OKLAHOMA TAX INSTITUTE

December 1-2, 2022

Speakers: Jennifer Benda, Ted Blodgett, Eric Kehmeier, Chris Kuehl, Tony Mastin, Bruce McGovern, Allison McLeod, Jason Oelrich, Mark Rogers, Mel Schwarz, Adam Sweet, Jimmy Williams

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OKLAHOMA TAX INSTITUTE

DECEMBER 1, 2022 | NORMAN, OK

EMBASSY SUITES NORMAN

DAY ONE | THURSDAY, DECEMBER 1 | ALL SESSIONS HELD IN OKLAHOMA F

8:00 – 9:15 AM	**GENERAL SESSION (75 MINUTES):** Federal Tax Legislative Update By Mel Schwarz
9:15 – 9:25 AM	BREAK
9:25 – 10:40 AM	**GENERAL SESSION (75 MINUTES):** Carbon Sequestration – Emerging Opportunities Panel: Mel Schwarz, Adam Sweet, Jason Oelrich, Mark Rogers
10:40 – 10:50 AM	BREAK
10:50 AM – 12:05 PM	**GENERAL SESSION (75 MINUTES):** Partnerships Hot Topics By Adam Sweet
12:05 – 1:00 PM	LUNCH BREAK (FOR IN PERSON)
1:00 – 2:15 PM	**GENERAL SESSION (75 MINUTES):** Recent Developments in Federal Income Tax By Bruce McGovern
2:15 – 2:25 PM	BREAK
2:25 – 3:15 PM	**GENERAL SESSION (50 MINUTES):** Gambling Tax Issues By Ted Blodgett
3:15 – 3:25 PM	BREAK
3:25 – 4:15 PM	**GENERAL SESSION (50 MINUTES):** Understanding the Economics of Cannabis Businesses: Business and Tax Considerations By Jennifer Benda

 All sessions recommended for CPE and CLE credit.

DAY TWO | FRIDAY, DECEMBER 2 | ALL SESSIONS HELD IN OKLAHOMA F

8:00 – 9:15 AM	**GENERAL SESSION (75 MINUTES):** Where From Here? Economic Scenarios for 2022 and 2023 By Chris Kuehl
9:15 – 9:25 AM	BREAK
9:25 – 10:40 AM	**GENERAL SESSION (75 MINUTES):** Tax Implication of Cryptocurrency By Allison McLeod
10:40 – 10:50 AM	BREAK
10:50 AM – 12:05 PM	**GENERAL SESSION (75 MINUTES):** Cybersecurity Trends By Eric Kehmeier
12:05 – 1:00 PM	BREAK
1:00 – 2:15 PM	**GENERAL SESSION (75 MINUTES):** Oklahoma Tax Update By Tony Mastin
2:15 – 2:25 PM	BREAK
2:25 – 3:15 PM	**GENERAL SESSION (50 MINUTES):** Ethics – You Don't Own Your CPA Certificate, You Lease It By Jimmy Williams, CPA
3:15 – 3:25 PM	BREAK
3:25 – 4:15 PM	**GENERAL SESSION (50 MINUTES):** Ethics – You Don't Own Your CPA Certificate, You Lease It (continued) By Jimmy Williams, CPA

All sessions recommended for CPE and CLE credit.

Welcome to the **OSCPA's 2022 Oklahoma Tax Institute - VIRTUAL**!

Here are a few important details to help you adjust to a virtual experience:

- **Connect.**
  Be sure you have high-speed INTERNET access to ensure your connection remains strong throughout the event.

- **Credit.**
  You will be prompted to verify your attendance throughout the broadcast. Respond to 70% or more of the prompts to receive full credit. We will send your CPE certificate within one week of the event.

- **Engage.**
  Use the chat feature to interact with other attendees and discussion leaders.

- **Evaluate.**
  You'll receive a link to evaluate the conference. Please share your thoughts so we can improve your experience.

- **Enjoy.**
  We're so happy to have you! Please reach out to cpe@oscpa.com or 800-522-8261 if you have questions.

Oklahoma Society of CPAs

Federal Tax Legislative Update

December 1, 2022

Leader: Mel Schwarz

CPAs & BUSINESS ADVISORS

FEDERAL TAX LEGISLATIVE UPDATE

December 1, 2022

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PRESENTER

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RECAP ON ENACTED TAX BILLS

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WHEN WE LAST SPOKE - DECEMBER, 2021

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TAXES IN 2021 HOUSE BUILD BACK BETTER RECONCILIATION BILL

- The House passed its bill on November 19, 2021
- Cap deductions for State and Local Taxes at $80,000 (2021 thru 2030)
- Above-the-line deduction of up to $250 for employee uniforms
- Increase the research credit against payroll tax for small businesses
- Tax on e-cigarettes
- Disallow excess business losses (i.e., net business deductions in excess of business income) for noncorporate taxpayers. (Disallowed losses can be carried forward)
- Reinstate the Superfund tax on crude oil and imported petroleum
- Delay the requirement to amortize R&D expenses by five years
- Renewable energy tax incentives
- 15% minimum tax on financial statement income on corporations with over $1 billion in profits
- 1% surcharge on corporate stock buybacks
- 15% GILTI rate with country-by-country computations, inflating the total tax on foreign operations
- 5% surcharge on modified adjusted gross income (MAGI) over $10 m, with an additional 3% rate on MAGIs over $25 m
- Application of the 3.8% Net investment income to non-passive income
- Increased IRS spending

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BUILD BACK BETTER – WINTER, 2022

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FROM BUILD BACK BETTER TO THE INFLATION REDUCTION ACT

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ANOTHER EFFORT: TAXES IN THE SENATE RECONCILIATION BILL

- The bill had been stalled in the Senate for roughly six months
- During a recent weekend (June 4th and 5th), Senate Democrats tried to move a Build Back Better bill. The listed tax provisions were discussed:
- These proposal did not move forward because it did not include an expansion of the Child Tax Credit.

Revenue	$ Billions	Notes
Intl and other biz reforms	$335	Changes re interest, Pillar 2 adaption, timing
15% corp AMT	$300	Further carve outs
1% buyback tax	$116	Delay until 2023
5%/8% AGI surtax	$200	Pass through exemption, possible delay
3.8% active income NIIT	$252	
Excess biz loss limit	$160	
IRS net investments*	$127	
Drug pricing	$250	
Other	$24	No fossil fuel sticks
Total Revenue	**$1,764**	
Spending	**$ Billions**	**Notes**
Climate	$500	No union EV credit
ACA premiums	$220	Made permanent
Medicaid gap	$180	Made permanent
Total Spending	**$900**	

Sources: Treasury, CBO, JCT, own estimates
*CBO's IRS estimate is $127B, Treasury's IRS estimate is $320B

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JUST NOT QUITE READY FOR PRIME TIME

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TIME OUT!!! -- THE SEMICONDUCTOR/CHINA TRADE BILL

- The House and Senate in late July passed legislation, dubbed the "Chips and Science" bill that provides a 25% tax credit for the cost of property placed in service in a US advanced manufacturing facility, a facility whose primary purpose is the **manufacturing of semiconductors or semiconductor manufacturing equipment.** (IRC §48D)
- The credit is for qualifying property that is placed in service after December 31, 2022, provided construction begins before January 1, 2027.
- The tax credit is eligible for **"direct pay"** as payment against tax.
- **President Joe Biden signed the bill into law on August 9th**

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WHAT IS "DIRECT PAY"?

- An annual election due by extended due date
- Direct pay credits are treated the same as a payment of estimated income tax.
  - Eligible for refund when the return is filed.
  - Does NOT offset estimated tax obligations
- Partnerships and S corporations
  - Election made at entity level and the IRS pays the entity
- "Excess payment" claw-backs
  - Any direct payment that would not have been allowed as a credit for the taxable year can be recovered by the IRS, plus a 20% penalty. Does NOT apply if disallowance only related to tax liability.

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THE INFLATION REDUCTION ACT OF 2022

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IRA

- What is not included with IRA (as compared to BBB):
  - Statutory rate increases.
  - Changing gift/estate statutes.
  - SALT deduction.
  - Modification of the carried interest rules.

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IRA

- What is included with the IRA:
  - Corporate minimum book tax.
  - Share buy-back tax.
  - ~$80 billion for the IRS.
  - AND according to the current administration, roughly $379 billion in various incentives to promote energy efficiency and “green” energy.

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TAX INCREASES IN THE INFLATION REDUCTION ACT OF 2022

- **A 15% minimum “book tax” on corporations with a (3 yr) average annual adjusted financial statement income in excess of $1 billion**
  - **Use tax depreciation, not book depreciation.**
  - **Special rules allow certain credits to offset minimum tax.**
  - **Includes “component members” in determination – section 52 single employer definition.**

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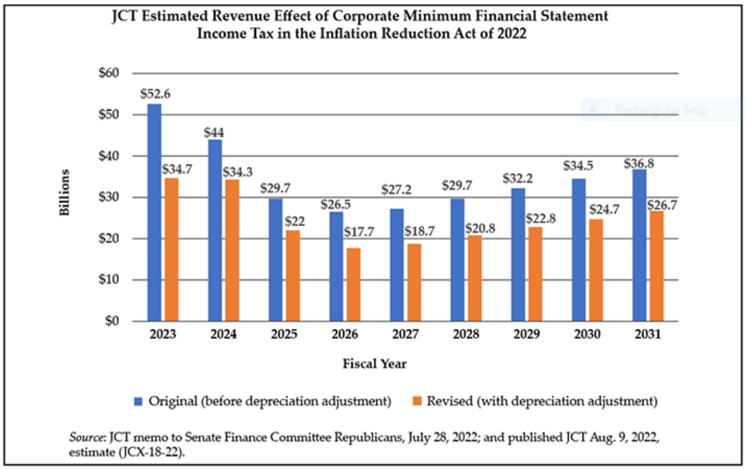
IMPACT OF ALLOWING TAX DEPRECIATION ON CORPORATE MINIMUM TAX



Marty Sullivan's estimates of corporations affected by the new alternative minimum tax:

IF BOOK DEPRECIATION: 124

IF TAX DEPRECIATION AND CREDITS ALLOWED: 90

Published in August 22 edition of Tax Notes

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TAX INCREASES IN THE INFLATION REDUCTION ACT OF 2022

- **A 15% minimum "book tax" on corporations with a (3 yr) average annual adjusted financial statement income in excess of $1 billion**
  - Use tax depreciation, not book depreciation.
  - Includes "component members" in determination – section 52 single employer definition
- **Places a 1 percent excise tax on corporate "net" stock buybacks**
  - The levy only applies if there is an excess of redemptions over new issues for the year.
- **Limitation on the Excess Business Losses of Noncorporate Taxpayers**
  - Extended for 2 years to apply to tax years ending before January 1, 2029.
- **Reinstate Superfund Tax on crude oil and imported petroleum products**
  - 16.4 cents/bbl. in 2023; indexed thereafter.

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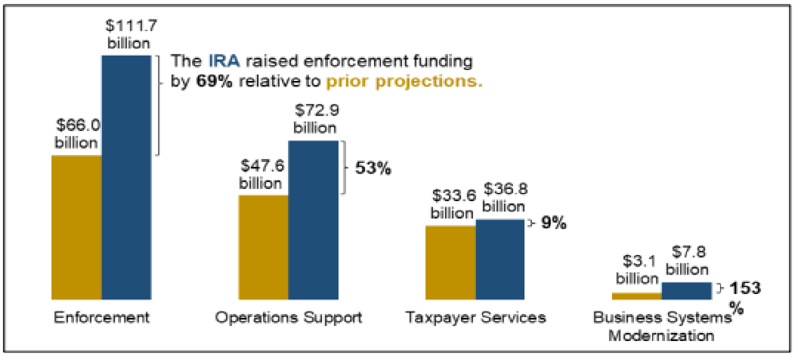
$80 BILLION OF ADDITIONAL IRS FUNDING – PER THE BILL

Figure 1. The IRS's Budget Authority Through FY2031 Under the Inflation Reduction



Source: Congressional Budget Office; Part 3 of Title I, Subtitle A of the Inflation Reduction Act.
Notes: Prior projection is for FY2022-FY2031. Assumes no change in base appropriations.

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$80 BILLION OF ADDITIONAL IRS FUNDING - REALITIES

- Scored as a revenue raiser - $200 billion revenue for $80 billion spent.
  - Is the $80 billion real or a way to solve for the desired revenue target?
- The money is for the next 10 years.
  - What can change during that period?
  - What effect will this have on future appropriations?
- Can the IRS really hire 87,000 new agents? When?
  - Early IRS plans for the new money assume a net increase of 5,000 to 7,500 agents per year
  - Up to 57,000 retirements expected during next 5 years
  - IRS has announced a front loading of customer-service personnel
    - Maybe we can now get an amended return processed

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ADDITIONAL $80 BILLION OF IRS FUNDING

Where could new agents be focused?

- Cryptocurrency transactions
- Offshore shenanigans
- Overinflated valuations
- Overly aggressive coronavirus claims

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METHANE EMISSIONS FEE BEGINNING IN 2024

- Applies to:
  - Onshore and offshore petroleum and natural gas production
  - Onshore natural gas processing and transmission compression
  - Underground natural gas and LNG storage
  - LNG export and import equipment
  - Onshore petroleum and natural gas gathering and boosting
  - Onshore natural gas pipelines
- Fee assessed on emissions in excess of "waste emissions threshold"
  - $900 per metric ton in 2024
  - $1200 per metric ton in 2025
  - $1500 per metric ton in 2026 and thereafter

Different thresholds for different activities and circumstances:

- 0.2% of natural gas sent for sale
- 10 metric tons per million barrels of oil
- .05% of natural gas sent through a nonproduction facility

Exemptions available if:

- Unreasonable delay in environmental permitting
- Facility is in regulatory compliance
- Plugged wells

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ENVIRONMENTAL INCENTIVES IN THE INFLATION REDUCTION ACT

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INFLATION REDUCTION ACT OF 2022 – CLEAN ENERGY ROADMAP

Clean electricity & reducing carbon emissions

Extending/modifying existing credits
- 45 – Production tax credit (PTC)
- 48 – Energy credit (ITC)
- 45Q – carbon capture

New credits
- 48 – increase ITC for solar in low-income communities
- 45U – Zero emission nuclear power PTC

Clean fuels

Extending/modifying existing credits
- 40, 40A, 6426, 6427 – biodiesel, alternative fuels
- 40(b)(6) – second generation biofuel

New credits
- 40B/6426/6427 – sustainable aviation fuel blender credit
- 45V – PTC – clean hydrogen

Manufacturing & energy security

Extending/modifying existing credits
- 48C – Advanced energy project credit – new credit allocation

New credits
- 45X – Advanced manufacturing PTC

Clean energy incentives for individuals

Extending/modifying existing credits
- 25C – Nonbusiness energy (extend/increase/modify)
- 25D – Residential energy efficient property
- 179D – Energy efficient commercial buildings
- 45L – New energy efficient homes

Clean vehicles

Extending/modifying existing credits
- 30C – Alternative fuel refueling property
- 30D – Clean vehicles credit

New credits
- 25E – Used clean vehicles
- 45W – Commercial vehicles

Clean electricity and transportation

Below new incentives generally effective 1/1/2025
- 45Y – Clean Electricity PTC
- 48D* - Clean Electricity ITC
- 45Z – Clean Fuel PTC
- Cost recovery for qualified facilities, property, and storage

Superfund excise tax

New tax
- 4611 – Reinstate hazardous superfund financing rate on crude oil and petroleum products

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OVERALL THEMES FOR ENERGY INCENTIVES

- Full credit available ONLY if wage and apprenticeship requirements met
- Domestic content requirements
- Geographic based benefits
- No double dipping
- Energy credits can be monetized

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WAGE AND APPRENTICESHIP REQUIREMENTS IN THE IRA

- In order to claim the full amount of most credits after 2022, wage and apprenticeship requirements must be met if construction commences 60 days after guidance is published.
- Wage requirement – laborers and mechanics must be paid the most recently published prevailing wage rates for the locality in which the project is located. Applies for duration of construction and 5 years after placed in service.
  - Guidance expected to be modeled on current US government construction and immigration rules.
- Apprenticeship requirement - Qualified apprentices must perform a minimum percentage of total labor hours on the project based on the year in which construction begins (10% in 2022, 12.5% in 2023, and 15% in later years).
  - Any contractor or subcontractor that employs 4 or more individuals to perform construction on a project must employ at least one qualifying apprentice UNLESS apprentices were requested, and the request was denied or not responded to within 5 business days.

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IRA AND INCENTIVE MONETIZATION

Traditionally, federal tax credits could not be "bought and sold" on an open market.

Instead, certain investment structures (like FLIP partnerships) were used to raise capital and then allocate the credit.

Big IRA changes:

- Allows for "direct pay" under certain circumstances- basically refundable.
- Also allows for transferability- essentially ability to sell credits for cash.

Unknowns:

- How will market adapt to these new provisions?
- And how will credits be priced on an open market?

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REFUNDABLE CREDITS / SALE FOR CASH

REFUNDABLE CREDITS FOR APPLICABLE ENTITIES (TAX EXEMPTS, TRIBES, POLITICAL SUBS,. ETC.)

- 30C Alt. fuel vehicle refueling pty.
- 45(a) Renewable source electricity
- 45U Zero emission nukes
- 45Y Clean electricity production
- 45Z Clean fuel production
- 48 Energy credit
- 48C Advanced energy project credit
- 48E Clean energy investment credit

BROADLY REFUNDABLE

- 45Q Carbon capture equipment
- 45V Clean hydrogen production
- 45X Advanced manufacturing production

NOTE: If listed credit is not refundable, generally can be sold for cash.

NOTE: May not be available if credit would otherwise be disallowed (passive, etc.)

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IRA PROVISIONS – ENERGY EFFICIENT CONSTRUCTION

- Energy Efficient Commercial Building Deduction (§179D)
  - Extended through 2032
  - Maximum deduction increased from $1.88/sq. ft to $5.00/sq.ft
- Energy Efficient Home Credit (§45L)
  - Extended through 2032
  - Maximum increased from $2,000/unit to $5,000/unit
  - 3 story limitation eliminated

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IRA PROVISIONS – ENVIRONMENTAL POWER PRODUCTION

- Production tax credits (§45) and investment credits (§48) extended for property placed in service before 2025 (Modified versions scheduled to be effective in 2025)
- Includes solar, wind, geothermal, fuel cell, microturbines, waste to energy, etc.
- NEW -- methane extraction from biofuels
- Size of credit can vary
  - 6% base credit
  - 30% credit if prevailing wage requirements met or deemed met
  - 40% credit if wage requirements and domestic content standards are met
  - 50% credit if all of above plus located in an energy community

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IRA PROVISIONS – ALTERNATIVE FUELS AND VEHICLES

- Credits for biodiesel, renewable diesel, biodiesel mixtures, alternative fuels, alternative fuel mixtures and second-generation biofuels retroactively extended through 2024.
- Credits for sustainable aviation fuel established
- $7500 per car clean vehicle credits modified beginning in 2023
  - Vehicle sales caps eliminated
  - Domestic content requirements established
  - Credits limited based on cost of car ($55,000/$80,000) and AGI of purchaser ($300,000 mfj).
- Used clean vehicle credit (lesser of $4,000 or 30% of price)
- Alternative fuel vehicle refueling property credits modified and restored

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IRA PROVISIONS – NEW FOCUS

- Expanded 45Q Carbon Capture Credit (see next presentation)
- Credits for making and recycling things needed for green energy
  - Investment credit (§48C) for building the facility to make the thing.
  - Production credit (§45X) for making and selling the thing.
  - No double dip – choose one or the other.
- Hydrogen production credit (§45V)

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ANY MORE TAX LEGISLATION IN 2022?

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TWO TYPES OF BILLS:

1. **Legislation that must pass**
2. **Legislation that might pass**

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LEGISLATION THAT MUST PASS

- Fund the Federal Government beyond December 16, 2022
- Pass the National Defense Authorization Act (NDAA)

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LEGISLATION THAT MIGHT PASS

- Retirement legislation
- Technical Corrections to the Inflation Reduction Act
- Military aid for Ukraine legislation
- Hurricane Relief legislation
- Same-sex marriage legislation
- Tax Extender legislation
- Energy permitting legislation (an IRA hangover)
- Electoral Count legislation
- Water resources legislation
- Flood insurance renewal legislation

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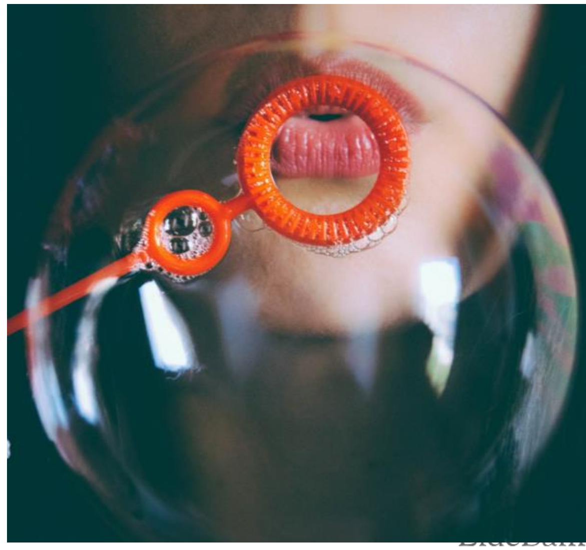
WHY THE RETIREMENT LEGISLATION

- The provisions (if not the details) are popular with lawmakers on both sides of the aisle
- Some lawmakers who helped write the House and Senate bills are retiring want this piece of legislation before retirement



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NOTABLE PROVISIONS IN POSSIBLE RETIREMENT LEGISLATION

- Employee self certification of hardship
- Automatic enrollment percentages increased
- Additional small employer incentives
- Expanded investment alternatives for 403(b) plans
- Increase in Required Minimum Distribution age
- Indexation of catch-up limitation
- Matching contributions allowed for repayment of student loans
- Part-time employees (1000+ hours) qualify after 2 years of service
- Penalty for failure to take a required distribution reduced from 50% to 25%
- Expanded IRA charitable contribution provisions

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OUTLOOK FOR TAX LEGISLATION 2023 AND LATER

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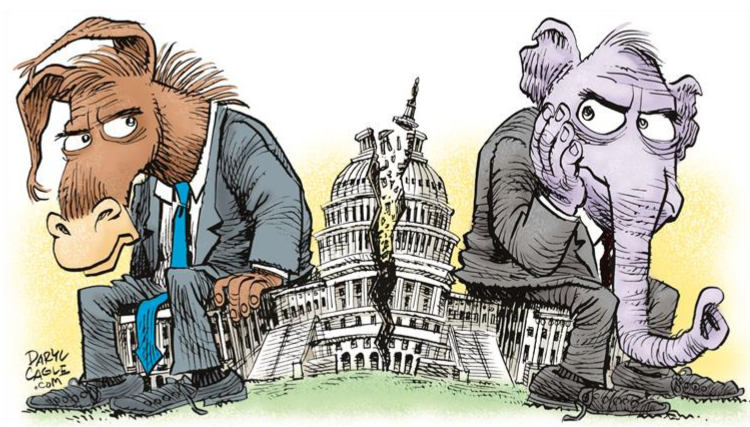

2023,4 - A HOUSE DIVIDED

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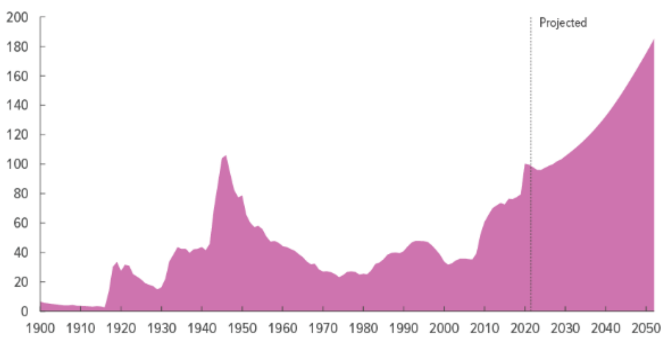
A POTENTIAL LIMITING FACTOR

Figure 1-8.

Federal Debt Held by the Public, 1900 to 2052

Percentage of GDP



Federal debt held by the public is projected to increase in most years in the projection period, reaching 110 percent of GDP in 2032 —higher than it has ever been. In the two decades that follow, growing deficits are projected to push federal debt higher still, to 185 percent in 2052.

Source: Congressional Budget Office

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QUESTIONS?

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Oklahoma Society of CPAs

Carbon Sequestration – Emerging Opportunities

December 1, 2022

Panel: Mel Schwarz, Adam Sweet, Jason Oelrich, Mark Rogers

CPAs & BUSINESS ADVISORS

INFLATION REDUCTION ACT: CCUS AND ENERGY EFFICIENCY INCENTIVES

December 2022

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THE EB BUSINESS CREDITS & INCENTIVES GROUP

Inflation Reduction Act: Reducing Your Carbon Footprint and Tax Liability

- **October 12** Part 1: An Overview
- **November 28** Part 2: New Opportunities for Tax Exempt Entities
- **December 14** Part 3: Individual Considerations

For more information and to register, visit eidebailly.com/inspired-perspectives.

- Carbon Capture and Sequestration Credit
- Discretionary Incentives
- Foreign-Derived Intangible Income (FDII)
- FHA Green Mortgage Insurance Premium
- Historical Tax Credit
- Interest Charge Domestic International Sales Corporation (IC-DISC)
- Opportunity Zones
- Research & Development Credit
- Statutory Incentives
- Utility Sales Tax Exemption

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EB HERE TODAY

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AGENDA

- Welcome to the Climate Economy
- CCUS and the 45Q Credit
- Environmental Incentives in the IRA
- Expanded Energy Efficiency Incentives

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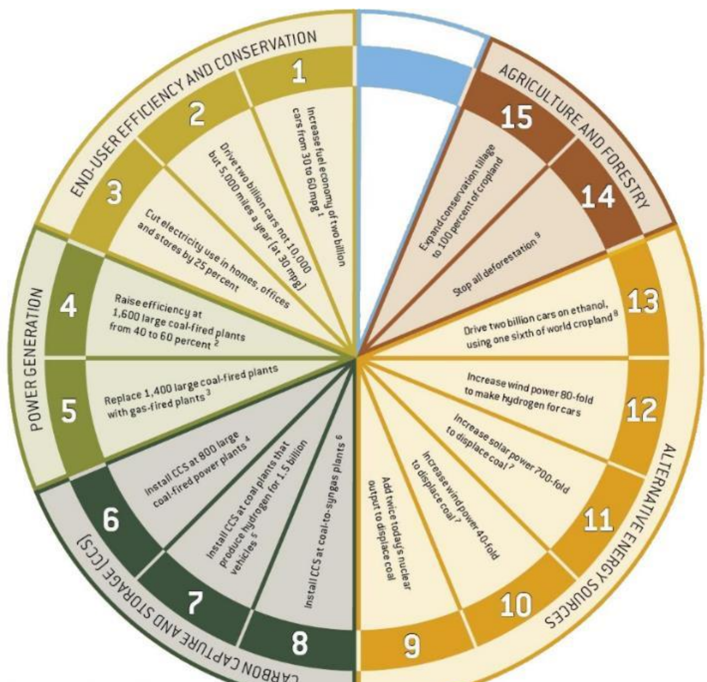

Source: www.thewashingtonnote.com

The Pacala and Socolow Wedges:

Fifteen possible wedges based on existing technology that each avoid 25 billion metric tons of carbon production over a period of 50 years.

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CARBON CAPTURE SEQUESTRATION 101

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NET ZERO EMISSIONS

- 27 CCS facilities operational globally; need up to 2700 by 2050 to achieve Paris Agreement
- Limiting global warming to 2°C requires installed CCS capacity to increase from around 40 Million Tons Per Annum (Mtpa) today to over 5,600 Mtpa by 2050.
- Between USD$655 billion and USD$1,280 billion in capital investment is needed by 2050.
- Building 70 to 100 facilities a year, up to 100,000 construction jobs and ongoing jobs for 30,000 to 40,000 operators and maintainers.
- Companies are measuring their Environmental, Social and Governance (ESG) impacts.
  - Carbon Accounting software such as NetZero by Salesforce.

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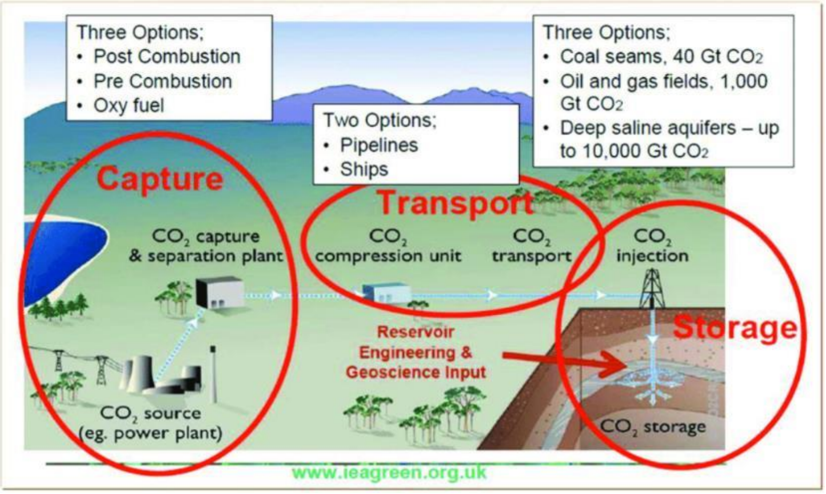
CARBON CAPTURE SEQUESTRATION



Carbon Capture Sequestration (CCS) mitigates the emission of CO2 by capturing it at the point of combustion and subsequently storing it in geological formations.

CCS can sustain a transition period in the world's energy use and help mitigate alarmingly high CO2 levels in the atmosphere.

The most important source of atmospheric CO2 is the burning of fossil fuels as part of our energy consumption. The burning of oil, coal and natural gas account for over 80% of CO2 emissions we use for energy.

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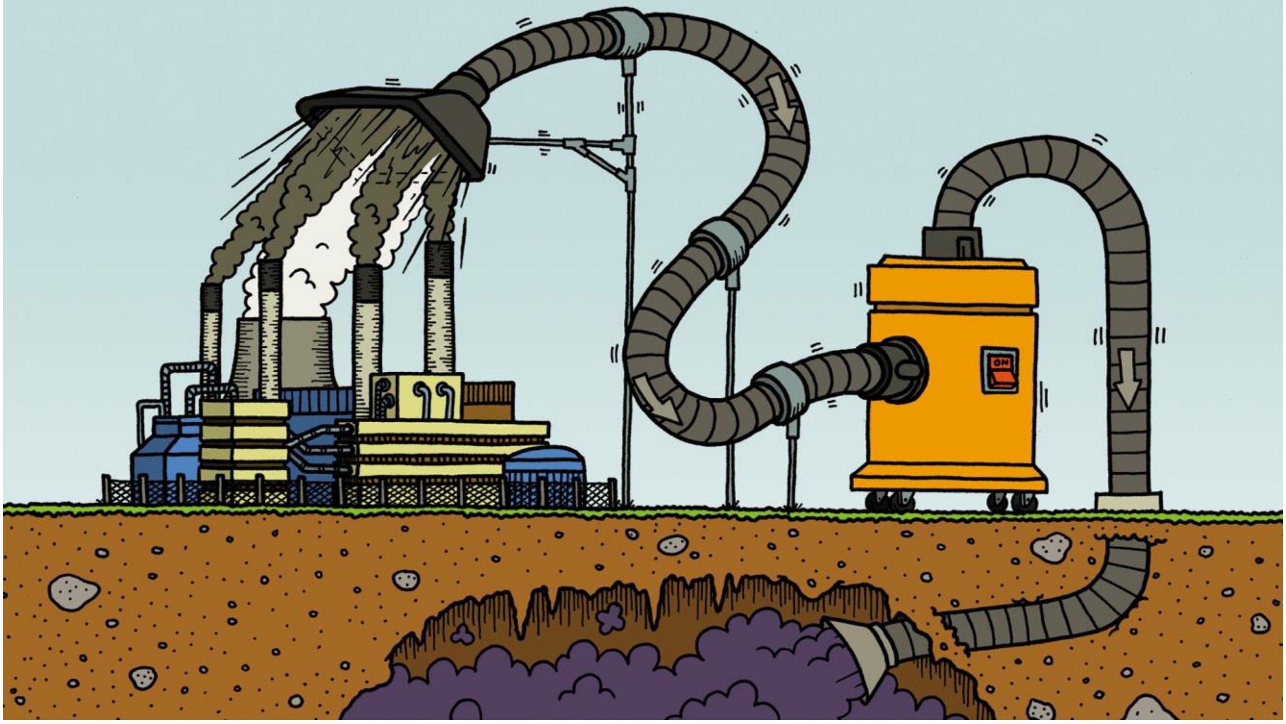

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CCS FACILITY DATA

	OPERATIONAL	IN CONSTRUCTION	ADVANCED DEVELOPMENT	EARLY DEVELOPMENT	OPERATION SUSPENDED	TOTAL
Number of facilities	27	4	58	44	2	135
Capture capacity (Mtpa)	36.6	3.1	46.7	60.9	2.1	149.3

FIGURE 6 COMMERCIAL CCS FACILITIES IN SEPTEMBER 2021 BY NUMBER AND TOTAL CAPACITY

PLANT	INDUSTRY	COUNTRY	MEAN CO_2 CAPTURE CAPACITY (Mtpa)
EARLY DEVELOPMENT			
Dave Johnson Plant	Electricity generation	United States	4.00
G2 Net zero LNG	Natural gas processing	United States	4.00
NextDecade Rio Grande LNG	Natural gas processing	United States	5.00
Keadby 3 Power Station	Electricity generation	United Kingdom	2.10
Repsol Sakakemang	Natural gas processing	Indonesia	1.80
Barents Blue Clean Ammonia	Chemical production	Norway	1.60
ADVANCED DEVELOPMENT			
Shell Refinery Rotterdam CCS	Hydrogen production	Netherlands	1.20
Stockholm Exergi BECCS	Electricity and heat generation	Sweden	0.80
Air Liquide Refinery Roterdam CCS	Hydrogen production	Netherlands	0.80
Lawler Biorefinery CCS	Bioethanol production	United States	0.53
Copenhill (Amager Bakke) Waste to Energy CCS	Waste processing	Denmark	0.50
Casselton Biorefinery CCS	Bioethanol production	United States	0.47
Marcus Biorefinery CCS	Bioethanol production	United States	0.43

FIGURE 8 LARGEST CONTRIBUTORS TO GROWTH OF PROJECTS IN DEVELOPMENT, 2021

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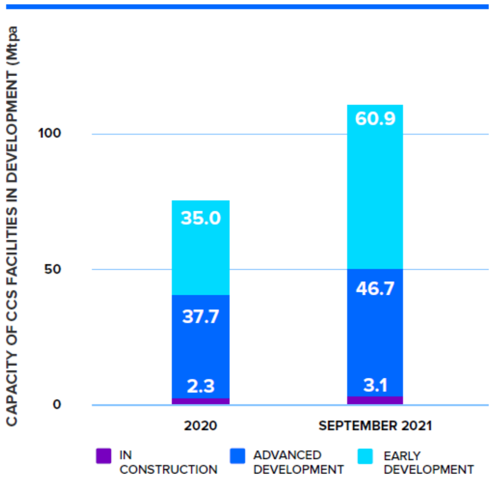
CCS IS AN ESSENTIAL CLIMATE MITIGATION TOOL

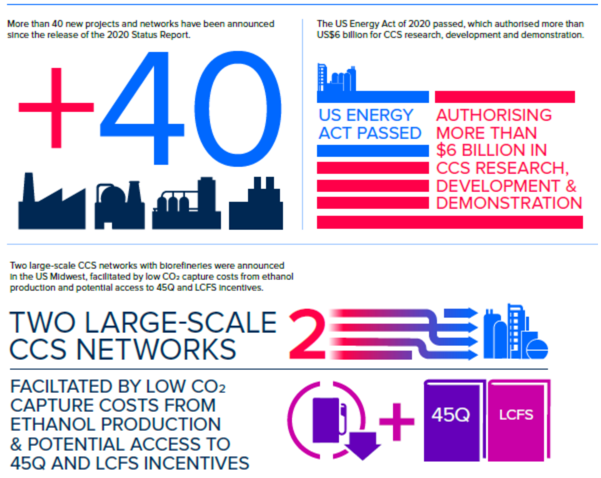
The CCS project pipeline is growing more robustly than ever. From 75 million tonnes a year (Mtpa) at the end of 2020, the capacity of projects in development grew to 111 Mtpa in September 2021 – a 48 per cent increase (1).



Excludes facilities that have not yet announced their capacity

FIGURE 1 CCS FACILITIES IN DEVELOPMENT
SOURCE: '*CO2RE Database*' 2021 (1)

3.1 NORTH AMERICA



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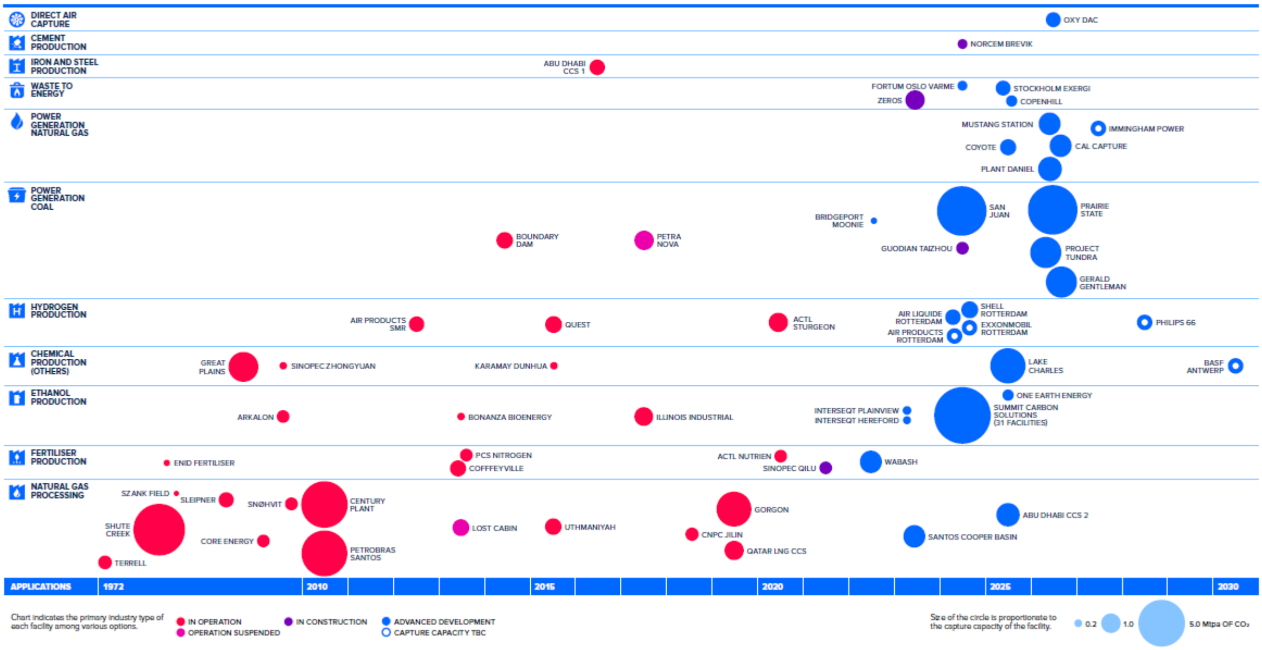

FIGURE 9 CCS PROJECTS BY SECTOR AND SCALE (BY CO_2 CAPTURE CAPACITY) OVER TIME

13

CCS FINANCIAL DRIVERS

FACILITY	SOURCE INDUSTRY	STORAGE	FINANCIAL DRIVERS
Wabash	Fertiliser Production	Geological	45Q, LCFS
Lake Charles Methanol	Methanol Production	EOR, Geological	EOR, 45Q
Dry Fork	Power Generation-Coal	EOR, Geological	EOR, 45Q
Tundra	Power Generation-Coal	EOR, Geological	EOR, 45Q
San Juan Generating	Power Generation-Coal	EOR, Geological	EOR, 45Q
Gerald Gentleman	Power Generation-Coal	*In evaluation*	45Q
Cal Capture	Power Generation-Natural Gas	EOR	EOR, 45Q, LCFS
Velocys Bayou Fuels	Power Generation-Biomass	Geological	45Q, LCFS
Clean Energy Systems	Power Generation-Biomass	*In evaluation*	45Q, LCFS
Illinois Clean Fuels	Power Generation-Waste-to-Energy	Geological	45Q, LCFS
ZEROS	Power Generation-Waste-to-Energy	EOR	45Q
CarbonSafe Illinois Storage Hub	Multiple	EOR, Geological	EOR, 45Q
Mid-Continent Storage Hub	Multiple	EOR, Geological	EOR, 45Q
ECO2S Storage Hub	Multiple	Geological	45Q

TABLE 2 US CCS FACILITIES AND STORAGE HUBS IN DEVELOPMENT[1]

- *Section 45Q tax credit*
- *Enhanced Oil Recovery (EOR)*
- *California Low Carbon Fuel Standard (LCFS)*

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CCUS STAGES FOR THE 45Q CREDIT

EXPLORATION

Begin the planning process with a kick-off meeting with all key stakeholders to confirm and clarify goals and objectives, identify known project pain points and define a timeline and/or tasks, as needed. During this phase we'll learn more about you, your business to best determine and align the project scope and objectives.

CREATION

As you and your stakeholders initiate the CCUS project, we'll document and report the initial decisions and verify alignment with the section 45Q tax credit regulations. We are able to review vendor contracts to ensure your goals are being addressed and that you remain in compliance with regulatory requirements. This will include baseline reports used to monitor and account for the tax credit.

OPERATION

Monitor, report and verify the section 45Q tax credit on a quarterly basis. During this phase we'll adapt utilization of the section 45Q tax credit with your financial and sustainable goals in any given tax year and continue to make recommendations on corrective actions, monitor target dates and track legislative changes or finding that may affect future activity. We will prepare the tax Form 8933 and the Model Certificates to comply with current law.

ONGOING COMMUNICATION

15

THE EVOLUTION OF THE 45Q CREDIT

The 45Q credit was initially established in 2008. Credits were made available only for the first 75 million tons of qualified carbon dioxide captured by all projects. Each taxpayer claiming the 45Q credits were required to capture at least 500,000 metric tons of qualified carbon dioxide in a single taxable year.

The Bipartisan Budget Act of 2018 made Section 45Q more attractive by eliminating the overall credits made available, expanded to cover both carbon dioxide and carbon oxide, and for some taxpayers, lowered thresholds for carbon needing to be captured.

In the Taxpayer Certainty and Disaster Tax Relief Act of 2020, 45Q was extended to projects that begin construction prior to January 1, 2026. Originally the date was January 1, 2024.

In 2020, the US Treasury Department and the Internal Revenue Service (IRS) released proposed regulations, Notice 2020-12 and Revenue Procedure 2020-12. The proposed regulations were followed by final regulations in early 2021.

The Inflation Reduction Act extends and expands the 45Q credit. Existing IRS guidance is expected to continue to apply until superceded.

16

CHANGES TO 45Q IN THE INFLATION REDUCTION ACT OF 2022

- Credit available if construction begins by 2032 (extended from 2026).
- Minimum capture requirement reduced to 12,500 tons/year (was 25,000 tons).
- Credit rate increased to $85/ton ($60 if carbon is utilized) provided wage and apprenticeship rules are met; otherwise, $17 per ton (previously $50/ton by 2026, phased in).
- 3 Year carryback allowed (previously 1 year).
- Credit can be monetized (made refundable) as a prepayment of tax.
- Credit can be transferred to 3rd parties in cash transactions.
- 5-year life for carbon capture property.

17

HOW DOES THE POST-IRA 45Q CREDIT INCENTIVIZE CARBON CAPTURE?

18

SECTION 45Q PROVIDES A MONETARY INCENTIVE

PRIOR LAW

- If sequestered, a section 45Q credit worth $34.81 per ton in 2022, increasing by $3.04 each year to $50 per ton in 2026 and thereafter indexed for inflation.
- If used as a tertiary injectant a section 45Q credit worth 25.15 per ton in 2022, increasing by $2.465 each year to $35 per ton in 2026 and thereafter indexed for inflation.

INFLATION REDUCTION ACT OF 2022

- If sequestered, a section 45Q credit worth $85 per ton ($17 if wage and apprenticeship rules not met), indexed for inflation after 2026.
- If used as a tertiary injectant a section 45Q credit worth $60 per ton ($12 if wage and apprenticeship rules not met) indexed for inflation after 2026.
- Changes generally effective for facilities placed in service after 2022.

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HOW LONG DOES THE 45Q CREDIT LAST?

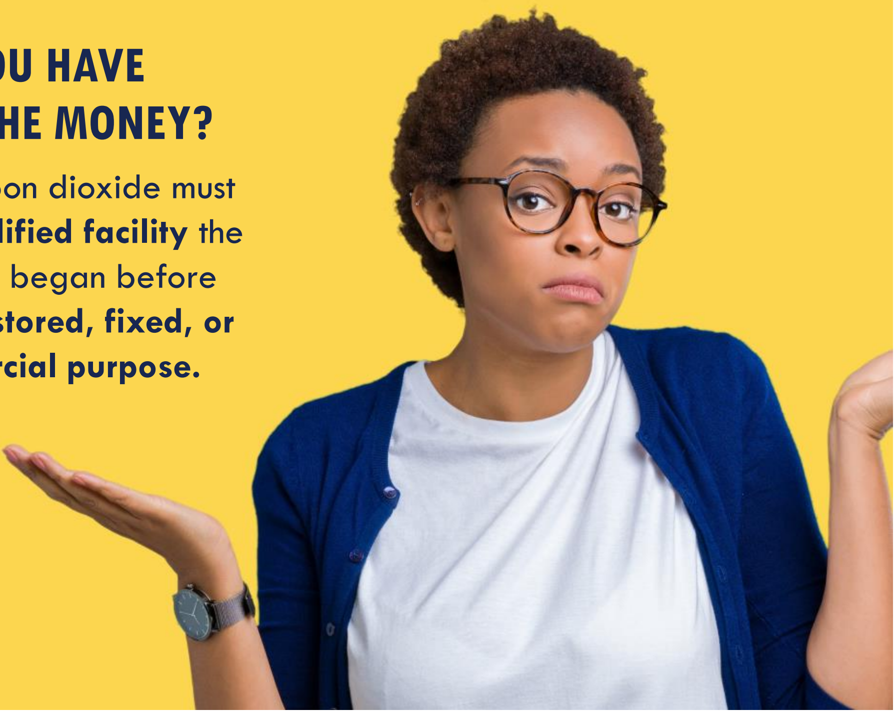
The 45Q credit is available for 12 years, beginning when the carbon capture equipment is placed in service. This provides more certainty for investors and increases the value of 45Q credits.

The Inflation Reduction Act of 2022 did not modify this rule.

20

WHAT DO YOU HAVE TO DO TO GET THE MONEY?

Carbon oxide or carbon dioxide must be **captured** at a **qualified facility** the construction of which began before 2032 and **securely stored, fixed, or used for a commercial purpose.**



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WHAT IS CONSIDERED A "QUALIFIED FACILITY" IN SECTION 45Q?

- A qualified facility is a facility that:
  - Stores or uses the carbon oxide it captures in accordance with the rules under Section 45Q.
  - Meets the "beginning of construction requirement". Construction begins before January 1, 2032 if either the:
    - Physical construction of the carbon capture equipment used at the facility has begun or,
    - 5% of costs have been incurred, including the original planning and design for a facility that includes the installation of carbon capture equipment.

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WHAT ARE THE STORAGE AND USE REQUIREMENTS UNDER SECTION 45Q?
A qualified facility must either properly dispose of the carbon oxide in a secure geological storage space or use it for certain approved processes, such as a tertiary injectant in connection with certain oil or natural gas extraction processes.

23


WHAT IS CONSIDERED A SECURE GEOLOGICAL STORAGE PLACE?
Secure geological storage includes storage in deep saline formations, oil & gas reservoirs and unminable coal seams.

24

Are there requirements to meet the definition of secure geological storage under Section 45Q for EOR?

Yes, existing regulations stipulate that a secure geological storage place requires compliance and reporting under Subpart RR of the Federal Environmental Protection Agency's Greenhouse Gas Reporting Program or under the International Organization of Standardization (ISO) standard for quantifying safe long-term storage of carbon dioxide is association with EOR.

25

WHAT ARE THE APPROVED WAYS FOR A QUALIFIED FACILITY TO USE CARBON OXIDE AS OPPOSED TO STORE IN A SECURE GEOLOGICAL STORAGE PLACE?

- Existing regulations stipulate three ways for a qualified facility to use carbon oxide:
  - Chemical conversion into a compound in which such carbon oxide is securely stored.
  - Fixation through photosynthesis or chemosynthesis (such as growing bacteria).
  - Use for other purposes for which a commercial market exists.

26

DO EXISTING REGULATIONS DEFINE "COMMERCIAL MARKET"?

Yes, the existing regulations define commercial market as a market in which a product, process, or service that utilizes carbon oxide is sold or transacted on commercial terms. This is a broad definition that is not limited to any product or market. This would seem to encourage innovation such as use of carbon oxide for meat preservation or creating soft drinks.

27

ARE THEIR MINIMUM REQUIREMENTS FOR CARBON CAPTURED AND SEQUESTERED IN A SINGLE TAXABLE YEAR?

In order to be considered a qualified facility, a facility such as an ethanol plant needs to capture and sequester at least 12,500 metric tons of qualified carbon oxide.

28

CAN THE 45Q CREDIT BE RECAPTURED?

Yes, Section 45Q credits are subject to recapture if previously stored or utilized carbon oxide leaks into the atmosphere during the recapture period.

29

WHAT IS THE RECAPTURE PERIOD?

- The recapture period is the period that begins on the date of the first injection of qualified carbon oxide and ends at the earlier of three years after the taxable year for which the applicable Section 45Q credit was claimed or the date the relevant monitoring requirements end.
- The monitoring requirements end under Subpart RR of the Federal Environmental Protection Agency's Greenhouse Gas Reporting Program regulations of the ISO standard, as applicable.

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HOW ARE THE CREDITS RECAPTURED?

In general, leaked carbon oxide first reduces the Section 45Q credits available in the taxable year in which the leak is identified and reported. If the amount exceeds the carbon oxide captured in such taxable year, the excess will result in recapture in preceding taxable years following a last-in-first-out (LIFO) basis.

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RECAPTURE EXAMPLE

- [TEXT]

year	deposit	leakage	credit	recapture	against
1	250	0	250		
2	300	50	250	0	
3	100	100	0	0	
4	0	50	0	50	YEAR 2

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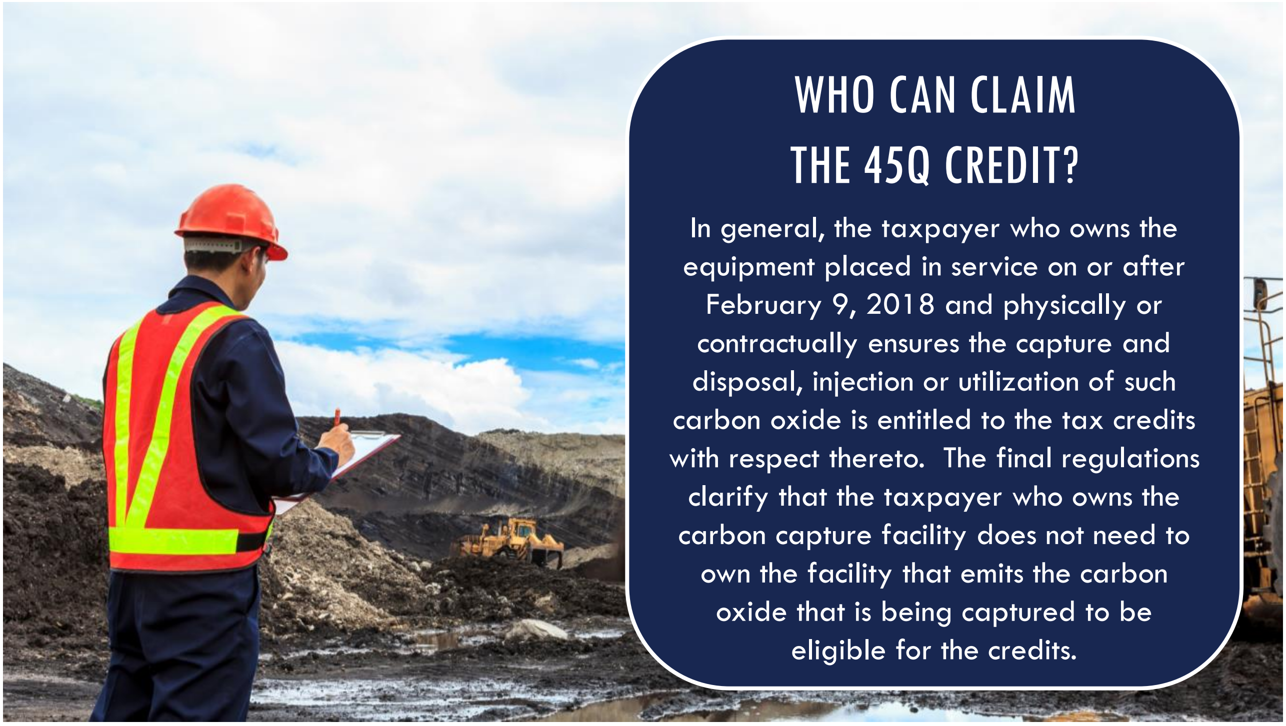

WHO CAN CLAIM THE 45Q CREDIT?

In general, the taxpayer who owns the equipment placed in service on or after February 9, 2018 and physically or contractually ensures the capture and disposal, injection or utilization of such carbon oxide is entitled to the tax credits with respect thereto. The final regulations clarify that the taxpayer who owns the carbon capture facility does not need to own the facility that emits the carbon oxide that is being captured to be eligible for the credits.

33

CAN THE OWNER OF THE CARBON CAPTURE EQUIPMENT STILL CLAIM THE 45Q CREDIT IF SOMEONE ELSE SEQUESTERS THE CARBON DIOXIDE?

Yes, an owner of the carbon capture equipment who "contractually ensures" the sequestration of carbon oxide can still claim the credit.

34

ARE THERE CONTRACTUAL REQUIREMENTS FOR ENGAGING WITH A THIRD PARTY TO SEQUESTER THE CARBON DIOXIDE?

Under the existing regulations, contractual requirements include:

- A binding written contract must be enforceable under state law and generally must not limit the amount of damages to less than 5 percent of the contract price.

The contract must include:

- Commercially reasonable terms
- Contain enforcement mechanisms
- Require the counterparty to comply with relevant tax law and regulatory requirements
- Provide information relating to recapture events (for qualified oxide intended to be disposed of in secure geological storage spaces, not used as tertiary injectant).
- Each party to the contract generally is required to report such contract (and certain other information) to the IRS on an annual basis.

35

CAN THE OWNER OF THE CARBON CAPTURE EQUIPMENT ELECT TO ALLOW THE PERSON WHO CONTRACTUALLY ENSURES THE SEQUESTRATION OF THE CARBON OXIDE TO CLAIM ALL OR A PORTION OF THE 45Q CREDIT?

Yes, the owner may make an election on an annual basis to allow the person who contractually ensures the sequestration to claim the 45Q credit. This pass-through credit mechanism provides significant flexibility for taxpayers to use or monetize a project's tax credits.

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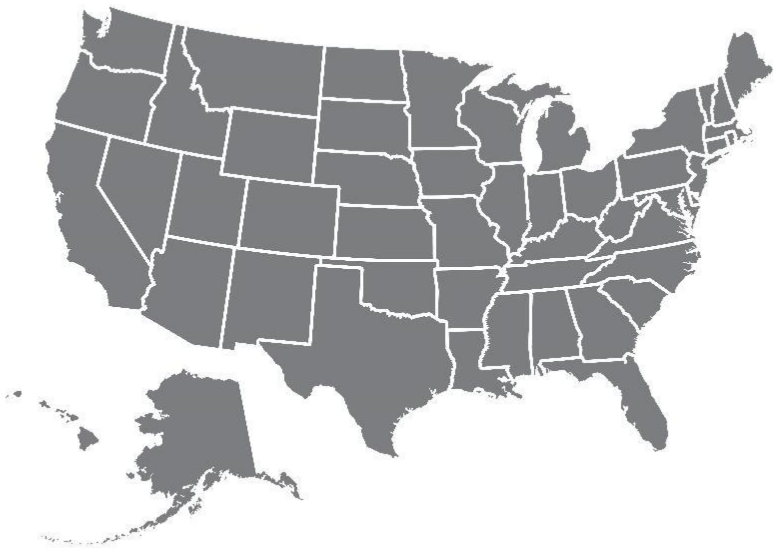
ARE THERE STATE TAX CREDITS AVAILABLE FOR TAXPAYERS CONSTRUCTING CCS PROJECTS?



Yes, several states offer tax incentives the vary on scale and timing. Texas, for example, has the widest variety of incentives, especially for projects involving enhanced oil recovery (EOR). Some states such as California, Hawaii, New York, and Washington have passed legislation adopting 100 percent clean or renewable energy mandates or goals.

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HOW TO USE THE 45Q CREDIT

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MONETIZING THE CARBON CAPTURE CREDIT

- All taxpayers are allowed to claim direct payment of the carbon capture credit for the first 5 years.
- For years 6 through 12, carbon capture credits can be sold.
- Recapture risk when carbon capture credits are monetized:
  - The original owner of the credit continues to be responsible for recapture.
  - Insurance may be available under certain circumstances.

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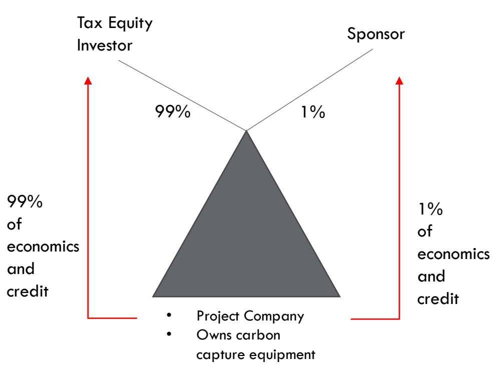
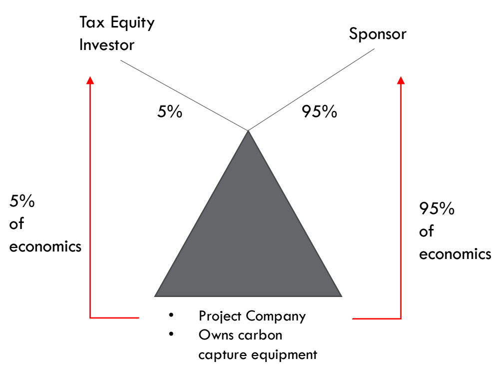
CREDIT MONETIZATION- "FLIP" PARTNERSHIPS

<u>PRE "FLIP"</u>



<u>POST "FLIP" (after recapture period)</u>



See Rev. Proc. 2020-12 for specific requirements

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IRA CHANGES TO CREDIT MONETIZATION

- IRA, in addition to increasing the 45Q credit, also provides additional monetization options.
- Before: Federal tax credits generally allocable, but not transferable (meaning can't sell them). State treatment traditionally varies.
- Now, certain credits (including the 45Q credit) can be "sold".
- Owner of qualified CCUS project can sell all or a portion of the 45Q credit to third parties (on annual basis over entire 12-year credit period).
- Generally, no gain for the CCUS project owner and no deduction for the buyer.
- Are limits to the total sales price.
- Is also a direct pay option (meaning, basically, a refundable credit) but not fully available to private businesses. Certain tax-exempt entities (including states, cities, tribal governments) can fully claim the direct pay option.

