Guam Society of CPAs
August 21, 2024
Federal Tax Update

1. Moore v. United States, 22-800 U.S. (2024)
2. Secure 2.0 provisions taking effect in 2023 and 2024
3. Overview of the Federal Tax System As In Effect For 2024—Joint Committee on Taxation
4. United Therapeutics v. Commissioner, 133 AFTR 2d 2024 (4th Cir.)—Research Tax Credit
5. In Re: Lee,133 AFTR 2d 2024 (Bankruptcy Court)—Tax Claims
6. In Re: Tampa Hyde Park Café Properties, 133 AFTR 2d 2024-1701 (Bankruptcy Court)—Tax claims-Objection to proof-Alter Ego Theory
7. Friedman v. IRS, 133 AFTR 2d 2024-1663 (Dist. Ct. Wash)—Actions against IRS and IRS Commissioner—proper defendant—damages
8. Cobai v United States, 133 AFTR 2d 2024-1636 (Dist. Ct. Calif)—Refund actions—administrative claims
9. Aguinaldo v. Yee, 133 AFTR 2d 2024-1604 (Dist. Hawaii)—Actions against U.S.—constitutional claims
10. United States v. Eaton Corp., 133 AFTR 2d 2024-1554 (Dist. Ct. Ohio)—Summons enforcement—procedure
11. Cognizant Technology Solutions v. United States, 133 AFTR 2d 2024-1498 (Dist. Ct. New Jersey)—District Court procedure—qui tam suits—False Claims Act—subpoenas—Administrative Procedure Act
12. Foley v. Commissioner, 95 F.4th 740 (2nd Cir. 2024)—Appeals from Tax Court—jurisdiction—small tax case
13. Farhy v. Commissioner, 133 AFTR 2d 2024-1462 (D.C. Cir.)—Information reporting penalties regarding foreign entities—assessment; IRS authority—collection due process
14. Watson v. Commissioner, 133 AFTR 2d 2024-1621 (10th Cir.)—Appeals from Tax Court—jurisdiction
15. United States v. Allahyari, 133 AFTR 2d 2024-1365 (9th Cir.)—Collection actions—lien foreclosure and priority—fraudulent transfers—appeals—jurisdiction
16. Notice 2023-42 Failure to pay corporate estimated tax penalties—corporate alternative minimum tax—waivers
17. Notice 2023-54 Employee benefit plans—required minimum distributions
18. Notice 2023-55 Foreign tax credit—determination of foreign income taxes—temporary relief
19. Notice 2023-59 Energy efficient home improvement credit—home energy audits—requirements and procedure for claiming credit
20. Notice 2023-62 Catch-up contributions—designation of contributions
21. Notice 2023-69 Gross income—leave-based donation programs—Hawaii wildfires

[File: H:\WS\LETTERS\9965-624 GUAM FEDERAL TAX UPDATE.DOCX]

52. Ninke v. Commissioner of Internal Revenue, T.C. Memo 2023-88
53. Lesson from The Tax Court: Gotta Get Physical for Casualty Loss Deduction
54. Cleary v. Commissioner of Internal Revenue, T.C. Memo 2023-43
55. Lesson from The Tax Court: Tax Consequence for Discharge of Non-Recourse Debt
56. Parker v. Commissioner of Internal Revenue, T.C. Memo 2023-104
57. Lesson from The Tax Court: The DOI Downside to Disregarded LLC
58. Jacobowitz v. Commissioner of Internal Revenue, T.C. Memo 2023-107
59. Lesson from The Tax Court: The Boundary Waters of Equity
60. Evenhouse v. Commissioner of Internal Revenue, T.C. Memo 2023-113
61. Lesson from the Tax Court: Equitable Tolling During Government Shutdown
62. Organic Cannabis Foundation v. Commissioner of Internal Revenue, 161 T.C. No. 4 (2023)
    General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals ["Green Book"]
63. Reform Business Taxation
64. Reform International Taxation
65. Strengthen Taxation of High-Income Taxpayers
66. Modify Rules Relating to Retirement Plans
67. Support Workers, Families, and Economic Security
68. Modify Estate and Gift Taxation
69. Close Loopholes
70. Improve Tax Administration
71. Improve Tax Compliance
72. Treasury Decision 9980 Identifying numbers—fee for obtaining preparer tax identification number
73. Treasury Decision 9981 Private foundation defined—supporting orgs.
74. Treasury Decision 9984 Penalties for failure to file correct information returns or furnish correct payee statements—de minimis safe harbor—broker returns—final regs.
75. Treasury Decision 9996 Generation-skipping transfer taxes—elections and extensions—final regs.
76. Lesson from The Tax Court: The Designated Payment Rule
77. Edwards v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-29
78. Lesson from The Tax Court: The Limits of Collection Due Process
79. Olson v. Commissioner of Internal Revenue, T.C. Memo 2023-123
80. Lesson from The Tax Court: The Rules for Penalty Approval Depend on Geography
81. Kraske v. Commissioner of Internal Revenue, 161 T.C. No. 7 (2023)
82. Lesson from The Tax Court: Section 6662 Is Sometimes Multiple Penalties For Supervisory Approval Purposes But Sometimes Not
83. Kelley v. Commissioner of Internal Revenue, T.C. Memo 2023-126
84. Lesson from The Tax Court: Merely Winning Does Not Entitle Taxpayer to Attorney Fees

85. Champions Retreat Golf Founders v. Commissioner of Internal Revenue, T.C. Memo 2023-143

Syllabus

SUPREME COURT OF THE UNITED STATES

Syllabus

MOORE ET UX. *v.* UNITED STATES

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 22–800. Argued December 5, 2023—Decided June 20, 2024

Congress generally taxes the income of American business entities in one of two ways. Some entities, such as S corporations and partnerships, are taxed on a pass-through basis, where the entity itself does not pay taxes. 26 U. S. C. §§1361–1362. Instead, the entity's income is attributed to the shareholders or partners, who then pay taxes on that income even if the entity has not distributed any money or property to them. §§61(a)(12), 701, 1366(a)–(c). Other business entities do pay taxes directly on their income. Those entities' shareholders ordinarily are not taxed on that income but are taxed when the entity distributes a dividend or when the shareholder sells shares.

Congress treats American-controlled foreign corporations as pass-through entities. Subpart F of the Internal Revenue Code attributes income of those business entities to American shareholders and taxes those shareholders on that income. §§951–952. Subpart F, however, applies only to a small portion of the foreign corporation's income, mostly passive income. In 2017, Congress passed the Tax Cuts and Jobs Act. As relevant here, Congress imposed a one-time, backward-looking, pass-through tax on some American shareholders of American-controlled foreign corporations to address the trillions of dollars of undistributed income that had been accumulated by those foreign corporations over the years. Known as the Mandatory Repatriation Tax, the tax imposed a rate from 8 to 15.5 percent on the pro rata shares of American shareholders. §§965(a)(1), (c), (d).

In this case, petitioners Charles and Kathleen Moore invested in the American-controlled foreign corporation KisanKraft. From 2006 to 2017, KisanKraft generated a great deal of income but did not distribute that income to its American shareholders. At the end of the 2017 tax year, application of the new MRT resulted in a tax bill of

$14,729 on the Moores' pro rata share of KisanKraft's accumulated income from 2006 to 2017. The Moores paid the tax and then sued for a refund, claiming, among other things, that the MRT violated the Direct Tax Clause of the Constitution because, in their view, the MRT was an unapportioned direct tax on their shares of KisanKraft stock. The District Court dismissed the suit, and the Ninth Circuit affirmed.

Held: The MRT—which attributes the realized and undistributed income of an American-controlled foreign corporation to the entity's American shareholders, and then taxes the American shareholders on their portions of that income—does not exceed Congress's constitutional authority. Pp. 5–24.

(a) Article I of the Constitution affords Congress broad power to lay and collect taxes. That power includes direct taxes—those imposed on persons or property—and indirect taxes—those imposed on activities or transactions. Direct taxes must be apportioned among the States according to each State's population, while indirect taxes are permitted without apportionment but must "be uniform throughout the United States," §8, cl. 1. Taxes on income are indirect taxes, and the Sixteenth Amendment confirms that taxes on income need not be apportioned. Pp. 5–7.

(b) The Government argues that the MRT is a tax on income and therefore need not be apportioned. The Moores contend that the MRT is a tax on property and that the tax is therefore unconstitutional because it is not apportioned. Income, the Moores argue, requires realization, and the MRT does not tax any income that they have realized. But the MRT *does* tax realized income—namely, the income realized by KisanKraft, which the MRT attributes to the shareholders. This Court's longstanding precedents, reflected in and reinforced by Congress's longstanding practice, confirms that Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners and then tax the shareholders or partners on their portions of that income. Pp. 8–16.

(1) The Court's longstanding precedents plainly establish that, when dealing with an entity's undistributed income, Congress may either tax the entity or tax its shareholders or partners. Whichever method Congress chooses, this Court has held that the tax remains a tax on income. In *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110, the Court held that the status of a business entity under state law could not limit Congress's power to tax a partnership's income as it chose, taxing either the partnership or the partners. *Id.*, at 114. The Court reiterated that principle in *Burnet* v. *Leininger*, 285 U. S. 136. Then, in *Heiner* v. *Mellon*, 304 U. S. 271, the Court reaffirmed that Congress may choose to tax either the partnership *or* the partners on the partnership's undistributed income, even where state law did not

allow the partners to personally receive the income. The principle articulated in *Heiner* also applies to corporations and their shareholders. *Helvering* v. *National Grocery Co.*, 304 U. S. 282. This line of precedents remains good law and establishes the clear principle that Congress can attribute the undistributed income of an entity to the entity's shareholders or partners and tax the shareholders or partners on their pro rata share of the entity's undistributed income. Notably, the principle has repeatedly been invoked by the lower courts in upholding subpart F.

The Moores' reliance on *Eisner* v. *Macomber*, 252 U. S. 189, which predates the *Heiner* and *Helvering* line of cases, is misplaced. There the question was whether a distribution of additional stock to all existing shareholders was taxable income. The Court said no, that income requires realization and that there was no change in the value of the shareholders' total stock holdings in the corporation before and after the stock distribution. The Court said separately in dicta that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." 252 U. S., at 219. The Moores' interpret that language to mean that a tax attributing an entity's undistributed income to its shareholders or partners is not an income tax. The clear and definitive holdings in *Burk-Waggoner Oil*, *Heiner*, and *Helvering* render the Moores' reading of *Eisner* implausible. Those cases squarely addressed attribution and allowed it, whereas *Eisner* did not address attribution. Pp. 9–14.

(2) Congress's longstanding practice of taxing the shareholders or partners of a business entity on the entity's undistributed income reflects and reinforces the Court's precedents. For example, Congress passed an 1864 income-tax law that taxed shareholders or partners on "the gains and profits of all companies." 13 Stat. 282. In 1913, Congress enacted a new income tax that, among other things, taxed partners on their "share of the profits of a partnership." 38 Stat. 169. As new business entities arose, Congress employed a similar approach to S corporations, 26 U. S. C. §§1361–1362; American shareholders of foreign business entities, 50 Stat. 822; and American shareholders of American-controlled foreign corporations, 26 U. S. C. §§951, 952, 957. Pp. 14–16.

(c) The Moores attempt to distinguish the MRT from those taxes long imposed by Congress and long upheld by this Court and argue that only the MRT is unconstitutional. Their ad hoc distinctions do not undermine the clear rule established by this Court's precedents. First, the Moores argue that taxes on partnerships are distinguishable from the MRT and not controlled by precedent because partnerships are not separate entities from their partners. But that assertion is incorrect. When the Sixteenth Amendment was ratified, the courts, Congress, and state legislatures treated partnerships as separate entities in many contexts, and numerous States imposed taxes directly on partnerships for partnership income. The federal and state treatment of partnerships as separate legal entities for tax purposes contravenes the Moores' theory. Second, the Moores argue that taxes on S corporations are distinguishable from the MRT because shareholders of S corporations choose to be taxed directly on corporation income. But consent cannot explain Congress's authority to tax the shareholders of S corporations directly on corporate income. Rather, S corporations are another example of Congress's authority to either tax the corporation itself on corporate income or attribute the undistributed income to the shareholders and tax the shareholders. Third, the Moores try to distinguish Congress's long history of taxing shareholders of closely held foreign corporations—including through subpart F—on the ground that those laws apply "the doctrine of constructive realization." That term seems to be a one-off label created by the Moores to allow them to sidestep any existing tax that does not comport with their proposed constitutional rule. In any event, the Moores' constructive-realization theory does not distinguish the MRT from subpart F and other pass-through taxes. For example, the Moores claim that constructive realization turns on a sufficient degree of control over the entity. But the level of shareholder control with the MRT (at least 10 percent) is the same as under the longstanding subpart F tax. And if, as the Moores concede, subpart F is not unconstitutional under the "constructive realization" theory, then the MRT is likewise not unconstitutional on that theory. Pp. 16–22.

(d) The Court's holding is narrow and limited to entities treated as pass-throughs. Nothing in this opinion should be read to authorize any hypothetical congressional effort to tax both an entity and its shareholders or partners on the same undistributed income realized by the entity. Nor does this decision attempt to resolve the parties' disagreement over whether realization is a constitutional requirement for an income tax. Pp. 22–24.

36 F. 4th 930, affirmed.

KAVANAUGH, J., delivered the opinion of the Court, in which ROBERTS, C. J., and SOTOMAYOR, KAGAN, and JACKSON, JJ., joined. JACKSON, J., filed a concurring opinion. BARRETT, J., filed an opinion concurring in the judgment, in which ALITO, J., joined. THOMAS, J., filed a dissenting opinion, in which GORSUCH, J., joined.

SUPREME COUNT OF THE UNITED STATES

No. 22–800

CHARLES G. MOORE, ET UX., PETITIONERS *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 20, 2024]

JUSTICE KAVANAUGH delivered the opinion of the Court.

For tax purposes, Congress has long treated some corporations and partnerships as pass-throughs: Congress does not tax the entity on its income, but instead attributes the undistributed income of the entity to the shareholders or partners and then taxes the shareholders or partners on that income. This Court has long upheld those taxes.

Since 1962, Congress has likewise treated American-controlled foreign corporations as pass-throughs. That 1962 law (known as subpart F) attributes certain income, mostly passive income, of American-controlled foreign corporations to their American shareholders and then taxes those shareholders on that income.

In 2017, Congress enacted a new law that attributes more income, including active business income, of American-controlled foreign corporations to their American shareholders and then taxes those shareholders on that income. The question is whether that 2017 tax (known as the Mandatory Repatriation Tax or MRT) is constitutional under Article I, §§8 and 9 and the Sixteenth Amendment. This Court's longstanding precedents establish that the answer is yes.

I

A

In general, Congress taxes the income of American business entities such as corporations and partnerships in one of two ways.

First, some entities such as S corporations and partnerships are taxed on a pass-through basis. (S corporations are corporations with 100 or fewer shareholders where the shareholders have elected to be taxed on a pass-through basis. 26 U. S. C. §§1361–1362.) Instead of the entity itself paying taxes, income is attributed to the entity's owners, such as shareholders or partners, who then pay taxes on the income of the entity even if the entity has not distributed any money or property to them. §§61(a)(12), 701, 1366(a)–(c).

Second, other entities are taxed directly on their income. For example, some corporations file a return and pay taxes each year just like individual taxpayers. §11(a). When a corporation pays taxes on its income, its shareholders are ordinarily not taxed on that income. Instead, the shareholders typically pay taxes either when the corporation distributes money, stock, or other property to them as a dividend or when the shareholders sell their shares and have capital gains. §§61(a)(7), 1001. But the shareholders are not taxed on the corporate income itself.

Congress has devised more nuanced rules for foreign entities such as foreign corporations. For legal and practical reasons, Congress generally does not directly tax foreign corporations, including American-controlled foreign corporations, on the income that they earn outside of the United States. Instead, Congress has imposed some taxes on income of those corporations on a pass-through basis.

Most notably, starting in 1962, in what is known as subpart F of the Internal Revenue Code, Congress has treated American-controlled foreign corporations as pass-through entities: Subpart F attributes income of the corporation to American shareholders, and taxes those American shareholders on that income. 26 U. S. C. §§951–952. But subpart F applies only to a small portion of the foreign corporation's income, mostly passive income.

In 2017, Congress passed and President Trump signed the Tax Cuts and Jobs Act. 131 Stat. 2054. In a variety of ways not relevant to this case, the Act altered the United States' approach to international corporate taxation. The primary goal was to encourage Americans who controlled foreign corporations to invest earnings from their foreign investments back in the United States instead of abroad.

As relevant here, one piece of that intricate and multifaceted 2017 Act imposed a new, one-time pass-through tax on some American shareholders of American-controlled foreign corporations. That one-time tax addressed one of the problems that had arisen under the old system: For decades before the 2017 Act, American-controlled foreign corporations had earned and accumulated trillions of dollars in income abroad that went almost entirely untaxed by the United States. The foreign corporations themselves were not taxed on their income. And other than subpart F, which applies mostly to passive income, the undistributed income of those foreign corporations was not attributed to American shareholders for the shareholders to be taxed.

As part of the complicated transition to a more territorial system, the 2017 Act imposed a one-time, backward-looking tax on that accumulated income. That backward-looking tax is known as the Mandatory Repatriation Tax or MRT. §965. Similar in structure to subpart F, the MRT attributed the long-accumulated and undistributed income of American-controlled foreign corporations to American shareholders, and then taxed those American shareholders on their pro rata shares of that long-accumulated income at a rate from 8 to 15.5 percent. §§965(a), (c), (d).[1]

---

[1] The Act also imposed a similar pass-through tax going forward.

B

In 2006, Charles and Kathleen Moore invested $40,000 in an American-controlled foreign corporation that one of their friends had started in India. In return, the Moores received a 13-percent ownership share. The company, KisanKraft, generated a great deal of income. But as of 2017, KisanKraft had not distributed that income to its American shareholders, including the Moores, meaning that neither KisanKraft nor the Moores had paid U. S. taxes on that income.

The MRT applied to the Moores because of their investment in KisanKraft. By the end of the 2017 tax year, the Moores' pro rata share of KisanKraft's accumulated income from 2006 to 2017 totaled about $508,000. After factoring in a deduction that is not relevant here, the Moores declared $132,512 in income under the MRT based on their KisanKraft shares. They owed $14,729 in taxes on that income.

The Moores paid that amount, then sued for a refund. They claimed that the MRT was unconstitutional for two reasons. First, they argued that the MRT violated the Direct Tax Clause of the Constitution because, in their view, the MRT was an unapportioned direct tax on their shares of KisanKraft stock. Second, they contended that the MRT violated the Due Process Clause of the Fifth Amendment because it applied retroactively to past income.

The District Court dismissed the suit, and the U. S. Court of Appeals for the Ninth Circuit affirmed. The Court of Appeals held that the MRT constitutes a tax on income within the meaning of the Constitution because "KisanKraft earned significant income, and the MRT assigns only a pro-rata share of that income to the Moores." 36 F. 4th 930, 936–937 (2022). The Court of Appeals also

---

§951A. That tax applies to what is referred to as "global intangible low-taxed income." §951A(a). That tax is not at issue in this case.

rejected the Moores' due process claim regarding retroactivity. *Id.*, at 938–939.

The Moores sought review in this Court, raising only their Direct Tax Clause argument. This Court granted certiorari. 599 U. S. ___ (2023).

II

We must decide whether the 2017 Mandatory Repatriation Tax, or MRT, exceeds Congress's constitutional authority. To analyze that question, we begin with a brief review of Congress's taxing power under the Constitution.

After Independence in 1776 and under the Articles of Confederation in effect from 1781 to 1789, the Federal Government relied primarily on contributions from the States for revenue. The Federal Government's expenses and needs sometimes far outpaced the contributions that the States were willing to provide. As George Washington famously recognized during the Revolutionary War, reliance on the States to fund the National Government hampered important national priorities—including the war against the British. 12 Papers of George Washington: Revolutionary War Series 683–687 (P. Chase & F. Grizzard eds. 2002) (letter from Valley Forge).

The National Government's continuing revenue problems under the Articles of Confederation helped prompt the Constitutional Convention that convened in Philadelphia in the summer of 1787. The Federalist No. 30 (A. Hamilton). The Framers responded to the revenue problem by granting Congress an expansive taxing power.

Article I of the Constitution affords Congress broad "Power To lay and collect Taxes, Duties, Imposts and Excises." Art. I, §8, cl. 1. That power includes "'two great classes of'" taxes—direct taxes and indirect taxes. *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 13 (1916).

Generally speaking, *direct* taxes are those taxes imposed on persons or property. See *National Federation of Independent Business* v. *Sebelius*, 567 U. S. 519, 570–571 (2012). As a practical matter, however, Congress has rarely enacted direct taxes because the Constitution requires that direct taxes be apportioned among the States. To be apportioned, direct taxes must be imposed "in Proportion to the Census of Enumeration." U. S. Const., Art. I, §9, cl. 4; see also §2, cl. 3. In other words, direct taxes must be apportioned among the States according to each State's population.

So if Congress imposed a property tax on every American homeowner, the citizens of a State with five percent of the population would pay five percent of the total property tax, even if the value of their combined property added up to only three percent of the total value of homes in the United States. To pay five percent, the tax rate on the citizens of that State would need to be substantially higher than the tax rate in a neighboring State with the same population but more valuable homes.

To state the obvious, that kind of complicated and politically unpalatable result has made direct taxes difficult to enact. Indeed, the parties have cited no apportioned direct taxes in the current Internal Revenue Code, and it appears that Congress has not enacted an apportioned tax since the Civil War. See 12 Stat. 297; E. Jensen, The Taxing Power: A Reference Guide to the United States Constitution 89 (2005).

By contrast, *indirect* taxes are the familiar federal taxes imposed on activities or transactions. That category of taxes includes duties, imposts, and excise taxes, as well as income taxes. U. S. Const., Art. I, §8, cl. 1; Amdt. 16. Under the Constitution, indirect taxes must "be uniform throughout the United States." Art. I, §8, cl. 1. A "'tax is uniform when it operates with the same force and effect in every place where the subject of it is found.'" *United States* v. *Ptasynski*, 462 U. S. 74, 82 (1983).

