Current Federal Tax Developments

Week of December 31, 2018

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Section: 61
Loan Financial Adviser Found Not Liable to Repay in FINRA Action Treated as Ordinary Income

Citation: Connell v. Commissioner, TC Memo 2018-213, 12/27/18

In the case of *Connell v. Commissioner*, TC Memo 2018-213, the taxpayer (who was employed by Merrill Lynch) attempted to classify the amount of a loan that was forgiven as part of a Financial Industry Regulatory Authority's (FINRA) decision in a dispute he had with Merrill Lynch as a capital gain.

The taxpayer had been a financial adviser since 1974. In 2009 when he discovered that Smith Barney, with whom he was then associated, was going to be acquired by Morgan Stanley, he decided to look for other employment opportunities. The best offer he received was from Merrill Lynch which he accepted.

As part of that offer, Merrill Lynch provided he was to be paid $42,980.07 per month from October 2009 to June 2017 in "transition compensation." At the same time, Merrill Lynch provided him with a loan of $3,637,217 which he was to repay at $42,980.07 per month from October 2009 to June 2017. As you might suspect, the perfect overlap was not a coincidence.

As the opinion noted:

> *However, "[f]or the convenience of the undersigned [i.e., Mr. Connell], such amount shall be deducted from the undersigned compensation from Merrill Lynch at the time compensation is paid during each month from October 2009 through June 2017." This arrangement, common to the industry, allowed Mr. Connell to receive the full amount of his transition compensation upfront, while recognizing income only as each monthly payment came due. No moneys changed hands with respect to each monthly "repayment" of the loan. The loan became immediately repayable under the following conditions: "Notwithstanding anything to the contrary contained herein, all outstanding principal and accrued but unpaid interest on this Note shall become due and immediately payable if (a) the undersigned's employment with Merrill Lynch is terminated for any reason; or (b) the undersigned becomes insolvent or files for bankruptcy."*

However, there was a falling out between Mr. Connell and Merrill Lynch. As the opinion notes:

> *Less than a year after Mr. Connell joined Merrill Lynch, their relationship collapsed. Merrill Lynch launched an investigation, conducted by outside counsel, with respect to how Mr. Connell brought his team's Smith Barney clients to Merrill Lynch and whether he violated the protocol and/or his employment agreement. Mr. Connell fully cooperated with all information requests made as part of the investigation, but he engaged Thomas B. Lewis as his counsel to accompany him to a followup interview.*

While Merrill Lynch's outside counsel recommended that Mr. Connell be reprimanded only and the issue end there. Merrill Lynch moved to force Mr. Connell's resignation shortly before his one year anniversary, a date on which he would have been eligible to receive a bonus.

As well, Merrill Lynch first delayed filing a Form U5, Uniform Termination Notice for Securities Industry Registration with FINRA and then later filed one that explained his reason for leaving as "Conduct resulting in loss of management's confidence, including conduct relating to the handling of customer information and lack of cooperation in the firm's review of the matter." Other financial services were unwilling to work with Mr. Connell during the period in which the U5 was not filed, and continued to be unwilling to work with him once the U5 with Merrill's statement was filed.

In the interim, Merrill Lynch kept all of Mr. Connell's staff as employees and had them contact his customers to convince them to stay with Merrill Lynch. They also sought to collect the balance due on the loan to Mr. Connell.

Mr. Connell filed an arbitration action with FINRA regarding Merrill Lynch's actions, seeking to find that he was not liable for repayment of the loan among other issues. Mr. Connell claimed that Merrill Lynch had breached its employment agreement with him by acting in bad faith, and had intentionally set out to gain access to his high-value client base while ensuring that he would be unable to offer those clients services on his own. Thus, Merrill Lynch was extremely likely to be able to keep these customers that were formerly Mr. Connell's long-term clients as its own.

FINRA did rule that Mr. Connell was not to be required to repay the loan to Merrill Lynch. But now the question was what the nature of the taxable income was.

The FINRA arbitration did not go into detail regarding the exact reasoning for the ruling that the loan did not need to be repaid. The taxpayer argued that the loan was payment for his client lists and relationships, an intangible asset that would generate capital gain income from this sale. The IRS argued that the taxpayer had advanced a number of theories, including that Merrill Lynch had violated the employment agreement, that would lead to any award being taxable as ordinary income.

The Tax Court, noting that the FINRA decision did not provide a clear answer to why the debt had been forgiven, agreed that the pleadings of the taxpayer would control.

The Court summarized the taxpayer's arguments as follows:

> *Mr. Connell argues that his filings with the FINRA Panel make it clear that the award was to compensate him for the taking of his book of business and hence should be taxed as a capital gain.*
>
>> *The gravamen of * * * [Mr. Connell's] claim in the FINRA arbitration was that he was entitled to retain the unpaid portion of the Loan proceeds because they represented fair compensation for Merrill Lynch's having taken his book of business. In fact, that was the only argument he made with respect to his claim for retention of those proceeds.*

But the Tax Court noted that while he had raised that issue with FINRA, he had also raised the other justifications for this payment.