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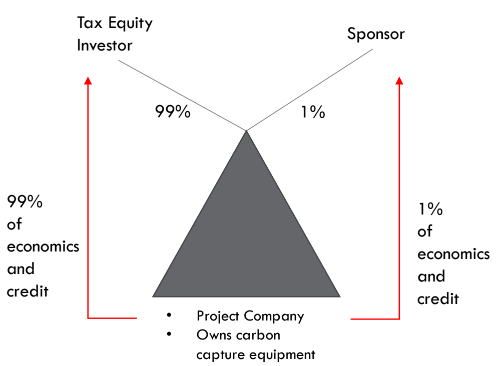
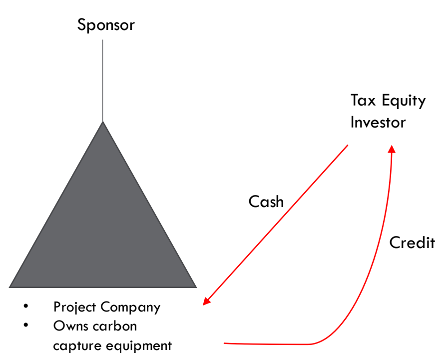
CREDIT MONETIZATION- SALE VS ALLOCATIONS

FLIP Partnership



- Investors receive credit and depreciation.
- Compliance costs (investors are partners receiving a K-1).

Sale of Credit



- Investors receive only the credit.
- "Cleaner" compliance?

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ALTERNATIVES TO PARTICIPATING IN 45Q?

- Sell the carbon stream to someone else who will install the equipment, transport and sequester the carbon:
  - Minimizes risk.
  - Avoids need for in house expertise.
  - May be necessary if a limited carbon stream.
- Joint venture – participate in the process for a share of the credits:
  - Shares risk.
  - Minimizes need for in house expertise.
- Do it Yourself:
  - Assumes risk, need for in house expertise.
  - Requires an economically significant carbon stream.

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WHAT INDUSTRIES ARE GOOD FITS FOR CARBON CAPTURE?

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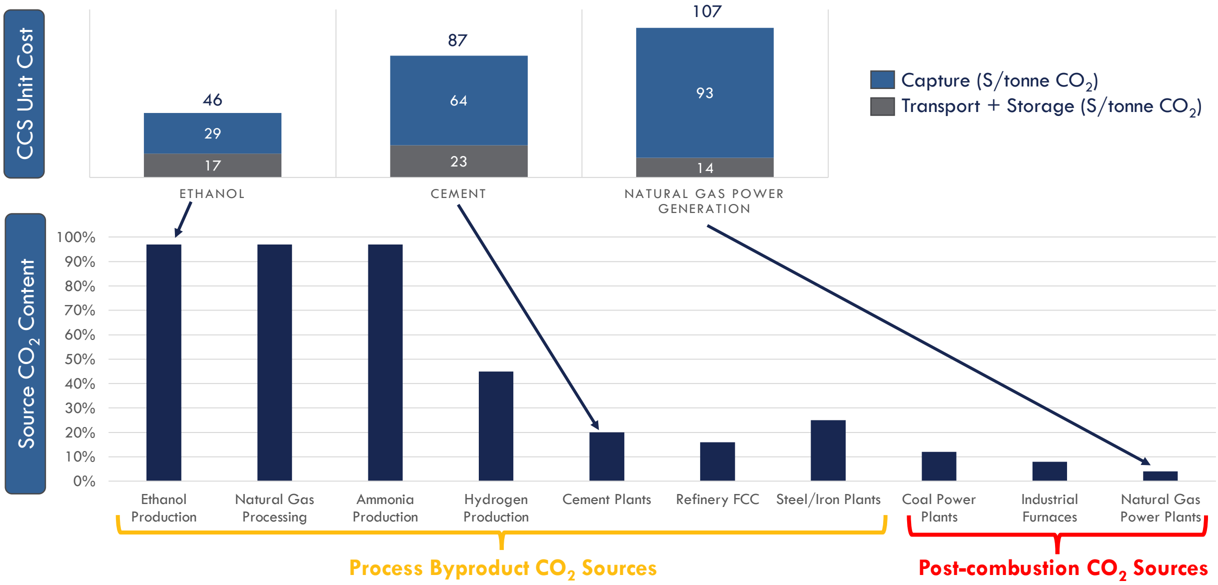
WHAT MAKES A GOOD CANDIDATE FOR CARBON CAPTURE?



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ENERGY INCENTIVES
ENHANCED & EXTENDED

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ENERGY DEDUCTION ALLOCATION PROGRAM (E-DAP)

An Opportunity for Tax Exempt Organizations

EB as a third-party firm with Professional Engineers (P.E.) licensed in all 50 states

"Designer(s)" such as the Architect, Engineer, General Contractor, Subcontractors (HVAC, Electrical, Structural)

Exempt Organization such as Healthcare, K-12, Higher Education, Government, Senior Living

The Inflation Reduction Act of 2022 was signed into law on August 16, 2022, and provides significant enhancements for several energy efficiency incentives, including the Section 179D Commercial Buildings Energy-Efficiency Tax Deduction.

Included in these provisions is an expansion, allowing all exempt orgs the ability to assign the deduction to the "designer" of the energy efficient property.

Project Costs (Structure Only)	75,000,000
Square Footage (SF)	100,000
Deduction per SF	5.00
Deduction	500,000
Designer Tax Rate	35%
Designer Tax Savings	**175,000**
Fees - Paid by Designer	
Certification Fee	30,000
Tax Exempt Entity Allocation Fee	40,000
Totals	**70,000**
Benefit Summary	
Designer (Net Benefit)	105,000
Tax Exempt Entity Allocation Fee	40,000
Eide Bailly Certification Fee	30,000
Totals	**175,000**

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Energy Efficient Commercial Buildings Deduction (§179D)

New Energy Efficient Home Credit (§45L)

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10 YEARS OF CERTAINTY

- §179D and §45L were introduced in the Energy Policy Act of 2005
- §179D and §45L were included as annual tax extenders
- §179D was made permanent at $1.80/SF in the Consolidated Appropriations Act of 2021
- §45L was extended through 2022 in the Inflation Reduction Act of 2022
- **§179D and §45L were enhanced through 2032 in the Inflation Reduction Act of 2022**

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10 YEARS OF MATERIALITY

§179D and §45L were enhanced through 2032 in the Inflation Reduction Act of 2022

§179D goes up from \$1.88/square foot in 2022 to as high as \$5.00/square foot in 2023-2032

§45L goes up from \$2,000/unit in 2022 to as high as \$5,000/unit in 2023-2032

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STACKING BY INDUSTRY

RESIDENTIAL

- §45L credit
- §179D deduction
- Cost Segregation
- Partial Dispositions
- Repairs & Maintenance
- Utility Sales Tax Exemption

MANUFACTURING

- §179D deduction
- Cost Segregation
- Qualified Improvement Property
- Partial Dispositions
- Repairs & Maintenance
- Utility Sales Tax Exemption

NONPROFIT

- §179D Energy Deduction Allocation Program (E-DAP)
- §48 Energy Credit
- Employee Retention Credit

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SECTION 179D ENERGY EFFICIENT DEDUCTION

Section 179D is available for HVAC, building envelope and lighting projects, up to $5.00 deduction per square foot.

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§179D ENERGY EFFICIENT DEDUCTION – TWO WAYS

Private

- Extended permanently
- Form 3115 back to January 1, 2006
- Building owners or tenants
- Energy modelers
- Professional Engineers licensed in state

Designers of Public

- Extended permanently
- Amended returns in open tax year
- Exempt Org assigns to designers
- Architects, Engineers and Contractors
- Energy modelers
- Professional Engineers licensed in state

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ENERGY EFFICIENT COMMERCIAL BUILDINGS DEDUCTION – PRIOR VS. TODAY

SECTION 179D PRIOR

- $1.80-$1.88 deduction per square foot
- Lighting, HVAC and Envelope
- Life-time cap
- Started in 2006 and has since been made permanent
- Applies to private owners, and designers of government buildings

SECTION 179D IN THE IRA

- Status quo for 2022

Starting in 2023 through 2032:

- Base Deduction: $0.50 to $1.00 per SF
- Bonus Deduction: $2.50 to $5.00 per SF
- Lighting, HVAC and Envelope
- **Three-year cap**
- **Enhancement for REITs**
- Applies to private owners, and designers of government, **Indian tribal government and certain tax-exempt entities buildings**

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INDUSTRY WINNERS

Square Footage Industries

- Manufacturing
- Hotels
- Casinos
- Warehouses
- Parking Garages
- Hospitals

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§45L – OVERVIEW

- $500-$5,000 credit per qualifying unit
- Residential, 3-stories or less thru 2022

  All residential 2023-32
- Sold/leased in an open tax year and prior to 1/1/2032
- Buildings with 10+ units - not a requirement, but yields a better value proposition
- The first step is a discovery call and provisional assessment

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§45L NEW ENERGY EFFICIENT HOME CREDIT – TWO WAYS

Sold

- Home Development
- Condominiums

Rented

- Apartments
- Student Living
- Senior Living
- Townhomes

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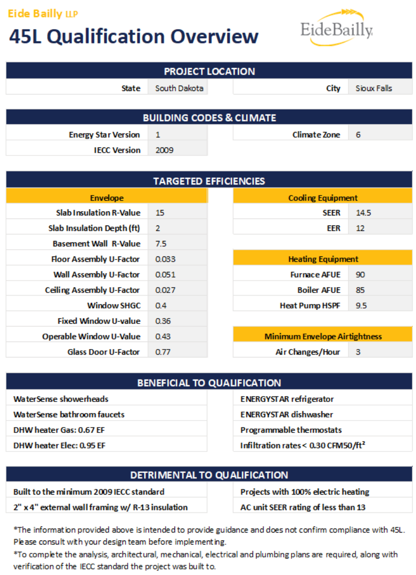
§45L – TARGETED EFFICIENCIES | PROVISIONAL ASSESSMENT



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45L Qualification Overview

PROJECT LOCATION			
State	South Dakota	City	Sioux Falls

BUILDING CODES & CLIMATE			
Energy Star Version	1	Climate Zone	6
IECC Version	2009		

TARGETED EFFICIENCIES			
Envelope		**Cooling Equipment**	
Slab Insulation R-Value	15	SEER	14.5
Slab Insulation Depth (ft)	2	EER	12
Basement Wall R-Value	7.5		
Floor Assembly U-Factor	0.033	**Heating Equipment**	
Wall Assembly U-Factor	0.051	Furnace AFUE	90
Ceiling Assembly U-Factor	0.027	Boiler AFUE	85
Window SHGC	0.4	Heat Pump HSPF	9.5
Fixed Window U-value	0.36		
Operable Window U-Value	0.43	**Minimum Envelope Airtightness**	
Glass Door U-Factor	0.77	Air Changes/Hour	3

BENEFICIAL TO QUALIFICATION	
WaterSense showerheads	ENERGYSTAR refrigerator
WaterSense bathroom faucets	ENERGYSTAR dishwasher
DHW heater Gas: 0.67 EF	Programmable thermostats
DHW heater Elec: 0.95 EF	Infiltration rates < 0.30 CFM50/ft²

DETRIMENTAL TO QUALIFICATION	
Built to the minimum 2009 IECC standard	Projects with 100% electric heating
2" x 4" external wall framing w/ R-13 insulation	AC unit SEER rating of less than 13

*The information provided above is intended to provide guidance and does not confirm compliance with 45L. Please consult with your design team before implementing.

*To complete the analysis, architectural, mechanical, electrical and plumbing plans are required, along with verification of the IECC standard the project was built to.

- Minimum qualifications are dependent on Climate Zone and applicable building code.
- Non-qualifying projects will receive the Non-Qualification Memo for future projects.

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AFFORDABLE HOUSING BOOM

- §45L credit will not reduce the Low-Income Housing Tax Credit (LIHTC) basis.
- For LIHTC properties without excess basis you can now stack the §45L credit.

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§45L NEW ENERGY EFFICIENT HOME CREDIT – PRIOR VS. TODAY

SECTION 45L PRIOR

- Expired at the end of 2021
- Units sold/leased in an open tax year
- 3-stories or less
- $1,000 credit per manufactured home
- $2,000 credit per unit for single family and multifamily homes

SECTION 45L IN THE IRA

- $2,000 per unit extended through 2022

Starting in 2023 through 2032:

- **Any number of stories (sky is the limit)**
- **No basis reduction for LIHTC affordable housing**

Multifamily homes:

- Base Credit : $500 or $1,000 per unit
- Bonus Credit : $2,500 or $5,000 per unit
- *Single family and manufactured homes:*
- Base Credit : $2,500 or $5,000 per unit

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INDUSTRY WINNERS
Nonprofit & Designers
• §179D Energy Deduction Allocation Program (E-DAP):
• Senior Living over 3 stories or no kitchen in units
• Tribal Governments
• Healthcare
• Schools
• §48 Energy Credit

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INDUSTRY WINNERS
Residential and Affordable Housing
• §179D and §45L can be stacked
• Low Income Housing Tax Credit (LIHTC) and §45L can be stacked
• §179D E-DAP for nonprofit residential (senior living)

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DISCOVERY CALL

Hi Alfred Pennyworth –

You may be eligible for the New Energy Efficient Home Credit. The recently enacted Inflation Reduction Act has extended and enhanced this energy incentive.

- Can I get on your calendar in the next week or two for a quick Discovery call?
- I would like to get our EB experts on the line and vet out the potential for this credit against your portfolio.
- Let me know of some times that work for you and I will get that invite out.

Looking forward to seeing what we can do here!

Mark Rogers
Principal, Business Credits & Incentives
Chicago, IL

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QUESTIONS?

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THANK YOU!

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Partnerships Hot Topics

December 1, 2022

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PARTNERSHIP HOT TOPICS

OSCPA Oklahoma Tax Institute
December 1, 2022

1

PRESENTER

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2

AGENDA

- PTET Regimes
- K-2 and K-3 Saga
- Partnerships and SE Tax
- IRS audit activity
- Interesting case law
- At risk reporting

3

PTET REGIMES

4

PTET BACKGROUND

- Tax Cuts and Jobs Act of 2017 (TCJA) generally limits SALT deductions to $10k
- In response, some states have adopted pass-through entity tax (PTET) elections
  - Allowing a partnership or S corporation to elect to pay income tax at the entity level
  - Contrast with treatment of Schedule C businesses
- Perhaps surprisingly, the government appears to "bless" the PTET work-around with Notice 2020-75

NOTICE 2020-75

- "The Treasury Department and the IRS intend to issue proposed regulations to provide certainty to individual owners of partnerships and S corporations in calculating their SALT deduction limitations. ….the forthcoming proposed regulations will clarify that Specified Income Tax Payments…are deductible by partnerships and S corporations **in computing their non-separately stated income or loss.**"
- Specified Income Tax Payment: "…the term "Specified Income Tax Payment" means any amount paid by a partnership or an S corporation to a State, a political subdivision of a State, or the District of Columbia (Domestic Jurisdiction) to satisfy its liability for income taxes imposed by the Domestic Jurisdiction on the partnership or the S corporation"

NOTICE 2020-75 AND TRADE OR BUSINESS

- Does the treatment under Notice 2020-75 depend upon the existence of a "trade or business"?
  - For example, can an investment partnership claim an ordinary line 1 deduction for PTET taxes paid?
- What does "**non-separately stated**" mean?
- For partnerships, Treas. Reg. 1.702-1(a): "Each partner is required to take into account separately in his return his distributive share, whether or not distributed, of each class or item of partnership income, gain, loss, deduction, or credit described in subparagraphs (1) through (9) of this paragraph."
  - Capital gains, 1231 gains/losses, charitable contributions, etc

NOTICE 2020-75 AND TRADE OR BUSINESS

- Reporting approaches
  - Line 1 ordinary deduction (conflict with existing case law and guidance)
  - Box 13 other deduction with a footnote (and determine tax consequences at the 1040 level)
  - Apportion the deduction to the various streams of income (for instance, reduce the capital gain in an investment partnership)
  - Others….
- Possible future guidance?

NOTICE 2020-75 AND TIMING

- Timing of PTET deduction depends on the partnership's method of accounting
  - Cash method- deducted when liability paid to state or local authority
  - Accrual method- deducted when "all events test" satisfied (fixed liability, determinable with reasonable accuracy, and economic performance)
    - Recurring item exception
- Some states are allowing retroactive PTET elections
  - Beware, because deduction could be claimed in current year (no federal refund for previous years)

NOTICE 2020-75 OPERATIONAL CONSIDERATIONS

- Partnerships with resident and non-resident partners
  - Generally, PTET regimes tax all income of resident partners and the apportioned income of non-resident partners
    - In order to equalize the economics, special allocations at the partnership level may be needed
    - May necessitate amending the partnership agreement

NOTICE 2020-75 OPERATIONAL CONSIDERATIONS

- Guaranteed payments
  - Some PTET regimes include guaranteed payments in tax base
  - Partners receiving only a guaranteed payment could obtain benefit for PTET taxes paid but not bear the expense at the partnership level
- Multi state partnerships- electing PTET in every state could introduce complexities

11

K-2/3 SAGA

12

K-2 AND K-3 AND THE 2021 TAX YEAR

1. What are the Schedules K-2 and K-3? (added February 16, 2022)

- The 2021 Form 1065 Schedule K-2 reports items of international tax relevance and is an extension of the Form 1065, Schedule K. It replaces line 16a-r, portions of line 20, and numerous unformatted statements attached to prior versions of the Schedule K. In general, the Form 1065 Schedule K-3 reports a partner's distributive share of items of international tax relevance and is an extension of the Form 1065 Schedule K-1. It replaces line 16, portions of line 20, and numerous unformatted statements attached to prior versions of the Schedule K-1 Form 1065, Schedule K-1. In tax years beginning in 2021, flow-through entities with items of international tax relevance must complete the new schedules, as described in the instructions and the updates posted on January 18, 2022. See FAQ #17 for links. International tax relevance is determined under each part of the new schedules. Similar revisions apply for the Forms 1120-S and 8865.

  - From https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865 (Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865))

- What are "items of international tax relevance"?

K-2 AND K-3 AND THE 2021 TAX YEAR

- Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)
  - https://www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065
  - Released January 2022- excellent timing!

The following changes are applicable for the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065) PDF:

The following note is added as the last paragraph in the section entitled "Who Must File" on page 2:

Note. A partnership with no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner claims a credit for foreign taxes paid by the partner, the partner may need certain information from the partnership to complete Form 1116. Also, a partnership that has only domestic partners may still be required to complete Part IX when the partnership makes certain deductible payments to foreign related parties of its domestic partners. The information reported in Part IX will assist any domestic corporate partner in determining the amount of base erosion payments made through the partnership, and in determining if the partners are subject to the Base Erosion and Anti-Abuse Tax. See each part for applicability.

- Could this encompass every partnership?

K-2 AND K-3: WHY?

2. Why is the IRS creating Schedules K-2 and K-3 for Forms 1065, 1120S, and 8865? (added February 16, 2022)

- The new schedules K-2 and K-3 were created to provide consistency in the reporting to partners and shareholders. Prior versions of schedules K and K-1 did not require any specific format to provide international information, resulting in what could be a confusing array of statements attached to the schedules K and K-1. The new schedules K-2 and K-3 provide greater certainty and consistency, helping partners and shareholders to voluntarily comply with their filing and reporting obligations. The greater certainty also enables the IRS to verify that partnership and S corporation items are properly reported on partners' and shareholders' returns. This should reduce the burden on both taxpayers and the IRS by reducing unnecessary inquiries and examinations that may arise due to inconsistent reporting of partnership and S corporation items.

- From https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865 (Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865))

- Reduce the burden?

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K-2 AND K-3 AND THE 2021 TAX YEAR

15. Is the IRS providing any additional exceptions for tax year 2021? (added February 16, 2022)

The IRS is providing an additional exception for tax year 2021 to filing the Schedules K-2 and K-3 for certain domestic partnerships and S corporations. To qualify for this exception, the following must be met:

- In tax year 2021, the direct partners in the domestic partnership are not foreign partnerships, foreign corporations foreign individuals, foreign estates, or foreign trusts.
- In tax year 2021, the domestic partnership or S corporation has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated, or may reasonably expected to generate foreign source income (see section 1.861-9(g)(3)).
- In tax year 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
  - Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S), and
  - Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (line 17d for Form 1120-S).
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.

- FAQ #15
- "No Knowledge"?

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K-2 AND K-3 AND THE 2021 TAX YEAR

- Penalty Relief: Notice 2021-39

SECTION 3. PENALTY RELIEF

This section provides transition relief for taxable years that begin in 2021 (processing year 2022) with respect to Schedules K-2 and K-3 to Forms 1065, 1120-S, and 8865. During this transition period, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a U.S. partner required to file Form 8865 (a "Schedule K-2/K-3 filer") will not be subject to the relevant penalties described in section 2 for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. A Schedule K-2/K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for penalty relief under this notice.

- Good faith effort?

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K-2 AND K-3 AND THE 2022 TAX YEAR

- Draft Schedule K-3 instructions create "domestic filing exception":

What's New

New exception to completing Schedule K-3. Under a new exception, in certain cases, partnerships with no or limited foreign activity are not required to furnish Schedule K-3 to you for tax years beginning in 2022. See *Domestic Filing Exception* in the Partnership Instructions for Schedules K-2 and K-3 (Form 1065).

Partnership with solely domestic activity. In many instances, a partnership with no foreign partners, no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may have reported information on Schedule K-3. For example, if you claim the foreign tax credit, you generally need certain information from the partnership on Schedule K-3, Parts II and III, to complete Form 1116 or 1118. This information should have been reported in prior years, including before the Tax Cuts and Jobs Act, with the Schedules K and K-1, and is information you need to compute the foreign tax credit limitation, which determines the amount of foreign tax credit available to you.

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K-2 AND K-3 AND THE 2022 TAX YEAR

- Draft Partnership Instructions for Schedules K-2 and K-3:
  - Domestic filing exception

1. ***No or limited foreign activity***. During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity (as defined below), or, if it does have foreign activity, such foreign activity is limited to **(a)** passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B)(iii)); **(b)** upon which not more than $300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the partnership; and **(c)** such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the partnership.

Foreign activity. For purposes of the domestic filing exception, foreign activity means any of the following. **(a)** foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder); **(b)** foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder); **(c)** ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5)); **(d)** ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5)); **(e)** ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii)); **(f)** ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).

2. ***U.S. citizen/resident alien partners.*** During tax year 2022, all the direct partners in the domestic partnership are: **(a)** individuals that are U.S. citizens; **(b)** individuals that are resident aliens (as defined in section 7701(b)(1)(A) and the regulations thereunder); **(c)** domestic decedent's estates (that is, decedent's estates that are not foreign estates as defined in section 7701(a)(31)(A)), with solely U.S. citizen and/or resident alien individual beneficiaries; **(d)** domestic grantor trusts (that is, trusts described under sections 671 through 678) that are not foreign trusts as defined in section 7701(a)(31)(B)) and that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries; or **(e)** domestic non-grantor trusts (that is, trusts subject to tax under section 641 that are not foreign trusts as defined in section 7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries.

3. ***Partner notification.*** With respect to a partnership that satisfies criteria 1 and 2, partners receive a notification from the partnership either electronically or by mail dated no later than 2 months before the due date (without extension) for filing the partnership's tax year 2022 Form 1065. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule.

4. ***No 2022 Schedule K-3 requests by the 1-month date.*** The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The "1-month date" is one month before the due date (without extension) of the partnership's Form 1065. For tax year 2022 calendar year partnerships, the 1-month date is February 15, 2023.

PARTNERSHIPS AND SE TAX

PARTNERSHIPS AND SE TAX BACKGROUND

- Section 1402(a): The term "net earnings from self-employment" means… [the] distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership…"
- Section 1402(a)(13): There shall be excluded the distributive share of any item of income or loss **of a limited partner,** as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

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PARTNERSHIPS AND SE TAX BACKGROUND

- Definition of "limited partner" for section 1402 purposes?
  - Just state law limited partners?
  - What about LLCs, LLPs, etc
- Can a true limited partner receive a guaranteed payment for services and report the rest of their income as not subject to SE tax?

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PARTNERSHIPS AND SE TAX BACKGROUND

- Draft 1065 instructions for 2021
  - "Generally, a limited partner's share of partnership income (loss) isn't included in net earnings (loss) from self-employment. Limited partners treat as self-employment earnings only guaranteed payments for services they actually rendered to, or on behalf of, the partnership to the extent that those payments are payment for those services. However, whether a partner (including a member of an LLC treated as a partnership for federal income tax purposes) qualifies as a limited partner for purposes of self-employment tax depends upon whether the partner meets the definition of a limited partner under section 1402(a)(13); **whether a partner is a limited partner under state limited partnership law is not determinative. Relevant to this determination is whether the partner merely invested in the partnership and is not actively participating in the partnership's business operations; a partner who is performing services for a partnership in their capacity as a partner and that is, based on the facts and circumstances, acting in the manner of a self-employed person is not a limited partner for self-employment tax purposes.** See Renkemeyer, Campbell & Weaver, LLP v. Commissioner, 136 T.C. 137, 150 (2011)."

PARTNERSHIPS AND SE TAX BACKGROUND

- Bolded language dropped from final forms
- Per the draft instructions and other IRS guidance (proposed regs from late 1990s, and other advisory opinions), whether a partner is a "limited partner" depends on the facts and circumstances
- In the proposed regs, IRS acknowledges is possible to have two classes of interest (a capital interest and SE tax interest) in the same partnership, provided right facts and circumstances
  - Proposed regs withdrawn after Congressional moratorium

PARTNERSHIPS AND SE TAX BACKGROUND

- The IRS often cites to *Renkemeyer*, but how far does this case actually go?
  - State law LLP- all owners similar to General Partners
  - Law firm at issue- clearly service income
  - Aggressive structuring- 99% of income came from legal services, yet taxpayers attempted to specially allocate income to a S corporation to avoid SE tax
  - Tax Court dicta: "…the intent of section 1402(a)(13) was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations (which was the archetype of limited partners at the time) would not receive credits toward Social Security coverage. The legislative history of section 1402(a)(13) does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes."

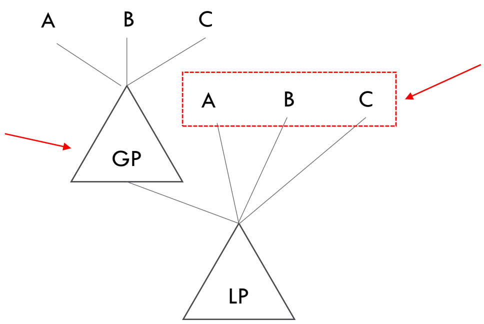
PARTNERSHIPS AND SE TAX BACKGROUND

- Although not an absolute statement, a fair conclusion could be that many practitioners advise clients to pay SE Tax on allocable income attributable to services
  - Mirroring S corporation treatment- after all, is there a rational policy reason for differentiation?
  - Particularly when the LLC is the preferred state law entity- who is a limited partner in the LLC? And is the manager member the de-facto General partner?
- Perhaps in a pure service partnership (law, accounting, etc), all of income is SE income (perhaps…what about self created goodwill/sweat equity and a return on investment)?

PARTNERSHIPS AND SE TAX BACKGROUND

- Recent Tax Court Petition/Answer
  - *Soroban Capital Partners LP v. Commissioner*
  - Simplied Fact Pattern

- GP holds ultimate authority to manage LP's business including material business decisions
- Distributive share of income reported as subject to SE Tax to GP and to A/B/C



Limited partners
- Receive guaranteed payments for services
- Distributive share not reported as subject to SE Tax because are "limited partners"

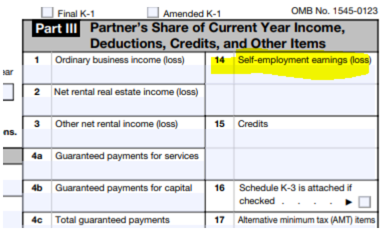
Hedge Fund converted from LLC to LP in 2015

PARTNERSHIPS AND SE TAX BACKGROUND

- IRS (in notice of deficiency) alleges all of the LP's distributive share of business income should be subject to SE tax because of the limited partner's services
  - Asking the Court to opine on section 1402(a)(13)
- Assuming the SE tax paid is appropriate for services performed, and assuming state law formalities followed, some commentators question "soundness" of IRS' position
- Common structuring involves use of multiple partnerships to isolate the services component of a partnership interest from the capital interest component
  - Meaning this is an important case (although a trial and final opinion may be years away, assuming the case does not settle)

PARTNERSHIPS AND SE TAX BACKGROUND

- In the meantime, K-1 reporting may take a variety of approaches



Final K-1 Amended K-1 OMB No. 1545-0123

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . ▶
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items

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IRS AUDIT ACTIVITY

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BBA REVIEW

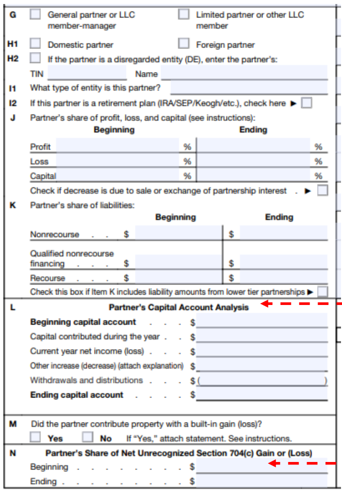
- Bipartisan Budget Act of 2015 (BBA) replaced the partnership audit procedures under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the electing large partnership rules. It is generally effective for partnership taxable years beginning on or after January 2018
- Determination of adjustments is made at the partnership level. Unless an election is made to "push out" the adjustments to partners for the year being adjusted, the partnership is liable for any tax due as a result of the adjustments
- Partners must report items consistent with the partnership return unless they attach notification of the inconsistency to their return (Form 8082)

INCREASED IRS BUDGET AND ENFORCEMENT

- IRA provides $80B plus to IRS, including for enforcement
- IRS has made numerous pronouncements about focusing on partnerships
- Will the IRS focus on the mandatory reporting it has introduced with K-1s (including K-2 and K-3)?
  - Stated differently, it appears the IRS is now requiring more disclosure from partnerships, and could this set the table for audits in the future?

INCREASED IRS BUDGET AND ENFORCEMENT

- 2021 K-1 snippet


G ☐ General partner or LLC member-manager ☐ Limited partner or other LLC member
H1 ☐ Domestic partner ☐ Foreign partner
H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN Name
I1 What type of entity is this partner?
I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ▶ ☐
J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to sale or exchange of partnership interest . ▶ ☐
K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐
L **Partner's Capital Account Analysis**
Beginning capital account . . . . $
Capital contributed during the year . . $
Current year net income (loss) . . . $
Other increase (decrease) (attach explanation) $
Withdrawals and distributions . . . $ ( )
Ending capital account . . . . . $
M Did the partner contribute property with a built-in gain (loss)?
☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.
N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

- If IRS adjusts these amounts pursuant to an audit, could it generate tax due at the partnership level? See example on next page.

Tax capital reporting

Built in gain reporting

INCREASED IRS BUDGET AND ENFORCEMENT

301.6225-1(d)(2)(iii)(B), Example 7

(7) ***Example 7.*** On its partnership return for the 2020 taxable year, Partnership reported a recourse liability of $100. During an administrative proceeding with respect to Partnership's 2020 taxable year, the IRS determines that the $100 recourse liability should have been reported as a $100 nonrecourse liability. Under paragraph (d)(2)(iii)(B) of this section, the adjustment to the character of the liability is an adjustment to an item that cannot be allocated under section 704(b). The adjustment therefore is treated as a $100 increase in income because such recharacterization of a liability could result in up to $100 in taxable income if taken into account by any person. The $100 increase in income is a positive adjustment in the residual grouping under paragraph (c)(5)(ii) of this section. There are no other adjustments for the 2020 partnership taxable year. The $100 positive adjustment is treated as a net positive adjustment under paragraph (e)(4)(i) of this section, and the total netted partnership adjustment under paragraph (b)(2) of this section is $100. Pursuant to paragraph (b)(1) of this section, the total netted partnership adjustment is multiplied by 40 percent for an imputed underpayment of $40.

INCREASED IRS BUDGET AND ENFORCEMENT

- Net effect- changing liability from recourse to nonrecourse produces partnership level tax liability, only option to make "push out" election?
- And if "tax capital", or "built in gain", or other K-1 items are substituted for recourse liability in this example, is there still a partnership level liability?

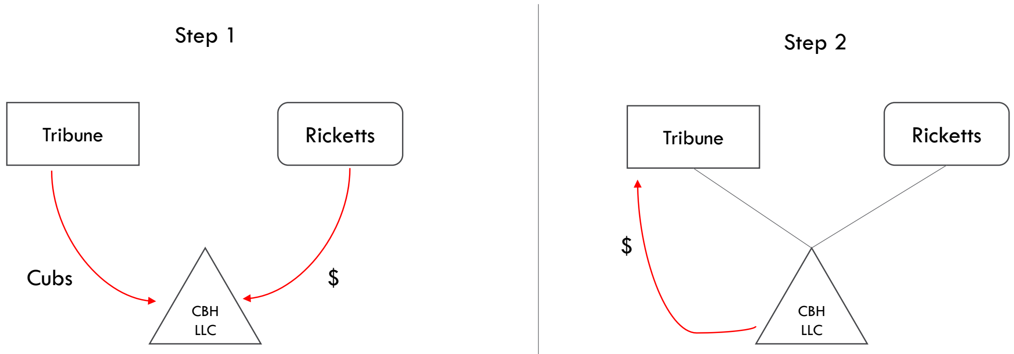
TRIBUNE MEDIA CO V COMM'R

TRIBUNE MEDIA CO V COMM'R

- Notable Subchapter K caselaw is rare
- *Tribune Media Co. et. al. v. Commissioner*, TC Memo 2021-12
- Issues
  - Disguised Sale and debt vs equity

TRIBUNE MEDIA CO V COMM'R

- Simplified fact pattern



- Cubs
- Two tranches of debt: 1) Commercial Lender, and 2) sub debt from Ricketts
- Tribune guarantees debt

TRIBUNE MEDIA CO V COMM'R

- Treas. Reg. 1.707-3(c)(1): "For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale."

TRIBUNE MEDIA CO V COMM'R

- Treas. Reg. 1.707-5(b)(1): "For purposes of § 1.707-3, if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under § 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner's allocable share of the partnership liability."
  - Debt financed distribution exception

TRIBUNE MEDIA CO V COMM'R

- Essentially, Tribune argued the distribution of cash was a debt financed distribution, and because Tribune guaranteed the debt, it was allocated all of the debt and thus the distribution did not exceed its allocable share of the debt.
- Tax Court analyzed both tranches of debt
  - Respected the 3rd party debt and Tribune's guaranty
  - But, re-classified the Rickett's debt as instead equity (resulting in disguised sale proceeds for Tribune)

TRIBUNE MEDIA CO V COMM'R PRACTITIONER POINTS

- Beware disguised sale transaction- contributed property followed by a cash distribution
- Also, liabilities assumed as part of a property contribution can trigger disguised sale treatment
- But also take advantage of the exceptions to disguised sale treatment
  - Debt financed distributions
  - Reimbursement of preformation expenditures
  - Qualified liabilities
  - Reasonable preferred returns

TRIBUNE MEDIA CO V COMM'R PRACTITIONER POINTS

- For guarantees and recourse debt, look to the "constructive liquidation test" under the section 752 regulations and who is ultimately liable for repayment
  - But also beware of regulatory changes in 2019 (not applicable to *Tribune*): facts and circumstances analysis for respecting recourse liability
- Tax Court:
  - "We agree with petitioners. Under the constructive liquidation test, Tribune bears the risk of economic loss for the senior debt. According to the terms of Tribune's guaranty of the senior debt, Tribune is obligated to pay when CBH fails to make a payment and the debt is accelerated, the creditors have exhausted their remedies, and the creditors have failed to collect the full amount of the debt. In a constructive liquidation, as contemplated by the test set forth in the regulations, the partnership fails to pay the debt, the debt comes due, the partnership assets are depleted, and the debt remains outstanding. Under the senior debt guaranty, Tribune would be required to pay in this circumstance."

TRIBUNE MEDIA CO V COMM'R PRACTITIONER POINTS

- Debt vs equity
  - Often times clients purport to loan money to a partnership when in substance the contribution could be viewed as equity
  - Is a facts and circumstances analysis: creditor rights, intent of parties, right to enforce payment, thin capitalization and debt to equity ratio, use of proceeds, and others
  - And if classified as debt and later forgiven, can produce COD ordinary income for partnership and possibly an offsetting capital loss for the creditor (character mismatch)
- Tax Court:
  - "The sub debt was equity, not bona fide debt, for tax purposes. Although the sub debt had the superficial appearance of bona fide debt, it more closely resembles equity. Most of the factors we addressed signaled equity. Many of these factors — intent of the parties, right to enforce payment, risk, identity of the interest, and use of the advance — weigh significantly toward equity.

  - Because the sub debt is equity, it cannot be allocated to Tribune as recourse debt. The portion of the special distribution funded by the sub debt thus does not qualify under the debt-financed distribution exception of the disguised sale rules."

CLARK RAYMOND AND COMPANY PLLC V COMM'R

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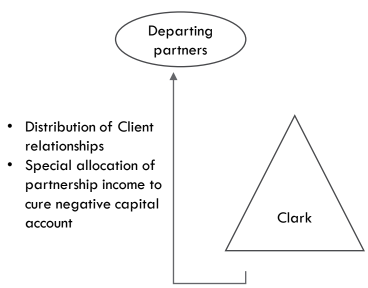
CLARK RAYMOND

- Accounting firm



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CLARK RAYMOND

- Departing partners file Form 8082 and report income inconsistent with Schedule K-1
- Audit and eventual Tax Court case

CLARK RAYMOND

- Tax Court recognizes substance of the distribution, even though is intangible property (and may have had $0 tax basis)
- Point- is possible to contribute or distribute intangible property (with $0 basis) from a partnership, and must reflect the contribution/distribution in capital accounts

CLARK RAYMOND

- Tax Court found partnership failed to allocate unrealized gain associated with client-based intangibles, contrary to partnership agreement (and 704(b) regs)
  - Treas. Reg. 1.704-1(b)(2)(iv)(e)(1): "the basic capital accounting rules…require that a partner's capital account be decreased by the fair market value of property distributed by the partnership…to such partner. To satisfy this requirement, **the capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized income, gain, loss, and deduction inherent in such property** (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for the fair market value of such property….on the date of distribution."
- Tax Court disregarded special allocation and re-allocated partnership income to all partners.
- **Point- Beware partnership boilerplate language**

CLARK RAYMOND

- Distribution of client-based intangibles drove departing partners' capital negative
- Tax Court holds Qualified Income Offset provision of partnership agreement requires income allocation to departing partners
  - Part of "alternate test for economic effect" in Treas. Reg. 1.704-1(b)(2)(ii)(d)
  - "The partnership agreement contains a "qualified income offset" if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution…will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."
- **Point- Beware negative partner capital accounts**

AT RISK ACTIVITY REPORTING

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AT RISK REPORTING

- 1065 Instructions

At-risk activity reporting requirements. If the partnership items of income, loss, or deduction reported on Schedule K-1 are from more than one activity covered by the at-risk rules, the partnership should report on an attachment to Schedule K-1 information relating to each activity as is required by *Item K. Partner's Share of Liabilities*, later. Additional information needed to enable the partner to compute the profit or loss from each at-risk activity and the amount at risk may be required to be separately reported pursuant to the Instructions for Form 6198 and Pub. 925.

If the partnership is engaged in two or more different types of at-risk activities, or a combination of at-risk activities and any other activity, attach a statement showing the partner's share of nonrecourse liabilities, partnership-level qualified nonrecourse financing, and other recourse liabilities for each activity. See Pub. 925 to determine if the partnership is engaged in more than one at-risk activity.

- K-1

22	☐ More than one activity for at-risk purposes*
23	☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

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AT RISK REPORTING

- What is an activity for section 465 purposes?
- Dearth of guidance
  - CCA 201805013:
    - "…it seems clear that Congress intended for definition of 'activity' for section 465 purposes to be a relatively narrow and asset-specific concept."
    - "…we believe it is reasonable to conclude…that the term 'activity'…is intended to mean the smallest indivisible piece or parcel of property, business asset, or integrated business unit in which that taxpayer possesses an interest."

AT RISK REPORTING

- Section 469 is not controlling
- Limited opportunities to aggregate for section 465 purposes
- Good policy? Why require a partnership to separately track activities/businesses under sections 465, 469, 199A, and others…
- At risk vs tax basis
  - Often biggest difference is debt
  - Both recourse and non-recourse liabilities provide tax basis, but only certain recourse and qualified non-recourse liabilities provide at risk basis

QUESTIONS?

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THANK YOU!

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Oklahoma Society of CPAs

Recent Developments in Federal Income Tax

December 1, 2022

Leader: Bruce McGovern

RECENT DEVELOPMENTS IN FEDERAL INCOME TAXATION

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

By

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December 1, 2022

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This recent developments outline discusses, and provides context to understand the significance of, the most important judicial decisions and administrative rulings and regulations promulgated by the Internal Revenue Service and Treasury Department during the most recent twelve months — and sometimes a little farther back in time if we find the item particularly humorous or outrageous. Most Treasury Regulations, however, are so complex that they cannot be discussed in detail and, anyway, only a devout masochist would read them all the way through; just the basic topic and fundamental principles are highlighted – unless one of us decides to go nuts and spend several pages writing one up. This is the reason that the outline is getting to be as long as it is. Amendments to the Internal Revenue Code are discussed to the extent that (1) they are of major significance, (2) they have led to administrative rulings and regulations, (3) they have affected items previously covered in the outline, or (4) they provide an opportunity to mock our elected representatives; again, sometimes at least one of us goes nuts and writes up the most trivial of legislative changes. The outline focuses primarily on topics of broad general interest (to us, at least) – income tax accounting rules, determination of gross income, allowable deductions, treatment of capital gains and losses, corporate and partnership taxation, exempt organizations, and procedure and penalties. It deals summarily with qualified pension and profit sharing plans, and generally does not deal with international taxation or specialized industries, such as banking, insurance, and financial services.

Although relatively little tax legislation was enacted in the last twelve months, there have nevertheless been many significant federal income tax developments. The Treasury Department and the IRS provided an abundance of administrative guidance and the courts issued many significant judicial decisions. The American Rescue Plan Act of 2021, Pub. L. No. 117-2, enacted on March 11, 2021, made several significant changes. The changes made by this legislation include expanding credits such as the child tax credit and earned income credit, suspending the requirement to repay excess advance premium tax credit payments for 2020, and providing exclusions for up to $10,200 of unemployment compensation received in 2020 and for cancellation of student loans. The Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, enacted on November 15, 2021, contains relatively few significant tax provisions but ends the employee retention credit of Code § 3134 for the fourth quarter of 2021. The Inflation Reduction Act, Pub. L. No. 117-169, enacted on August 16, 2022, imposes a 15 percent alternative minimum tax (AMT) on corporations with "applicable financial statement income" over $1 billion, imposes an excise tax of 1 percent on redemptions of stock by publicly traded corporations, extends through 2025 certain favorable changes to the premium tax credit of § 36B, and extends through 2028 the § 461(*l*) disallowance of "excess business losses" for noncorporate taxpayers. This outline discusses the major administrative guidance issued in the last year, summarizes recent legislative changes that, in our judgment, are the most important, and examines significant judicial decisions rendered in the last twelve months.

I. ACCOUNTING

A. Accounting Methods

B. Inventories

C. Installment Method

D. Year of Inclusion or Deduction

II. BUSINESS INCOME AND DEDUCTIONS

A. Income

B. Deductible Expenses versus Capitalization

1. Required amortization of specified research or experimental expenditures incurred after 2021. The 2017 Tax Cuts and Jobs Act, § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures. The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred. The term "specified research or experimental expenditures" is defined as research or experimental expenditures paid or incurred by the taxpayer during a taxable year in connection with the taxpayer's trade or business. The term includes expenditures for software development. Expenditures paid or incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas) are not subject to the required capitalization and amortization of § 174. Expenditures for the acquisition or improvement of land or for the acquisition or improvement of property that is depreciable under § 167 or subject to depletion under § 611 also are not subject to the required capitalization and amortization of § 174; however, allowances for depreciation under § 167 or for depletion under § 611 are treated as expenditures subject to § 174. For further explanation and details, the complete Conference Report accompanying TCJA may be found here. Amended § 174 applies to amounts paid or incurred in taxable years beginning after 2021.

2. Legal expenses incurred to defend patent infringement suits are currently deductible. Actavis Laboratories, FL, Inc. v. United States, 130 A.F.T.R.2d 2022-5601 (Ct. Fed. Cl. 8/19/22). The plaintiff in this case, Actavis Laboratories Florida, Inc. (Actavis), was the substitute agent for Watson Pharmaceuticals, Inc. (Watson). Watson manufactured both brand name and generic pharmaceutical drugs. To obtain approval of generic drugs, Watson submitted to the Food and Drug Administration abbreviated new drug applications (ANDAs). The ANDA application process for generic drugs includes a requirement that the applicant certify the status of any patents covering the respective brand name drug previously approved by the FDA (referred to as a "paragraph IV certification"). One option available to the applicant is to certify that the relevant patent is invalid or will not be infringed by the sale or use of the generic version of the drug. An applicant making this certification is required to send notice letters to the holders of the patents informing them of the certification. Such a certification is treated by statute as patent infringement and the holder of the patent is entitled to bring suit in federal district court. Watson incurred substantial legal expenses in defending patent infringement lawsuits brought by the name-brand drug manufacturers against Watson in response to the notice letters that Watson sent. Watson deducted these legal expenses on its 2008 and 2009 tax returns. Following audits of these returns, the IRS issued a notice of deficiency disallowing Watson's deductions on the basis that the costs incurred in defending the patent infringement litigation were capital expenditures under § 263(a). Watson paid the amounts sought by the IRS and, after filing amended returns requesting refunds, brought this action in the U.S. Court of Federal Claims seeking refunds of $1.9 million for 2008 and $3.9 million for 2009.

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

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

- The court's analysis and conclusions in this case are consistent with those of the Tax Court in *Mylan, Inc. & Subsidiaries v. Commissioner*, 156 T.C. No. 10 (4/27/21).

C. Reasonable Compensation

D. Miscellaneous Deductions

1. Seinfeld warned us: no double-dipping (with your PPP money)! Or, on second thought, maybe you can! Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20). Section 1102 of the CARES Act, in tandem with § 7(a)(36) of the Small Business Act (15 U.S.C. § 636(a)(36)), establishes the much-touted Paycheck Protection Program ("PPP"). The PPP was created to combat the devastating economic impact of the coronavirus pandemic. Generally speaking, the PPP facilitates bank-originated, federally-backed loans ("covered loans") to fund payroll and certain other trade or business expenses ("covered expenses") paid by taxpayers during an eight-week period following the loan's origination date. Moreover, § 1106(b) of the CARES Act allows taxpayers to apply for debt forgiveness with respect to all or a portion of a covered loan used to pay covered expenses. Section 1106(i) of the CARES Act further provides that any such forgiven debt meeting specified requirements may be excluded from gross income by taxpayer-borrowers.

Background. The CARES Act does not address whether covered expenses funded by a forgiven covered loan are deductible for federal income tax purposes. Normally, of course, covered expenses would be deductible by a taxpayer under either Code § 162, § 163, or similar provisions; however, a long-standing provision of the Code, § 265(a)(1), disallows deductions for expenses allocable to one or more classes of income "wholly exempt" from federal income tax. Put differently, § 265(a)(1) generally prohibits taxpayers from double-dipping: taking deductions for expenses attributable to tax-exempt income. Section 265 most often has been applied to disallow deductions for expenses paid to seek or obtain tax-exempt income. (For example, a taxpayer claiming nontaxable social security disability benefits pays legal fees to pursue the claim. The legal fees are not deductible under Code § 265(a)(1). *See* Rev. Rul. 87-102, 1987-2 C.B. 78.) Covered expenses, on the other hand, presumably would have been incurred by taxpayers (at least in part) regardless of the PPP. The question arises, therefore, whether covered expense deductions are disallowed by Code § 265 when all or a portion of a PPP covered loan *subsequently* is forgiven.

Notice 2020-32. The notice sets forth the IRS's position that covered expenses funded by the portion of a PPP covered loan subsequently forgiven are not deductible pursuant to § 265. The IRS reasons that regulations under § 265 define the term "class of exempt income" as any class of income (whether or not any amount of income of such class is received or accrued) that is either wholly excluded from gross income for federal income tax purposes or wholly exempt from federal income taxes. *See* Reg. § 1.265-1(b)(1). Thus, because the forgiven portion of a covered loan is nontaxable (i.e., "wholly exempt") and is tied to the taxpayer's expenditure of the loan proceeds for covered expenses, § 265 disallows a deduction for those expenses. The IRS also cites several cases in support of its position. *See Manocchio v. Commissioner*, 78 T.C. 989 (1982) (taxpayer-pilot's flight-training expenses funded with a nontaxable Veteran's Administration allowance not deductible pursuant to § 265(a)(1)), *aff'd on other grounds*, 710 F.2d 1400 (9th Cir. 1983); *Banks v. Commissioner*, 17 T.C. 1386 (1952) (deduction for business-related educational expenses disallowed under § 265(a)(1) when paid by the Veterans' Administration and not taxable to taxpayer); *Heffelfinger v. Commissioner*, 5 T.C. 985 (1945) (Canadian income taxes on income exempt from U.S. tax are not deductible in computing U.S. taxable income pursuant to § 265(a)(1)'s statutory predecessor). As if to convince itself, though, the IRS also cites as support—but without analysis—several arguably inapposite cases that do not rely upon § 265(a)(1). Instead, these cases hold that expenditures reimbursed from or directly tied to nontaxable funds are not deductible. *See, e.g., Burnett v. Commissioner*, 356 F.2d 755, 759-60 (5th Cir. 1966) (living expenses advanced by personal injury attorney to clients pending outcome of lawsuit not deductible because the expenses will be reimbursed from the lawsuit proceeds); *Wolfers v. Commissioner*, 69 T.C. 975 (1978) (taxpayer cannot deduct relocation costs funded with nontaxable proceeds from Federal Reserve Bank); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620 (1977) (similar).

A possible legislative solution? The authors doubt that Notice 2020-32 is the last word on the tax treatment of PPP covered loans and covered expenses. Apparently, many practitioners and at least a few members of Congress believe that the IRS's position in Notice 2020-32 contravenes congressional intent. *See* Chamseddine and Yauch, *Neal Plans PPP Fix to Provide Expenses Deduction*, 2020 TNTF 86-5 (5/4/20). Treasury Secretary Mnuchin, though, has defended the IRS's position. *See* Chamseddine, "Tax 101": Mnuchin Defends Nondeductibility of PPP Expenses, 2020 TNTF 87-2 (5/5/20). Furthermore, what happens to capitalized covered expenses? Are taxpayers forced to reduce basis when a portion of a covered loan is forgiven? What about outside basis adjustments for S corporations and partnerships that have paid covered expenses with the proceeds of a subsequently forgiven covered loan? Remember *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) (excludable cancellation of indebtedness increases S corporation shareholder's outside basis allowing use of previously suspended losses) followed by enactment of § 108(d)(7)(A) (legislatively overruling *Gitlitz*)?

A broader perspective. Perhaps the unstated but no less unsettling aspect of Notice 2020-32 is that the Notice fails to address adequately the inconsistent application of § 265 by the IRS and Treasury. It is well established that § 265(a)(1) disallows so-called "forward looking" deductions allocable to "wholly exempt" income (i.e., expenses paid to earn or obtain exempt income). For instance, as mentioned above § 265(a)(1) disallows a deduction for legal fees paid to pursue a nontaxable social security disability award. *See* Rev. Rul. 87-102, 1987-2 C.B. 78. Less established, however, is whether § 265 disallows so-called "backward looking" deductions (i.e., expenses funded with tax-exempt income but not paid to obtain such tax-exempt income). *Cf.* Rev. Rul. 75-232, 1975-1 C.B. 94 (taxpayer can exclude from income under § 104(a)(2) a settlement, including the portion allocated to future medical expenses, but cannot deduct that portion of the future medical expenses when incurred). For example, a taxpayer might receive an excludable bequest of artwork but nonetheless is allowed a charitable contribution deduction upon donating the artwork to a tax-exempt museum. For a thorough analysis, see Dodge, *Disallowing Deductions Paid with Excluded Income*, 32 Va. Tax Review 749 (2013).

a. Don't think you can avoid having deductions disallowed just because your PPP loan has not yet been forgiven, says the IRS. Rev. Rul. 2020-27, 2020-50 I.R.B. 1552 (11/18/20). Following the IRS's issuance of Notice 2020-32, which provides that costs are not deductible to the extent they are paid with the proceeds of a PPP loan that is forgiven, many taxpayers questioned whether they could take deductions for costs paid in 2020 with the proceeds of a PPP loan if the loan is not forgiven in 2020. In this revenue ruling, the IRS has crushed the hopes of many taxpayers. According to the ruling:

> A taxpayer … [that paid expenses with the proceeds of a PPP loan] may not deduct those expenses in the taxable year in which the expenses were paid or incurred *if, at the end of such taxable year, the taxpayer reasonably expects to receive forgiveness of the covered loan* on the basis of the expenses it paid or accrued during the covered period."

(Emphasis added.) The revenue ruling illustrates this rule in two situations. In the first, the taxpayer paid qualifying costs (payroll, mortgage interest, utilities, and rent) in 2020 with the proceeds of a PPP loan, satisfied all requirements for forgiveness of the loan, and applied for forgiveness of the loan, but the lender did not inform the taxpayer by the end of 2020 whether the loan would be forgiven. In the second situation, the facts were the same except that the taxpayer did not apply for forgiveness of the loan in 2020 and instead expected to apply for forgiveness of the loan in 2021. The ruling concludes that, in both situations, the taxpayers have a reasonable expectation that their loans will be forgiven and therefore cannot deduct the expenses they paid with the proceeds of their PPP loans. The ruling relies on two distinct lines of authority to support this conclusion. One line involves taxpayers whose deductions are disallowed because they have a reasonable expectation of reimbursement at the time they pay the costs in question. *See, e.g.*, *Burnett v. Commissioner*, 356 F.2d 755 (5th Cir. 1966) (attorney who advanced costs for client and was entitled to reimbursement if successful in the client's matter); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd*, 447 F.2d 484 (9th Cir. 1971) (same). The IRS reasons in the ruling that the taxpayers in the two situations described have a reasonable expectation of reimbursement in the form of forgiveness of their PPP loans. The second line of authority is under § 265(a)(1), which disallows deductions for any amount otherwise deductible that is allocable to one or more classes of tax-exempt income regardless of whether the tax-exempt income is received or accrued. *See* Reg. § 1.265-1(a)(1), (b). Thus, according to the ruling, the fact that the loans in the two situations have not yet been forgiven does not preclude the costs paid by the taxpayers from being allocable to tax-exempt income.

b. But taxpayers can deduct expenses paid with the proceeds of a PPP loan to the extent their applications for loan forgiveness are denied or to the extent they decide not to seek forgiveness of the loan. Rev. Proc. 2020-51, 2020-50 I.R.B. 1599 (11/18/20). This revenue procedure provides a safe harbor that allows taxpayers to claim deductions in a taxable year beginning or ending in 2020 for otherwise deductible expenses paid with proceeds of a PPP loan that the taxpayer expects to be forgiven after 2020 to the extent that, after 2020, the taxpayer's request for loan forgiveness is denied or the taxpayer decides not to request loan forgiveness. The deductions can be claimed on a timely filed (including extensions) original 2020 income tax return or information return, an amended 2020 return (or, in the case of a partnership, an administrative adjustment request for 2020), or timely filed original income tax return or information return for the subsequent year in which the request for loan forgiveness is denied or in which the taxpayer decides not to seek loan forgiveness. The deductions the taxpayer claims cannot exceed the principal amount of the PPP loan for which forgiveness was denied or will not be sought. To be eligible for the safe harbor, the taxpayer must attach a statement (titled "Revenue Procedure 2020-51 Statement") to the return on which the taxpayer claims the deductions. The statement must include information specified in the revenue procedure. The revenue procedure seems to acknowledge that, for taxpayers claiming the deductions in the subsequent taxable year in which loan forgiveness is denied, the safe harbor is unnecessary because such taxpayers would be able to deduct the expenses in the subsequent taxable year under general tax principles.

c. Congress finally has stepped in and provided legislative relief. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 276 of the 2021 Consolidated Appropriations Act, provides that, for purposes of the Internal Revenue Code:

> no deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income [of the forgiveness of a PPP loan]

The legislation also provides that, in the case of partnerships and subchapter S corporations, any amount forgiven is treated as tax-exempt income, which has the effect of providing a basis increase to the partners or shareholders. The provision applies retroactively as if it had been included in the CARES Act. In a related development, Rev. Rul. 2021-2, 2021-4 IRB 495 (1/25/2021) obsoletes Notice 2020-32 and Rev. Rul. 2020-27 discussed above. Further, Notice 2021-6, 2021-6 IRB 822 (1/19/21) waives any requirement that lenders file information returns or furnish payee statements under § 6050P (Form 1099-C, cancellation of debt) reporting the amount of qualifying forgiveness with respect to covered PPP loans (thereby obsoleting Announcement 2020-12, 2020-41 I.R.B. 893 (9/22/2020)). Finally, Announcement 2021-2, 2021-8 I.R.B. 892 (2/1/21) notifies lenders who have filed with IRS or furnished to a borrower a Form 1099-MISC, Miscellaneous Information, reporting certain payments on loans subsidized by the Administrator of the U.S. Small Business Administration as income of the borrower that the lenders must file and furnish corrected Forms 1099-MISC that exclude these subsidized loan payments.

d. But, this seems a little weird to us. Rev. Proc. 2021-20, 2021-19 I.R.B. 1150 (4/22/21). In an unusual move arguably inconsistent with annual accounting principles, the IRS has announced a safe harbor for taxpayers who did not deduct PPP loan expenses on a previously filed 2020 tax return. Taxpayers may not have deducted such expenses based upon the IRS's prior position announced in Notice 2020-32, 2020-21 I.R.B. 1 (5/1/20) and Rev. Rul. 2020-27, 2020-50 I.R.B. 1552 (11/18/20), as discussed above. Under Rev. Proc. 2021-20, "covered taxpayers" (as defined) who have not previously claimed deductions for PPP loan expenses paid or incurred between March 27, 2020 (the date the PPP loan program initially was authorized), and December 27, 2020 (the date Congress legislatively overruled the IRS) may elect to deduct those previously unclaimed expenses on their 2021 returns. Although this solution may be practical, it runs counter to annual accounting principles. *Of course, we're sure nothing can go wrong with allowing taxpayers who paid or incurred deductible expenses in 2020 to elect to deduct those expenses on their 2021 returns, right?* Granted, Rev. Proc. 2021-20 has narrow applicability. Most taxpayers would not have filed their 2020 federal income tax returns prior to December 27, 2020, when, as noted above, Congress granted legislative relief for deducting PPP loan expenses. Rev. Proc. 2021-20 also obsoletes Rev. Proc. 2020-51 discussed above.

e. The IRS has provided guidance on the timing of reporting tax-exempt income resulting from the forgiveness of PPP loans. Rev. Proc. 2021-48, 2021-49 I.R.B. 835 (11/18/21). Section 1106(i) of the CARES Act provides that the forgiveness of any PPP loan may be excluded from gross income by taxpayer-borrowers. In the case of partnerships and subchapter S corporations, any amount forgiven is treated as tax-exempt income, which has the effect of providing a basis increase to the partners or shareholders. (The clarification that the amount forgiven is treated as tax-exempt income was made with retroactive effect by a provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 276 of the 2021 Consolidated Appropriations Act.) A similar basis adjustment is required when one member of a consolidated group of corporations holds stock of another member and the other member has tax-exempt income. To apply these rules, and to take into account tax-exempt income for other purposes, such as including tax-exempt income in gross receipts, taxpayers must determine *when* the tax-exempt income resulting from forgiveness of a PPP loan should be taken into account. The IRS has provided guidance on this issue in Rev. Proc. 2021-48. According to the revenue procedure, taxpayers may treat such income as received or accrued when (1) expenses eligible for forgiveness are paid or incurred; (2) an application for PPP loan forgiveness is filed; or (3) PPP loan forgiveness is granted. Taxpayers may report tax-exempt income on a timely filed original or amended federal income tax return, information return or administrative adjustment request (AAR) under § 6227 of the Code. If a partner or subchapter S corporation shareholder receives an amended Schedule K-1, the partner or shareholder must file an amended return to the extent necessary to reflect the amended K-1. If a taxpayer reports tax-exempt income resulting from forgiveness of a PPP loan and subsequently receives forgiveness of less than the full amount reported as tax-exempt income, the taxpayer must make appropriate adjustments on an amended return. The revenue procedure indicates that form instructions for the 2021 filing season will detail how taxpayers can report tax-exempt income consistently with this guidance, but that taxpayers do not need to wait until the instructions are published to apply the guidance provided by this revenue procedure.

f. Guidance for partnerships and consolidated groups regarding amounts excluded from gross income and deductions relating to PPP loans. Rev. Proc. 2021-49, 2021-49 I.R.B. 838 (11/18/21). In this revenue procedure, the IRS has provided guidance for partnerships and their partners regarding (1) allocations under § 704(b) of tax-exempt income arising from the forgiveness of PPP loans and the receipt of certain other COVID-related relief, (2) allocations under § 704(b) of deductions resulting from expenditures attributable to forgiven PPP loan proceeds and the proceeds of certain other COVID-related relief, and (3) the corresponding adjustments to the partners' bases in their partnership interests (so-called "outside basis") under § 705. The revenue procedure also provides guidance for consolidated groups of corporations regarding the corresponding adjustments to the basis of stock of subsidiary members of the group held by other group members to reflect tax-exempt income resulting from the forgiveness of PPP loans and the receipt of certain other COVID-related relief.