Because income taxes are indirect taxes, they are permitted under Article I, §8 without apportionment. As this Court has said, Article I, §8's grant of taxing power "is exhaustive," meaning that it could "never" reasonably be "questioned from the" Founding that it included the power "to lay and collect income taxes." *Brushaber*, 240 U. S., at 12–13. In 1861, Congress enacted the Nation's first unapportioned income tax. 12 Stat. 309. The Civil War income tax was recognized as an indirect tax "under the head of excises, duties and imposts." *Brushaber*, 240 U. S., at 15; see also *Springer* v. *United States*, 102 U. S. 586, 598, 602 (1881).

In 1895, however, in *Pollock* v. *Farmers' Loan & Trust Co.*, this Court held that a tax on income from property equated to a tax on the property itself, and thus was a direct tax that had to be apportioned among the States. 158 U. S. 601, 627–628. The *Pollock* decision sparked significant confusion and controversy throughout the United States.

Congress and the States responded to *Pollock* by approving a new constitutional amendment. Ratified in 1913, the Sixteenth Amendment rejected *Pollock*'s conflation of (i) income from property and (ii) the property itself. The Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, *from whatever source derived*, without apportionment among the several States, and without regard to any census or enumeration." U. S. Const., Amdt. 16 (emphasis added).

Therefore, the Sixteenth Amendment expressly confirmed what had been the understanding of the Constitution before *Pollock*: Taxes on income—including taxes on income from property—are indirect taxes that need not be apportioned. *Brushaber*, 240 U. S., at 15, 18. Meanwhile, property taxes remain direct taxes that must be apportioned. See *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371, 378–379 (1934).

III

With that background, we turn to the 2017 Mandatory Repatriation Tax. The MRT is not apportioned among the States. The Government argues that the MRT is a tax on income and therefore need not be apportioned. The Moores contend that the MRT is a tax on property, rather than a tax on income, and that the tax is therefore unconstitutional because it is not apportioned.

What distinguishes income from property? The Moores argue that income requires realization. The Moores say that realization occurs when gains come into the taxpayer's coffers—for example, through wages, sales, or dividends, as distinct from appreciation in the value of a home, stock investment, or other property. And the Moores contend that the MRT does not tax any income that they have realized.

Critically, however, the MRT *does* tax realized income—namely, income realized by the corporation, KisanKraft. The MRT attributes the income of the corporation to the shareholders, and then taxes the shareholders (including the Moores) on their share of that undistributed corporate income.

So the precise and narrow question that the Court addresses today is whether Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income. This Court's longstanding precedents, reflected in and reinforced by Congress's longstanding practice, establish that the answer is yes.[2]

---

[2] As discussed below, *infra*, at 22–24, our analysis today does not address the distinct issues that would be raised by (i) an attempt by Congress to tax both the entity and the shareholders or partners on the entity's undistributed income; (ii) taxes on holdings, wealth, or net worth; or (iii) taxes on appreciation.

A

Congress sometimes chooses to tax a business entity itself on the income that the entity earns. Alternatively, Congress sometimes elects to treat an entity as a pass-through—attributing the entity's undistributed income to the shareholders or partners and then taxing the shareholders or partners on that income. Either way, this Court has held that the tax remains a tax on income—and thus an indirect tax that need not be apportioned.

In 1925, in *Burk-Waggoner Oil Assn.* v. *Hopkins*, the Court articulated that fundamental principle. 269 U. S. 110. The case involved a tax on the income of an entity that state law treated as a partnership. Under state law, the partnership's property was considered the property of the partners. For that reason, the partnership argued that Congress had to tax the partners on the income and could not tax the partnership.

This Court rejected that argument. The Court stated: "Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed." *Id.*, at 114. In other words, Congress could tax the income as it chose, taxing either the partnership or the partners on the partnership's undistributed income. So the tax on the partnership was proper.

In 1932, in *Burnet* v. *Leininger*, the Court reiterated that principle. 285 U. S. 136. There, the Court considered "the validity" of a tax attributing partnership income to partners. *Id.*, at 142. The Court again held that "Congress, having the authority to tax the net income of partnerships, could impose the liability upon the partnership directly," or it could impose tax liability "upon the individuals carrying on business in partnership." *Ibid.* (quotation marks omitted).

Next, in 1938 in *Heiner* v. *Mellon*, the Court again addressed a situation closely akin to the Moores' case here—a tax on partners for the undistributed income of their partnership. 304 U. S. 271. In that case, the partnership earned income, but state law did not allow the partners to personally receive the income. Nonetheless, under the relevant federal tax law, the individual partners owed taxes on the partnership's income. The partners argued that Congress could not tax them on income that they did not and could not personally receive.

This Court upheld the tax on the partners, reasoning that it was immaterial that the partners did not actually receive the income earned by the partnership. The Court reaffirmed that Congress may choose to tax either the partnership *or* the partners on the partnership's undistributed income.

The principle articulated by this Court in *Heiner* v. *Mellon* also applies to corporations and their shareholders. On the same day in 1938 that the Court decided *Heiner* v. *Mellon*, the Court also decided *Helvering* v. *National Grocery Co.* In that case, the Court ruled that the controlling shareholder of a corporation could not "prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits." 304 U. S. 282, 288. Citing *Heiner* v. *Mellon*, the Court stated that Congress may tax shareholders of the corporation on the corporation's undistributed income, in much the same way that Congress can tax the partners of a partnership on the partnership's undistributed income. 304 U. S., at 288–289.

So by 1938, this Court's precedents had established a clear rule that directly contradicts the Moores' argument in this case. That line of precedent remains good law to this day. Indeed, since then, it has gone without serious question in both Congress and the federal courts that Congress can attribute the undistributed income of an entity to the entity's shareholders or partners, and tax the shareholders or partners on their pro rata share of the entity's undistributed income.

Most notably, the courts have repeatedly invoked that principle in upholding subpart F, which Congress enacted in 1962. Like the MRT, subpart F treats certain foreign corporations as pass-throughs by attributing undistributed income of foreign corporations to their American shareholders, and then taxing the American shareholders on their pro rata shares of the income. As the Second Circuit concluded in a leading case upholding subpart F: The constitutional challenge to subpart F "borders on the frivolous" in light of *Heiner* v. *Mellon*. *Garlock, Inc.* v. *Commissioner*, 489 F. 2d 197, 202–203, and n. 5 (1973); see also *Estate of Whitlock* v. *Commissioner*, 59 T. C. 490, 507 (1972) (The "Supreme Court's pronouncements have been to the effect that taxation of undistributed current corporate income at the stockholder level rather than at the corporate level is within the congressional power"), aff'd in relevant part, 494 F. 2d 1297, 1301 (CA10 1974) (adopting the Tax Court's analysis); B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts ¶1.2.4 (2024) (noting the consensus in favor of Congress's power to tax foreign corporations as pass-through businesses); cf. *Eder* v. *Commissioner*, 138 F. 2d 27, 28 (CA2 1943) ("In a variety of circumstances it has been held that the fact that the distribution of income is prevented by operation of law, or by agreement among private parties, is no bar to its taxability").

In response to that dispositive line of precedents against them, the Moores invoke the Court's earlier 1920 decision in *Eisner* v. *Macomber*, 252 U. S. 189. The Moores argue that some language in *Eisner* v. *Macomber* is inconsistent with the rule subsequently established in *Burk-Waggoner Oil Assn.* v. *Hopkins*, *Heiner* v. *Mellon*, and *Helvering* v. *National Grocery Co.* and followed ever since by Congress and the federal courts.

The Moores' reliance on *Eisner* v. *Macomber* with respect to the attribution issue is misplaced. Importantly, *Eisner* v. *Macomber* was *not* a case about Congress's power to attribute the income of an entity to the entity's shareholders or partners. Rather, the Court in *Eisner* v. *Macomber* addressed a situation where a corporation created and distributed additional stock to existing shareholders. 252 U. S., at 200. The corporation distributed the additional shares of stock in proportion to each shareholder's percentage of ownership. *Id.*, at 210–211. So the actual value of the shareholders' total stock holdings in the corporation did not change. *Ibid.*

The question in *Eisner* v. *Macomber* was whether the new stock was nonetheless taxable income for the shareholders. *Id.*, at 199. The Court said no. *Id.*, at 212. The Court reasoned that there was no change in the value of the shareholders' total stock holdings in the corporation before and after the stock distribution. *Id.*, at 210–211. So the new stock did not represent any kind of economic gain to the shareholders. *Ibid.* And the Court further stated that income requires realization. *Id.*, at 207, 211–212. Yet neither the corporation nor the shareholders had realized income from the corporation's creation and distribution of additional stock. *Id.*, at 210–213.[3]

---

[3] The Government argues that a gain does not need to be realized to constitute income under the Constitution. The Government contends that *Eisner* v. *Macomber*'s discussion of realization was dicta because the stock dividend did not represent any kind of economic gain (realized *or* unrealized) for the shareholders. The Government further contends that *Eisner* v. *Macomber*'s discussion of realization has, in any event, been abrogated by later decisions of this Court, such as *Helvering* v. *Bruun*, 309 U. S. 461 (1940), *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), and *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426 (1955). Because the MRT taxes realized income—namely, income realized by the corporation and attributed to the shareholders—we do not address the Government's argument that a gain need not be realized to constitute income under the

Separate from that analysis, the Court went on to say in dicta that "what is called the stockholder's share in the accumulated profits of the company is capital, not income." *Id.*, at 219. Because the corporation had already paid taxes on its income, that statement and the surrounding discussion may have been designed to cast doubt on the legality of double taxation—taxing both the corporation and its shareholders on the corporation's undistributed income. See, *e.g.*, Brief for American College of Tax Counsel as *Amicus Curiae* 16–17; Brief for Tax Law Center at NYU Law et al. as *Amici Curiae* 6–7.

But the Moores interpret that language in *Eisner* v. *Macomber* to mean that a tax attributing an entity's undistributed income to its shareholders or partners is not an income tax. The Moores' reading is implausible. The Court in *Eisner* v. *Macomber* did not purport to address attribution, no doubt because the tax at issue there did not attribute income of the corporation to the shareholders. And if there were any ambiguity on that point, it was quickly eliminated by this Court's clear and definitive holdings in *Burk-Waggoner Oil Assn.* v. *Hopkins*, *Heiner* v. *Mellon*, and *Helvering* v. *National Grocery Co.* In those three cases, unlike in *Eisner* v. *Macomber*, the Court squarely addressed attribution—and allowed it. None of those cases so much as mentioned *Eisner* v. *Macomber*, which is not surprising because, to reiterate, *Eisner* v. *Macomber* did not address attribution. So whatever else *Eisner* v. *Macomber* might stand for, it does not proscribe attribution and thus has no bearing on the attribution issue in this case.

To sum up: The Court's longstanding precedents plainly establish that, when dealing with an entity's undistributed income, Congress may tax either (i) the entity or (ii) its

---

Constitution. See also *infra*, at 22–24.

shareholders or partners.[4]

B

Consistent with this Court's case law, Congress has long taxed the shareholders and partners of business entities on the entities' undistributed income. That longstanding congressional practice reflects and reinforces this Court's precedents upholding those kinds of taxes.

In 1864, for example, Congress passed and President Lincoln signed an income-tax law that taxed individuals on "the gains and profits of all companies, whether incorporated or partnership," in which they were shareholders or partners. 13 Stat. 282. In 1871, the Court upheld the constitutionality of that tax. *Collector* v. *Hubbard*, 12 Wall. 1, 18.[5]

In 1913, soon after the Sixteenth Amendment was ratified, Congress enacted a new income tax on shareholders for their share of the incomes of corporations formed or used to evade taxes. 38 Stat. 166. That 1913 law also taxed partners on each partner's "share of the profits of a partnership." *Id.*, at 169. As explained above, the Court upheld that approach to partnership taxation in *Burnet* v. *Leininger*, 285 U. S., at 142, and *Heiner* v. *Mellon*, 304 U. S., at 280. Ever since that 1913 law and those cases, the basic partnership-tax rule has been settled: It "is axiomatic that each partner must pay taxes on his

[4] The Government acknowledges that there are due process limits on attribution to ensure that the attribution is not arbitrary—for example, limits based on the taxpayer's relationship to the underlying income. Tr. of Oral Arg. 66–67, 96–97; see also *Burnet* v. *Wells*, 289 U. S. 670, 678–679 (1933). In this Court, the Moores have not raised a due process issue regarding the attribution of KisanKraft's income to them.

[5] This Court's 1895 decision in *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, later proscribed unapportioned federal taxation of income from property, and therefore overruled that holding of *Hubbard*. See *supra*, at 7. But in 1913, the Sixteenth Amendment then overruled that aspect of *Pollock*.

distributive share of the partnership's income without regard to whether that amount is actually distributed to him." *United States* v. *Basye*, 410 U. S. 441, 453 (1973).

As new kinds of corporate entities arose, Congress employed a similar approach. For example, in the 1918 Revenue Act, Congress decided to tax shareholders of personal service corporations—that is, shareholders of closely held corporations that earn most of their income from the work of their principal owners and shareholders—"in the same manner as the members of partnerships." 40 Stat. 1070.

And since 1958, the Internal Revenue Code has also taxed the shareholders of S corporations in the same way as partnerships—by taxing the shareholders on their share of the undistributed income of the corporation. See *Bufferd* v. *Commissioner*, 506 U. S. 523, 524–525 (1993). S corporations are corporations with 100 or fewer shareholders where the shareholders have elected to be taxed directly on the corporate income. 26 U. S. C. §§1361–1362. A majority of the corporations in the United States are S corporations, so the taxation of individual shareholders of S corporations is widespread.

In addition, Congress has long taxed major American shareholders of *foreign* business entities on some of the income of those entities. For example, in 1937, Congress taxed American shareholders of foreign personal holding companies on those companies' undistributed income. 50 Stat. 822.

And in 1962, Congress enacted subpart F, which remains in place to this day. 76 Stat. 1006, 26 U. S. C. §951 *et seq.* To reiterate, subpart F taxes American shareholders of American-controlled foreign corporations on several kinds of undistributed corporate income, mostly passive income. §§951, 952, 957. And as noted above, in light of this Court's precedents, the Courts of Appeals have uniformly rejected constitutional challenges to subpart F. See *Garlock*, 489

F. 2d, at 202–203, and n. 5 (the constitutional challenge to subpart F "borders on the frivolous" in light of *Heiner* v. *Mellon*); *Estate of Whitlock*, 494 F. 2d, at 1301.

In short, before and after ratification of the Sixteenth Amendment, Congress has often taxed the shareholders or partners of a business entity on the entity's undistributed income. Such a "[l]ong settled and established practice" can carry "great weight in" resolving constitutional questions—and here it reflects and reinforces this Court's precedents. *Chiafalo* v. *Washington*, 591 U. S. 578, 592 (2020) (quotation marks omitted); see also *Moore* v. *Harper*, 600 U. S. 1, 32 (2023) (The Court has "long looked to 'settled and established practice' to interpret the Constitution" (quoting *The Pocket Veto Case*, 279 U. S. 655, 689 (1929))); *Walz* v. *Tax Comm'n of City of New York*, 397 U. S. 664, 678 (1970) (An "unbroken practice . . . is not something to be lightly cast aside"); The Federalist No. 37, p. 229 (C. Rossiter ed. 1961) (J. Madison).

IV

The Moores are obviously aware of those longstanding congressional practices and Supreme Court precedents, so they had two choices of how to deal with that stark reality in this Court. They could have argued that all of those taxes are unconstitutional and that all of those precedents should be overruled. Or in an effort to contain the blast radius of their legal theory, they could have tried to distinguish the MRT from those other taxes and argue that only the MRT is unconstitutional. They chose the latter approach.

To be specific: The Moores explicitly concede that partnership taxes, S-corporation taxes, and subpart F taxes are income taxes that are constitutional and need not be apportioned. Tr. of Oral Arg. 9, 48; Brief for Petitioners 50–51. The Moores likewise do not ask the Court to overrule any of the precedents that we have discussed above, which upheld the attribution of entities' undistributed income.

Id., at 49–52.

Instead, the Moores seek to differentiate the MRT from all of those other taxes long imposed by Congress and long upheld by this Court. The Moores have advanced an array of ad hoc distinctions to try to explain why those longstanding taxes are constitutional and why those precedents are correct, and to simultaneously try to explain why those taxes and precedents do not eviscerate their argument that the MRT is unconstitutional. But the Moores' effort to thread that needle, although inventive, is unavailing.

According to the Moores: (1) taxes on partnerships are distinguishable from the MRT and not controlled by precedent because partnerships are not separate entities from their partners; (2) taxes on S corporations are distinguishable from the MRT and not controlled by precedent because shareholders of S corporations choose to be taxed directly on corporate income; and (3) subpart F taxes on American shareholders' portions of undistributed foreign corporate income are distinguishable from the MRT and not controlled by precedent because those taxes apply what the Moores call "constructive realization."

To begin, and perhaps most importantly, the Moores' set of ad hoc distinctions does not undermine the clear rule established by this Court's precedents: Congress can choose either to tax the entity on its income or to tax the entity's shareholders or partners on their share of the entity's undistributed income. *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110, 114 (1925).

In any event, the Moores' attempted distinctions of the various taxes fail on their own terms.

First, the Moores contend that partners can be taxed on a partnership's income only because, as of the time that the Sixteenth Amendment was ratified in 1913, partnerships were not seen as legal entities separate from the partners. But that assertion is incorrect. When the Sixteenth

Amendment was ratified, the courts, Congress, and state legislatures treated partnerships as separate entities in many contexts. See, *e.g.*, *Forsyth* v. *Woods*, 11 Wall. 484, 486 (1871) ("The partnership is a distinct thing from the partners themselves . . . "); W. Cowles, The Firm as a Legal Person, 57 Central L. J. 343 (1903) (citing many additional ratification-era cases); see also H. Black, Law of Income Taxation Under Federal and State Laws 100 (1913) (The "undivided earnings of a partnership . . . properly constitute income of the firm but not of the individual partners"); 30 Stat. 545, 547–548 (1898) (federal bankruptcy law that treated partnerships as separate entities); F. Burdick, Law of Partnership, ch. 3, §1, pp. 85–86 (rev. 2d ed. 1906) (It "is becoming more and more customary for legislation and judicial decisions to treat a partnership as an entity").

During the time period around ratification of the Sixteenth Amendment, moreover, numerous States imposed taxes directly on partnerships for partnership income. 1 S. Rowley, The Modern Law of Partnership §306 (1916); 2 *id.*, §935, at 1295, and n. 1 (collecting 21 state laws); Black 146. And during World War I, Congress enacted the Revenue Act of 1917, which also imposed a tax directly on partnerships. 40 Stat. 303. The federal and state treatment of partnerships as separate legal entities for tax purposes contravenes the Moores' theory that pass-through taxation is inherent in the nature of partnerships rather than a legislative choice.

In short, the Moores are incorrect to claim that partnerships were not historically seen as separate taxable entities.

To be sure, courts declined to recognize partnerships as separate entities in certain common-law contexts. 1 Rowley §118; Burdick, ch. 3, §1. But those cases simply demonstrate that partnerships were (and are) flexible entities that can receive flexible legal treatment. Those cases are consistent with the longstanding principle recognized by this Court that "Congress, having the authority to tax the net income of partnerships, could impose the liability upon the partnership directly, as it did under the Revenue Act of 1917, or upon the 'individuals carrying on business in partnership.'" *Burnet* v. *Leininger*, 285 U. S. 136, 142 (1932) (citation omitted). As with other business entities, Congress may choose whether to tax (i) the entity or (ii) its shareholders or partners on the entity's undistributed income.

Second, the Moores seek to distinguish the taxation of S corporations by saying that shareholders' choice to become an S corporation necessarily means that the S corporation's income is truly the shareholders' income. But consent cannot explain S-corporation taxation; after all, consent to taxation as an S corporation can be revoked only if shareholders who hold a majority of the corporation's shares agree. 26 U. S. C. §1362(d)(1)(B). So, for example, if shareholders who hold 49 percent of the shares no longer consent to paying taxes on undistributed earnings, they nonetheless still must do so. Moreover, there is no reason to think that shareholder consent can eliminate the apportionment requirement (which is a structural requirement of the Constitution) and allow Congress to enact an otherwise unconstitutional tax.

In short, the Moores' consent theory does not explain Congress's authority to tax the shareholders of S corporations directly on corporate income. Rather, S corporations are another example of Congress's authority to either tax the corporation itself on corporate income or attribute the undistributed income to the shareholders and tax the shareholders.

Third, the Moores try to distinguish Congress's long history of taxing shareholders of closely held foreign corporations—including through subpart F—on the ground that those laws apply "the doctrine of constructive realization." Brief for Petitioners 47.

The Moores have not pointed to any use of the phrase "constructive realization" in this Court's case law or the Internal Revenue Code. Instead, the term seems to be a one-off label woven out of whole cloth by the Moores to allow them to sidestep any existing tax, especially subpart F, that does not accord with their proposed constitutional rule. See Brief for American Tax Policy Institute as *Amicus Curiae* 28 (noting that "'constructive realization' actually is a new, amorphous phrase of petitioners' devising").

In any event, whatever its label, the Moores' constructive-realization theory does not distinguish the MRT from subpart F and other pass-through taxes. For example, the Moores claim that constructive realization turns on a sufficient degree of control over the entity. But the level of shareholder control with the MRT (at least 10 percent) is the same as under the longstanding subpart F tax. (And control provides an even less persuasive distinction for partners and for shareholders of S corporations, who may have even less than a 10 percent share and still have the entity's income attributed to them.)

As part of their effort to distinguish the MRT from subpart F, the Moores also argue that subpart F is limited to taxing "'movable income'" that may have been shifted abroad to avoid taxes. Brief for Petitioners 45. But that is not accurate. Subpart F also includes income from doing business in a country under certain sanctions. §952(a)(5). Moreover, like subpart F, the MRT responds to concerns that the owners of American-controlled foreign corporations keep money offshore to defer taxation. So it is not clear why the MRT would not also satisfy the Moores' requirement of an anti-tax-avoidance purpose.