> *Admittedly, the filings heavily emphasize Mr. Connell's argument that Merrill Lynch lured Mr. Connell to Merrill Lynch in order to acquire his book of business and that thereafter it set out to ruin his professional reputation so as to keep him from working at a competing financial services firm. But this argument was not the only one Mr. Connell presented to the FINRA [*34] Panel. Mr. Connell's attorney, Mr. Lewis, an experienced and successful litigator, made certain of that. Mr. Connell's filings forcefully argue that the FINRA Panel should reject Merrill Lynch's position and conclude that Mr. Connell need not pay the balance of the upfront forgivable loan. Indeed, Mr. Connell's filings emphasized that Merrill Lynch breached the terms of the employment contract, not Mr. Connell, causing Mr. Connell to suffer damages. This argument, by itself, would relieve Mr. Connell of his obligation to pay the outstanding balance of the promissory note to Merrill Lynch.*

And, as the Tax Court notes, the burden is on the taxpayer to show why the IRS's view of the payment as representing ordinary income is not the correct view:

> *The record herein does not reveal the specific argument the FINRA Panel found most persuasive when it extinguished the balance of the upfront forgivable loan. Petitioners bear the burden of answering the question "in lieu of what were the damages awarded?" On the basis of our examination of the record, we conclude that petitioners have not met their burden to establish that the amount at issue was solely for the acquisition of Mr. Connell's book of business. Consequently, we sustain respondent's determination that the extinguishment of Mr. Connell's debt to Merrill Lynch constitutes cancellation of debt income and that the amount of the extinguishment is taxable as ordinary income.*

Section: 61
IRS Significantly Raises Limits On Value of Vehicles for Cents Per Mile and Fleet-Average Valuation Rule

Citation: Notice 2019-08, 12/21/18

In Notice 2019-8 the IRS has set the maximum values for 2018 for employer provided vehicles under which the cents per mile method (Reg. §1.61-21(e)) or fleet-average valuation rule (Reg. §1.61-21(d)) may apply.

The IRS is making a significant increase in this number. The agency explains its reasoning as follows:

> *Consistent with the substantial increase in the dollar limitations on depreciation deductions under section 280F(a), as modified by section 13202(a)(1) of the Act, the IRS and the Treasury Department intend to amend Treas. Reg. § 1.61-21(d) and (e) to incorporate a higher base value of $50,000 as the maximum value for use of the vehicle cents-per-mile and fleet-average valuation rules effective for the 2018 calendar year. Further, the IRS and the Treasury Department intend that the regulations will be modified to provide that this $50,000 base value will be adjusted annually using section 280F(d)(7) for 2019 and subsequent years.*

The maximum value of vehicles for which the cents per mile method may be used for 2018 is $50,000.

The maximum value of vehicles for the fleet valuation rule for 2018 is also set at $50,000.

Section: 162
IRS Issues Safe Harbor Procedure on Charitable Contribution Credits That Apply to Payments Made for a Trade or Business

Citation: Revenue Procedure 2019-12, 12/28/18

In Revenue Procedure 2019-12 the IRS released a set of safe harbor rules that apply to C corporations and certain passthrough entities that receive a state tax credit for amounts paid to organizations qualified under §170(c).

The procedure was issued in response to proposed regulations issued in 2018 that will apply to charitable contributions made by individuals after August 27, 2018. In such cases, an individual must reduce any charitable contribution claimed by any state tax credit received for making the contribution exceeds 15% of the contribution amount.

Following the issuance of those regulations, the IRS issued a set of frequently asked questions (FAQs) that noted that, under Reg. §1.170A-1(c)(5), if a taxpayer transfers property to such an organization that bears a direct relationship to the taxpayer's trade or business, and are made with a reasonable expectation of a financial reward commensurate with the transfer, the payment is deductible as a trade or business expense under IRC §162 and is not impacted by the proposed regulations.

The IRS notes in the procedure that there are similarities and differences for businesses conducted as C corporations and those that are conducted via a passthrough entity.

> *To the extent a C corporation receives or expects to receive a state or local tax credit in return for a payment to an organization described in section 170(c), it is reasonable to conclude that there is a direct benefit to the C corporation's business in the form of a reduction in the state or local taxes the C corporation would otherwise have to pay and, therefore, to the extent of the amount of the credit received orexpected to be received, there is a reasonable expectation of financial return to the C corporation commensurate with the amount of the transfer.*
>
> *Similarly, in the case of a business entity other than a C corporation that is regarded as separate from its owner for all federal tax purposes under section 301.77013 of the Procedure and Administration Reg ulations (passthrough entity) and that is operating a trade or business within the meaning of section 162, to the extent the credit received in return for such a payment can reduce the pass liability, it is reasonable to conclude thatthrough entity's tax there is a direct benefit to the passthrough entity in the form of a reduction in the state or local taxes the entity would otherwise have to pay. However, under the principles of sections 702 and 1366, the deductibility of the payment must be determine d at the level of the individual owners of the entity if the credit received or expected to be received will reduce a state or local income tax subject to the limitations in section 164(b)(6).*

Because of these differences, the IRS provides two different safe harbors, one applicable to C corporations and one applicable to passthrough entities.