With respect to partnerships, the revenue procedure generally provides that, if the partnership satisfies specified requirements and complies with certain information reporting requirements, the IRS will treat the taxpayer's allocation of tax-exempt income and deductions as made in accordance with § 704(b), i.e., will respect the allocation. The requirements the partnership must satisfy are: (1) the allocation of deductions resulting from expenditures giving rise to the forgiveness of a PPP Loan is determined under Reg. § 1.704-1(b)(3), according to the partners' overall economic interests in the partnership, (2) the allocation of amounts treated as tax exempt is made in accordance with the allocation of the deductions just described, and (3) the partnership complies with special rules if any expenditure giving rise to the forgiveness of a PPP Loan is required to be capitalized. To comply with information reporting requirements, a partnership must report to the IRS all partnership items whose tax treatment is described in the revenue procedure as required by the IRS in forms, instructions, or other guidance.

With respect to consolidated groups, section 5 of the revenue procedure provides that the IRS will treat the forgiveness of a PPP loan (and the receipt of certain other COVID-related relief) as tax-exempt income for purposes of Reg. § 1.1502-32(b)(2)(ii). The result of this treatment is that a member of a consolidated group of corporations that holds stock of another member must adjust its basis in the stock for the PPP loan forgiveness (or other COVID-related relief) received by the other group member. A member of a consolidated group can rely on this treatment only if the consolidated group attaches a signed statement to its consolidated tax return indicating that all affected taxpayers in the consolidated group are relying on section 5 of the revenue procedure and are reporting consistently.

Taxpayers can apply this revenue procedure for any taxable year ending after March 27, 2020.

g. Partnerships subject to the centralized audit regime that experienced PPP loan forgiveness and that filed returns before Rev. Proc. 2021-48 and Rev. Proc. 2021-49 were issued can file amended returns on or before December 31, 2021. Rev. Proc. 2021-50, 2021-49 I.R.B. 844 (11/18/21). Generally, § 6031(b) prohibits partnerships subject to the centralized audit regime enacted by the Bipartisan Budget Act of 2015 (BBA partnerships) from amending the information required to be furnished to their partners on Schedule K-1 after the due date of the partnership return, unless specifically authorized by the Secretary of the Treasury or her delegate. This revenue procedure provides such authorization. Specifically, the revenue procedure authorizes BBA partnerships to file amended partnership returns and furnish amended Schedules K-1 to partners if they filed partnership tax returns on Form 1065 and furnished Schedules K-1 to partners prior to the issuance of Rev. Proc. 2021-48 or Rev. Proc. 2021-49 (discussed above) for partnership taxable years ending after March 27, 2020. To take advantage of this opportunity, a BBA partnership must file a Form 1065 (with the "Amended Return" box checked) and furnish corresponding amended Schedules K-1 to its partners on or before December 31, 2021. The BBA partnership must clearly indicate the application of this revenue procedure on the amended return and write "FILED PURSUANT TO REV PROC 2021-50" at the top of the amended return and attach a statement with each amended Schedule K-1 furnished to its partners with the same notation.

2. Go ahead and deduct 100 percent of the cost of that business meal, at least through 2022. A provision of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE, Title I, § 210 of the 2021 Consolidated Appropriations Act, amends § 274(n)(2), which sets forth exceptions to the normal 50 percent limitation on deducting business meals, to add an additional exception. The exception is for the cost of food or beverages provided by a restaurant paid or incurred before January 1, 2023. This rule applies to amounts paid or incurred after December 31, 2020.

a. *Seriously, it's come to this?* Whole Foods and Costco are not "restaurants," but your favorite food truck and street vendor are. As for your "go to" catering company, who knows? Notice 2021-25, 2021-17 I.R.B. 1118 (4/8/21). According to the IRS, a "restaurant" within the meaning of amended § 274(n)(2) means "a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises." Notice 2021-25 further states that a "restaurant" does not include a business primarily selling "pre-packaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk." Notice 2021-25 goes on to provide that regardless of whether the facility is operated by a third-party under contract with an employer, a § 274(n)(2) "restaurant" is neither (i) an employer's on-premises eating facility used in furnishing meals excluded from its employees' gross income under § 119 nor (ii) an employer-operated eating facility treated as a de minimis fringe under § 132(e)(2).

b. Are your employees traveling on business getting by on Slim Jims from the 7-Eleven? No worries! Go ahead and treat the meal portion of the per diem rate as being attributable to food or beverages provided by a restaurant. Notice 2021-63, 2021-49 I.R.B. 835 (11/16/21). Generally, taxpayers must comply with the substantiation requirements of § 274(d) in order to deduct traveling expenses, including meals while away from home. Taxpayers can use a per diem rate to substantiate the amount of ordinary and necessary business expenses paid or incurred for lodging, meals, and incidental expenses. *See* Rev. Proc. 2019-48, 2019-51 I.R.B. 1392. Nevertheless, the meal portion of the per diem rate is normally subject to the 50 percent limitation of § 274(n)(1) on deducting meals as business expenses. Congress's authorization of a 100 percent deduction for the cost of meals provided by a restaurant created a dilemma for employers using a per diem rate because employees receiving per diems normally are not required to turn in receipts, which means that employers providing per diems don't have any basis for determining whether the meal portion of the per diem rate is subject to a 50-percent or a 100-percent limitation. The IRS has resolved this issue in Notice 2021-63, which provides that, if an employer properly applies the rules of Rev. Proc. 2019-48, the employer can treat the meal portion of a per diem rate or allowance as being attributable to food or beverages provided by a restaurant. This means that, even if an employee traveling on business gets take-out sandwiches from a convenience store, or stays in an extended stay hotel room with a kitchen and cooks his or her own meals, the employer can deduct 100 percent of the meal portion of the per diem. This rule applies to costs paid or incurred after December 31, 2020, and before January 1, 2023.

- *Self-employed individuals*. The notice indicates that this same rule applies (and for the same period of time) to the meal portion of the per diem rate for self-employed individuals traveling away from home.

3. Standard mileage rates for 2022. Notice 2022-3, 2022-2 I.R.B. 308 (12/17/21). The standard mileage rate for business miles in 2022 goes up to 58.5 cents per mile (from 56 cents in 2021) and the medical/moving rate goes up to 18 cents per mile (from 16 cents in 2021). The charitable mileage rate remains fixed by § 170(i) at 14 cents. The portion of the business standard mileage rate treated as depreciation is unchanged compared to 2021 and remains 26 cents per mile for 2022. The maximum standard automobile cost may not exceed $56,100 (up from $51,100 in 2021) for passenger automobiles (including trucks and vans) for purposes of computing the allowance under a fixed and variable rate (FAVR) plan.

- The notice reminds taxpayers that (1) the business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed miscellaneous itemized deductions for 2022, and (2) the standard mileage rate for moving has limited applicability for the use of an automobile as part of a move during 2022 because, in the 2017 Tax Cuts and Jobs Act, Congress disallowed the deduction of moving expenses for 2022 (except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station, who can still use the standard mileage rate for moving).

a. Given the price at the pumps, it's no surprise the IRS has increased the standard mileage rate for 2022 effective July 1, 2022. Announcement 2022-13, 2022-26 I.R.B. 1185 (6/10/22). Because of recent increases in the price of fuel, the IRS has increased the standard mileage rates for 2022. The increased standard mileage rates apply to deductible transportation expenses paid or incurred for business, medical, or moving expense purposes on or after July 1, 2022, and to mileage allowances that are paid both (1) to an employee on or after July 1, 2022, and (2) for transportation expenses paid or incurred by the employee on or after July 1, 2022. Taking into account these increases, the standard mileage rates for 2022 are as follows:

Category	Jan. 1-Jun. 30, 2022	Jul. 1-Dec. 31, 2022
Business miles	58.5 cents	62.5 cents
Medical/moving	18 cents	22 cents
Charitable mileage	14 cents	14 cents

The announcement modifies Notice 2022-3, 2022-2 I.R.B. 308. Except as modified, all other provisions of Notice 2022-3 continue to apply.

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

E. Depreciation & Amortization

1. Section 280F 2022 depreciation tables for business autos, light trucks, and vans. Rev. Proc. 2022-17, 2022-13 I.R.B. 930 (3/16/22). Section 280F(a) limits the depreciation deduction for passenger automobiles. For this purpose, the term "passenger automobiles" includes trucks and vans with a gross vehicle weight of 6,000 pounds or less. The IRS has published depreciation tables with the 2022 depreciation limits for business use of passenger automobiles acquired after September 27, 2017, and placed in service during 2022:

2022 Passenger Automobiles with § 168(k) first year recovery:	
1st Tax Year	$19,200
2nd Tax Year	$18,000
3rd Tax Year	$10,800
Each Succeeding Year	$ 6,460
2022 Passenger Automobiles (no § 168(k) first year recovery):	
1st Tax Year	$11,200
2nd Tax Year	$18,000
3rd Tax Year	$10,800
Each Succeeding Year	$ 6,460

For leased vehicles used for business purposes, § 280F(c)(2) requires a reduction in the amount allowable as a deduction to the lessee of the vehicle. Under Reg. § 1.280F-7(a), this reduction in the lessee's deduction is expressed as an income inclusion amount. The revenue procedure provides a table with the income inclusion amounts for lessees of vehicles with a lease term beginning in 2022. For 2022, this income inclusion applies when the fair market value of the vehicle exceeds $56,000.

F. Credits

1. More guidance on the employee retention credit. Notice 2021-49, 2021-34 I.R.B. 316 (8/4/21). Section 9651 of the 2021 American Rescue Plan added Code § 3134, which provides an employee retention credit against specified payroll taxes for eligible employers, including tax-exempt organizations, that pay qualified wages (including certain health plan expenses) to employees after June 30, 2021, and before January 1, 2022. Previously, Congress had provided for an employee retention credit in § 2301 of the CARES Act, which applies to qualified wages paid after March 12, 2020, and before January 1, 2021, and in § 207 of the Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the 2021 Consolidated Appropriations Act, which applies to qualified wages paid after December 31, 2020, and before July 1, 2021. Thus, the CARES Act provided an employee retention credit for much of 2020, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 provided an employee retention credit for the first two quarters of 2021, and the 2021 American Rescue Plan provided an employee retention credit for the last two quarters of 2021. This notice provides guidance on the employee retention credit authorized by Code § 3134, which is available during the last two quarters of 2021. The notice also amplifies two earlier notices, Notice 2021-20, 2021-11 I.R.B. 922, which addresses the employee retention credit in effect for 2020, and Notice 2021-23, 2021-16 I.R.B. 1113, which addresses the employee retention credit in effect for the first two quarters of 2021.

As originally enacted in the CARES Act, the employee retention credit was not available to an employer if the employer or any member of its controlled group received a Paycheck Protection Program (PPP) loan. The Taxpayer Certainty and Disaster Tax Relief Act of 2020, Division EE of the 2021 Consolidated Appropriations Act, enacted in December 2020, changed this rule retroactively. Under the revised rule, an employer that receives a PPP loan can still qualify for an employee retention credit, but cannot use the same wages to qualify for both forgiveness of the PPP loan and the employee retention credit.

Notice 2021-49 provides guidance on several important issues, including:

- The definition of a "full-time employee" for purposes of the employee retention credit.
- Whether cash tips can be treated as qualified wages.
- Whether wages paid to an employee who owns more than 50 percent (majority owner) or to the spouse of a majority owner may be treated as qualified wages.

***Note*:** the Infrastructure Investment and Jobs Act, enacted on November 15, 2021, ends the employee retention credit for the fourth quarter of 2021.

a. The IRS has provided a safe harbor permitting taxpayers to exclude the forgiveness of a PPP loan and certain other items from gross receipts for purposes of determining eligibility for the employee retention credit. Rev. Proc. 2021-33, 2021-34 I.R.B. 327 (8/10/21). An employer may be eligible for the employee retention credit if its gross receipts for a calendar quarter decline by a certain percentage as compared to a prior calendar quarter. The method used to determine if an employer is an eligible employer based on experiencing the required percentage decline in gross receipts varies depending on the calendar quarter for which the employer is determining its eligibility for the employee retention credit. For example, according to section III.C of Notice 2021-23, 2021-16 I.R.B. 1113, for the first and second calendar quarters of 2021, an employer generally is an eligible employer based on a decline in gross receipts if its gross receipts for the calendar quarter are less than 80 percent of its gross receipts for the same calendar quarter in 2019. For this purpose, a taxable employer's gross receipts are determined under the rules of § 448(c) and the gross receipts of a tax-exempt employer are determined by reference to § 6033. Under these rules, the forgiveness of a PPP loan would be included in an employer's gross receipts, which could have the effect of making the employer ineligible for the employee retention credit. This revenue procedure provides a safe harbor under which an employer can exclude the forgiveness of a PPP loan from gross receipts for purposes of determining eligibility for the employee retention credit. An employer can take advantage of the safe harbor by consistently applying it in determining eligibility for the employee retention credit. According to the revenue procedure, an employer consistently applies the safe harbor by (1) excluding the amount of the forgiveness of any PPP loan from gross receipts for each calendar quarter in which gross receipts for that calendar quarter are relevant in determining eligibility to claim the employee retention credit, and (ii) applying the safe harbor to all employers treated as a single employer under the employee retention credit aggregation rules. Employers are required to retain in their records support for the employee retention credit claimed, including their use of the safe harbor.

- *Safe harbor also applies to shuttered venue operator grants and restaurant revitalization grants.* The safe harbor provided by Rev. Proc. 2021-33 also applies to two congressionally authorized grants. The first, known as shuttered venue operator grants, were authorized by section 324 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, enacted in December 2020 as part of the Consolidated Appropriations Act, 2021. This legislation authorized the Small Business Administration to make grants to eligible live venue, performing arts, and museum operators and promoters to be used for certain qualifying expenses, including payroll costs. The second grant is the restaurant revitalization grant, which was authorized by section 5003 of the American Rescue Plan Act of 2021, enacted in March 2021. Restaurant revitalization grants are authorized to be made to qualifying restaurants and food vendors to be used for certain qualifying expenses, including payroll costs. Like forgiveness of PPP loans, these two grants normally would be included in gross receipts in determining eligibility for the employee retention credit. According to Rev. Proc. 2021-33, employers receiving these grants can use the safe harbor provided by the revenue procedure to exclude them from gross receipts in determining eligibility for the employee retention credit.

b. Employers that had the employee retention credit rug pulled out from under them can avoid penalties. Notice 2021-65, 2021-51 I.R.B. 880 (12/6/21). Employers eligible for the employee retention credit had two options to receive the credit. They could (1) receive advance payment of the credit, or (2) reduce employment tax deposits in anticipation of receiving the credit. An advance payment of any portion of the employee retention credit to an employer in excess of the amount to which the employer is entitled is an erroneous refund that the employer must repay. In this notice, the IRS has provided relief from penalties for employers that used one of these options in anticipation of receiving an employee retention credit for the fourth quarter of 2021. The Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, enacted on November 15, 2021, ends the employee retention credit of Code § 3134 for the fourth quarter of 2021 (except for so-called "recovery startup businesses"). This notice clarifies steps employers (other than recovery startup businesses) should take if they (1) paid wages after Sept. 30, 2021, (2) received an advance payment of the employee retention credit for those wages or reduced employment tax deposits in anticipation of the credit for the fourth quarter of 2021, and (3) are now ineligible for the credit due to the repeal of the employee retention credit. The notice provides that employers (other than recovery startup businesses) that received advance payments for fourth quarter wages of 2021 will avoid failure-to-pay penalties if they repay those amounts by the due date of their employment tax returns. Employers (other than recovery startup businesses) that reduced deposits on or before Dec. 20, 2021, for wages paid during fourth calendar quarter of 2021 in anticipation of receiving the employee retention credit, will not be subject to a failure-to-deposit penalty with respect to the retained deposits if they take specified steps.

- The notice provides that employers that do not qualify for penalty relief under the notice may reply to an IRS notice about a penalty with an explanation and the IRS will consider reasonable cause relief pursuant to § 6656(a).

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

G. <u>Natural Resources Deductions & Credits</u>

H. <u>Loss Transactions, Bad Debts, and NOLs</u>

1. Disallowance of excess business losses of noncorporate taxpayers extended through 2028. The 2017 Tax Cuts and Jobs Act enacted Code § 461(*l*), which disallows the deduction of "excess business losses" (over $250,000 for single filers and $500,000 for joint filers) of noncorporate taxpayers. Losses disallowed by § 461(*l*) are carried over to the next taxable year and are treated as NOL carryforwards. As enacted, the provision was effective for tax years beginning before January 1, 2027. The Inflation Reduction Act, § 13903, extends the effective date of § 461(*l*) through tax years ending before January 1, 2029.

I. <u>At-Risk and Passive Activity Losses</u>

III. INVESTMENT GAIN AND INCOME

A. <u>Gains and Losses</u>

B. <u>Interest, Dividends, and Other Current Income</u>

C. <u>Profit-Seeking Individual Deductions</u>

D. <u>Section 121</u>

E. <u>Section 1031</u>

F. <u>Section 1033</u>

G. <u>Section 1035</u>

H. <u>Miscellaneous</u>

IV. COMPENSATION ISSUES

A. <u>Fringe Benefits</u>

1. Limits for contributions to health savings accounts for 2023. Rev. Proc. 2022-24, 2022-20 I.R.B. 1075 (4/29/22). The IRS has issued the inflation-adjusted figures for contributions to health savings accounts. For calendar year 2023, the annual limitation on deductions under § 223(b)(2)(A) for an individual with self-only coverage under a high deductible health plan is $3,850. For calendar year 2023, the annual limitation on deductions under § 223(b)(2)(B) for an individual with family coverage under a high deductible health plan is $7,750. For this purpose, for calendar year 2023, a "high deductible health plan" is defined under § 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,500 for self-only coverage or $3,000 for family coverage, and for which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $7,500 for self-only coverage or $15,000 for family coverage.

2. There are no adverse tax consequences for employees if they forgo their vacation, sick, or personal leave in exchange for the employer's contributions to charitable organizations providing aid to victims of the further Russian invasion of Ukraine. Notice 2022-28, 2022-3 I.R.B. 1182 (5/19/22). In this notice, the IRS has provided guidance on the tax treatment of cash payments that employers make pursuant to leave-based donation programs to aid victims of the further Russian invasion of Ukraine that began on February 24, 2022. For this purpose, victims of the further Russian invasion of Ukraine include citizens and residents of Ukraine, individuals working, traveling, or currently present in Ukraine, and refugees from Ukraine. Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations described in § 170(c). The notice provides that: (1) cash payments an employer makes before

January 1, 2023, to charitable organizations described in § 170(c) to aid victims of the further Russian invasion of Ukraine in exchange for vacation, sick, or personal leave that its employees elect to forgo will not be treated as gross income, wages, or compensation of the employees; and (2) employees making or having the opportunity to make such an election will not be treated as having constructively received gross income, wages, or compensation. Employers are permitted to deduct these cash payments either under the rules of § 170 as a charitable contribution or under the rules of § 162 as a business expense if the employer otherwise meets the requirements of either provision. Employees who make the election cannot claim a charitable contribution deduction under § 170 for the value of the forgone leave. The employer should not include cash payments made pursuant to the program in Box 1, 3 (if applicable), or 5 of the employee's Form W-2.

B. Qualified Deferred Compensation Plans

1. Final regulations provide guidance under § 401 relating to new life expectancy and distribution period tables used to calculate minimum distributions for 2022 from qualified plans, IRAs, and annuities. T.D. 9930, Updated Life Expectancy and Distribution Period Tables Used for Purposes of Determining Minimum Required Distributions, 85 F.R. 72472 (11/12/20). The Treasury Department and the IRS have finalized proposed regulations that provide guidance on the use of updated life expectancy and distribution period tables under Reg. § 401(a)(9)-9. *See* REG-132210-18, Updated Life Expectancy and Distribution Period Tables Used for Purposes of Determining Minimum Required Distributions, 84 F.R. 60812 (11/8/19). In general, the proposed regulations seek to update the existing tables using current mortality data based on mortality rates for 2021. The new tables allow for longer life expectancies than the current tables under the existing regulations and generally result in a reduction of required minimum distributions. In turn, this allows for retention of larger amounts in retirement accounts in contemplation of participants having slightly longer lives. The preamble to the final regulations gives the following example:

> "[a] 72-year-old IRA owner who applied the Uniform Lifetime Table under formerly applicable § 1.401(a)(9)-9 to calculate required minimum distributions used a life expectancy of 25.6 years. Applying the Uniform Lifetime Table set forth in these regulations, a 72-year-old IRA owner will use a life expectancy of 27.4 years to calculate required minimum distributions."

The updated life expectancy and distribution period tables apply to distribution calendar years beginning on or after January 1, 2022. Thus, for an individual who attains the age at which required minimum distributions must begin (age 72) in 2021, the regulations would not apply to the distribution for the 2021 calendar year (which must be taken by April 1, 2022). The regulations would apply to the required minimum distribution for the individual's 2022 calendar year, which must be taken by December 31, 2022. The regulations also include a transition rule that applies under certain circumstances if an employee dies prior to January 1, 2022. The transition rule applies in three situations: (1) the employee died with a non-spousal designated beneficiary; (2) the employee died after the required beginning date without a designated beneficiary; and (3) the employee, who is younger than the designated beneficiary, died after the required beginning date. Under these circumstances, a set of specific rules applies in relation to the distribution period for calendar years following the calendar year of the employee's death. A similar transition rule applies if an employee's sole beneficiary is the employee's surviving spouse and the spouse died before January 1, 2022.

The following table compares selected life expectancies used for calculating RMDs under the old tables, which apply through 2021, and the new tables, which apply to distribution calendar years beginning on and after January 1, 2022:

Age	Life Expectancy Factor	RMD with Prior Year-End Account Balance of $100,000	Age	Life Expectancy Factor	RMD with Prior Year-End Account Balance of $100,000
2021 Distributions			*2022 Distributions*		
72	25.6	$3,906	72	27.4	$3,650
73	24.7	$4,049	73	26.5	$3,774
74	23.8	$4,202	74	25.5	$3,922
75	22.9	$4,367	75	24.6	$4,065
80	18.7	$5,348	80	20.2	$4,951
85	14.8	$6,757	85	16.0	$6,250
90	11.4	$8,772	90	12.2	$8,197

2. **Some inflation-adjusted numbers for 2022.** Notice 2021-61, 2021-47 I.R.B. 738 (11/4/21).

- The limit on elective deferrals in §§ 401(k), 403(b), and 457 plans is increased to $20,500 (from $19,500) with a catch-up provision for employees aged 50 or older that remains unchanged at $6,500.

- The limit on contributions to an IRA remains unchanged at $6,000. The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $68,000-$78,000 (from $66,000-$76,000) for single filers and heads of household, increased to $109,000-$129,000 (from $105,000-$125,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $204,000-$214,000 (from $198,000-$208,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $204,000-$214,000 (from $198,000-$208,000) for married couples filing jointly, and increased to $129,000-$144,000 (from $125,000-$140,000) for singles and heads of household.

- The limit on the annual benefit from a defined benefit plan under § 415 is increased to $245,000 (from $230,000).

- The limit for defined contribution plans is increased to $61,000 (from $58,000).

- The amount of compensation that may be taken into account for various plans is increased to $305,000 (from $290,000), and is increased to $450,000 (from $430,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $68,000 (from $66,000) for married couples filing jointly, increased to $51,000 (from $49,500) for heads of household, and increased to $34,000 (from $33,000) for singles and married individuals filing separately.

3. Some inflation-adjusted numbers for 2023. Notice 2022-55, 2022-45 I.R.B. 443 (10/21/22).

- The limit on elective deferrals in §§ 401(k), 403(b), and 457 plans is increased to $22,500 (from $20,500) with a catch-up provision for employees aged 50 or older that is increased to $7,500 (from $6,500).

- The limit on contributions to an IRA is increased to $6,500 (from $6,000). The AGI phase-out range for contributions to a traditional IRA by employees covered by a workplace retirement plan is increased to $73,000-$83,000 (from $68,000-$78,000) for single filers and heads of household, increased to $116,000-$136,000 (from $109,000-$129,000) for married couples filing jointly in which the spouse who makes the IRA contribution is covered by a workplace retirement plan, and increased to $218,000-$228,000 (from $204,000-$214,000) for an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered. The phase-out range for contributions to a Roth IRA is increased to $218,000-$228,000 (from $204,000-$214,000) for married couples filing jointly, and increased to $138,000-$153,000 (from $129,000-$144,000) for singles and heads of household.

- The limit on the annual benefit from a defined benefit plan under § 415 is increased to $265,000 (from $245,000).

- The limit for annual additions to defined contribution plans is increased to $66,000 (from $61,000).

- The amount of compensation that may be taken into account for various plans is increased to $330,000 (from $305,000), and is increased to $490,000 (from $450,000) for government plans.

- The AGI limit for the retirement savings contribution credit for low- and moderate-income workers is increased to $73,000 (from $68,000) for married couples filing jointly, increased to $54,750 (from $51,500) for heads of household, and increased to $36,500 (from $34,000) for singles and married individuals filing separately.

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

The SECURE Act changes to RMDs from inherited retirement accounts. A provision of the SECURE Act, Division O, Title IV, § 401 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(E) to modify the required minimum distribution (RMD) rules for inherited retirement accounts (defined contribution plans and IRAs). The amendments require all funds to be distributed by the end of the 10th calendar year following the year of death (the "10-year rule"). The statute contains no requirement to withdraw any minimum amount before that date. Section 401(a)(9)(H)(i)(II), as also amended by the SECURE Act, provides that this rule applies whether or not RMDs to the employee or IRA owner have begun. The current rules, which permit taking RMDs over life expectancy, continue to apply to a designated beneficiary who is an "eligible designated beneficiary," which is any of the following: (1) a surviving spouse, (2) a child of the participant who has not reached the age of majority, (3) disabled within the meaning of § 72(m)(7), (4) a chronically ill individual within the meaning of § 7702B(c)(2) with some modifications, or (5) an individual not in any of the preceding categories who is not more than 10 years younger than the deceased individual. These changes generally apply to distributions with respect to those who die after December 31, 2019.

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

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

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

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

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

a. The IRS will not assert that the 50% excise tax of § 4974 is due from those who failed to take certain RMDs from inherited retirement accounts in 2021 or 2022. Notice 2022-53, 2022-45 I.R.B. 437 (10/7/22). This notice announces that, when the proposed regulations described above become final, the final regulations will apply no earlier than the 2023 distribution calendar year. The notice also addresses the tax treatment of individuals who failed to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule set forth in the proposed regulations. Section 4974 provides that, if the amount distributed from a qualified retirement plan during the year is less than the RMD for that year, then an exise tax is imposed equal to 50 percent of the amount by the which the RMD exceeds the amount actually distributed. The notice provides that the IRS will not assert that an excise tax is due under § 4974 from an individual who did not take a "specified RMD." It also provides that, if an individual paid an exise tax for a missed RMD in 2021 that constitutes a specified RMD, the taxpayer can request a refund of the excise tax paid. A "specified RMD" is defined as any distribution required to be made in 2021 or 2022 under a defined contribution plan or IRA if the payment would be required to be made to (1) a designated beneficiary of an employee or IRA owner who died in 2020 or 2021 and on or after the employee or IRA owner's required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments as required by § 401(a)(9)(B)(iii). In other words, the IRS will not assert that the excise tax of § 4974 is due from a beneficiary who (1) is not an eligible designated beneficiary (and who therefore is subject to the 10-year rule), (2) inherited the retirement account from an employee or IRA owner who died in 2020 or 2021 and on or after the required beginning date of distributions, and (3) were required to take RMDs in 2021 or 2022 under the interpretation of the 10-year rule in the proposed regulations but failed to do so. The notice provides the same relief to beneficiaries of eligible designated beneficiaries if the eligible designated beneficiary died in 2020 or 2021 and was taking lifetime or life expectancy distributions.

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

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

D. Individual Retirement Accounts

1. There are a lot of reasons not to establish a self-directed IRA. This is one of them. McNulty v. Commissioner, 157 T.C. 120 (11/18/21). The taxpayers in this case, a married couple, established self-directed individual retirement accounts (IRAs). To establish her self-directed IRA, Ms. McNulty used the services of Check Book IRA LLC (Check Book), through its website. The IRA became the sole member of a limited liability company (LLC) and transferred assets to the LLC. Ms. McNulty and her husband were the LLC's managers. The LLC invested in American Eagle Gold coins. The coins were shipped to the taxpayers' residence and kept in a safe there. The IRS audited the taxpayers' 2015 and 2016 tax returns and asserted that the taxpayers had received taxable distributions equal to the cost of the American Eagle Gold coins. With respect to Ms. McNulty, the IRS asserted that she had received taxable distributions of $374,000 and $37,380 for 2015 and 2016, respectively. The Tax Court (Judge Goeke) agreed with the IRS. According to the court, "an owner of a self-directed IRA may not take actual and unfettered possession of the IRA assets." Although the LLC was the nominal owner of the coins, the court reasoned, Ms. McNulty had unfettered possession of them. Accordingly, the court held, she had received a taxable distribution equal to the value of the coins. The court also upheld accuracy-related penalties for substantial understatement of income tax. The taxpayers, according to the court, were unable to establish a reasonable cause defense based on reliance on professional advice because they had received no such advice. The court "question[ed] whether Check Book's website and/or services could constitute professional advice upon which a reasonable person could rely for purposes of section 6664(c)(1)." In summary, the court stated:

> Petitioners are both professionals. They liquidated nearly $750,000 from their existing qualified retirement accounts to invest in a questionable internet scheme without disclosing the transactions to their C.P.A. They are not entitled to the reasonable cause defense, and we sustain the penalties for both years.

V. PERSONAL INCOME AND DEDUCTIONS

A. Rates

B. Miscellaneous Income

1. ♪♫To everything (turn, turn, turn), There is a season (turn, turn, turn) … ♫♪ And this is the season to have your student loans cancelled. The cancellation of student loans from 2021 through 2025 is excluded from gross income. Section 9675 of the 2021 American Rescue Plan amends Code § 108(f) by striking § 108(f)(5) and replacing it with new § 108(f)(5), which provides that gross income does not include any amount resulting from the cancellation of certain loans to finance postsecondary educational expenses regardless of whether the loan is provided through the educational institution or directly to the borrower. This rule applies to several different kinds of loans, including loans made by federal or state governments, private educational loans (as defined in § 140(a)(7) of the Truth in Lending Act), and loans made by educational institutions. The definition of qualifying loans is broad enough to cover the vast majority of postsecondary educational loans. The exclusion does not apply if the lender is an educational organization or a private lender and the cancellation is on account of services performed for the lender. New § 108(f)(5) applies to discharges of loans that occur after December 31, 2020 and before January 1, 2026.

a. The IRS has instructed lenders that cancel student loans not to issue Form 1099-C. Notice 2022-1, 2022-2 I.R.B. 304 (12/21/21). Generally, § 6050P and the regulations issued pursuant to it require a lender that discharges at least $600 of a borrower's indebtedness to file Form 1099-C, Cancellation of Debt, with the IRS and to furnish a payee statement to the borrower. In this notice, the IRS has instructed those normally required to issue Form 1099-C not to do so for any student loan described in § 108(f)(5) (as amended by the 2021 American Rescue Plan) that is discharged after 2020 and before 2026. The notice explains the rationale for the IRS's decision as follows:

> The filing of an information return with the IRS, although not required, could result in the issuance of an underreporter notice (IRS Letter CP2000) to the borrower through the IRS's Automated Underreporter program, and the furnishing of a payee statement to the borrower could cause confusion for a taxpayer with a tax-exempt discharge of debt.

2. The taxpayer's attorneys might have committed malpractice, but the settlement she received from the law firm was not on account of her physical injuries and therefore was not excludable from her gross income. Blum v. Commissioner, 129 A.F.T.R.2d 2022-1170 (9th Cir. 6/2/22), *aff'g*, *Blum v. Commissioner*, T.C. Memo. 2021-18 (2/18/21). The taxpayer allegedly fell to the floor when she attempted to sit in a broken wheelchair while in the hospital for knee replacement surgery. She brought legal action against the hospital for personal injuries. The trial court in that action granted summary judgment for the hospital and the trial court's decision was affirmed on appeal. The taxpayer then brought a malpractice suit against the attorneys who had represented her. The law firm settled the malpractice action by paying the taxpayer $125,000. According to the court, the settlement agreement provided:

> "Blum maintains, and … [her former attorneys] do not dispute, that Blum did not sustain any physical injuries as a result of the alleged negligence of either ... [of her former attorneys]" and that "Blum's physical injuries are ... alleged to have resulted

> from the … [hospital] incident, which did not occur as a result of any fault or negligence by … [her former attorneys].”

The taxpayer excluded the $125,000 from gross income under § 104(a)(2) as damages received on account of personal physical injury or physical sickness. She argued that, but for the alleged negligence of her attorneys, she would have received damages from the hospital that would have been excluded from her income under § 104(a)(2). In a memorandum opinion, the U.S. Court of Appeals for the Ninth Circuit affirmed the decision of the U.S. Tax Court and held that the settlement proceeds the taxpayer received were not excludable from gross income under § 104(a)(2). In its prior decision in *Rivera v. Baker W., Inc.*, 430 F.3d 1253 (9th Cir. 2005), the Ninth Circuit had held that damages are received on account of a personal, physical injury within the meaning of § 104(a)(2) only if there is a direct causal link between the damages and the personal injury sustained. In this case, the court concluded, the settlement agreement pursuant to which the taxpayer received the settlement proceeds stated that the settlement was to settle a malpractice claim and that she had not suffered any physical injuries as a result of the alleged negligence of her attorneys. Accordingly, the court held, the taxpayer could not exclude the settlement proceeds from gross income under § 104(a)(2).

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

D. Deductions and Credits for Personal Expenses

1. Standard deduction for 2022. Rev. Proc. 2021-45, 2021-48 I.R.B. 764 (11/10/21). The standard deduction for 2022 will be $25,900 for joint returns and surviving spouses (increased from $25,100), $12,950 for unmarried individuals and married individuals filing separately (increased from $12,550), and $19,400 for heads of households (increased from $18,800). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater of $1,150 (increased from $1,100) or the sum of $400 (increased from $350) and the individual’s earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,750 (increased from $1,700) for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,400 (increased from $1,350) for married taxpayers ($2,800 on a joint return if both spouses are age 65 or older).

2. Standard deduction for 2023. Rev. Proc. 2022-38, 2022-45 I.R.B. 445 (10/18/22). The standard deduction for 2023 will be $27,700 for joint returns and surviving spouses (increased from $25,900), $13,850 for unmarried individuals and married individuals filing separately (increased from $12,950), and $20,800 for heads of households (increased from $19,400). For individuals who can be claimed as dependents, the standard deduction cannot exceed the greater of $1,250 (increased from $1,150) or the sum of $400 (unchanged from 2022) and the individual’s earned income. The additional standard deduction amount for those who are legally blind or who are age 65 or older is $1,850 (increased from $1,750) for those with the filing status of single or head of household (and who are not surviving spouses) and is $1,500 (increased from $1,400) for married taxpayers ($3,000 on a joint return if both spouses are age 65 or older).

3. Home mortgage interest is deductible despite the fact that the taxpayers received a discharge in bankruptcy, which converted the debt to nonrecourse debt, and sold their home in a short sale. Milkovich v. United States, 28 F.4th 1 (9th Cir. 3/2/22). The taxpayers purchased their home in Renton, Washington, using the proceeds of a mortgage loan and subsequently refinanced the loan. They later filed for Chapter 7 bankruptcy. The taxpayers received a discharge in the bankruptcy proceeding. The taxpayers and the government agreed that the effect of the discharge was to change their home mortgage loan from recourse to nonrecourse because it eliminated the ability of the lender, CitiMortgage, to enforce the mortgage debt personally against the taxpayers. Instead, the lender was able to enforce only the value of its lien against the property. The taxpayers were unable to make the mortgage payments and the value of their home was significantly less than their outstanding mortgage debt. Given this situation, the lender agreed to a short sale of the property, i.e., a sale for less than the amount of mortgage debt owed. From the sale, CitiMortgage received just over $522,000, of which it credited approximately

$115,000 towards accumulated unpaid interest on the loan. CitiMortgage issued Form 1098 reporting the amount of mortgage interest paid and the taxpayers claimed a deduction for the mortgage interest, presumably on Schedule A of their return. The IRS mailed a notice of deficiency to the taxpayers disallowing their deduction of mortgage interest. The taxpayers never received the notice of deficiency because the IRS mailed it to the address of the home they had sold. The taxpayers paid the tax allegedly due and brought this action seeking a refund. The IRS argued in this litigation that the taxpayers' deduction for the mortgage interest was disallowed by § 265(a)(1), which disallows deductions "allocable to one or more classes of income ... wholly exempt from the taxes imposed by [subtitle A of the Code]." The U.S. District Court dismissed the taxpayers' refund action not on the basis of § 265(a)(1), but instead on the basis that they had engaged in a transaction that lacked economic substance analogous to the transaction in *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976). In *Estate of Franklin*, the taxpayer acquired property using the proceeds of nonrecourse debt that significantly exceeded the value of the property acquired. Although the taxpayers in this case did not acquire their property using nonrecourse debt that exceeded the value of the property, the District Court reasoned that their position was analogous to that of the taxpayer in *Estate of Franklin* and therefore disallowed their mortgage interest deductions. In an opinion by Judge Collins, the U.S. Court of Appeals for the Ninth Circuit reversed the District Court's decision. According to the Ninth Circuit, the District Court erred in extending the holding of *Estate of Franklin* to the taxpayers' situation. There was no suggestion, the court observed, that the taxpayers had acquired their mortgage loan in a transaction that lacked economic substance. According to the court:

> Nothing in *Estate of Franklin* suggests that, without more, a subsequent collapse in real estate values means that the now-underwater mortgage should be considered a sham debt that cannot support a mortgage interest deduction.

The fact that the discharge the taxpayers received in bankruptcy changed the debt to nonrecourse debt, the court reasoned, did not alter the fact that the debt was bona fide debt that supported an interest deduction.

The court also rejected the government's argument that § 265(a)(1) disallowed the taxpayers' deduction. The court reviewed basic principles under which a taxpayer experiences discharge of indebtedness income if the taxpayer engages in a short sale of property subject to recourse indebtedness followed by cancellation of the remaining balance owed. *See* Reg. §§ 1.1001-2(a)(2), 1.1001-2(c) (ex. 8). In contrast, if the debt is nonrecourse, the entire amount of the debt is included in the taxpayer's amount realized. *See, e.g.*, *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Simonsen v. Commissioner*, 150 T.C. 201 (2018); Reg. §§ 1.1001-2(a)(1), 1.1001-2(c) (ex. 7). When the debt is nonrecourse and fully included in amount realized, the taxpayer does not experience cancellation of indebtedness income. Accordingly, the taxpayers did not have any cancellation of indebtedness that was excluded from their income and therefore it was inappropriate to disallow their mortgage interest deduction under § 265(a)(1). The court also concluded that, even if a discharge of indebtedness had occurred in the context of the bankruptcy proceeding, § 265(a)(1) did not preclude the taxpayer's deduction of the mortgage interest in question. The court reasoned that taxpayers who exclude cancellation of indebtedness income from gross income pursuant to § 108(a)(1)(A) because the cancellation occurred in a bankruptcy proceeding must reduce favorable tax attributes pursuant to § 108(b) by the amount of cancelled debt they excluded from gross income. For this reason, the court observed, the "exclusion" from gross income provided by § 108(a)(1)(A) is not a true exclusion, but rather a deferral of income. For this reason, the court concluded, "cancellation-of-indebtedness income exempted under § 108(a)(1)(A) is not 'wholly exempt' from income taxation within the meaning of § 265(a)(1)."

Dissenting opinion by Judge Stearns. Judge Stearns dissented, primarily on the basis that the taxpayers had not actually "paid" the mortgage interest in question.

4. Congress has increased and made more widely available the § 36B premium tax credit for 2021 and 2022, eliminated the need to repay excess advance premium tax credits for 2020, and has made the credit available for 2021 to those who receive unemployment compensation. The 2021 American Rescue Plan made several significant changes to the premium tax credit authorized by § 36B. This credit is available to individuals who meet certain eligibility requirements and purchase coverage under a qualified health plan through a health insurance exchange. *First*, for taxable years beginning in 2021 or 2022, § 9661 of the legislation amends Code § 36B(b)(3)(A) by adding new clause (iii), which increases the amount of the credit at every income level and makes the credit available to those whose household income is 400 percent or higher of the federal poverty line. *Second*, for any taxable year beginning in 2020, § 9662 of the legislation suspends the rule of § 36B(f)(2)(B), which requires repayment of excess premium tax credits. An individual who receives advance premium tax credit payments is required by § 36B(f)(1) to reconcile the amount of the advance payments with the premium tax credit calculated on the individual's income tax return for the year and, normally, pursuant to § 36B(f)(2)(B), must repay any excess credit received. This repayment obligation does not apply for 2020. *Third*, for taxable years beginning in 2021, § 9663 of the legislation amends § 36B by adding new subsection (g), which caps the household income of those receiving unemployment compensation at 133 percent of the federal poverty line. This has the effect of making such persons eligible for the maximum amount of premium tax credit.

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

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

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

E. Divorce Tax Issues

1. A taxpayer can deduct as alimony his payments of his wife's health insurance premiums even though he paid the premiums with amounts excluded from his gross income, says the Tax Court. Leyh v. Commissioner, 157 T.C. 86 (10/4/21). The taxpayer and his wife signed an agreement pursuant to which he agreed to pay alimony until their final decree of divorce, which was granted in a later year. As part of the agreement, the taxpayer agreed to pay the premiums for his wife's health and vision insurance. In 2015 he paid $10,683 for his wife's health insurance premiums as pretax payroll reductions from his wages through his employer's cafeteria plan. The taxpayer excluded from his gross income the health care coverage premiums he and his wife received through his employer's cafeteria plan and also claimed a deduction for the $10,683 as alimony. The IRS did not dispute that the taxpayer's payments constituted alimony but asserted that he could not deduct the payments as alimony because he had paid it from funds that he excluded from income. The Tax Court (Judge Greaves) disagreed and upheld the taxpayer's deduction of alimony. The court noted that, absent a clear declaration of congressional intent, double deductions or their equivalent are not permitted, but reasoned that the taxpayer's situation did not present such a scenario. The court explained that the tax consequence to the payee was relevant to the question whether the husband, the payor, was entitled to a deduction. Under the regime that applied to alimony in 2015, § 215 permitted an above-the-line deduction for the payor of alimony and § 71 required the recipient to include the alimony in gross income. According to the court, under this matching regime, if the taxpayer's wife was required to include the alimony payments in gross income, then the taxpayer should be entitled to a deduction for the payments. This result is consistent, the court reasoned, with the result that would have occurred had the taxpayers, who were still married at the time, filed a joint return rather than separate returns. If they had filed a joint return, the health insurance premiums would have been excluded from their gross income, the husband would have had no deduction, and the wife would not have had any income. The court also rejected the IRS's argument that § 265 precluded the husband's deduction. Section 265(a)(1) generally provides that an amount may not be deducted if it is allocable to wholly tax-exempt income (other than interest). According to the court:

> Our decisions broadly interpreting section 265(a)(1) have instead generally shared the same basic concern: But for the application of section 265, a taxpayer would have recognized a double tax benefit where one was not otherwise available to him. See, e.g., Induni v. Commissioner, 98 T.C. 618, 623 (1992), aff'd, 990 F.2d 53 (2d Cir. 1993); Rickard v. Commissioner, 88 T.C. 188, 193 (1987); Manocchio v. Commissioner, 78 T.C. at 994-995, 997. Such application is consistent with the text of the statute. As we have explained supra, this threat does not exist here given the special nature of the alimony regime. Furthermore, the alimony payments are not considered allocable to wholly tax-exempt income for section 265 purposes as Ms. Leyh was required to include it in her income. For these reasons, we decline to extend the reach of section 265 to petitioner's alimony deduction.

- In the 2017 Tax Cuts and Jobs Act, Congress repealed §§ 71 and 215 for divorce or separation instruments executed or modified after 2018.

2. A hedge fund manager's deductions of $18 million and $33 million for alimony were properly disallowed, says the Eighth Circuit. Redleaf v. Commissioner, 43 F.4th 825 (8th Cir. 8/5/22). Andrew and Elizabeth Redleaf were married in 1984. Following Andrew's initiation of divorce proceedings in a Minnesota state court in 2007, they entered into and submitted to the court with jurisdiction over their divorce proceeding a Marital Termination Agreement (MTA). The MTA, which provided that its terms would become part of any subsequent divorce decree, provided for division of the extensive marital assets, including a home in Telluride, Colorado, valuable artwork, and five vehicles. Among other requirements, the MTA provided, in a section entitled "Property Settlement," that Andrew, the founder and manager of a hedge fund, would pay to Elizabeth $1.5 million per month for sixty months and that, on March 15, 2013, he would pay her $30 million. Pursuant to these provisions, Andrew paid Elizabeth $18 million in 2012 and $33 million in 2013. Under the regime that applied to alimony for divorce or separation instruments entered into before 2019, § 215 permitted an above-the-line deduction for the payor of alimony and § 71 required the recipient to include the alimony in gross income. On his federal income tax returns for 2012 and 2013, Andrew deducted these payments as alimony. Elizabeth did not report them as income. The IRS issued a notice of deficiency to each spouse. The notice of deficiency issued to Andrew disallowed his deductions on the basis that the payments were not alimony but rather a nondeductible property settlement. The notice of deficiency issued to Elizabeth increased her income by the amount of the payments she received on the basis that the payments constituted alimony. Both parties filed petitions in the U.S. Tax Court, where the cases were consolidated. In the Tax Court, the IRS changed its position with respect to Elizabeth and argued that she was entitled to summary judgment because the payments were a nondeductible property settlement. The Tax Court (Judge Holmes) held that the payments were not alimony within the meaning of § 71(b). Accordingly, the Tax Court granted Elizabeth's motion for summary judgment and granted the government's motion for summary judgment with respect to Andrew. In an opinion by Judge Loken, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision. Under former § 71(b)(1), the term "alimony or separate maintenance payment" was defined to mean any payment in cash that met four requirements. One of these requirements, set forth in former § 71(b)(1)(D), was that the payor could not have any liability to make the payments (or any substitute for the payments) after the recipient's death. The court observed that approach used by many courts to determine whether there is any obligation to make the payments after the recipient's death is to look first for any unambiguous termination provision in the parties' agreement and, if there is no such provision, to look to state law. If state law is ambiguous, then the court will look solely to the parties' divorce or separation instrument. In this case, the court concluded, the MTA did not plainly state whether the payments would continue after Elizabeth's death. Turning to state law, the court observed that Minnesota law provides that "maintenance" payments do not continue after the recipient's death, but concluded that these payments were not maintenance payments under Minnesota law, which requires a showing of need on the part of the recipient for payments to constitute maintenance. Despite Andrew's argument that Elizabeth needed tens of millions of dollars "to self-support her extravagant lifestyle," the court concluded that there was no showing of need. Accordingly, the disallowed Andrew's deductions on the basis that the payments were part of a property settlement.

F. Education

G. Alternative Minimum Tax

VI. CORPORATIONS

A. Entity and Formation

B. Distributions and Redemptions

1. Tax Court holds management fees paid by C corporation to its shareholders were constructive dividends. Aspro, Inc. v. Commissioner, T.C. Memo. 2021-8 (1/21/21). The issue in this case was whether Aspro, Inc. (Aspro) was entitled to deduct management fees paid to its shareholders. Aspro was an Iowa C corporation for federal tax purposes and was engaged in the asphalt paving business. The company had three shareholders: Jackson Enterprises, Corp. (40%) (Jackson), Mannatt's Enterprises, Ltd. (40%), and Mr. Dakovich, Aspro's president (20%). In each year relevant to this dispute, the shareholders received, among other forms of payment, substantial management fees that Aspro deducted. In examining whether the payments were in fact distributions of earnings rather than compensation for services rendered, the Tax Court (Judge Pugh) turned for guidance to Reg. § 162-7(b)(1), which governs the classification of such payments. This regulation provides:

> Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock.

The Tax Court concluded that Aspro had failed to show the management fees were paid purely or wholly for services and agreed with the IRS that Aspro could not deduct the fees. The Tax Court came to this conclusion for numerous reasons. Aspro did not enter into any written agreement and did not agree on any management fee rate or billing structure with any one or more of its shareholders. Rather, the board of directors approved management fees each year. The minutes of the board of directors meetings did not reflect how the directors determined to approve the management fees paid to the shareholders. The board did not attempt to value or quantify any of the management services performed. The management fees paid to each shareholder were approximately the same each year even though the services provided by each shareholder varied from year to year. The percentage of management fees paid roughly corresponded to each of the three shareholders' respective ownership interests. Aspro paid the management fees as a lump sum at the end of each year even though services were rendered throughout the year. Another circumstance that influenced the Tax Court was the coincidence that Aspro had very little income after deducting management fees. Finally, it was unfortunate for Aspro that none of the witnesses that testified could explain how the company had determined the appropriate amount of management fees. The testimony regarding how management fees were valued was vague and contradictory. No expert testimony was introduced to aid the court in establishing the reasonableness of the amounts paid for the purported management services. For these reasons, Aspro failed to prove that the management fees it had paid to shareholders qualified as compensation for services rendered.

Whether management fees along with other compensation paid to Mr. Dakovich was reasonable compensation. Having found at every turn that Aspro had failed to provide any evidence to support its deduction for management fees as compensation for services rendered, the court then turned to whether the payments to Mr. Dakovich in his capacity as president of the company were deductible as reasonable compensation. With respect to shareholder-employees, one approach to determining reasonable compensation commonly used by courts is a multi-factor test. *See, e.g.,* Charles Schneider & Co. v. Commissioner, 500 F.2d 148, 152 (8th Cir. 1974). The Tax Court relied on these factors and on the analysis in the report of the IRS's expert, Mr. Nunes (the Nunes Report), which the court found persuasive. Mr. Dakovich had decades of experience as Aspro's top executive. He had wide ranging duties and worked long hours. Only this factor was found to weigh in favor of treating Mr. Dakovich's compensation as reasonable. On the other hand, under the prevailing economic conditions, which were found to be stable, Aspro's sales declined by 7 percent. Further, the Nunes Report supported a finding that individuals with positions similar to Mr. Dakovich within the same industry had an upper quartile compensation rate substantially less than Mr. Dakovich did. Because the management fees paid to Mr. Dakovich were in addition to his salary, and his salary was in excess of that paid to individuals in comparable positions, this factor weighed heavily against treating the management fees as reasonable compensation. In computing compensation paid to shareholders as a percentage of net income before shareholder compensation is paid, the Tax Court found that Aspro's shareholder compensation was 90 percent, over 100 percent, and 67 percent of net income for the years in issue. These high percentages were found to weigh against treating the amounts paid to Mr. Dakovich as reasonable compensation. Finally, the Tax Court observed that Aspro had never paid dividends. By paying such high shareholder compensation, Aspro was less profitable than its industry peers. Low profits led to low retained earnings which, in turn, led to low returns for Aspro shareholders. Needless to say, the Tax Court found Mr. Dakovich's compensation to be unreasonably high.

Aftermath and observations. Because the management fees that Aspro paid to its shareholders did not constitute reasonable compensation, the court upheld the IRS's disallowance of the corporation's deductions and treated the management fees as nondeductible distributions to shareholders. The decision presents a roadmap of how not approach compensation of shareholders who provide services to the corporation. In the inverse, this case provides an excellent menu of how a closely held C corporation can structure reasonable compensation and avoid or survive a challenge by the IRS. Given the court's heavy reliance on the Nunes Report, one of the most important steps that might be taken is to seek a qualified valuation expert who can support the compensation paid by the corporation to a employee-shareholders in high level positions.

a. The Eighth Circuit agrees: management fees paid by C corporation to its shareholders were constructive dividends. Aspro, Inc. v. Commissioner, 32 F.4th 673 (8th Cir. 4/26/22). In an opinion by Judge Gruender, the U.S. Court of Appeals for the Eighth Circuit has affirmed the Tax Court's decision that disallowed the deductions taken by Aspro, Inc., a subchapter C corporation, for "management fees" paid to its shareholders. As previously discussed, the corporation had three shareholders: Jackson Enterprises, Corp. (40%) (Jackson), Mannatt's Enterprises, Ltd. (40%) (Mannatt's), and Mr. Dakovich, Aspro's president (20%). The court first considered the management fees paid to Jackson and Mannatt's. The court concluded that the Tax Court had not clearly erred in finding that Aspro had failed to meet its burden to show that these management fees were reasonable. Aspro, the court observed, had failed to quantify the value of services provided, failed to produce documentary evidence of a service relationship with Jackson and Mannatt's, and produced no evidence of how it had determined the amount of the management fees. Further, the court agreed with the Tax Court that the management fees paid to Jackson and Mannatt's were not purely for services rendered and instead were disguised distributions of profit. The court noted that Aspro had not paid dividends since the 1970s and that the management fees were roughly proportional to the ownership interests of these two shareholders. The court next considered the management fees that Aspro had paid to its president, Mr. Dakovich, and concluded, for similar reasons, that Aspro could not deduct the management fees. According to the court, Aspro had not quantified the value of the management services provided by Mr. Dakovich. The government's expert, the court observed, had concluded that the salary and bonus that Aspro paid to him exceeded the industry average and median by a substantial margin and that the management fees, which were paid in addition to his salary and bonus, were not reasonable. In addition, the court noted, the sum of the management fees plus the excess salary and bonus paid to Mr. Dakovich was roughly proportional to his ownership interest in the corporation. Finally, the court concluded, the management fees paid to Mr. Dakovich were not purely for services rendered and instead were disguised distributions of profit:

> Aspro paid the management fees as lump sums at the end of the tax year even though the purported services were performed throughout the year, had an unstructured process of setting the management fees that did not relate to the services performed, and had a relatively small amount of taxable income after deducting the management fees.

Accordingly, the court concluded, the Tax Court did not clearly err in finding that Aspro had failed to carry its burden of showing that the management fees were reasonable and purely for services actually performed.

2. A new excise tax of 1% on redemptions of stock by publicly traded corporations. The Inflation Reduction Act, § 10201, adds new Code § 4501, which imposes on a publicly traded U.S. corporation a 1 percent excise tax on the value of any of its stock that is repurchased by the corporation during the taxable year. The term "repurchase" means a redemption within the meaning of Code § 317(b) with regard to the stock of the corporation and any other economically similar transaction as determined by the Secretary of Treasury. The amount of repurchases subject to the tax is reduced by the value of any new issuance to the public and stock issued to the employees of the corporation. A subsidiary of a publicly traded U.S. corporation that performs the buyback for its parent or a U.S. subsidiary of a foreign corporation that buys back its parent's stock is subject to the excise tax. The provision excludes certain repurchases from the excise tax. The provision applies to repurchases of stock after December 31, 2022.

C. Liquidations

D. S Corporations

E. Mergers, Acquisitions and Reorganizations

F. Corporate Divisions

G. Affiliated Corporations and Consolidated Returns

H. Miscellaneous Corporate Issues

1. Congress has revived the corporate AMT for corporations with "applicable financial statement income" over $1 billion. The corporate alternative minimum tax (AMT) was repealed by the 2017 Tax Cuts and Jobs Act. The Inflation Reduction Act, § 10101, amends Code § 55(b) to reinstate a corporate AMT. Specifically, the legislation imposes a 15 percent minimum tax on corporations (other than S corporations, regulated investment companies, and real estate investment trusts) with average "adjusted financial statement income" measured over three years of over $1 billion. Adjusted financial statement income (AFSI) is the net income or loss stated on the taxpayer's "applicable financial statement" with certain modifications. One modification is that AFSI is adjusted to allow depreciation deductions calculated for tax purposes rather than book purposes. An "applicable financial statement" is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS. The corporate AMT applies for tax years beginning after December 31, 2022.

VII. PARTNERSHIPS

A. Formation and Taxable Years

1. A partnership that was made profitable by the availability of a tax credit was a bona fide partnership, says the DC Circuit. Cross Refined Coal, LLC v. Commissioner, 45 F.4th 150 (D.C. Cir. 8/5/22). In an opinion by Judge Katsas, the U.S. Court of Appeals for the District of Columbia Circuit has affirmed a decision of the U.S. Tax Court and held that a partnership that was made profitable only by the availability of tax credits was a bona fide partnership. Congress enacted a refined-coal tax credit in 2004 to encourage the production of cleaner-burning coal. The credit, which was set forth in former § 45(c)(7)(A), was available to those who opened refined coal production facilities before 2012. Eligible taxpayers could claim the credit for each ton of refined coal sold for a ten-year period. AJG Coal, Inc. (AJG), sought to take advantage of the new credit by forming Cross Refined Coal, LLC (Cross), to operate a refined coal production facility in South Carolina. Cross entered into certain agreements with Santee Cooper, a state-owned electric and water utility that owned the power station where the new refined coal production facility would be located. These agreements included a lease that allowed Cross to build and operate a coal refining facility at the power station and a purchase-and-sale agreement under which Cross would purchase unrefined coal from Santee, refine it, and then sell it back to Santee for $0.75 *less* per ton than Cross had paid for it. This guaranteed that Cross would lose money on each purchase and sale. Cross also entered into a license agreement with AJG under which Cross obtained the right to use AJG's coal-refining technology. The lease, the purchase-and-sale agreement, and the license agreement all had ten-year terms that matched the ten-year period during which the refined coal tax credit was available. AJG formed two other LLCs that entered into similar agreements with Santee and AJG at two other power stations owned by Santee. The business model of Cross could produce a profit only by taking into account the refined-coal tax credit:

> Considering (1) the operating expenses that Cross incurred to refine coal, (2) the losses it sustained in buying and then re-selling the coal, and (3) the royalties it paid to obtain the necessary technology, Cross's operations inevitably would produce a pre-tax loss. Its sole opportunity to turn a profit was to claim a tax credit that exceeded these costs.

