section.~~]

(i) [~~(h)~~] Use tax. The customer is responsible to report and pay use tax if the service provider: [~~If a provider of a data processing service is not doing business in Texas or in a specific local taxing jurisdiction and is not required to collect Texas tax, it is the Texas customer's responsibility to report and pay the state and local use tax directly to this office.~~]

(1) is not required to collect and remit the sales or use tax; or

(2) does not collect the correct amount of sales or use tax.

The agency certifies that legal counsel has reviewed the proposal and found it to be within the state agency's legal authority to adopt.

Filed with the Office of the Secretary of State on August 30, 2024.

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Jenny Burleson
Director, Tax Policy
Comptroller of Public Accounts
Earliest possible date of adoption: October 13, 2024
For further information, please call: (512) 475-2220

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TITLE 37. PUBLIC SAFETY AND CORRECTIONS

PART 11. TEXAS JUVENILE JUSTICE DEPARTMENT

CHAPTER 380. RULES FOR STATE-OPERATED PROGRAMS AND FACILITIES

SUBCHAPTER B. TREATMENT

DIVISION 1. PROGRAM PLANNING

37 TAC §380.8703

The Texas Juvenile Justice Department (TJJD) proposes amendments to §380.8703, Rehabilitation Program Stage Requirements and Assessment.

SUMMARY OF CHANGES

Amendments to the section will include: 1) adding that a youth's stage in the rehabilitation program may be lowered when the youth has been unresponsive to intervention attempts over an extended period of time and the youth's current stage does not reflect the youth's current progress; 2) for Stage 1, adding that youth are expected to review their own unique vulnerabilities with the case manager; 3) for Stage 2, clarified that the goal is for youth to become *interpersonally* successful in the future; 4) for Stage 2, adding that youth are expected to identify a long-term success plan; 5) for Stage 2, clarifying that youth are expected to explore patterns in thoughts, feelings, attitudes, beliefs and *vulnerabilities* (rather than values); 6) for Stage 2, removing requirements for youth to make progress toward personalized goals, to present and discuss progress with the treatment team, and to complete case plan objectives; 7) for Stage 4, adding that completing case plan objectives includes the ability to articulate plans for successful community reentry; 8) for all stages, clarifying that youth are expected to participate *safely,* (rather than just participate) in various areas of programming; 9) removing the requirement for youth to receive a stage assessment based on current behavior and progress upon being returned to a high- or medium-restriction facility for disciplinary reasons or upon receiving an additional commitment, and adding that such youth will be placed on the most appropriate stage as specified by written procedure manual; and 10) clarifying that one of the situations in which a youth's stage may be lowered is when the youth *receives an additional commitment* (rather than being recommitted).

FISCAL NOTE

Emily Anderson, Deputy Executive Director: Support Operations and Finance, has determined that, for each year of the first five years the new section is in effect, there will be no significant fiscal impact for state government or local governments as a result of enforcing or administering the section.

PUBLIC BENEFITS/COSTS

Evan Norton, Senior Director of Integrated Treatment and Intervention Services, has determined that for each year of the first five years the revised section is in effect, the public benefit anticipated as a result of administering the section will be improvements to the rehabilitative stage system to more appropriately indicate a youth's motivation and readiness to change patterns of behavior and thinking, to more clearly articulate expectations of each stage in the program to youth and staff, and to more accurately capture a youth's readiness for parole in order to enhance public safety.

Ms. Anderson has also determined that there will be no effect on small businesses, micro-businesses, or rural communities. There is no anticipated economic cost to persons who are re-