For a C corporation, the following safe harbor applies:

> *If a C corporation makes a payment to or for the use of an organization described in section 170(c) and receives or expects to receive a tax credit that reduces a state or local tax imposed on the C corporation in return for such payment, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received.*

Passthrough are subjected to two tests. First, the passthrough must pass a test to be a *specified passthrough entity* for these purposes. That test is described as follows:

> *An entity will be considered a specified passthrough entity described in this section 4.02 only if each of the requirements set forth in section 4.02(1) through (4) is satisfied.*
>
> > *(1) The entity is a business entity other than a C corporation that is regarded for all federal income tax purposes as separate from its owners under section 301.77013;*
> >
> > *(2) The entity operates a trade or business within the meaning of section 162;*
> >
> > *(3) The entity is subject to a state or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and*

> *(4) In return for a payment to an organization described in section 170(c), the entity receives or expects to receive a state or local tax credit that the entity applies or expects to apply to offset a state or local tax described in section 4.02(3) of this revenue procedure other than a state or local income tax.*

The "other than a state or local income tax" language may come as a surprise to those who read the "clarification" in the summer from the Treasury Secretary and the IRS to allow this to be used to bypass the individual itemized deduction limit on state and local taxes.

If passthrough passes that test, then the following safe harbor applies:

> *If a specified passthrough entity described in section 4.02 of this revenue procedure makes a payment to or for the use of an organization described in section 170(c) and receives or expects to receive a tax credit described in section 4.02(4) of this revenue procedure that the entity applies or expects to apply to o ffset a state or local tax described in section 4.02(3) of this revenue procedure other than a state or local income tax, the specified passthrough entity may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the credit received or expected to be received.*

The IRS provides the following examples of applying these safe habors. First, there is a set of examples for the C corporation safe harbor:

> *Example 1. A, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, A receives or expects to receive a dollar-for-dollar state tax credit to be applied to A's state corporate income tax liability. Under section 3 of this revenue procedure, A may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.*
>
> *Example 2. B, a C corporation engaged in a trade or business, makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, B receives or expects to receive a tax credit equal to 80 percent of the amount of this payment ($800) to be applied to B's local real property tax liability. Under section 3 of this revenue procedure, B may treat $800 as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.*

The IRS then provides a pair of examples for the passthrough entity rules:

> *Example 1 . P is a limited liability company (LLC) classified as a partnership for federal income tax purposes under section 301.77013 and is owned by individuals A and B. P is engaged in a trade or business within the meaning of section 162 and makes a payment of $1,000 to an organization described in section 170(c). In return for the payment, P receives or expects to receive a dollar-for-dollar state tax credit to be applied to P's state excise tax liability incurred by P in carrying on its trade or business. Under applicable state law, the state's excise tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, P may treat the $1,000 payment as meeting the requirements of an ordinary and necessary business expense under section 162.*
>
> *Example 2. S is an S corporation engaged in a trade or business and is owned by individuals C and D. S mak es a payment of $1,000 to an organization described in section 170(c). In return for the payment, S receives or expects to receive a state tax credit equal to 80 percent of the amount of this payment ($800) to be applied to S's local real property tax liability incurred by S in carrying on its*

> *trade or business. Under applicable state and local law, the real property tax is imposed at the entity level (not the owner level). Under section 4 of this revenue procedure, S may treat $800 of the payment as meeting the requirements of an ordinary and necessary business expense under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by this revenue procedure.*

One key item to note is the applicability date of this Revenue Procedure's safe harbors. Section 5.01 provides:

> *This revenue procedure applies to amounts described in section 3.02 of this revenue procedure that are paid on or after January 1, 2018, by a C corporation described in section 3.01 of this revenue procedure. In addition, this revenue procedure applies to amounts described in section 4.03 of this revenue procedure that are paid on or after January 1, 2018, by a specified pass-through entity described in section 4.02 of this revenue procedure.*

Section: 168
Revenue Procedure Released to Deal with ADS Depreciation Issues for Electing Farm and Real Property Businesses and Section 179 Changes Found in TCJA

Citation: Revenue Procedure 2019-08, 12/21/18

In Revenue Procedure 2019-08 the IRS gives information on the following items following the enactment of the Tax Cuts and Jobs Act:

- Qualified real property under IRC §179;
- Alternative depreciation system (ADS) depreciation of real property with the new 30 and 40 year lives; and
- Handling the transition to ADS depreciation for certain property of electing farming and electing real property businesses.

For years beginning after 2017, the following types of property are qualified real property that may be treated as eligible §179 property under IRC §179(d)(1):

- Qualified improvement property as defined by IRC §168(e)(6) and
- Improvements to nonresidential real property if the improvement:
    - Is §1250 property and
    - Is
        - A roof;
        - Heating, ventilation and air conditioning (HVAC) property;
        - A fire protection or alarm system; or
        - A security system.