Within a few months after Cross built and began operating the new coal-refining facility, AJG recruited two other investors, who became members of Cross. One of the new members purchased a 51-percent interest in Cross for $4 million and the other purchased a 25-percent interest for $1.8 million. Because of limitations on the refined-coal tax credit, AJG could use only a portion of the available credit each year and had to carry forward the excess. Bringing in new members who could use the credit effectively allowed AJG to monetize the credit by selling interests in Cross and minimizing the credits it carried forward. The two new members of Cross also contributed to Cross a total of approximately $1.6 million to cover the business's operating expenses. All three members were actively involved in Cross's operations. Because of lengthy shutdowns attributable to various factors, Cross failed to produce the $140 million in profits that AJG had projected over the relevant ten-year period. Nevertheless, Cross did generate $19 million in after-tax profits over the four years during which the two additional members AJG had recruited were members. During 2011 and 2012, Cross claimed more than $25.8 million in refined-coal tax credits and $25.7 million in ordinary business losses. Cross, which was classified as a partnership for federal tax purposes, allocated the credits and losses among its members. Following an audit, the IRS issued a final notice of partnership administrative adjustment in which it concluded that Cross was not a partnership and, accordingly, only AJG could claim the refined-coal tax credits. The IRS:

> determined that Cross was not a partnership for federal tax purposes "because it was not formed to carry on a business or for the sharing of profits and losses," but instead "to facilitate the prohibited transaction of monetizing 'refined coal' tax credits."

Cross challenged the final notice of partnership administrative adjustment by filing a petition in the U.S. Tax Court. In a ruling from the bench, the Tax Court (Judge Gustafson) held that Cross was a bona fide partnership because all three members had made substantial contributions, participated in management, and shared in profits and losses.

The U.S. Court of Appeals for the D.C. Circuit affirmed the Tax Court's decision. For guidance, the court relied on the U.S. Supreme Court's decisions in *Commissioner v. Tower*, 327 U.S. 280 (1946), and *Commissioner v. Culbertson*, 337 U.S. 733 (1949). According to the court, *Tower* and *Culbertson* provided a definition of a partnership that has two requirements: (1) those involved must intend to carry on a business as a partnership, *i.e.*, the enterprise must be undertaken for profit or for another legitimate nontax business purpose, and (2) those involved must intend to share in profits, losses, or both. The court concluded that Cross satisfied this definition. *First*, the court held that the Tax Court had correctly concluded that AJG and the two other members of Cross intended to carry on a business jointly. The court observed that AJG had legitimate, non-tax reasons for forming Cross and recruiting investors, including AJG's "spreading its investment risk over a larger number of projects." Further, the court added,

> there was nothing untoward about seeking partners who could apply the refined-coal credits immediately, rather than carrying them forward to future tax years. Low-tax entities (like AJG) often use the prospect of tax credits to attract high-tax

> entities … into a partnership, and in return, the high-tax partners provide the financing needed to make the tax-incentivized project possible.

The court also emphasized that the two other investors, although motivated by the availability of tax credits, made substantial contributions of capital and were actively involved in Cross's day-to-day operations. The court rejected the government's argument that Cross's members did not have the requisite intent to carry on a business because there was no expectation of a *pre-tax* profit. After reviewing relevant judicial decisions, the court concluded that transactions that are profitable only on a *post-tax basis* can still have a "nontax business purpose." Congress's objective in enacting the refined-coal tax credit, the court explained, was to encourage investments that would not otherwise have been made, and if the government is permitted to treat a partnership as a sham simply because there is no expectation of a pre-tax profit, then the only investments that would be made are those that would have been made without the congressional incentive. According to the court, this approach would undermine Congress's ability to use tax credits to encourage socially desirable activities.

Second, the court held that the Tax Court had correctly concluded that all members of Cross shared in profits and losses. The two investors that AJG recruited for Cross, the court concluded, clearly shared in profits and faced downside risk from Cross's business. The court rejected the government's argument that the investors did not face meaningful downside risk given the expected tax benefits. The government argued that the imbalance between the amounts of capital contributed by the investors and their expected tax benefits demonstrated that the investors merely bought tax credits and did not become true equity partners. The court emphasized that the amount of tax credits available to the partners depended on the amount of refined coal sold by Cross and that it was entirely possible that the investors would not recover much of their capital. In fact, the court observed, these same investors lost substantial amounts of money on their investments in another LLC formed by AJG to produce refined coal and that had the same investment structure as Cross.

In summary, the court held that Cross was a bona fide partnership for federal tax purposes.

2. An investor entitled to interest measured by the net cash flow from real property owned by a partnership and by the appreciation in value of the partnership's assets was a lender and not a participant in a joint venture with the partnership; therefore, the partnership was entitled to deduct the interest paid. Deitch v. Commissioner, T.C. Memo. 2022-86 (8/25/22). The issue in this case was whether a party that provided financing for a partnership's acquisition and renovation of real property was a lender or instead a participant in a joint venture with the partnership. Two individuals, Mr. Deitch and Mr. Barry, formed West Town Square Investment Group, LLC (WTS), which was classified as a partnership for federal tax purposes. These two individuals, along with Mr. Barry's wife, were the petitioners in this case. They formed WTS to acquire commercial real property in Rome, Georgia, renovate it, and lease a portion of the property to a hospital that sought space in which to provide physical therapy services. Protective Life Insurance Co. (PLI) provided financing for the project. PLI offered both conventional loans and participating loans. In this case, PLI agreed to lend $4.4 million to WTS in the form of a participating loan. The loan documents consisted of a promissory note providing for a fixed rate of interest (6.25%), a security agreement giving PLI a security interest in the property, and an "Additional Interest Agreement" that obligated WTS to pay additional interest of two types: NCF Interest (50 percent of net cash flow from the property) and Appreciation Interest (50 percent of the appreciation in value of the property if it was ever sold or the loan was terminated). Both the promissory note and the Additional Interest Agreement provided that the relationship between PLI and WTS "shall be solely that of creditor and debtor" and that noting in any of the loan documents would be construed to create a partnership, joint venture, "or any relationship other than that of creditor and debtor." From 2006 to 2014, WTS paid interest on the loan, including NCF Interest, which it reported on Form 1065, the partnership's tax return. In 2014, WTS sold the property and reported (1) a net § 1231 gain of $2.6 million, which it allocated equally between WTS's two members, and (2) a deduction of approximately $1 million for Appreciation Interest, which had the effect of producing a net rental loss of approximately $1.2 million for 2014. The Schedule K-1s issued to Mr. Deitch and Mr. Barry for 2014 each reported one-half of the $1.3 million net § 1231 gain and one-half of the $1.2 million net rental loss. The IRS audited the 2014 returns filed by the two individuals and took the position that each of them had a share of WTS's net rental loss of approximately $100,000 rather than $600,000 because they had not established that the $1 million of Appreciation Interest deducted by WTS was either interest or an ordinary and necessary business expense. Accordingly, the IRS increased each individual's taxable income by approximately $500,000. Mr. Deitch and Mr. and Mrs. Barry each challenged the IRS's position by filing petitions in the U.S. Tax Court. In the Tax Court, the government argued that the Additional Interest Agreement created a joint venture between WTS and PLI and that the $1 million of Appreciation Interest paid by WTS was a nondeductible return on PLI's equity interest in the joint venture. The Tax Court (Judge Gustafson) held that PLI and WTS had not formed a joint venture classified as a partnership and that their relationship was that of creditor-debtor. The court observed that the government had stipulated that the original promissory note, later amendments to the note, and the security agreement constituted genuine indebtedness, and that the Additional Interest Agreement could not be separated from those three agreements. These stipulations contradicted the government's position that PLI and WTS had formed a joint venture. Nevertheless, the court analyzed whether PLI and WTS had formed a joint venture by applying the eight factors from the court's decision in *Luna v. Commissioner*, 42 T.C. 1067 (1964). The *first factor*, the agreement of the parties and their conduct in executing its terms, the court observed, weighed against the existence of a joint venture because the agreements between PLI and WTS expressly provided that their relationship was creditor-debtor and expressly disclaimed the existence of a joint venture. The *second factor*, the contributions (if any) that each party has made to the venture, weighed against the existence of a joint venture because PLI provided capital in its capacity as an arm's-length lender. The *third factor*, the parties' control over income and capital and the right of each to make withdrawals, weighed in favor of the existence of a joint venture because, in the court's view, PLI had significant control over the capital, was guaranteed to receive more than half of the income from the property (because of the manner in which net cash flow was defined), and was not liable for operating losses, which meant that its interest resemble that of a preferred equity holder. The *fourth factor* is

> whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income.

This fourth factor, the court reasoned, weighed against the existence of a joint venture because, although PLI shared in profits, it did not share in operating losses. The *fifth factor*, whether business was conducted in the joint names of the parties, weighed against the existence of a joint venture because, as the government conceded, the business was conducted under the name WTS and not that of PLI or any other entity. The *sixth factor*, whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers, weighed against the existence of a joint venture because, as the government conceded, WTS and PLI did not file partnership tax returns indicating they were partners and did not otherwise represent that they were partners. The *seventh factor*, whether separate books of account were maintained for the venture, weighed against the existence of a joint venture because, although the parties agreed on how books and records would be kept, this was solely for purposes of calculating the interest due to PLI and "WTS and PLI did not jointly maintain books of account that would normally be expected in the operation of a business." The *eighth factor*, whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise, weighed against the existence of a joint venture because, although PLI exercised control over the capital it provided to WTS, WTS exercised primary responsibility for and control over the rental operations of the property and most of the terms set forth in the security agreement were standard terms present in an arm's-length secured commercial loan. In short, seven of the eight Luna *factors* weighed against the existence of a joint venture. Accordingly, the court held that the relationship between PLI and WTS was that of creditor-debtor and that the Appreciation Interest paid by WTS was interest that WTS was entitled to deduct under § 163(a).

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

1. Are partners not keeping track of outside basis? It could come back to bite them. New compliance campaigns by the IRS focus on losses and distributions that exceed a partner's outside basis. The IRS has announced compliance campaigns focusing on losses and distributions that exceed a partner's outside basis. Pursuant to the limitation set forth in § 704(d), a partner can deduct the partner's share of partnership losses only to the extent of the partner's basis in the partnership interest, as determined under § 705. Under the rules that apply to distributions in § 731(a), a partner's basis in the partnership interest functions as a limitation on the partner's ability to receive certain liquidating and non-liquidating distributions without the recognition of gain. In February 2022, the IRS announced a compliance campaign focusing on the allocation of losses to a partner that exceed the partner's outside basis. The identification of this issue as the focus of a compliance campaign is available on the IRS website through the following link: https://perma.cc/5BX8-GZJP. In August 2022, the IRS announced a compliance campaign focusing on distributions to a partner that exceed the partner's outside basis. The identification of this issue as the focus of a compliance campaign is available on the IRS website through the following link: https://perma.cc/M4PR-UERJ.

- Partnerships now must report annually a partner's tax capital account on Schedule K-1. Query whether the IRS plans to use a partner's tax capital account as a proxy for the partner's basis in the partnership interest. This possibility combined with the new compliance campaigns reinforce the importance of partners having records to support the determination of their basis in the partnership interest.

C. Distributions and Transactions Between the Partnership and Partners

D. Sales of Partnership Interests, Liquidations and Mergers

E. Inside Basis Adjustments

1. The IRS has finally recognized that partnership returns are filed electronically. Section 754 elections no longer require a partner's signature. T.D. 9963, Streamlining the Section 754 Election Statement, 87 F.R. 47931 (8/5/22). The Treasury Department and the IRS have finalized, without changes, proposed regulations that eliminate the requirement that a § 754 election made by the partnership be signed by one of the partners. *See* REG-116256-17, Streamlining the Section 754 Election Statement, 82 F.R. 47408 (10/12/17). If a partnership wishes to make a § 754 election, the former regulations (Reg. § 1.754-1(b)) required the partnership to attach to its return a written statement that (i) set forth the name and address of the partnership making the election, (ii) was signed by one of the partners, and (iii) contained a declaration that the partnership elects under § 754 to apply the provisions of §§ 734(b) and 743(b). Many partnership returns are filed electronically with § 754 elections that, in the IRS's view, do not comply with the requirement that the election be signed by one of the partners. As a result, the IRS received many requests for so-called "9100 relief" to make a late § 754 election. In these final regulations, the IRS has eliminated the requirement that a partnership's § 754 election be signed by one of the partners. Pursuant to this amendment, a § 754 election must comply only with the other two requirements to be a valid election. This change applies to taxable years ending on or after August 5, 2022, but taxpayers can apply the change to taxable years ending before that date. Therefore, partnerships filing their returns electronically with an otherwise valid § 754 election need not request 9100 relief.

F. Partnership Audit Rules

G. Miscellaneous

VIII. TAX SHELTERS

A. Tax Shelter Cases and Rulings

B. Identified "tax avoidance transactions"

C. Disclosure and Settlement

D. Tax Shelter Penalties

IX. EXEMPT ORGANIZATIONS AND CHARITABLE GIVING

A. Exempt Organizations

B. Charitable Giving

1. What does "protected in perpetuity" mean? These cases provide some answers in the context of conservation easements. It is well known that the IRS is battling syndicated conservation easements. Moreover, after recent victories, the IRS has announced a time-limited settlement offer to certain taxpayers with pending Tax Court cases involving syndicated conservation easements. *See* IR 2020-130 (6/25/20). Other than challenging valuations, the IRS's most successful strategy in combating syndicated conservation easements generally has centered around the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The IRS has argued successfully in the Tax Court that the "protected in perpetuity" requirement is not met where the taxpayer's easement deed fails to meet the strict requirements of the "extinguishment regulation." *See* Reg. § 1.170A-14(g)(6)(ii). The extinguishment regulation ensures that conservation easement property is protected in perpetuity because, upon destruction or condemnation of the property and collection of any proceeds therefrom, the charitable donee must proportionately benefit. According to the IRS's and Tax Court's reading of the extinguishment regulation, the charitable donee's proportionate benefit must be determined by a fraction determined at the time of the gift as follows: the value of the conservation easement as compared to the total value of the property subject to the conservation easement (hereinafter the "proportionate benefit fraction"). *See* *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (10/28/19). Thus, upon extinguishment of a conservation easement due to an unforeseen event such as condemnation, the charitable donee must be entitled to receive an amount equal to the product of the proportionate benefit fraction multiplied by the proceeds realized from the disposition of the property. As part of its litigation strategy against syndicated conservation easements, the IRS pounces upon any technical flaws in the deed's extinguishment clause/proportionate benefit fraction language. In fact, the IRS recently has been successful in challenging extinguishment clause/proportionate benefit fraction language that either (i) would allow the donor to reclaim from the charitable donee property subject to a conservation easement by conveying to the donee substitute property in exchange therefor or (ii) would reduce the charitable donee's benefit upon extinguishment of the conservation easement by the fair market value of post-contribution improvements made to the subject property after the date of the taxpayer-donor's deductible gift. *See, e.g.,* *Pine Mountain Preserve, LLLP v. Commissioner*, 151 T.C. 247 (12/27/18), including its companion case, *Pine Mountain Preserve, LLLP v. Commissioner*, T.C. Memo. 2018-214 (12/27/18) (deed allowed substituted property), *aff'd in part, vac'd in part, rev'd in part*, 978 F.3d 1200 (11th Cir. 10/22/20); and *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 9/14/18) (deed reduced charitable donee's benefit for subsequent improvements made by taxpayer donor). The latter argument by the IRS—that a properly-drafted extinguishment clause/proportionate benefit fraction cannot give the donor credit for post-contribution improvements to the conservation easement property—is particularly potent. This argument by the IRS is the subject of the two Tax Court companion opinions rendered in *Oakbrook Land Holdings, LLC v. Commissioner*, as discussed below. Reportedly, many conservation easement deeds have such language, especially syndicated conservation easement deeds originating in the southeastern U.S. Hence, the Tax Court's opinions in *Oakbrook Land Holdings, LLC v. Commissioner* are very important to the conservation easement industry. For a discussion of other IRS and Tax Court developments relating to conservation easements, see the Agricultural Law and Taxation Blog post of July 8, 2020, available here.

a. A crack in the IRS's armor with respect to syndicated conservation easements? Or, a death knell for taxpayers? You be the judge. Oakbrook Land Holdings LLC v. Commissioner, 154 T.C. 180 (5/12/20), including the companion memorandum opinion Oakbrook Land Holdings LLC v. Commissioner, T.C. Memo 2020-54 (5/12/20). In these companion opinions totaling 172 pages, the Tax Court disallowed a taxpayer-donor's charitable contribution deduction because the language in the conservation easement deed was found to be defective under either of two theories argued by the IRS and supported by the Tax Court's reading of Reg. § 1.170A-14(g)(6)(ii). See below for further discussion. The taxpayer-donor's counter arguments, that the conservation easement deed's language was correct and that Reg. § 1.170A-14(g)(6)(ii) is invalid, failed to persuade the Tax Court. Just to keep us on our toes, perhaps, the Tax Court's decision resulted in two lengthy opinions. Judge Lauber wrote the majority opinion for the Tax Court's reviewed decision regarding one theory of the case, while Judge Holmes wrote a memorandum decision based upon another theory of the case. Interestingly, *Oakbrook Land Holdings* did not arise out of a syndicated conservation easement; however, it is very informative as to the IRS's litigation strategy with respect to syndicated conservation easements as well as the Tax Court's view of the law applicable to conservation easements generally.

Facts. The facts of *Oakbrook Land Holdings* are typical of recent conservation easement cases litigated in the Tax Court. The taxpayer-donor, Oakbrook Holdings LLC, acquired a 143-acre parcel of property near Chattanooga, Tennessee in 2007 for $1.7 million. The plan was to develop the property for "higher-end, single family residences." In late 2008 Oakbrook Holdings LLC transferred approximately 37 acres of the property to related entities to allow a portion of the property to be developed without restrictions relating to the remainder of the property. The remaining 106 acres of the property then was subjected to a conservation easement in favor of Southeast Regional Land Conservancy (the "Conservancy"), a § 501(c)(3) organization. The taxpayer-donor, Oakbrook Holdings LLC, claimed a charitable contribution deduction of over $9.5 million for the donated conservation easement even though the contribution occurred only a little over a year after Oakbrook Holdings LLC had acquired the property for $1.7 million.

Oakbrook Holdings LLC, the taxpayer-donor, largely relied upon the charitable donee, the Conservancy, and its attorneys to draft the conservation easement deed. The Conservancy in turn relied upon language found in similar conservation easement deeds that have been executed and approved by numerous taxpayers and their attorneys. The deed provided as follows in relevant part:

> This Conservation Easement gives rise to a real property right and interest immediately vested in [the Conservancy]. For purposes of this Conservation Easement, the fair market value of [the Conservancy]'s right and interest shall be equal to the difference between (a) the fair market value of the Conservation Area as if not burdened by this Conservation Easement and (b) the fair market value of the Conservation Area burdened by this Conservation Easement, as such values are determined as of the date of this Conservation Easement, (c) less amounts for improvements made by O[akbrook] in the Conservation Area subsequent to the date of this Conservation Easement, the amount of which will be determined by the value specified for these improvements in a condemnation award in the event all or part of the Conservation Area is taken in exercise of eminent domain as further described in this Article VI, Section B(3) below. If a change in conditions makes impossible or impractical any continued protection of the Conservation Area for conservation purposes, the restrictions contained herein may only be extinguished by judicial proceeding. Upon such proceeding, [the Conservancy], upon a

> subsequent sale, exchange or involuntary conversion of the Conservation Area, shall be entitled to a portion of the proceeds equal to the fair market value of the Conservation Easement as provided above. [The Conservancy] shall use its share of the proceeds in a manner consistent with the conservation purposes set forth in the Recitals herein.

Article VI, Section B(3) of the deed further stated:

> Whenever all or part of the Conservation Area is taken in exercise of eminent domain * * * so as to abrogate the restrictions imposed by this Conservation Easement, * * * [the] proceeds shall be divided in accordance with the proportionate value of [the Conservancy]'s and O[akbrook]'s interests as specified above; all expenses including attorneys fees incurred by O[akbrook] and [the Conservancy] in this action shall be paid out of the recovered proceeds to the extent not paid by the condemning authority.

First argument of the IRS and taxpayer's response. The IRS's first argument to disallow the taxpayer-donor's charitable contribution deduction was that the above-quoted language of the conservation easement deed only entitled the charitable donee, the Conservancy, to a fixed (not proportionate) benefit (i.e., historical value of the conservation easement at the time of the gift) upon the destruction or condemnation of the subject property. According to the IRS, Reg. § 1.170A-14(g)(6)(ii) requires that the charitable donee be entitled to a *proportionate* (i.e., fractional) benefit upon extinguishment of a conservation easement. Further, the IRS's position is that the amount of the benefit must be determined by applying the proportionate benefit fraction against the fair market value of the subject property at the time of the extinguishment. Put differently, the IRS contends that Reg. § 1.170A-14(g)(6)(ii) does not merely establish a baseline amount equal to the value of the conservation easement as the amount of the benefit to be received by the charitable donee upon extinguishment of a conservation easement. Rather, upon extinguishment of the easement, if the subject property has appreciated in value the charitable donee must be entitled to receive more than the claimed charitable contribution value of the conservation easement. (It is not entirely clear what the IRS's position would be under Reg. § 1.170A-14(g)(6)(ii) if upon extinguishment of the easement the subject property has decreased in value after the taxpayer-donor's gift, although consistency would argue that the charitable donee should receive less than the claimed charitable contribution value.)

On the other hand, the taxpayer-donor argued, of course, that the above-quoted language in the deed complied with Reg. § 1.170A-14(g)(6)(ii) because the regulation should be read to require only a fixed (not fractional) amount that must be received by the charitable-donee upon extinguishment of a conservation easement. In other words, the taxpayer-donor believed that Reg. § 1.170A-14(g)(6)(ii) was meant to protect the chartable donee's downside risk: i.e., that the event extinguishing the conservation easement would result in proceeds much less than the taxpayer-donor's claimed charitable contribution deduction. The taxpayer-donor's reading of Reg. § 1.170A-14(g)(6)(ii) was that the extinguishment clause in a conservation easement deed must entitle the charitable donee to an amount equal to the previously claimed charitable contribution deduction (or, if less, all of the proceeds from the disposition of the property).

Memorandum Opinion of Judge Holmes. In Oakbrook Land Holdings LLC v. Commissioner, T.C. Memo 2020-54 (5/12/20), Judge Holmes, citing the Tax Court's prior decision in *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (10/28/19), agreed with the IRS's position regarding Reg. § 1.170A-14(g)(6)(ii) and the conservation easement language at issue, thereby disallowing the taxpayer-donor's more than $9.7 million charitable contribution deduction. Judge Holmes reasoned that the language in the deed did not grant a fractional proportionate benefit to the Conservancy. It granted only a minimum benefit equal to the amount of the taxpayer-donor's claimed charitable contribution deduction. Judge Holmes agreed with the IRS that Reg. § 1.170A-14(g)(6)(ii) requires a fractional benefit, not a fixed amount. Other cases also have interpreted Reg. § 1.170A-14(g)(6) to require a fractional, not fixed, benefit in favor of the charitable donee. *See, e.g.*, *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 9/14/18). This aspect of the Tax Court's decision in *Oakbrook Land Holdings* is not novel, and presumably this lack of novelty is the reason for this memorandum decision written separately from the Tax Court's reviewed opinion written by Judge Lauber.

Second argument of the IRS and taxpayer's response. Alternatively, the IRS argued that the above-quoted language in the conservation easement deed was flawed in another respect. Specifically, the IRS contended that the deed's extinguishment language, which required that the charitable-donee's benefit upon destruction or condemnation of the property be reduced by the value of improvements to the property made by the taxpayer-donor after the contribution, was not allowed by the strict requirements of Reg. § 1.170A-14(g)(6)(ii). This position of the IRS is not explicitly supported by Reg. § 1.170A-14(g)(6)(ii) and is a novel argument by the IRS. The taxpayer-donor responded that to the extent Reg. § 1.170A-14(g)(6)(ii) is read to disallow such a reduction in the charitable-donee's benefit upon extinguishment of a conservation easement, the extinguishment regulation violates either the procedural or substantive requirements of the Administrative Procedures Act ("APA") and is invalid. This alternative argument by the IRS, and the taxpayer-donor's response, was the subject of the Tax Court's reviewed opinion by Judge Lauber, discussed below.

Reviewed opinion of Judge Lauber. In Oakbrook Land Holdings LLC v. Commissioner, 154 T.C. 180 (5/12/20), a reviewed opinion (12-4-1) by Judge Lauber, the Tax Court agreed with the IRS's position concerning Reg. § 1.170A-14(g)(6)(ii) and post-contribution improvements to conservation easement property by a taxpayer-donor. We will spare the reader pages and pages of arguments and counter-arguments regarding the requirements of the APA. Suffice it to say that a majority of the Tax Court held that Reg. § 1.170A-14(g)(6)(ii) reflects a reasonable interpretation of the "protected in perpetuity" requirement of § 170(h)(2)(C) and (h)(5)(A). The majority also agreed with the IRS's position that Reg. § 1.170A-14(g)(6)(ii) does not permit the extinguishment clause of a conservation easement deed to reduce the charitable donee's proportionate benefit by the fair market value of post-contribution improvements to the subject property made by the donor. Hence, the majority disallowed the taxpayer-donor's claimed $9.7 million plus charitable contribution deduction based upon the IRS's alternative argument (in addition to the grounds expressed in Judge Holmes's separate memorandum opinion).

Concurring opinion of Judge Toro. In a concurring opinion, Judge Toro, joined by Judge Urda and in part by Judges Gustafson and Jones, wrote that, although the majority reached the correct result for the reasons expressed in Judge Holmes's memorandum decision, the majority was mistaken concerning whether Reg. § 1.170A-14(g)(6)(ii) violates the APA and whether the IRS's interpretation of the extinguishment regulation (regarding post-contribution improvements made by a taxpayer-donor) was permissible.

Dissenting opinion of Judge Holmes. In an interesting twist, Judge Holmes (who held in favor of the IRS in his memorandum opinion) dissented from the Tax Court's reviewed opinion. Judge Holmes wrote: "Our decision today will likely deny any charitable deduction to hundreds or thousands of taxpayers who donated the conservation easements that protect perhaps millions of acres." And Judge Holmes made his views clear regarding the IRS's interpretation of Reg. § 1.170A-14(g)(6)(ii) to prohibit reduction of a charitable donee's extinguishment benefit for the value of improvements made by a taxpayer-donor and Treasury's compliance with the APA: "[I]f the majority is right, the Treasury Department can get by with the administrative-state equivalent of a quiet shrug, a knowing wink, and a silent fleeting glance from across a crowded room."

b. The Eleventh Circuit has agreed that a conservation easement with an extinguishment clause that does not allow the charitable donee, in the event the easement is extinguished, to share in appreciation of the property due to improvements does not comply with applicable regulations. TOT Property Holdings, LLC v. Commissioner, 1 F.4th 1354 (11th Cir. 6/23/21). The taxpayer in this case donated to a qualifying organization (a land conservancy) a conservation easement on 652 acres of undeveloped land in Van Buren County, Tennessee. As required by Reg. § 1.170A-14(g)(6)(ii), the deed granting the easement addressed the rights of the donee organization in the event the easement was extinguished. The deed provided that, upon extinguishment of the easement, the donee organization would be entitled to a proportionate share of the sale proceeds resulting from the extinguishment. The proportionate share was to be determined by comparing, at the time of donation, (i) the value of the easement to (ii) the value of the property subject to the easement without reduction by the value of the easement. In other words, the donee's proportionate share of extinguishment proceeds would be determined by constructing a fraction, the numerator of which was the value of the easement at the time of donation and the denominator of which was the value of the entire property (without reduction by the value of the easement) at the time of donation. So far, so good. However, the deed provided that, if the easement were extinguished, the donee's proportionate share of sale proceeds would be determined by applying this fraction to:

> the fair market value of the Property unencumbered by this Easement (minus any increase in value after the date of this grant attributable to improvements) …

The effect of this language was to preclude the charitable donee from sharing, upon extinguishment of the easement, in any increase in value of the property attributable to post-donation improvements. In an opinion by Judge Anderson, the U.S. Court of Appeals for the Eleventh Circuit agreed with the IRS that this provision in the deed conveying the easement did not comply with Reg. § 1.170A-14(g)(6)(ii):

> Appellants do not seriously dispute that the formula in … the deed is different from [the] regulatory formula. Nor could they plausibly do so…. [T]he regulation does not allow for "any increase in value after the date of th[e] grant attributable to improvements" to be subtracted from the extinguishment (e.g. condemnation) proceeds before the fraction is applied to the proceeds. No such "minus" language is included in the formula set out in § 1.170A-14(g)(6)(ii). Thus, the deed is different from and out of compliance with the formula set out in the regulation.

The court noted that its holding was consistent with the holding of the Fifth Circuit in *PBBM Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193 (5th Cir. 2018), and that of the Tax Court in *Coal Property Holdings, LLC v. Commissioner*, 153 T.C. 126 (2019).

The court also rejected the taxpayer's argument that the language in the deed complied with the applicable regulation because it stated that the donee organization's proportionate share of proceeds resulting from extinguishment of the easement would be determined either in accordance with the deed or in accordance with Reg. § 1.170A-14 "if different." The court referred to this provision as the "Treasury Regulation Override." "For federal tax purposes," the court observed, "courts and the IRS have refused to enforce a clause that purports to save an instrument from being out of compliance with the tax laws if the clause is operative by way of a condition subsequent." The court concluded that the Treasury Regulation Override was a condition subsequent savings clause that did not bring the language in the deed into compliance with the applicable regulation.

The court also upheld the Tax Court's valuation of the easement in question, the Tax Court's imposition of accuracy-related penalties, and held that the IRS had complied with § 6751(b) by obtaining the required supervisory approval of the penalties.

- The taxpayer in this case did not challenge the validity of the regulation in question, Reg. § 1.170A-14(g)(6)(ii), under the Administrative Procedure Act (APA). In a subsequent case, *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21), the Eleventh Circuit held that the regulation was arbitrary and capricious under the APA for failing to comply with the APA's procedural requirements and therefore is invalid.

c. According to the Eleventh Circuit, Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, is arbitrary and capricious under the Administrative Procedure Act for failing to comply with procedural requirements and therefore is invalid. Hewitt v. Commissioner, 21 F.4th 1336 (11th Cir. 12/29/21), *rev'g*, T.C. Memo. 2020-89 (6/17/20). In an opinion by Judge Lagoa, the U.S Court of Appeals for the Eleventh Circuit has held that Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, violates the Administrative Procedure Act (APA) and therefore is invalid. The taxpayers in this case donated to a qualifying organization a conservation easement on land in Randolph County, Alabama. Like the deed in *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 6/23/21) (discussed above), the deed conveying the easement in this case provided that, in the event of judicial extinguishment of the easement, the value of post-donation improvements to the property would be subtracted from the extinguishment proceeds before determining the donee's share of the proceeds. The IRS argued that this subtraction of the value of post-donation improvements is not permitted by the relevant regulation, Reg. § 1.170A-14(g)(6)(ii). The Eleventh Circuit had agreed with the IRS on this issue in *TOT Property Holdings, LLC*. In this case, however, the taxpayers, unlike the taxpayers in *TOT Property Holdings, LLC*, argued that the regulation was invalid under the APA. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule's basis and purpose. *See, e.g.*, *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92, 96 (2015). The taxpayer argued that, in issuing Reg. § 1.170A-14(g)(6)(ii), Treasury had not complied with the second step because seven commenters, including the New York Land Conservancy (NYLC), had expressed concern about the required allocation of proceeds upon extinguishment of the easement reflected in the proposed version of the regulation. The NYLC specifically had commented on the issue of whether post-donation improvements to the property subject to the easement should be taken into account in determining the charitable donee's proportionate share of extinguishment proceeds and had argued that such a requirement was undesirable to prospective donors and that the proposed version of the regulation should be revised. When the Treasury Department issued the final version of the regulation, the preamble stated that Treasury had considered all comments submitted but did not specifically address or respond to the comments submitted on allocation of post-extinguishment proceeds. The Eleventh Circuit agreed with the taxpayer:

> Simply put, NYLC's comment was significant and required a response by Treasury to satisfy the APA's procedural requirements. And the fact that Treasury stated that it had considered "all comments," without more discussion, does not change our analysis, as it does not "enable [us] to see [NYLC's] objections and why [Treasury] reacted to them as it did."

(quoting *Lloyd Nolan Hosp. & Clinic v. Heckler*, 762 F.2d1561, 1566 (11th Cir. 1985).) Accordingly, the court held that the IRS's interpretation of Reg. § 1.170A-14(g)(6)(ii) as precluding the subtraction of post-donation improvements to the easement property in determining the donee organization's proportionate share of extinguishment proceeds is arbitrary and capricious and therefore invalid under the APA's procedural requirements. The court therefore reversed the Tax Court's decision that had disallowed the taxpayer's charitable contribution deduction.

d. The Sixth Circuit has disagreed with the Eleventh Circuit and has held that Treasury complied with the Administrative Procedure Act in issuing Reg. § 1.170A-14(g)(6)(ii) and that the regulation is valid. Oakbrook Land Holdings, LLC v. Commissioner, 28 F.4th 700 (6th Cir. 3/14/22), *aff'g*, 154 T.C. 180 (5/12/20). The taxpayers in this case donated to a qualifying organization a conservation easement on 106 acres of land on White Oak Mountain, an outcropping of the Appalachians near Chattanooga, Tennessee. As discussed above, the deed conveying the easement provided that, if the easement were to be extinguished, the done organization's proportionate share of the extinguishment proceeds would be determined by subtracting the value of any post-donation improvements to the property. The Tax Court had held in a reviewed opinion that Treasury had complied with the Administrative Procedure Act (APA) in issuing the regulation. In an opinion by Judge Moore, the U.S. Court of Appeals for the Sixth Circuit has affirmed the Tax Court's decision. The taxpayers in this case, like those in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21), argued that Treasury had failed to comply with the APA in issuing the regulation. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule's basis and purpose. *See, e.g.*, *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92, 96 (2015). The taxpayer argued that, in issuing Reg. § 1.170A-14(g)(6)(ii), Treasury had not complied with the either the second or third steps. With respect to the third step, the taxpayer argued that Treasury had not adequately explained the purpose and basis of the regulations because the preamble to the final version of the regulations stated only that the regulations "provide necessary guidance to the public for compliance with the law and affect donors and donees of qualified conservation contributions." The court rejected this argument. Even without an ideal statement of basis and purpose for regulations, the court explained, a regulation can meet the requirement of including a concise statement of its basis and purpose if the basis and purpose are obvious. In its notice of proposed rulemaking for Reg. § 1.170A-14, Treasury had discussed the legislative history of § 170(h) and had described how Congress had shifted from limiting the deductibility of conservation easements to allowing them when the easement was perpetual. Here, the court reasoned,

> the statutory text and the legislative history that Treasury contemplated in promulgating Treas. Reg. § 1.170A-14(g)(6)(ii) illuminate the regulation's basis and purpose: to provide an administrable mechanism that would ensure that an easement's conservation purpose as per I.R.C. § 170(h)(5)(A) continued to be protected should the interest be extinguished.

With respect to the second step for notice-and-comment rulemaking, the taxpayers argued that several commenters, including the New York Land Conservancy (NYLC), had expressed concern about the required allocation of proceeds upon extinguishment of the easement reflected in the proposed version of the regulation. The NYLC specifically had commented on the issue of whether post-donation improvements to the property subject to the easement should be taken into account in determining the charitable donee's proportionate share of extinguishment proceeds and had argued that such a requirement was undesirable to prospective donors and that the proposed version of the regulation should be revised. When the Treasury Department issued the final version of the regulation, the preamble stated that Treasury had considered all comments submitted but did not specifically address or respond to the comments submitted on allocation of post-extinguishment proceeds. The court held that none of the comments identified by the taxpayers required a response by Treasury. None of the comments, the court observed, raised a concern that Reg. § 1.170A-14(g)(6)(ii), which addresses allocation of proceeds to the donee organization upon extinguishment of the easement, failed to satisfy the perpetuity requirement of § 170(h)(2)(C) and (h)(5)(A), which was Congress's central concern. The court rejected as unpersuasive the contrary decision of the Eleventh Circuit in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21).

The court also rejected the taxpayer's argument that Reg. § 1.170A-14(g)(6)(ii) reflects an impermissible construction of § 170(h). The court assessed the validity of the regulation by applying the two-step analysis of *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). The court concluded in *Chevron* step one that the statute, § 170(h)(5)(A), is ambiguous, and in step two that Reg. § 1.170A-14(g)(6)(ii) is a reasonable interpretation of the statute.

Finally, the court rejected as unpersuasive the taxpayer's argument that Treasury had acted arbitrarily or capriciously in issuing Reg. § 1.170A-14(g)(6)(ii) because it had provided no explanation for why it adopted the rule, and because it had failed to consider a variety of alternatives.

Concurring opinion by Judge Guy. In a concurring opinion, Judge Guy concluded that Reg. § 1.170A-14(g)(6)(ii) is procedurally invalid under the APA for substantially the same reasons articulated by the Eleventh Circuit in *Hewitt v. Commissioner*, 21 F.4th 1336 (11th Cir. 12/29/21). Nevertheless, Judge Guy concurred in the court's judgment affirming the Tax Court's decision. Judge Guy reasoned that the relevant statute, § 170(h)(2)(C), requires that the donee organization receive the fair market value of the easement upon judicial extinguishment of the easement, that this right be protected in perpetuity, and that the provisions in the deed conveying the easement in this case failed to comply with this requirement. In other words, Judge Guy reasoned that it is unnecessary to rely on Reg. § 1.170A-14(g)(6)(ii) to conclude that the easement in this case failed to satisfy the statutory requirement. The majority declined to consider this argument by the government because the government had failed to raise it in the Tax Court. Judge Guy observed that parties can be permitted to raise arguments for the first time on appeal in exceptional cases, and concluded that this was an exceptional case.

2. If you are donating a used motor vehicle, boat, or airplane, you better not neglect to obtain and attach to your return Form 1098-C, says the Tax Court. Izen v. Commissioner, 148 T.C. 71 (3/1/17). On April 14, 2016, during a pending Tax Court proceeding, the taxpayer filed an amended federal income tax return for 2010 and claimed a charitable contribution deduction of $338,080 for his donation of a 50 percent interest in a 1969 model Hawker-Siddley DH125-400A private jet to the Houston Aeronautical Heritage Society (Society), an organization exempt from tax under § 501(c)(3), which operates a museum at the William P. Hobby Airport. The taxpayer included with his amended return: (1) an acknowledgment letter dated December 30, 2010, and signed by the president of the Society; (2) a Form 8283, *Noncash Charitable Contributions*, dated April 13, 2016, and executed by the managing director of the Society; (3) a copy of an "Aircraft Donation Agreement" allegedly executed on December 31, 2010, by the president of the Society (but not by the taxpayer); and (4) an appraisal dated April; 7, 2011, stating that the fair market value of the taxpayer's 50 percent interest in the aircraft, as of December 30, 2010, was $338,080. The IRS moved for summary judgment and asserted that the taxpayer was not entitled to the charitable contribution deduction because he had failed to satisfy the substantiation requirements of § 170(f)(12), which applies to contributions of used motor vehicles, boats, and airplanes. Section 170(f)(8) requires a contemporaneous written acknowledgement from the donee organization as a condition for deducting charitable contributions of $250 or more, but § 170(f)(12) imposes more stringent substantiation requirements. Section 170(f)(12) requires a more detailed contemporaneous written acknowledgment and, unlike § 170(f)(8), requires the taxpayer to include the acknowledgment with the return that includes the deduction. The statute directs the donee organization to provide to the government the information contained in the acknowledgment, and the IRS has designated for this purpose Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, a copy of which is to be provided to the donor. The taxpayer did not submit Form 1098-C with his amended return. The Tax Court (Judge Lauber) concluded that the documentation the taxpayer did submit with his amended return did not comply with the requirements of § 170(f)(12). Accordingly, the court disallowed the taxpayer's deduction.

a. The Fifth Circuit has agreed: no 1098-C, no deduction. Izen v. Commissioner, 129 A.F.T.R.2d 2022-2171 (5th Cir. 6/29/22), *aff'g* 148 T.C. 71 (3/1/17). In a per curiam opinion, the U.S. Court of Appeals for the Fifth Circuit has affirmed the Tax Court's decision. Section 170(f)(12) requires a taxpayer to attach Form 1098-C to the return in order to claim a deduction for a charitable contribution of used motor vehicles, boats, and airplanes. The court rejected the taxpayer's argument that he had substantially complied with the statute's requirements by attaching to the return the documentation that he did:

> The doctrine of substantial compliance may support a taxpayer's claim where he or she acted in good faith and exercised due diligence but nevertheless failed to meet a regulatory requirement. We cannot accept the argument that substantial compliance satisfies statutory requirements. Congress specifically required the contemporaneous written acknowledgment include the taxpayer identification number, but that is lacking here.

X. TAX PROCEDURE

A. Interest, Penalties, and Prosecutions

1. Is the IRS ever going to learn that the § 6751(b) supervisory approval requirement is not met unless the required supervisory approval of a penalty occurs *before* the initial determination that formally communicates the penalty to the taxpayer? Laidlaw's Harley Davidson Sales, Inc. v. Commissioner, 154 T.C. 68 (1/16/20). The taxpayer, a C corporation, failed to disclose its participation in a listed transaction as required by § 6011 and Reg. § 1.6011-4(a). The IRS revenue agent examining the taxpayer's return issued a 30-day letter to the taxpayer offering the opportunity for the taxpayer to appeal the proposal to the IRS Office of Appeals (IRS Appeals). The 30-day letter proposed to assess a penalty under § 6707A for failing to disclose a reportable transaction. Approximately three months after the 30-day letter was issued, the revenue agent's supervisor approved the penalty by signing a Civil Penalty Approval Form. Following unsuccessful discussions with IRS Appeals, the IRS assessed the penalty and issued a notice of levy. The taxpayer requested a collection due process (CDP) hearing with Appeals, following which Appeals issued a notice of determination sustaining the proposed levy. In response to the notice of determination, the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer filed a motion for summary judgment on the basis that the IRS had failed to comply with the supervisory approval requirement of § 6751(b). Section 6751(b)(1) requires that the "initial determination" of the assessment of a penalty be "personally approved (in writing) by the immediate supervisor of the individual making such determination." The Tax Court (Judge Gustafson) granted the taxpayer's motion. The court first concluded that the supervisory approval requirement of § 6751(b) applies to the penalty imposed by § 6707A. Next the court concluded that the supervisory approval of the §6707A penalty in this case was not timely because it had not occurred before the IRS's initial determination of the penalty. The parties stipulated that the 30-day letter issued to the taxpayer reflected the IRS's initial determination of the penalty. The supervisory approval of the penalty occurred three months later and therefore, according to the court, was untimely. The IRS argued that the supervisory approval was timely because it occurred before the IRS's *assessment* of the penalty. In rejecting this argument, the court relied on its prior decisions interpreting § 6751(b), especially *Clay v. Commissioner*, 152 T.C. 23 (2019), in which the court held in a deficiency case "that when it is 'communicated to the taxpayer formally … that penalties will be proposed', section 6751(b)(1) is implicated." In *Clay*, the IRS had issued a 30-day letter when it did not have in hand the required supervisory approval of the relevant penalty. The IRS can assess the penalty imposed by § 6707A without issuing a notice of deficiency. Nevertheless, the court observed "[t]hough Clay was a deficiency case, we did not intimate that our holding was limited to the deficiency context." The court summarized its holding in the present case as follows:

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

The court therefore concluded that it had been an abuse of discretion for the IRS Office of Appeals to determine that the IRS had complied with applicable laws and procedure 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 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 chips 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.

2. Tax Court holds IRS does not need written supervisory approval to apply the § 72(t) 10% penalty for early withdrawal from a retirement plan. Grajales v. Commissioner, 156 T.C. 55 (1/25/21). 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, Ms. Grajales, who was in her early 40s, took loans in connection with her New York State pension plan (the "Plan"). The Plan sent her a Form 1099-R that reflected total distributions of $9,026. Subject to certain exceptions, § 72(t)(1) provides that, if a taxpayer who has not attained age 59-1/2 receives a distribution from a retirement plan, the taxpayer's tax must be increased by 10 percent of the distribution. In filing her tax return, Ms. Grajales did not report any retirement plan distributions as income. The IRS determined that she should have included the $9,026 of Plan distributions in her income and that the distributions were subject to the 10-percent additional tax on early distributions under § 72(t). The issue in this case was whether the 10 percent exaction of § 72(t) is a penalty, addition to tax, or additional amount within the meaning of § 6751(c). If so, then the IRS was required by § 6751(b) to have written, supervisory approval in order to impose the 10-percent additional amount provided for in § 72(t). The Tax Court (Judge Thornton) held that the § 72(t) exaction is a "tax" and not a "penalty," "addition to tax," or "additional amount." Because it is a "tax," the court held, it is not subject to the § 6751(b) written supervisory approval requirement. In reaching this conclusion, Judge Thornton acknowledged that none of the court's prior decisions have expressly addressed whether the § 6751(b) written supervisory approval requirement applies to the 10-percent exaction of § 72(t). Judge Thornton relied on several Tax Court decisions that have held that the § 72(t) exaction is a "tax." The court previously had held that the § 72(t) exaction is not a "penalty, addition to tax, or additional amount" within the meaning of § 7491(c) for purposes of imposing the burden of production. *See, e.g., Williams v. Commissioner*, 151 T.C. 1 (2018). Further, in *El v. Commissioner*, 144 T.C. 140, 148 (2015), the Tax Court had concluded that the exaction under §72(t) was a tax for the following reasons:

> First, section 72(t) calls the exaction that it imposes a "tax" and not a "penalty", "addition to tax", or "additional amount". Second, several provisions in the Code expressly refer to the additional tax under section 72(t) using the unmodified term "tax". See secs. 26(b)(2), 401(k)(8)(D), (m)(7)(A), 414(w)(1)(B), 877A(g)(6). Third, section 72(t) is in subtitle A, chapter 1 of the Code. Subtitle A bears the descriptive title "Income Taxes", and chapter 1 bears the descriptive title "Normal Taxes and Surtaxes". Chapter 1 provides for several income taxes, and additional income taxes are provided for elsewhere in subtitle A. By contrast, most penalties and additions to tax are in subtitle F, chapter 68 of the Code.

In following the court's prior holdings, Judge Thornton rejected the taxpayer's argument that the exaction of § 72(t) is an "additional amount" within the meaning of § 6751(c), reasoning that use of the phrase "additional amounts" when used in a series that also includes "tax" and "additions to tax" is a term of art that refers exclusively to civil penalties. Judge Thornton rejected several other arguments made by the taxpayer, including the assertion that the Tax Court must employ the "functional approach" under which the U.S. Supreme Court applied a constitutional analysis to conclude that the § 72(t) exaction was a "penalty" and not a "tax." *See Nat'l Fed'n of Indep. Bus. (NFIB) v. Sebelius*, 567 U.S. 519 (2012). Judge Thornton distinguished *NFIB* on the basis that the circumstances in this case presented no constitutional issue. Further, neither party argued that § 72(t) is unconstitutional in this case. According to the Tax Court, for purposes of § 6751(b) and (c), the § 72(t) exaction is a "tax," not a "penalty," "addition to tax," or "additional amount." Therefore, § 6751(b) did not require written supervisory approval.

a. The Second Circuit has agreed: the IRS need not comply with the § 6751(b) supervisory approval requirement to apply the § 72(t) 10% penalty for early withdrawal from a retirement plan. Grajales v. Commissioner, 47 F.4th 58 (2d Cir. 8/24/22), *aff'g Grajales v. Commissioner*, 156 T.C. 55 (1/25/21). In an opinion by Judge Wesley, the U.S. Court of Appeals for the Second Circuit has affirmed the Tax Court's decision and held that the 10-percent additional amount imposed by § 72(t) on early distributions from a retirement plan is not a penalty and therefore is not subject to the supervisory approval requirement of § 6751(b). The court emphasized that the plain language of § 72(t) indicates that the exaction it imposes is a tax and not a penalty. That language, the court observed, states that a "taxpayer's tax … *shall be increased* by an amount equal to 10 percent of the portion of such amount which is includible in gross income." (emphasis added). The terms "penalty," additional amount," and "addition to tax," the court reasoned, do not appear in the language of § 72(t). The court rejected the taxpayer's argument that the exaction of § 72(t) is a penalty because it is calculated by adding 10 percent to the taxpayer's tax, and therefore is not calculated in the same way as the underlying tax and is a separate exaction based on income that has already been taxed. According to the court, the fact that the exaction of § 72(t) is calculated differently from the regular income tax does not mean that it is not a tax:

> Like various other taxes, the Exaction is calculated differently than regular income tax. But that does not make it a penalty—it is a feature, not a bug in the Code triggering the written supervisory approval requirement.

Similarly, the court rejected the taxpayer's argument that the purpose of § 72(t) is to discourage individuals from making early withdrawals from retirement plans and therefore is penal in nature. What is determinative, the court reasoned, is not the purpose of the statute, but rather the meaning that Congress ascribed to it. The court observed that at least six other provisions of the Code refer to the exaction of § 72(t) as a tax. The court concluded:

> Together with the substantive text of Section 72(t)(1), the plain language of Section 72(t) considered in connection with the rest of the Code is unambiguous: the Exaction is a tax, not a penalty.

3. Updated instructions on how to rat yourself out. Rev. Proc. 2021-52, 2021-51 I.R.B. 883 (12/16/21). This revenue procedure updates Rev. Proc. 2020-54, 2020-53 I.R.B. 1806, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d), relating to the substantial understatement aspect of the accuracy-related penalty, and for the purpose of avoiding the tax return preparer penalty under § 6694(a), relating to understatements due to unreasonable positions. There have been no substantive changes. The revenue procedure does not apply with respect to any other penalty provisions, including § 6662(b)(1) accuracy-related penalties. If this revenue procedure does not include an item, disclosure is adequate with respect to that item only if made on a properly completed Form 8275 or 8275-R, as appropriate, attached to the return for the year or to a qualified amended return.

A corporation's complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, is treated as if the corporation had filed a Form 8275 or Form 8275-R regarding the tax position. The revenue procedure applies to any income tax return filed on a 2021 tax form for a taxable year beginning in 2021 and to any income tax return filed on a 2021 tax form in 2022 for a short taxable year beginning in 2022.

4. According to Ronald Regan, "The nine most terrifying words in the English language are 'I'm from the government and I'm here to help.'" Well, this time they're true! The IRS has provided relief from late-filing and other penalties with respect to certain 2019 and 2020 returns. Notice 2022-36, 2022-36 I.R.B. 188 (8/24/22). This notice provides relief for certain taxpayers from certain late-filing penalties and certain international information return penalties with respect to tax returns for taxable years 2019 and 2020 that are filed on or before September 30, 2022. More specifically, the notice provides relief from late-filing penalties imposed by § 6651(a) for failure to timely file several types of income tax returns, including individual income tax returns (Form 1040 series), income tax returns of trusts and estates (Form 1041 and Form 1041-QFT), corporate income tax returns (Form 1120 series), and certain returns of exempt organizations (Forms 990-PF and 990-T). The notice also provides relief from late-filing penalties for partnership returns (Form 1065) and returns of subchapter S corporations (Form 1120-S). In addition, the notice provides relief from certain information return penalties with respect to taxable year 2019 returns that were filed on or before August 1, 2020, and with respect to taxable year 2020 returns that were filed on or before August 1, 2021. This latter relief applies to most information returns on Form 1099. The notice provides relief only from specific penalties and with respect to specific returns. Accordingly, readers should consult the notice in determining whether relief is available in specific situations. The penalties to which the notice applies will be automatically abated, refunded, or credited, as appropriate without any need for taxpayers to request relief. The IRS issued this notice pursuant to the emergency declaration issued by the President on March 13, 2020, in response to the COVID-19 pandemic. That declaration instructed the Secretary of the Treasury "to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate, pursuant to 26 U.S.C. 7508A(a)."

B. Discovery: Summonses and FOIA

C. Litigation Costs

1. A taxpayer who offered to concede 100 percent of the proposed tax and penalties but who reserved the right to seek innocent spouse protection was not entitled to reasonable litigation costs under §7430(a)(2) because her offer was not a qualified offer and the IRS's position was substantially justified. Lewis v. Commissioner, 158 T.C. No. 3 (3/3/22). The issue in this case is whether the taxpayer was a prevailing party and therefore entitled to recover reasonable litigation costs from the IRS pursuant to § 7430(a)(2). Generally, § 7430(a) provides that, in an administrative or court proceeding brought by or against the government in connection with the determination, collection, or refund of any tax, interest or penalty, the *prevailing party* is entitled to recover reasonable administrative costs in connection with an administrative proceeding within the IRS and reasonable litigation costs incurred in connection with a court proceeding. The taxpayer here sought only reasonable litigation costs. The taxpayer filed joint returns with her former husband for 2008, 2009, and 2010. The IRS audited the returns and proposed adjustments and penalties. The taxpayer responded by sending a letter to the IRS that stated she was making a qualified offer pursuant to § 7430(g). If a taxpayer makes a qualified offer, and if the liability of the taxpayer pursuant to the judgment in the court proceeding is equal to or less than the liability of the taxpayer that would have resulted if the government had accepted the qualified offer, then, pursuant to § 7430(c)(4)(E), the taxpayer is treated as a prevailing party. In her letter to the IRS, the taxpayer offered to concede 100 percent of the tax and penalties proposed by the IRS for the years in question and to agree to immediate assessment of the tax and penalties, but she reserved all collection rights, including (among others) the right to seek innocent spouse relief and to submit an offer-in-compromise. The IRS neither accepted nor rejected the taxpayer's offer, which accordingly lapsed. The IRS later issued a notice of deficiency, in response to which the taxpayer filed a petition in the U.S. Tax Court in which she asserted that she was entitled to innocent spouse protection under § 6015(b) and (c). In its answer, the IRS admitted that the taxpayer had sought innocent spouse protection and committed to review her request and make a determination regarding her eligibility for it. Although the taxpayer refused to submit a claim for innocent spouse protection on Form 8857 as the IRS requested, the IRS ultimately determined that she was entitled to innocent spouse protection for all years in question under § 6015(c) and moved for entry of a decision granting her relief from joint and several liability. The taxpayer moved for an award of reasonable litigation costs.

The Tax Court (Judge Pugh) denied the taxpayer's motion for an award of reasonable litigation costs. The court first considered whether the taxpayer had submitted a qualified offer and therefore treated as a prevailing party under § 7430(c)(4)(E). The court noted that one requirement of a qualified offer, specified in § 7430(g)(1)(B), is that the offer must "specif[y] the offered amount of the taxpayer's liability (determined without regard to interest)." The relevant regulation, Reg. § 301.7430-7(c)(3), provides that the offer may be expressed as a specific dollar amount or as a percentage and "must be an amount, the acceptance of which by the United States will fully resolve the taxpayer's liability, and only that liability … for the type or types of tax and the taxable year or years at issue in the proceeding." The court agreed with the IRS that the taxpayer's offer was not a qualified offer because her offer reserved the right to challenge the assessed liability by seeking innocent spouse relief. The text of the Code provision that authorizes innocent spouse relief (§ 6015), the court reasoned, makes clear that it does not relate to collection of tax, but rather provides relief from liability for tax. For this reason, the court concluded, the taxpayer's offer did not specify the offered amount of the taxpayer's liability. The court noted that, if the IRS had accepted the taxpayer's offer to agree to assessment of 100 percent of the proposed tax and penalties, the acceptance would not have fully resolved the taxpayer's liabilities because her reserved right to seek innocent spouse relief could (and in fact did) result in her liability for the years in question being reduced to zero.

After concluding that the taxpayer could not be considered a prevailing party pursuant to § 7430(c)(4)(E) because she had not submitted a qualified offer, the court turned to the issue whether the taxpayer was a prevailing party under the generally applicable rules of § 7430(c)(4) for determining status as a prevailing party. Under § 7430(c)(4)(B), a party is not considered a prevailing party if the IRS's position is "substantially justified." The relevant regulation, Reg. § 301.7430-5(d)(1), provides:

> A significant factor in determining whether the position of the Internal Revenue Service is substantially justified as of a given date is whether, on or before that date, the taxpayer has presented all relevant information under the taxpayer's control and relevant legal arguments supporting the taxpayer's position to the appropriate Internal Revenue Service personnel. …

The IRS's position, reflected in its answer in the Tax Court proceeding, was a concession that the taxpayer had sought innocent spouse protection and a commitment to review her request and make a determination regarding her eligibility for it. The court concluded that the IRS's position was substantially justified because the taxpayer had not submitted all relevant information regarding her request:

> A reasonable person could require information such as Form 8857 or other documentation supporting petitioner's claim for innocent spouse relief before making a determination.

Because the taxpayer had not submitted a qualified offer, and because the IRS's position was substantially justified, the court concluded, that taxpayer was not a prevailing party and therefore was not entitled to reasonable litigation costs under § 7430(a)(2).

D. Statutory Notice of Deficiency

E. Statute of Limitations

1. ♪♫Eight miles high and when you touch down, you'll find that it's stranger than known.♫♪ These United Airlines employees paid FICA taxes on the present value of future retirement benefits they will never receive and filed their refund claims too late. Koopman v. United States, 129 A.F.T.R.2d 2022-1445 (Fed. Cir. 4/11/22). In 2000 and 2001, these taxpayers retired from their positions as employees of United Airlines. Pursuant to § 3121(v)(2), the present values of their future retirement benefits (approximately $348,000 and $415,000 respectively) were included in their FICA bases for the years of their retirement. Section 3121(v)(2) provides that amounts deferred under a nonqualified deferred compensation plan must be taken into account for FICA purposes as of the later of the time the services are performed or the time when there is no substantial risk of forfeiture of the right to such amounts. The regulations issued under § 3121(v)(2), Reg. § 31.3121(v)(2)-(1)(c)(2)(ii), prescribe the method of determining the present value of the future retirement benefits and provide that the present value cannot be discounted to take into account the risk of the future benefits not being paid. United Airlines entered bankruptcy proceedings in 2002 and its liability for the taxpayer's retirement benefits was ultimately discharged in 2006. The taxpayers received only a portion of the promised benefits. The taxpayers brought this action in the U.S. Court of Federal Claims seeking refunds of the FICA taxes they paid on the retirement benefits they never received. In a prior decision, the U.S. Court of Appeals for the Federal Circuit had upheld the method of determining present that is set forth in Reg. § 31.3121(v)(2)-(1)(c)(2)(ii) and declined to order a refund for a similarly situated United Airlines employee. *Balestra v. United States*, 803 F.3d 1363 (Fed. Cir. 2015).

In this litigation, the government moved to dismiss for lack of subject matter jurisdiction on the ground that the taxpayers had filed their administrative claims for refund late. Section § 7422(a) provides that no suit or proceeding for a refund of tax can be maintained unless an administrative claim for refund has been "duly filed." Accordingly, if a taxpayer has not filed a timely administrative claim for a tax refund, the taxpayer is barred from bringing legal action seeking the refund. Section 6511(a) provides that a claim for refund must be filed within the later of two years from the time tax was paid or three years from the time the return was filed.

In a per curiam opinion, the U.S. Court of Appeals for the Federal Circuit affirmed the Claims Court's decision that the taxpayers had not filed timely administrative claims for refunds. In the case of FICA taxes, the court explained, pursuant to § 6513(c), a return for any quarterly period ending in a calendar year is considered filed on April 15 of the following year; and a tax with respect to any quarterly period is considered paid on the following April 15 (as long as it was actually paid before that date). In this case, the two taxpayers paid the FICA taxes in 2000 and 2001, which means the quarterly returns filed by United Airlines were filed on April 15, 2001, and April 15, 2002, respectively. Therefore, the deadline to file administrative claims for refunds were April 15, 2004, and April 15, 2005, respectively. The taxpayers did not file their administrative claims for refunds until 2007. Accordingly, the court held, the taxpayers had not duly filed administrative claims for refunds and were barred by § 7422 from brining legal action for refunds. This was so even though United Airlines' obligation to pay their retirement benefits was not discharged until 2006. In reaching this conclusion, the court rejected various arguments by the taxpayers that they should be entitled to equitable exceptions to the limitations period on claims for refunds. Among other authorities, the court relied on the U.S. Supreme Court's decision in *United States v. Brockamp*, 519 U.S. 347 (1997), in which the Court held that the limitations periods of § 6511(a) on claims for refund are not subject to equitable exceptions. The court concluded:

> But, ultimately, to the extent this case illustrates that there may be a problem of unfairness in the way that the Internal Revenue Code operates with respect to taxes paid on deferred compensation retirement benefits when an employer later goes

bankrupt, that would be a problem for Congress and the Treasury Department to address.