Therefore, even if we were to accept the Moores' constructive-realization nomenclature and theory, the Moores' concession that subpart F imposes taxes on so-called constructively realized income would necessarily mean that the MRT likewise imposes taxes on constructively realized income. After all, the MRT is integrated into subpart F's framework, and it has the same essential features as subpart F. If subpart F is not unconstitutional under the "constructive realization" theory—and the Moores explicitly concede that it is not, Tr. of Oral Arg. 9—then the MRT is likewise not unconstitutional on that theory.

In short, the Moores cannot meaningfully distinguish the MRT from similar taxes such as taxes on partnerships, on S corporations, and on subpart F income.[6] The upshot is that the Moores' argument, taken to its logical conclusion, could render vast swaths of the Internal Revenue Code unconstitutional. See, *e.g.*, 26 U. S. C. §305(c) (deemed stock distributions); §§446, 448 (accrual accounting); §701 (partnership taxation); §§951–965 (subpart F); §951A (pass-through tax on global intangible low-taxed income); §1256(a) (certain futures contracts); §1272(a) (original-issue discount instruments); §§1361–1379 (S corporations); §§2501–2524 (gift taxes).

And those tax provisions, if suddenly eliminated, would deprive the U. S. Government and the American people of trillions in lost tax revenue. The logical implications of the Moores' theory would therefore require Congress to either drastically cut critical national programs or significantly increase taxes on the remaining sources available to it—including, of course, on ordinary Americans. The

---

[6] The MRT applies to income that was realized and accumulated in the past by foreign corporations, but not taxed by the United States. In the lower courts, the Moores raised a due process retroactivity argument—that the MRT taxes income that was earned too far in the past. The Ninth Circuit rejected that argument based on this Court's decision in *United States* v. *Carlton*, 512 U. S. 26, 30 (1994). And the Moores did not seek certiorari on that issue. "We do not normally consider a separate legal question not raised in the certiorari briefs," and "see no reason to make an exception here." *Kasten* v. *Saint-Gobain Performance Plastics Corp.*, 563 U. S. 1, 17 (2011); see also this Court's Rule 14.1(a).

Constitution does not require that fiscal calamity.[7]

* * *

The MRT attributes the undistributed income of American-controlled foreign corporations to their American shareholders, and then taxes the American shareholders on that income. By doing so, the MRT operates in the same basic way as Congress's longstanding taxation of partnerships, S corporations, and subpart F income. And the MRT is consistent with the principles that this Court articulated in upholding those kinds of taxes in cases such as *Burk-Waggoner Oil Assn.* v. *Hopkins*, *Heiner* v. *Mellon*, and *Helvering* v. *National Grocery Co.* The MRT therefore falls squarely within Congress's constitutional authority to tax.

For their part, the dissent and the opinion concurring in the judgment focus primarily on the realization issue—namely, whether realization is required for an income tax. We do not decide that question today. When they reach the attribution question that we do decide, the separate opinions disagree with our reading of some of the Court's precedents. We respect their views. But as we thoroughly explained above, we read the Court's precedents differently.

That said, we emphasize that our holding today is narrow. It is limited to: (i) taxation of the shareholders of an entity, (ii) on the undistributed income realized by the entity, (iii) which has been attributed to the shareholders,

---

[7] According to the Moores, because the Internal Revenue Code's "definition of 'gross income' exerts the full measure of Congress's taxing power," a ruling against them would instantly subject all American stockholders to taxes on corporate income. Tr. of Oral Arg. 4–5. That claim is entirely incorrect. Congress has chosen to directly tax some corporations on their income. See 26 U. S. C. §11. Congress's choice to tax the entity rather than the shareholders controls in that context, just as its contrary choice to tax certain shareholders or partners, not the entity, on the entity's undistributed income controls for the MRT, partnerships, S corporations, and subpart F.

(iv) when the entity itself has not been taxed on that income. In other words, our holding applies when Congress treats the entity as a pass-through.[8]

To be clear, as we indicated earlier, the Due Process Clause proscribes arbitrary attribution. See *supra*, at 14, n. 4. And nothing in this opinion should be read to authorize any hypothetical congressional effort to tax both an entity and its shareholders or partners on the same undistributed income realized by the entity. In such a scenario, the entity would not simply be a traditional pass-through.[9]

In addition, as the Government explains, other kinds of taxes could of course raise different issues. See Tr. of Oral Arg. 58–59, 62, 127–128. In its brief and at oral argument, for example, the Government indicated that a hypothetical unapportioned tax on an individual's holdings or property (for example, on one's wealth or net worth) might be considered a tax on property, not income. See Brief for United States 19 (distinguishing an income tax from a tax on wealth or net worth because "an income tax targets economic gain 'between two points of time'"); Tr. of Oral Arg. 69, 127–128.

And the Government further acknowledges that the constitutionality of a hypothetical unapportioned tax on appreciation may depend on, among other things, whether realization is a constitutional requirement for an income tax. See *id.*, at 58–59, 62, 70, 93–95, 106–108, 126–127; see

---

[8] The opinion concurring in the judgment reads the Court's attribution precedents to draw a line that might call for a "different" conclusion for "a tax on shareholders of a widely held or domestic corporation." *Post*, at 1 (opinion of BARRETT, J.). We do not agree that the Court's precedents draw such a line. Nor does our opinion today draw such a line.

[9] That issue is distinct from Congress's well-established practice of taxing the corporation on corporate income and then taxing shareholders when they receive a dividend. See *Hellmich* v. *Hellman*, 276 U. S. 233, 237–238 (1928); see also *United States* v. *Hemme*, 476 U. S. 558, 572 (1986).

also Brief for United States 32. The Moores argue that realization is a constitutional requirement; the Government argues that it is not. To decide this case, we need not resolve that disagreement over realization.

Those are potential issues for another day, and we do not address or resolve any of those issues here. As to the Moores' case, Congress has long taxed shareholders of an entity on the entity's undistributed income, and it did the same with the MRT. This Court has long upheld taxes of that kind, and we do the same today with the MRT. We affirm the judgment of the U. S. Court of Appeals for the Ninth Circuit.

It is so ordered.

SUPREME COURT OF THE UNITED STATES

No. 22–800

CHARLES G. MOORE, ET UX., PETITIONERS *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 20, 2024]

JUSTICE JACKSON, concurring.

Our Constitution grants Congress "plenary power" over taxation. *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 13 (1916). The text supplies only two relevant conditions: Direct taxes must be apportioned among the States based on population, see Art. I, §9; all other taxes must "be uniform throughout the United States," §8. During the century after our Nation's founding, the Court repeatedly recognized that, in matters of tax policy, Congress's view was controlling. See, *e.g.*, *Pacific Ins. Co.* v. *Soule*, 7 Wall. 433, 443 (1869) ("Where the power of taxation, exercised by Congress, is warranted by the Constitution . . . it is, necessarily, unlimited in its nature"); *Collector* v. *Hubbard*, 12 Wall. 1, 18 (1871) (upholding a tax on undistributed corporate earnings because "it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards").

Then came *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601 (1895). In that case, the Court invalidated a federal income tax, holding that a tax on income derived from property was a direct tax requiring apportionment. See *id.*, at 637. *Pollock* provoked immediate outcry. President Taft, later Chief Justice of this Court, said, "'Nothing has ever injured the prestige of the Supreme Court more.'" B. Ackerman, Taxation and the Constitution, 99 Colum. L. Rev. 1, 5

(1999). In 1913, the People's representatives responded, using their power to overturn *Pollock* via constitutional amendment. The Sixteenth Amendment restored to Congress the power to tax "incomes, from whatever source derived, without apportionment."

Against that stark backdrop, the Court wisely takes a restrained approach today. Petitioners allege that the Mandatory Repatriation Tax (MRT) exceeded Congress's power by taxing shareholders on the undistributed income of a corporation; such a tax, petitioners argue, is really a direct tax requiring apportionment. The majority opinion rightly rejects that challenge, thoroughly explaining why the MRT falls within Congress's long-recognized, oft-exercised power to tax shareholders on the undistributed income of a business entity. See *ante,* at 22. I write separately to emphasize that, before taking up petitioners' invitation to strike down a lawfully enacted tax, the Court would need to be persuaded of several additional arguments that we wisely do not reach. I highlight two.

First, we would need to agree with petitioners that Congress can tax income only if it is actually received or "realized." That alleged requirement appears nowhere in the text of the Sixteenth Amendment. See Brief for John R. Brooks et al. as *Amici Curiae* 14–21 (explaining that the phrase "from whatever source derived" served only to overrule *Pollock*). Moreover, both before and after the Sixteenth Amendment was adopted, the term "income" was widely recognized as flexible enough to include both realized and unrealized gains. See Brief for United States 14–26 (collecting sources); Brief for Professors of Tax Law et al. as *Amici Curiae* 6–20 (same).

The alleged realization requirement is, instead, drawn from a decision of this Court, *Eisner* v. *Macomber*, 252 U. S. 189 (1920). *Macomber* struck down a tax on stock dividends, ostensibly because the taxpayer "ha[d] not realized or received any income in the transaction." *Id.*, at 212. Like

Pollock, *Macomber* was "promptly and sharply criticised." *Helvering* v. *Griffiths*, 318 U. S. 371, 373 (1943). Over the two decades that followed our pronouncement, we "limited" *Macomber*'s realization requirement "to the kind of dividend there dealt with," 318 U. S., at 375, while also "undermin[ing] . . . the original theoretical bases of the decision in" other contexts, *id.*, at 394.

Thus, there is no constitutional requirement, from *Macomber* or otherwise, that a taxpayer "be able to sever . . . the gain from his original capital" in order to be taxed on it. *Helvering* v. *Bruun*, 309 U. S. 461, 469 (1940); see also *Cottage Savings Assn.* v. *Commissioner*, 499 U. S. 554, 559 (1991) (explaining that, properly understood, "the concept of realization is 'founded on administrative convenience,'" compared to the "'cumbersome'" process of "valuing assets on an annual basis to determine . . . appreciat[ion]"). In the lower courts too, *Macomber*'s definition of income has long been deemed outmoded, if not overruled.[1] Any litigant seeking to sustain her case on the basis of *Macomber* would have to bring back from the dead its Court-created limit on Congress's power.[2]

[1] See, *e.g.*, *Commissioner* v. *Obear-Nester Glass Co.*, 217 F. 2d 56, 60 (CA7 1954) ("Even as to income derived from capital [*Macomber*] has been limited to its specific facts"); *United States* v. *James*, 333 F. 2d 748, 752 (CA9 1964) ("[I]nsofar as [*Macomber*] purported to offer a comprehensive definition of the term income as used in the Sixteenth Amendment, it has been discarded"); *Prescott* v. *Commissioner*, 561 F. 2d 1287, 1293 (CA8 1977) ("[T]he Supreme Court has found it necessary to abandon [*Macomber*'s] attempt at an all-inclusive definition of income").

[2] To be sure, *Macomber* is a hard decision to parse, and it might be read to allow taxation of an asset only if the owner receives some new, increased value. See *Eisner* v. *Macomber*, 252 U. S. 189, 211 (1920) (emphasizing that a stock dividend does not necessarily "increase the intrinsic value of [the taxpayer's] holding"); see also *Koshland* v. *Helvering*, 298 U. S. 441, 445–446 (1936). If that reading is correct, *Macomber* would not preclude taxation of unrealized gains. See Brief for United States 33–34; Brief for Alex Zhang as *Amicus Curiae* 26.

Second, even if we were to hold that a uniform tax violated the Sixteenth Amendment, we would still need to confirm that the tax was a direct tax before requiring apportionment. The Constitution does not exhaustively define direct taxes, though it appears the category was originally intended to encompass only land and head taxes. See, *e.g.*, *Hylton* v. *United States*, 3 Dall. 171, 175 (1796) (opinion of Chase, J.); *id.*, at 177 (opinion of Paterson, J.); *id.* at 183 (opinion of Iredell, J.). But the Constitution does expressly exclude certain taxes—"Duties, Imposts and Excises"—from apportionment, and we have long interpreted those categories of taxes broadly. Art. I, §8; see also *Steward Machine Co.* v. *Davis*, 301 U. S. 548, 581–582 (1937). Indeed, we have upheld uniform taxes as excises, even when predicated on something that, if taxed on its own, might require apportionment or even be nontaxable. See *Flint* v. *Stone Tracy Co.*, 220 U. S. 107, 150–152, 165 (1911). In this case, the Government argues that the MRT can be understood as an excise tax on the privilege of doing business through a controlled foreign corporation. See Brief for United States 46–49. That argument, too, would need to be considered before we could strike down a uniform tax like the MRT.

* * *

I have no doubt that future Congresses will pass, and future Presidents will sign, taxes that outrage one group or another—taxes that strike some as demanding too much, others as asking too little. There may even be impositions that, as a matter of policy, all can agree are wrongheaded. However, *Pollock* teaches us that this Court's role in such disputes should be limited. "[T]he remedy for such abuses is to be found at the ballot-box, and in a wholesome public opinion which the representatives of the people will not long, if at all, disregard, and not in the disregard by the judiciary of powers that have been committed to another branch of the government." *Pollock*, 158 U. S., at 680 (Harlan, J., dissenting).

With that understanding, I join the Court's opinion in full.

SUPREME COURT OF THE UNITED STATES

No. 22–800

CHARLES G. MOORE, ET UX., PETITIONERS *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 20, 2024]

JUSTICE BARRETT, with whom JUSTICE ALITO joins, concurring in the judgment.

This case comes down to two questions. Have the Moores realized income from their KisanKraft shares? And if they have not, may Congress attribute KisanKraft's income to the Moores?

Our precedent already decides the first question: Shareholders receive income when they sell their shares or when a corporation distributes profits back to its investors by declaring a dividend. Notwithstanding this precedent, the Government asserts its power to tax without apportionment *all* economic gains, including appreciation in property value. The Court does not address this issue. *Ante*, at 8. It focuses on the second instead, and, casting our precedent as well settled, holds that Congress can attribute KisanKraft's income to the Moores. As I explain below, I think the issue is more complex than the Court lets on. But whatever my disagreement with the Court's reasoning, it bears emphasis that the Moores' case involves the Mandatory Repatriation Tax (MRT), which is a specific tax imposed upon the American shareholders of a closely held foreign corporation. A different tax—for example, a tax on shareholders of a widely held or domestic corporation—would present a different case.

I

The question on which we granted review is "[w]hether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states." Pet. for Cert. i. The answer is straightforward: No.

A

The Constitution distinguishes between taxes on income and taxes on property. Income taxes must apply uniformly across the country, Art. I, §8, cl. 1, while "direct" taxes—like property taxes—must be apportioned among the States, §2, cl. 3; §9, cl. 4.[1] Apportionment is an onerous burden, both technically and politically, because it requires Congress to allocate the total tax liability to each State according to its population. There have been very few federal property taxes in this nation's history (and none in the modern era). By design and in fact, the apportionment rule has left property taxation primarily to the States. See *post*, at 7–12 (THOMAS, J., dissenting).

In *Pollock* v. *Farmers' Loan & Trust Co.*, the Court held that the apportionment rule applies not only to taxes on real and personal property, but also to taxes on income "derived" from that property—say, rents from leasing farmland. 158 U. S. 601, 618 (1895). The decision left Congress effectively unable to tax most nonlabor income. The Sixteenth Amendment overruled *Pollock*'s second holding, stating that "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment." But it did not overrule *Pollock*'s first holding that taxes on personal property are direct taxes. See *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 19 (1916);

[1] Direct taxes also include a capitation tax, which imposes a tax on every person "without regard to property, profession, or any other circumstance." *National Federation of Independent Business* v. *Sebelius*, 567 U. S. 519, 571 (2012) (*NFIB*) (internal quotation marks omitted; emphasis deleted).

National Federation of Independent Business v. *Sebelius*, 567 U. S. 519, 571 (2012).

As the text of the Sixteenth Amendment indicates, income is financial gain that "derive[s]" from property or another source. See, *e.g.*, *United States* v. *Phellis*, 257 U. S. 156, 168–169 (1921); *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, 415 (1913); Webster's New International Dictionary 1089 (1909) (Webster's) ("income" is "[t]hat gain or recurrent benefit (usually measured in money) which proceeds from labor, business, or property"). To capture the distinction between property and income, we have described property as the "seed" and income as the "fruit that it will yield." *United States* v. *Safety Car Heating & Lighting Co.*, 297 U. S. 88, 99 (1936). Thus, a condominium is a landlord's property, and rents are the income she receives from leasing it. A patent is an inventor's property, and royalties are the income she receives from licensing it. A capital fund is a banker's property, and interest is the income she receives from lending it.

The Sixteenth Amendment's reference to income "derived" from any source encompasses a requirement that income, to be taxed without apportionment, must be *realized*. See *post*, at 23–25 (THOMAS, J., dissenting). While the Government stresses that the Amendment did not include a "realization" requirement, Brief for United States 15–16, "realize" and "derive" have long referred to the same concept. Compare Webster's 1778 ("realize" means to "convert an intangible right or property into real (tangible) property"; to "convert any kind of property (considered as fluctuating or uncertain in value) into money"), with *id.*, at 601 ("derivation" is the "[a]ct of receiving anything from a source, as profits from capital"). The Court has used "realization" this way (including in today's opinion) when discussing income taxes on corporate shareholders. See, *e.g.*, *ante*, at 8; *Cullinan* v. *Walker*, 262 U. S. 134, 138 (1923). And we have also used the term "realized" in cases involving a tax on accumulated corporate earnings, *Ivan Allen Co.* v. *United States*, 422 U. S. 617, 627–629 (1975), debt discharge, *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, 3 (1931), real estate improvements, *Helvering* v. *Bruun*, 309 U. S. 461, 469 (1940), punitive damages, *Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426, 431 (1955), and meal allowances, *Commissioner* v. *Kowalski*, 434 U. S. 77, 83 (1977), to name a few. Many opinions use "derived" and "realized" more or less interchangeably. See, *e.g.*, *Diedrich* v. *Commissioner*, 457 U. S. 191, 199 (1982); *Commissioner* v. *Jacobson*, 336 U. S. 28, 39 (1949); *Helvering* v. *Horst*, 311 U. S. 112, 118 (1940); *Goodrich* v. *Edwards*, 255 U. S. 527, 535 (1921); *Gray* v. *Darlington*, 15 Wall. 63, 65–66 (1872); *Pollock*, 158 U. S., at 696 (Jackson, J., dissenting).

The "commonly understood meaning of the term" income when the Sixteenth Amendment was ratified requires that a gain be "realized" or "derived"—*e.g.*, through a sale or other transaction—to be taxed without apportionment. *Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, 519–520 (1921); see *post*, at 23–25 (THOMAS, J., dissenting). "Income within the meaning of the Sixteenth Amendment . . . is income as the word is known in the common speech of men." *Safety Car*, 297 U. S., at 99. And in the years surrounding the ratification of the Sixteenth Amendment, income "was used in ordinary parlance to refer only to realized gains." Brief for Professors of Law and Linguistics as *Amicus Curiae* 17; see *id.*, at 18–22 (instances of the word "income" between 1900 and 1912 in the Corpus of Historical American English referred to "economic gain tied to a realization event").

Regardless of whether one uses the term "derived" or "realized," the important point is this: The Sixteenth Amendment and the Direct Tax Clause distinguish between taxes on property, which are subject to apportionment, and taxes on income derived or realized from that property, which are not.

B

The Moores have not realized income from their KisanKraft shares. Shares yield income when the corporation declares a dividend—*i.e.*, when the corporation distributes its profits to shareholders. See *Lynch* v. *Hornby*, 247 U. S. 339, 344 (1918) ("Dividends are the appropriate fruit of stock ownership [and] are commonly reckoned as income"); *Gibbons* v. *Mahon*, 136 U. S. 549, 557–558 (1890). But KisanKraft has never declared a dividend. Nor have the Moores realized income by selling or otherwise disposing of their shares. See *Taft* v. *Bowers*, 278 U. S. 470, 481–482 (1929). Because they have not received a dividend, profit from selling their shares, or any other pecuniary benefit from their stock ownership, the Moores have not yet received a return on their original investment in the company. In short, they have not "derived" income from their shares because nothing has *come in*.

The Government resists this conclusion. It concedes, as it must, that a tax on the "total value of" the shares "at a particular point [in] time" is a "quintessential tax on property" that must be apportioned. Tr. of Oral Arg. 127–128; see *NFIB*, 567 U. S., at 571; *Brushaber*, 240 U. S., at 19. But looking at property value *across two points in time* makes a difference, the Government says, because then the tax targets *appreciation* rather than the asset's value. As the Government sees it, Congress may tax without apportionment "*all* economic gains" measured "'between two points in time.'" Brief for United States 9, 15. And the increase in value between Time A and Time B is "income."

The Government is unable to cite a single decision upholding an unapportioned tax on appreciation. Tr. of Oral Arg. 89, 91–92. That is no surprise, because our precedent forecloses the Government's argument. We have explained that income includes neither "a gain accruing to capital" nor "a growth or increment of value in the investment." *Phellis*, 257 U. S., at 169; see also *Safety Car*, 297 U. S., at 99 (income is the "fruit that is born of capital, not the potency of fruition"). And we have stressed that "economic gain is *not* always taxable as income." *Bruun*, 309 U. S., at 469 (emphasis added); see also *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U. S. 203, 214 (1990) ("[A] taxpayer does not realize taxable income from every event that improves his economic condition"). Although appreciation looks valuable on paper, "the stockholder has received nothing out of the company's assets for his separate use and benefit," and market fluctuations could "wip[e] out the entire investment" before the owner ever receives a dime of "income within the meaning of the Sixteenth Amendment." *Eisner* v. *Macomber*, 252 U. S. 189, 211 (1920).

If the Government were right that appreciation is income, it is hard to make sense of our decision in *Ivan Allen Co.* There, we considered a tax on accumulated earnings—*i.e.*, income that the corporation retains as assets on its balance sheet instead of distributing to its shareholders. 422 U. S., at 624–625. Because corporate tax rates were generally lower than individuals' marginal tax rates, Congress was concerned that corporations would be used to reduce their "shareholders' overall tax liability by accumulating earnings beyond the reasonable needs of the business." *Id.*, at 624. So Congress imposed a tax on earnings that corporations allowed to accumulate "beyond the reasonable and reasonably anticipated needs of the business." *Id.*, at 621, 624. In upholding the tax, we took great care to explain that the tax "is not directed at the unrealized appreciation of liquid assets"; "any unrealized appreciation in the value of the taxpayer's portfolio . . . does not enter into the computation" of the tax. *Id.*, at 627–628. The tax took into account the value and appreciation of the corporation's assets "only in measuring reasonableness of accumulation of the earnings and profits that otherwise independently exist."