The Revenue Procedure provides the following information on the definition of qualified improvement property:

> *The definition of qualified improvement property in § 168(e)(6) is the same definition of that term in § 168(k)(3) as in effect on the day before the date of enactment of the TCJA. Accordingly, see section 4.02 of Rev. Proc. 2017-33 for further guidance on the definition of qualified improvement property…*

The procedure provides the following method for electing to treat qualified real property as §179 property:

> *A taxpayer may elect to expense under § 179(a) the cost, or a portion of the cost, of qualified real property placed in service by the taxpayer during any taxable year beginning after 2017 by filing an original or amended Federal tax return for that taxable year in accordance with procedures similar to those in § 1.179-5(c)(2) and section 3.02 of Rev. Proc. 2017-33. If a taxpayer elects or elected to expense under § 179(a) a portion of the cost of qualified real property placed in service by the taxpayer during any taxable year beginning after 2017, the taxpayer is permitted to increase the portion of the cost of such property expensed under § 179(a) by filing an amended Federal tax return for that taxable year. Any such increase in the amount expensed under § 179 is not deemed to be a revocation of the prior election for that taxable year.*

The Revenue Procedure also provides an optional depreciation table for 30 year ADS property in Section 4.02(2).

The procedure also deals with the change to ADS depreciation for certain assets of electing farm and real property businesses. Such businesses that wish take advantage of electing out of the interest limitations of IRC §163(j) have to depreciation certain property using ADS depreciation.

The property which must be depreciated using ADS are:

> *(a) Any nonresidential real property (as defined in § 168(e)(2)(B)), residential rental property (as defined in § 168(e)(2)(A)), and qualified improvement property (as defined in § 168(e)(6)) held by an electing real property trade or business (as defined in § 163(j)(7)(B) and the regulations thereunder); and*

> *(b) Any property with a recovery period of 10 years or more that is held by an electing farming business (as defined in § 163(j)(7)(C) and the regulations thereunder). For determining what MACRS property has a recovery period of 10 years or more, the recovery period is determined in accordance with § 168(c).*

The requirement to use ADS depreciation applies both to property placed in service in years prior to the year the election is made and property placed in service in the year of election and later years.

The Revenue Procedure provides the following procedure to deal with transitioning existing property to the appropriate ADS depreciation method:

> *For existing property described in section 4.02(1) of this revenue procedure, as applicable, a change in use occurs under § 168(i)(5) and § 1.168(i)-4(d) for the election year as a result of the election under § 163(j)(7)(B) or (C), as applicable. Accordingly, depreciation for such property beginning for the election year is determined in accordance with § 1.168(i)-4(d). Pursuant to § 1.168(i)-4(f), a change in computing depreciation for the election year for such existing property is not a change in method of accounting under § 446(e). If any such existing property was qualified property under § 168(k) in the taxable year in which the trade or business placed the property in service, the additional first year depreciation deduction allowable for that property is not redetermined. See § 1.168(k)-1(f)(6)(iv)(A)*

Under Reg. §1.168(i)-4(d)(4)(ii) the appropriate depreciation for periods beginning with the year of change is computed as follows:

> *The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year.*

The applicable depreciation period is defined by Reg. §1.168(i)-4(d)(4)(ii)(A) as follows:

> *The applicable depreciation method is the depreciation method that would apply in the year of change and any subsequent taxable year for the MACRS property had the taxpayer used the longer recovery period and/or the slower depreciation method in the placed- in-service year of the property.*

The applicable recovery period depends on whether straight line or an accelerated method (150- or 200-percent declining balance) is used. If straight line depreciation is used the applicable recovery period is:

> *The number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) had the taxpayer used the longer recovery period in the placed-in-service year of the property if the applicable depreciation method is the straight line method (as determined under paragraph (d)(4)(ii)(A) of this section)...*[1]

If an accelerated method is used, the applicable recovery period is:

> *The longer recovery period resulting from the change in the use if the applicable depreciation method is the 200- or 150- percent declining balance method (as determined under paragraph (d)(4)(ii)(A) of this section)…*[2]

For newly-acquired property, the Revenue Procedure provides the following rules:

> *For newly-acquired property described in section 4.02(1) of this revenue procedure, as applicable, the taxpayer determines the depreciation in accordance with the alternative depreciation system for such property for its placed-in-service year and the subsequent taxable years. Because such newly-acquired property is required to be depreciated under the alternative depreciation system, the property is not qualified property for purposes of the additional first year depreciation deduction under § 168(k). See § 168(k)(2)(D).*

The Revenue Procedure also provides information for a taxpayer that makes the election and fails to use ADS on either existing or newly-acquired property.