F. Liens and Collections

1. The 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is jurisdictional and not subject to equitable tolling. Boechler, P.C. v. Commissioner, 967 F.3d 760 (8th Cir. 7/24/20), *aff'g* Boechler, P.C. v. Commissioner, No. 18578-17L (U.S. Tax Court (2/15/19)). Following a collection due process hearing, the IRS issued a notice of determination upholding proposed collection action. The notice informed the taxpayer, a law firm in Fargo, North Dakota, that, if it wished to contest the determination, it could do so by filing a petition with the United States Tax Court within a 30-day period beginning the day after the date of the letter. The IRS mailed the notice on July 28, 2017. The 30-day period expired on August 27, 2017, but because this date fell on a Sunday, the taxpayer had until the following day, August 28, to file his petition. The taxpayer mailed its petition to the Tax Court on August 29, 2017, which was one day late. The Tax Court (Judge Carluzzo) granted the government's motion to dismiss for lack of subject matter jurisdiction. On appeal, the taxpayer argued that the 30-day period specified in § 6330(d)(1) for filing his Tax Court petition should be equitably tolled. In an opinion by Judge Erickson, the U.S. Court of Appeals for the Eighth Circuit affirmed the Tax Court's decision. The court held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore is not subject to equitable tolling. In reaching this conclusion, the court relied on the plain language of § 6330(d)(1), which provides:

> The person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

This provision, the court reasoned, "is a rare instance where Congress clearly expressed its intent to make the filing deadline jurisdictional." According to the court, the parenthetical expression regarding the Tax Court's jurisdiction "is clearly jurisdictional and renders the remainder of the sentence jurisdictional." Because the 30-day period specified in § 6330(d)(1) is jurisdictional, the court concluded, it is not subject to equitable tolling. In reaching this conclusion, the court found persuasive the reasoning of the U.S. Court of Appeals for the Ninth Circuit in *Duggan v. Commissioner*, 879 F.3d 1029 (9th Cir. 2018), in which the Ninth Circuit similarly held that the 30-day period specified in § 6330(d)(1) is jurisdictional and therefore not subject to equitable tolling. *See also Cunningham v. Commissioner*, 716 Fed. Appx. 182 (4th Cir. 2018) (holding that, assuming without deciding that the 30-day period specified in § 6330(d)(1) is not jurisdictional and therefore is subject to equitable tolling, the taxpayer had not established circumstances warranting equitable tolling). The Eighth Circuit found unpersuasive the taxpayer's reliance on *Myers v. Commissioner*, 928 F.3d 1025 (D.C. Cir. 2019), in which the D.C. Circuit held that a similarly worded 30-day limitations period in § 7623(b)(4) for filing a Tax Court petition to challenge an adverse IRS determination regarding entitlement to a whistleblower award was not jurisdictional and was subject to equitable tolling.

a. We are sure that Justice Barrett was thrilled to be assigned to write, as one of her first opinions, an opinion on a technical issue of tax procedure. The U.S. Supreme Court has reversed the Eighth Circuit and held that the 30-day period for requesting review in the Tax Court of a notice of determination following a CDP hearing is not jurisdictional and is subject to equitable tolling. Boechler, P.C. v. Commissioner, 142 S. Ct. 1493, 129 A.F.T.R.2d 2022-1489 (4/21/22). In a unanimous opinion by Justice Barrett, the U.S. Supreme Court has reversed the Eighth Circuit and held that the 30-day period specified in § 6330(d)(1) for requesting review in the Tax Court of a notice of determination following a CDP hearing is not jurisdictional and is subject to equitable tolling. The Court began with the proposition that a procedural requirement is jurisdictional only if Congress clearly states that the provision is jurisdictional. The provision in question, § 6330(d)(1), provides:

> The person may, within 30 days of a determination under this section, petition the Tax Court for review of such determination (and the Tax Court shall have jurisdiction with respect to such matter).

Although the parenthetical expression at the end of the provision refers to the Tax Court having jurisdiction, the Court reasoned that whether the provision is jurisdictional depends on whether the phrase "such matter" at the end of the provision refers to the entire first clause of the sentence (as the government argued) or instead refers to the immediately preceding phrase that states "petition the Tax Court" (as the taxpayer argued). In other words, the question is whether the provision indicates that the Tax Court has jurisdiction over the taxpayer's petition, or instead indicates that the Tax Court has jurisdiction only if the taxpayer complies with the 30-day period for requesting review. The Court reasoned that the provision "does not clearly mandate the jurisdictional reading," but that the non-jurisdictional reading "is hardly a slam dunk for Boechler." Nevertheless, the Court concluded that "Boechler's interpretation has a small edge." According to the Court, there are multiple plausible interpretations of the phrase "such matter," and "[w]here multiple plausible interpretations exist—only one of which is jurisdictional—it is difficult to make the case that the jurisdictional reading is clear." Further, the Court reasoned, other tax provisions enacted around the same time as § 6330(d)(1) are much more clear that the filing deadlines they contain are jurisdictional. For example, § 6015(e)(1)(A), which governs the filing of petitions in the Tax Court by taxpayers seeking innocent spouse protection, provides:

> In addition to any other remedy provided by law, the individual may petition the Tax Court (and the Tax Court shall have jurisdiction) to determine the appropriate relief available to the individual under this section *if such petition is filed* … [within a 90-day period]

(Emphasis added.) Such provisions "accentuate the lack of clarity in § 6330(d)(1)."

Having concluded that the 30-day period specified in § 6330(d)(1) is not jurisdictional, the Court turned to the issue of whether this 30-day period is subject to equitable tolling. The Court previously had held in *Irwin v. Department of Veterans Affairs*, 498 U.S. 89 (1990), that non-jurisdictional limitations periods are presumptively subject to equitable tolling, and the Court saw "nothing to rebut the presumption here." The Court rejected the government's argument that the 30-day limitations period set forth in § 6330(d)(1) is similar to the limitations periods for filing claims for refund in § 6511, which the Court had held were not subject to equitable tolling in *United States v. Brockamp*, 519 U.S. 347 (1997):[1]

> Section 6330(d)(1)'s deadline is a far cry from the one in *Brockamp*. This deadline is not written in "emphatic form" or with "detailed" and "technical" language, nor is it reiterated multiple times. The deadline admits of a single exception (as opposed to *Brockamp's* six), which applies if a taxpayer is prohibited from filing a petition with the Tax Court because of a bankruptcy proceeding. §6330(d)(2). That makes this case less like *Brockamp* and more like *Holland v. Florida*, 560 U. S. 631 (2010), in which we applied equitable tolling to a deadline with a single statutory exception.

Accordingly, the Court reversed the judgment of the Eighth Circuit and remanded for further proceedings, which will require a determination of whether the taxpayer's circumstances warrant equitable tolling of § 6330(d)(1)'s 30-day period.

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[1] *See generally* Bruce A. McGovern, *The New Provision for Tolling the Limitations Periods for Seeking Tax Refunds: Its History, Operation and Policy, and Suggestions for Reform*, 65 Mo. L. Rev. 797 (2000) (discussing equitable tolling and the U.S. Supreme Court's decision in *Brockamp*).

2. If a taxpayer responds to a notice of intent to levy by timely filing Form 12153 to request a hearing, the taxpayer has requested a collection due process hearing, not an equivalent hearing, even if the taxpayer checks the box indicating they are requesting an equivalent hearing. Ruhaak v. Commissioner, 157 T.C. 103 (11/16/21). The IRS issued a final notice of intent to levy with respect to the taxpayer's 2013 and 2014 taxable years. In response, the taxpayer filing Form 12153, which is the form used to request a collection due process (CDP) hearing before an IRS Appeals Officer. The taxpayer submitted Form 12153 within the 30-day period required by § 6330(a)(2), (a)(3), and (b)(1) to request a CDP hearing. On Form 12153, the taxpayer checked the box on the line labeled "Equivalent Hearing" that states "I would like an Equivalent Hearing - I would like a hearing equivalent to a CDP Hearing if my request for a CDP hearing does not meet the requirements for a timely CDP Hearing." Although a CDP hearing and an equivalent hearing are conducted in the same manner, there are two principal differences: (1) a request for a CDP hearing suspends the running of the limitations period for the IRS to collect tax but a request for an equivalent hearing does not, and (2) when the IRS issues a notice of determination that reflects its decision following a CDP hearing, the taxpayer has the right to seek review in the Tax Court pursuant to § 6330(d)(1), but the taxpayer has no right of judicial review following an equivalent hearing. The taxpayer in this case explained

> that he had requested an equivalent hearing so that he could present to Appeals his views on the morality of paying Federal income tax but without the possibility of subsequent Tax Court litigation or a fine.

The Tax Court (Judge Gale) observed that one reason the taxpayer may have requested an equivalent hearing was to avoid the $5,000 penalty of § 6702(b) for making a "specified frivolous submission." The IRS's position, as reflected in the Internal Revenue Manual, is that, although the penalty can apply to a timely requested CDP hearing, the IRS will not impose the penalty when the taxpayer has requested an equivalent hearing. When the taxpayer failed to submit information requested by the IRS Appeals Officer assigned to conduct the hearing, the IRS issued a notice of determination upholding the collection action. The taxpayer then sought review of the notice of determination in the Tax Court. The taxpayer argued that he had requested an equivalent hearing because he had complied with Reg. § 301.6330-1(i)(1), (2), Q&A-I7, Q&A-I9, which provides that a taxpayer who fails to timely request a CDP hearing may instead request a similar administrative hearing, called an "equivalent hearing," within the one-year period following the mailing date of the written levy notice. In other words, the taxpayer argued that a request submitted within the 30-day period for requesting a CDP hearing is necessarily submitted within the one-year period following the mailing date of the written levy notice, and that he had indicated on Form 12153 that he was requesting an equivalent hearing. The Tax Court rejected this argument and held that the taxpayer's timely request on Form 12153 was a request for a CDP hearing, and not a request for an equivalent hearing, despite the taxpayer's indication on Form 12153 that he was requesting an equivalent hearing in the event his request did not meet the requirements for a timely CDP hearing. The court interpreted Reg. § 301.6330-1(i)(1) to mean that

> only those taxpayers who fail to timely request a CDP hearing are eligible to request an equivalent hearing. Logically, a taxpayer cannot yet have failed to make a timely request for a CDP hearing before the 30-day period for requesting a CDP hearing has expired.

After concluding that the taxpayer had requested a CDP hearing, the court reviewed the IRS's determination that the levy against the taxpayer should be upheld. The court upheld the IRS's position. The court also considered whether to impose penalties under § 6673, which authorizes the Tax Court to impose a penalty of up to $25,000 against a taxpayer who advances a frivolous or groundless position in proceedings before the court or who institutes such proceedings primarily for delay. The court observed that this was the third CDP case that the taxpayer had filed in the Tax Court and that the court had imposed penalties under § 6673 in the taxpayer's most recent case. The court determined, however, that the taxpayer's position in this case that he had requested an equivalent hearing was not frivolous. At the same time, the court made clear to the taxpayer that "advancing frivolous arguments relating to his conscientious objection to the payment of Federal taxes is likely to result in the imposition of a significant section 6673 penalty against him."

3. When a taxpayer seeks review in the Tax Court of an IRS determination to uphold proposed collection action, the Tax Court does not have jurisdiction to consider the taxpayer's refund claim if the proposed collection action becomes moot. McLane v. Commissioner, 24 F.4th 316 (4th Cir. 1/25/22), *aff'g* T.C. Memo. 2018-149. The issue in this case was whether the Tax Court had jurisdiction to consider the taxpayer's claim for a refund. After the taxpayer filed his 2008 return, the IRS disallowed his claimed business deductions on Schedule C and determined that he had underreported his tax liability by $23,615. The IRS issued a notice of deficiency, but the taxpayer and the IRS agreed that the taxpayer never received it. After assessing the tax allegedly due, the IRS issued a notice of federal tax lien. In response, the taxpayer requested a collection due process (CDP) hearing. In a CDP hearing, § 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." Because the taxpayer had not received the notice of deficiency, the IRS Settlement Officer allowed the taxpayer to present evidence to substantiate his business deductions and allowed approximately one-half of the deductions, which reduced the amount of tax allegedly due. Following the CDP hearing, the IRS issued a notice of determination sustaining the notice of federal tax lien and the taxpayer filed a petition in the Tax Court. In the Tax Court, the taxpayer presented evidence of his claimed deductions and the IRS ultimately conceded that (1) the taxpayer was entitled to deductions that exceeded those he initially claimed, (2) there was no tax due, and (3) the taxpayer was entitled to abatement of his tax liability for 2008 and release of the lien. The taxpayer's petition to the Tax Court did not claim that he was entitled to a refund. Following these concessions, in a conference call with the court, the taxpayer asserted for the first time that he was entitled to a refund of tax paid for 2008. The Tax Court (Judge Halpern) concluded that it did not have jurisdiction to consider the taxpayer's refund claim. In an opinion by Judge Motz, the U.S. Court of Appeals for the Fourth Circuit affirmed the Tax Court's decision. According to the Fourth Circuit, the question was whether § 6330(c)(2)(B) (which applies in CDP hearings held to review a notice of federal tax lien pursuant to § 6320(c)) gives the Tax Court jurisdiction to hear a claim for refund. Section 6330(c)(2)(B) provides:

> The person may also raise at the [CDP] hearing challenges to the existence or amount of the *underlying tax liability* for any tax period if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability.

(Emphasis added.) Further, § 6330(d)(1) provides that the Tax Court has jurisdiction to review the IRS's determination following the CDP hearing. The Fourth Circuit reasoned that "the phrase 'underlying tax liability' does not provide the Tax Court jurisdiction over independent overpayment claims when the collection action no longer exists." Here, the court explained:

> When as here, the Commissioner has already conceded that a taxpayer has no tax liability and that the lien should be removed, any appeal to the Tax Court of the Appeals Office's determination as to the collection action is moot. No collection action remains, for which there is underlying tax liability, to appeal.

Accordingly, the Fourth Circuit affirmed the Tax Court's decision that the Tax Court did not have jurisdiction to consider the taxpayer's refund claim.

- The analysis required to conclude that the Tax Court did not have jurisdiction to consider the taxpayer's refund claim is far more nuanced than the Fourth Circuit's opinion suggests. The Tax Court's opinion in this case engages in an extensive analysis of the relevant statutory provisions and of the Tax Court's prior decision in *Greene-Thapedi v. Commissioner*, 126 T.C. 1 (2006). In *Greene-Thapedi*, the taxpayer filed a petition in the Tax Court seeking review of the IRS's determination in a CDP hearing to uphold a proposed levy, but the proposed levy became moot because the IRS applied the taxpayer's refund from a later year to the year in question, which reduced her tax liability to zero. The taxpayer sought a refund of accrued interest on the liability. The Tax Court concluded that, in enacting § 6330, Congress did not intend to provide for the allowance of tax refunds. In this case, the Tax Court declined to reconsider its holding in *Greene-Thapedi* and rejected the taxpayer's arguments that *Greene-Thapedi* was distinguishable. The Fourth Circuit's opinion in this case discusses *Greene-Thapedi* in a footnote and concludes that it is unnecessary to consider whether § 6330 *ever* allows a taxpayer to claim a refund because the limited holding in this case is that § 6330 does not permit a claim for refund when the IRS's proposed collection action that provides the basis for the Tax Court's jurisdiction becomes moot.

4. A taxpayer cannot avoid the trust fund recovery penalty by claiming innocent spouse relief, says the Tax Court. Chavis v. Commissioner, 158 T.C. No. 8 (6/15/22). The taxpayer and her former husband were officers of Oasys Information Systems, Inc., a subchapter C corporation. Her former husband was the president of the corporation, and she was the secretary. The corporation withheld payroll taxes from the wages of its employees but did not pay those taxes to the government. After attempting unsuccessfully to collect the taxes from the corporation, the IRS determined that the taxpayer and her former husband were responsible for total penalties equal to $146,682 of the business' unpaid employment taxes pursuant to § 6672(a). This provision imposes a penalty (commonly referred to as the trust fund recovery penalty) on responsible persons who willfully fail to collect or pay over any tax due. The IRS sent to the taxpayer by certified mail a Letter 1153 (notice of proposed assessment) informing her that the IRS intended to hold her responsible for a penalty equal to the unpaid employment taxes pursuant to § 6672(a). The letter informed the taxpayer that she had the right to appeal the proposed assessment within sixty days to the IRS Office of Appeals. Although the taxpayer received the Letter 1153, she did not appeal the proposed assessment. The IRS assessed the penalties and issued Letter 3172, Notice of Federal Tax Lien Filing. The taxpayer requested a collection due process (CDP) hearing with the IRS Office of Appeals. In her request for a CDP hearing, she indicated that she could not pay the balance due and that she was requesting innocent spouse relief. She sought removal of the lien. Shortly after requesting the CDP hearing, the taxpayer filed a request for innocent spouse relief on Form 8857. The IRS's Cincinnati Centralized Innocent Spouse Operation (CCISO) determined that the taxpayer did not qualify for innocent spouse relief because the provision that authorizes such relief, § 6015, applies to jointly filed income tax returns and not to liability for payroll taxes. In the CDP hearing, the IRS Settlement Officer explained that the taxpayer was not entitled to innocent spouse relief. The Settlement Officer also advised the taxpayer that she could not challenge the underlying tax liability in the CDP hearing because she had received a prior opportunity to challenge the liability when she received IRS Letter 1153. The taxpayer also requested currently not collectible (CNC) status, but the IRS Settlement Officer, after reviewing financial information submitted by the taxpayer and consulting with an IRS collection specialist, determined that the taxpayer did not qualify for CNC status because she could pay $1,685 per month. Following the CDP hearing, the IRS issued a notice of determination upholding the collection action and the taxpayer filed a petition in the Tax Court. The Tax Court (Judge Lauber) granted the IRS's motion for summary judgment. First, Judge Lauber concluded that the taxpayer was precluded from challenging the underlying tax liability in the CDP hearing. Section 6330(c)(2)(B) permits a taxpayer to challenge the existence or amount of the taxpayer's underlying tax liability in a CDP hearing only "if the person did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute such tax liability." In this case, although the IRS did not issue (and was not required to issue) a notice of deficiency with respect to the § 6672(a) penalty it assessed, the court reasoned that the taxpayer had received a prior opportunity to challenge the liability when she received IRS Letter 1153 and had declined to do so. Accordingly, the court held, the IRS Settlement Officer had properly determined that the taxpayer could not challenge the underlying liability in the CDP hearing. Because the taxpayer was precluded from challenging the underlying tax liability, the court concluded, it was required to apply an abuse-of-discretion standard in reviewing the Settlement Officer's decision to uphold the proposed collection action. The court agreed with the IRS that the taxpayer could not avoid the trust fund recovery penalty by claiming innocent spouse relief:

> Petitioner's TFRP liabilities were not shown on, and did not arise from the filing of, a joint Federal income tax return. Rather, her TFRP liabilities arose from her failure to discharge her duty, as an officer of Oasys, to ensure that payroll taxes collected from the company's workers were properly paid over to the Department of the Treasury. Petitioner was therefore not eligible for relief under section 6015(b) or (c).

The court similarly concluded that the taxpayer was not eligible for innocent spouse relief under § 6015(f) (equitable relief). Finally, the court concluded that there was no abuse of discretion in the Settlement Officer's rejection of collection alternatives.

G. Innocent Spouse

1. If you miss the deadline to file a petition in the Tax Court seeking review of the IRS's denial of the taxpayer's request for innocent spouse protection, you just might want to submit a second request. If the IRS responds with a final determination regarding the second request, you can seek review by filing a petition in the Tax Court. Vera v. Commissioner, 157 T.C. 78 (8/23/21). The taxpayer filed joint returns with her then-husband for 2010 and 2013. She later submitted to the IRS a claim on Form 8857 seeking innocent spouse relief for 2013. The IRS issued a final determination denying her request. The taxpayer filed a petition in the Tax Court seeking review of this determination, but the Tax Court dismissed the petition for lack of jurisdiction because, pursuant to § 6015(e)(1), petitions seeking review of innocent spouse determinations must be filed no later than the 90th day after the date the IRS mails the determination, and the taxpayer had filed her petition on the 91st day after the IRS mailed the determination. The taxpayer later submitted to the IRS on Form 8857 a request for innocent spouse relief for 2010, but she included with her request a number of documents related to 2013, including the previous request for innocent spouse relief she had submitted for 2013. The IRS issued a final determination denying her request. The determination, issued as Letter 3288, Final Appeals Determination, referred in the header only to 2010, but the substance of the determination addressed both 2010 and 2013. For example, the letter stated "For tax year 2013, you didn't comply with all income tax laws for the tax years that followed the years that are the subject of your claim." The taxpayer filed a timely petition in the Tax Court seeking review of this determination and specified in her petition that she was contesting the determination as to both 2010 and 2013. The IRS moved to dismiss as to 2013 on the basis that the IRS's determination was not a second determination for 2013. The Tax Court (Judge Buch) denied the motion and held that the court had jurisdiction as to both 2010 and 2013 because the IRS's determination was a final determination as to both years. Under § 6015(e)(1), the Tax Court has jurisdiction to review a "final determination" by the IRS regarding the taxpayer's eligibility for innocent spouse relief. The court noted that "[f]inal determinations in innocent spouse cases are typically singular, conclusive decisions." Nevertheless, the court observed, there is no prohibition on the issuance of more than one final determination and the regulations under § 6015 contemplate that the IRS will issue a second final determination in some circumstances. The court recognized the policy concern that taxpayers should not be able to defeat or extend the 90-day period for filing a petition in the Tax Court by submitting duplicative claims for innocent spouse relief. In this case, the court reasoned, the IRS could have avoided this policy concern by issuing something other than a final determination in response to the taxpayer's second request for innocent spouse relief for 2013. The IRS had done so in *Barnes v. Commissioner*, 130 T.C. 248 (2008). In that case, after the IRS issued a final determination denying the taxpayer's request for innocent spouse relief, the taxpayer submitted a second request for the same year. The IRS responded by issuing Letter 3657C, No Consideration Innocent Spouse, stating that the taxpayer had not met the basic eligibility requirements for relief because her claim had previously been considered and denied. The court in *Barnes* concluded that this letter was not a final determination and that the court therefore had no jurisdiction to consider the taxpayer's petition. In the same way, the IRS could have avoided issuing a second final determination in this case for 2013 by issuing Letter 3657C for that year. The IRS argued that its references to 2013 in the final determination were an error. "Error or not," the court responded, "the Commissioner's notice is unambiguous in its denial as to both 2010 and 2013." Accordingly, the court concluded, it had jurisdiction to consider the taxpayer's petition regarding both years.

2. The Tax Court loses jurisdiction over a taxpayer's petition seeking innocent spouse relief if a refund action is filed for the years in question. Coggin v. Commissioner, 157 T.C. 144 (12/8/21). Prior to his death, the taxpayer's late husband filed joint federal income tax returns late for the years 2001 through 2009 and made late full or partial payments for those years but did not pay any interest or penalties. Following her husband's death, the taxpayer learned for the first time of the joint returns and the tax liabilities arising from them. She filed returns for all years in question with the filing status of married filing separately. The court's opinion is not clear whether these returns were original returns or amended returns. The returns filed by the taxpayer claimed refunds for the years 2001 through 2007. The IRS issued a notice of disallowance as to three of the years for which the taxpayer sought refunds and, in response, the taxpayer filed a complaint in a federal district court seeking refunds for 2001 through 2007. Her complaint asserted that the joint returns filed by her late husband had been filed without her knowledge or consent and therefore were invalid and that she was entitled to refunds based on the separate returns she had filed. In its answer in federal district court, the government asserted counterclaims seeking to reduce the taxpayer's liabilities for 2002 through 2009 to judgment. The federal district court granted the government's motion for summary judgment and dismissed the taxpayer's refund claims on the basis that the returns filed by the taxpayer's late husband were valid joint returns. The court also ordered that the government's counterclaims proceed to trial. However, the federal district court did not enter a final appealable order or judgment as to the taxpayer's refund claims. The taxpayer then filed an administrative claim for innocent spouse relief for 2001 through 2009 on Form 8857 pursuant to § 6015. The federal district court granted the taxpayer's motion for a stay of proceedings pending the outcome of the taxpayer's request for innocent spouse relief. The IRS did not issue a notice of determination denying the taxpayer's request for innocent spouse relief; instead, the U.S. Justice Department Tax Division sent a letter to the taxpayer's attorney denying her request for innocent spouse relief. In response, the taxpayer filed a petition in the Tax Court asking the court to determine that she is entitled to innocent spouse relief for 2001 through 2009. The Tax Court (Judge Weiler) granted the IRS's motion to dismiss for lack of jurisdiction. Section 6015(e)(1) provides that the Tax Court has jurisdiction to determine whether a taxpayer is entitled to innocent spouse relief if the taxpayer files a petition within specified time periods. However, § 6015(e)(3) provides that, if either individual who filed the joint return in question files a suit for refund in a federal district court or the United States Court of Federal Claims, then the Tax Court loses jurisdiction over the taxpayer's petition seeking innocent spouse relief to the extent the court in which the refund action was filed acquires jurisdiction over the years that are the subject of the refund suit. In this case, the Tax Court concluded, the federal district court in which the taxpayer had filed her refund action acquired jurisdiction over her refund claims for the years 2001 through 2007 and retained jurisdiction because that court had not entered judgment as to her refund claims. Although the taxpayer had not asserted her entitlement to innocent spouse protection in the federal district court action, the Tax Court also observed that the federal district court had not ruled on the taxpayer's request for innocent spouse relief. As to the years 2008 and 2009, however, the Tax Court observed that the federal district court did not have or claim to have jurisdiction over refund claims of the taxpayer for 2008 and 2009. Accordingly, the Tax Court retained jurisdiction over the taxpayer's petition seeking innocent spouse protection for these years.

3. When a taxpayer raises innocent spouse relief as an affirmative defense in a petition filed in the Tax Court, can the IRS Chief Counsel attorneys litigating the case refer the matter to the IRS's Centralized Innocent Spouse Operation but then ignore CCISO's conclusion that the taxpayer is entitled to innocent spouse protection? Yes, says the Tax Court. DelPonte v. Commissioner, 158 T.C. No. 7 (5/5/22). The taxpayer's former husband, William Goddard, was an attorney whom the Tax Court's opinion characterized as "a lawyer who sold exceptionally aggressive tax-avoidance strategies with his business partner David Greenberg and became very wealthy in the process." The taxpayer filed joint returns with her former husband for the years 1999, 2000, and 2001 and therefore became jointly and severally liable with him pursuant to § 6013(d)(3) for several million dollars of tax liability associated with those returns. In response to a notice of deficiency issued in 2004, the taxpayer's former husband, who never told her about the notice of deficiency, filed a petition on her behalf in the Tax Court raising as an affirmative defense that she was entitled to innocent spouse protection under § 6015. (Similar notices of deficiency were issued in 2005 and 2009 and the taxpayer's former husband filed similar petitions in the Tax Court on her behalf.) In 2011, the IRS Office of Chief Counsel referred the taxpayer's request for innocent spouse relief to the IRS's Cincinnati Centralized Innocent Spouse Operation (CCISO) for a determination of whether she was entitled to innocent spouse protection. CCISO asked the taxpayer to submit a request for innocent spouse relief on Form 8857, which she did. In December 2011, CCISO concluded that she should be granted innocent spouse relief for all of the years in question. Rather than send a determination letter to the taxpayer, CCISO sent a letter explaining its conclusion to the Office of Chief Counsel. The IRS attorneys handling the case decided that more information was necessary to determine whether the taxpayer was entitled to innocent spouse relief and asked the taxpayer to provide it. The taxpayer declined on the basis that CCISO ha already determined that she was entitled to innocent spouse relief. With a new team of lawyers, she ultimately did provide additional information to the Chief Counsel attorneys but insisted that doing so was unnecessary. The taxpayer moved for entry of a decision in her favor. The Tax Court (Judge Holmes) agreed with the IRS that, when a request for innocent spouse relief is raised as an affirmative defense for the first time in a petition that invokes the court's deficiency jurisdiction, the IRS Office of Chief Counsel has final authority to concede or settle the issue with the taxpayer and that the IRS Office of Chief Counsel therefore was not bound by CCISO's conclusion. The court reviewed the history of innocent spouse protection and the relevant statutory provisions in detail. The court also reviewed relevant provisions of the Internal Revenue Manual and certain Chief Counsel Notices. Specifically, the court focused on IRM 25.15.12.25.2(1) (Nov. 9, 2007), which provides:

> if innocent-spouse relief is raised for the first time in a case already docketed in court, "[j]urisdiction is retained by … Counsel, and a request is sent to CCISO to consider the request for relief. … Counsel … has functional jurisdiction over the matter and handles the case and request for relief, and either settles or litigates the issue on its merits, as appropriate.

The court reasoned that this provision, as well as other relevant guidance, directs CCISO to provide assistance rather than to make a determination of entitlement to innocent spouse relief. The court concluded:

> The Chief Counsel in these cases has considered the determination of CCISO to grant DelPonte relief and decided not to adopt it without further investigation. That is his prerogative, and we will not force him to do otherwise.

H. Miscellaneous

1. You say "FBAR." We say "FUBAR." Although Treasury has failed to update relevant FBAR regulations, the penalty for willful violations is not capped at $100,000 per account, says the Federal Circuit. Norman v. United States, 942 F.3d 1111 (Fed. Cir. 11/8/19), *aff'g* 138 Fed. Cl. 189 (7/31/18). The issue in this case is whether substantial foreign bank account reporting ("FBAR") penalties assessed by the Service were reduced. Under 31 U.S.C. § 5321(a)(5)(A), the Secretary of the Treasury "may impose" a penalty for FBAR violations, and pursuant to administrative orders, the authority to impose FBAR penalties has been delegated by the Secretary to the Service. Further, under the *current* version of 31 U.S.C. § 5321(a)(5)(B)(i), the normal penalty for an FBAR violation is $10,000 per offending account; however, the penalty for a *willful* FBAR violation "shall be increased to the greater of" $100,000 or 50 percent of the balance in the offending account at the time of the violation. *See* 31 U.S.C. § 5321(a)(5)(C). These minimum and maximum penalties for willful FBAR violations were changed by the American Jobs Creation Act of 2004 ("AJCA"), Pub. L. No. 108-357, § 821, 118 Stat. 1418 (2004). The prior version of 31 U.S.C. § 5321(a)(5) provided that the penalty for *willful* FBAR violations was the greater of $25,000 or the balance of the unreported account up to $100,000. Treasury regulations issued under the pre-AJCA version of 31 U.S.C. § 5321(a)(5), reflecting the law at the time, capped the penalty for willful FBAR violations to $100,000 per account. *See* 31 C.F.R. § 1010.820(g). In this case, the government assessed a penalty of $803,500 for failure to file an FBAR in 2007 with respect to a Swiss Bank account. The taxpayer argued that the "may impose" language of the relevant statute, 31 U.S.C. § 5321(a)(5), provides the Secretary of the Treasury with discretion to determine the amount of assessable FBAR penalties and that, because the outdated Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the Service's authority was limited to the amount prescribed by the existing regulations. The court reasoned that the amended statute, which provides that the amount of penalties for willful FBAR violations *shall be* increased to the greater of $100,000 or 50 percent of the account value, is mandatory and removed Treasury's discretion to provide for a smaller penalty by regulation. According to the court, the statute gives Treasury discretion *whether* to impose a penalty in particular cases, but not discretion to set a cap on the penalty that is different than the cap set forth in the statute.

- *Recklessness as willfulness*. The relevant statute provides an enhanced penalty for a person who "willfully" fails to comply with the requirement to file an FBAR. The court considered whether a taxpayer who *recklessly* fails to comply with the requirement to file an FBAR can be treated as having committed a *willful* violation. The taxpayer argued "that willfulness in this context require[d] a showing of actual knowledge of the obligation to file an FBAR." The court disagreed. The court relied on the U.S. Supreme Court's decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had "generally taken it to cover not only knowing violations of a standard, but reckless ones as well." Accordingly, in this case, the court held, "willfulness in the context of [31 U.S.C.] § 5321(a)(5) includes recklessness." The court observed that its interpretation of the statute was consistent with prior decisions of the U.S. Courts of Appeals for the Third and Fourth Circuits. See *Bedrosian v. United States*, 912 F.3d 144 (3d Cir. 2018); *United States v. Williams*, 489 F. Appx. 655 (4th Cir. 2012). The court examined the taxpayer's conduct, which included false statements to the IRS about her foreign account, and concluded that the U.S. Court of Federal Claims had not clearly erred in determining that she had willfully violated the requirement to file an FBAR. Specifically, the court rejected the taxpayer's argument that her failure could not be willful because she had not read her federal income tax return before signing it.

- *Other courts have concluded that the penalty for willful violations is not capped at $100,000*. Several federal district courts have considered whether the outdated Treasury regulation limits the penalty for a willful FBAR violation to $100,000 per account and reached different conclusions. For cases holding that the outdated FBAR regulations limit the penalty for willful FBAR violations to $100,000 per account, see *United States v. Wadhan*, 325 F. Supp. 3d 1136 (D. Colo. 7/18/18); *United States v. Colliot*, 121 A.F.T.R.2d 2018-1834 (W.D. Tex. 5/16/18). For cases holding that the outdated FBAR regulations do *not* limit the penalty for willful FBAR violations, see *United States v. Schoenfeld*, 396 F. Supp. 3d 1064 (M.D. Fla. 6/25/19); *United States v. Park*, 389 F. Supp. 3d 561 (N.D. Ill. 5/24/19); *United States v. Garrity*, 123 A.F.T.R.2d 2019-941 (D. Conn. 2/28/19); *Kimble v. United States*, 141 Fed. Cl. 373 (12/27/18).

a. The Fourth Circuit agrees that recklessness is sufficient to establish a willful FBAR violation and that the penalty for a willful FBAR violation is not capped at $100,000. United States v. Horowitz, 978 F.3d 80 (4th Cir. 10/10/20). In an opinion by Judge Niemeyer, the U.S. Court of Appeals for the Fourth Circuit held that (1) recklessness is sufficient to establish a willful FBAR violation, and (2) the penalty for a willful FBAR violation is not capped at $100,000. With respect to the first issue, the court adopted the same line of reasoning as the U.S. Court of Appeals for the Federal Circuit in *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 11/8/19), i.e., the court relied on the U.S. Supreme Court's decision in *Safeco Ins. Co. of Am.*

v. Burr, 551 U.S. 47, 57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had "generally taken it to cover not only knowing violations of a standard, but reckless ones as well." The court provided further guidance on the meaning of the term "recklessness":

> In the civil context, "recklessness" encompasses an objective standard—specifically, "[t]he civil law generally calls a person reckless who acts or (if the person has a duty to act) fails to act in the face of an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Farmer v. Brennan*, 511 U.S. 825, 836 (1994); *see also Safeco*, 551 U.S. at 68 (same). In this respect, civil recklessness contrasts with criminal recklessness and willful blindness, as both of those concepts incorporate a subjective standard.

In this case, the court concluded, the taxpayers, who were aware that their Swiss bank account was earning interest and that interest was taxable income and who failed to disclose the foreign account to the accountant preparing their tax return, had been reckless and therefore willful in failing to file an FBAR.

The court also rejected the taxpayer's argument that, because the "may impose" language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury and the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the IRS's authority was limited to the amount prescribed by the existing regulations. The existing regulations limit the FBAR penalty for willful violations to $100,000 per unreported account. The court reasoned that the relevant statute did not authorize the Secretary of the Treasury to impose a lower maximum penalty for willful FBAR operations. According to the court, "the 1987 regulation on which the Horowitzes rely was abrogated by Congress's 2004 amendment to the statute and therefore is no longer valid."

b. The Eleventh Circuit agrees: recklessness is sufficient to establish a willful FBAR violation and the penalty for a willful FBAR violation is not limited to $100,000. United States v. Rum, 995 F.3d 882 (11th Cir. 4/23/21). In a per curiam opinion, the U.S. Court of Appeals for the Eleventh Circuit has held that (1) recklessness is sufficient to establish a willful FBAR violation, and (2) the penalty for a willful FBAR violation is not capped at $100,000. With respect to the first issue, the court adopted the same line of reasoning as the U.S. Courts of Appeals for the Federal and Fourth Circuits in *Norman v. United States*, 942 F.3d 1111 (Fed. Cir. 11/8/19), and *United States v. Horowitz*, 978 F.3d 80 (4th Cir. 10/10/20), i.e., the court relied on the U.S. Supreme Court's decision in *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007), in which the Court had observed that, when willfulness is a statutory condition of civil (as opposed to criminal) liability, the Court had "generally taken it to cover not only knowing violations of a standard, but reckless ones as well." For purposes of determining whether a reckless (and therefore willful) FBAR had violation occurred, the Eleventh Circuit adopted the meaning of recklessness set forth in *Safeco*:

> The Safeco Court stated that "[w]hile the term recklessness is not self-defining, the common law has generally understood it in the sphere of civil liability as conduct violating an objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." 551 U.S. at 68, 127 S. Ct. at 2215 (internal quotations and citations omitted).

In this case, the taxpayer had filed tax returns for many years on which he indicated that he had no interest in a foreign financial account despite the fact that he had a Swiss bank account at UBS. He also reported the account for some purposes, such as to demonstrate his financial strength when obtaining a mortgage, but not for others, such as applying for financial aid for his children's college costs. According to the Eleventh Circuit, the District Court had not erred in granting summary judgment to the government on the issue of whether the taxpayer had acted recklessly and therefore willfully in failing to file FBARs.

The court also rejected the taxpayer's argument that, because the "may impose" language of 31 U.S.C. § 5321(a)(5)(A) leaves the amount of assessable FBAR penalties to the discretion of the Secretary of the Treasury and the (albeit outdated) Treasury regulations had not been amended to reflect the AJCA's increase in the minimum and maximum FBAR penalties, the IRS's authority was limited to the amount prescribed by the existing regulations:

> The plain text of § 5321(a)(5)(C) makes it clear that a willful penalty may exceed \$100,000 because it states that the maximum penalty "shall be . . . the greater of (I) \$100,000, or (II) 50 percent of the amount determined under subparagraph (D)," which is the balance of the account.

c. The Second Circuit also holds that the penalty for a willful FBAR violation is not capped at \$100,000. United States v. Kahn, 5 F.4th 167 (2d Cir. 7/13/21). In an opinion by Judge Kearse, the U.S. Court of Appeals for the Second Circuit has agreed with the other federal courts of appeal that have considered the issue and held that the penalty for willful FBAR violations is not capped at \$100,000 per account. The court concluded that the 2004 amendments to 31 U.S.C. § 5321(a)(5)(C) rendered invalid the 1987 Treasury regulation that limits the penalty for willful FBAR violations to \$100,000 per account.

- *Dissenting opinion by Judge Menashi*. In a dissenting opinion, Judge Menashi argued that the regulation does not conflict with the statute and that the Treasury Department was bound by its own regulation:

> The Treasury Department's current regulations provide that the penalty for Harold Kahn's willful failure to file a Report of Foreign Bank and Financial Accounts ("FBAR") may not exceed \$100,000. *See* 31 C.F.R. § 1010.820(g)(2). This penalty falls within the statutorily authorized range. *See* 31 U.S.C. § 5321(a)(5). While the governing statute also authorizes penalties greater than \$100,000, it nowhere mandates that the Secretary impose a higher fine. *See id.* In fact, the statute gives the Secretary discretion to impose no fine at all. *See id.* § 5321(a)(5)(A). The current regulation therefore does not conflict with the governing statute and the Secretary must adhere to that regulation as long as it remains in effect.

d. Better late than never? FinCEN finally has amended the relevant regulations to remove the provision that limited the penalty for a willful FBAR violation. RIN 1507-AB54, Bank Secrecy Act Regulations—Reports of Foreign Financial Accounts Civil Penalties, 86 F.R. 72844 (12/23/21). More than seventeen years after Congress changed the minimum and maximum penalties for willful FBAR violations in the American Jobs Creation Act of 2004, the Financial Crimes Enforcement Network (FinCEN) has amended the relevant regulations to remove 31 C.F.R. § 1010.820(g), which limited the penalty for willful FBAR violations to \$100,000 per account. The stated rationale for the removal is that the 2004 amendments to the statute, 31 U.S.C. § 5321(a)(5), rendered this part of the regulation obsolete. The Administrative Procedure Act permits an agency to find that notice and public procedure on the notice are impracticable, unnecessary, or contrary to the public interest. Because the statutory change rendered this provision of the regulations obsolete, FinCEN "determined that publishing a notice of proposed rulemaking and providing opportunity for public comment [were] unnecessary." This amendment of the regulations is effective on December 23, 2021. Nevertheless, because the prior regulation was rendered obsolete by a 2004 statute, the government's position presumably is that the statutory rule, rather than the now-repealed provision of the regulations, applies for prior years as well beginning on the effective date of the statutory change.

e. The First Circuit has agreed: the penalty for a willful FBAR violation is not capped at \$100,000. United States v. Toth, 33 F.4th 1 (1st Cir. 4/29/22). In an opinion by Judge Baron, the U.S. Court of Appeals for the First Circuit has agreed with every other federal court of appeals and held that the penalty for willful FBAR violations is not capped at $100,000 per account. The court concluded that the 2004 amendments to 31 U.S.C. § 5321(a)(5)(C) superseded the 1987 Treasury regulation that limits the penalty for willful FBAR violations to $100,000 per account:

> Thus, when Congress amended § 5321(a)(5)(C)-(D) to permit the IRS to impose a penalty in excess of $100,000, the 1987 regulation was superseded because the regulation -- as merely a regulation parroting a then-operative statutory maximum -- could have no effect once a new statutory maximum had been set.

2. Tax Court retains jurisdiction in a § 7345 passport revocation case to review IRS's certification of taxpayer's "seriously delinquent" tax liability, but finds case is moot. Ruesch v. Commissioner**,** 154 T.C. 289 (6/25/20). Section 7345, which addresses the revocation or denial of passports for seriously delinquent tax debts, was enacted in 2015 as section 32101(a) of the Fixing America's Surface Transportation Act, Pub. L. 114-94 (Dec. 4, 2015). It provides that, if the IRS certifies that an individual has a "seriously delinquent tax debt," the Secretary of the Treasury must notify the Secretary of State "for action with respect to denial, revocation, or limitation of a passport." § 7345(a). In general, a seriously delinquent tax debt is an unpaid tax liability in excess of $50,000 for which a lien or levy has been imposed. § 7345(b)(1). A taxpayer who seeks to challenge such certification may petition the Tax Court to determine if it was made erroneously. § 7345(e)(1). If the Tax Court finds the certification was either made in error or that the IRS has since reversed its certification, the court may then notify the State Department that the revocation of the taxpayer's passport should be cancelled. § 7345(c). This is a case of first impression in which the Tax Court interprets the requirements of § 7345. The Tax Court (Judge Lauber) held that, while the Tax Court had jurisdiction to review Ms. Ruesch's challenge to the IRS's certification of her tax liabilities as being a "seriously delinquent tax debt," the controversy was moot because the IRS had reversed its certification as being erroneous. Further, the IRS had properly notified the Secretary of State of its reversal. The IRS had assessed $160,000 in penalties for failing to file proper information returns for a period of years. *See* § 6038. Thereafter, the IRS sent a final notice of intent to levy and Ms. Ruesch properly appealed the penalty amounts with the IRS's Collection Appeals Program (CAP). In a series of errors, the IRS mistakenly misclassified the CAP appeal as a Collection Due Process (CDP) hearing. Committing yet further errors, the IRS failed to properly record Ms. Ruesch's later request for a CDP hearing and never offered Ms. Ruesch her CDP hearing. The IRS then certified Ms. Ruesch's liability to the Secretary of State as a "seriously delinquent tax debt" under § 7345(b). Discovering their many errors as well as the oversight of Ms. Ruesch's timely requested a CDP hearing, the IRS determined her tax debt was not "seriously delinquent" and reversed the certification. Because, under § 7345, the Tax Court's jurisdiction in passport revocation cases is limited to reviewing the IRS's certification of the taxpayer's liabilities as "seriously delinquent," the only relief the Tax Court may grant is to issue an order to the IRS to notify the Secretary of State that the IRS's certification was in error. Since the IRS had already notified the Secretary of State of the error, the Tax Court could not offer any additional relief. Judge Lauber, therefore, found the controversy was not ripe to be heard and the issues were moot.

a. The Second Circuit has agreed with the Tax Court that the taxpayer's challenge to the IRS's certification that she had a seriously delinquent tax debt was moot, but has reminded the Tax Court that determinations of mootness must precede determinations of subject matter jurisdiction. Ruesch v. Commissioner, 25 F.4th 67 (2d Cir. 1/27/22), *aff'g in part, vacating and remanding in part* 154 T.C. 289 (6/25/20). In a per curiam opinion, the U.S. Court of Appeals for the Second Circuit has affirmed the Tax Court's decision to the extent that the Tax Court's decision dismissed as moot the taxpayer's challenge to the IRS's certification pursuant to § 7345(a) that she had a seriously delinquent tax debt. The Second Circuit agreed with the Tax Court that, because the IRS had reversed its certification, her challenge to the certification in the Tax Court was moot. In reaching this conclusion, the Second Circuit rejected the taxpayer's argument that an exception to mootness, the voluntary cessation doctrine, allowed the taxpayer to continue to pursue her challenge in the Tax Court. The voluntary cessation doctrine applies when a defendant voluntarily ceases the offending conduct and is intended to prevent defendants from avoiding judicial review temporarily changing their behavior. According to the Second Circuit, however, the voluntary cessation doctrine is not absolute and a case can still be moot if two requirements are met: (1) the defendant demonstrates that interim relief or events have irrevocably and completely eradicated the effects of the alleged violation, and (2) there is no reasonable expectation that the allegedly offending conduct will recur. In this case, the court reasoned, both requirements were satisfied. The IRS's reversal of its certification completely eradicated the effect of the erroneous certification and there was no reasonable expectation that the alleged offending conduct will recur because the IRS was barred by statute from certifying her as having a seriously delinquent tax debt while her collection due process hearing with IRS Appeals was pending.

The taxpayer also had sought in the Tax Court to contest the underlying penalties the IRS had imposed and that led to certification of a seriously delinquent tax debt. The Tax Court had dismissed these claims for lack of subject matter jurisdiction because § 7345 does not confer jurisdiction on the Tax Court to consider challenges to the underlying liabilities that lead to certification. The Second Circuit, however, held that the Tax Court should instead have dismissed those claims as moot. The taxpayer, the court reasoned, had already received all the relief to which she was entitled under § 7345, i.e., reversal of the IRS's certification, which rendered moot any challenges to the underlying liability for penalties. According to the court:

> questions relating to Article III jurisdiction, including those concerning the doctrine of mootness, … are antecedent to and should ordinarily be decided before other issues such as statutory jurisdiction or the merits ….

3. Taxpayers did not duly file their refund claim because their attorney, rather than the taxpayers, signed their amended returns claiming refunds. Brown v. United States, 22 F 4th 1008 (Fed. Cir. 1/5/22). The taxpayers were U.S. citizens living and working in Australia for Raytheon Corporation. They filed amended returns for 2015 and 2016 claiming refunds on the basis that they were entitled to the foreign earned income exclusion of § 911. The amended returns were signed by their attorney but no power of attorney accompanied the returns. In this litigation, the U.S. Court of Federal Claims granted the government's motion to dismiss for lack of subject matter jurisdiction on the ground that the returns were not "duly filed" as required by § 7422, which provides:

> No suit or proceeding shall be maintained ... until a claim for refund ... has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

The U.S. Court of Appeals for the Federal Circuit has affirmed the Claims Court's decision. The court held that the "duly filed" requirement of § 7422 is not jurisdictional, but rather more akin to a claims processing rule. Nevertheless, the court agreed with the government that the taxpayer's refund claims were not duly filed because the taxpayers had not personally signed the returns or signed them in a manner that complied with applicable regulations. The applicable regulations provide:

> No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. *The statement of the grounds and facts must be verified by a written declaration that it is made under the penalties of perjury.* A claim which does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.

Reg. § 301.6402-2(b)(1) (emphasis added). This requirement can be satisfied when a taxpayer's legal representative certifies the claim if the representative attaches evidence of a valid power of attorney. In this case, however, the attorney who prepared and signed the returns in question did not submit a power of attorney to the IRS. Because the taxpayers had failed to comply with the regulation's requirement, they had not "duly filed" their claim for refund within the meaning of § 7422. Accordingly, the court affirmed on the basis that the taxpayers had failed to state a claim on which relief could be granted.

4. The Tax Court lacks jurisdiction to review the IRS Whistleblower Office's threshold rejection of an application for a whistleblower award for failure to meet minimum threshold criteria for such claims. Li v. Commissioner, 22 F.4th 1014 (D.C. Cir. 1/11/22). The petitioner, Ms. Li, filed Form 211, Application for Award for Original Information, with the IRS's Whistleblower Office (WBO) asserting four tax violations by a third party. The WBO concluded that Ms. Li's allegations were "speculative and/or did not provide specific or credible information regarding tax underpayments or violations of internal revenue laws," and that she therefore was not eligible for an award. Therefore, the WBO did not forward her form to an IRS examiner for any potential action against the target taxpayer. The IRS informed her of this in a letter that stated that she could appeal the decision to the U.S. Tax Court. Ms. Li filed a petition in the Tax Court, which held that the IRS did not abuse its discretion in rejecting her application for an award. On appeal, the U.S. Court of Appeals for the D.C. Circuit (Judge Sentelle) dismissed the appeal for lack of jurisdiction and remanded to the Tax Court with a direction for the Tax Court to do the same. For the Tax Court to have jurisdiction in a whistleblower case, the court reasoned, § 7623(b)(4) requires that there be a "determination" regarding an award. In this case, the court held, the IRS WBO's rejection of a claim for failure to meet the minimum threshold criteria for a claim is not a determination and therefore the Tax Court has no jurisdiction. In reaching this conclusion, the court rejected and characterized as "wrongly decided" the Tax Court's decisions in *Cooper v. Commissioner*, 135 T.C. 70 (2010), and *Lacey v. Commissioner*, 153 T.C. 146 (2019).

5. The IRS has provided simplified procedures for taxpayers who are not required to file 2021 federal income tax returns to claim the child tax credit, the 2021 recovery rebate credit, and the earned income credit. Rev. Proc. 2022-12, 2022-7 I.R.B. 494 (1/24/22). Whether a taxpayer must file a federal income tax return generally depends on the taxpayer's filing status and level of income. If a taxpayer has gross income that is less than the standard deduction for the taxpayer's filing status, then the taxpayer generally is not required to file a federal income tax return. For example, for 2021, a single individual under age 65 is not required to file a return if the individual's gross income is less than $12,550 and a married couple filing jointly where both spouses are under age 65 is not required to file a return if their gross income is less than $25,100. There are exceptions to this rule. The principal exception is that a self-employed individual with net income from self-employment of $400 or more is required to file a return.

An individual who is not required to file a federal income tax return might nevertheless want to file a return to claim certain tax benefits. This revenue procedure provides simplified filing procedures for individuals who are not required to file 2021 federal income tax returns to claim the child tax credit, 2021 recovery rebate credit, and earned income credit. Specifically, the revenue procedure provides the following simplified procedures:

- *Zero income taxpayers can file electronically.* The revenue procedure provides a method for taxpayers with adjusted gross income (AGI) of zero to e-file their returns. Normally, such taxpayers are precluded by most tax preparation software from filing electronically. The revenue procedure instructs taxpayers with zero AGI to list $1 of taxable interest income, $1 of total income, and $1 of AGI, all on the appropriate lines of Form 1040, Form 1040-SR, or 1040-NR. This procedure applies to returns filed after January 24, 2022.

- *Taxpayers claiming the child tax credit and 2021 recovery rebate credit.* The revenue procedure provides a method for taxpayers to claim the child tax credit and 2021 recovery rebate credit by making limited entries on the normal tax return, which can be e-filed or mailed to the IRS. For example, the revenue procedure instructs taxpayers to enter the taxpayer's filing status and personal information (name, address, Social Security Number, or ITIN), to indicate whether the taxpayer can be claimed as a dependent, to enter information about any qualifying children for purposes of the child tax credit, and to enter zero on or leave blank specific lines of the tax return. Taxpayers who file on paper are instructed to enter "Rev. Proc. 2022-12" at the top of the first page of the return. This procedure applies to returns filed after April 18, 2022.
- *Taxpayers claiming the earned income credit, the child tax credit, and the 2021 recovery rebate credit.* The revenue procedure provides a method for taxpayers with earned income to claim the earned income credit, the child tax credit and 2021 recovery rebate credit by making limited entries on the normal tax return, which can be e-filed or mailed to the IRS. For example, the revenue procedure instructs taxpayers to enter the taxpayer's filing status and personal information (name, address, Social Security Number, or ITIN), to indicate whether the taxpayer can be claimed as a dependent, to enter information about any qualifying children for purposes of the earned income credit and child tax credit, and to enter zero on or leave blank specific lines of the tax return. Taxpayers who file on paper are instructed to enter "Rev. Proc. 2022-12" at the top of the first page of the return. This procedure applies to returns filed after April 18, 2022.

The revenue procedure sets forth various criteria that taxpayers must meet to take advantage of each of these simplified methods.

6. In Notice 2007-83, the IRS concluded that certain trust arrangements involving cash value life insurance policies are listed transactions. According to the Sixth Circuit, the IRS failed to comply with the Administrative Procedure Act in issuing Notice 2007-83 and the notice therefore is invalid. Mann Construction, Inc. v. United States, 27 F.4th 1138 (6th Cir. 3/3/22). In an opinion by Chief Judge Sutton, the U.S. Court of Appeals for the Sixth Circuit has held that the IRS failed to comply with the Administrative Procedure Act (APA) in issuing Notice 2007-83, 2007-2 C.B. 960, and that the notice therefore is invalid.

Notice 2007-83. In Notice 2007-83, the IRS examined certain trust arrangements being promoted to business owners. In these arrangements, a taxable or tax-exempt trust is established to provide certain benefits, such as death benefits, to owners of the business and to employees. The business makes contributions to the trust, which the trustees use to purchase cash value life insurance policies on the lives of the owners and term insurance on the lives of non-owner employees. The arrangements are structured so that, upon termination of the plan, the owners of the business receive all or a substantial portion of the assets of the trust. According to the notice, those promoting the arrangements take the position that the business can deduct contributions to the trust and that the owners have no income as a result of the contributions or the benefits provided by the trust. The notice identifies these transactions as listed transactions that must be disclosed to the IRS. Accordingly, those who fail to disclose these transactions are subject to significant penalties pursuant to § 6707A.

Facts of this case. In this case, from 2013 to 2017, a corporation, Mann Construction, Inc., established an employee-benefit trust that paid the premiums on a cash-value life insurance policy benefitting the corporation's two shareholders. The corporation deducted these payments and the shareholders reported as income part of the insurance policy's value. Neither the individuals nor the company reported this arrangement to the IRS as a listed transaction. In 2019, the IRS concluded that this transaction fell within Notice 2007-83 and imposed a $10,000 penalty on the corporation and on both of its shareholders ($8,642 and $7,794) for failing to disclose their participation in the transaction. The corporation and the shareholders paid the penalties for the

2013 tax year, sought administrative refunds on the ground that the IRS lacked authority to penalize them, and ultimately brought legal action seeking a refund in a U.S. District Court. The District Court upheld the validity of Notice 2007-83 and held in favor of the government.

Sixth Circuit's analysis. The U.S. Court of Appeals for the Sixth Circuit reversed the District Court's holding and concluded that the IRS had failed to comply with the APA in issuing Notice 2007-83. The APA generally prescribes a three-step process for notice-and-comment rulemaking. First, the agency must issue a general notice of proposed rulemaking. Second, assuming notice is required, the agency must consider and respond to significant comments received during the period for public comment. Third, in issuing final rules, the agency must include a concise general statement of the rule's basis and purpose. *See, e.g.*, *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92, 96 (2015). The IRS did not comply with the first requirement in issuing Notice 2007-83 because it did not issue a notice of proposed rulemaking. The government made two principal arguments as to why it was not required to comply with the APA's notice-and-comment requirements. *First*, the government argued that Notice 2007-83 is an interpretive rule that is not subject to the APA's notice-and-comment procedures rather than a legislative rule that is subject to such procedures. The Sixth Circuit rejected this argument and concluded that Notice 2007-83 is a legislative rule. According to the court, the notice imposes new duties on taxpayers by requiring them to report certain transactions and imposes penalties for failure to do so. The notice also carries out an express delegation of authority from Congress, the court reasoned, because § 6011(a) provides that the Secretary of the Treasury is to determine by regulations when and how taxpayers must file returns and statements and § 6707A(c) delegates to the Secretary of the Treasury the authority to identify which transactions have the potential for tax avoidance or evasion and which transactions are substantially similar to such transactions. Because Notice 2007-83 imposes new duties and penalties on taxpayers and carries out an express delegation of congressional authority, the court concluded, the notice is a legislative rule that is subject to the APA's notice-and-comment procedures. *Second*, the government argued that, even if Notice 2007-83 is a legislative rule, Congress had exempted it from the APA's notice-and-comment procedures. The Sixth Circuit rejected this argument as well. According to the court, nothing in the language of the relevant statutory provisions or their legislative history indicated a congressional intent to exempt the IRS from the APA's notice-and-comment procedures when the IRS identifies transactions that have the potential for tax avoidance or evasion and substantially similar transactions. Because the IRS was required to comply with the APA's notice-and-comment procedures in issuing Notice 2007-83 and failed to do so, the court concluded, the notice is invalid. Accordingly, the taxpayers are entitled to a refund of the penalties they paid for failing to disclose the transaction.

Broader implications. The effect of the Sixth Circuit's decision is to preclude the IRS from imposing penalties under § 6707A for failing to disclose a transaction that the IRS identifies in a notice issued without complying with the APA's notice-and-comment requirements. Because the IRS normally does not comply with the APA's requirements in issuing notices, the broader implication of the court's decision is that taxpayers, at least those whose appeals will be heard by the Sixth Circuit, can challenge penalties imposed pursuant to similar notices that identify transactions as listed or reportable transactions. These include Notice 2016-66, 2016-47 I.R.B. 745, which identifies certain captive insurance arrangements, referred to as "micro-captive transactions," as transactions of interest for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code, and Notice 2017-10, 2017-4 I.R.B. 544, which identifies certain syndicated conservation easement transactions entered into after 2009 as listed transactions.

7. The shared responsibility payment imposed by § 5000A for failure to maintain health insurance is a tax for bankruptcy purposes and is entitled to priority. Internal Revenue Service v. Juntoff, 636 B.R. 868 (B.A.P. 6th Cir. 3/21/22). Section 5000A of the Code, enacted as part of the Affordable Care Act, requires individuals to maintain health insurance that provides minimum essential coverage. Prior to tax-year 2019, the statute imposed a penalty, referred to as a shared responsibility payment, on individuals who did not maintain minimum essential coverage. The taxpayers in these two consolidated cases filed Chapter 13 bankruptcy petitions. The IRS filed a proof of claim in each proceeding for a shared responsibility payment based on their failure to maintain minimum essential coverage in 2017 and 2018. The proof of claim characterized the shared responsibility payment as an "excise/income tax." The taxpayers argued that the shared responsibility payment was a penalty and not a tax, and therefore was not entitled to priority in bankruptcy. In *NFIB v. Sebelius*, 567 U.S. 519 (2012), the U.S. Supreme Court held that the shared responsibility payment is a tax for constitutional purposes but is not a tax for purposes of the Anti-Injunction Act. In an opinion by Judge Stout, the court concluded that the penalty is a tax for bankruptcy purposes. The court also concluded that it is a tax described in § 507(a)(8) of the Bankruptcy Code and therefore entitled to priority in bankruptcy.

Dissenting opinion of Chief Judge Dales. In a dissenting opinion, Chief Judge Dales argued that the shared responsibility payment is not a tax. He argued that the general approach of courts to be sparing in permitting priority treatment and the text of the statute (§ 5000A), which consistently refers to the shared responsibility payment as a penalty, suggest that the shared responsibility payment is a penalty rather than a tax. Judge Dales also relied on prior decisions of the Sixth Circuit, which provide guidance on determining when a payment to a governmental entity is a tax:

> Where a State "compel[s] the payment" of "involuntary exactions, regardless of name," and where such payment is universally applicable to similarly situated persons or firms, these payments are taxes for bankruptcy purposes.