Id., at 628. In other words, asset appreciation was only relevant with respect to how much of the corporation's *income* could be taxed under the statute. More assets meant less income reasonably could be accumulated. If asset appreciation itself were just as taxable as income, there would have been no reason for the Court's painstaking efforts to explain the scope of the tax. See *id.*, at 627–629.[2]

C

In upholding the tax, the Ninth Circuit opined that "[w]hether the taxpayer has realized income does not determine whether a tax is constitutional." 36 F. 4th 930, 935 (2022). In its view, the "Supreme Court has made clear that realization of income is not a constitutional requirement." *Id.*, at 936. The Ninth Circuit misread our cases. Contrary to its assertion, this Court has "never abandoned the core requirement that income must be realized to be taxable without apportionment." 53 F. 4th 507, 508 (CA9 2022) (Bumatay, J., dissenting from denial of rehearing en banc). What we *have* done is reject efforts to narrow what it means to realize income.

For example, in *Helvering* v. *Bruun*—one of the cases on which the Ninth Circuit relied—we clarified that "the realization of gain need not be in cash derived from the sale of an asset" but can also "result [from] exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction." 309 U. S., at 469. In that case, a tenant built a valuable building on the landlord's property. Upon termination of the lease, the landlord regained possession of the

[2] Although *Ivan Allen Co.* involved the interpretation of a tax statute, our analysis sheds light on the Constitution's definition of income because we have long interpreted "gross income" in the Internal Revenue Code to reach "'the full measure of [Congress's] taxing power.'" *Commissioner* v. *Kowalski*, 434 U. S. 77, 82 (1977) (quoting *Helvering* v. *Clifford*, 309 U. S. 331, 334 (1940)).

property—and acquired the building too. When the Internal Revenue Service came calling, the landlord protested that he had realized no taxable gain from the building in the year that the lease ended. We sided with the IRS. Gain from a contributed building is *not* like an "accrua[l] of value due to extraneous and adventitious circumstances"—for example, appreciation from a booming real estate market. *Id.*, at 467. Nor does realization require the ability to "sever the improvement begetting the gain from [the] original capital." *Id.*, at 469. "If that were necessary," we said, "no income could arise from the exchange of property; whereas such gain has always been recognized as taxable gain." *Ibid.* None of that remotely suggests, however, that realization is not required or (relatedly) that appreciation counts as taxable income. Instead, it explains that profit (there, the building) is realized when received, even if it cannot be physically separated from the capital (there, the land).

In dispensing with the realization requirement, the Ninth Circuit also cited *Helvering* v. *Horst*. But *Horst*, like *Bruun*, emphasizes that realization does not require cash in hand—*not* that realization is irrelevant. In *Horst*, "the owner of negotiable bonds . . . detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity." 311 U. S., at 114. The bond owner insisted that the interest coupons were not income taxable to *him*, because his son owned them at the time they came due. See *id.*, at 114–115. We rejected the argument that the bond owner could "escape all tax by giving away his right to income in advance of payment." *Id.*, at 116. "The power to dispose of income is the equivalent of ownership of it." *Id.*, at 118. And while the donor chose not to take the interest itself, he still "*realized* the fruits of his investment." *Id.*, at 117 (emphasis added). Realization does not depend on how the user chooses to enjoy the income—whether through "the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from . . . a gift to his favorite son." *Ibid.* Far from disavowing the realization requirement, the Court emphasized that a taxpayer cannot escape realization (and therefore tax liability) by giving away the fruit of his capital.

In sum, realization may take many forms, but our precedent uniformly holds that it is required before the Government may tax financial gain without apportionment. Realization is a question of substance, not form. *Diedrich*, 457 U. S., at 195. In general, realization is "the last step . . . by which [one] obtains the fruition of the economic gain which has already accrued to him." *Horst*, 311 U. S., at 115. Our cases describe many ways income might be realized; a rigid definition does not capture them all. See, *e.g.*, *MacLaughlin* v. *Alliance Ins. Co.*, 286 U. S. 244, 249 (1932) ("sale or other disposition of property"); *Safety Car*, 297 U. S., at 93 ("profits owing to a patentee by the infringer of a patent"); *Kirby Lumber*, 284 U. S., at 2–3 ("clear gain" resulting from corporation repurchasing bonds it issued for less than the corporation had initially "received [for] their par value"). The common thread is that to realize income, one must receive something new and valuable beyond the property she already owns.

II

Though the Moores did not realize income as shareholders, KisanKraft realized income as a corporation—profits from supplying farm equipment to customers in India. The Government argues that, because the MRT targets KisanKraft's realized income, it falls within the Sixteenth Amendment and is not subject to the apportionment rule. Brief for United States 42. But the question is not whether *some* taxable person or entity has realized income at *some* point. Rather, as the Court emphasizes, we must determine whether Congress has the power to tax the Moores on income that KisanKraft realized. *Ante*, at 8. Put differently, can Congress disregard KisanKraft's corporate form, attribute KisanKraft's income to its shareholders, and tax its shareholders on that income?

The Court concludes that it can, describing our case law as "clear and definitive" in the Government's favor. *Ante*, at 13. I read our cases differently. As I understand our precedent, it leaves room for Congress to disregard the corporate form in some circumstances. But that is not because Congress—as the Court suggests—can treat corporations interchangeably with partnerships, whose partners have always been subject to pass-through taxation on the partnership's income. See *United States* v. *Basye*, 410 U. S. 441, 453–454 (1973). Rather, our cases allow Congress to disregard the corporate form to determine whether the shareholder received income *in substance*, if not in form.

A

Our precedent suggests that Congress's power to attribute a corporation's income to its shareholders for tax purposes is limited. *Eisner* v. *Macomber* is the most recent case addressing this issue—and it was decided more than a century ago. There, the Standard Oil Company of California chose to reinvest its profits back into the corporation rather than distributing them to shareholders. 252 U. S., at 200. Those retained earnings caused an imbalance in the corporation's capital account. So to adjust its books, Standard Oil declared a stock dividend that issued new shares to existing shareholders while diluting the value of their previous shares—which left the shareholders in the same financial position as before the transaction. See *id.*, at 200–201, 212. The Court held that shareholder Myrtle Macomber did not *realize income* from the stock dividend because she "received nothing out of the company's assets for [her] separate use and benefit." *Id.*, at 211. The shareholder's original investment "still remains the property of the company, and subject to business risks which may result in wiping out the entire investment." *Ibid.* The stock dividends were "evidenc[e]" that her capital previously had *appreciated*, but the dividends themselves "added nothing to" her property and were therefore not *income derived from* it. *Id.*, at 212 (while the "shareholder is the richer because of an increase of his capital . . . he has not realized or received any income in the transaction").[3]

Importantly for our purposes, the Court also rejected the Government's theory that Congress could attribute the *corporation's* income to its shareholders. See *id.*, at 213. The Court expressed "no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain *whether he has received income* taxable by Congress without apportionment." *Ibid.* (emphasis added). But the Court would not "disregard the essential truth disclosed": It would not "ignore the substantial difference between corporation and stockholder" and "treat the entire organization as unreal; look upon stockholders as partners, when they are not such . . . and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized." *Id.*, at 214. The Court therefore refused to uphold the tax as a tax on attributed corporate income.

That left one potential justification for the tax—that the Direct Tax Clause's apportionment requirement did not apply to taxes on the stockholder's undivided interest in the corporation. The Court rejected that argument too, adhering to *Pollock*'s holding that a tax on a shareholder's ownership interest is a tax on property. The Court explained

[3]The Court today does not cast doubt on *Macomber*'s holding that appreciation is not income. See *ante*, at 23.

that *Pollock* "overruled" the holding of *Collector* v. *Hubbard*, 12 Wall. 1 (1871), that Congress could "tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared," *Macomber*, 252 U. S., at 218. The Court acknowledged that the Sixteenth Amendment had overruled *Pollock*'s holding that a tax on *income derived from* property must be apportioned. 252 U. S., at 219. But it stressed that the Sixteenth Amendment did not otherwise disturb the law concerning the Direct Tax Clause—including *Pollock*'s holding that the Clause applies to "property, real and personal." *Id.*, at 206; see *id.*, at 219 ("[T]he Amendment applies to income only"). Because a stockholder's ownership interest in the corporation is personal property—"capital, not income"—Congress must apportion any tax on it. *Ibid.*

Today, the Court does not dispute either that income requires realization or that a tax on stock ownership must be apportioned. Instead, it says that the income of a closely held foreign corporation can be attributed to its shareholders for tax purposes. That might be right, but the Court's reasons for saying so are wrong: It dismisses the "attribution" portion of *Macomber* as dicta and argues that four subsequent cases undercut it. *Ante*, at 13. I disagree. None of these cases contradicts *Macomber*'s admonition that Congress cannot "look upon stockholders as partners . . . when they are not"; Congress may not "indulge the fiction that they have received and realized a share of the profits of the company" when they have not. 252 U. S., at 214; see also *Helvering* v. *Griffiths*, 318 U. S. 371, 376–377, and n. 11 (1943). Rather, the Court's cases all illustrate the principle that the validity of an income tax must be assessed "according to truth and substance, [not] form." *Macomber*, 252 U. S., at 206.

Burk-Waggoner Oil Assn. v. *Hopkins* upheld Congress's power to tax an "unincorporated joint stock association" as a corporation even though state law treated it as a partnership. 269 U. S. 110, 110–111 (1925). We disregarded the state-law label because the associations acted as corporations: They had "a fixed capital stock divided into shares," they "manage[d] their affairs by a board of directors and executive officers," and they "conduct[ed] their business in the general form and mode of procedure of a corporation." *Id.*, at 113–114. "[N]othing in the Constitution," we explained, "precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were." *Id.*, at 114. *Burk-Waggoner* thus held that for tax purposes, Congress could treat a partnership like a corporation when it acts like a corporation. We did not decide whether Congress may treat a *corporation like a partnership*—*e.g.*, attributing its income to shareholders—when, in truth and substance, it operates as a corporation.

Next up is *Burnet* v. *Leininger*, 285 U. S. 136 (1932). Although that case involved a partnership, the issue was about the "anticipatory assignment of income doctrine." See *Commissioner* v. *Banks*, 543 U. S. 426, 433–434 (2005) ("A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party" (citing, *inter alia*, *Lucas* v. *Earl*, 281 U. S. 111, 114–115 (1930)); 1 B. Bittker, J. Eustice, G. Goldstein, & T. Brantley, Federal Income Taxation of Corporations and Shareholders ¶2.07[3] (2024). The taxpayer, who happened to be one-half partner in a laundry business, tried to reduce his tax liability by assigning a portion of his income to his wife. 285 U. S., at 141. We rejected that artifice and affirmed Congress's ability to "ta[x] the salary and fees of the person who earned them." *Id.*, at 141–142 (citing *Lucas*, 281 U. S., at 114). This case, too, is about classifying taxes according to substance rather than form.

The Court also invokes *Heiner* v. *Mellon*, which blesses Congress's power to tax "partners" on their "proportionate share of the net income of the partnership" even where the partnership's income is not "currently distributable" to the partners under state law. 304 U. S. 271, 280–281 (1938). The case rests on the "axiomatic" and "firmly established" rule of partnership taxation that "each partner must pay taxes on his distributive [*i.e.*, proportional] share of the partnership's income without regard to whether that amount is actually distributed to him." *Basye*, 410 U. S., at 453–454 (discussing *Heiner*). Given the unique partnership context, *Heiner* sheds no light on Congress's power to tax shareholders on *a corporation's* income.[4]

Finally, in *Helvering* v. *National Grocery Co.*, 304 U. S. 282 (1938), the Court sustained a deficiency tax imposed on a corporation that was used to shelter the income of its sole shareholder. (Notably, the corporation, not the shareholder, was the taxpayer.) In the course of rejecting the corporation's various challenges to the tax, the Court opined that "Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits." *Id.*, at 288. That dictum, if correct, is consistent with *Macomber*'s recognition that courts can look through the corporate form to determine the substance of the shareholder's relationship to the income. Because National Grocery's income was really just the income of Kohl, its sole owner, the Court suggested that attributing it to him for tax purposes would be permissible.

---

[4] Partnerships are distinct from corporations in many other fundamental ways. For example, partnerships traditionally do not have a legal identity distinct from the partners and do not enjoy the limited liability characteristic of the corporate form. They are instead "an aggregation of individuals operating the business as co-owners with individual rights and duties." 1 J. Cox & T. Hazen, Law of Corporations §1.07 (3d ed. 2010). For purposes of federal diversity jurisdiction, partnerships are citizens wherever their partners are, whereas corporations have citizenship distinct from their shareholders. See *Carden* v. *Arkoma Associates*, 494 U. S. 185, 187–189 (1990).

Thus, in matters of corporate form and income attribution—as in the definition of income—labels do not control. But acknowledging that substance controls is a far cry from asserting that Congress is free to wholly disregard the corporate form. That would permit Congress to tax the shareholder without regard to the substance of her relationship to the corporation and would contradict *Macomber*'s holding that Standard Oil's income could not be attributed to its shareholders. See 252 U. S., at 213–214. Our precedent does not give Congress carte blanche to attribute corporate income to a shareholder. Instead, it suggests that Congress has a limited power to do so that depends on the relationship between the shareholder and the income.[5]

B

Although I believe that the Court today is too quick to bless the attribution of corporate income to shareholders, its holding is narrow. The Court affirms Congress's power to tax shareholders on "the undistributed income of American-controlled foreign corporations," but it says that the

---

[5] The Court asserts that Congress no longer observes *Macomber*'s distinction between shareholders and the corporate entity for tax purposes. *Ante*, at 11. That paints an incomplete picture. After *Macomber*, Congress ended its longstanding practice of attributing corporate income to shareholders when the corporation operated as a tax shelter. See *Ivan Allen Co.*, 422 U. S., at 624–626, and n. 8; *Griffiths*, 318 U. S., at 377 n. 12, 385. That practice reemerged in the 1930s when Congress began taxing shareholders of *closely held foreign* corporations on undistributed corporate earnings. Revenue Act of 1937, §201, 50 Stat. 822. To my knowledge, Congress has not returned to that approach for domestic or widely held corporations of the kind *Macomber* considered. And while Congress continues to attribute income of certain closely held foreign corporations to their U. S. shareholders today, see 26 U. S. C. §951 *et seq.* ("subpart F"), doing so might be consistent with *Macomber*'s recognition that Congress can disregard the corporate form when, in substance, it is reasonable to treat the income of the corporation as that of the shareholders. The Court's "arbitrariness" test seems to get at a similar point, but, by dismissing the relevance of the corporate form altogether, it confuses the analysis.

Due Process Clause cabins that power by requiring income attributions not to be "arbitrary." *Ante*, at 22–23. The arbitrariness inquiry, the Court previews, turns on "the taxpayer's relationship to the underlying income." *Ante*, at 14, n. 4 (citing *Burnet* v. *Wells*, 289 U. S. 670, 678–679 (1933)).

I agree that the Constitution prohibits Congress from arbitrarily attributing to the taxpayer someone else's income. Our cases have located that limit in the Due Process Clause. See *Burnet*, 289 U. S., at 678–679; *Hoeper* v. *Tax Comm'n of Wis.*, 284 U. S. 206, 215 (1931) ("That which is not in fact the taxpayer's income cannot be made such by calling it income"). But an arbitrariness limit is implicit in the Sixteenth Amendment too. Virtually all property was income at some point. Ford Motor Company uses its income to buy steel for making trucks. But surely Congress cannot attribute Ford's earnings to anyone who owns an F–250. The Amendment's reference to "derived" income presupposes that the income belongs to the taxpayer, or is at least fairly attributable to her. Otherwise the taxpayer's property (*e.g.*, the truck she drives) could be taxed without apportionment just because it was once *somebody else's* income (*e.g.*, the earnings Ford used to purchase the steel).

While an arbitrariness limit on income attribution surely exists, its contours are uncertain. We have never before applied the arbitrariness test to a tax law that attributes a corporation's income to its shareholders. At oral argument, the Government identified a series of factors that the Court has considered in attribution cases involving license agreements and trusts. See Tr. of Oral Arg. 119–123. One is whether the taxpayer has "sufficient power and control over . . . the income" that it is "reasonable to treat him as the recipient of the income for tax purposes." *Commissioner* v. *Sunnen*, 333 U. S. 591, 604 (1948). Another is whether the taxpayer receives a special "privilege or benefit" from the entity that earns the income. *Burnet*, 289 U. S., at 679. A third is whether the corporation is foreign and thus outside the reach of an accumulated earnings tax. Cf. *Ivan Allen Co.*, 422 U. S., at 624. These factors may serve as a useful guide for lower courts when applying today's decision to taxes that attribute income from other types of corporations to an individual taxpayer. Just because Congress can attribute income of a closely held foreign corporation like KisanKraft to its shareholders does not mean it has equal power to attribute the income of a publicly traded domestic corporation to anyone holding a few shares in her retirement account.

C

Congress's power to attribute the income of closely held corporations to their shareholders is a difficult question—and unfortunately, the parties barely addressed it. Without focused briefing on the attribution question, I would not resolve it. Subpart F and the MRT may or may not be constitutional, nonarbitrary attributions of closely held foreign corporations' income to their shareholders. In this litigation, however, the Moores have conceded that subpart F is constitutional. Tr. of Oral Arg. 9. And I agree with the Court that subpart F is not meaningfully different from the MRT in how it attributes corporate income to shareholders. *Ante*, at 20–21. Taxpayers generally bear the burden to show they are entitled to a refund. *United States* v. *Janis*, 428 U. S. 433, 440 (1976); see also *Haaland* v. *Brackeen*, 599 U. S. 255, 277–278 (2023) (burden to show unconstitutionality). Given the Moores' concession, they have not met that burden here. For that reason, I concur in the Court's judgment affirming the judgment below.

SUPREME COURT OF THE UNITED STATES

No. 22–800

CHARLES G. MOORE, ET UX., PETITIONERS *v.* UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

[June 20, 2024]

JUSTICE THOMAS, with whom JUSTICE GORSUCH joins, dissenting.

Charles and Kathleen Moore paid $14,729 in taxes on an investment that never yielded them a penny. They challenge that tax—the Mandatory Repatriation Tax (MRT)—as unconstitutional. As relevant, they argue that a tax on unrealized investment gains is not a tax on "incomes" within the meaning of the Sixteenth Amendment, and it therefore cannot be imposed "without apportionment among the several States."

The Moores are correct. Sixteenth Amendment "incomes" include only income realized by the taxpayer. The text and history of the Amendment make clear that it requires a distinction between "income" and the "source" from which that income is "derived." And, the only way to draw such a distinction is with a realization requirement. Our precedent says as much. In *Eisner* v. *Macomber*, 252 U. S. 189 (1920), the Court explained that "the characteristic and distinguishing attribute of income," as the term is used in the Sixteenth Amendment, is that it is "*received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal." *Id.*, at 207. Because the Moores never actually received any of their investment gains, those unrealized gains could not be taxed as "income" under the Sixteenth Amendment.

The Ninth Circuit wrongly rejected the Moores' challenge on the ground that "realization of income is not a constitutional requirement." 36 F. 4th 930, 936 (2022). That conclusion cannot be reconciled with the Sixteenth Amendment as the Court correctly interpreted it in *Macomber*. We therefore granted certiorari to answer the question "[w]hether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states," *i.e.*, as "incomes." Pet. for Cert. i.

Today, the Court upholds the MRT only by ignoring the question presented. It does "not address the Government's argument that a gain need not be realized to constitute income under the Constitution." *Ante*, at 12–13, n. 3. Instead, the Court answers the question "whether Congress may attribute an entity's realized and undistributed income to the entity's shareholders or partners, and then tax the shareholders or partners on their portions of that income." *Ante*, at 8. After changing the subject, the majority upholds the MRT by relying on unrelated precedent to derive a "clear rule" that "Congress can attribute the undistributed income of an entity to the entity's shareholders or partners." *Ante*, at 10–11.

I respectfully dissent. The Ninth Circuit erred by concluding that realization is not a constitutional requirement for income taxes. And, the majority's "attribution" doctrine is an unsupported invention.

I

The Sixteenth Amendment provides: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." The central dispute in this case—at least, in the case briefed by the parties—concerns the meaning of the word "incomes" in the Amendment. The Moores define "income" as "'a gain, a profit, [or] something of exchangeable value'

[that] is '*received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal.'" Brief for Petitioners 1 (quoting *Macomber*, 252 U. S., at 207). This idea—that "income" is only something actually available for the taxpayer's use—is known as "realization." The Government rejects the realization requirement, arguing instead that "income" captures "all economic gains" whether or not they are actually realized. Brief for United States 14 (internal quotation marks omitted).

"Income" in the Sixteenth Amendment refers only to income realized by the taxpayer. The Amendment resolved a long-running conflict over the scope of the Federal Government's taxing power. It paved the way for a federal income tax by creating a new constitutional distinction between "income" and the "source" from which that income is "derived." Drawing that distinction necessitates a realization requirement.

A

To understand the text of the Sixteenth Amendment—and, in particular, the meaning of the word "income"—one must first understand how the Amendment came about. The Constitution's original taxing provisions divided taxes into two classes: direct and indirect taxes. And, as part of a delicate constitutional compromise, the original taxing provisions required direct taxes to be apportioned among the States based on population. Disputes about the scope of the direct-tax category came to a head in *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601 (1895), when this Court held that many income taxes were direct taxes subject to the apportionment requirement. In reaching this conclusion, the Court held that income could not be distinguished from its source for purposes of classifying an income tax as direct or indirect. The Sixteenth Amendment was ratified to overrule that holding from *Pollock*, and it can therefore be understood only in the context of *Pollock* and the preceding history.

1

The Sixteenth Amendment modified the Constitution's original regulations of Congress's taxing power. The text of those provisions is therefore the natural starting point for interpreting the Sixteenth Amendment. The Taxing Clause provides Congress with broad authority to impose taxes. Other Clauses, including the Direct Tax Clause, classify different kinds of taxes and set corresponding limitations on Congress's power to impose them. The Sixteenth Amendment alters those rules by making clear that taxes on income are not subject to the limitations imposed on direct taxes.