For existing property, the Revenue Procedure provides the following guidance in that situation:

> *If an electing real property trade or business or an electing farming business does not depreciate any existing property that is described in section 4.02(1) of this revenue procedure, as applicable, under the alternative depreciation system for the election year and the subsequent taxable year then that trade or business has adopted an impermissible method of accounting for that item of MACRS property. As a result, a change from that impermissible method of accounting to the straight-line method, the applicable recovery period, and/or the applicable convention under the alternative depreciation system for the item*

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[1] Reg. §1.168(i)-4(d)(4)(ii)(B)(2)

[2] Reg. §1.168(i)-4(d)(4)(ii)(B)(1)

> *of MACRS property is a change in method of accounting under § 446(e). See § 1.446-1(e)(2)(ii)(d)(2)(i). The taxpayer requests to make such a method change by filing Form 3115, Application for Change in Accounting Method, in accordance with the automatic change procedures or non-automatic change procedures, as applicable, in Rev. Proc. 2015-13, 2015-5 I.R.B. 419 (or any successor). If the taxpayer is eligible to make this method change under the automatic change procedures, the method change is described in section 6.05 of Rev. Proc. 2018-31 (or any successor). The § 481(a) adjustment as of the first day of the year of change is calculated as though the change in use occurred for the item of MACRS property in the election year.*

For newly-acquired property, the following guidance is provided:

> *If an electing real property trade or business or an electing farming business does not determine its depreciation under the alternative depreciation system for any newly-acquired property that is described in section 4.02(1) of this revenue procedure, as applicable, for its placed-in-service year and the subsequent taxable year then that trade or business has adopted an impermissible method of accounting for that item of MACRS property. As a result, a change from that impermissible method of accounting to the straight-line method, the applicable recovery period, and/or the applicable convention under the alternative depreciation system for the item of MACRS property is a change in method of accounting under § 446(e). See § 1.446-1(e)(2)(ii)(d)(2)(i). The taxpayer requests to make such a method change by filing Form 3115 in accordance with the automatic change procedures or non-automatic change procedures, as applicable, in Rev. Proc. 2015-13 (or any successor). If the taxpayer is eligible to make this method change under the automatic change procedures, the method change is described in section 6.01 of Rev. Proc. 2018-31 (or any successor), provided none of the inapplicability provisions in section 6.01(1)(c) of Rev. Proc. 2018-31 (or any successor) apply. The § 481(a) adjustment as of the first day of the year of change is calculated as though the taxpayer determined depreciation under the alternative depreciation system for the item of MACRS property beginning for its placed-in-service year.*

Section 199A
IRS Publication Indicates Real Estate & Insurance Agents and Brokers Are Considered in a Specified Service Trade or Business

Citation: Draft Publication 535 (Section), 12/19/18

The draft copy of the §199A section of Publication 535 released by the IRS on December 19, 2018, in describing what is a specified service trade or business has language in it that does not track what was found in the proposed regulations released in August. The issue involves whether "services performed in the field of brokerage services" includes services performed by real estate agents, real estate brokers, insurance agents, etc. or is limited to the brokerage of financial products.

The original Proposed Reg. §1.199A-5(b)(2)(x) provided the following definition for that category:

> *For purposes of section 199A(d)(2) and paragraph (b)(1)(ix) of this section only, the performance of services in the field of brokerage services includes services in which a person arranges transactions between a buyer and a seller with respect to securities (as defined in section 475(c)(2)) for a commission or fee. This includes services provided by stock brokers and other similar professionals,* ***but does not include services provided by real estate agents and brokers, or insurance agents and brokers.*** (emphasis added)

However, the recently released pages from Publication 535 has the following information on these services:

> *Brokerage services, including arranging transactions between a buyer and a seller for a commission or fee such as stock brokers,* ***real estate agents and brokers, insurance agents and brokers,*** (emphasis added) *and intellectual property brokers;*

The publication specifically includes the categories specifically called out as being excluded in the proposed regulations. The publication also states that intellectual property brokers are included in the category, while the proposed regulations made no mention of this category.

If, in fact, the final regulations reflect the language in the proposed regulations then even if this language is not changed in the publications, real estate agents and brokers and insurance agents and brokers would not face a change of treatment. The regulations would override the publication which would simply be in error.

But one other possibility needs to be taken into account. A few days before the draft publication was released, Treasury sent the final regulations under IRC §199A to the Office of Information and Regulatory Affairs (OIRA) for review prior to publication. Thus, the publication, which otherwise seems to quote much of its definitions in this area word for word from the proposed regulations, may reflect a change that exists in the final regulations we are waiting to see following the OIRA review and final release.

This quirk in the publication was brought to my attention by a Twitter post by Stephen L. Nelson CPA of Seattle that was commented on by Glen Birnbaum, CPA.