Yoder v. Ohio Bur. of Workers' Comp. (In re Suburban Motor Freight, Inc.), 998 F.2d 338, 342 (6th Cir. 1993). The shared responsibility payment, he argued, is not universally applicable to similarly situated persons because it is triggered only by default, i.e., by virtue of an individual's failure to maintain minimum essential coverage. Because the shared responsibility payment is not a tax, he concluded, it is not entitled to priority in bankruptcy.

a. The Third Circuit has agreed: the shared responsibility payment imposed by § 5000A for failure to maintain health insurance is a tax for bankruptcy purposes and is entitled to priority. In re Szczyporski, 34 F.4th 179 (3d Cir. 5/11/22). The taxpayers in this case, a married couple, filed a Chapter 13 bankruptcy petition. The IRS filed a proof of claim for a shared responsibility payment based on their failure to maintain minimum essential coverage in 2018. The proof of claim characterized the shared responsibility payment as an excise tax. The taxpayers argued that the shared responsibility payment was a penalty and not a tax, and therefore was not entitled to priority in bankruptcy. The U.S. Court of Appeals for the Third Circuit concluded that the penalty is a tax for bankruptcy purposes. The court also concluded that it is a tax described in § 507(a)(8) of the Bankruptcy Code and therefore entitled to priority in bankruptcy.

XI. WITHHOLDING AND EXCISE TAXES

A. Employment Taxes

B. Self-employment Taxes

C. Excise Taxes

1. Butane does not qualify as a liquified petroleum gas and therefore does not qualify for the alternative fuel mixture credit authorized by § 6426(e), says the Fifth Circuit. Vitol, Inc. v. United States, 30 F.4th 248 (5th Cir. 3/23/22). In an opinion by Judge Willett, the U.S. Court of Appeals for the Fifth Circuit has held that butane does not qualify as a liquified petroleum gas (LPG) and therefore does not qualify for the alternative fuel mixture credit authorized by § 6426(e). The taxpayer brought this action seeking a tax refund of $8.8 million on the basis that it was entitled to the credit provided by § 6426(e). Sections 4081 and 4041(a)(2)(A) impose excise taxes on fuel made from certain components. Section 6426(e) provides a credit for a fuel that is "a mixture of alternative fuel and taxable fuel." The term "alternative fuel" is defined in § 6426(d) to include LPG. The court adopted a textualist approach and declined to rely on legislative history. The court acknowledged that the common meaning of LPG includes butane. According to the court, however, § 4083 defines butane as a *taxable fuel* for purposes of the excise tax imposed by § 4081.

> the statutory framework is mutually exclusive: A given fuel is either taxable or alternative, but not both. The statutory context of § 6426 provides sound reason to depart from butane's common meaning.

If butane is a taxable fuel, the court reasoned, it cannot be an alternative fuel, and therefore cannot be LPG within the meaning of § 6426(d).

Dissenting opinion by Judge Elrod. In a thoughtful dissenting opinion, Judge Elrod rejected the statutory analysis set forth in the majority opinion. According to Judge Elrod, the majority was too quick to reject the ordinary meaning of the term LPG and the government had not persuasively shown that Congress meant to override the ordinary meaning of that term:

> As everyone in the oil and gas industry knows, and as the United States readily concedes, butane is an LPG. Indeed, the government's own witness testified that "butane is always an LPG." That should be the end of it: Vitol gets a tax credit.

a. The U.S. Court of Federal Claims also has concluded that butane is not liquified petroleum gas and therefore does not qualify for the alternative fuel mixture credit authorized by § 6426(e). Philadelphia Energy Solutions Refining and Marketing, LLC v. U.S., 159 Fed. Cl. 230 (3/25/22) In an opinion by Judge Meyers, the U.S. Court of Federal Claims also concluded that butane is not liquified petroleum gas and therefore does not qualify for the alternative fuel mixture credit authorized by § 6426(e).

2. The tax imposed by § 4611 on oil exported from the United States is a tax on exports in violation of Article I, § 9 of the U.S. Constitution and therefore is unconstitutional. Trafigura Trading, LLC v. United States, 29 F.4th 286 (5th Cir. 3/24/22), *aff'g* 485 F.Supp.3d 822 (S.D. Tex. 2020). The taxpayer, a commodity trading company, purchased and exported from the United States approximately 50 million barrels of crude oil between 2014 and 2017. Section 4611(b) of the Code imposes a tax on "any domestic crude oil [that] is used in or exported from the United States." The taxpayer paid over $4 million to the IRS based on the oil it exported and filed an administrative claim for a refund of the tax. When the IRS denied the claim, the taxpayer brought legal action seeking a refund in a federal district court. In the U.S. District Court for the Southern District of Texas, the taxpayer argued that the tax imposed on exported oil by § 4611(b) violates the Export Clause of the U.S. Constitution (Art. I, § 9, cl. 5), which provides: "No Tax or Duty shall be laid on Articles exported from any State." The U.S. District Court (Judge Hanen) granted summary judgment in favor of the taxpayer and the government appealed. In an opinion by Judge Ho, the U.S. Court of Appeals for the Fifth Circuit affirmed the District Court's decision. The Fifth Circuit observed that, according to the U.S. Supreme Court's decisions in *United States v. U.S. Shoe Corp.*, 523 U.S. 360 (1998), and *Pace v. Burgess*, 92 U.S. 372 (1876), the label Congress uses to describe an impost (e.g., as a tax) is not controlling and the Export clause does not bar a charge or user fee that lacks the attributes of a generally applicable tax and instead is "designed as compensation for Government-supplied services, facilities, or benefits." Thus, according to the Fifth Circuit, the question is whether § 4611(b) imposes an impermissible tax or instead a permissible user fee. According to § 9509(b)(1), proceeds from § 4611(b) go to the Oil Spill Liability Trust Fund. The Oil Spill Liability Trust Fund is used for several purposes, including reimbursing those held liable for the cleanup costs of an oil spill, covering costs incurred by federal, state, and Indian tribe trustees for natural resource damage assessment and restoration, and supporting certain environmental research and testing. The "tax" imposed by § 4611(b) therefore might be characterized as a user fee that provides a source of funds for these initiatives. After analyzing relevant precedent from the U.S. Supreme Court, Judge Ho summarized the guiding principles regarding whether an impost is a tax or instead a user fee as follows:

> First, we must consider whether the charge under § 4611(b) is based on the quantity or value of the exported oil—if so, then it is more likely a tax. Second, we must consider the connection between the Fund's services to exporters, if any, and what exporters pay for those services under § 4611(b). That connection need not be a perfect fit. See *Pace*, 92 U.S. at 375–76. But a user fee must "fairly match" or "correlate reliably with" exporters' use of government services. *U.S. Shoe*, 523 U.S. at 369–70. Finally, we apply "heightened scrutiny," *Matter of Buffets, LLC*, 979 F.3d 366, 380 (5th Cir. 2020), and strictly enforce the Export Clause's ban on taxes by "guard[ing] against . . . the imposition of a [tax] under the pretext of fixing a fee," *U.S. Shoe*, 523 U.S. at 370 (quotations omitted).

With respect to the first issue, the Judge Ho concluded that the charge imposed by § 4611(b) is based on the volume of oil transported and therefore is based on the quantity or value of the exported oil, which makes it more likely that the charge is a tax. With respect to the second issue, Judge Ho concluded that there is not a sufficient connection between exporters' payment of the charge imposed by § 4611(b) and their use if government services. He reasoned that "[a] user fee is a charge for a specific service provided to, and used by, the payor," and that the charge imposed by § 4611(b) does not meet this criterion. Section 4611(b) requires oil exporters to pay for several things that cannot be regarded as services provided to the oil exporters, such as reimbursements to federal, state, and Indian tribe trustees for assessing natural resource damage; research and development for oil pollution technology; studies into the effects of oil pollution; marine simulation research; and research grants to universities. Although oil exporters benefit indirectly from these initiatives, they do not receive a specific service in return for the amounts they pay. Society as a whole benefits from these initiatives. By analogy, Judge Ho reasoned, [t]he fact that people pay taxes to fund police and fire protection does not somehow turn those taxes into user fees." Accordingly, the court held that the charge imposed by § 4611(b) is a tax rather than a user fee, and because it is a tax on exports, it violates the Export clause and is unconstitutional.

Concurrence of Judge Wiener. Judge Wiener concurred in the judgment of the court.

Dissenting opinion of Judge Graves. In a dissenting opinion, Judge Graves concluded that there are genuine issues of material fact as to whether § 4611(b) imposes a user fee and that it was therefore inappropriate for the District Court to grant summary judgment in favor of the taxpayer. Judge Graves disagreed with Judge Ho's conclusion that the charge imposed by § 4611(b) is based on the quantity or value of the exported oil. In his view, the charge is a per-barrel fee that does not depend on the value of the exported oil. He also disagreed with Judge Ho's analysis regarding exporters' payment of the charge and their receipt of services:

> it is implausible to suggest that random taxpayers or random members of society are the primary beneficiaries of exporters simply being responsible for their own actions and business practices. There would be no oil spills, resulting damage, or need for research and development regarding oil pollution if oil was not exported. The oil was not exported by random taxpayers or random members of society, and they are neither responsible for any subsequent pollution/damage of precious natural resources nor the beneficiaries of any cap on liability. The oil is exported by exporters, who are not forced to share any resulting profit with random taxpayers or random members of society. To borrow from the plurality, exporters pay and exporters benefit.

XII. TAX LEGISLATION

A. Enacted

1. The American Rescue Plan provides significant tax benefits for many taxpayers. The American Rescue Plan Act of 2021, Pub. L. No. 117-2, signed by the President on March 11, 2021, made several significant changes. The changes made by this legislation include expanding credits such as the child tax credit and earned income credit, suspending the requirement to repay excess advance premium tax credit payments, and providing exclusions for up to $10,200 of unemployment compensation and for cancellation of student loans.

2. The Infrastructure Investment and Jobs Act ends the employee retention credit of Code § 3134 for the fourth quarter of 2021. The Infrastructure Investment and Jobs Act, Pub. L. No. 117-58, signed by the President on November 15, 2021, contains relatively few significant tax provisions but section 80604 of the legislation ends the employee retention credit of Code § 3134 for the fourth quarter of 2021.

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

Recent Developments in Federal Income Taxation

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December 1, 2022

1

Provisions That Expired or Changed After 2021

Code Section	Topic	Change for 2022
21	Child and dependent care credit	For 2022, the child and dependent care credit for a qualifying child under age 13 or a disabled dependent of any age is up to 35% of up to: • $3,000 of qualifying expenses (for a maximum credit of $1,050) for one child or dependent, or • $6,000 of qualifying (for a maximum credit of $2,100) for two or more children or dependents. Credit is no longer fully refundable.
24	Expanded child tax credit	The child tax credit for 2022 is back to $2,000 per qualifying child

2

2

Provisions That Expired or Changed After 2021

Code Section	Topic	Change for 2022
163(h)(3)(E)	Mortgage insurance premiums	The ability to treat mortgage insurance premiums as deductible home mortgage interest expired for tax years beginning after 2021.
163(j)	Limit on deducting business interest	The deduction of business interest is limited by § 163(j). One component of the limit is 30% of "adjusted taxable income." For tax years beginning before 2022, ATI was similar to EBITDA. For tax years beginning after 2021, depreciation, amortization and depletion are no longer added back to taxable income to determine ATI. Therefore, ATI is now similar to EBIT.

3

3

Provisions That Expired or Changed After 2021

Code Section	Topic	Change for 2022
170	Charitable contributions	The ability of non-itemizers to deduct up to $300 of cash charitable contributions to public charities in addition to the standard deduction expired.
170	Charitable contributions	For 2022, the charitable contribution deduction limit for a gift of cash to a public charity is now back to 60 percent of one's adjusted gross income. The 100 percent limit expired as of December 31, 2021.

4

4

Provisions That Expired or Changed After 2021

Code Section	Topic	Change for 2022
174	Deduction of research or experimental expenditures	Such expenditures formerly could be deducted. For tax years beginning after 2021, such expenditures must be capitalized and amortized over 5 years (15 years for foreign research).

5

5

Section 174: Capitalization of Research or Experimental Expenditures
Outline: item B.1, page 4

- The 2017 Tax Cuts and Jobs Act, § 13206, amended Code § 174 to require the capitalization and amortization of specified research or experimental expenditures.
- The amortization period is 5 years (15 years for expenditures attributable to foreign research), beginning at the midpoint of the year in which the expenditures are paid or incurred.
- Applies to amounts paid or incurred in tax years beginning after 2021.
- The term "specified research or experimental expenditures":
  - Defined as research or experimental expenditures paid or incurred by the taxpayer during a tax year in connection with taxpayer's trade or business.
  - Includes expenditures for software development.
  - Includes depreciation and depletion
  - Does not include:
    - Amounts paid or incurred for ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral (including oil and gas)

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Actavis Laboratories, FL, Inc. v. United States, 130 A.F.T.R.2d 2022-5601 (Ct. Fed. Cl. 8/19/22)
Outline: item B.2, page 4

- The taxpayer was a manufacturer of brand-name and generic drugs.
- The taxpayer sought FDA approval of generic drugs by submitting Abbreviated New Drug Applications (ANDAs).
- As required by the ANDA process, the taxpayer:
  - Certified to the FDA that existing patents on the drugs were invalid or would not be infringed by the sale or use of the generic version of the drug, and
  - Sent notice letters to the holders of the patents informing them of the certification.
- <u>Issue</u>: were legal fees incurred to defend patent infringement suits brought in response to the notice letters capital expenditures?
- <u>Held</u>: No. The legal fees were not costs incurred as part of the FDA approval process and therefore were not costs incurred to facilitate the acquisition of an intangible asset (an FDA-approved ANDA).

7

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100% Deduction of Restaurant Business Meals
Outline: item D.2, page 10

- Taxpayer Certainty and Disaster Tax Relief Act of 2020.
  - Part of the 2021 Consolidated Appropriations Act, Pub. L. No. 116-260, enacted on December 27, 2020.
- Amends § 274(n)(2)
  - Provides exceptions to normal 50 percent limitation on deducting business meals
  - Legislation adds a new exception:
    - Can deduct 100% of the cost of food or beverages <u>provided by a restaurant</u> paid or incurred before January 1, 2023
    - Applies to amounts paid or incurred after December 31, 2020.
- <u>Notice 2021-25</u>, 2021-17 I.R.B. 1118 (4/8/21).
  - A <u>restaurant</u> is "a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises."
  - Your favorite food truck and street vendors are "restaurants," but Whole Foods is not. Caterers that don't operate restaurants? Who knows?

8

8

100% Deduction of Restaurant Business Meals
Outline: item D.2.b, page 10

- Notice 2021-63, 2021-49 I.R.B. 835 (11/16/21).
  - Allows taxpayers to treat the meal portion of a per diem rate or allowance as being attributable to food or beverages provided by a restaurant.
  - Effect: can deduct 100% of the meal portion of a per diem even if the employee is not actually eating at a restaurant.

9

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Notice 2022-3
2022-2 I.R.B. 308 (12/17/21)
Outline: item D.3, page 11

- Standard mileage rate for business miles in 2022 goes up to 58.5 cents per mile (from 56 cents in 2021).
- Medical/moving rate for 2022 goes up to 18 cents per mile (from 16 cents in 2021).
- Charitable mileage rate remains fixed by § 170(i) at 14 cents.
- The portion of the business standard mileage rate treated as depreciation remains the same at 26 cents per mile for 2022 (unchanged from 2021).
- Reminders:
  - Unreimbursed employee business expenses are miscellaneous itemized deductions and therefore not deductible through 2025.
  - Moving expenses are not deductible through 2025 except for members of the military on active duty who move pursuant to military orders incident to a permanent change of station.

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Announcement 2022-13
2022-26 I.R.B. 1185 (6/10/22)
Outline: item D.3.a, page 11

- Standard mileage rates are increased for deductible transportation expenses paid or incurred on or after July 1, 2022, and to mileage allowances that are paid both (1) to an employee on or after July 1, 2022, and (2) for transportation expenses paid or incurred by the employee on or after July 1, 2022.

Category	**Jan. 1-Jun. 30, 2022**	**Jul. 1-Dec. 31, 2022**
Business mileage	58.5 cents	62.5 cents
Medical/moving	18 cents	22 cents
Charitable mileage	14 cents	14 cents

11

11

Excess Business Losses and NOLs
Outline: item H.1, page 15

- 2017 TCJA changes to rules for net operating losses:
  - "Excess business losses" of noncorporate taxpayers disallowed by new § 461(*l*)
    - "Excess business loss" is amount by which taxpayer's aggregate trade or business deductions exceed aggregate gross income from those trades or businesses, plus $250,000 ($500,000 for joint filers), adjusted for inflation after 2018.
  - NOLS not carried back (only forward); capped at 80% of taxable income.
  - NOLs do not expire

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Excess Business Losses and NOLs
Outline: item H.1, page 15

- The CARES Act:
  - Suspended the disallowance of "excess business losses" for TY beginning before 2021
  - NOLS arising in 2018, 2019, and 2020:
    - May be carried back to each of the five preceding taxable years, then forward indefinitely.
  - For TY beginning before January 1, 2021 (generally, 2019 and 2020), the 80 percent taxable income limitation on NOL carryforwards does not apply.

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Excess Business Losses and NOLs
Outline: item H.1, page 15

- As enacted, § 461(*l*) was effective for tax years beginning before January 1, 2027.
- The Inflation Reduction Act (August 16, 2022), § 13903, extends the effective date of § 461(*l*) through tax years ending before January 1, 2029.

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Updated Life Expectancy Tables for Calculating RMDs
Outline: item B.1, page 16

- Final regulations update existing life expectancy tables for determining required minimum distributions from qualified plans (including IRAs)
- Generally, the tables reflect longer life expectancies, which results in smaller RMDs.
- Apply to distribution calendar years beginning on or after January 1, 2022
  - For someone who reached age 72 in 2021, the new tables would not apply to the distribution for 2021 (which must be made by April 1, 2022).
  - The new tables would apply to the distribution for 2022, which must be made by December 31, 2022.

15

15

Updated Life Expectancy Tables for Calculating RMDs
Outline: item B.1, page 16

Age	Life expectancy factor	RMD with prior-year balance of $100,000 (2021)
72	25.6	$3,906
73	24.7	$4,049
74	23.8	$4,202
75	22.9	$4,367

Age	Life expectancy factor	RMD with prior-year balance of $100,000 (2022)
72	27.4	$3,650
73	26.5	$3,774
74	25.5	$3,922
75	24.6	$4,065

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Notice 2021-61 (11/4/21)
Notice 2022-55 (10/21/22)
Outline: items B.2-3, pages 17-18

- Sets forth inflation-adjusted figures for benefits and contributions under qualified retirement plans for 2022 and 2023.
- Among other figures:

Category	2021	2022	2023
Elective deferrals- 401(k) plans	19,500	20,500	22,500
Catch-up contributions (age 50+)	6,500	6,500	7,500
IRA contribution limit	6,000	6,000	6,500

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17

Proposed Regulations on RMDs (2/24/22)
Increase in Age for RMDs to 72
Outline: item B.4, page 18

- A provision of the SECURE Act, Division O, Title I, § 114 of the 2020 Further Consolidated Appropriations Act, amended Code § 401(a)(9)(C)(i)(I)
- Increases the age at which required minimum distributions (RMDs) from a qualified plan (including IRAs) must begin from 70-½ to 72.
- RMDs now must begin by April 1 of the calendar year following the later of:
  - Calendar year in which the employee attains age 72, or
  - In the case of an employer plan, the calendar year in which the employee retires (does not apply to a 5-percent owner (as defined in § 416))
- Applies to distributions required to be made after December 31, 2019, with respect to individuals who attain age 70-½ after that date.

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Proposed Regulations on RMDS (2/24/22) No More Stretch RMDs from Non-Spousal Inherited Retirement Accounts *Outline: item B.4, page 18*

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

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Proposed Regulations on RMDs (2/24/22) 87 F.R. 10504 *Outline: item B.4, page 18*

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

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Notice 2022-53
2022-45 I.R.B. 437 (10/7/2022)
Outline: item B.4.a, page 19

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

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Possible Legislative Relief
SECURE Act 2.0

- H.R.2954 - Securing a Strong Retirement Act of 2022
  - Passed the House of Representatives on March 29, 2022
  - Referred to the Senate:
    - Senate Comm. on Finance passed EARN Act (S.B. 4808)
    - Senate Comm. on Health, Educ., Labor & Pensions is considering RISE and SHINE Act (S.B. 4353)
- House version would make several changes, including:
  - Increasing RMD age from 72 to 73 by 2022, to 74 by 2029, and to 75 by 2032.
  - Automatically enrolling employees in newly-created 401(k) or 403(b) plans at 3% contribution rate (increased annually to 10%), with the ability of employees to opt out.
  - Increase catch-up contribution limits for employees ages 62 to 64.
- The proposed legislation currently does not address the 10-year rule as interpreted by the proposed RMD regulations, but there is speculation that it will be amended to do so.

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McNulty v. Commissioner, 157 T.C. No. 10 (11/18/21)
Outline: item D.1, page 20

- The taxpayers, a married couple, established self-directed individual retirement accounts (IRAs).
  - They used the services of Check Book IRA LLC (Check Book), through its website.
  - The IRA became the sole member of a limited liability company (LLC) and transferred assets to the LLC.
  - Ms. McNulty and her husband were the LLC's managers.
  - The LLC invested in American Eagle Gold coins, which were shipped to the taxpayers' residence and kept in a safe there.
- Issue: did Ms. McNulty receive taxable distributions equal to the cost of the American Eagle Gold coins ($374,000 for 2015 and $37,380 for 2016)?
- Held: Yes. "An owner of a self-directed IRA may not take actual and unfettered possession of the IRA assets."
  - Taxpayers also were subject to accuracy-related penalties for substantial understatement of income tax.

23

American Rescue Plan 2021 (Mar. 2021) Cancellation of Student Loans
Outline: item B.1, page 21

- Section 9675 of the American Rescue Plan of 2021 amends Code § 108(f)(5) to provide that the cancellation of student loans is excluded from gross income.
- The definition of qualifying loans is broad enough to cover the vast majority of postsecondary educational loans.
- The exclusion does not apply if the lender is an educational organization or a private lender and the cancellation is on account of services performed for the lender.
- New § 108(f)(5) applies to discharges of loans that occur after December 31, 2020 and before January 1, 2026.
- Notice 2022-1 (12/21/21): instructs lenders that cancel student loans described in § 108(f)(5) not to issue Form 1099-C through 2025.

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Blum v. Commissioner
129 A.F.T.R.2d 2022-1170 (9th Cir. 6/2/22)
Outline: item B.2, page 21

- The taxpayer allegedly fell to the floor when she attempted to sit in a broken wheelchair while in the hospital for knee replacement surgery.
  - She brought legal action against the hospital for personal injuries.
  - The trial court in that action granted summary judgment for the hospital and the trial court's decision was affirmed on appeal.
- The taxpayer then brought a malpractice suit against the attorneys who had represented her. The law firm settled the malpractice action by paying the taxpayer $125,000.
- <u>Issue</u>: could the taxpayer exclude the settlement proceeds from her gross income under § 104(a)(2) as damages received on account of personal, physical injury or physical sickness?
- <u>Held</u>: No. There is no direct causal link between the damages and her injury. The settlement agreement specifically provided that her physical injuries did not result from the alleged attorney negligence.

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Leyh v. Commissioner
157 T.C. No. 7 (10/4/21).
Outline: item E.1, page 25

- In a written agreement, the taxpayer agreed to pay alimony to his wife until their final divorce decree.
- In 2015, the taxpayer paid $10,683 for his wife's health insurance premiums as pretax payroll reductions from his wages through his employer's cafeteria plan.
- The taxpayer excluded from his gross income the health care coverage premiums he and his wife received through his employer's cafeteria plan and also claimed a deduction for the $10,683 as alimony.
- <u>Issue</u>: Can the taxpayer deduct the amount paid as alimony?
- <u>Held</u>: Yes. This situation does not present an impermissible "double deduction" or its equivalent. His wife is required to include the payments in gross income. Section 265, which precludes deduction of amounts attributable to tax-exempt income, does not preclude a deduction.
  - In the 2017 Tax Cuts and Jobs Act, Congress repealed §§ 71 and 215 for divorce or separation instruments executed or modified after 2018.

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Redleaf v. Commissioner, 43 F.4th 825 (8th Cir. 8/5/22)
Outline: item E.2, page 25

- Andrew and Elizabeth entered into a Marital Termination Agreement in connection with their divorce proceedings.
- Among other requirements, the MTA required Andrew to pay Elizabeth $1.5 million per month for 60 months and to pay her $30 million in 2013.
- Andrew paid $18 million in 2012 and $33 million in 2013 and deducted then as alimony under former sections 71(b) and 215. Elizabeth did not report them as income.
- The IRS issued notices of deficiency to each spouse, asserting that Andrew could not deduct the payments because they were not alimony and asserting that Elizabeth had to include them in income because they were alimony.
  - IRS later conceded in Tax Court the payments were not income to Elizabeth because they were not alimony.
- <u>Issue</u>: were the payments alimony under former section 71(b)?
- <u>Held</u>: No. Andrew was obligated to make the payments following Elizabeth's death. The payments were part of the parties' property settlement and therefore not deductible.

Corporate Changes in Inflation Reduction Act August 16, 2022
Outline: item B.2, page 28

- The Inflation Reduction Act, § 138102, adds new Code section 4501
- Imposes excise tax of 1% on the value of any stock that is repurchased by a publicly traded corporation
  - Only repurchases that are treated as redemptions are subject to the tax. Repurchases that are treated as dividends are not.
- Certain exceptions apply, including:
  - Repurchases that are part of a tax-free reorganization, or
  - Repurchases in which total value of stock repurchased does not exceed $1 million
  - Repurchases in which stock repurchased is contributed to employer-sponsored retirement plan, stock ownership plan, or similar plan
- Applies to stock repurchased after December 31, 2022

Corporate Changes in Inflation Reduction Act August 16, 2022 *Outline: item H.1, page 29*

- The Inflation Reduction Act, § 10101, amends Code section 55(b)
- Imposes a 15 percent AMT on corporations with average "adjusted financial statement income" measured over three years of over $1 billion.
- Does not apply to:
  - S corporations
  - Regulated investment companies
  - Real estate investment trusts
- Applies to tax years beginning after December 31, 2022

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Cross Refined Coal, LLC v. Commissioner, 45 F.4th 150 (D.C. Cir. 8/5/22) *Outline: item A.1, page 29*

- Former § 45(c)(7)(A) provided a tax credit for the production of refined coal.
- AJG, Inc. formed Cross Refined Coal, LLC, to operate a refined coal production facility.
- Because of limits on the refined coal tax credit, AJG carried forward unused credits.
- AJG recruited two other investors, who became members of Cross and who:
  - Contributed substantial amounts of capital to Cross, and
  - Actively participated in Cross's day-to-day operations.
- Cross's operations were made profitable only by the refined coal tax credit.
- <u>Issue</u>: was Cross Refined Coal, LLC a bona fide partnership for federal tax purposes?
- <u>Held</u>: Yes. All three members intended to carry on a business, and all three members shared in profits and losses.
  - Court rejected the government's argument that Cross could not be a partnership because there was no expectation of a *pre-tax* profit.

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Deitch v. Commissioner, T.C. Memo. 2022-86 (8/24/22)

Outline: item A.2, page 31

- Two individuals, Mr. Deitch and Mr. Barry, formed West Town Square Investment Group, LLC (WTS), classified as a partnership for tax purposes.
  - They formed WTS to acquire commercial real property in Rome, Georgia, renovate it, and lease a portion of it to a hospital.
- Protective Life Insurance Co. (PLI) provided $4.4 million of financing for the project in the form of a participating loan.
  - The loan had a fixed interest rate (6.25%) and also provided for additional interest equal to 50% of net cash flow and 50% of appreciation in value.
- When WTS sold the property in 2014, it reported a net § 1231 gain of $2.6 million and a deduction of approximately $1 million for Appreciation Interest, which had the effect of producing a $1.2 million net rental loss.
- Issue: was the relationship between PLI and WTS that of creditor-debtor, so that WTS could deduct the Appreciation Interest, or was PLI a participant in a joint venture with WTS?
- Held: PLI and WTS had a creditor-debtor relationship. Seven of the eight factors from *Luna V. Comm'r* (T.C. 1964) weighed against a joint venture.

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IRS Compliance Campaigns Targeting Partnerships (Losses and Distributions in Excess of Outside Basis)

Outline: item B.1, page 33

- Pursuant to the limitation set forth in § 704(d), a partner can deduct the partner's share of partnership losses only to the extent of the partner's basis in the partnership interest, as determined under § 705.
  - In February 2022, the IRS announced a compliance campaign focusing on the allocation of losses to a partner that exceed the partner's outside basis.
- Under the rules that apply to distributions in § 731(a), a partner's basis in the partnership interest functions as a limitation on the partner's ability to receive certain liquidating and non-liquidating distributions without the recognition of gain.
  - In August 2022, the IRS announced a compliance campaign focusing on distributions to a partner that exceed the partner's outside basis.
- Partnerships now must report annually a partner's tax capital account on Schedule K-1.
  - Query whether the IRS plans to use a partner's tax capital account as a proxy for the partner's basis in the partnership interest.

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Final Regs. on Section 754 Elections
87 F.R. 47931 (8/5/22)
Outline: item E.1, page 33

- Final regulations provide that section 754 elections no longer require a partner's signature.
- This facilitates e-filing of partnership tax returns.
- Applies to tax years ending on or after August 5, 2022.
  - Taxpayers can apply to tax years ending before that date.

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Conservation Easements
Outline: item B.1, pages 34-40

- IRS has made a series of attacks on charitable contribution deductions for conservation easements
- Most successful IRS strategy: easement does not <u>protect the property in perpetuity</u>, as required by § 170(h)(2)(C) and (h)(5)(A).
- Recent cases disallowing large charitable contribution deductions for conservation easements:
  - *TOT Property Holdings, LLC v. Commissioner*, 1 F.4th 1354 (11th Cir. 6/23/21).
  - *Oakbrook Land Holdings, LLC v. Commissioner*, 28 F.4th 700 (6th Cir. 3/14/22)
  - Both cases disallowed donor's charitable contribution deduction because extinguishment language in the deed dictating what would happen if the easement were extinguished:
    - Failed to preserve donee's proportionate benefit, as required by Reg. § 1.170A-14(g)(6)(ii) .
    - Required that charitable-donee's benefit upon destruction or condemnation of the property be reduced by value of improvements to the property made by the taxpayer-donor after the contribution, contrary to Reg. § 1.170A-14(g)(6)(ii).

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34

Conservation Easements
Outline: item B.1, pages 34-40

- Issue: did Treasury comply with the Administrative Procedure Act in issuing Reg. § 1.170A-14(g)(6)(ii)?
  - IRS interprets the regulation as requiring that, in the event the easement is extinguished, the charitable-donee share in post-donation increases in value of the property attributable to improvements made by the taxpayer-donor after the contribution.
- Hewitt v. Commissioner, 21 F.4th 1336 (11th Cir. 12/29/21) *[item c, p.39]*:
  - Holds that Reg. § 1.170A-14(g)(6)(ii), as interpreted by the IRS, is arbitrary and capricious under the APA for failing to comply with procedural requirements and therefore is invalid.
- Oakbrook Land Holdings, LLC v. Commissioner, 28 F.4th 700 (6th Cir. 3/14/22) *[item d, p. 39]*:
  - Holds that Treasury complied with the APA in issuing Reg. § 1.170A-14(g)(6)(ii) and that the regulation is valid.

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Conservation Easements
[Not in outline]

- New case:
  - *Green Valley Investors, LLC v. Commissioner*, 159 T.C. No. 5 (11/9/22).
  - Holds that Notice 2017-10, which identifies syndicated conservation easements as listed transactions, is a legislative rule, improperly issued by the IRS without notice and comment as required under the APA.
  - IRS was prohibited from imposing penalties for failing to disclose listed transactions

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Mann Construction, Inc. v. United States, 27 F.4th 1138 (6th Cir. 3/3/22)

Outline: item H.6, page 65

- In Notice 2007-83, the IRS concluded that certain trust arrangements involving cash value life insurance policies are listed transactions.
- The IRS imposed penalties on a corporation and its two shareholders under § 6707A for failing to disclose a transaction that, according to the IRS, was a transaction described in Notice 2007-83.
- Held: the IRS failed to comply with the Administrative Procedure Act in issuing Notice 2007-83 and the notice therefore is invalid.

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Vitol, Inc. v. United States, 30 F.4th 248 (5th Cir. 3/23/22)

Outline: item C.1, page 67

- Issue: is butane a liquefied petroleum gas (LPG) within the meaning of § 6426(d) and therefore eligible for the alternative fuel mixture credit authorized by § 6426(e)?
- Held: No. the statutory framework is mutually exclusive: A given fuel is either taxable or alternative, but not both. The statutory context of § 6426 provides sound reason to depart from butane's common meaning. Because butane is a taxable fuel, it cannot be an alternative fuel, and therefore cannot be LPG within the meaning of § 6426(d).
  - Dissenting opinion by Judge Elrod: As everyone in the oil and gas industry knows, and as the United States readily concedes, butane is an LPG. Indeed, the government's own witness testified that "butane is always an LPG." That should be the end of it: Vitol gets a tax credit.
- Update: the U.S. Court of Federal Claims reached the same result with respect to this issue. *Philadelphia Energy Solutions Refining and Marketing, LLC v. U.S.*, 159 Fed. Cl. 230 (3/25/22)

38

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Trafigura Trading, LLC v. United States
29 F.4th 286 (5th Cir. 3/24/22)
Outline: item C.2, page 68

- <u>Held</u>: The tax imposed by § 4611 on oil exported from the United States is a tax on exports in violation of Article I, § 9 of the U.S. Constitution and therefore is unconstitutional.

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Oklahoma Society of CPAs

Gambling Tax Issues

December 1, 2022

Leader: Ted Blodgett

Gaming Taxation

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What we are going to talk about today

1. Changes starting in 2018 on the Federal and Oklahoma Return for the reporting for Gambling Reporting
2. How to get the information from the IRS Transcript for gambling winnings, and its limitations.
3. The Session Method for Reporting Gambling Winnings
4. Example of a spreadsheet to work with your clients for reporting their gambling winnings
5. Required documentation by the IRS/OTC
6. What to do when you get the IRS letter and does it matter if the client itemizes

2

Warm Up Stuff

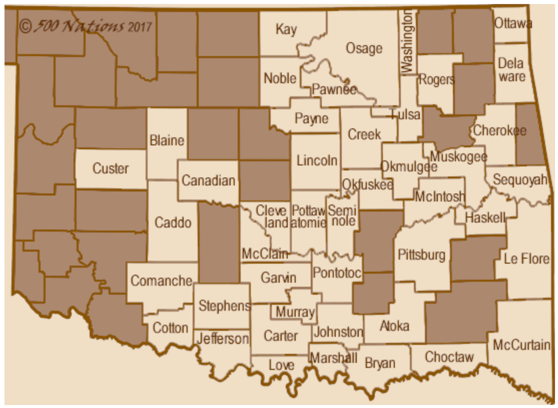
3

Oklahoma and Casinos

- Oklahoma has almost 150 casinos across 50 Oklahoma Counties operated by 33 tribes
- Indian gaming is Oklahoma's second largest industry, second in state revenue after California.
- Winstar has over 600,000 square feet and 2,700 employees
- Durant is about 50% of that number.
- Riverwind – 2,700 games and 1,200 employees
- Lots of out of state tags
  - More on this later

4

Oklahoma Casino Map



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Do you recognize this man?

6

References on Gambling Taxation

- Taxation of Gambling – Brad Polizzano – The Tax Advisor – October 1, 2016 - Really good summary of the Session Method
- IRS Notice 2015-21 – Safe Harbor Method for Determining a Wagering Gain or Loss for Slot Machine Play
- Oklahoma Law Review – Volume 70 – Number 3 – Taxation of Gamblers: The House Always Wins – Christine Manolakas

7

Are Gambling Losses Deductible

- Code Section 165(d) – "Losses from wagering transactions shall be allowed only to the extent of gains from such transactions."
  - Gains includes FMV of any prize or award received, including cars, watches and trips.
  - Comps?
- This is called the Gambler Penalty – Inflates the gambler's AGI.
  - Social Security
  - Medical expenses
  - Child Tax Credit
  - EIC

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Other issues caused by Gambling Winnings

- Loss of Educational Credits
  - AOTC
  - Lifetime Learning –
  - Medical Expenses
  - AGI limitation 7.5%
- Child Credit
- IRA Deduction

9

Where are gambling winnings taxable

- Oklahoma Source Gross Income – Income received from all sources of wagering games of chance or any other winnings from sources within Oklahoma are taxable Oklahoma income.
- Oklahoma requires a non-resident to file a 511NR

10

Professional Gambler

Professional

Not a professional

11

Difference in Professional and Recreational Gamblers

- A professional gambler can also deduct gambling-related expenses incurred in the business of gambling to the extent of wagering gains
  - NOT in excess of wagering gains.
  - For both, wagering gain is the difference between the value of the property and the cost of the winning bet or ticket. Rev Ruling 83-130.

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Professional Gambler

- In the trade or business of gambling
  - As trade or business is defined in the Internal Revenue Code? (trick question)
- Boneparte v. Commissioner TC Memo 2015-128 (July 2015) – (Taxpayer had no fixed address)
  - Court determined that taxpayer didn't become a professional gambler because he:
    - Didn't carry on in a business like manner
    - Did not maintain books and records
    - Kept track in his head
    - Had no evidence
    - Court stuck him with a 6662 penalty
- Benefit of a professional gambler – you can deduct other expenses. If you don't have net winnings, it doesn't matter

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The law

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Prebola v. Commissioner – 482 F. 3d 610

- Taxpayer won the lottery – 17.5M
- Payable in 26 annual installments
- Sold the rights to the payments for 7.1M
  - Taxpayer claimed the 7.1M was long term gain
  - Court said no. The 7.1M was a substitute for the ordinary income that would have been received in the future.

15

Lakhani v. Commissioner 142 TC 151 (2014)

- Taxpayer is a CPA
- Gambled on horses
- "Gamblers should be allowed the same protection as any other profession." – Taxpayer
  - To not "constitutes a discriminatory, unconstitutional deprivation of professional gamblers right to equal protection of the laws"
- The court disagreed.

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Other Cases

- Boyd v. US, 762 F.2d 1369 – Gambling losses cannot reduce income from non-gambling sources
- Excess gambling losses can't be used as a carryover to reduce gambling in other years.
  - Session method if you are playing slots on New Years Eve and hit a big one that night.
  - Better have a way to document this.
- Skeeles v. US, 95 F. Supp 242 – Married taxpayers that file a joint return may pool their gambling wins and losses.

17

6662 – Accuracy Related Penalty

- Two part test
  - Negligence or disregard of tax rules and regs
  - And, substantial underpayment of tax.
- Penalty is 20% of the underpayment
  - Negligence includes failure to make a reasonable attempt to comply with the tax laws, exercise ordinary care in tax return preparation, or keep adequate books and records.
  - Substantial Understatement if the understatement of tax exceeds
    - 10% of the tax required to be shown
    - $5,000 - for a recreational slot player that gets a lot of W-2G this is a low number

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6663 – Civil Fraud Penalty

- Civil fraud penalty is 75% of the underpayment that is attributable to fraud
- Different from negligence. Fraud is an intentional act.
- See Tschetschot v. Commissioner – professional poker player case.
  - Using a Schedule C and not the page 1 income for gambling.

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Necessary Documentation for Gambling losses

- Plisco v. US, 306 F 2d 784 – Wagering gains and losses must be evidenced by adequate documentation to take full advantage of the wagering loss limitiation.
- Schooler v. Commissioner – 68 TC 867 – The taxpayer has the burden of proving that wagering gains and losses were in fact sustained.
- Rev. Proc. 77-29 – Taxpayer should maintain an accurate diary or similar record supplements by verifiable documentation to substantiate wagering winnings and losses.

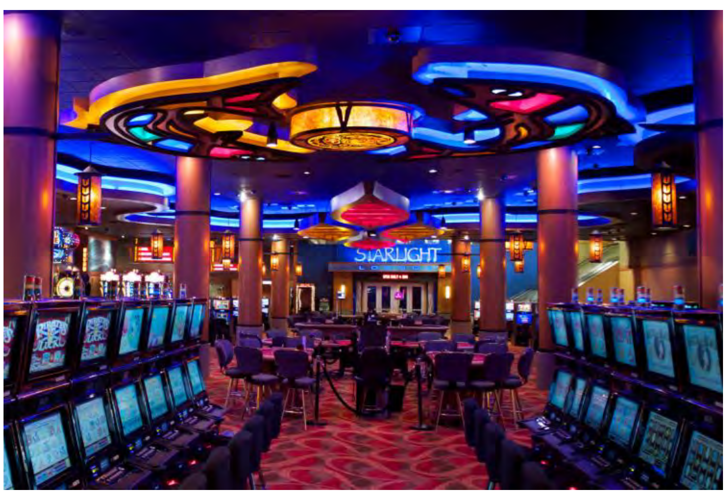
20

What does the diary need to contain

- Date
- Type of wagering
- Name of the establishment
- Address and location of the establishment
- Names of other persons present
- Amounts won or loss
    - Sessions method.

21

Changes for 2018 on Gambling Reporting



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What happened – Pre 2018

- The client drops off their information, maybe they even filled out the organizer.
- Sometimes they have a few W-2Gs. Sometimes they have a stack of them.
- The client sometimes has a statement from the casino that reports their net losses for the year.
  - Has anyone seen one with net winnings
- The return is prepared putting the total W-2Gs on page one and the exact same number on the Schedule A.

23

What happened in 2017 and before

- If there were only a few W-2Gs, and the client wasn't a high income taxpayer, usually nothing.
  - Until you get an IRS notice that a W2-G was missed
- But if the taxpayer has many W-2Gs, the 3% phase-out on Schedule A would catch them and they would owe tax on the spread between the gambling winnings and the schedule A allowed
    - "(Say your name), this can't be right"
- You would talk with your client about the session method, and the client nods and that's the end of it for 2017.

24

Actual Taxpayer - 2017

- Married couple in 2017 had 305 W2-Gs.
- Total reported winnings in 2017 were $750,000
- Total losses from the various casinos - over $100,000
  - The client did have a statement from the Choctaw Casino in Durant that had daily sessions broken out. Save this thought for later.
- Because of the itemized deduction phase-out they had a balance due of approximately $7,500 attributable to their gambling hobby.

25

Current Federal Return - Flawed idea

- Because itemized deductions are no longer subject to a phase-out, gaming no longer has any detrimental effect on the federal return.

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Starting Point for our Examples

- Jim and Mary Riverwind
- Married filing joint
- $20,000 each in social security ($40,000 total)
- Without gambling on Schedule A, the Riverwinds would use the standard deduction.

27

With only social security income and the standard deduction

- If the Riverwinds only had to report their Social Security Income, they would not even have a filing requirement.
  - No tax due to either IRS or Oklahoma.

28

Let's Add a 1099-R for $24,000 – with no withholding for IRS or OTC

- This puts the AGI at $30,000.
  - $24,000 of taxable retirement
  - $6,000 of taxable social security.
  - Federal Tax is only $600.
  - Oklahoma Tax is only $150.
  - Not a bad result on $64,000 of income.
- The means the Riverwinds would have about $5,300 per month to live on.

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Let's Add Gambling Winnings of $10,000

- Assume Gross Winnings are $10,000 and Gross Losses are $15,000
- This puts the Riverwind's AGI at $48,500.
  - $24,000 of taxable retirement
  - $14,500 of taxable social security.
  - Still can't itemize.
  - Federal Tax is $2,600.
  - Oklahoma Tax is $600.
  - Have fun telling Jim and Mary they owe $3,200 when they lost a net $5,000. ($400 per month)
    - "(Say your name), this can't be right"

30

Big Change on Oklahoma Return

- Beginning in 2018, Oklahoma Itemized Deductions are now capped at $17,000.
  - Not applicable for medical and charitable deductions.
- Background on the Oklahoma Legislature on this issue.
  - Two big OTC items
    - PTE
    - Adjustment for gambling losses like for charity and medical
    - Federal Form could fix this problem – let me know if you think that is coming
- Current Oklahoma issues – The tribes, the legislature and the Governor don't seem to always get along.

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2018 Tax Return – Real Taxpayer

- 416 W2-Gs
- Total W2-Gs gambling winnings – **over $1,000,000**
- Casino Statements – **over $300,000 of losses**
- Federal Return – Balance Due of approximately $500
- Oklahoma Return – Balance Due of approximately **$60,000**
- "Ted, That can't be right. We lost $300,000 gambling. How can they tax us when we lost"

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IRS transcript

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The IRS Transcript

- If you aren't signed up with E-Services with the IRS, you should be.
- Limitation used to be 250 total transactions available.
  - Now 999 or more
- No state withholding listed.
- W2-Gs are not available until later in the following year
- Important because they give you the W2-G at the casino when you hit the "jackpot"
  - This means the Riverwinds might have to keep track of their W2-Gs for more than a year and half.

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Sessions Method for all the big winners

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Session method

- IRS Notice 2015-21 (not finalized)
  - Discusses the Session Method
  - **Shollenberger v. Commissioner. TC Memo 2009-306**
    - **Fluctuating gains and losses left in play are not accessions to wealth until the tax payer terminates the play.**
  - LaPlante v. Commissioner. TC Memo 2009-226.
- **Definition of Session – A session of play begins when a patron places the first wager on a particular type of game and ends when the same patron completes his or her last wager on the same type of game before the end of the same calendar day.**
  - A taxpayer recognizes a wagering gain if, at the end of a single session of play, the total dollar amount of payouts from electronically tracked slot machine play during that session exceeds the dollar amount of wagers placed by the taxpayer on electronically tracked slot machine play during that session.
  - Notice 2015-21 has 7 Examples
    - The Choctaw Casino in Durant can provide this
    - Other casinos?

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IRS Topic 419 – Not very helpful

- The following rules apply to casual gamblers who aren't in the trade or business of gambling. Gambling winnings are fully taxable and you must report the income on your tax return. Gambling income includes but isn't limited to winnings from lotteries, raffles, horse races, and casinos. It includes cash winnings and the fair market value of prizes, such as cars and trips.

- Gambling Winnings
  - A payer is required to issue you a Form W-2G, Certain Gambling Winnings if you receive certain gambling winnings or have any gambling winnings subject to federal income tax withholding. You must report all gambling winnings as "Other Income" on Form 1040 or Form 1040-SR (use Schedule 1 (Form 1040) PDF), including winnings that aren't reported on a Form W-2G PDF. When you have gambling winnings, you may be required to pay an estimated tax on that additional income. For information on withholding on gambling winnings, refer to Publication 505, Tax Withholding and Estimated Tax.

- Gambling Losses
  - You may deduct gambling losses only if you itemize your deductions on Schedule A (Form 1040) and kept a record of your winnings and losses. The amount of losses you deduct can't be more than the amount of gambling income you reported on your return. Claim your gambling losses up to the amount of winnings, as "Other Itemized Deductions."

  - https://www.irs.gov/help/ita/how-do-i-claim-my-gambling-winnings-andor-losses

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Basics of the Session Method

- Time, Place and Activity
  - Time – Generally 24 hour period
    - Exception: Tournament lasts more than one day
  - Place – By casino
    - River Spirt
    - Hard Rock
  - Activity – By Game?
    - Black Jack
    - Slot Machines
    - Poker
      - Is video poker a slot machine? I think so.
  - Suggestion: A gambling diary

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Money in, and money taken home

- A basic concept of the session method:
  - How much money did you take out of your wallet/purse during the gambling session.
    - Playing Poker: $200 buy in.
    - Slot machine: Put a $100 bill in the machine
- Second basic concept:
  - How much money do you leave with.
    - Poker – cashed in $240 of chips
      - This is a winning session of $40
    - Slot machine - Cash out a ticket for $95
      - This is a losing session of $5
      - You could have a jackpot in here that will get you a W2-G

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Items that don't count

- ATM fees to get your cash
- Check fees to get cash
  - Client that cashes checks at the casino
    - Check for $2,120 to get $2,000
- Other casino costs
  - Bar tab
  - Tips
  - Cabana rental by the pool
  - Parking
  - Cigars to celebrate the winning

40

Why doesn't everyone use the session method

41

Practical issues with the Session method

- Takes the fun out of going to the casino
- Requires actual record keeping
  - You have to know how much money you put in the machines
  - You have to know how much money you add
  - You have to know much you left with
- Requires a log
- If you have a couple that gamblers, you have two sets of records to keep
  - Player Cards – These don't work. The report itself says you can't rely on it.

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IRS Issues with the session method

- The IRS computers do a great job of matching amounts submitted by the casinos.
  - Because the IRS computer doesn't know the bet, the match is automatically wrong.
- However the IRS doesn't have a method to match up the information for the session method.
  - E-File Attachment
  - Notice from the IRS is likely
    - Three years in a row for one taxpayer
    - Same letter was effective for all three years to have the IRS accept the sessions method

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Oklahoma Benefit to the Session method

- The Oklahoma limitation occurs on the itemized deduction amount.
- For the slot machine player, the session method will almost always results in a lower itemized deduction amount for gambling losses
  - This will reduce the effect on the $17,000 limit
- The notice will come from the IRS not the OTC
  - How you show the losses on Schedule A will matter

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Spreadsheet Example

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Questions

- I shall try my best. No guarantees.

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OSCPA
Oklahoma Society of CPAs

Understanding the Economics of Cannabis Businesses: Business and Tax Considerations

December 1, 2022

Leader: Jennifer Benda

Understanding the Economics of Cannabis Businesses: Business and Tax Considerations

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OSCPA OKLAHOMA TAX INSTITUTE: DECEMBER 1, 2022

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AGENDA

- Section 280E
  - Section 280E Background
  - IRS Enforcement
  - 280E Cases
  - Structuring
- Other Tax Compliance
  - State and Local Taxes
  - Information Returns

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Section 280E

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Section 280E Background

- *Edmundson v. Comm'r*, T.C. Memo. 1981-623
  - Illegal drug trafficker was permitted to deduct his ordinary and necessary business expenses incurred in his illegal drug business.
- Legislative History of Section 280E
  - There is a sharply defined public policy against drug dealing to allow drug dealers the benefit of business expense deductions at the same time that U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal, enterprises. Such deductions must be disallowed on public policy grounds.
  - To preclude possible challenges on constitutional grounds, the adjustment to gross receipts with respect to effective cost of goods sold is not affected by this provision of the bill.
    - S. Rep. No. 97-494, Vol. 1 (July 12, 1982), p. 309.

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Section 280E

- Expenditures in connection with the illegal sale of drugs
  - No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of Schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.
- Either the MORE Act or the STATES Act would repeal Section 280E for state-licensed marijuana businesses.

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Impact of Section 280E

	Non-Marijuana Business	Marijuana Business
Gross Sales	1,000,000	1,000,000
COGS	500,000	500,000
Total Income	500,000	500,000
Deductions	350,000	0
Taxable Income	150,000	500,000
Tax (21%)	31,500	105,000
Net Cash After Taxes	118,500	45,000
Net Margin	11.85%	4.5%

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Hemp and Section 280E

- Agricultural Improvement Act of 2018
  - Provides for Federal licensing of hemp producers through state programs approved by Department of Agriculture.
  - Hemp produced under these programs is excluded from definition of marijuana under Controlled Substances Act (must have less than .3% THC).
  - USDA Opinion.
  - Prior to AIA 2018, Section 280E likely applies to hemp businesses.
  - Hot hemp, Delta-8 (federally legal, state illegal?), Delta-9

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IRS Enforcement

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1996 Memo

- In a 1996 memo to President Clinton discussing legalization and how to preserve National Drug Control Strategy
  - Federal strategy to "blunt the negative consequences of the recent 'medical marijuana' Propositions in California and Arizona."
  - "IRS will continue to enforce existing Federal tax law as it relates to the disallowance of expenditures in connection with the illegal sale of drugs. To the extent state laws result in efforts to conduct sales of controlled substances prohibited by Federal law, the IRS will disallow expenditures in connection with such sales to the fullest extent permissible under existing Federal tax law."

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CCA 201504011

- How is COGS determined when a taxpayer is subject to Section 280E?
- Even though rules for computing inventory costs have expanded over time, IRS position is that inventory rules in force when Section 280E was passed must be applied
  - Section 471, no Section 263A
- Contrary to position IRS would take if a taxpayer is permitted to deduct business expenses that are not COGS
- Section 471 for producers is broad and generally favors capitalization
- Section 471 for retailers is more narrow

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2020 IRS FAQs

- State legal marijuana companies are subject to income taxes and are required to collect and pay employment taxes the same as any other business.
- Payment plans and other collection options are available to marijuana businesses. Further, the IRS has procedures for making payments of income taxes and employment taxes in cash if a marijuana business does not have access to banking.
  - Reading between the lines, marijuana businesses will not be given a pass for failure to make tax payments and deposits on the basis of the business's limited access to banking. Note: failure to make the appropriate tax payment and deposits can result in significant penalties.
- Because the marijuana industry largely deals in cash, marijuana businesses should be mindful of the obligation to file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, within 15 days of receiving such payment.

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2020 IRS FAQs

- Section 280E applies to the marijuana industry and must be applied in computing a marijuana business's income tax. The IRS position is that marijuana businesses should calculate cost of goods sold using the methodologies available under Section 471. According to the FAQs, this Internal Revenue Code Section 280E disallows "advertising and selling expenses."
- The IRS has been successful in litigation in imposing penalties on marijuana businesses which it has audited. Taxpayers should be mindful of these situations when they are preparing income taxes and applying Section 280E.

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2021 IRS Cannabis/Marijuana Initiative

- IRS will ensure training and job aids are available to IRS examiners working cases so they can conduct quality examinations (audits) consistently throughout the country.
- IRS will make sure there is coordination and a consistent approach by the IRS to the cannabis/marijuana industry.
- IRS will to find ways to identify non-compliant taxpayers.
- IRS will collaborate with external stakeholders to increase an awareness of tax responsibilities to improve compliance.
- IRS will give taxpayers access to information on how to properly comply with the filing requirements.
- https://www.irs.gov/about-irs/providing-resources-to-help-cannabis-business-owners-successfully-navigate-unique-tax-responsibilities

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IRS Enforcement: Constitutional Challenges

- Fifth Amendment/Summons Enforcement
  - *Feinberg v. Comm'r*, 808 F.3d 813 (10th Cir. 2015), T.C. Memo. 2017-211
  - *Alpenglow Botanicals, LLC v. U.S.*, 2016 WL 7856477 (D. Colo. 2016), *Alpenglow Botanicals, LLC v. U.S.*, 894 F.3d 1187 (10th Cir. 2018)
  - *The Green Solution Retail v. U.S.* (10th Cir. 2017)
  - *The Green Solution Retail v. U.S.* (10th Cir. 2017), *cert. denied* 2018.
  - *High Desert Relief, Inc. v. U.S.* (D. N.M. 2016), *aff'd* Tenth Cir. 2019.
  - *Futurevision, Ltd. v. U.S.* (D. Colo. 2017)
  - *Rifle Remedies, LLC v. U.S.* (D. Colo. 2017)
  - *CSW Consulting, Inc. v. U.S.* (D. Colo. 2020)
  - *Speidell v. Comm'r*, 978 F.3d 731 (10th Cir. 2020)
  - *Standing Akimbo, LLC v. U.S.*, 955 F.3d 1146 (10th Cir. 2020), petition for cert pending.
  - *Medicinal Wellness Ctr., LLC v. U.S.* (D. Colo. 2019)

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Eighth Amendment Considerations

- Is Section 280E an excessive fine or penalty?
- *U.S. v. Sanchez*, 340 U.S. 42 (1950)
  - Challenge to the Marijuana Tax Act on the basis that placed on the penal nature of the tax.
  - "[A] tax does not cease to be valid merely because it regulates, discourages, or even definitely deters the activities taxed."
- Courts have rejected arguments that 280E violates excessive fines and penalties clause
- *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65 (2019)
  - Motion for partial summary judgment that Section 280E is excessive fine or penalty
  - Majority held "disallowing a deduction from gross income is not a punishment" and that deductions are not equitable, they are a matter of legislative grace
  - Dissenters willing to consider it a penalty but no indication whether they would also fine it to be excessive
- *The Green Solution Retail v. U.S.*, 10th Cir, May 2, 2017: "Section 280E is not a penalty." *See also Alpenglow Botanicals v. U.S.*, 894 F.3d 1187 (10th Cir. 2018).
- *Today's Healthcare II LLC v. Comm'r*, T.C. Memo. 2021-96

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Sixteenth Amendment Arguments

- *N. Cal. Small Bus. Assistants, Inc. v. Comm'r*, 153 T.C. 65 (2019)
  - Motion for partial summary judgment that Section 280E is excessive fine or penalty
  - Gustafson dissent: "gain" also means profit, after taking into account ordinary and necessary expenses – in other words, "deductions are mandatory under the Sixteenth Amendment" – he reasons that some deductions can be denied, but denying <u>all</u> business deductions is a bridge too far
  - In *Standing Akimbo*, Tenth Circuit specifically declined to adopt dissent's reasoning on Sixteenth Amendment (955 F.3d 1146, 1157 n.7 (10th Cir. 2020))
- *Today's Health Care II, LLC v. Comm'r*, T.C. Memo. 2021-96
- *Alpenglow Botanicals, LLC. v. U.S.*, 894 F.3d 1187, 1201-1202 (10th Cir. 2018.

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Section 280E Cases

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What is trafficking? *CHAMP*

- *Californians Helping to Alleviate Medical Problems, Inc. v. Comm'r,* 128 T.C. 173 (2007)
  - Taxpayer's business was a community center focused on persons suffering from HIV/AIDS which involved extensive caregiving services other than providing marijuana.
  - Dispensary was 10% of facility.
  - Seven of the taxpayer's employees distributed marijuana, eighteen employees provided caregiving services, and no employees did both.
  - Director with significant healthcare background testified secondary purpose was providing marijuana.
  - More income was attributable to caregiving services than to sale of marijuana.
  - Taxpayer was allowed to allocate expenses between two separate trades or businesses, only one of which was subject to Section 280E.

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Definition of Trafficking

- Well settled that state legal businesses are "trafficking" as that term applies under Section 280E.
- *CHAMP*
  - "Petitioner argues that its supplying of medical marijuana to its members was not "trafficking" within the meaning of section 280E. We disagree. We define and apply the gerund "trafficking" by reference to the verb "traffic", which as relevant herein denotes "to engage in commercial activity: buy and sell regularly"."
- Many Section 280E case includes a similar analysis.
- Ninth and Tenth Circuits have affirmed.

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Definition of Trafficking

- *Olive v. Comm'r*, 139 T.C. 19 (2012)
  - "We have previously held that a California medical marijuana dispensary's dispensing of medical marijuana pursuant to the CCUA was ''trafficking'' within the meaning of section 280E."
  - "The dispensing of medical marijuana, while legal in California (among other States),is illegal under Federal law. Congress in section 280E has set an illegality under Federal law as one trigger to preclude a taxpayer from deducting expenses incurred in a medical marijuana dispensary business. This is true even if the business is legal under State law."

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Trafficking: Sales of Non-Marijuana Items

- *Alterman v. Comm'r* , T.C. Memo. 2018-83
  - Sales of non-marijuana products were 1.4% of gross receipts in 2010 and 3.5% of gross receipts in 2011.
  - Sales of non-marijuana products were complimentary to the sales of marijuana products and, therefore, were not a separate trade or business.