The Constitution gives Congress the power to impose "Taxes" of any kind, including income taxes. The Taxing Clause provides that "Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." Art. I, §8, cl. 1. This Clause is the sole source of Congress's authority to impose taxes. And, that authority is broad. Nothing in the Constitution limits the kinds of taxes that Congress may impose. As the Court has explained, "the authority conferred upon Congress by" the Taxing Clause "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1, 12 (1916).

But, the Constitution restricts the manner in which Congress may impose taxes. It accomplishes this by dividing taxes into two classes—direct and indirect taxes—and imposing a distinct limitation applicable to each of those classes.[1]

---

[1] The General Welfare Clause—quoted alongside the rest of the Taxing

Start with the class of direct taxes. The Direct Tax Clause provides: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." Art. I, §9, cl. 4. The Constitution does not expressly identify any tax as direct other than a "Capitation." A "capitation"—also called a "poll tax"—is "[a] fixed tax levied on each person within a jurisdiction." Black's Law Dictionary 1760 (11th ed. 2019) (defining "tax"). At the founding, the class of direct taxes was also understood to include taxes on real property, and perhaps taxes on personal property. See *infra*, at 14–15.

Indirect taxes, on the other hand, include "Duties, Imposts and Excises." Art. I, §8, cl. 1. These were taxes that people could avoid by adjusting their behavior—generally, taxes on articles of consumption. See The Federalist No. 21, p. 116 (E. Scott ed. 1898) (A. Hamilton). "Indirect taxes" are not identified by that name in the Constitution. But, the Constitution's delineation of a direct-tax category signals the existence of a complementary indirect-tax category.

For each class of taxes, the Constitution limits Congress's power with a distinct rule. Direct taxes are subject to the rule of apportionment. The Constitution twice specifies that "direct Taxes shall be apportioned among the several States . . . according to their respective Numbers."[2] Art. I, §2, cl. 3; see also §9, cl. 4. A tax is apportioned among the States if "each State pays in proportion to its population." *National Federation of Independent Business* v. *Sebelius*,

Clause above—is also an important "qualification on the substantive taxing power." *Health and Hospital Corporation of Marion Cty.* v. *Talevski*, 599 U. S. 166, 206 (2023) (THOMAS, J., dissenting). But, because this case does not implicate that limitation, I do not further explore the General Welfare Clause.

[2] Those "Numbers," were originally "determined by adding to the whole Number of free Persons . . . three fifths of all other Persons." Art. I, §2, cl. 3; but see Amdt. 14, §2.

567 U. S. 519, 570 (2012). An example best demonstrates what apportionment requires. Suppose that Congress imposed a direct tax on houses, and apportioned the tax such that two States of equal population were both responsible for paying $100 in taxes. If the first State contained 100 houses and the second State only 10, houses in the first State would be taxed at $1 each ($100 divided by 100 houses), whereas houses in the second State would be taxed at $10 each ($100 divided by 10 houses).

Indirect taxes are subject to the rule of uniformity: "[A]ll Duties, Imposts and Excises shall be uniform throughout the United States." Art. I, §8, cl. 1. The Court has explained that "the words 'uniform throughout the United States' . . . signify . . . a geographical uniformity." *Knowlton* v. *Moore*, 178 U. S. 41, 106 (1900). In other words, a "tax is uniform when it operates with the same force and effect in every place where the subject of it is found." *Head Money Cases*, 112 U. S. 580, 594 (1884). So, a duty on the importation of tea must impose the same rate on imports coming through Boston as those coming through Savannah.[3]

The Sixteenth Amendment, on its face, narrows the scope of the apportionment requirement. While direct taxes must be apportioned, the Sixteenth Amendment allows Congress

[3] For the sake of completeness, three remaining taxing provisions in the Constitution of 1789 bear mentioning. First, "a Tax or duty may be imposed" on the "Importation of such Persons as any of the States now existing shall think proper to admit"—*i.e.*, upon the foreign slave trade—"not exceeding ten dollars for each Person." Art. I, §9, cl. 1. Second, "[n]o Tax or Duty shall be laid on Articles exported from any State." Cl. 5. And third, "[n]o State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports" (with limited exceptions). §10, cl. 2. Together, these provisions define the limits of state and federal taxing power with respect to foreign and interstate commerce. I mention them below only in passing. But, like the division between direct and indirect taxes, these provisions reflect the delicate balance that the Constitution struck regarding the scope of the federal taxing power.

to tax incomes "without apportionment." But, it did not remove the Direct Tax Clause or the apportionment requirement from the Constitution entirely. To appreciate the extent of the change, and its implications for the meaning of the word "incomes," it is necessary to examine the origins of the Direct Tax Clause and how disputes about the Clause's scope led to the Sixteenth Amendment.

2

The Direct Tax Clause was a critical aspect of the balance between state and federal power in the original design of the Constitution. It is easy today to take the federal taxing power for granted. But, at the founding, allowing the National Government to exercise such a power was a radical proposal. The importance of the limitations imposed by the Direct Tax Clause to the compromise struck by the Constitution has significant implications for the meaning of "incomes" in the Sixteenth Amendment.

The American colonial experience inspired widespread distrust of taxation. See, *e.g.*, Declaration of Independence ¶19. The Articles of Confederation reflected that distrust. Under the Articles, the entire taxing power was exclusive to the States. The National Government had no power to impose taxes of any kind. The only revenue for the National Government was funds "supplied by the several States" pursuant to requisitions "in proportion to the value of all land within each State." Articles of Confederation, Art. 8. And, the taxes for paying those requisitions were imposed solely by the States themselves.

The requisition system showed immediate signs of inadequacy. Raising funds through requisitions was often ineffective because States felt little urgency to pay their obligations. See Federalist No. 30, at 160 (A. Hamilton) (explaining that requisitions were formally "obligatory upon the States," but that "in practice" the right to disregard them was "constantly exercised"). And, the financial strain placed on the National Government by the Revolutionary War made that inefficiency an existential threat to the fledgling Nation.

The Continental Congress quickly concluded that financing the war effort would require another source of revenue for the National Government. "[T]o establish the national credit," the Congress's finance Committee reported in December 1780, "it will be necessary" for the States to "vest[t] in Congress" "[t]he exclusive right to duties arising on certain imported articles." 18 Journals of the Continental Congress 1774–1789, p. 1157 (G. Hunt ed. 1910). The Congress therefore proposed the Impost of 1781, "recommend[ing] to the several states, as indispensably necessary, that they . . . vest a power in Congress, to levy for the use of the United States, a duty of five per cent." on most imports. 19 Journals of the Continental Congress 112 (1912) (footnote omitted). The President of the Continental Congress transmitted the proposal to the States on February 8, 1781, under a cover letter stressing the "precarious Manner" in which Congress had to fund the Army under the requisition system. 5 Letters of Members of the Continental Congress 564 (E. Burnett ed. 1931).

Every State but Rhode Island approved the Impost of 1781. See 1 Documentary History of the Ratification of the Constitution 63 (M. Jensen ed. 1976) (Documentary History). But, because the Articles of Confederation required amendments like the impost to be approved unanimously, Rhode Island's refusal defeated the amendment. Articles of Confederation, Art. 13; see also 23 Journals of the Continental Congress 783–784 (1914). In a letter to the Confederation Congress,[4] the Rhode Island Legislature explained that it rejected the impost "[b]ecause it would be unequal in

[4] After the ratification of the Articles of Confederation in March 1781, the Continental Congress became the Confederation Congress. See 1 Documentary History 136.

its operation, bearing hardest on the most commercial states," including Rhode Island. *Id.*, at 788. One State's jealousy of its lucrative tax base prevented the reform of the Articles' flawed requisition system.

A year later, the Confederation Congress again proposed a national taxing power with the Impost of 1783. The proposal languished for years, and then failed after New York refused its consent in February 1787. See 1 Documentary History 190, n. 3. As the second impost awaited its slow death, the Confederation Congress issued a dire warning about the financial condition of the National Government in February 1786. See 30 Journals of the Continental Congress 70, 75 (J. Fitzpatrick ed. 1934). Faced with mounting threats to the security of the country, and requisitions that had become "so irregular in their operation" as to be "dangerous to the welfare and peace of the Union," Congress asserted "that the crisis has arrived" when the people of the United States must decide whether, "for want of a timely exertion in establishing a general revenue," they will risk both the existence of the Union and the liberty that they won in the Revolution. *Id.*, at 72, 75.

The practical impossibility of reforming the Articles to include a national taxing power was among the primary reasons for the Constitutional Convention of 1787. John Adams later reflected as Vice President: "The opposition of Rhode Island to the impost seems to have been the instrument which providence thought fit to use for the great purpose of establishing the present constitution." 26 Documentary History 743 (J. Kaminski et al. eds. 2013). In February 1787, the Continental Congress endorsed the call for a convention of delegates in Philadelphia. See 32 Journals of the Continental Congress 74 (R. Hill ed. 1936). Virginia had been the first State to answer that call, and in appointing delegates, made prominent reference to the Confederation Congress's "alarming representations" about the poor state of public finance. 1 Documentary History 196–198 (discussing Congress's warning of February 1786). The Virginia delegation likewise emphasized the "inefficiency of requisitions" when it opened the proceedings at the Convention. 1 Records of the Federal Convention of 1787, pp. 18–19 (M. Farrand ed. 1911) (Farrand's Records).

The possibility of a federal taxing power was highly controversial at the Constitutional Convention, despite widespread acknowledgment of the need to reform public finance. The Virginia plan—a broad outline that was selected as the basis for the new Government—did not go so far as to include a federal taxing power. The Virginia delegation apparently considered it less controversial to open the Convention with a proposal that gave the Federal Government the ability to enforce requisitions against the States by military force. *Id.,* at 21. The New Jersey plan, by contrast, did include federal taxing powers. *Id.*, at 243. Reason prevailed, and the Convention judged it more prudent to risk a federal taxing power than the extraction of federal revenue by the use of military force against the States. See *id.*, at 54 ("[Madison] observed that the more he reflected on the use of force [against delinquent States], the more he doubted the practicability, the justice and the efficacy of it"). The Convention proposed the Constitution with its taxing provisions as described above; they would be ratified unchanged. See 2 *id.,* at 590, 594, 596; *supra,* at 4–6.

Unsurprisingly, the proposed creation of a federal taxing power provoked many of the most passionate criticisms by opponents of ratification. The Antifederalists warned that a federal taxing power would destroy the state governments. Brutus wrote that the central question presented by ratification was "whether the thirteen United States should be reduced to one great republic . . . or whether they should continue thirteen confederated republics." Brutus No. 1 (Oct. 18, 1787), in 2 The Complete Anti-Federalist 364

(H. Storing ed. 1981). In support of his dramatic thesis, Brutus asserted that "the individual states must very soon be annihilated," in part by the federal taxing power. *Id.*, at 365.

The destructive force of the federal taxing power, as Brutus explained it, arose from the fact that it forced the States to compete with the Federal Government for a tax base. Because the Constitution prevented the States from emitting paper money and laying duties or imposts, "[t]he only mean therefore left, for any State to support its government and discharge its debts, is by direct taxation." *Id.*, at 366. But, even the ability to resort to direct taxes would be fruitless, because the power of direct taxation was shared with the Federal Government. *Ibid.* Brutus thus argued that once the Federal Government "begins to exercise the right of taxation in all its parts, the legislatures of the several states will find it impossible to raise monies to support their governments" and then "dwindle away." *Ibid.* Other Antifederalists sounded the same theme at the state ratifying conventions. See, *e.g.*, 3 Debates on the Constitution 29 (J. Elliot ed. 1836) (Elliot's Debates) (George Mason arguing in Virginia that the "two concurrent powers" of the State and Federal Governments to impose taxes directly upon the people "cannot exist long together").

The Federalists' defense of the new national taxing power stressed that the Federal Government would impose direct taxes only sparingly, as needed to supplement the revenue from imposts in emergencies. Madison explained that "[w]hen . . . direct taxes are not necessary, they will not be recurred to. It can be of little advantage to those in power to raise money in a manner oppressive to the people." *Id.*, at 95. And, Federalists highlighted the protection provided by the rule of apportionment. Hamilton explained that direct taxes "never can oppress a particular state by an unequal imposition; because the Constitution has provided a fixed ratio, a uniform rule, by which this must be regulated." 2 *id.*, at 365. Madison argued that because representation and direct taxation were apportioned by the same formula, unjust taxes could not feasibly be imposed; those responsible for paying direct taxes are correspondingly able to defeat their imposition. See 3 *id.*, at 256–257.[5]

With the Constitution's ratification, the requisition system was replaced by a system that gave the Federal Government the taxing power it had lacked under the Articles of Confederation. That increase in power came at the expense of the States. The States gave up the power to tax interstate and foreign commerce, which was expected to be the main source of federal revenue. They did retain the power of direct taxation, but had to share it with the Federal Government—an arrangement that motivated significant opposition to the new Constitution. The limitations on the Federal Government's ability to exercise that concurrent power were thus an essential component of the constitutional compromise.

3

Postratification disagreement about what qualified as a "direct tax" would eventually lead to the adoption of the Sixteenth Amendment. Even though the distinction between direct and indirect taxes was an important component of

---

[5] Several state ratifying conventions proposed amendments to strengthen the protection provided by the Direct Tax Clause. For example, the Massachusetts ratifying convention proposed that the Constitution be modified to allow direct taxes only "when the moneys arising from the impost and excise are insufficient for the public exigencies," and even then only after Congress first attempted to obtain such funds through requisitions. 1 Elliot's Debates 322–323. The ratifying conventions of South Carolina, New Hampshire, New York, and Rhode Island concurred in the proposed amendment. *Id.*, at 325, 326, 329, 336. Although those proposals never became part of the Constitution, they demonstrate the importance that many ratifying States placed upon limitations to Congress's power to lay direct taxes.

the founding compromise, it was not entirely clear how to distinguish between the two classes of taxes. The scope of the "direct tax" category proved immediately controversial. And, that controversy eventually came to bear on the question of income taxation, with the Court initially concluding that the Direct Tax Clause was not a barrier to taxing incomes.

As the Constitution's text made clear, a "Capitation" was "direct." Art. I, §9, cl. 3. And, all agreed that taxes on land and slaves were considered direct. See 3 Elliot's Debates 229. But, beyond that, the precise boundary between direct and indirect taxes was debatable. An exchange at the Constitutional Convention preserved in Madison's notes is often cited on the subject: "Mr King asked what was the precise meaning of *direct* taxation? No one answd." 2 Farrand's Records 350.

This Court grappled with the question in a significant case decided soon after ratification. In 1794, the Third Congress passed "An Act laying duties upon Carriages for the conveyance of Persons." Act of June 5, 1794, ch. 45, 1 Stat. 373. The tax was not apportioned among the States. Some opposed the tax on the theory that a tax on personal property, such as carriages, was a direct tax that required apportionment.[6]

When Daniel Hylton failed to pay the tax on his 125 carriages, the United States brought a suit against him, and the case soon found its way to the Supreme Court. *Hylton* v. *United States*, 3 Dall. 171, 171–172 (1796) (*Hylton's Case*). "The argument turned entirely upon . . . whether the tax . . . was a direct tax." *Id.*, at 172. The four Justices who

---

[6] James Madison, for example, despaired about the unconstitutionality of the tax in a letter to Thomas Jefferson. See 15 Papers of James Madison 327 (T. Mason, R. Rutland, & J. Sisson eds. 1985) ("And the tax on carriages succeeded in spite of the Constitution . . . . By breaking down the barriers of the constitution . . . wealth may find a precarious defence in the shield of justice").

sat for the case each agreed that the tax was constitutional, and the three who offered reasons suggested that "direct" taxes were limited to capitation and land taxes. But, they did so with some caution.

Justice Chase was "inclined to think, but [did] not give a judicial opinion, that the *direct* taxes contemplated by the Constitution, are only *two*, to wit, a *capitation,* or *poll* tax, *simply*, without regard to *property*, *profession*, or any *other circumstance*; and a tax on LAND." *Id.*, at 175. He "doubt[ed] whether a tax, by a *general assessment* of *personal* property, . . . is included within the term *direct* tax." *Ibid.* Justice Paterson observed that "[w]hether direct taxes, in the sense of the Constitution, comprehend any other tax than a capitation tax, and tax on land, is a questionable point." *Id.*, at 177. Justice Iredell opined that "[p]erhaps a direct tax in the sense of the Constitution, can mean nothing but a tax on something inseparably annexed to the soil . . . . A land or poll tax may be considered of this description." *Id.*, at 183.

Additional disputes over what constituted direct taxation arose when the Government resorted to new forms of taxation to finance the Civil War. In several cases decided shortly after the war, the Court relied on *Hylton's Case* to conclude that new taxes were indirect. First, the Court reasoned that "[i]f a tax upon carriages, kept for his own use by the owner, [was] not a direct tax," then "a tax upon the business of an insurance company" was not a direct tax. *Pacific Ins. Co.* v. *Soule*, 7 Wall. 433, 446 (1869). Next, the Court concluded that a tax on the circulation of bank notes was also indirect, but it surveyed ratification-era sources to hint at a slightly more expansive definition of direct taxes. *Veazie Bank* v. *Fenno*, 8 Wall. 533, 544 (1869) ("direct taxes were such as may be levied by capitation, and on lands and appurtenances; or, perhaps, by valuation and assessment of personal property upon general lists"). Finally, the Court concluded that a tax on the devolution of title to real estate was indirect, acknowledging that "it never ha[d] been decided" whether any taxes besides "[t]axes on lands . . . and capitation taxes" were "direct taxes." *Scholey* v. *Rew,* 23 Wall. 331, 347 (1875).

The Civil War also prompted Congress to enact the Nation's first-ever federal income tax. In 1861, Congress imposed a tax of three percent "upon the annual income of every person residing in the United States, whether such income is derived from any kind of property, or from any profession, . . . or from any other source whatever," to the extent that income exceeded $800. §49, 12 Stat. 309. Over the course of the Civil War, the income tax was paid by as many as 1 in 10 Union households and accounted for about a fifth of federal revenues. S. Weisman, The Great Tax Wars 101–102 (2002) (Weisman). The tax remained in force, with modifications, until it expired in 1871. §6, 16 Stat. 257.

The Court did not consider the constitutionality of the Civil War income tax until a decade after its expiration, in *Springer* v. *United States*, 102 U. S. 586 (1881). The "main question" was whether the tax was an unapportioned direct tax that violated the Direct Tax Clause. *Id.*, at 595. The Court held that the income tax was not a direct tax. Relying heavily on *Hylton's Case*, the Court reasoned "that *direct taxes*, within the meaning of the Constitution, are only capitation taxes . . . and taxes on real estate." 102 U. S., at 602. Accordingly, the income tax at issue was "within the category of an excise or duty." *Ibid.*[7]

---

[7] In the case before us, the Government relies heavily on another case involving the Civil War income tax, *Collector* v. *Hubbard,* 12 Wall. 1 (1871). According to the Government, *Hubbard* "upheld [Congress's] power to" impose "taxes on undistributed corporate earnings" as "income taxes," a result that subsequent decisions "temporarily undermined" until "the Sixteenth Amendment . . . reinstat[ed]" it. Brief for United States 9. But, *Hubbard* is of virtually no relevance to the Sixteenth Amendment. Contrary to the Government's assertions, the taxpayer in *Hub-*

In summary, after disputes over the scope of the Direct Tax Clause between the founding and the expiration of the Civil War income tax, the Court apparently concluded that direct taxes were limited to poll taxes and taxes on land. *Ibid.* But, the Court expressed some doubt as to the proper classification of taxes "levied by . . . valuation and assessment of personal property." *Veazie Bank*, 8 Wall., at 544. Based on that narrow reading of the Direct Tax Clause, the Court upheld the Civil War income tax against a constitutional challenge. But, the long-running skirmishes about direct taxation would soon come to a dramatic climax following the imposition of the first federal income tax in peacetime.

4

I next consider the single most important piece of context for understanding the Sixteenth Amendment: *Pollock* v. *Farmers' Loan & Trust Co.*, 158 U. S. 601, the case that the Amendment overruled. In *Pollock*, the Court concluded, for the first time, that a tax was direct, not apportioned, and therefore unconstitutional. The Court's reasoning turned on the premise that the Constitution permits no distinction between taxing income and taxing the source from which that income is derived. The holding of *Pollock* thus meant that most income taxes would have to be apportioned, a requirement that made them politically unpalatable. See *supra*, at 6 (describing possible state-by-state variations in rates for apportioned taxes). Because the Sixteenth

---

bard made a statutory argument about the meaning of the word "entitled," not any argument about the scope of Congress's power. See Brief for Respondent in *Collector* v. *Hubbard*, O. T. 1870, No. 122, p. 4. Nor did *Hubbard* uphold the tax as an income tax. Instead, it interpreted the statute as a tax on a shareholder's *property rights* in undistributed profits. 12 Wall., at 18. Because the taxpayer did not bring a constitutional challenge based on the Direct Tax Clause, the Court had no occasion to consider the potential implications of treating the tax as a property tax.

Amendment overruled the result in *Pollock*, an accurate understanding of the case is essential to understanding the Amendment.

Congress imposed the Nation's first peacetime income tax as part of the Revenue Act of 1894. The Act paired a new tax on the incomes of the wealthiest two percent of Americans with tariff cuts that would benefit less wealthy consumers. See Weisman 132–133, 145. The income-tax component of the Act provided:

> "That [from 1895 until 1900] there shall be assessed, levied, collected, and paid annually upon the gains, profits, and income received in the preceding calendar year by [citizens and resident aliens], whether said gains, profits, or income be derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation . . . , or from any other source whatever, a tax of two per centum on the amount so derived over and above four thousand dollars." §27, 28 Stat. 553.

The income tax was not apportioned among the States by population.