Section: 867
Rules Proposed to Implement Requirement to Treat Sale of Partnership Interests as Effectively Connected with US Trade or Business by Foreign Partners

Citation: REG-113604-18, 12/20/18

Proposed regulations dealing with the sale of a partnership have been issued by the IRS (REG-113604-18) to implement changes made by Congress in the Tax Cuts and Jobs Act. Specifically, TCJA made the following changes to deal with foreign holders of partnership interests:

- Requiring foreign partners to treat the sale of a partnership interest as "effectively connected" with a U.S. trade or business if a sale of the partnership's assets would have created such effectively connected income (overturning the result in *Grecian Mining v. Commissioner*, 149 TC No. 3)[3]; and
- Requiring the buyer of a partnership interest to withhold 10% of the purchase price unless the buyer certifies the buyer is not a foreign person.[4]

These proposed regulations deal only with the first category of transactions--rules on withholding are not in this of regulations, though the preamble notes that Treasury and the IRS "intend to issue guidance under section 1446(f) expeditiously."

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[3] IRC §864(c)(8)
[4] IRC §1446(f)

The proposed regulations begin by dealing with new IRC §864(c)(8) with rules on how the foreign interest holder determines the effectively connected gain or loss. That provision is outlined in the preamble:

> *Section 864(c)(8)(A) provides that gain or loss of a foreign transferor from the transfer of an interest, owned directly or indirectly, in a partnership that is engaged in any trade or business within the United States is treated as effectively connected gain or loss to the extent such gain or loss does not exceed the amount determined under section 864(c)(8)(B). In general, section 864(c)(8)(B) limits the amount of effectively connected gain or loss to the portion of the foreign transferor's distributive share of gain or loss that would have been effectively connected gain or loss if the partnership had sold all of its assets at fair market value. The proposed regulations set forth rules for determining gain or loss described in section 864(c)(8)(A) and the limitation described in section 864(c)(8)(B), each of which is discussed in this section I of this Explanation of Provisions.*

As the preamble describes the issue:

> *To determine the amount of gain or loss described in section 864(c)(8)(A), generally, the proposed regulations require that a foreign transferor first determine its gain or loss on the transfer of a partnership interest ("outside gain" and "outside loss"). For this purpose, the proposed regulations provide that outside gain or loss is determined under all relevant provisions of the Code and the regulations thereunder. As described in section I.A.1 of this Explanation of Provisions, a foreign transferor may recognize capital gain or loss ("outside capital gain" or "outside capital loss") and ordinary gain or loss ("outside ordinary gain" or "outside ordinary loss") on the transfer of its partnership interest and must separately apply section 864(c)(8) with respect to its capital gain or loss and its ordinary gain or loss.*

IRC §§741 and 751 govern gain and loss calculations generally when a taxpayer sells an interest in a partnership.

> *In general, the proposed regulations provide that a foreign transferor must determine the portion of its capital gain or loss, and the portion of its ordinary income or loss from section 751 property, that must each be characterized as effectively connected gain or loss under section 864(c)(8). See proposed §1.864(c)(8)-1(b). As provided in section 864(c)(8)(A) and further described in section I.B of this Explanation of Provisions, the proposed regulations provide that a foreign partner's effectively connected gain or loss will not exceed its outside gain or loss on the sale of the interest as determined under sections 741 and 751 and the regulations thereunder. Thus, the amount of gain or loss determined under section 741 (before application of section 751) is not a limitation on the amount of gain or loss characterized as effectively connected with the conduct of a trade or business within the United States under the proposed regulations.*

The preamble indicates that although IRC §864(c)(8)(E) authorizes the IRS to issue regulations to deal with the impact of nonrecognition transactions with this provision, such regulations are not included in this set of proposed regulations. Rather, the preamble continues:

> *The Treasury Department and the IRS recognize, however, that certain nonrecognition transactions may have the effect of reducing gain or loss that would be taken into account for U.S. federal income tax purposes. For example, if a partnership that conducts a trade or business within the United States owns property not subject to tax under section 871(b) or 882(a) in the hands of a foreign partner, the partnership may distribute that property to the foreign partner rather than a U.S. partner. The Treasury Department and the IRS continue to consider, and comments are requested regarding, whether other Code provisions adequately address transactions that rely on section 731 distributions to reduce*

> *the scope of assets subject to U.S. federal income taxation, and may propose rules addressing these types of transactions.*

The preamble notes that once a taxpayer has determined the outside gain or loss, the taxpayer must then determine the limitation found in IRC §864(c)(8)(B) by determining the following three amounts:

- With respect to each asset held by the partnership, the amount of gain or loss that the partnership would recognize in connection with a deemed sale to an unrelated party in a fully taxable transaction for cash equal to the asset's fair market value immediately before the partner's transfer of its partnership interest;
- The amount of that gain or loss that would be treated as effectively connected gain or loss ("deemed sale EC gain" and "deemed sale EC loss"); and
- The foreign transferor's distributive share of the ordinary and capital components of any deemed sale EC gain and deemed sale EC loss.