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Tax Court: Inventory Accounting

- *Alterman v. Comm'r* , T.C. Memo. 2018-83
  - Cost of goods sold claimed on the return was, for the most part, amounts paid for purchases of inventory and did not include production costs.
  - At trial, the taxpayer asserted that it incurred over $100,000 of production costs each year in addition to the amounts paid for purchases of inventory.
  - Taxpayer was reseller. Section 471 applied and allows taxpayers to include direct and indirect production costs in cost of goods sold.
  - Taxpayers failed to properly account for beginning and ending inventories and, therefore, couldn't argue that cost of goods sold should be increased.

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Tax Court: Inventory Accounting

- *Patients Mutual Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018), *aff'd* (9th Cir. Apr. 22, 2021)
  - California's largest dispensary known as Harborside.
  - In compliance with California regulations, patient members grew marijuana and sold it to the dispensary. Dispensary included areas where there was further processing of product, i.e., trimming, curing, packaging, quality control.
  - Questions:
    - Whether Harborside was a manufacturer/producer or a reseller.
    - Whether Section 263A can be used by taxpayers subject to Section 280E.

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Tax Court: Inventory Accounting

- *Patients Mutual Assistance Collective Corp. v. Comm'r*
  - "This was not the type of contract-manufacturing arrangement we saw in *Suzy's Zoo*, 273 F.3d at 877, where a designer hired others to make its products but owned those products at all stages of their creation. Harborside merely sold or gave members clones that it had purchased from nurseries and bought back bud if and when it wanted. In between these two steps it had no ownership interest in the marijuana plants. Harborside is therefore a reseller for purposes of section 471 and must adjust for its COGS according to section 1.471-3(b), Income Tax Regs."

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Tax Court: Inventory Accounting

- *Patients Mutual Assistance Collective Corp. v. Comm'r*
  - "In 1988 Congress amended section 263A(a)(2), adding flush language that says: "Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph." TAMRA sec. 1008(b)(1). The regulations show that "cost" here means expenses that would otherwise be deductible. See sec. 1.263A-1(c)(2), Income Tax Regs."

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Ninth Circuit: Inventory Accounting

- *Patients Mutual Assistance Collective Corp. v. Comm'r*
  - "Harborside presents no cogent argument for why a marijuana dispensary cannot compute its "cost of production" under the usual rules that apply to a retailer."
  - "Although Harborside is subject to serious tax consequences because of the nature of its business, *see* I.R.C. § 280E , the primary argument it has preserved for our review fails based on generally applicable provisions of federal tax law. Marijuana dispensaries, like all taxpayers, must abide by the intricacies of the Internal Revenue Code and the Treasury Regulations."

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Patients Mutual Amicus Brief

- Inventory Costs are not limited because of Section 280E
- Therefore, Section 263A should not be off limits
- Section 471 is expansive, regulations are permissive
- Tax Court misinterpreted Section 263A flush language
- Doctrine of Constitutional Avoidance

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Production Depreciation Methods

- In audits, IRS is denying MACRS and bonus depreciation for production assets.
- *Lord v. Comm'r*, T.C. Memo. 2022-14
  - Tax Court determined that tax depreciation methods applied to production assets did not conform with Section 471, therefore Commissioner could change method to GAAP depreciation method.
  - Tax Court also held that depreciation methods provided in the Code are not available to taxpayers subject to Section 280E.
  - How to prepare returns going forward?

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Tax Court Litigation: Substantiation/Penalties

- *Feinberg v. Comm'r* , T.C. Memo. 2017-211: IRS determination was upheld because taxpayer failed to provide proper substantiation for business expenses.
- *Alterman v. Comm'r* , T.C. Memo. 2018-83
  - Taxpayers failed to properly account for beginning and ending inventories and therefore, couldn't argue that cost of goods sold should be increased.
  - Negligence penalty applied because taxpayer did not keep adequate records to compute beginning and ending inventories or adequate books and records.
  - No reasonable cause because the taxpayers did not seek advice regarding inventory accounting or the application of Section 280E.

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Tax Court Litigation: Substantiation/Penalties

- *Patients Mutual Assistance Collective Corp. v. Comm'r*, T.C. Memo. 2018-208
  - Penalties not imposed based on extensive analysis of timing of case law – no clear guidance on some issues.
  - Taxpayer had good records.
- *San Jose Wellness v. Comm'r*, 156 T.C. 4 (2021)
  - 2010-2015 tax years – in addition to COGS, other costs were deducted for holistic services
  - Penalty applied to 2015 tax year – law on Section 280E was no longer unsettled in 2016.

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Structuring

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Choice of Entity

Factors to Consider When Determining Entity Type

- State and local marijuana licensing requirements
- Scope of operations: vertical integration, producer, retailer
- Corporate formalities that must be maintained (board of directors, regulatory reporting requirements, annual meetings, etc.)
- Restrictions on owners or type of equity that can be issued (under tax law and corporate law)
- Tax rates of different structures: One or two levels of income tax, Section 199A, self-employment taxes, and ACA taxes
- Exit strategy

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Comparing Options

Flow through entities
- Higher tax rate on Section 280E expense
- Limited deduction for state taxes
- Some uncertainty on application of Section 199A

C corporations
- Double taxation
- Reasonable comp
- Accumulated earnings tax

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Establishing a Separate Trade or Business

- *Patients Mutual Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018)
  - An activity is a trade or business if the taxpayer does it continuously and regularly with the intent of making a profit. *See*, e.g., *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987); *United States v. Am. Bar Endowment*, 477 U.S. 105, 110 n.1 (1986). A single taxpayer can have more than one trade or business, *CHAMP*, 128 T.C. at 183, or multiple activities that nevertheless are only a single trade or business, *see*, *e.g.*, *Davis v. Commissioner*, 29 T.C. 878, 891 (1958). Even separate entities' activities can be a single trade or business if they're part of a "unified business enterprise" with a single profit motive. *Morton v. United States*, 98 Fed. Cl. 596, 600 (2011).

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Establishing a Separate Trade or Business

- *Patients Mutual Assistance Collective Corp. v. Comm'r*, 151 T.C. 176 (2018)
  - "Whether two activities are two trades or businesses or only one is a question of fact. *See,* e.g., *CHAMP*, 128 T.C. at 183; *Owens v. Commissioner*, T.C. Memo. 2017-157, at *21. To answer it, we primarily consider the "degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together * * *, and the similarity of the various undertakings." *Olive*, 139 T.C. at 41; sec. 1.183-1(d), Income Tax Regs."

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Trafficking: Non-Licensed Businesses

- *Alternative Healthcare Advocates v. Comm'r*, 151 T.C. No. 13 (Dec. 20, 2018)
  - The licensed entity, Alternative, was C corporation, sold marijuana and non-marijuana products, claimed deductions other than COGS.
  - Wellness Management Group, Inc. was in business of providing employees to dispensaries, and provided employees to Alternative to work in the dispensary.
    - S corporation, took deductions for compensation, salaries and wages, rent, taxes and licenses, advertising, etc.; only customer was Alternative.

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Trafficking: Non-Licensed Businesses

- *Alternative Healthcare Advocates v. Comm'r*, 151 T.C. No. 13 (Dec. 20, 2018)
  - "In the Controlled Substances Act, "[t]he term 'dispense' means to deliver a controlled substance to an ultimate user". 21 U.S.C. sec. 802(10); *see id.* sec. 841(a)(1) (prohibiting the manufacture, distribution, dispensation, or possession of marijuana)."
  - "Section 7208(4)(B) defines "trafficking" as "[k]nowingly or willfully buy[ing], sell[ing], offer[ing] for sale, or giv[ing] away * * * washed or restored stamp[s] to any person for use". While the Internal Revenue Code is silent with respect to trafficking in controlled substances, congressional findings and declarations on controlled substances, *see* 21 U.S.C. sec. 801(2), describe it as "[t]he illegal importation, manufacture, distribution, and possession and improper use of controlled substances."

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Trafficking: Non-Licensed Businesses

- *Alternative Healthcare Advocates v. Comm'r*, 151 T.C. No. 13 (Dec. 20, 2018)
  - "Further, the Federal statute criminalizing trafficking in counterfeit goods or services provides that "the term 'traffic' means to transport, transfer, or otherwise dispose of, to another, for purposes of commercial advantage or private financial gain, or to make, import, export, obtain control of, or possess, with intent to so transport, transfer, or otherwise dispose of". 18 U.S.C. sec. 2320(f)(5) (2012)."

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Trafficking: Non-Licensed Businesses

- *Alternative Healthcare Advocates v. Comm'r*, 151 T.C. No. 13 (Dec. 20, 2018)
  - Court concluded that both Alternative and Wellness were trafficking in marijuana.
  - "…the only difference between what Alternative did and what Wellness did (since Alternative acted only through Wellness) is that Alternative had title to the marijuana and Wellness did not. Wellness employees were directly involved in the provision of medical marijuana to the patient- members of Alternative's dispensary. While Wellness and Alternative were legally separate, Wellness employees were engaged in the purchase and sale of marijuana (albeit on behalf of Alternative); that was Wellness' primary business. We do not read the term "trafficking" to require Wellness to have had title to the marijuana its employees were purchasing and selling."

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Tax Court: Double Taxation

- *Alt. Healthcare Advocates v. Comm'r*, 151 T.C. 225 (2018)
  - "We, therefore, hold that Wellness was engaged in the business of "trafficking in controlled substances" during the taxable years at issue. And, to the extent Wellness engaged in nontrafficking activities, the record before us does not allow us to allocate expenses between marijuana-related and non-marijuana-related activities."
  - "Petitioners also argue that applying section 280E to both Alternative and Wellness is inequitable because deductions for the same activities would be disallowed twice. These tax consequences are a direct result of the organizational structure petitioners employed, and petitioners have identified no legal basis for remedy."

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State and Local Taxes

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Oklahoma Income Taxes

- Oklahoma taxable income starts with Federal taxable income/AGI
- Oklahoma has not decoupled from 280E
- Most recent bill (H.B. 3347) proposed:
  - For taxable years beginning on or after January 1, 2023, there shall be allowed a deduction from Oklahoma taxable income equal to the amount of any deduction for business expense incurred in conducting applicable *licensed medical marijuana business activity* within this state which was disallowed for the same tax year pursuant to the provisions of Section 280E of the Internal Revenue Code of 1986, as amended.
  - Excludes adult-use if SQ 820 passes

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OK Marijuana Tax Revenue

TAX REVENUE REPORT Oct. 13, 2022

SQ 788 EXCISE TAX	
FY 2020 (July 2019 - June 2020)	$42,409,066
FY 2021 (July 2020 - June 2021)	$66,098,861
FY 2022 (July 2021 - June 2022)	$60,215,200
FY 2023 (July 2022 - Sept. 2022)	$12,944,307 (Sept. = $4,176,361)

STATE AND LOCAL SALES TAX	
FY 2020 (July 2019 - June 2020)	$53,982,833
FY 2021 (July 2020 - June 2021)	$82,750,797
FY 2022 (July 2021 - June 2022)	$77,650,906
FY 2023 (July 2022 - Sept. 2022)	$16,660,191 (Sep. = $5,487,738)

Data obtained from https://oklahoma.gov/omma/about/licensing-and-tax-data.html on November 12, 2022.

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Excise and Sales Taxes

- The SQ 788 excise tax is for retail medical marijuana sales. It is 7% and is collected at the point of sale.
- State sales tax 4.5% applies in addition to local sales taxes.
- SQ 820 proposes adult-use sales would be subject to a 15% excise tax on sale of adult-use marijuana.
- Sales tax systems are easiest to enforce and comply with because of extensive tracking of inventory.

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Form 8300

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The Bank Secrecy Act: Form 8300

- Anti-Money laundering law which requires financial institutions and other businesses to keep records and report cash transactions exceeding $10,000 to the IRS.
  - Currency Transaction Report (CTR) (FinCen)
  - Suspicious Activity Report (SAR) (FinCen)
    - CTRs and SARs are generally filed by financial institutions and are filed with Financial Crimes Enforcement Network (FinCen).
  - Form 8300: Report of Cash Payments over $10,000 Received in a Trade or Business
- Impacts marijuana businesses and those providing goods and services to them. Separate IRS audits focus on Form 8300 compliance.

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Type of Payments Requiring Form 8300

- The amount of cash is more than $10,000, and
- The business receives the cash as:
  - One lump sum of more than $10,000, or
  - Two or more related transactions that total more than $10,000, and
- The establishment receives the cash in the ordinary course of business, and
- The same agent or buyer provides the cash.
  - Section 6050I

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Penalties for Failure to File

- Non-Willful Failures (Section 6721): $280 penalty per Form 8300 not filed (2021 rate – adjusts to $290 in 2023)
  - $50 if failure is corrected within 30 days of due date.
  - $110 if corrected after 30 days but on or before August 1.
  - $570 (2022) if intentional disregard of the rules (i.e., you knew about the rule, knew you should have filed but made decision not to file)
  - Rev. Proc. 2020-45
- Criminal Sanctions for Willful Failures
  - Includes intentional failure to timely file or an intentional failure to include correct information.
  - Penalty is equal to the greater of $25,000 ($100,000 for corporations) or the amount of cash not reported, up to $100,000 ($500,000 for corporations).
  - Imprisonment + criminal prosecution costs.

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Completing the Form — Part I

Part I **Identity of Individual From Whom the Cash Was Received**

2 If more than one individual is involved, check here and see instructions . . . . . ▶ ☐

3 Last name	4 First name	5 M.I.	6 Taxpayer identification number
7 Address (number, street, and apt. or suite no.)	8 Date of birth . . . ▶ (see instructions)		M M D D Y Y Y Y
9 City	10 State	11 ZIP code	12 Country (if not U.S.)	13 Occupation, profession, or business
14 Identifying document (ID)	a Describe ID ▶ / c Number ▶		b Issued by ▶

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Completing the Form — Part II

Part II **Person on Whose Behalf This Transaction Was Conducted**

15 If this transaction was conducted on behalf of more than one person, check here and see instructions . . . . . ▶ ☐

16 Individual's last name or organization's name	17 First name	18 M.I.	19 Taxpayer identification number
20 Doing business as (DBA) name (see instructions)			Employer identification number
21 Address (number, street, and apt. or suite no.)			22 Occupation, profession, or business
23 City	24 State	25 ZIP code	26 Country (if not U.S.)
27 Alien identification (ID)	a Describe ID ▶ / c Number ▶		b Issued by ▶

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Completing the Form — Part III

Part III **Description of Transaction and Method of Payment**

28 Date cash received M M D D Y Y Y Y

29 Total cash received $ .00

30 If cash was received in more than one payment, check here . . . ▶ ☐

31 Total price if different from item 29 $ .00

32 Amount of cash received (in U.S. dollar equivalent) (must equal item 29) (see instructions):

a U.S. currency $ .00 (Amount in $100 bills or higher $ .00)

b Foreign currency $ .00 (Country ▶)

c Cashier's check(s) $ .00

d Money order(s) $ .00

e Bank draft(s) $ .00

f Traveler's check(s) $ .00

Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶

33 Type of transaction

a ☐ Personal property purchased

b ☐ Real property purchased

c ☐ Personal services provided

d ☐ Business services provided

e ☐ Intangible property purchased

f ☐ Debt obligations paid

g ☐ Exchange of cash

h ☐ Escrow or trust funds

i ☐ Bail received by court clerks

j ☐ Other (specify in item 34) ▶

34 Specific description of property or service shown in 33. Give serial or registration number, address, docket number, etc. ▶

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Completing the Form — Part IV

Part IV **Business That Received Cash**

35 Name of business that received cash

36 Employer identification number

37 Address (number, street, and apt. or suite no.)

Social security number

38 City

39 State

40 ZIP code

41 Nature of your business

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Signature ▶ Authorized official **Title** ▶

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Thank You

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Oklahoma Society of CPAs

Where From Here? Economic Scenarios for 2022 and 2023

December 2, 2022

Leader: Chris Kuehl

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Oklahoma Society of CPAs

Tax Implication of Cryptocurrency

December 2, 2022

Leader: Allison McLeod

TAX IMPLICATIONS OF CRYPTOCURRENCY

Prof. Allison M. McLeod, LL.M., CPA
A PLLC

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LEARNING OBJECTIVES

By the end of the course, the participant should be able to:

1. Discuss what constitutes blockchain and the various types of cryptocurrency it supports.
2. Determine whether a cryptocurrency transaction creates a taxable event.
3. Be able to identify the IRS forms needed to report cryptocurrency transactions.

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LEARNING OBJECTIVES (CONT'D)

4. Develop a working knowledge of possible reports due to other regulatory agencies.
5. Discuss the traps that cryptocurrency traders can encounter which could unexpectedly increase the trader's tax liability.
6. Become knowledgeable of current enforcement actions employed by the IRS.

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BACKGROUND OF BLOCKCHAIN AND CRYPTOCURRENCY

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CRYPTOCURRENCY - GENERALLY

- Decentralized form of digital cash
- Functions as a medium of exchange.
- Not issued or backed by a government.
- Does not have legal tender status in any jurisdiction.
- Originally associated with the dark web – Silk Road
- Eliminates the need for traditional intermediaries like banks and governments to make financial transactions

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BITCOIN (BTC)

- The very first cryptocurrency.
- Created in 2008 by a group of individuals operating under the name Satoshi Nakamoto.
- Recently broke the $68,000 per unit trading barrier but has been volatile since.
- First BTC transaction in 2010- 2 Papa John's pizzas for 10,000 BTC.

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DEFINITION OF BLOCKCHAIN

- System that supports the trading of cryptocurrency like Bitcoin.
- Any two willing parties can transact directly peer-to-peer without the need for a trusted third party such as a bank.
- Virtual transactions are recorded in a digitized public ledger called a "blockchain."
- Individual units of the currency are called "coins."

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DEFINITION OF BLOCKCHAIN (CONT'D)

- System is based on cryptographic proof and cannot be reversed.
- Designed to protect sellers from fraud.
- System is secure "as long as honest nodes collectively control more CPU power than any cooperating group of attacker nodes."

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EXAMPLES OF CRYPTOCURRENCY

- Dogecoin – up 1500% after Elon Musk Tweets
- Ether
- Liteco
- Ripple

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PROBLEMS WITH CRYPTOCURRENCY

- Anonymity could facilitate tax evasion, money laundering, and support other crimes.
- Operates in a decentralized manner and is unregulated.

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CRYPTOCURRENCY IS NOW MAINSTREAM

- Paypal and several investment banks (e.g., BNY Mellon) are providing services to clients in managing their cryptocurrency.
- Recent launches:
  - Blackrock – new spot crypto product for institutional clients
  - Facebook – Libra
  - Coinbase – USD Coin (stablecoin)

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KNOWLEDGE CHECK #1

Which of the following is NOT an example of cryptocurrency?

A. Etherium

B. Bitcoin

C. Blockchain

D. Litecoin

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OTHER DEFINITIONS

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PRIVATE KEY

- A string of numbers and letters that are used to access your "wallet."
- Private key acts as a password when selling or withdrawing cryptocurrencies.
- Acts as a digital signature.

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TOKEN

- Acts as the “coin.”
- Actually is a digital code which can be owned, bought and sold.

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WALLET

- An app that allows cryptocurrency users to store and retrieve their digital assets.
- A user can store cryptocurrency in a wallet and from there use it to make transactions.

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COLD STORAGE

- An offline wallet provided for storing bitcoins or other cryptocurrencies.
- Wallet is stored on a platform that is not connected to the internet.
- Protects the wallet from unauthorized access, cyber hacks, and other vulnerabilities.
- Also known as a "cold wallet."

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ADDRESS

- Unique identifier where the cryptocurrency sits on the blockchain. The coin's ownership data is stored here.
- Address registers any changes when the cryptocurrency is traded.

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INITIAL COIN OFFERING (ICO)

The creator of a cryptocurrency will put an initial batch of its coins up for purchase in order to raise funds.

AIRDROP

- A marketing play where free tokens are sent into wallets for free or in return for a social media post in order to promote a new virtual currency.

EXCHANGES

- A platform where cryptocurrencies are exchanged with each other, other traditional currencies (like US Dollars) and between entities.
- Examples of popular cryptocurrency exchanges:
  - Coinbase
  - Binance
  - Gemini
  - Bittrex
  - Kraken
  - KuCoin

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FORK

- A new version of a blockchain that is created, resulting in two versions of the blockchain running side-by-side.
- Hard forks – is a major update to this protocol. there is not a consensus about the changes that have been made so a new blockchain is created to run in parallel with the original. The problem is that of backwards compatibility.
- Soft forks – a minor update that improves efficiency.

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BLOCK

- A blockchain is made up of blocks.
- Each block holds a historical database of all cryptocurrency transactions made until the block is full.
- Is a permanent record that can be reviewed.

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FIAT

- Refers to money recognized as legal tender by governments, such as the US dollar, British pound, Euro, and Australian dollar.

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ETHEREREUM

- One of the top three cryptocurrencies in the world based on capitalization.
- Differs from bitcoin in it allows developers to create applications on top of it and also write smart contracts.

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ALTCOINS

- All the other coins outside of bitcoin are grouped together under the category of altcoins.
- Examples: Ethereum, Litecoin

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WHERE TO BUY CRYPTOCURRENCY

- Cryptocurrency exchanges – e.g., Coinbase.
- Investment brokerages – e.g. Robinhood.
- Peer-to-Peer
- Cryptocurrency ATMs

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KNOWLEDGE CHECK #2

An offline wallet provided for storing bitcoins or other cryptocurrencies is called a:

A. Hot purse
B. Cold wallet
C. Hot wallet
D. Warm fannypack

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CLASSIFYING CRYPTOCURRENCY

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IS CRYPTOCURRENCY PROPERTY OR CURRENCY?

- IRS - property, much like stock or real estate.
  - Does not give rise to foreign currency gain or loss for U.S. tax purposes.
- Commodity Futures Trading Commission ("CFTC") – commodities
- Financial Crimes Enforcement Network's ("FinCEN") - substitute for real currencies as "money transmitters."
- Regulators motivated to bring virtual currency under their jurisdiction.

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CRYPTOCURRENCY AS PROPERTY

- Under **Notice 2014-21**, cryptocurrency is treated as property for federal tax purposes.
- Gain or loss based on the difference between the taxpayer's basis in the property and its FMV must be recognized on the exchange of cryptocurrency for cash or for other property.

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CRYPTOCURRENCY AS PROPERTY (CONT'D)

- Character of gain or loss is capital if it is a capital asset in the hands of the taxpayer, otherwise, the character is ordinary.
- Capital gains or losses are reported on Form 1040, Schedule D and Form 8949.
- Ordinary gains or losses should be reported Form 1040, line 21 (*Other Income*) or Schedule C.

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ADDITIONAL TAX PLANNING IDEAS

- Rolling over capital gains from cryptocurrency into Opportunity Zones. Can defer, reduce or eliminate taxes by investing proceeds into businesses and personnel located into the Opportunity Zones.
- Place the cryptocurrency in a self-directed cryptocurrency IRA.
  - Tax-free if in a Roth IRA
  - Tax-deferred if a non-Roth account.

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KNOWLEDGE CHECK #3

Estaban purchased 0.3 Dogecoin for $3,000 in early 2021 and then sold it six months later for $5,000. Which of the following is correct?

A. The character of the gain is short-term and is treated as ordinary income.

B. The character of the gain is long-term and is subject to capital gain rates.

C. Estaban has a $2,000 capital gain.

D. Estaban has a $2,000 capital loss.

E. Both A and C.

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TAXABLE TRANSACTIONS

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IRS NOTICE 2014-12

- A taxable event occurs when a taxpayer:
  - ✓Trade cryptocurrency to fiat currency like the US dollar
  - ✓Trade one cryptocurrency for another cryptocurrency
  - ✓Use cryptocurrency to pay for goods and services
  - ✓Earning crypto as income

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KNOWLEDGE CHECK #4

Sammy buys 1 Bitcoin for $4,000 and later trades it 2 years later for 5 Ether. One Ether is worth $10,000 on the date of the trade. What gain or loss, if any, is Sammy required to report?

A. Sammy does not have a reportable transaction since he did not exchange his Bitcoin for cash.
B. Sammy has a $6,000 short-term capital gain.
C. Sammy has a cost basis of $10,000 per Ether.
D. Sammy has a $46,000 long-term capital gain.
E. Both C. and D.

PAYING FOR SERVICES

- Wages or paid by virtual currency must be reported on a Form W-2. Subject to FIT withholding, FICA, and FUTA.
- Virtual currency payments to independent contractors constitute self-employment income that is subject to self-employment tax.
- Payor of virtual currency should first obtain the contractor's tax ID since these payments are subject to the backup withholding rules.

AIRDROPS

- A random distribution of coins during a marketing campaign typically to promote a new cryptocurrency.
- IRS considers marketing giveaways to be ordinary income.
- Valued on the date the cryptocurrency is received.
- Cost basis = Value.

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TAXABILITY OF HARD FORKS

- Cryptocurrency that is being held by an individual goes through a hard fork, the new forked cryptocurrency received is taxed as income.
- The cost basis in the newly received cryptocurrency becomes the income recognized.
- Soft forks (minor upgrades) are not taxable.

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MARGIN TRADING

- Margin trade - borrowing funds from an exchange to effect a trade The borrowed funds are repayed later.
- Tax impact – the borrowed funds are treated as the taxpayer's investment and will therefore establish cost basis.
- The margin trading profit and loss can be calculated using this cost basis.

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MARGIN TRADING (CONT'D)

- Gains or losses will be capital in nature (typically short-term).
- BitMex and other similar cryptocurrency exchanges have popularized margin trading.
- No IRS guidance yet specifically on cryptocurrency margin transactions.

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KNOWLEDGE CHECK #5

Jorge purchases 3 Litecoin for $5,500. Two years later, Jorge trades all his Litecoin for 1 ETH. At the time of the trade, 3 Litecoin is worth $9,000. Which of the following is true?

A. Jorge has a taxable event upon the exchange.

B. Gain equals $3,500.

C. The gain is long-term in nature.

D. All of the above.

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MINING

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MINING

- A process where an individual solves complex mathematical problems and gives "computing" power in order to add new transactions to the blockchain. Mining consists of certification of transactions on a blockchain.
- The person donating the computer power is granted new fractions of the cryptocurrency.
- IRS asserts that if the taxpayer's "mining" activities rise to the level of a trade or business, the income is also subject to self-employment tax.

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MINING RIGS V. CLOUD MINING

- "Mining Rig" – individual owns the computers and equipment in order to reap all of the mining rewards.
  - Income received from the mining rewards off set by expenses should be reported on Schedule C.
  - Will also be subject to self employment taxes to be reported on Schedule SE
  - May qualify under the Section 199A Qualified Business Income Deduction.
  - Consider accelerating deductions through Sec. 179 or bonus deprecation provisions.

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MINING RIGS V. CLOUD MINING (CONT'D)

- "Cloud mining" where the individual invests in another company that is operating the computers and mining equipment. In this case, the individual is paid out a portion of the mining rewards.
  - FMV of the rewards is reported on Schedule B as dividend income.

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MINING MISMATCH BETWEEN ORDINARY INCOME AND CAPITAL LOSS

Example: Bob joins a mining pool and spends $4,000 on electricity and get rewarded with a bitcoin worth $7,500. Bob has to recognize $3,500 ordinary income on the date of the reward.

Bob shortly thereafter sells his BTC which had collapsed in value from $7,500 to $4,000. While it looks like he has broken even, Bob will probably owe tax. This is because he has $3,500 of ordinary income taxed at higher rates and now $3,500 of capital loss, some or all which will result in a lower tax benefit. This is due to the fact that the capital losses can only offset capital gains, which are taxed at a lower rate. Excess capital losses may be used to offset up to $3,000 of other ordinary income, but any excess amounts remaining after this offset are suspended.

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MINING AND THE HOBBY LOSS RULES

Assume the same facts as above, except Bob had never intended for the mining to be a money-making enterprise but enjoyed mining for mere entertainment purposes.

If the IRS can Bob's mining was a hobby, then Bob will be required to report all of his $7,500 revenue as income but would not be able to deduct his $4,000 in costs.

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KNOWLEDGE CHECK #6

Kiera runs a cryptocurrency mining rig in her dorm room. Every week, she earns 0.1 bitcoin from her mine. On May 1, one Bitcoin was worth $35,000. Which of the following is NOT true?

A. Kiera will then recognize income of $3,500.

B. Kiera recognizes taxable income equal to the FMV of her bitcoin when receiving her mining payouts.

C. Kiera does not have to recognize any income.

D. None of the above.

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GIFTS

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GIVING GIFTS TO INDIVIDUALS

- Under the general gift exemption rules, gifts of up to $15,000 of cryptocurrency per recipient is not subject to gift tax.
- FMV is established on date of gift.
- Multiple donors can possibly give to the same donee gift tax-free.
- Recipient will inherit donor’s holding period and tax basis.
- Remember that cryptocurrency is property, not currency!

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KNOWLEDGE CHECK #7

Laurie bought a Litecoin for $9,000 and 3 years later gave it to her grandson Mike when it was worth $10,000. Mike sells it a month later for $8,500. Which of the following is NOT true?

A. Mike will recognize a $500 loss.

B. Mike will recognize a $1,500 ordinary loss.

C. Laurie's holding period carries over to Mike.

D. The loss will be capital in nature.

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GIVING GIFTS TO CHARITABLE ORGANIZATIONS

- Donor may be able to deduct the full FMV of cryptocurrency given to public or private charities under IRC § 501(c)(3) or to governmental entities or political subdivisions thereof (e.g., a public school).
- Gift is valued as of date of gift.
- Donations greater than $500 have to be reported on Form 8283.

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LIMITATIONS ON GIFTS TO CHARITIES

- Cryptocurrency held for more than 1 year - deduct FMV up to 30% of AGI. Built-in gain not taxed.
- Cryptocurrency held for less than a year - deduct up to 50% of AGI and the lesser of: cost-basis or FMV of the donated cryptocurrency.
- Unused charitable contributions may be carried over to future years.

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TRAPS FOR THE UNWARY

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WASH RULES

- Wash sale rules prohibit the claiming of a loss on sale of a security purchased within 30 days before or after.
- Wash sale rules don't apply to cryptocurrency since it is "property" and not "securities."
- Cryptocurrency traders can therefore harvest a loss and then immediately repurchase the cryptocurrency without losing the right to immediately claim the loss.

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KNOWLEDGE CHECK #8

Stewart has already recognized $23,000 capital gains for selling his Dogecoin this year. He is also holding some ETH which has fallen in value by $12,000 since he purchased it. Stewart can "harvest" some losses by which of the following actions?

A. By selling it for a fiat currency.

B. By trading it into another cryptocurrency.

C. By paying for goods or services using the ETH

D. All of the above.

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STOLEN CRYPTOCURRENCY EXAMPLE

Assume that Lisa purchased $10,000 of cryptocurrency as an investment. Two years later when the crypto is worth $12,000, a thief hacks into Lisa's wallet and steals all of her cryptocurrency.

Can Lisa deduct the loss? If so, for what amount?

If the crypto had been purchased by a corporation, would the answer be different?

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FORM 1099-K

- Coin exchanges are required to issue a Form 1099-K to customer who received $600 or more from payment card entities and third-party network transactions in a one year There is no minimum transaction threshold.
- Form1099-K form does not provide cost basis for each coin.
- Traders also have to keep track of the FMV of any cryptocurrency traded into, which is can be challenging since trades can occur between platforms.

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FORM 1099-B

- The 2021 Infrastructure Bill will make it mandatory for all cryptocurrency exchanges that are considered "brokers" (i.e., cryptocurrency exchanges and other third parties that facilitate the transfer of digital assets) to provide 1099-B forms starting the 2022 tax year.
- Problems may arise due to the fact that the blockchain may not have the cost basis.
- This level of reporting flies in the face of the "interoperability" inherent in blockchains.

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EXPANDED REPORTING IN 2024

- The Infrastructure Bill also expands Section 6050I so that any person or entity who receives more than $10,000 in virtual assets must file a report with the IRS with the sender's personal information.
- Provision was initially created to discourage large, in-person cash transactions.
- If applied to digital assets, it will heavily discourage swaps due to the requirement to exchange the parties' sensitive information.

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ORDINARY INCOME CREATED BY FORKS

- IRS treats coin split ups that occur when a blockchain forks into two chains as constituting current ordinary income equal to the value of the newly created coin even if it is not sold.
- Rationale is that the split creates a windfall to the holder, even though arguably it more resembles a stock split, which does not result in an immediate tax implication

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§ 1031 LIKE-KIND EXCHANGES

- Cryptocurrency does not qualify as like-kind property, in part because it is not real estate.
- Sec. 1031 tax deferral not available for cryptocurrency since January 1, 2018.
- Exchanges for one cryptocurrency for another is therefore a taxable event.

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CRYPTOCURRENCY FUTURES AND §1256 CONTRACTS

- The CFTC ruled virtual currencies are "commodities."
- Query – Do the "Section 1256 Contract" rules apply?
- Futures are subject to the following tax treatment:
  - Positions are "marked to market" on Dec. 31, with paper gains and losses recognized as if the futures position were sold and immediately bought back.
  - The gains and losses are split 60% long-term, 40% short-term irrespective of actual holding period.

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SECTION 475(F) ELECTION FOR TRADERS

- Traders are considered to be carrying on a trade or business.
- Generally, traders must treat gains and losses as capital in nature and are reported on Schedule D.
- Dividend and interest income are treated as investment income and are reported on Schedule B.
- Can make Sec. 475(f) election where gains or losses are treated as ordinary and reported on Form 4797.

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SEC. 475(F) ELECTION – MARK-TO-MARKET RULES

- The Sec. 475(f) election permits the taxpayer to use the mark-to-market rules.
- Traders can elect as having sold all their securities on the last day of the tax year at their fair market value (FMV), with gain or recognized as taxed as ordinary income or ordinary loss.
- Dealers' and traders' expenses are considered business expenses and are deductible.
- Wash rules will not apply if election is made.

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MAKING THE SEC. 475(F) ELECTION

- No special form – file a statement with following information:
  - A description of Sec. 475 claiming the use of mark-to-market method of accounting);
  - The first tax year for which the election is effective; and
  - The trade or business for which the taxpayer is making the election.
  - Must be filed by the unextended due date of the tax return.

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STRADDLE RULES

- Straddle rules apply to cryptocurrency.
- Losses are not permitted on closing a position in an actively traded investment if an open position is being maintained in the opposite direction.
- Situation can arise if an individual maintains multiple positions in cryptocurrency futures, options, puts or calls.

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FBAR AND FATCA REPORTING

- Cash and securities held in offshore accounts are subject to the reporting requirements under **FBAR (Foreign Bank & Financial Accounts)** and **FATCA (Foreign Account Tax Compliance Act)**. Failure to report results in severe penalties.
- Since cryptocurrency is property and not cash or securities, FBAR and FATCA normally should not apply.
- An individual who trades during the year into fiat currencies may cross a threshold and be required to file.
  - FBAR required if offshore account exceeds $10,000 – filed electronically.
  - FATCA – filed on Form 8938 and is required if $50,000 threshold is met.

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FBAR AND FATCA REPORTING (CONT'D)

- FinCEN cryptocurrency administrators/exchanges to be engaged in a "money service business," which is regulated by the Bank Secrecy Act. Cryptocurrencies can arguably be reportable if they can be characterized as a "foreign" account (or similar asset)
- As of November 13th, 2019, FinCEN officials at an AICPA conference stated that FBAR is not required to be filed for cryptocurrency assets.

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FINCEN NOTICE 2020-2

- Current FBAR regulations do not define a foreign account holding virtual currency as a type of reportable account.
- FinCEN intends to amend the Bank Secrecy Act (BSA) regulations to include virtual currency as a type of reportable account under FBAR.

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LINKS TO IRS RESOURCES

- Rev. Rul. 2019-24 - https://www.irs.gov/pub/irs-drop/rr-19-24.pdf
- Notice 2014-21 - https://www.irs.gov/pub/irs-drop/n-14-21.pdf
- 2019 IRS FAQ on Crypto currency - https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions

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REPORTING CHALLENGES

- Exchanges of one cryptocurrency for another are typically not expressed in US dollars (e.g., .034 Litecoin for 2.9 Ripple), so cost basis and FMV may be hard to determine without diligent and contemporaneous record-keeping.
- Traders typically trade and operate on a multitude of platforms where cryptocurrency is sent back and forth and assets are comingled. This can cause fragmented data and difficulty establishing cost basis and sale price.
- Many traders are unaware of the tax reporting requirements and have not kept records of trades, purchases and sales. This can make it difficult to accurately reflect complete and accurate basis.

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FIFO V. SPECIFIC ID IN CALCULATING GAIN/LOSS

- Since cryptocurrency is considered a capital asset, the IRS's default method for determining basis for purposes of calculating gain or loss on a disposition is first-in, first-out (FIFO) method of accounting.
- Traders may be tempted to use specific identification to reduce the recognized gain especially when the value of the cryptocurrency is rapidly rising and the trader has acquired multiples of the same cryptocurrency. This may be considered an aggressive approach.

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FIFO V. SPECIFIC ID IN CALCULATING GAIN/LOSS (CONT'D)

- Notice 2014-21 does not specifically refer to cryptocurrency as stock. It is also unlikely that an "adequate identification" can be made since it is merely an entry in a distributed ledger held by various parties. The cryptocurrency can be divided into an infinite number of parts, and lacks any sort of lot number. It would be difficult establish adequate ID.

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NO BANKING INSURANCE COVERAGE

- SIPC insurance covering up to $500,000 of funds stolen from a brokerage or bank does not cover crypto currency.
- No FDIC insurance since not a bank account.
- Example: $40 m hacked from from Binance in 2019 was not covered by insurance.

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REPORTING CRYPTOCURRENCY

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INFORMATION RELEASE-2022-61 – CRYPTOCURRENCY REPORTING

- All filers of Forms 1040, 1040-SR, and 1040-NR, must answer the forms' question regarding virtual currency.
- The question asks, "At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?"
- Taxpayers must check either the "yes" or "no" regardless of whether they engaged in any transaction involving virtual currency during the tax year.

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CRYPTO (CONT'D)

Transactions with cryptocurrency requiring a "yes" answer:

- Paying or receiving crypto for goods or services
- The receipt or transfer of crypto for free that does not qualify as a bona fide gift;
- Receiving crypto as a result of "mining" and "staking" activities
- Receiving crypto as a result of a "hard fork"
- Exchanging cryptocurrency for another virtual currency
- Selling cryptocurrency
- Any other disposition of a financial interest in virtual currency.

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CRYPTO (CONT'D)

Transactions that permit taxpayers to check the "no" box:

- Merely holding the cryptocurrency in taxpayer's own wallet or account;
- Transferring virtual currency between wallets or accounts the taxpayer owns or controls; or
- Purchasing virtual currency using real currency, including purchases using real currency electronic platforms such as PayPal and Venmo.
- Any combination of holding, transferring, or purchasing virtual currency in the above three ways will not require a "yes" answer.

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CRYPTOCURRENCY REPORTING

- The Infrastructure Investment and Jobs Act will require Forms 1099-B filed after Dec. 31, 2023, to include certain cryptocurrency transactions.
- Still awaiting additional guidance on the scope of the requirement from Treasury department.
- Early indications that "ancillary parties" without access to relevant information about transactions but merely validating them, selling storage devices for private keys, or writing related software code will not likely be considered brokers.

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REPORTING CRYPTOCURRENCY ON RETURNS

- Acquiring virtual currency can require reporting as wages on the taxpayer's return if it was received as compensation for services.
- If held for sale to customers in a trade or business, it would be reported as inventory.
- If held as a capital asset, then any resulting capital gain or loss will be reported on Schedule D.

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FORM 1099-DA (DIGITAL ASSET).

IRS is currently working on the form which will be used to report taxpayer cryptocurrency activity and will include the kind of information you'd traditionally see on Form 1099-B, like number and kind of assets, cost basis, fair market value, and holding period.

Under the law, the new reporting requirement begins in tax year 2023, which means Form 1099-DA should land in the hands of taxpayers in 2024—assuming that the IRS remains on schedule. However, rumblings about a potential delay in implementation are growing louder.

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IRS ENFORCEMENT

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RECENT IRS ENFORCEMENT ACTIONS

- CP 2000 Notices - for unreported/underreported 1099-K transactions
- More than 10,000 warning and action letters sent out to non-compliant cryptocurrency investors in 2019.
  - Letter 6173 (Action Letter)
  - Letter 6174 & 6174-A (No Action Letter)

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OPERATION HIDDEN TREASURE

- New IRS initiative to catch unreported cryptocurrency transactions.
- Joint effort between IRS civil and CID units.

U.S. V. KVASHUK – 11/9/2020

- Microsoft engineer stole $10 million in digital currency while testing MS's online retail sales platform.
- Exchanged the currency for $2.8 million in Bitcoin, and used a Bitcoin "mixing" service to hide the transactions.
- Bought $160K Tesla and $1.7m lakefront home.
- Claimed that the Bitcoin was a gift from a relative in filed returns.
- Received 9 year sentence in prison in November 2020.

U.S. V. ELMANNI – 12/9/2020

- Elmaani ("Bruno Block") promoted Pearl tokens, a new cryptocurrency, which were part of a 2017 initial coin offering ("ICO").
- SEC asserted that the Pearl tokens were securities and the $1.3 m sale had not be properly registered.
- Elmaani also used a web of digital wallets to covertly mint approximately four million unauthorized Pearl tokens.

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U.S. V. ELMANNI – 12/9/2020 (CONT'D)

- Made millions in illicit gains through the minting and sale of Pearl tokens.
- Elmaani spent over $10 million to purchase several yachts, two homes and other personal expenses.
- Did not report any income on his tax returns for 2017 or 2018 even though he received a 2018 Form 1099 reporting$12.5 million in cryptocurrency proceeds.

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JOHN DOE SUMMONSES

- IRS issued a" John Doe" summons to Coinbase for transactions from 2013 to 2015.
- Coinbase provided information on transactions exceeding $20,000.
- IRS is aggressively pursuing enforcement of compliance in cryptocurrency transactions.

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INDUSTRY UPDATES

- Recent Senate bill setting up crypto as a new category to be regulated by the Commondity Futures Trade Commission (CFTC).
- Meltdown of TerraUSD stablecoin issued by Celsius on the Solana platform. Company currently seeking bankruptcy.
- Voyager Digital Limited also declared bankruptcy, freezing deposits.
- 8,000 Solana wallets were hacked in cyberattack.
- Microstrategy put $250m of its corporate reserves in crypto during 2020. CEO Michael Saylor has now stepped down because of losses.

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Thank You!

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CONTACT US!

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Cybersecurity Trends

December 2, 2022

Leader: Eric Kehmeier

Cybersecurity Awareness

Eric Kehmeier / December 2nd, 2022

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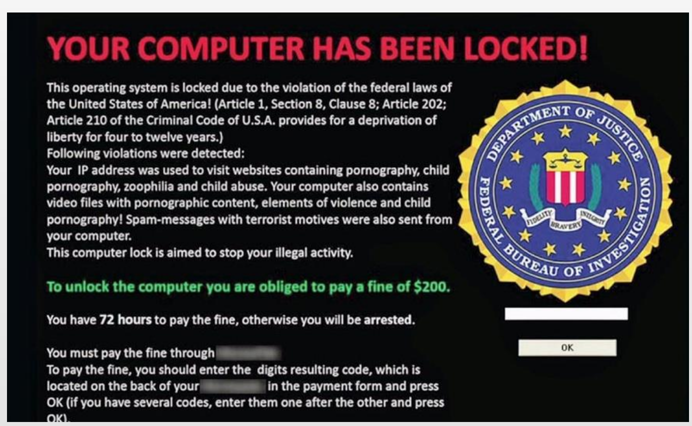
1

WHY WE'RE HERE



- My mission when I started as an MSP
- My experience with Ransomware
- My new mission has been to bring security focus to the owners and staff of all small businesses who CAN avoid getting breached.

2

AGENDA

- Evolution of Cybercrime – WHY this is happening
- Prime Targets – WHO it's happening to
- Threat Vectors – HOW the bad guys get in
- Your Role – WHAT you can do to protect yourself, your family and your employer
- Time to Shift – WHAT you need to win
- Resources – WHERE you can go to learn more

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3

EVOLUTION OF CYBERCRIME

Why is this happening?

4

WHY – THE EVOLUTION OF CYBERCRIME

Payment systems*

#	NAME	MARKET CAP	PRICE
1	BTC Bitcoin	1.04724416244e+11	$6117.67
2	ETH Ethereum	43575743019.4	$434.30
3	XRP Ripple	18177638381.9	$0.462982
4	BCH Bitcoin Cash	12160605068.9	$706.75

от 2000$ за выполненный проект

Постоянно требуется написание автозаливных инжектов под Zeus/SpyEye

Job postings

Silk Road
anonymous marketplace

Marketplaces

*Source: Coinmarketcap.com/currencies/icon 7-8-2018

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CYBERCRIME ON THE DARK WEB

Stolen credentials are used to test for open door access into corporate networks

197 Days: the average length of time it takes for organizations to identify a data breach

19 Minutes to Escalation: Russian Hackers Move the Fastest

New data from CrowdStrike's incident investigations in 2018 uncover just how quickly nation-state hackers from Russia, North Korea, China, and Iran pivot from patient zero in a target organization.

News

By KELLY JACKSON HIGGINS Executive Editor at Dark Reading, 2/19/2019

Stolen Credentials Are Sold Here

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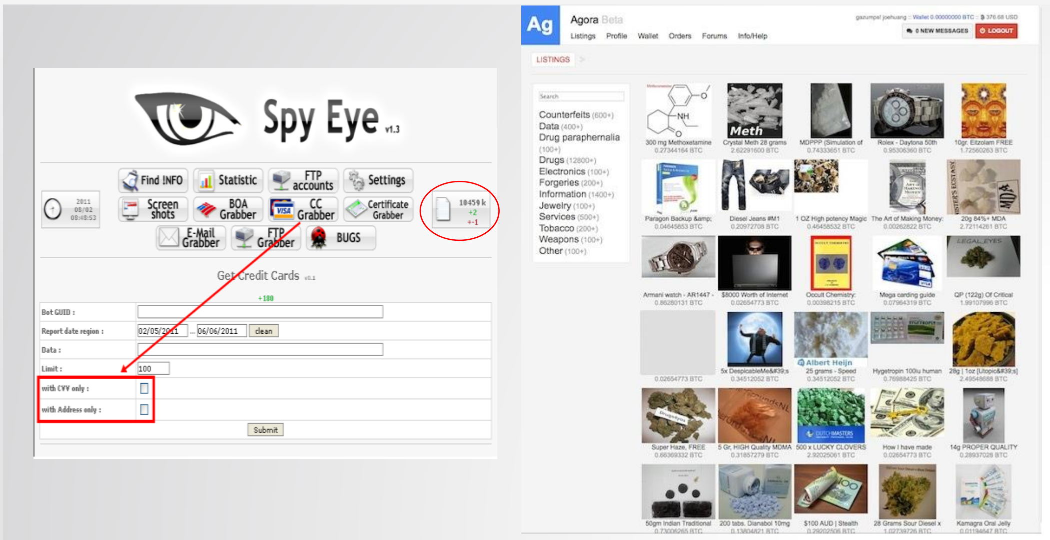
6

CYBERCRIME ONLINE SHOPPING…



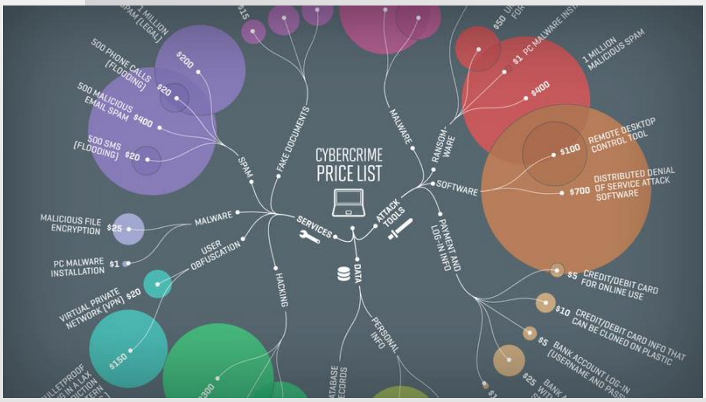
7

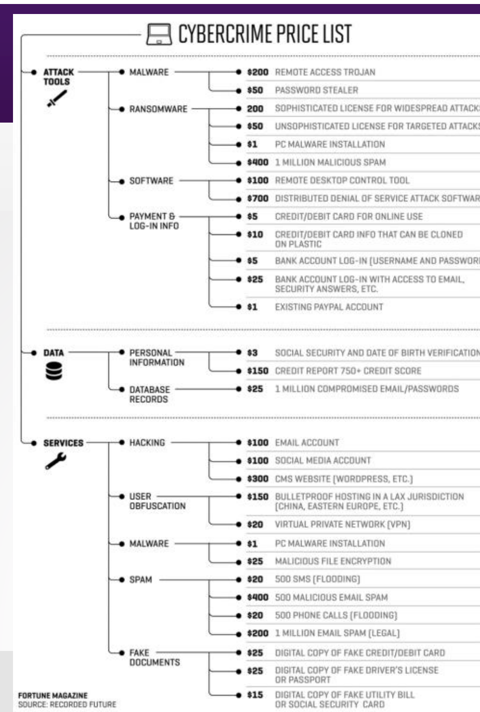
CYBER CRIME IS COMPETITIVE!

8

PHISHING

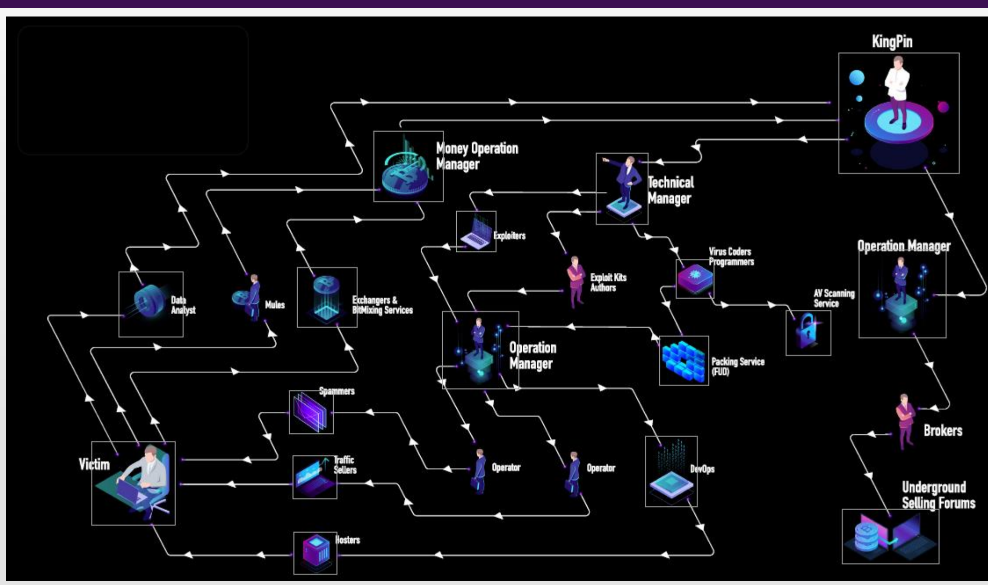
Lucrative Payoff





9

WHAT ORGANIZED CRIME LOOKS LIKE



Source: Check Point Research, RSA presentation 2019

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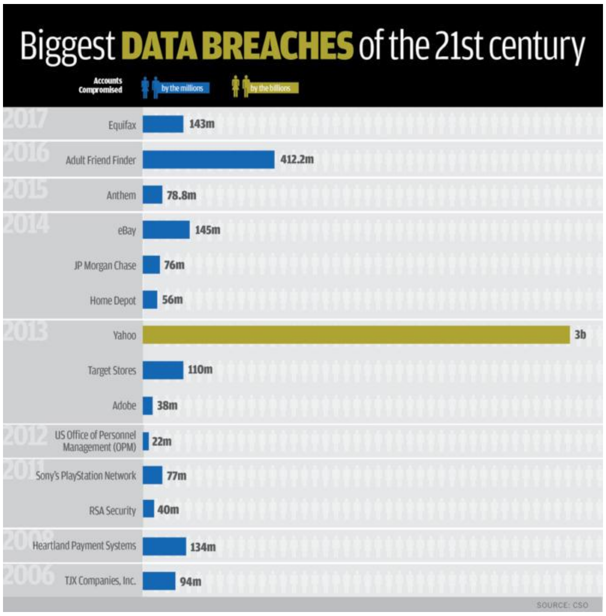
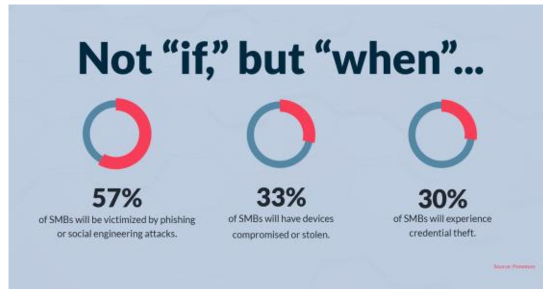
PRIME TARGETS

Who is this happening to?

11

12





Will you be prepared?

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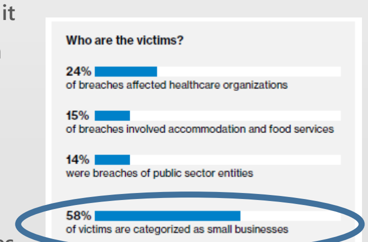
WHY SMALL BUSINESSES ARE PRIME TARGETS

MALICIOUS EMAIL PER USER BY ORGANIZATION SIZE (YEAR)

ORGANIZATION SIZE	USERS TARGETED (1 IN)
1-250	6
251-500	6
501-1000	4
1001-1500	7
1501-2500	4
2501+	11

Source: Symantec 2019 Internet Threat Report

- ❑ Budget – SMB's spend less than 10% of their annual budget on IT (including support). They can't afford a $40,000 firewall and CISO on staff.
- ❑ Low IT skill level or no support unless something breaks
- ❑ Aging equipment and unpatched devices
- ❑ Owners wear many hats and don't focus on security
- ❑ SMB's don't believe it will happen to them
- ❑ SMB"s believe their data is not valuable
- ❑ SMB's far behind Enterprise in educating employees



Source: Verizon 2018 DBIR Report

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THREAT VECTORS

How the bad guys get in

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PHISHING - HOW IT WORKS

1. You inadvertently download a file with a spy-agent attached.
   How?
   a) Opening an email attachment with a hidden payload.
   b) Visiting an infected website via link from an email or just normal web browsing.

2. The agent sits dormant on your PC or Mac undetected by Malware/Virus scanning tools. This is called a Zero Day infection.

"In 2019, it is estimated that a business will fall victim to a Ransomware attack every 14 seconds." Cybersecurity Ventures, 2018

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RANSOMWARE

Average Ransomware Payment Hits $570,000 in H1 2021

A new report finds ransomware gangs now bundle extortion methods to make victims pay up after an attack.

August 09, 2021

- Reported by Unit 42, a cyber forensic and reporting entity of Palo Alto Networks: As of Summer of 2021 – the average ransomware payment demand has hit a new record high of $570,000.
- 2020's average was $312,000, a 171% growth in just a year – meaning it is working.
- Quadruple extortion is the newest trend amongst ransomware groups, coming in 4 different forms:

#1 = Encryption, in which victims pay to regain access to scrambled data and compromised systems

#2 = Public Disclosure, in which attackers release sensitive information if ransom isn't paid

#3 = Denial of service (DoS), in which ransomware gangs launch DoS attacks to shut down a victim's public websites.

#4 = Harassment, in which attackers contact a victim's customers, business partners, employees, and media to tell them an organization was hacked.

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RANSOMWARE

- As a further form of persuasion, ransomware threat actors are more recently masking their identities, carrying out their attacks from various countries such as China or Russia.
- The reason for them doing this not only to mask their identity, but also coercing victims into paying that which cyber insurance firms are having tough times covering claims with due to "Act of War" clauses.
- Did you know you could be breaking the law if you pay a ransom, and those funds go to a terrorist group?

Attacks/Breaches

News

'Act of War' Clause Could Nix Cyber Insurance Payouts

The indictment of six members of the Russian military for the NotPetya ransomware attack places companies on notice that insurance "is not a get-out-of-jail-free card."

October 29, 2020

Contributing Writer

CYBERSECURITY

WSJ PRO CYBERSECURITY

WSJ PRO

Cyberattacks Complicate War Exclusions for Insurers

Insurance contracts typically exclude acts of war, but what is that exactly? With cybercrime, attacks often defy characterization.

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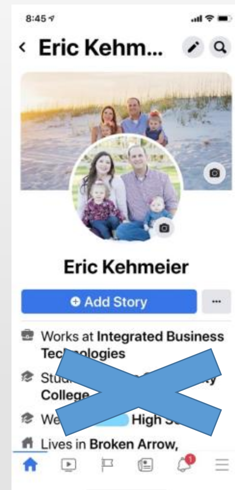
SOCIAL ENGINEERING & PRETEXTING

Social engineering, in the context of information security, refers to psychological manipulation of people into performing actions or divulging confidential information. A type of confidence trick for the purpose of information gathering, fraud, or system access, it differs from a traditional "con" in that it is often one of many steps in a more complex fraud scheme.

Social Engineering & Pretexting *do not* involve Malware at the outset. They are plotted and planned against specific victims.

As of 2018, global losses to BEC (business email compromise) have exceeded US$12 billion. ~Trend Micro, Year End Review 2018



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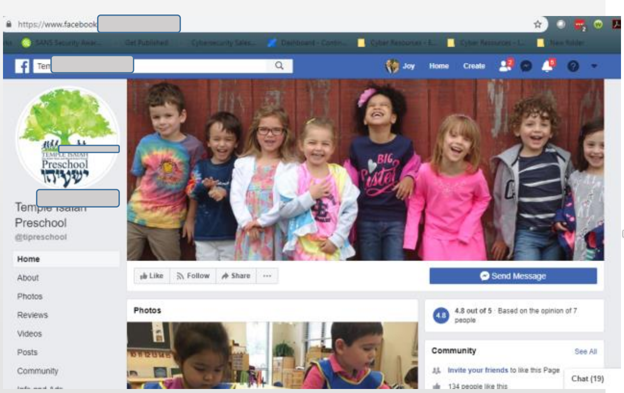
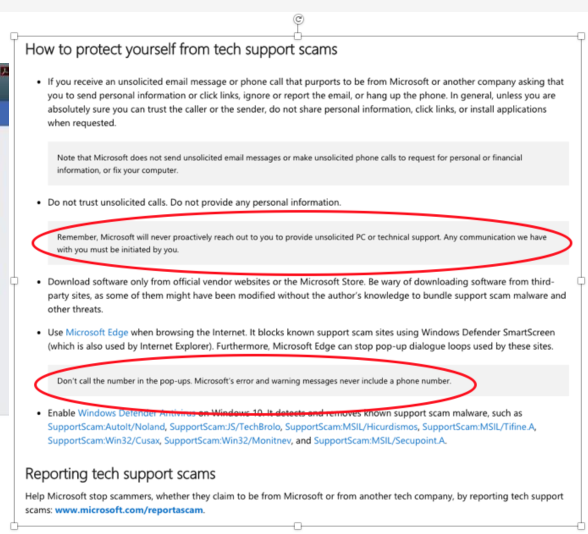
SOCIAL ENGINEERING - PHONE CALLS





How to protect yourself from tech support scams

- If you receive an unsolicited email message or phone call that purports to be from Microsoft or another company asking that you to send personal information or click links, ignore or report the email, or hang up the phone. In general, unless you are absolutely sure you can trust the caller or the sender, do not share personal information, click links, or install applications when requested.

  Note that Microsoft does not send unsolicited email messages or make unsolicited phone calls to request for personal or financial information, or fix your computer.

- Do not trust unsolicited calls. Do not provide any personal information.

  Remember, Microsoft will never proactively reach out to you to provide unsolicited PC or technical support. Any communication we have with you must be initiated by you.

- Download software only from official vendor websites or the Microsoft Store. Be wary of downloading software from third-party sites, as some of them might have been modified without the author's knowledge to bundle support scam malware and other threats.

- Use Microsoft Edge when browsing the Internet. It blocks known support scam sites using Windows Defender SmartScreen (which is also used by Internet Explorer). Furthermore, Microsoft Edge can stop pop-up dialogue loops used by these sites.