In *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429 (1895), the Court considered whether the 1894 income tax was a direct tax that failed to satisfy the Direct Tax Clause's apportionment requirement. The taxpayer argued that portions of the tax were direct because "imposing a tax on the income or rents of real estate, imposes a tax upon the real estate itself." *Id.*, at 555. And, taking the position that taxes on personal property are also direct taxes, the taxpayer argued that "imposing a tax on the . . . income of bonds or other personal property . . . imposes a tax on the personal estate itself." *Ibid.*

The Court endeavored to determine what "were recognized as direct taxes" "at the time the Constitution was framed and adopted." *Id.*, at 558. The Court considered historical context, the records of the Constitutional Convention, the Federalist Papers, other documents from the ratification debates, the 1794 carriage tax, and *Hylton's Case.* 157 U. S., at 558–568, 570–572. The Court concluded that "all taxes on real estate or personal property or the rents or income thereof were regarded as direct taxes" at the time the Constitution was ratified. *Id.*, at 573–574. After reaching a conclusion about the original meaning of the Constitution, the Court surveyed its precedents and observed that "in none of them is it determined that taxes on rents or income derived from land are not taxes on land," and that "none . . . discussed the question whether a tax on the income from personalty is equivalent to a tax on that personalty." *Id.*, at 579. The Court had some difficulty explaining *Springer*, which stated that direct taxes are limited to capitation and land taxes and concluded that a tax on income was an indirect tax. See *supra*, at 15. But, the Court returned to "[t]he original record" in *Springer* to review the sources of the taxpayer's income, and it distinguished the case on that ground. 157 U. S., at 578–579.

In the end, the Court concluded that income could not be distinguished from the source from which it was derived for purposes of determining whether a tax on that income would be direct or indirect. It was "unable to perceive any ground" "upon which to rest the contention that real estate belongs to one of the two great classes of taxes," *i.e.*, the direct-tax class, "and the rent or income which is the incident of its ownership belongs to the other," *i.e.*, the indirect-tax class. *Id.*, at 581. It grounded that conclusion in the fact that the Direct Tax Clause was a federalism provision at the heart of the constitutional compromise: "If, by calling a tax indirect when it is essentially direct, the rule of protection could be frittered away, one of the great landmarks defining the boundary between the Nation and the States of which it is composed, would have disappeared, and with it one of the bulwarks of private rights and private property."

Id., at 583.

The Court held that the Act was unconstitutional in part, "so far as it levies a tax on the rents or income of real estate." *Ibid.* But, the Justices divided evenly on the question whether the tax was unconstitutional "as to the income from personal property." *Id.*, at 586. The case was therefore scheduled for rehearing.

After rehearing, the Court extended its logic and held that a tax on income derived from personal property—like a tax on income derived from real property—was a direct tax. 158 U. S., at 625. The Court offered a more thorough explanation for why income could not be distinguished from its source when classifying a tax. It began by observing that the distinction between direct and indirect taxes was critical to our system of federalism. By ratifying the Constitution, the States "gave up the great sources of revenue derived from commerce" and "retained the power of direct taxation," but only concurrently with the Federal Government. *Id.*, at 620. Limitations on federal direct taxation offered state governments a fiscal safe haven against expanding federal authority, in recognition of the fact "that the power to tax involved the power to destroy." *Id.*, at 621. "[T]he qualified grant" of an apportioned direct-taxation power built security into the "structure of the government itself . . . by providing that direct taxation and representation in the lower house of Congress should be adjusted on the same measure." *Id.*, at 621–622.

The Court relied on those federalism principles to reject the argument "that income is taxable irrespective of the source from whence it is derived." *Id.*, at 629. It explained that the Constitution—read "in its plain and obvious sense" and in the context of "the circumstances attending the formation of the government"—could not be understood to treat income "as belonging to a totally different class" of taxation than the class "which includes the property from whence the income proceeds." *Id.*, at 627–628. Such an interpretation would leave the Direct Tax Clause "utterly illusory and futile, and the object of its framers defeated." *Id.*, at 628. The Court refused to allow the effect of the Direct Tax Clause to be "refined away by forced distinctions between" income and source. *Ibid.*

5

The Sixteenth Amendment was designed to overrule *Pollock*'s obstacle to an income tax, and it was understood by the public in those terms. *Pollock* stood in some tension with the Civil War tax cases, and it was not well received. Critics likened it to *Dred Scott* v. *Sandford*, 19 How. 393 (1857), and the decision became a major issue in the 1896 Presidential election. Weisman 148. By the 1908 Presidential election, both major political parties supported finding a way, *Pollock* notwithstanding, to impose an income tax. See E. Seligman, The Income Tax 591–592 (2d ed. 1914).

In 1909, President Taft pledged his support for an income-tax amendment. In a widely published message to Congress, he explained that "[t]he decision of the Supreme Court" in *Pollock* "deprived the national government of a power which" it "ought to have." Taft Asks for Tax, Washington Post, June 17, 1909, p. 4. Taft therefore asked Congress to "propose an amendment to the Constitution conferring the power to levy an income tax upon the national government without apportionment." *Ibid.*

Shortly after the President delivered his message, Senator Norris Brown of Nebraska proposed an income-tax amendment providing: "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several States according to population." 44 Cong. Rec. 3377 (1909). The proposed amendment's narrow focus on an income tax was significant. After all, a constitutional amendment could have easily eliminated *Pollock*'s obstacle to income taxation by removing the Constitution's direct-tax provisions wholesale.[8]

A few weeks later, the proposed amendment emerged from Committee in its modern form. It is not clear how the original proposal's reference to "direct taxes" was removed, or how the phrase "from whatever source derived" was added. See E. Jensen, The Taxing Power, the Sixteenth Amendment, and the Meaning of "Incomes," 33 Ariz. St. L. J. 1057, 1116–1117 (2001). The Amendment was passed by Congress on July 12, 1909. See 44 Cong. Rec. 4440. And, the Secretary of State certified that the Amendment had been ratified by the States on February 25, 1913. 37 Stat. 1785.

B

With a full understanding of the context against which the Sixteenth Amendment was ratified, two conclusions become clear. First, because the Amendment abolished *Pollock*'s rule that an income tax must be classified as direct or indirect based on whether a tax on the *source* of that income would be direct or indirect, the Amendment created a constitutional distinction between income and its source. Second, because Sixteenth Amendment "income" must be distinguished from its source, the Amendment includes a realization requirement.

1

I return, finally, to the text of the Sixteenth Amendment: "The Congress shall have power to lay and collect taxes on

---

[8] In fact, that possibility was suggested on the Senate floor as soon as the proposed amendment was read. 44 Cong. Rec. 3377 ("[I]f the Senator from Nebraska will change his amendment to the Constitution so as to strike out" all references to direct taxes, "he will accomplish all that his amendment proposes to accomplish and not make a constitutional amendment for the enacting of a single act of legislation"). But, Senator Brown responded that his "purpose [was] to confine it to income taxes alone." *Ibid.*

incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Against the background of *Pollock*, the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment" under the Sixteenth Amendment has an obvious and narrow meaning. The only thing the Amendment changed about the Constitution was to abolish *Pollock*'s rule that an income tax is a direct tax if a tax on the source of the income would be a direct tax. The Sixteenth Amendment left everything else in place, including the federalism principles bound up in the division between direct and indirect taxes.

The Court was first asked to interpret the Sixteenth Amendment in *Brushaber* v. *Union Pacific Railroad Co.*, 240 U. S. 1. A taxpayer raised an exhaustive set of "twenty-one constitutional objections" to the first income tax under the Sixteenth Amendment. *Id.*, at 10. Recognizing that the text of the Amendment could not be understood in a vacuum, the Court began with the text of the original taxing provisions and the history of the disputes over direct taxes from *Hylton's Case* to *Pollock*. 240 U. S., at 12–17. I can little improve on *Brushaber*'s explanation of the Sixteenth Amendment.

"[T]he whole purpose of the Amendment was to relieve all income taxes . . . from apportionment [based on] a consideration of the source whence the income was derived." *Id.*, at 18. *Pollock* stood for the rule that "whether a tax on income [is] direct" must be determined based upon a consideration of "the property from which the income [is] derived." 240 U. S., at 18. It was by "the rule applied in the *Pollock Case* . . . alone" that income "taxes were removed from the great class of [indirect taxes] and were placed under the . . . direct class." *Id.*, at 19. The Amendment did nothing more than remove that rule. The result was "the prevention of the resort to the sources from which a taxed income was derived in order to . . . place [an income tax] in the class of direct taxes." *Ibid.* But, other than that change, the Amendment "was drawn with the object of maintaining the limitations of the Constitution," including *Pollock*'s holding that direct taxes included "taxes levied directly on personal property because of its ownership." *Ibid.*

The Sixteenth Amendment thus facilitated an income tax by creating a new constitutional distinction between "income" and its "source." Under the Amendment, "from whatever source" income is "derived," a tax on it is indirect and therefore not subject to the rule of apportionment. But, as to taxes on the sources of income, the restrictions imposed by the division between direct and indirect taxes continued to apply with full force. And, taxes on property continued to be classified as direct taxes.

2

Because the Sixteenth Amendment requires a way to distinguish between income and source, it includes a realization requirement. The text of the Amendment incorporates such a requirement, and the concept of realization was well understood at the time of ratification. The Constitution thus limits unapportioned income taxes to taxes on *realized* income.

The word "income" in the Sixteenth Amendment must be interpreted in light of the Amendment's distinction between income and source. As the Court appreciated in *Eisner* v. *Macomber*, failure to understand "income" in this way leads to an interpretation of the Sixteenth Amendment that mistakenly displaces aspects of the original taxing provisions that the Amendment left in place: "In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income.'" 252 U. S., at 206.

Without an understanding of "income" that distinguishes it from "source," the Sixteenth Amendment undermines the restriction imposed by the Direct Tax Clause. The Government asserts that the Sixteenth Amendment uses "'income' . . . to refer to all economic gains." Brief for United States 14 (some internal quotation marks omitted). That understanding of "income" would allow taxes on real and personal property without apportionment. To be sure, most of the Government's arguments focus on "taxes on individuals' pro rata shares of undistributed corporate earnings." *Id.*, at 13. But, the Government is not shy about the fact that its definition of income includes things such as "increase in the value of a corporation's capital assets," "increase in the value of unsold property," and "appreciation in the value of securities." *Id.*, at 16 (alterations and internal quotation marks omitted). Those increases are "income" in a purely economic sense, but not in a sense that meaningfully distinguishes between "income" and the "source" from which it is "derived." A tax on each, whether it be an increase in assets, unsold property, or securities, would be a tax on the value of real estate or property, and should therefore require apportionment under the Direct Tax Clause.

The text of the Sixteenth Amendment points to the concept of realization, as the Court explained that concept in *Macomber*. The Amendment is clear that the word "income" refers to something that is "derived." Dictionaries at the time of ratification defined "derive" as "[t]o receive, as from a source or origin" and "to draw." Webster's New International Dictionary 601 (1913) (Webster's). And, that sense of "derived" maps neatly onto *Macomber*'s realization-focused definition of "income" as being "*received* or *drawn by* the recipient (the taxpayer) for his *separate* use." 252 U. S., at 207.

In fact, the idea of realization as the distinction between income and source long predates both *Macomber* and the Sixteenth Amendment. As the Government acknowledges, "the concept" of "realization . . . was well established when the Amendment was adopted." Brief for United States 15. The term "*realized*" appeared in several Civil War income tax provisions. *Id.*, at 16 (citing §116, 13 Stat. 281; §7, 16 Stat. 257–258). And, contemporaneous "[d]ictionaries defined 'realize' as 'to convert any kind of property into money.'" Brief for United States 15–16 (quoting Webster's 1778, and citing Black's Law Dictionary 993 (2d ed. 1910); alteration omitted). The Government argues that the decision to omit the often-used word "realized" from the Sixteenth Amendment is significant evidence that the Amendment does not require realization. See Brief for United States 16. But, the choice to instead use the near-synonym "derived" merely reflects the repeated use of the word "derive" to describe the relationship of income to its source in *Pollock*, to which the Sixteenth Amendment was a direct response. See 158 U. S., at 618, 629, 635.

The metaphor that the Court famously used in *Macomber* also shows the deep roots of the realization concept. To illustrate the "fundamental relation of 'capital' to 'income,'" *Macomber* compared "the former . . . to the tree or the land, [and] the latter to the fruit or crop." 252 U. S., 206. That understanding of income as being something "*severed from*" its source predated the Sixteenth Amendment. In a well-cited case from 1878, the Georgia Supreme Court relied on a tree-and-fruit analogy in a tax case to explain the difference between income and property: "The fact is, property is a tree; income is the fruit." *Waring* v. *Mayor and Aldermen of Savannah*, 60 Ga. 93, 100 (1878); see also Black's Law Dictionary, at 612 (defining "income" (citing *Waring*, 60 Ga., at 99)).

The text of the Sixteenth Amendment, read against the background of its adoption, confirms that the "incomes" that the Sixteenth Amendment allows Congress to tax without apportionment are only *realized* incomes. We granted certiorari in this case to answer whether Congress may "tax unrealized sums without apportionment among the states." Pet. for Cert. i. As the Sixteenth Amendment makes clear, the answer to that question is a resounding "no." The Court errs today by failing to correct the Ninth Circuit's contrary understanding.

* * *

It is imperative to give the original taxing provisions in Article I their proper effect. Those provisions reflect a delicate compromise under which the founding generation took the great risk of ceding much of the States' exclusive taxing authority to the Federal Government. *Supra*, at 7–12. Without that compromise, the Constitution could easily have been rejected. To be sure, the States slightly altered the original agreement by ratifying the Sixteenth Amendment. But, a constitutional amendment does not affect our duty of fidelity to the aspects of the original agreement that remain in place—including the Direct Tax Clause. If a written constitution is to mean anything, the compromises it records must bind us until we amend them.

II

The Court strains to uphold the Mandatory Repatriation Tax without addressing whether the Sixteenth Amendment includes a realization requirement, the question we agreed to answer in this case. The majority starts by surveying a scattered sampling of precedents—mostly about tax avoidance—to invent an "attribution" doctrine that sustains the MRT. The majority also relies on "longstanding congressional practice" to conclude that the Moores' claim fails because they cannot distinguish the MRT from similar taxes imposed by Congress in the past, which the Moores concede are constitutional. Neither point can withstand scrutiny.

A

To avoid the question whether the Sixteenth Amendment requires realization, the majority reframes the case as being about whether Congress may attribute an entity's realized income to shareholders or partners. *Ante*, at 8. According to the majority, our precedents establish a "clear rule" that the Sixteenth Amendment empowers Congress to choose whether "to tax [an] entity on its income" or instead "tax the entity's shareholders or partners on their share of the entity's undistributed income." *Ante*, at 17. Applying this rule, the Court concludes that the MRT permissibly chooses to attribute undistributed income earned by foreign corporations to their American shareholders. The Court thus refuses to address the "Government's argument that a gain need not be realized to constitute income under the Constitution" because the foreign corporation has realized the income. *Ante*, at 12–13, n. 3.

The majority's Sixteenth Amendment "attribution" doctrine is a new invention. The majority justifies its creation by plucking superficially supportive phrases from an eclectic selection of tax cases. But, none of the cases supports the proposition that the Sixteenth Amendment empowers Congress to freely attribute income to any taxpayer it reasonably chooses.

The majority begins with *Burk-Waggoner Oil Assn.* v. *Hopkins*, 269 U. S. 110 (1925), a case that it says "articulated [the] fundamental principle" that "Congress could tax . . . income as it ch[ooses]," either by taxing an entity or an individual. *Ante*, at 9. But, *Burk-Waggoner* merely held that Congress may tax a *de facto* corporation on its own income, even if it is formally a partnership under state law. See 269 U. S., at 114 ("[N]othing in the Constitution precludes Congress from taxing as a corporation an association which, although unincorporated, transacts its business as if it were incorporated"). Tellingly, we have never cited *Burk-Waggoner* for the proposition derived by the majority, but instead for the proposition that federal statutes "designed to tax income actually earned . . . are not to be frustrated by state laws." *Commissioner* v. *Tower*, 327 U. S.

280, 288 (1946) (citing 269 U. S., at 114); see also *Lyeth* v. *Hoey*, 305 U. S. 188, 194 (1938) (same); *Hemphill* v. *Orloff*, 277 U. S. 537, 550 (1928) (same). *Burk-Waggoner* thus shows that state law may not be used as a means of evading federal taxes—not that Congress may choose whether to attribute income to entities or individuals.

The majority then cites *Burnet* v. *Leininger*, 285 U. S. 136 (1932), which it says "reiterated" that Congress can choose to impose income-tax liability "'upon [a] partnership directly'" or "'upon the individuals carrying on business in partnership.'" *Ante*, at 9 (quoting 285 U. S., at 142; internal quotation marks omitted). But, the majority quotes language that is part of a due process holding, not an application of the Sixteenth Amendment. *Leininger* involved a taxpayer's attempt to evade taxation by assigning half of his share in a partnership's income to his wife. *Id.*, at 138. The taxpayer argued that assessing income taxes against him based on "a partnership interest owned by his wife" violated the Fifth Amendment's Due Process Clause. Brief for Respondent in *Burnet* v. *Leininger*, O. T. 1931, No. 426, p. 24. The Court rejected the argument, concluding that it did not violate due process to "tax the distributive share of each partner" by ignoring the taxpayer's attempt to divert his income to his wife. 285 U. S., at 142. The majority is clear that it offers no opinion about due process questions. See *supra*, at 4–5, nn. 4, 6. Because *Leininger* is a due process case, it is unclear how it supports the majority's Sixteenth Amendment attribution doctrine.

Next, the majority claims that the Court "reaffirmed that Congress may choose to tax either [a] partnership *or* [its] partners" in *Heiner* v. *Mellon*, 304 U. S. 271 (1938), when it rejected the argument by members of a partnership "that Congress could not tax them on income that they did not and could not personally receive." *Ante*, at 10. But, *Heiner* is a statutory interpretation case. Under the applicable statute, the taxpayers were subject to a tax on their "distributive share, whether distributed or not, of the net income of the partnership." §218(a), 40 Stat. 1070. The taxpayers argued only that "there was no distributive share" within the meaning of the statute, because distribution was currently impossible under state law; they made no argument about the scope of Congress's power. Brief for Respondents in *Heiner* v. *Mellon*, O. T. 1937, No. 144 etc., p. 34. *Heiner*'s interpretation of the statutory phrase "distributive share" cannot be understood as a holding about the scope of Congress's supposed attribution power.

The majority completes its survey of "attribution" precedents with *Helvering* v. *National Grocery Co.*, 304 U. S. 282 (1938), which it says extended *Heiner*'s attribution principle from partnerships to corporations. *Ante*, at 10. But, *National Grocery* demonstrates Congress's ability to legislate against tax-avoidance schemes—not an ability to freely attribute corporate income to shareholders. The majority misleadingly describes *National Grocery* as involving "the controlling shareholder of a corporation" being taxed "individually . . . on the year's profits." *Ante*, at 10 (internal quotation marks omitted). In reality, the case involved a tax paid by a corporation—owned 100% by one person—after the corporation permitted profits to accumulate without distribution "'for the purpose of preventing the imposition of [a] surtax upon [the] sole stockholder.'" 304 U. S., at 285. In essence, the sole stockholder used the corporation as a tax-free bank account to hold what was really his income. The Court concluded that Congress may legislate to prevent "the sole owner of [a] business" from "conducting it as a corporation" to avoid the tax consequences that would attach if the business had "been carried on as a partnership." *Id.*, at 288. The Court cited *Heiner* merely to explain those tax consequences, not to support an attribution principle. *National Grocery* is yet another tax-evasion case, not an application of an attribution principle.

At most, the cases cited by the majority demonstrate that Congress may attribute income to the entity or individual who actually controlled it when necessary to defeat attempts to evade tax liability. They do not suggest that Congress may freely choose whether to impose an income tax on a corporation or on its shareholders. The "clear rule" that the majority relies on to sidestep the realization question is thus a mirage. *Ante*, at 17.

B

The majority separately concludes that the Moores' claim fails because they cannot distinguish the MRT from other longstanding taxes that they concede are constitutional. The majority sees no distinction between the MRT and older taxes on partnerships, "S corporations," and closely held foreign corporations under other parts of subpart F. *Ante*, at 16–21. But, the majority's insistence that the MRT is just like other forms of pass-through taxation is not convincing.

First, the MRT's taxation of corporate shareholders is not like pass-through taxation of partners. The Moores are correct that the Sixteenth Amendment allows Congress to tax partners on partnership income because "partnerships hav[e] no existence separate from their partners." Brief for Petitioners 51. A partner's share of partnership income is therefore understood to be his own income. The majority quibbles with the Moores' understanding of early-20th century partnership law and points out that "legislatures treated partnerships as separate entities in many contexts," including for some tax purposes. *Ante*, at 17–18. But, the fact that a partnership can sometimes be treated as an entity is beside the point. The significant fact is that partners had long been considered to be subject to income taxes without consideration of the partnership; longstanding taxes based on that understanding are not implicated by the Moores' challenge to the MRT.

Second, and for similar reasons, the MRT's taxation of corporate shareholders is not like pass-through taxation of shareholders of "S corporations." An S corporation is a corporation that does not have more than 100 shareholders, does not have any shareholder who is not an individual or who is a nonresident alien, does not have more than one class of stock, and which elects to be treated as an S corporation. 26 U. S. C. §§1361(a)(1), (b)(1). These eligibility requirements make it clear that pass-through taxation of S corporations is merely an extension of the pass-through taxation of partnerships. Indeed, for most tax purposes, S corporations are equivalent to partnerships, not to corporations. "Tax practitioners often say that an S corporation is taxed like a partnership." CCH S Corp. Guide ¶510, p. 505 (2013); see also West's Tax Law Dictionary (2024) (defining "S Corporation" as "Corporation which elects S status and receives tax treatment similar to a partnership"). Taxing S corporation shareholders on corporate income is constitutional for the same reasons as taxing partners on partnership income. To the majority, "S corporations are another example of Congress's authority to either tax the corporation itself on corporate income or attribute the undistributed income to the shareholders and tax the shareholders." *Ante*, at 19. But, it does not make sense to look to S corporations for conclusions about the pass-through taxation of corporate shareholders generally.