The preamble then describes terms used for items determined by these calculations:

> *The proposed regulations refer to the separate sums of the foreign transferor's distributive shares of the ordinary and capital components of deemed sale EC gain and deemed sale EC loss items for all assets, determined at the level of the foreign transferor, as "aggregate deemed sale EC capital gain," "aggregate deemed sale EC capital loss," "aggregate deemed sale EC ordinary gain," and "aggregate deemed sale EC ordinary loss."*

The preamble next describes how to apply the limitation:

> *After each of these aggregate amounts is determined, the proposed regulations implement the limitation described in section 864(c)(8)(B), generally, by comparing the foreign transferor's outside gain or loss amounts with the relevant aggregate deemed sale EC gain or loss. This determination is made separately with respect to capital gain or capital loss and gain or loss treated as ordinary income or ordinary loss. Thus, for example, a foreign transferor would compare its outside capital gain to its aggregate deemed sale EC capital gain, treating the former as effectively connected gain only to the extent it does not exceed the latter. See proposed §1.864(c)(8)-1(b)(3).*

The rule proposed in the regulations generally turn any deemed sale gain or loss as coming from sources inside the United States. However, the regulations provide an exception:

> *To prevent this rule from potentially converting gain or loss from assets with no connection to the partnership's trade or business within the United States into effectively connected gain or loss, the proposed regulations provide that gain or loss from the deemed sale of a partnership asset is not treated as effectively connected gain or loss if (1) no income or gain previously produced by the asset was taxable as effectively connected with the conduct of a trade or business within the United States by the partnership (or a predecessor of the partnership) during the ten-year period ending on the date of the transfer, and (2) the asset was not used, or held for use, in the conduct of a trade or business within the United States by the partnership (or a predecessor of the partnership) during the ten-year period ending on the date of transfer. See proposed §1.864(c)(8)-1(c)(2)(ii).*

The proposed regulations provide the following rules for determining a partner's share of the deemed sale EC gain and deemed sale EC loss:

> *The proposed regulations provide that a partner's distributive share of gain or loss from the deemed sale is determined under all applicable Code sections (including section 704), taking into account allocations of tax items applying the principles of section 704(c), including any remedial allocations under §1.704-3(d), and any section 743 basis adjustment pursuant to §1.743-1(j)(3). The Treasury Department and IRS propose this approach because applying section 704 more closely ties the results of the deemed sale with regard to the selling foreign partner to the economic results of an actual sale, as compared (for example) to an approach that did not consider special allocations or considered only a partner's share of ordinary business income, which would distort the economic agreement among the partners. See proposed §1.864(c)(8)-1(c)(3)(i).*

However, the IRS is concerned whether such use of IRC §704 could allow for evasion of this rule and ask for comments on the issue:

> *The Treasury Department and the IRS are considering whether section 704 and the regulations thereunder adequately prevent the avoidance of the purposes of section 864(c)(8) through allocations of effectively connected gain or loss to specific partners. For example, immediately before a foreign transferor sells its interest in a partnership, adjustments could be made to partnership allocations that would result in the foreign transferor recognizing less effectively connected gain from the deemed sale by the partnership. While statutory and regulatory provisions, as well as judicial doctrines, may limit the extent to which inappropriate results may be obtained in that transaction or similar transactions, the Treasury Department and the IRS are considering whether additional guidance is necessary to prevent abuse.*

IRC §897(g) provides for effectively connected treatment for real property held by a partnership, a provision that existed in the IRC before TCJA. To coordinate the new rule with that prior provision, the regulations provide the following:

> *…[W]hen a partnership holds United States real property interests and is also subject to section 864(c)(8) because it is engaged in the conduct of a trade or business within the United States without regard to section 897, the amount of the foreign transferor's effectively connected gain or loss will be determined under section 864(c)(8) and not under section 897(g). Therefore, the reduction called for by section 864(c)(8)(C) is not necessary. See proposed §1.864(c)(8)-1(d).*

The regulations contain provisions to force tiered partnership structures to take the deemed sale rules into account both when a partner disposes of an interest in an upper tier partnership and when an upper tier partnership with foreign partners transfers an interest in a lower tier partnership that is conducting a trade or business.

Section: 6241
IRS Announces Plans to Issue Regulations for Two Special Enforcement Matters Under CPAR

Citation: Notice 2019-6, 12/20/18

In Notice 2019-6 the IRS announced its intention to issue proposed regulations to deal with "special enforcement matters" under the centralized partnership audit regime (CPAR). Special enforcement matters are defined at IRC §6241(11), a provision added by the Consolidated Appropriations Act of 2018 as part of the technical corrections to the CPAR partnership audit regime that was created by the Bipartisan Budget Act of 2015 and which will first be effective for partnership tax years beginning in 2018.