  Don't call the number in the pop-ups. Microsoft's error and warning messages never include a phone number.

- Enable Windows Defender Antivirus on Windows 10. It detects and removes known support scam malware, such as SupportScam:AutoIt/Noland, SupportScam:JS/TechBrolo, SupportScam:MSIL/Hicurdismos, SupportScam:MSIL/Tifine.A, SupportScam:Win32/Cusax, SupportScam:Win32/Monitnev, and SupportScam:MSIL/Secupoint.A.

Reporting tech support scams

Help Microsoft stop scammers, whether they claim to be from Microsoft or from another tech company, by reporting tech support scams: **www.microsoft.com/reportascam**.

*Source: Microsoft website 6-28-2018

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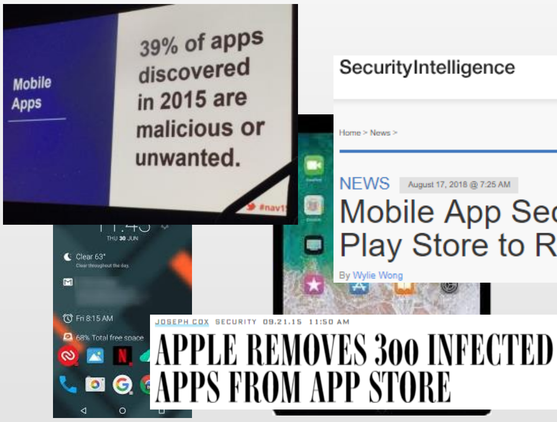
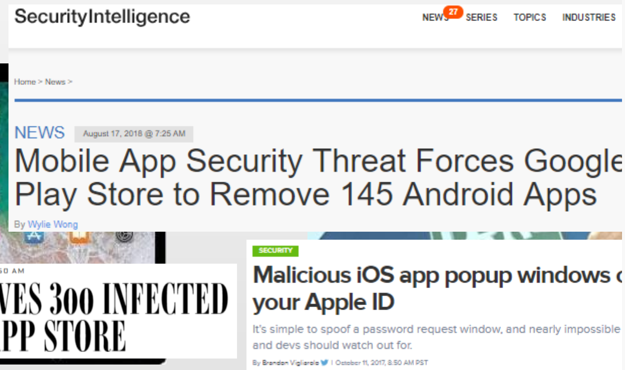
MOBILE DEVICES ARE FAIR GAME






Google Play St

September 24, 2019 | Malwa

- Recently, Google Play Store has been in the spotlight quite often for hosting malware-laced apps.
- Some of these apps have millions of downloads, posing a massive threat to a considerable chunk of Android users.

Context

Although Google lets in an app on the Play Store only after it satisfies a list of requirements, certain malicious apps seem to have discovered cracks to slip through. Sometimes, such apps record millions of downloads before they're discovered containing malware.

Google has been regularly weeding out malware-infected apps from the Play Store, but the openness of the platform is a roadblock in this battle.

Prominent incidents

Android users are told only to download apps from the official Play Store. Let's take a look at the recent instances of Google-approved apps sneaking in malware.

July 2019 - Around 205 malicious apps that were reported to have been downloaded more than 32 million times in July alone. These apps were found to contain malicious code that had the capabilities of stalkerware, backdoor, subscription scams, and more.

August 2019 - A popular PDF creator called CamScanner was discovered to contain a malicious module called 'Trojan-Dropper.AndroidOS.Necro.n'. The module was observed to show intrusive ads. After Kaspersky reported this to Google, the application was immediately removed.

September 2019 - This month witnessed the discovery of a new malware campaign to deliver the Joker Trojan. Google promptly removed the 24 apps that hid malicious code in the advertisement framework.

The takeaway

Google Play Store is still the safest place to download Android applications, but with so many incidents reported, users are advised to be on alert. No app is completely immune to being exploited for malicious purposes.

Just in September 2019, 25 malicious apps with 2.1 million downloads in total were observed serving random ads to generate revenue.

*Source: Webroot 2016, Verizon State of Security Report 2018,
http://fortune.com/2017/09/14/google-play-android-malware/
Wired online magazine https://www.wired.com/2015/09/apple-removes-300-infected-apps-app-store/
https://securityintelligence.com/news/mobile-app-security-threat-forces-google-play-store-to-remove-145-android-apps/

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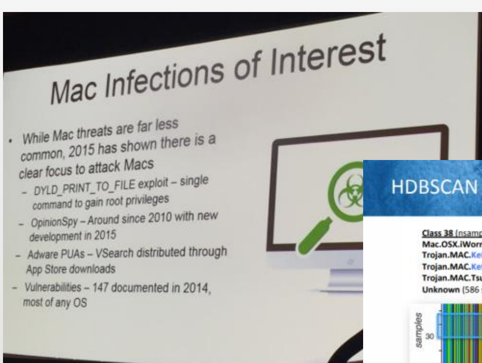
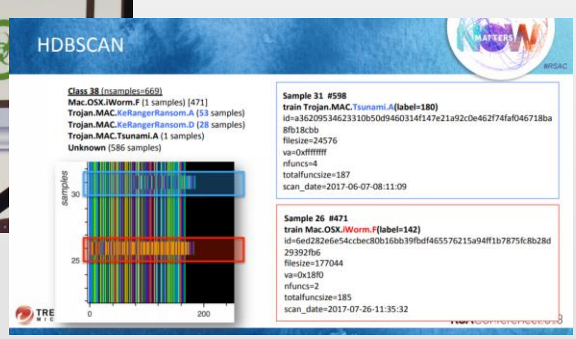
MACS ARE FAIR GAME




```
Cluster 2 (nsamples=668)
        KeRangerRansom.A (53 samples)
        KeRangerRansom.D (28 samples)
        Tsunami.A (1 samples)
        Unknown (586 samples)
```



	name
1344	Blackhole.D
30	Freezer.A
690	Freezer.A
866	Freezer.A
553	Freezer.A
1046	Blackhole.B
355	Blackhole.C

*Source: Webroot 2016, Verizon State of Security Report 2018,
http://fortune.com/2017/09/14/google-play-android-malware/
RSA Conference 2018; Mac OSX Threats session By Trend Micro

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AND MUCH MORE

- Social Engineering – Phone calls! Microsoft is never going to call you to tell you they found a problem/breach!
- Mobile devices are fair game!
- Apple Mac’s are fair game too!
- Text/SMS messages
- Cryptojacking - Malicious mining via compromised websites
- Cryptomining - Malware-based attacks a user’s device (CPU)
- IoT (Internet of Things) devices – Alexa, doorbells, camera’s, TV’s, Thermostats, and even your refrigerator. There is no anti-virus or firewall installed on these devices.

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YOUR ROLE

What you can do to protect yourself, your family and your employer

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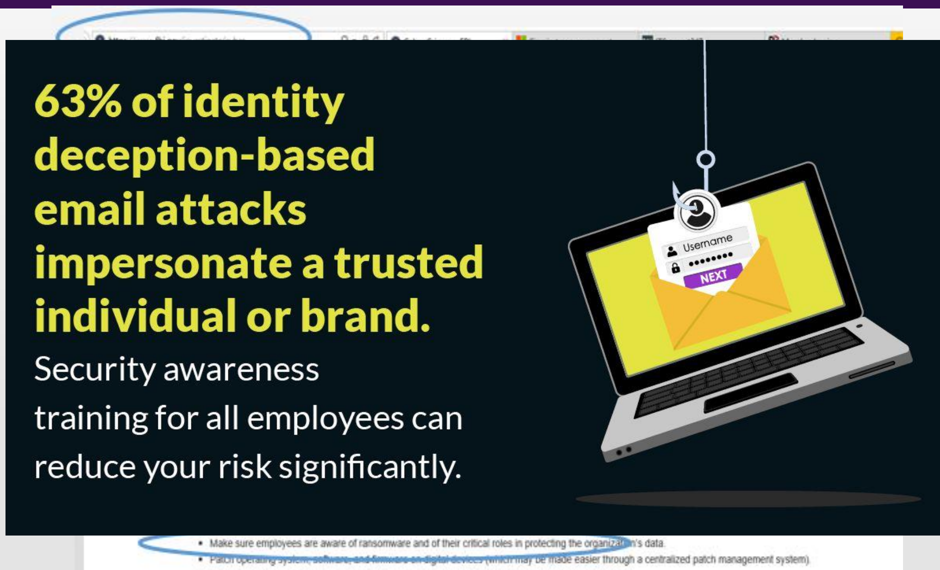
OFFICIAL WORD ON PREVENTION…



*Source: https://www.fbi.gov/investigate/cyber 07-08-2018

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I.T. SECURITY SUGGESTIONS

What YOU can do!

Passwords:

Strong passwords that rotate every 90 days

Example 1:

- Animal (static) Antelope
- 2nd Character cap aNtelope
- How many letters total? aNtelope8
- How many vowels? aNtelope84
- One character or symbol aNtelope84/

Example 2:

- Phrase: Crazy Hackers Can't Guess My Password 1510 chcgmP1510*

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STRONGER IS BETTER

Number of Characters	Numbers Only	Lowercase Letters	Capital & Lowercase Letters	Numbers, Capital & Lowercase Letters	Numbers, Capital & Lowercase Letters, Symbols
4	Instantly	Instantly	Instantly	Instantly	Instantly
5	Instantly	Instantly	Instantly	Instantly	Instantly
6	Instantly	Instantly	Instantly	1 sec	5 secs
7	Instantly	Instantly	25 secs	1 min	6 mins
8	Instantly	5 secs	22 mins	1 hour	8 hours
9	Instantly	2 mins	19 hours	3 days	3 weeks
10	Instantly	58 mins	1 month	7 months	5 years
11	2 secs	1 day	5 years	41 years	400 years
12	25 secs	3 weeks	300 years	2k years	34k years
13	4 mins	1 year	16k years	100k years	2m years
14	41 mins	51 years	800k years	9m years	200m years
15	6 hours	1k years	43m years	600m years	15b years
16	2 days	34k years	2b years	37b years	1t years
17	4 weeks	800k years	100b years	2t years	93t years
18	9 months	23m years	6t years	100t years	7q years

Source: howsecureismypassword.net

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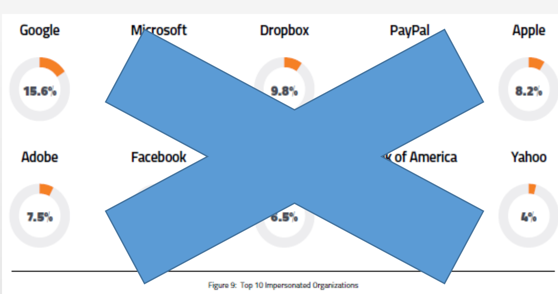
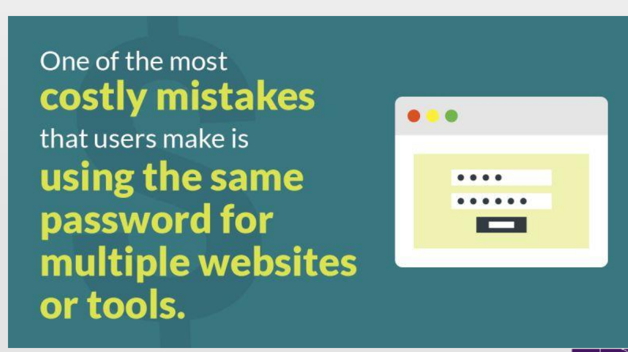
RE-USE OF PASSWORDS



Use a password manager!



Examples: Keeper, Lastpass, 1Password

Source: Webroot 2019 Threat Report

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I.T. SECURITY SUGGESTIONS

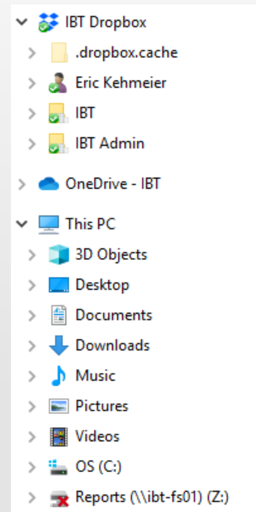
What YOU can do!

Data Saving:

Must be on the (company name) server drives (not your desktop) or the company (One Drive, SharePoint, Drop Box, or other cloud-based storage).

If accessing from home:

- ❑ Make sure your computer is updated with latest paid Anti-Virus, Anti- Malware updates /subscription
- ❑ Make sure your Windows Updates are turned on – spot check monthly.
- ❑ Restart your computer at least weekly to refresh and install pending updates.
- ❑ Follow remote worker policy



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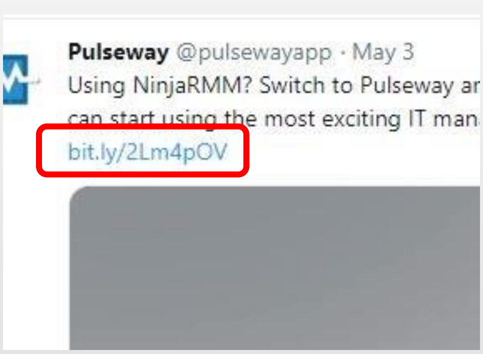
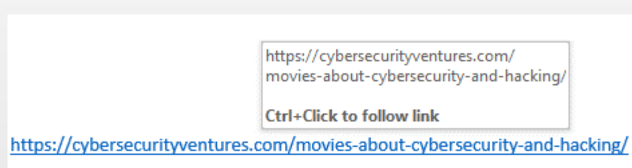
ABBREVIATED DOMAINS





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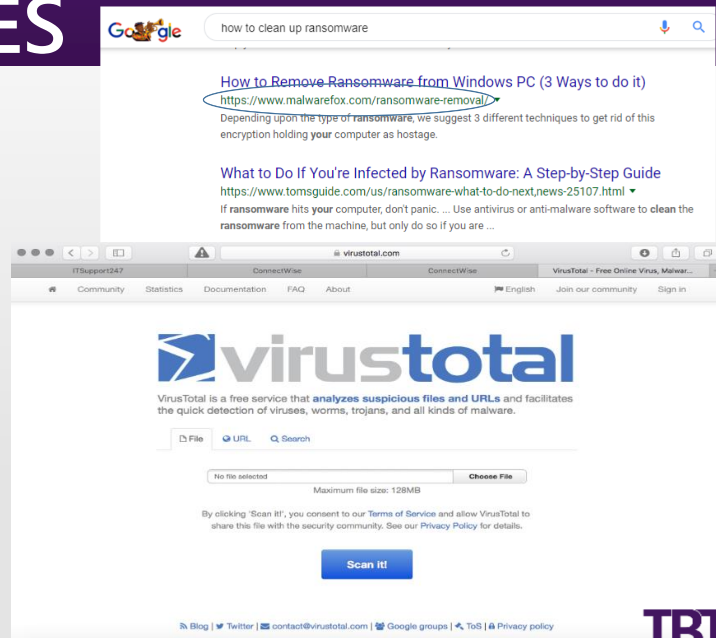
WEB SEARCHES

- Note the actual URL (green) that you are being sent to *Ignore Blue Header*

Unsure? https://virustotal.com to check it first



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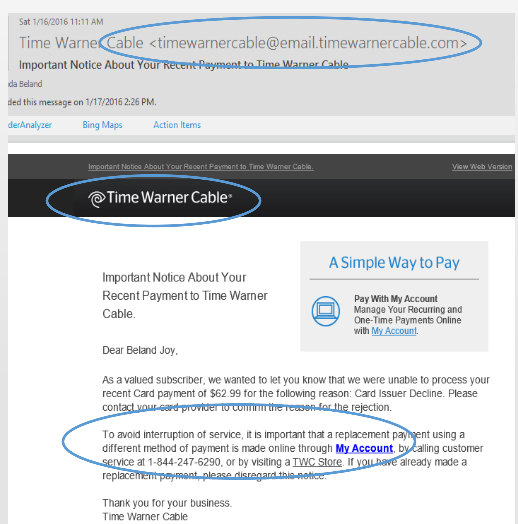
I.T. SECURITY SUGGESTIONS

What are the signs of a phishing email?

- Sender actual email address is not correct
- Logos misplaced, off color or missing all-together
- URL's to click on with an urgent request to take action immediately



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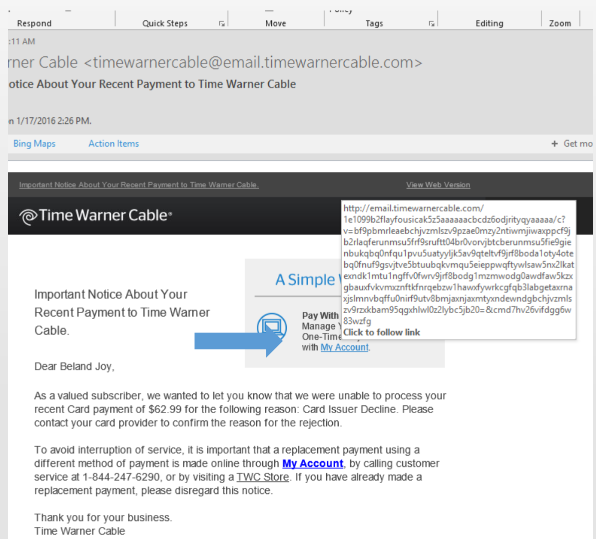
I.T. SECURITY SUGGESTIONS

The URL "hover":

- Be the master of your mouse.



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HOW DO YOU THINK YOU'VE BEEN DOING SO FAR?

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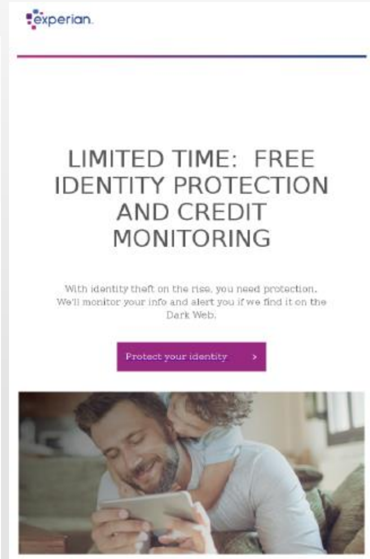
HOW DO YOU THINK YOU'VE BEEN DOING SO FAR?

1 of you clicked on the hyperlink in our test email. That's 9%. Way better than the average we see, which is upwards of 30% … but still, it's 9% more than we want!

Random Phishing Test Report - JAN 2019

	IP	Event	Timestamp
@ .com	162.208.94.226	open	2019-01-08T19:11:58.694Z
com	162.208.94.226	open	2019-01-09T00:47:06.934Z
le@ .com	99.112.138.7	open	2019-01-09T01:48:26.535Z
@g com	167.89.85.54	delivered	2019-01-08T17:27:57.530Z
@g com	167.89.85.54	delivered	2019-01-08T18:40:40.057Z
.com	167.89.85.54	delivered	2019-01-08T18:44:10.080Z
@g com	167.89.85.54	delivered	2019-01-08T19:31:15.670Z
ez@g com	167.89.85.54	delivered	2019-01-08T23:08:07.221Z
@g com	167.89.85.54	delivered	2019-01-08T23:11:56.570Z
.com	167.89.85.54	delivered	2019-01-09T00:54:25.895Z
@g .com	162.208.94.226	click	2019-01-08T22:19:08.709Z



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TIME TO SHIFT

WHAT you need to win

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DOES THIS SOUND LIKE YOU OR SOMEONE YOU KNOW?

Do you cross your fingers and hope every time you hear about the latest cybersecurity breach, praying that you aren't using any of the software, scripts, or vendors impacted?

Do you have a wavering sense of security relying on the same cybersecurity protocols you've utilized for years, knowing deep down they're not enough to keep you safe?

Do you lay awake at night worrying what security threat is going to hit next and hoping that you'll have a clean enough back-up to be able to recover if you're impacted?

Do you think I'm not big enough, our data is sensitive, or it will never happen to us?

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TIME TO SHIFT

There are 5 key shifts every business needs to make to ensure their business and employees are safe in a constantly-changing and more threatening world.

Once You Make Them…

You can focus on running your business

You'll have full confidence in your technology stack, whether your employees are working in the office or remote.

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SHIFT #1

Acknowledge Your Weak Links.

- ❑ Employees are the primary cause of breaches
- ❑ Understand the full attack surface/what's at stake
- ❑ One simple mistake is all it takes to undermine years of hard work building up your organization's reputation
- ❑ Properly tune your tools, being only as efficient as the team or individual handling the tuning. More security tools are pointless if you aren't using the correct ones properly. (There is no silver bullet)

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SHIFT #2

Support Your Employees Wherever they Are

- ❑ The lay of the land has changed in 2022. Workstations are no longer assumed to be confined within the locked office doors of a business outside of the normal 8AM – 5PM day.
- ❑ Thus – you need to keep in mind the following:
  - Have the right security tools
  - Tune these mechanisms effectively
  - Protect the full attack surface, wherever the employee may travel.

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SHIFT #3


In a Zero Trust World, Compliance Doesn't Equal Security

JNE VALOKUVAUS/SHUTTERSTOCK.COM

By // DECEMBER 28, 2020

An agency can run a completely compliant network and still be breached by a trusted user's account being exposed.

CYBER DEFENSE CYBER THREATS

Compliance isn … in Hand

- True or False – At … ect your business's reputation
- True or False – Co … turity insights
- True or False – Co … ity-mindedness
- True or False – W … liance businesses do not need to focus … measures.
- Complacency wh … edes every breach.

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SHIFT #4

Ounce of Prevention is better than Pound of Cure

- Using a Hammer VS Using a Screwdriver
- In 2022, we speak with a ton of businesses who still think backups are a sufficient control to augment their security posture.
- This, contrary to popular belief, is a reactive use of the wrong tool for the job.
- Negotiating with Criminals VS Budgeting for Prevention
- Absorbing the cost of a breach is inherently more financially disruptive than paying for cyber security that prevents breaches.

CIO Magazine laid out good guidelines for IT budgeting and found that Small and Medium Business on average spent 6.9% of revenue on IT.

Source: https://www.techtarget.com/searchsecurity/tip/Cybersecurity-budget-breakdown-and-best-practices

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SHIFT #5

Invest in Support

Accessibility & Security – A Fragile Balance

Accessibility is the process of creating products that are usable by people with the widest possible range of abilities, operating within the widest possible range of situations.

In IT Support, Engineers work to assist users to leverage technology to make their workday more efficient. When technology fails to meet its trusted expectation, that's where IT Support comes into play.

Where accessibility is added, security is always subtracted.

Security can be simply described as the quality or state of being secure.

In Cyber Security, SOC Engineers work alongside MSPs to implement various forms of security technology to prevent malicious activity entering a company's environment. In almost every form of security implementation, either cyber or physical, some form of Accessibility is sacrificed for higher levels of security.

Where security is added, accessibility is always subtracted.

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WHAT YOU NEED TO WIN

1. Acknowledge Your Weak Links.
2. Support your employees wherever they are.
3. Compliance isn't security, but they go hand in hand.
4. Ounce of Prevention is better than Pound of Cure.
5. Invest in support.

These five shifts alone are enough to upgrade your cybersecurity posture and put you ahead of 88% of businesses.

And… You'll be able to sleep better at night!

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RESOURCES

WHERE you can go to learn more?

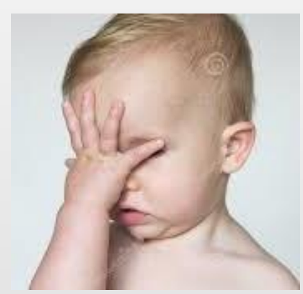
45

INCIDENT RESPONSE

Signs of infection:

- ✓ Browser redirecting to a different website than what you'd expect
- ✓ Someone tells you they received an email from you that you did not send
- ✓ Popups that tell you your computer is infected or that you need to run a tool that you're not expecting and familiar with
- ✓ Computer slows down immediately after clicking something
- ✓ An overload of coupons or junk mail

- ❑ First step: Unplug the computer from the internet / network connection (demo blue cables on back of computers). If you're on Wi-Fi, turn off the Wi-Fi connection.
- ❑ Second step: Take a photo of the pop-up or website redirect with your smart phone and open a service ticket so we can receive the photo and advise on how to handle.



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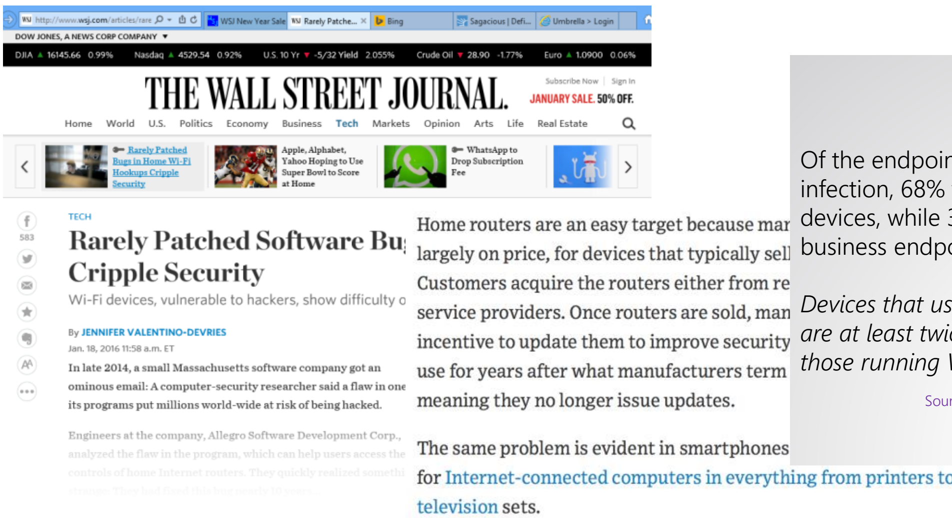
NOT JUST IN THE OFFICE, BUT AT HOME


DOW JONES, A NEWS CORP COMPANY

DJIA ▲ 16145.66 0.99% Nasdaq ▲ 4529.54 0.92% U.S. 10 Yr ▼ -5/32 Yield 2.055% Crude Oil ▼ 28.90 -1.77% Euro ▲ 1.0900 0.06%

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Home World U.S. Politics Economy Business Tech Markets Opinion Arts Life Real Estate

Rarely Patched Bugs in Home Wi-Fi Hookups Cripple Security

Apple, Alphabet, Yahoo Hoping to Use Super Bowl to Score at Home

WhatsApp to Drop Subscription Fee

TECH

Rarely Patched Software Bu[gs in Home Wi-Fi Hookups] Cripple Security

Wi-Fi devices, vulnerable to hackers, show difficulty o[f...]

By JENNIFER VALENTINO-DEVRIES

Jan. 18, 2016 11:58 a.m. ET

In late 2014, a small Massachusetts software company got an ominous email: A computer-security researcher said a flaw in one its programs put millions world-wide at risk of being hacked.

Engineers at the company, Allegro Software Development Corp., analyzed the flaw in the program, which can help users access the controls of home Internet routers. They quickly realized somethi[ng...]

Home routers are an easy target because mar[...] largely on price, for devices that typically sell [...] Customers acquire the routers either from re[...] service providers. Once routers are sold, man[...] incentive to update them to improve security [...] use for years after what manufacturers term [...] meaning they no longer issue updates.

The same problem is evident in smartphones [...] for Internet-connected computers in everything from printers to television sets.

Of the endpoints reporting an infection, 68% were consumer devices, while 32% were business endpoints

Devices that use Windows 10 are at least twice as secure as those running Windows 7.

Source: Webroot 2019 Threat Report

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I.T. SECURITY SUGGESTIONS

What you can do – iPhone Mobile Devices

- Turn on Apple iCloud/Find my iPhone, Review all settings
- Settings /Privacy
  - /Contacts, Camera
  - /Bluetooth Sharing
  - /Advertising
  - Settings /Privacy /Location Services /Look at list to see what is using your location
    - System Services /
      - Location-Based iAds
      - Frequent Locations
- Back up regularly using iTunes
- Don't download any app that you don't NEED if it's not from an established company
- If you lose it, let your IT team know RIGHT AWAY

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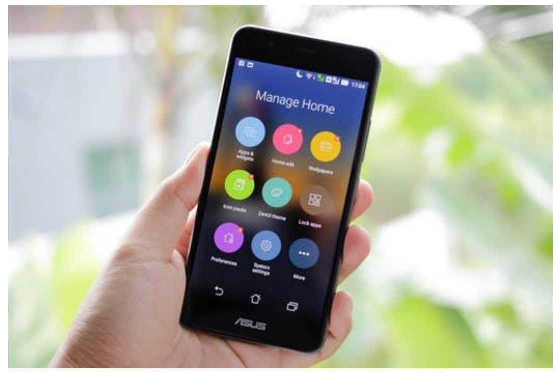
I.T. SECURITY SUGGESTIONS

What you can do – Android Mobile Devices

- All Mobile Devices should have a PIN (phones and tablets)
- Android devices should use Google Play Protect or Android Oreo for updates and security
- Use Brave Browser Ad Blocker (from Google Play Store)



Source: https://www.android.com/play-protect/
https://play.google.com/store/apps/details?id=com.brave.browser

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CALL BLOCKING

FREE Apps from your cellular carrier!

- AT&T - Active Armor
- Verizon - Call Filter
- T-Mobile - Scam Shield
- U.S. Cellular - Call Guardian
- Sprint - Call Screener

Register you Cell Phone Number!

https://www.donotcall.gov/

Source: https://www.fcc.gov/call-blocking

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CALL BLOCKING

Wireless Device Solutions

- Apple iPhones have an opt-in "Silence Unknown Callers" call-screening and blocking feature.
- Google Pixel phones have a "Call Screen" call-screening and blocking feature; Google offers several free, opt-in, call-blocking tool apps for Android phones; and Google Voice users can use a call management tool to block unwanted calls.
- Samsung partners with Hiya to offer a call-blocking solution called Smart Call to label potentially unwanted calls.

Source: https://www.fcc.gov/call-blocking

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EXECUTIVES

The tip of the spear!

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EXECUTIVE BEST PRACTICES

- Business
  - Remove your personal info from your website
  - Have a conversation with your Bank about security. They may have recommendations like Positive Pay for your business and could enable MFA on your accounts
  - Setup google alerts for your company and yourself
  - Is your employee handbook updated? This is where your computer and acceptable use policy is and that is what IT should be implementing
- Personal
  - Update your home router and computer (change wi-fi password yearly)
  - Lock your credit reports
  - Rotate your credit cards yearly (Read your statements)
  - Stop Junk Mail - www.optoutprescreen.com or call 1-888-567-8688

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Five Things CEOs should Know

1. Cyber-attacks and security breaches will occur and will negatively impact your business. Today, the average cost of the impact of a cyber breach is $4.9 million.
2. According to most cybersecurity surveys, over 60% of all data breaches originate from unauthorized access from one of your current or former employees, or third-party suppliers.
3. Achieving information security compliance with one or more government regulatory standards for information security (i.e. ISO 27001, NIST 800-171, HIPAA, NYDFS, etc.) is good, but not sufficient to ensure real cybersecurity.
4. Cyber liability insurance premiums are significantly increasing in cost and often do not cover all of the damages caused by a cyber breach.
5. To achieve real information security and data resilience it is vital to combine managed Monitoring, Detection, and Response services with comprehensive disaster recovery and business continuity plans.

Source: https://www.bdo.com/insights/business-financial-advisory/cybersecurity/%E2%80%8Bwhat-ceos-should-know-do-about-cybersecurity

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Ten Things CEOs should Do!

1. Ensure everyone in the organization from the top-down receives appropriate cybersecurity education and awareness training.
2. Hire an independent company to conduct a cyber risk assessment against government regulatory compliance requirements and industry standards to identify potential gaps in your company's information security policies, processes, plans, and procedures.
3. Verify that periodic penetration testing by certified Ethical Hackers is being conducted to identify potential cybersecurity vulnerabilities in your organization's information systems.
4. Require a timely and effective software patch management program be implemented by your Information Technology team to mitigate known security vulnerabilities as quickly as possible.
5. Ensure the organization has 24/7/365 monitoring, detection, and response capabilities for its information systems.

Source: https://www.bdo.com/insights/business-financial-advisory/cybersecurity/%E2%80%8Bwhat-ceos-should-know-do-about-cybersecurity

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Ten Things CEOs should Do!

6. Verify the organization has an appropriate cyber breach incident response plan, including the policy and procedures related to ransomware attacks.
7. Hire an independent firm to conduct a cyber liability insurance coverage adequacy evaluation.
8. Establish information security key performance indicators (i.e. number of cyber-attacks, number of data breaches, network uptime, network downtime, cost of cyber breaches, cost of cyber insurance, cost of information security as a percentage of total company IT cost, etc.).
9. Ensure your company has well-documented and periodically tested disaster recovery and business continuity plans to quickly recover lost or stolen data to mitigate potential damages of cyber breaches.
10. Mandate additional layers of information security via encryption, multi-factor authentication, and highly restricted access to your company's most valuable information assets.

Source: https://www.bdo.com/insights/business-financial-advisory/cybersecurity/%E2%80%8Bwhat-ceos-should-know-do-about-cybersecurity

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CYBERSECURITY CHECKLIST

SCAN ME

For a copy of our 15-point checklist to protect your business from a Cyber Attack, please scan this QR Code.

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THANK YOU!

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918.770.8738 / www.IBTsupport.com

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Oklahoma Society of CPAs

Oklahoma Tax Update

December 2, 2022

Leader: Tony Mastin

Oklahoma Tax and Legislative Update

Oklahoma Society of CPAs
Oklahoma Tax Institute

December 2, 2022

presented by
Tony Mastin

McAFEE&TAFT

1

2022 Oklahoma Legislative Session

2

2

Income tax

- HB 3418 (2022)
  - Provides an income tax deduction based on the cost of business assets that are qualified property or qualified improvement property covered under Section 168 of the Internal Revenue Code, effective for tax year 2022 and subsequent tax years.
  - Qualified property eligible for 100% Oklahoma bonus depreciation and may be deducted as an expense incurred by the taxpayer during the taxable year during which the property is placed in service.

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3

Income Tax *(cont'd)*

- HB 3418 – OTC Rules
  - The bill called on the OTC to promulgate emergency rules to administer the legislation.
  - OTC adopted rules on September 27th which provide:
    - Beginning with tax year 2022, taxpayers have the option for immediate and full expensing of qualified property and qualified improvement property by deducting the full cost of these expenditures in the tax year in which the cost is incurred or the property is placed in service,
    - If this option is taken, amounts that are depreciated for federal income tax purposes in future tax years shall be added back to Oklahoma taxable income in the year the depreciation is claimed, and
    - The option is irrevocable unless specifically authorized by the OTC.

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Income tax *(cont'd)*

- HB 3088 (2022)
  - Eliminates existing $20,000 annual income tax deduction for nonrecurring adoption expenses incurred by a resident individual taxpayer for the adoption or proposed adoption of a minor.
  - New, refundable income tax credit is created for adoption expenses paid by a resident individual taxpayer in connection with the adoption or proposed adoption of a minor that did not result in a decreed adoption.
  - Effective for tax years 2023 and subsequent years, the credit is 10% of qualified expenses, not to exceed $2,000 per calendar year with respect to single filing status or married filing separate income tax returns, and not to exceed $4,000 per calendar year with respect to married filing joint return filing status.

Income tax *(cont'd)*

- SB 401
  - Increases income tax exemption for retirement benefits received from any component of the Armed Forces of the United States that is currently the greater of 75% or $10,000.
  - Beginning with tax year 2022, Armed Forces retirement benefits are fully exempt from state income taxes.

Income tax *(cont'd)*

- SB 1857
  - Extends the credit for investments in qualified clean-burning motor vehicle fuel property to tax year 2028 and expands the definition of qualifying property to include a motor vehicle originally propelled by a hydrogen fuel cell electric fueling system, as well as related hydrogen fueling property.
  - The maximum allowable credit amount for a qualifying natural gas, LPG or hydrogen fuel cell vehicle in excess of 26,501 pounds is increased from $50,000 to $100,000.
  - Also provides statewide caps on the credits used.

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Oklahoma legislative updates

- Legislation that did not become law
  - One-time direct rebate of $75 for single tax filers and $150 for couples
  - Elimination of 1.25% sales tax on vehicle sales
  - Additional decrease in individual income tax rates
  - Elimination of the state sales tax on groceries
  - Corporate income and/or franchise tax reform
- What's next for 2023?

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Oklahoma Tax Commission Issues

9

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OTC: HB 3905

- Enacted various amendments relating to the administration of various taxes
  – Expanded the liability for medical marijuana gross receipts tax to individual officers and members in the same manner as sales tax and other taxes.
  – Allows for show cause hearings to be conducted in the OTC's Oklahoma City location by using teleconferencing or videoconferencing capabilities.
  – Limits the filing of sales/use tax refund claims on medical equipment to persons who have a direct pay permit.

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OTC: HB 3419

- Creates Service Oklahoma and transfers applicable powers, duties, and responsibilities exercised by the Motor Services Division of the OTC to Service Oklahoma on January 1, 2023.
- The Motor Services Division administers the titling and registration of motor vehicles and commercial trailers. The division also administers the titling and registration of boats and outboard motors.
- Motor License Agents will be licensed by Service Oklahoma as "Licensed Operators" and tag agencies will referred to as "Service Oklahoma Locations."

OTC: Audits

- Use of data analytics to audit
  - Sales Tax Audits
    - Comparing sales tax return data to federal income tax data
  - Withholding Tax Audits
    - Comparing withholding tax data to unemployment tax data
  - Income Tax Audits
    - Comparing state and federal income tax returns

OTC: Impact of McGirt

- Impact of McGirt decision on state taxes
  - Thousands of income tax refunds have been filed by tribal members and hundreds appealed their denials and are pending before the agency's administrative law judges.
  - One ALJ has ruled that a Muscogee Nation member who works for the tribe and lives on its reservation is entitled to refund of income taxes paid for tax years 2017 - 2019
  - Ruling appealed to the full Commission, and hearing was held before the Commission in August 2022.
  - Commission issued an order on Oct. 4 vacating the ALJ's decision and held that the McGirt decision did not apply to state taxation and that to rule otherwise was an unauthorized extension of the U.S. Supreme Court decision.

OTC: Oklahoma Supreme Court

- Recent Oklahoma Supreme Court decisions
  - Warehouse Market v. Oklahoma Tax Commission
    - Okmulgee retailer located on federally restricted Indian land sought relief from Muscogee Nation and Tax Commission both seeking to collect sales taxes.
    - Court held that the relief sought was a "tax protest" and retailer was required to exhaust administrative remedies before seeking relief in trial court.
  - Raytheon Company v. Oklahoma Tax Commission
    - Case involved the denial of corporate income refund claim. Claim denied as being filed out of time.
    - Issue involved calculation of the 3-year statute of limitation. Court held that the tax was paid when the company filed its return (with an extension) in September and not the original due date of March.

OTC: Oklahoma Supreme Court

(cont.d)

- Kingfisher Wind v. Wehmuller
  - Appeal taken by Canadian and Kingfisher County Assessors regarding taxation of Production Tax Credits (PTCs) for ad valorem tax purposes.
  - PTCs are federal tax equity financing tools which Kingfisher Wind used to finance their facilities in exchange for tax credits.
  - Court ruled that the PTCs are "intertwined with real estate" and may "enhance the value of real property."
  - However, the Court reviewed the language in the Constitution exempting intangible personal property and found the PTCs were intangible personal property and are not subject to ad valorem taxation.

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State and Local Tax Issues

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State and local tax issues

- Defining "intangible personal property"
  - Definition impacts sales and property taxes
- Remote employees
  - Employee tax nexus and employer tax obligations
- Continuing impact of *Wayfair*
  - Understanding economic nexus
- Taxing internet activities
  - Eroding of Public Law 86-272
- Pass-through entity tax elections
  - When and how to make elections

Questions?

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Ethics – You Don't Own Your CPA Certificate, You Lease It

December 2, 2022

Leader: Jimmy Williams, CPA

You Don't Own Your CPA Credential, You Lease It

Author: Jimmy J. Williams, CPA/PFS, CFP®

1

1

Disclaimer

- Tax Advice Disclosure: To ensure compliance with IRS requirements, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.
- The purpose of these materials are purely educational and should not be relied upon without substantial research and consideration given to your particular circumstances.
- Author is not responsible to update materials after submission for publication.

2

2

Session Objectives

Learn	Learn about CPA Ethics and the underlying behaviors that cause unethical decisions.
Explore	Explore why it is important to know the impact of ethics violations to your career.
Understand	Understand why ethical violations occur and the behaviors to instill in your life to prevent them.

3

Participation Request

One of the greatest opportunities for learning comes from first being engaged in the process. To that notion, I would be honored if you would participate today in the various polling questions throughout the material.

Guidance on using this simple polling system is provided on the following slide. Thank you!

4

OSCPA.CNF.IO

- Navigate to https://oscpa.cnf.io/ and tap the session titled "You Don't Own Your CPA Certificate, You Lease It - Ethics"
- OR just point your phone's camera at the QR code to join directly

5

Practice Polling Questions

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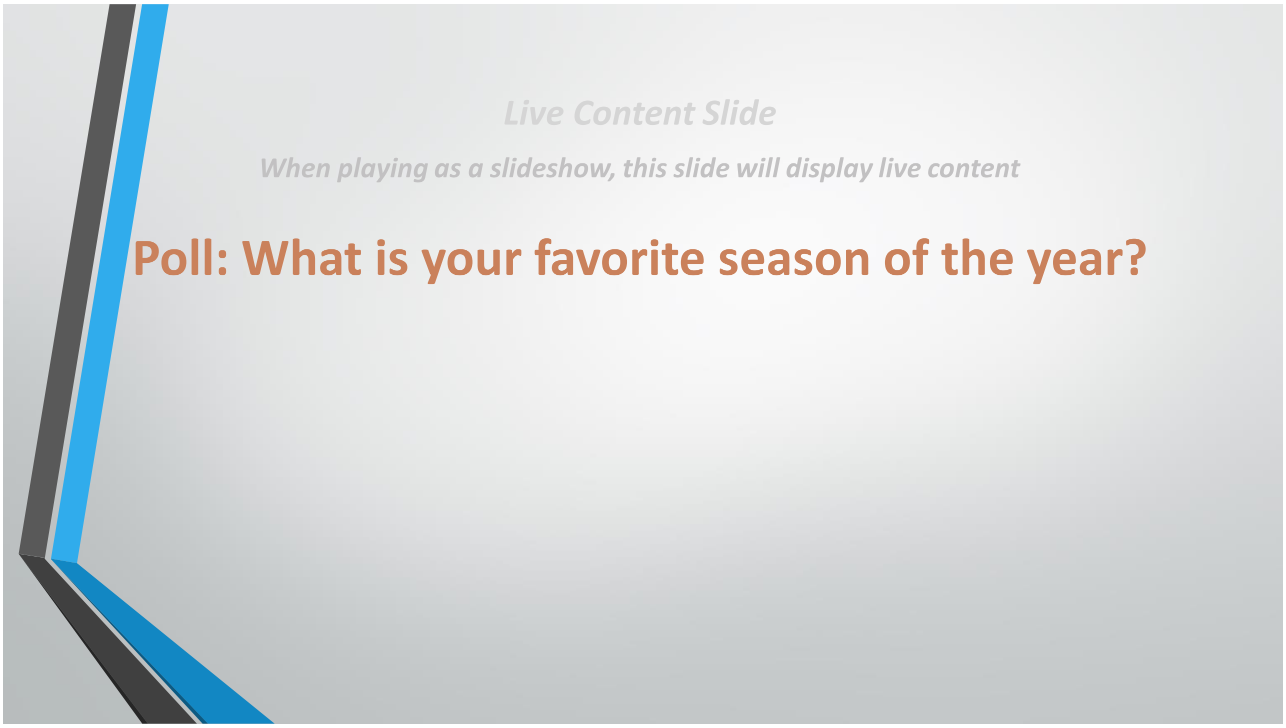
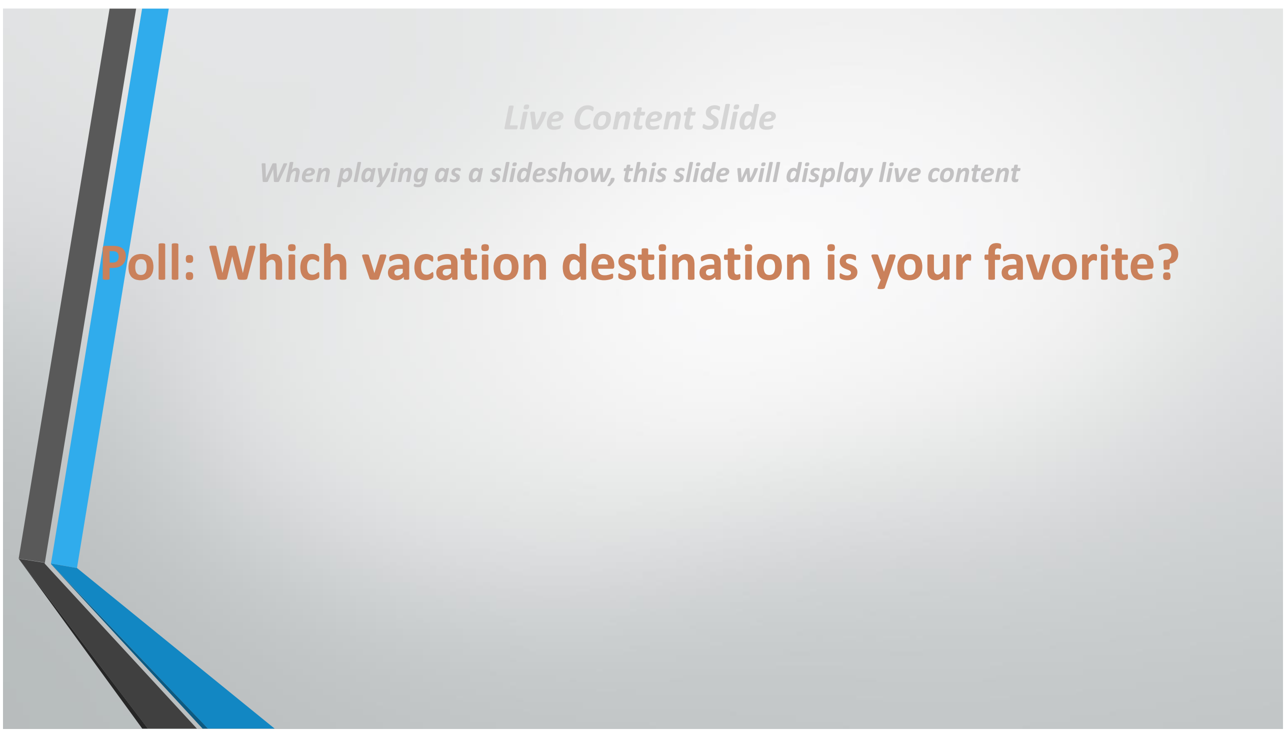

Live Content Slide
When playing as a slideshow, this slide will display live content
Poll: What is your favorite season of the year?

7


Live Content Slide
When playing as a slideshow, this slide will display live content
Poll: Which vacation destination is your favorite?

8

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: Have you ever lied to a police officer to avoid a speeding ticket?

9

Agenda

- The Role of the PEEC
  - How did we get to this point?
  - Recent changes to the AICPA Code of Professional Conduct
  - Discipline areas and results of violations of COPC
- Proposed New SSTSs
  - Why it is important for quality of your tax practice!
  - How to mitigate tax ethical claims
- Changing Landscape for CPAs
- Q & A

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The Role of the PEEC

- Senior Executive Committee of the AICPA
- Standards setting responsibility
- Enforcement of the Code of Conduct through JEEP

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The Role of the PEEC

- Brian Lynch of EY – Chairman
- 20 members (includes 2 public members)
- Directly authorized by AICPA Council

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The Role of the PEEC

- Amend Code of Conduct as needed by changing business landscape
- Present disciplinary matters to Joint Trial Board
- Investigate potential code violations

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What is JEEP?

- Established in 1978
- Purpose: To work with state societies to perform a single investigation into code of conduct violations of a joint member. Also, can perform investigations for societies of state member only.

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What is JEEP?

- Sources of cases:
  - Government referrals (IRS, DOL, SEC, PCAOB, etc.)
  - Outside parties – aicpa.org/fileacomplaint
  - Peer review referrals
  - State boards
  - Work product follow up
  - Media

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15

What is JEEP?

- Possible sanctions
  - Pre-issuance review
  - Work product follow-up review
  - Accelerate peer review

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Case Statistics in 2021

400+
remediated

66
admonished

37
suspended

37
expelled

17

17

Most Common Violations

- ✓ Reporting standards not met
- ✓ Evidence of fieldwork lacking (workpapers)
- ✓ Risk evaluation inadequate or not considered
- ✓ Failing to make tax election/missing deadlines

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Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: What date was the AICPA Code of Conduct codified?

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AICPA Online Ethics Library

- https://pub.aicpa.org/codeofconduct/Ethics.aspx
- Contains the Code of Conduct, Ethics Q & A, Plain English Guide to Independence and much more.

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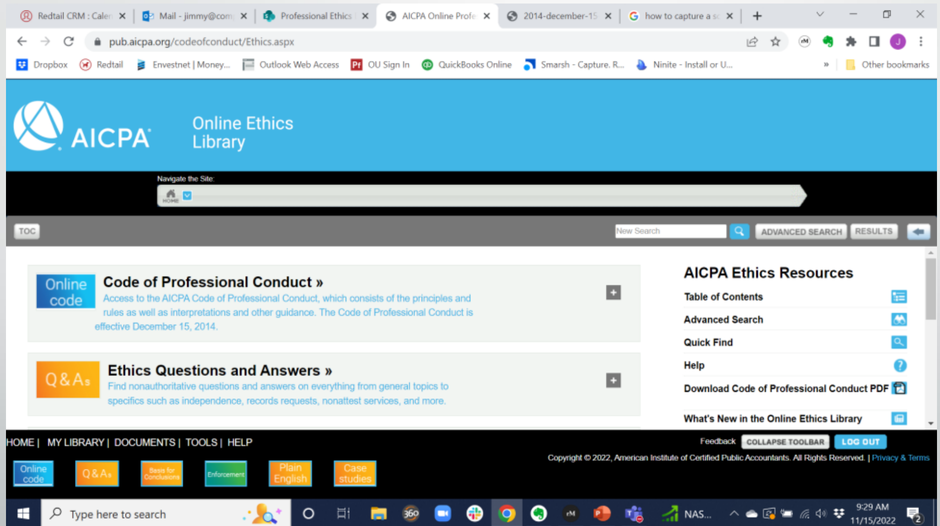
AICPA Online Ethics Library



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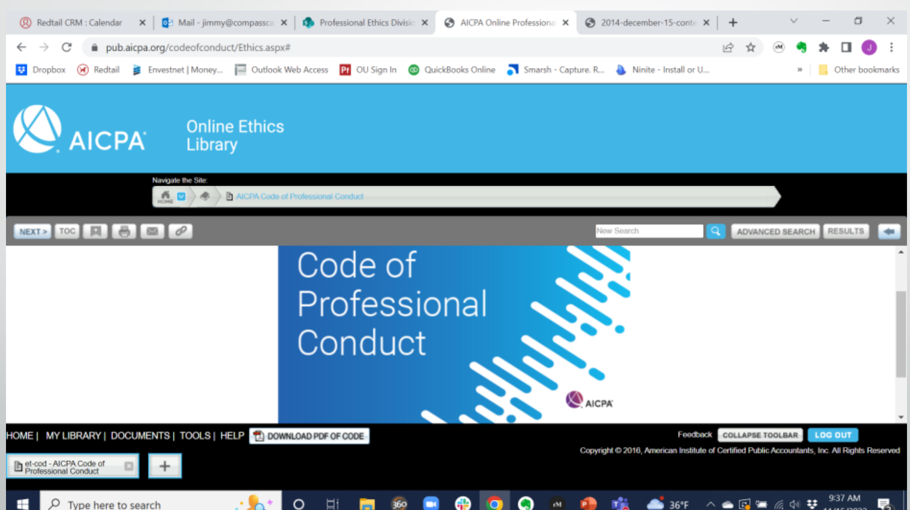
AICPA Online Ethics Library



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AICPA Online Ethics Library

- Under development for some areas
- Recommend saving link in your bookmarks for easy access

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New SSTSs Revisions

- Background
  - SSTSs origin was the Statements on Responsibilities in Tax Practice (SRTPs)
  - Originally issued between 1964 and 1977
  - Currently SSTSs 1 through 7 in effect

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New SSTSs Revisions

- SSTS No. 1 - Tax return positions

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New SSTSs Revisions

- SSTS No. 2 - Answers to questions on returns

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New SSTSs Revisions

- SSTS No. 3 – Certain procedural aspects to preparing returns

27

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New SSTSs Revisions

- SSTS No. 4 – Use of estimates

28

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New SSTSs Revisions

- SSTS No. 5 – Departure from a position previously concluded in an administrative proceeding or court decision

29

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New SSTSs Revisions

- SSTS No. 6 – Knowledge of error: return preparation and administrative proceedings

30

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New SSTSs Revisions

- SSTS No. 7 – Form and content of advice to taxpayers

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New SSTSs Revisions

- The Statements on Standards for Tax Services can be found at

https://www.aicpa.org/resources/toolkit/statements-on-standards-for-tax-services

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New SSTSs Revisions

The goal of the revisions are to ensure that the current standards are better aligned to reflect the current state of the tax profession and emerging needs of members.

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New SSTSs Revisions

Proposed updates include:

- Reorganization of the SSTSs by type of tax work performed; and
- Promulgation of 3 new standards.

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New SSTSs Revisions

Reorganization

- Standard No. 1 includes general tax guidance with broad applicability (includes new standards on data protection and reliance on tools).

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New SSTSs Revisions

Reorganization

- Standard No. 2 includes tax return preparation guidance.

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New SSTSs Revisions

Reorganization

- Standard No. 3 includes guidance specific to providing a tax service.

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New SSTSs Revisions

Reorganization

- Standard No. 4 includes guidance for members providing tax representation services (new standard).

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New SSTSs Revisions

Reorganization

Standard No. 4 is intended to assist members in applying standards to specific tax practice situations and to help them understand the scope and expectations of these standards (i.e., representation services).

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New SSTSs Revisions

NEW

Data protection: A member is responsible to make a reasonable effort to safeguard confidential client information.

40

40

New SSTSs Revisions

Items to be considered in the implementation of this standard are:

- ✓ Proper use of encryption and other safeguard apps/software
- ✓ Policy to protect client's information when sharing files with others.
- ✓ Other resources and policies to protect client from inadvertent exposure of such information to the public.

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New SSTSs Revisions

NEW

Reliance on tools: Protects members by defining when they may reasonably rely on tools of all types used in the performance of tax services.

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New SSTSs Revisions

In today's tax practice environment, members rely on technology to provide services more than at any point in history. That trend will continue with the introduction of artificial intelligence, data science, quantum computers and other developing technologies.

New SSTSs Revisions

NEW

Tax representation: The new standard will specifically address representation of clients with government agencies.

New SSTSs Revisions

Currently, existing standards govern representation including Circular 230. However, Circular 230 governs only representation before the IRS.

CPAs are representing clients before many different agencies for a variety of taxes (i.e., sales, estate, gross production, etc.) and this standard will provide guidance to these services.

Comment Period

- Target effective date no later than January 1, 2024
- Invitation to Comment (ITC) will offer an online form or you may email your submission to:

SSTScomments@aicpa-cima.com

Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: Do you think additional standards for tax services will improve the level of service provided to clients?

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6 Principles of the AICPA COPC

- Primary areas of the code of professional conduct are:
  - Responsibilities
    - Clients
    - Colleagues
    - Others
  - Public Interest
  - Integrity
  - Objectivity and independence
  - Due Care
  - Scope and nature of services

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Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: Does stress and unhappiness give rise to unethical behavior?

49

Integrity

- Element of Character
  - Benchmark against which a member is evaluated.
- Requires honesty and candor in providing services and dealing with the public.
- Measured in terms of what is right and just.

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Integrity

- ET § 0.300.040
- Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. (ET §0.300.040.03)
- Integrity also requires a member to observe the principles of objectivity and independence and of due care. (ET §0.300.040.05)

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Most Compromised Principles in the COPC

Objectivity and Independence

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Objectivity and Independence

- Clearly most ethical violations for tax services occur when objectivity becomes impaired.
- Clients pushing the limits on allowable deductions or the underreporting of income because certain documentation was not received (i.e., "The Case of the Missing 1099 Forms).
- Tax shelters and other reportable transactions typically cause problems for CPAs.

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Never-Ending Improvement of your Skills

Due Care

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Due Professional Care

- ET § 0.300.060
- A member should observe the profession's technical and ethical standards, strive continually to improve competence and diligence.
- It imposes the obligation to perform professional services to the best of a member's ability, with concern for the best interest of those for whom the services are performed, and consistent with the profession's responsibility to the public.

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Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: Which method of CPE deliver do you prefer?

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Internal Revenue Code Standards for Preparers

Circular 230, §10.35:

"In June, 2014, practitioner competence was added to Circular 230. A practitioner must possess the necessary competence to engage in practice before the IRS."

"Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged."

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Internal Revenue Code Standards for Preparers

Circular 230, §10.36 "Quality Control Provision":

Any practitioner who has principal authority and responsibility for overseeing a firm's practice of preparing tax returns, claims for refunds, or other documents for submission to the IRS must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with Circular 230.

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Conflicts of Interest in Tax Practice

AICPA Code of Conduct:

As advocates, firm personnel should seek to advance the client's position as long as that position and their efforts are in compliance with applicable professional standards, including the AICPA Code of Professional Conduct and the SSTSs, and applicable laws and regulations. Positions advocated should not result in a conflict of interest for the firm or any of its personnel, compromise the credibility of the firm or its personnel, go beyond sound and reasonable practice, pose an unreasonable risk of impairing the reputation of the firm or its personnel, or subordinate the judgment of firm personnel to that of the client.

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Statements on Standards for Tax Services

- SSTS No. 1 – Tax Return Positions
- SSTS No. 2 - Answers to Questions on Returns
- SSTS No. 3 - Certain Procedural Aspects of Preparing Returns
- SSTS No. 4 - Use of Estimates

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Statements on Standards for Tax Services

- SSTS No. 5 - Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
- SSTS No. 6 - Knowledge of Error: Return Preparation and Administrative Proceedings
- SSTS No. 7 - Form and Content of Advice to Taxpayers

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Live Content Slide

When playing as a slideshow, this slide will display live content

Poll: How many IRS representation cases do you serve in a typical year?

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Live Content Slide

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Poll: Do you rely on tax research software or prefer to manually search for information pertaining to tax matters?

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Poll: What software do you utilize to research tax matters?

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Disciplinary Decisions 2022

CPA in Cincinnati, OH terminated from AICPA membership effective September 19, 2022, because of a final judgment of conviction for a crime punishable by imprisonment for more than one year. CPA was found guilty of Aggravated Theft, a violation of Revised Code Section 2913.02(A)(2) (B)(2) a third degree felony in the state of Ohio.

P.S. Don't steal!

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Disciplinary Decisions 2022

As a result of a decision of a hearing panel of the Joint Trial Board, CPA's AICPA membership was suspended for a period of two years effective September 16, 2022. CPA was found guilty of violating the "Acts Discreditable Rule" (1.400.001) and the "Advertising and Other Forms of Solicitation Rule" (1.600.001) of the AICPA Code of Professional Conduct. CPA was also directed to complete 16 hours of specific continuing professional education.

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Disciplinary Decisions 2022

CPA providing tax services for a client failed to follow standards by withholding tax schedules from a client for their failure to sign a disengagement letter and was owed fees for services unrelated to the depreciation schedules requested.

CPA made false representations to the case investigator.

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Disciplinary Decisions 2022

She violated the Due Care Standard by shredding the client's paper tax returns and failed to document what client records were returned to the client.

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Disciplinary Decisions 2022

She was admonished with her name published in the local paper and the Journal of Accountancy.

Must complete the ***8.5 hours AICPA Ethics Course***.

And you thought this ethics course seemed long!

Questions?

Thank You!

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Contact Information

JJW & Co.

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