Finally, the MRT is unlike other taxes on shareholders of closely held foreign corporations. The MRT "differs from other provisions of Subpart F"—the portion of the Internal Revenue Code dealing with controlled foreign corporations—because the MRT does not focus on "the corporation's receipt of investment earnings while subject to the shareholders' control." Brief for Petitioners 44–45. Subpart F "aligns the corporation's earning of the money being taxed with the shareholder's control *in the same year*." Reply Brief 23. But, "[t]he MRT by its terms takes no account of whether a shareholder had any interest or control when the corporation made the earnings that it attributes to her." *Ibid.* In fact, the MRT "tags a shareholder with taxable 'income' even if" he purchased shares "long after the corporation earned the sums being taxed," and it imposes no liability on taxpayers who owned shares for years of retained earnings but sold them before the MRT's trigger date. Brief for Petitioners 45. Subpart F includes some minimal requirements to ensure that taxable "income" belongs to the shareholder in some way; the MRT abandons that effort entirely.

The majority concludes that "the MRT . . . has the same essential features as subpart F." *Ante*, at 21. But, unlike the rest of subpart F, the MRT has no connection at all to any "recognition event" or "constructive receipt of income," and it offers no "rational basis for Congress to attribute *income* to a taxpayer." S. McElroy, The Mandatory Repatriation Tax Is Unconstitutional, 36 Yale J. Reg. Bull. 69, 80–81 (2018). The MRT turns solely on the ownership of stock on a certain date. That is a significant difference between the MRT and the rest of subpart F, and one with constitutional implications.

The fact that the MRT has novel features does not mean that it is unconstitutional. But, the MRT is undeniably novel when compared to older income taxes, and many of those differences are constitutionally relevant. Because the MRT is imposed merely based on ownership of shares in a corporation, it does not operate as a tax on income.

C

The majority is not ashamed to lay bare the consequentialist heart of its opinion. Because it wrongly concludes that the Moores' constitutional argument would invalidate not only the MRT but also other longstanding taxes, the majority frets that the Moores would "deprive the U. S. Government and the American people of trillions in lost tax revenue" and "require Congress to either drastically cut critical national programs or significantly increase [other] taxes." *Ante*, at 21. "The Constitution does not require that fiscal calamity," the majority proclaims. *Ibid.* I agree. But, if Congress invites calamity by building the tax base on constitutional quicksand, "[t]he judicial Power" afforded to this Court does not include the power to fashion an emergency escape. Art. III, §1, cl. 1.

Even as the majority admits to reasoning from fiscal consequences, it apparently believes that a generous application of dicta will guard against unconstitutional taxes in the future. The majority's analysis begins with a list of nonexistent taxes that the Court does not today bless, including a wealth tax. *Ante,* at 8, n. 2. And, it concludes by offering a narrow interpretation of its own holding, hinting at limiting doctrines, prejudging future taxes, cataloguing the Government's concessions, and reserving other questions "for another day." *Ante*, at 22–24. Sensing that upholding the MRT cedes additional ground to Congress, the majority arms itself with dicta to tell Congress "no" in the future. But, if the Court is not willing to uphold limitations on the taxing power in expensive cases, cheap dicta will make no difference.

III

The Court today upholds the MRT, but not because it endorses the Ninth Circuit's erroneous view that "realization of income is not a constitutional requirement." 36 F. 4th, at 936. The majority acknowledges that the Sixteenth Amendment draws a distinction between income and its source. *Ante*, at 7. And, it does not dispute that realization is what distinguishes income from property. *Ante*, at 8. Those premises are sufficient to establish that realization is a constitutional requirement. Sixteenth Amendment "income" is only realized income. We should not have hesitated to say so in this case. I respectfully dissent.

June 21, 2024
Exceptions to penalty on early retirement plan distributions outlined

May 1, 2024
Establishing a SIMPLE IRA plan for only a few employees

January 4, 2024
Stock-based compensation: Tax forms and implications

TOPICS

Employee Benefits

Types & Qualifications

The SECURE 2.0 Act[1] is an extensive piece of retirement plan legislation passed on Dec. 29, 2022. Its stated goals are to expand and increase retirement savings and to simplify and clarify retirement plan rules. Its passage affects virtually all forms of retirement plans and increases conformity across different types of plans. The legislation expands and builds upon the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019,[2] which was known for increasing the age for required minimum distributions (RMDs) and eliminating age requirements for traditional IRA contributions.

A behemoth, SECURE 2.0 contains over 90 changes to retirement plan and tax law (versus the 30 or so in the SECURE Act) and myriad effective dates.[3] Not surprisingly, further guidance is expected regarding its implementation, and calls for technical corrections and delayed effective dates are surfacing and being considered by congressional leaders and Treasury as of this writing.

SECURE 2.0 was organized in seven titles:

- Title I — Expanding Coverage and Increasing Retirement Savings (Sections 101–128);
- Title II — Preservation of Income (Sections 201–204);
- Title III — Simplification and Clarification of Retirement Plan Rules (Sections 301–350);
- Title IV — Technical Amendments (Section 401);
- Title V — Administrative Provisions (Section 501);
- Title VI — Revenue Provisions (Sections 601–606); and
- Title VII — Tax Court Retirement Provisions (Sections 701–702).

This article focuses on selected provisions in the first six titles of the act with effective dates in 2023 and 2024, including anticipated technical corrections, potential delayed effective dates, and guidance issued by Treasury and the IRS as of this writing.

SECURE 2.0 provisions taking effect in 2023 and 2024

Student loan payment matching

SECURE 2.0 Act Section 110[4] provides that employers may make matching contributions to a retirement plan when employees make qualified student loan payments, for defined contribution plans in years beginning after Dec. 31, 2023. "Qualified student loan payments" are defined as the repayment by an employee of a qualified education loan incurred by the employee and used to pay qualified higher education expenses. These matching retirement contributions must vest under the same schedule as other matching retirement contributions under the plan, and annual employee certification of student loan payment is required. Thus, where plans allow, employees need no longer forgo employer matching retirement contributions because they elect to pay off student loans instead of investing in retirement.

Expansion of penalty-free withdrawals

An early withdrawal penalty is imposed on distributions from tax-deferred retirement accounts received before age 59½. SECURE 2.0 expanded the avenues for exemption from this early withdrawal penalty in several ways and attempted to conform the hardship distribution rules for Sec. 403(b) plans to those of Sec. 401(k) plans.

Emergency personal expense distributions: Beginning in 2024, penalty-free distributions of up to $1,000 are allowed by act Section 115[5] as "emergency personal expense distributions" for "unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses." Only one distribution may be made every three calendar years, or one per year if any previous emergency personal expense distribution within the three-year period has been repaid.

Distribution in case of domestic abuse: Penalty-free withdrawals are also allowed by act Section 314,[6] beginning in 2024, for certain amounts for individuals who need the funds in cases of domestic abuse. Victims of domestic abuse may receive the lesser of (1) $10,000 (adjusted for inflation after 2024) or (2) 50% of their account value without penalty. Domestic abuse is defined to include physical, psychological, sexual, emotional, or economic abuse by a spouse or domestic partner and includes efforts to control, isolate, humiliate, or intimidate the victim by means of abuse of others — the victim's child or other family members — living in the household. The participant may repay withdrawn amounts over a three-year period and recoup income taxes paid on distributions that are repaid.

Individuals with a terminal illness: Act Section 326[7] allows an exception for terminal illness (effective for distributions made after Dec. 29, 2022).[8] For a taxpayer to qualify for this penalty waiver, a physician's certification is required, and death must be reasonably expected within 84 months of the date of certification.

Qualified disaster recovery: Act Section 331,[9] also effective in 2023, exempts from penalties distributions of up to $22,000 made due to qualified disasters.[10] A 180-day window for receiving such qualified disaster distributions is specified,[11] and these distributions are to be included in taxable income ratably over a three-year period. The participant may repay withdrawn amounts over a three-year period.

Other notable provisions: Beginning in December 2025, retirement plans will be permitted to distribute up to $2,500 per year to pay premiums for specified long-term-care insurance contracts, under act Section 334. The distributions will be penalty-free.[12] Act Section 312,[13] effective in 2023, allows employees to self-certify that they have had an event that constitutes a hardship for purposes of hardship withdrawal certification.

SIMPLE plan changes

SIMPLE IRAs and simplified employee pension plans (SEPs) can allow employees to treat contributions as nondeductible Roth contributions under act Section 601, which repealed Sec. 408A(f), effective for tax years beginning in 2023.[14] Act Sections 116, 117, and 332 make other changes to SIMPLE plans that are effective in 2024.

SIMPLE plans previously required employer contributions of either (1) a nonelective 2% of compensation or (2) 100% of employee elective deferral contributions, up to 3% of compensation. Act Section 116 eases those limitations and allows an employer with a SIMPLE plan to make additional contributions to each employee of the plan in a uniform manner, provided that the contributions do not exceed the lesser of (1) up to 10% of compensation or (2) $5,000, indexed for inflation after 2024.

In 2023, the annual contribution limit for employee elective deferrals was $15,500, and the catch-up contribution limit was $3,500 (for those 50 and older). Act Section 117 increases the annual SIMPLE IRA and SIMPLE 401(k) deferral limit and the catch-up contribution limit by 10% to 110% of the 2024 deferral/catch-up contribution limits (indexed for inflation after 2024), in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees is permitted to provide these higher deferral limits if the employer provides either a (1) 4% matching contribution or (2) 3% employer contribution. Act Section 332 allows an employer to replace a SIMPLE IRA plan with a SIMPLE 401(k) plan or other 401(k) plan that requires mandatory employer contributions during a plan year.

'Starter' 401(k) plans for employers with no retirement plan

Effective in 2024, act Section 121 allows employers with no retirement plan to create "starter" 401(k) wage deferral plans (and 403(b) safe-harbor plans).[15] The plans allow employees to save up to $6,000 per year (indexed for inflation, with a $1,000 catch-up for those 50 and older) in a tax-preferred retirement account, without the administrative burden or expense of a traditional 401(k) plan for the employer. The qualified percentage of compensation, between 3% and 15%, must be applied uniformly. The plans do not permit employer contributions or require complex testing. All employees must be eligible to participate if age and service requirements are met, but they may opt out.

For employers subject to retirement plan coverage requirements in certain states, these plans provide a route to meet that state mandate. Employee contributions to these plans were intended to have the same limits as IRAs, the likely alternative investment. As passed, however, the starter 401(k) and 403(b) plan contribution limit ($6,000) will be less than the IRA limit in 2024 ($7,000, after indexing) when the provision first becomes effective. A change to conform the limits of starter plans to those of IRAs seems a likely target for technical corrections.

529-plan-to-Roth-IRA rollovers

For distributions in 2024 and later, act Section 126 allows beneficiaries of 529 college savings plans to roll over up to an aggregate of $35,000 of excess 529 plan funds to Roth IRAs throughout their lifetime. The 529 plan must have been open for at least 15 years, and the rollovers are subject to the annual Roth IRA contribution limit.[16]

Emergency savings accounts linked to retirement plans

Uncertainty surrounding the possible need to tap into retirement savings for urgent financial needs often discourages retirement plan participation, because of the penalties associated with early fund withdrawals. To mitigate this employee hesitation, act Section 127 introduces emergency savings accounts linked to an employer's retirement plan. Employers may automatically enroll non–highly compensated employees (defined in 2023 as those earning up to $150,000) at no more than 3% of their salary, limited to $2,500. The employee's first four withdrawals each plan year may not be subject to any withdrawal fees. Contributions to these accounts, together with any excess contributions, must all be made on an after-tax (Roth) basis and treated as employee elective deferrals for purposes of matching contributions. Any excess contributions are funneled into any other Roth designated account the employee has. Upon separation from service, employees have options to roll over into another Roth plan or Roth IRA or receive the cash balance in their account. These provisions are effective for plan years beginning after 2023.

Provisions affecting RMDs

Several important changes were made to RMDs. Act Section 107 increased the applicable age for RMDs to 73, effective Jan. 1, 2023, and to age 75 on Jan. 1, 2033, for certain individuals. An ambiguity regarding the 2033 change may require technical correction; this will be discussed later in this article. Also, act Section 327, effective in 2024, allows surviving spouses to be treated as the deceased employee for RMD purposes where the spouse is designated as the sole beneficiary and RMDs have not yet begun. This provision effectively negates the need under prior law to roll the deceased spouse's plan interest into an IRA to receive a more favorable distribution period. Distributions are not required to begin earlier than the applicable age date of the deceased employee.

In addition, act Section 325 specifies that, as of Jan. 1, 2024, Roth accounts in employer retirement plans will no longer have RMDs.

Other provisions

Some other noteworthy provisions of the SECURE 2.0 Act are described below in connection with the discussion of anticipated technical corrections.

Anticipated technical corrections and potential delayed effective dates

As of this writing, the House Ways and Means Committee and Senate Finance Committee leaders plan to introduce legislation to clarify congressional intent with respect to certain aspects of SECURE 2.0, as indicated in a letter to Treasury.[17]

Specifically, the congressional tax leaders' letter highlighted the following four provisions as needing technical clarification or correction:

- The availability of catch-up contributions (act Section 603);
- The age at which RMDs should begin (act Section 107);
- Roth contributions to SIMPLE IRAs and SEPs (act Section 601); and
- Tax credits for small employer startup retirement plans (act Section 102).

The availability of catch-up contributions

The SECURE 2.0 Act contains several provisions affecting catch-up contributions. Act Section 108 increases the $1,000 IRA catch-up contribution available to taxpayers 50 and older by indexing the amount to inflation.[18]

19

Also, act Section 109 provides for a larger catch-up contribution amount for those 60 to 63 years old, effective for tax years beginning after 2024. For most plans, the 2025 catch-up amount increases to the greater of (1) $10,000 ($5,000 for SIMPLE plans) or (2) 50% more than the usual, or standard, catch-up amount. Beginning in 2026, the amount will be indexed for inflation. The year reference for SIMPLE plans is 2025 when computing this limit. Conformity in these provision date references may be an item for the technical corrections list.

In addition, act Section 603 requires any catch-up contributions to be characterized as Roth contributions if made by participants in 401(k), 403(b), or 457(b) plans earning wages exceeding $145,000 in the preceding year, beginning in tax year 2024. This means that employers who allow catch-up contributions must begin offering Roth plans in addition to their pretax retirement plans, if not offered already. This could pose a significant problem for those government plans not offering a Roth option, because changes in state laws and/or union contracts may be required to allow compliance with act Section 603.

Some technical corrections to these provisions are expected. As written, the SECURE 2.0 Act mistakenly eliminates catch-up contributions entirely (due to the inadvertent deletion of Sec. 402(g)(1)(C), which states that catch-up contributions are excludable from gross income). The anticipated technical correction legislation will clarify that there was no congressional intent to eliminate catch-up contributions. According to the congressional tax leaders' letter to Treasury:

Congress did not intend to disallow catch-up contributions nor to modify how the catch-up contribution rules apply to employees who participate in plans of unrelated employers. Rather, Congress's intent was to require catchup contributions for participants whose wages from the employer sponsoring the plan exceeded $145,000 for the preceding year [highly paid participants] to be made on a Roth basis and to permit other participants to make catch-up contributions on either a pretax or a Roth basis.

The IRS has addressed this administratively in Notice 2023-62, issued in August 2023, by indicating it will ignore the drafting error that eliminates catch-up contributions entirely.

Separately, another potential oversight is apparent because the high-earnings provision is based upon $145,000 of FICA[19] wages, thereby excluding sole proprietors and partners. Their exclusion presumably allows sole proprietors and partners to make pretax catch-up contributions without regard to the level of earned income, which appears inconsistent with the spirit of the law. Act Section 603 was introduced and passed as a revenue raiser rather than to distinguish between taxpayers as to status based upon business form. Thus, technical corrections or future guidance may indicate conformity of the treatment of sole proprietors and partners with other taxpayers. In the interim, the IRS has indicated in Notice 2023-62 that it intends to issue guidance that individuals with self-employment income and no Social Security wages, such as partners in a partnership, are not subject to the requirement that their catch-up contributions must be characterized as Roth contributions.

On June 29, 2023, over 200 organizations — including large retirement plan employers, advocacy organizations, and retirement plan investment vendors — lobbied the leaders of the House Ways and Means Committee and the Senate Finance Committee via a letter to delay the effective date of this revenue raiser provision for two years.[20] Another similar letter was sent to Treasury and IRS officials on July 19, 2023.[21] The gist of this effort is that the organizations do not expect to be able to comply with the increased recordkeeping and systems burdens imposed by this provision by its current effective date. Thus, affected employers will be forced to disallow all catch-up contributions if relief is not forthcoming in the interim period before updated systems are in place to ensure compliance. The letter urges Congress to act but alternatively exhorts Treasury to provide transitional relief in the event Congress does not act soon.

In response to taxpayer feedback, the IRS has also postponed the implementation of the high-earnings provision in Notice 2023-62. Although the high-earnings provision is technically still effective on Jan. 1, 2024, the IRS announced a two-year administrative transition period, thereby effectively extending the effective date to Jan. 1, 2026. During the transition period, plans may continue to allow pretax catch-up contributions by highly paid participants, and plans that do not have Roth features may continue to allow catchup contributions. Thus, through 2025, a plan that does not provide for designated Roth contributions will be deemed to have satisfied the Sec. 414(v)(7)(B) requirements.

The age at which RMDs should begin

Another provision highlighted by the congressional tax leaders' letter to Treasury as needing technical clarification involves the RMD applicable age. As noted earlier, SECURE 2.0 Act Section 107 increased the applicable age for RMDs to 73, effective Jan. 1, 2023, and to age 75 on Jan. 1, 2033, for certain individuals, but there was some ambiguity in the law as written. Specifically, it increased the applicable age to 73 for those individuals who turn age 72 after Dec. 31, 2022 (and 73 by Dec. 31, 2032), and to age 75 for those individuals turning 74 after Dec. 31, 2032. Technical corrections are expected to indicate that the RMD age will be 75 for taxpayers turning 73 (rather than 74) after Dec. 31, 2032.

Roth contributions to SIMPLE IRAs and SEPs

Under former Sec. 408A(f), SIMPLE IRAs and SEP plans could not have Roth accounts, and a specific rule stated that contributions to SIMPLE IRAs or SEP plans did not count against the annual limit on contributions to a Roth IRA. As passed, act Section 601 repealed Sec. 408A(f), thus permitting SIMPLE IRAs and SEPs to include Roth IRAs. As a result, however, act Section 601 might be read as requiring SIMPLE and SEP contributions to now be included in determining whether an individual has exceeded the Roth IRA contribution limits. The congressional letter clarifies that this was not the intent of SECURE 2.0.

That is, Roth IRA contribution limits should not be reduced by amounts contributed to SIMPLE IRAs or SEP plans:

Congress intended to retain the result under the law as it existed before SECURE 2.0 was enacted regarding SIMPLE IRA and SEP contributions. ... Thus, Congress intended that no contributions to a SIMPLE IRA or SEP plan (including Roth contributions) be taken into account for purposes of the otherwise applicable Roth IRA contribution limit.

Tax credits for small employer startup retirement plans

Another ambiguity in SECURE 2.0 involves tax incentives for small employers to create startup retirement plans. The act expanded an existing credit and created a new and separate one, but the drafting left some confusion. As background, the Code provides a tax credit of up to $5,000 for 50% of qualified startup costs, defined as costs to set up and administer plans and educate employees about the plan, incurred by employers having 100 or fewer employees that earned at least $5,000 in compensation in the prior year.[22]

Act Section 102(a), effective in 2023, expands this credit for startup costs for smaller employers.[23] The new credit rate is 100% of eligible startup costs for employers with up to 50 employees but remains 50% of eligible costs for employers with 51–100 employees. An eligible employer may elect that the first credit year be the year prior to the year the plan is effective. The credit is available to small employers that currently do not, and in the past three years have not, maintained a Sec. 401(a), 403, SIMPLE, or SEP plan. The minimum credit is $500; the employer is eligible for the credit for up to three tax years.

Additionally, act Section 102(b)[24] created a new and separate tax credit for employer contributions for the first five years of a qualified new plan (excluding defined benefit plans), of up to $1,000 per employee. The maximum credit for employers with 50 or fewer employees is the lesser of the actual employer contribution, or $1,000 per employee earning $100,000 (or less) in FICA wages. The tax credit is 100% of eligible employer contributions for the first two years, decreasing thereafter by 25% each year to 25% in the fourth tax year after the tax year of the plan's adoption. For employers with more than 50 employees, the credit is subject to a phasein, under which it is reduced by an amount equal to the product of the credit as determined before the phase-in, multiplied by a percentage equal to 2 percentage points for each employee of the employer for the preceding tax year over 50 employees. Drafting ambiguity in Section 102 has given rise to concern that the legislation could be read as limiting the new employer contribution credit to the existing $5,000 limit on the credit for costs associated with establishing new plans. Accordingly, congressional tax leaders clarified in their letter that Congress intended the new credit for employer contributions to be available in addition to the startup credit otherwise available to the employer.

Selected guidance issued to date

Notices 2023-23 and 2023-54

These two notices granted transition relief related to 2023 RMDs. As a result of the brief amount of time to implement the change in the RMD onset age, financial institutions may have notified some plan participants and IRA owners of a required 2023 RMD based on prior law. In addition, plan participants may have received distributions in 2023 mischaracterized as RMDs (ineligible for rollover) due to delayed changes in employer systems necessary to comply with the age changes in SECURE 2.0. The notices provided transition relief.

Notice 2023-43

Act Section 305 provided for the expansion of the Employee Plans Compliance Resolution System and directed Treasury to revise Rev. Proc. 2021-30 within two years of enactment of SECURE 2.0. Notice 2023-43 provides interim guidance until this revision takes place. The guidance allows plan sponsors to self-correct an eligible inadvertent failure (as defined in act Section 305(e)), disallows selfcorrection by IRA custodians, and provides interpretive guidance that applies with respect to corrections of eligible inadvertent failures.

The notice identifies IRS enforcement positions regarding self-corrections in 11 questions and answers.

Notice 2023-62

In Notice 2023-62, besides granting the previously noted relief regarding catch-up contributions, the IRS indicated its intention to provide additional guidance. That expected guidance will specify that a plan sponsor may treat a pretax contribution election by a highly paid participant as an election to make Roth catch-up contributions and that separate employers in a plan maintained by unrelated employers are not required to aggregate wages with unrelated employers in the plan for purposes of determining whether an employee is highly paid.