IRC §6241(11) provides:

> *(11) Treatment of special enforcement matters. --*
>
> *(A) In general. -- In the case of partnership-related items which involve special enforcement matters, the Secretary may prescribe regulations pursuant to which --*
>
> > *(i) this subchapter (or any portion thereof) does not apply to such items, and*
> >
> > *(ii) such items are subject to such special rules (including rules related to assessment and collection) as the Secretary determines to be necessary for the effective and efficient enforcement of this title.*
>
> *(B) Special enforcement matters. -- For purposes of subparagraph (A), the term "special enforcement matters" means --*
>
> > *(i) failure to comply with the requirements of section 6226(b)(4)(A)(ii),*
> >
> > *(ii) assessments under section 6851 (relating to termination assessments of income tax) or section 6861 (relating to jeopardy assessments of income, estate, gift, and certain excise taxes),*
> >
> > *(iii) criminal investigations,*
> >
> > *(iv) indirect methods of proof of income,*
> >
> > *(v) foreign partners or partnerships, and*
> >
> > *(vi) other matters that the Secretary determines by regulation present special enforcement considerations.*

The IRS has announced its intention to issue regulations that deal with two matters under this provision. In these cases, the CPAR regime will not apply to these items and regulations will provide special rules to deal with these issues

The first case involves situations where the examination of a person other than the partnership requires an adjustment to a partnership item. As the Notice explains:

> *Specifically, the regulations will allow the IRS to effectively and efficiently focus on a single partner or a small group of partners with respect to a limited set of partnership-related items without unduly burdening the partnership and avoiding procedural concerns about the appropriate level at which such items must be examined. Consequently, the regulations will provide that the IRS may determine that the centralized partnership audit regime does not apply to adjustments to partnership-related items when the following conditions are met:*
>
> > *(1) The examination being conducted is of a person other than the partnership;*
> >
> > *(2) A partnership-related item must be adjusted, or a determination regarding a partnership-related item must be made, as part of an adjustment to a non-partnership-related item of the person whose return is being examined; and*

(3) The treatment of the partnership-related item on the return of the partnership under section 6031(b) or in the partnership's books and records was based in whole or in part on information provided by, or under the control of, the person whose return is being examined.

The other area mentioned in the Notice involves situations where a QSUB is a partner in a partnership. The IRS argues that special rules are needed in this case for the following reasons:

The regulations will provide that this situation presents special enforcement considerations because partnership structures with QSubs as partners could have far more than 100 ultimate partners, including many thousands, and still potentially elect out of the centralized partnership audit regime. Allowing such a large partnership to elect out of the centralized partnership audit regime would give rise to significant enforcement concerns for the IRS and frustrate the efficiencies introduced by the centralized partnership regime.

Thus, the Notice continues:

As a result, the regulations will provide that section 6221(b) generally does not apply to a partnership with a QSub as a partner. The regulations will also provide, however, that if a partnership meets certain requirements as set forth in the regulations, the partnership may make an election under section 6221(b). Specifically, the regulations will apply a rule similar to the rules for S corporations under section 6221(b)(2)(A). The regulations will also provide that for purposes of determining whether a partnership has 100 or fewer partners for the taxable year for purposes of the election under section 6221(b), the partnership must include (1) the statement the partnership is required to furnish to the QSub partner under section 6031(b) and (2) each statement the S corporation that holds 100 percent of the stock of the QSub partner is required to furnish to its shareholders under section 6037(b).

The Notice provides the following information about the expected timing of the release of the regulations:

The Treasury Department and the IRS intend to issue proposed and final regulations prior to eighteen months after enactment of the TTCA such that the intended regulations described in this section of the Notice may be applicable to all partnership taxable years beginning after December 31, 2017. Section 7805(b)(2). If final regulations are not issued prior to eighteen months after enactment of the TTCA, the Treasury Department and the IRS intend the regulations to be applicable to partnership taxable years beginning after December 31, 2017 and ending after the date this Notice is issued to the public. Section 7805(b)(1)(C).

Section: 6662
Annual Disclosure Revenue Procedure Updated by IRS

Citation: Revenue Procedure 2019-9, 12/20/18

The IRS has updated its annual disclosure revenue procedure (Revenue Procedure 2019-9). Proper disclosure can prevent imposition of various penalties imposed on taxpayers (IRC §§6662(b)(2), (h), (i) and (j)) and on tax preparers (IRC §6694).

The procedure provides:

In general, this revenue procedure provides guidance for determining when disclosure by return is adequate for purposes of section 6662(d)(2)(B)(ii) and section 6694(a)(2)(B). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable.

Normally such disclosures will be required to be made on a Form 8275 or Form 8275-R, with this procedure providing for specific exception. As the procedure indicates:

> *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.*

Special rules apply to corporations required to file a Schedule UTP (*Uncertain Tax Position Statement*):

> *A complete and accurate disclosure of a tax position on the appropriate year's Schedule UTP, Uncertain Tax Position Statement, will be treated as if the corporation filed a Form 8275 or Form 8275-R regarding the tax position. The filing of a Form 8275 or Form 8275-R, however, will not be treated as if the corporation filed a Schedule UTP.*

The procedure does not made any significant changes to the provisions found in the prior year's version (Revenue Procedure 2018-11. As Section 2 notes:

> *Editorial changes have been made throughout this revenue procedure. In addition, minor changes have been made in order to update the taxable years and tax forms to which this revenue procedure applies. No additional substantive changes have been made.*