SECURE 2.0's expansive reach

SECURE 2.0 was heralded as simplifying and clarifying retirement plan law as well as facilitating retirement savings. The provisions that went into force Jan. 1, 2024, are a subset of its reach, with other provisions having taken effect in 2023, and an additional slate of provisions to become effective in years 2025 and beyond. Partly because of the sheer breadth and farreaching influence of the act, uncertainty has arisen in applying several of its key provisions, which has spawned calls by employers and financial institutions to postpone implementation.

The act will provide fruitful ground for analyses by CPAs and other retirement specialists and may require further congressional action to clarify certain new rules in the years to come.

[1] SECURE 2.0 Act, Division T of the Consolidated Appropriations Act, 2023, P.L. 117-328.

[2] Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, Division O of the Further Consolidated Appropriations Act, 2020, P.L. 116-94.

[3]For a discussion of major provisions of the act, see Nevius, "Key Tax and Retirement Provisions in the SECURE 2.0 Act," The Tax Adviser (Jan. 4, 2023).

[4]Amending Sec. 401(m)(4).

[5]Amending Sec. 72(t)(2).

[6]Adding Sec. 72(t)(2)(K).

[7]Adding Sec. 72(t)(2)(L).

[8]The date of enactment of SECURE 2.0.

[9]Adding Sec. 72(t)(2)(M) and Sec. 72(t)(11).

[10]Generally, any major disaster, as declared by the president under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Sec. 72(t)(11)(E)).

[11]Beginning on the first day of the "incident period" specified by the Federal Emergency Management Agency or the date of a federal disaster declaration with respect to the qualified disaster.

[12]Adding Sec. 401(a)(39). The $2,500 maximum distribution is adjusted for inflation for tax years beginning after 2024.

[13] Adding Sec. 401(k)(14)(C).

[14]Employers can provide a similar option in defined contribution plans under act Section 604, also effective in 2023.

[15]Adding Secs. 401(k)(16) and 403(b)(16) and amending Sec. 416(g)(4).

[16]See also Demosthenes, "529 Plans and Education Funding," 54-9 The Tax Adviser 50 (September 2023), and Toolson, "The Unique Benefits of 529 College Savings Plans," 54-5 The Tax Adviser 30 (May 2023).

[17]Letter from Reps. Jason Smith, R-Mo., and Richard E. Neal, D-Mass., and Sens. Ron Wyden, D-Ore., and Mike Crapo, R-Idaho, to Treasury Secretary Janet Yellen and IRS Commissioner Daniel Werfel (May 23, 2023).

[18]Sec. 219(b)(5).

[19]Federal Insurance Contributions Act.

[20]Letter to Reps. Jason Smith, R-Mo., and Richard E. Neal, D-Mass., and Sens. Ron Wyden, D-Ore., and Mike Crapo, R-Idaho (June 29, 2023).

[21]Letter to Carol Weiser, Benefits Tax Counsel, Treasury, and Rachel Leiser Levy, Associate Chief Counsel, IRS (July 19, 2023).

[22]Sec. 45E.

[23]Adding Sec. 45E(e)(4).

[24]Adding Sec. 45E(f).

Contributors

Nell Adkins, CPA, Ph.D., is an associate professor at the University of Southern Mississippi in Hattiesburg, Miss. B. *Charlene Henderson,* CPA, Ph.D., is an instructor at Louisiana State University in Baton Rouge, La. For more information about this article, contact thetaxadviser@aicpa.org.

OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2024

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

May 23, 2024
JCX-26-24

CONTENTS

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation ("Joint Committee staff"), provides a summary of the present-law Federal tax system as in effect for 2024.

The current Federal tax system has four main elements: (1) an income tax on individuals, estates, trusts, and corporations (which consists of both a "regular" income tax and, in the case of individuals and certain large corporations, an alternative minimum tax);[2] (2) payroll taxes on wages (and corresponding taxes on self-employment income) to finance certain social insurance programs; (3) estate, gift, and generation-skipping transfer taxes; and (4) excise taxes on selected goods and services. This document provides a broad overview of each of these elements.

Several aspects of the Internal Revenue Code of 1986 (the "Code") are subject to change over time. For example, some dollar amounts and income thresholds are indexed for inflation, including the standard deduction, tax rate brackets, and the annual gift tax exclusion. In general, the Internal Revenue Service ("IRS") adjusts these numbers annually and publishes the inflation-adjusted amounts in effect for taxable years beginning in a calendar year before the beginning of such calendar year. Where applicable, this document generally includes dollar amounts in effect for 2024[3] and notes whether dollar amounts are indexed for inflation.[4]

In addition, many provisions in the Federal tax laws are temporary or have parameters that change over time according to the statute. For simplicity, this document describes the Federal tax laws in effect for 2024, as of the date of publication, and generally does not include references to provisions as they may be in effect for future years or to termination dates for expiring provisions.[5]

---

[1] This document may be cited as follows: Joint Committee on Taxation, *Overview of the Federal Tax System as in Effect for 2024* (JCX-26-24), May 23, 2024. This document can be found on the Joint Committee on Taxation website at www.jct.gov. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986.

[2] If certain requirements are met, certain entities or organizations are exempt from Federal income tax. A description of such entities and organizations is beyond the scope of this document. For a description, see Joint Committee on Taxation, *Report to the House Committee on Ways and Means on Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups* (JCS-3-13), May 6, 2013, pp. 19-58.

[3] For certain inflation-adjusted amounts in effect for 2024, see Rev. Proc. 2023-34, 2023-48 I.R.B. 1287, November 27, 2023.

[4] Parameters in the Code generally are indexed for inflation by applying the CPI-U up to 2017 values and the C-CPI-U for years thereafter.

[5] See Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2024-2034* (JCX-1-24), January 11, 2024.

I. SUMMARY OF THE PRESENT-LAW FEDERAL TAX SYSTEM

A. Individual Income Tax

In general

The worldwide taxable income of a United States citizen or resident alien generally is subject to the U.S. individual income tax.[6] Taxable income equals the taxpayer's total income less certain exclusions, exemptions, and deductions. Income tax liability is determined by applying graduated tax rates to a taxpayer's taxable income. A taxpayer may face additional liability if the alternative minimum tax applies. Income tax liability may be reduced by applicable tax credits.

The taxable income of estates and trusts is generally calculated in the same manner as the taxable income of individuals.[7]

Gross income

Under the Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute.[8] Sources of income include compensation for services, interest, dividends, capital gains, rents, royalties, annuities, income from life insurance and endowment contracts (other than certain death benefits), pensions, gross profits from a trade or business, income in respect of a decedent, income distributed from trusts or estates, and income allocated from S corporations or partnerships.[9] Statutory exclusions from

---

[6] Foreign tax credits generally are available to offset U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. Sec. 901, *et. seq.* A nonresident alien generally is subject to the U.S. individual income tax only on income with a sufficient nexus to the United States. Sec. 872(a). A U.S. citizen or resident who satisfies certain requirements for presence in a foreign country also is allowed a limited exclusion ($126,500 in 2024) for foreign earned income and a limited exclusion for employer-provided housing. Sec. 911.

[7] Sec. 641(b). In general, estates and most trusts pay tax on income at the entity level to the extent that the income is not distributed or required to be distributed under governing law or under the terms of the governing instrument. Such entities determine their tax liability using a special tax rate schedule and are subject to the alternative minimum tax and net investment income tax. They may also claim the qualified business income deduction. Certain trusts do not pay any Federal income tax at the entity level (*e.g.*, trusts that distribute all income currently to beneficiaries). Other trusts are treated for tax purposes as being owned by a grantor or other person; in such cases, the grantor or other person is taxed on the income of the trust.

[8] Sec. 61.

[9] In general, partnerships and S corporations (*i.e.*, corporations subject to the provisions of subchapter S of the Code) are treated as pass-through entities for Federal income tax purposes. Thus, no Federal income tax is imposed at the entity level. Rather, income of such entities is passed through and taxed at the owner level. A business entity organized as a limited liability company ("LLC") under applicable State law generally is treated as a partnership for Federal income tax purposes if it has two or more members; a single-member LLC generally is disregarded as an entity separate from its owner for Federal income tax purposes.

gross income[10] include death benefits payable under a life insurance contract, interest on certain State and local bonds, the receipt of property by gift or inheritance, certain disaster relief payments, certain benefits and payments to members of qualified volunteer emergency response organizations, as well as employer-provided health insurance and certain other benefits. Contributions to qualified retirement plans, along with any attributable earnings, generally are included in gross income when distributed.[11]

Adjusted gross income

An individual's adjusted gross income ("AGI") is determined by subtracting certain "above-the-line" deductions from gross income. These deductions[12] include trade or business expenses or losses, losses from the sale or exchange of property, contributions to a qualified retirement plan by a self-employed individual, contributions to certain individual retirement accounts ("IRAs"), certain moving expenses for members of the Armed Forces, and certain expenses of elementary and secondary school teachers.

Taxable income

In general

To determine taxable income, an individual reduces AGI by (1) the applicable standard deduction or applicable itemized deductions[13] and (2) the deduction for qualified business income.[14]

The standard deduction is the sum of the basic standard deduction and the additional standard deduction. The amount of the basic standard deduction depends on a taxpayer's filing status. For 2024, the amount of the standard deduction is $14,600 for a single individual and for a married individual filing separately, $21,900 for a head of household, and $29,200 for married individuals filing jointly and for a surviving spouse. The additional standard deduction is allowed with respect to any individual who is elderly (*i.e.*, above age 64) and/or blind.[15] The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

---

[10] Sec. 101, *et. seq.*

[11] The rules governing qualified retirement plans are found in section 401, *et. seq.* This treatment contrasts with designated Roth accounts, distributions from which are generally not included in gross income. Sec. 402A.

[12] Sec. 62.

[13] Sec. 63.

[14] Sec. 199A.

[15] For 2024, the additional amount is $1,550 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,950. If an individual is both elderly and blind, the individual is entitled to two additional standard deductions, for a total additional amount (for 2024) of $3,100 or $3,900, as applicable. See sec. 63(c)(3).

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. The deductions that may be itemized include certain State and local income, property, and sales taxes (up to $10,000 annually ($5,000 for married taxpayers filing separately)),[16] home mortgage interest (on mortgages up to certain specified dollar amounts), charitable contributions, certain investment interest, medical expenses (in excess of 7.5 percent of AGI), and casualty and theft losses attributable to Federally declared disasters (in excess of 10 percent of AGI and in excess of $100 per loss).[17]

The Joint Committee staff estimates that for the 2024 taxable year approximately 150.3 million taxpayers will claim the standard deduction while 16.4 million taxpayers will elect to itemize deductions.

Deduction for qualified business income

In addition to standard or itemized deductions, an individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified real estate investment trust ("REIT") dividends and qualified publicly traded partnership income. A specified agricultural or horticulture cooperative generally may deduct nine percent of qualified production activities income.[18]

For taxpayers with taxable income[19] in excess of the threshold amount (for 2024, $383,900 for married taxpayers filing jointly, $191,950 for married taxpayers filing separately, and $191,950 for all other taxpayers),[20] the deduction with respect to qualified business income is limited based on (1) the taxpayer's allocable share of W-2 wages paid by the trade or business and the taxpayer's allocable share of capital investment with respect to the trade or business[21]

[16] A taxpayer may elect to itemized State and local income taxes or general sales taxes, but not both. See sec. 164(b)(5).

[17] Section 67(b) provides a list of allowable itemized deductions. All other itemized deductions ("miscellaneous itemized deductions") are suspended through 2025. Sec. 67(g).

[18] Sec. 199A(b)(7). The deduction is limited by the cooperative's taxable income for the year (computed without regard to the 199A deduction and reduced by certain payments or allocations to patrons). The deduction may instead be allocated to and deducted by the cooperative's patrons, limited to each patron's taxable income for the year (computed without regard to any section 199A deduction under the general rule and after taking into account the cooperative's section 199A deduction). See sec. 199A(g).

[19] Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

[20] These threshold amounts are indexed for inflation.

[21] The deduction is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. Sec. 199A(b)(2)(B).

and (2) the type of trade or business in which the income is earned.[22] These limitations begin to phase in above the threshold amount of taxable income.[23] In addition, the deduction calculated with respect to qualified business income, qualified REIT dividends, and qualified publicly traded partnership income may not exceed 20 percent of the taxpayer's taxable income for the taxable year.[24]

The Joint Committee staff estimates that for the 2024 taxable year approximately 24 million taxpayers will claim the deduction for qualified business income representing approximately $222 billion in tax deductions.[25]

Tax liability

In general

A taxpayer's net income tax liability is the greater of (1) regular individual income tax liability reduced by credits allowed against the regular tax or (2) tentative minimum tax reduced by credits allowed against the minimum tax.[26] The amount of income subject to tax is determined differently under the regular tax and the alternative minimum tax ("AMT"), and separate rate schedules apply. Lower rates apply for long-term capital gain and certain dividends; those rates apply for both the regular tax and the AMT.

Regular tax liability

To determine regular tax liability, the tax rate schedules (or the tax tables) are applied to a taxpayer's regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, with the marginal tax rate increasing as a taxpayer's taxable

---

[22] Qualified business income generally excludes income from a specified service trade or business when taxable income is in excess of the threshold amount and always excludes income from the trade or business of performing services as an employee. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities. Sec. 199A(d).

[23] Taxable income is computed without regard to the deduction allowable under section 199A with respect to the threshold amount.

[24] Taxable income is computed without regard to the deduction allowable under section 199A and is reduced by net capital gain with respect to this limitation.

[25] These estimates do not include taxpayers claiming deductions for qualified REIT dividends and qualified publicly traded partnership income.

[26] Sec. 55.

income increases.[27] Separate rate schedules apply based on an individual's filing status. For 2024, the regular individual income tax rate schedules are as follows:

Table 1.–Federal Individual Income Tax Rates for 2024

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $11,600	10% of the taxable income
Over $11,600 but not over $47,150	$1,160 plus 12% of the excess over $11,600
Over $47,150 but not over $100,525	$5,426 plus 22% of the excess over $47,150
Over $100,525 but not over $191,950	$17,168.50 plus 24% of the excess over $100,525
Over $191,950 but not over $243,725	$39,110.50 plus 32% of the excess over $191,950
Over $243,725 but not over $609,350	$55,678.50 plus 35% of the excess over $243,725
Over $609,350	$183,647.25 plus 37% of the excess over $609,350
Heads of Households	
Not over $16,550	10% of the taxable income
Over $16,550 but not over $63,100	$1,655 plus 12% of the excess over $16,550
Over $63,100 but not over $100,500	$7,241 plus 22% of the excess over $63,100
Over $100,500 but not over $191,950	$15,469 plus 24% of the excess over $100,500
Over $191,950 but not over $243,700	$37,417 plus 32% of the excess over $191,950
Over $243,700 but not over $609,350	$53,977 plus 35% of the excess over $243,700
Over $609,350	$181,954.50 plus 37% of the excess over $609,350
Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $23,200	10% of the taxable income
Over $23,200 but not over $94,300	$2,320 plus 12% of the excess over $23,200
Over $94,300 but not over $201,050	$10,852 plus 22% of the excess over $94,300
Over $201,050 but not over $383,900	$34,337 plus 24% of the excess over $201,050
Over $383,900 but not over $487,450	$78,221 plus 32% of the excess over $383,900
Over $487,450 but not over $731,200	$111,357 plus 35% of the excess over $487,450
Over $731,200	$196,669.50 plus 37% of the excess over $731,200

[27] The term "marginal tax rate" generally refers to the additional, or incremental, increase in tax liability from a $1.00 increase in the taxpayer's income. The marginal tax rates for individuals defined in section 1 of the Code and described in Table 1 are referred to as "statutory marginal tax rates."

If taxable income is:	Then income tax equals:
Married Individuals Filing Separate Returns	
Not over $11,600	10% of the taxable income
Over $11,600 but not over $47,150	$1,160 plus 12% of the excess over $11,600
Over $47,150 but not over $100,525	$5,426 plus 22% of the excess over $47,150
Over $100,525 but not over $191,950	$17,168.50 plus 24% of the excess over $100,525
Over $191,950 but not over $243,725	$39,110.50 plus 32% of the excess over $191,950
Over $243,725 but not over $365,600	$55,678.50 plus 35% of the excess over $243,725
Over $365,600	$98,334.75 plus 37% of the excess over $365,600
Estates and Trusts	
Not over $3,100	10% of the taxable income
Over $3,100 but not over $11,150	$310 plus 24% of the excess over $3,100
Over $11,150 but not over $15,200	$2,242 plus 35% of the excess over $11,150
Over $15,200	$3,659.50 plus 37% of the excess over $15,200

An individual's effective marginal tax rate may be reduced by the allowance of the deduction for qualified business income.[28] Effective marginal tax rates may also be altered by the phase-in and phaseout of certain exemptions or credits.[29]

<u>Preferential rates on capital gain and dividends</u>

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income.[30] Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the

[28] Deductions of income amounts can be viewed as substitutes for exemptions or rate reductions for the affected income.

[29] The term "effective marginal tax rate" refers to the additional, or incremental increase in tax liability *under the income tax* from a $1.00 increase in the taxpayer's income. For example, a credit that is phased out, or incrementally reduced, by $.05 for every $1.00 above a certain threshold would cause the effective marginal tax rate to be five percentage points higher than the statutory marginal tax rate in the phase out range. The Code contains many provisions that may cause effective marginal tax rates to differ from statutory marginal rates.

[30] Gain from the sale of a taxpayer's principal residence may be excluded up to certain limits if certain conditions are met. See sec. 121.

year.[31] Gain or loss is treated as long-term if the asset is held for more than one year. Qualified dividend income generally is taxed at the same rate as net capital gain.[32]

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year.[33] Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

The maximum rate of tax on the adjusted net capital gain of an individual depends on the individual's taxable income and filing status. These maximum rates apply for purposes of both the regular tax and the alternative minimum tax. For 2024, the adjusted net capital gain rate schedules are as follows:

Table 2.–Adjusted Net Capital Gain Maximum Rates for 2024

Filing Status and Rate Start Amount (Taxable Income)					Rate
Single Individuals	Heads of Households	Married Individuals Filing Joint Returns and Surviving Spouses	Married Individuals Filing Separate Returns	Estates and Trust	
$0	$0	$0	$0	$0	0%
$47,025	$63,000	$94,050	$47,025	$3,150	15%
$518,900	$551,350	$583,750	$291,850	$15,450	20%

Net investment income

An additional tax is imposed on net investment income in the case of an individual, estate, or trust.[34] In the case of an individual, the tax is 3.8 percent of the lesser of net investment income or the excess of modified adjusted gross income[35] over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in

[31] Sec. 1222(11).

[32] Sec. 1(h).

[33] Sec. 1211(b).

[34] Sec. 1411.

[35] For this purpose, modified adjusted gross income is adjusted gross income increased by the amount excluded from income as foreign earned income under section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

the case of a married individual filing a separate return, and $200,000 in any other case.[36] Thus, for taxpayers with modified adjusted gross income in excess of those thresholds, the rate on certain capital gains and dividends is 23.8 percent while the maximum rate on other investment income, including interest, annuities, royalties, and rents, is 40.8 percent.

Net investment income is, in general, the excess of (1) the sum of (a) gross income from interest, dividends, annuities, royalties, and rents (with certain exclusions[37]), and (b) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property (with certain exclusions[38]), over (2) deductions properly allocable to such gross income or net gain.

The Joint Committee staff estimates that for the 2024 taxable year, approximately 8.7 million taxpayers will pay the additional tax on net investment income, representing approximately $45.8 billion in tax revenue.

Credits against tax

An individual's income tax liability may be reduced by using available tax credits. For example, tax credits are allowed for certain business expenditures, certain foreign income taxes paid or accrued, certain energy conservation expenditures, certain education expenditures, certain child care expenditures, certain health care costs, and for certain elderly or disabled individuals.

Some credits are wholly or partially "refundable," meaning that if the amount of the credit exceeds the taxpayer's pre-credit tax liability (after reduction for other nonrefundable credits), the credit creates an overpayment that may generate a refund, even if it exceeds actual payments credited to the taxpayer account. Two large refundable credits (in terms of overall loss of Federal revenues) are the child tax credit and the earned income tax credit.[39]

An individual may claim a refundable child tax credit ("CTC") which includes an amount of $2,000 for each qualifying child under age 17.[40] The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable CTC is reduced by $50 for each $1,000, or fraction thereof,

---

[36] These thresholds are not indexed for inflation.

[37] This does not include income which is derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer or a trade or business of trading in financial instruments or commodities.

[38] Net gain for this purpose does not include net gain from property held in the active conduct of a trade or business that is not in the trade or business of trading in financial instruments or commodities.

[39] Other refundable credits include the American opportunity tax credit (sec. 25A), the premium tax credit (sec. 36B), and the health coverage tax credit (sec. 35).

[40] Sec. 24.

of modified adjusted gross income[41] over $400,000 for married individuals filing jointly and $200,000 for all other individuals. To the extent the credit amount exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15 percent of earned income in excess of $2,500,[42] not to exceed $1,700 per child in 2024. The maximum amount of the refundable portion of the credit is indexed for inflation.

For taxpayers with dependents other than qualifying children, such as a 17-year-old child living at home, a full-time college student, or other adult member of the household for whom the taxpayer provides financial support, taxpayers are able to claim a $500 nonrefundable credit.

A refundable earned income tax credit ("EITC") is available to low-income workers who satisfy certain requirements.[43] The amount of the EITC varies depending on the taxpayer's earned income and whether the taxpayer has more than two, two, one, or no qualifying children. For 2024, the maximum EITC for taxpayers is $7,830 with more than two qualifying children, $6,960 with two qualifying children, $4,213 with one qualifying child, and $632 with no qualifying children. The credit amount begins to phase out at an income level of $29,640 for joint-filers with qualifying children, $22,720 for other taxpayers with qualifying children, $17,250 for joint-filers with no qualifying children, and $10,330 for other taxpayers with no qualifying children. The phaseout percentages, or the rates at which the credit amount phases out, are 21.06 percent for taxpayers with two or more qualifying children, 15.98 percent for taxpayers with one qualifying child, and 7.65 percent for taxpayers with no qualifying children.

Alternative minimum tax liability

The personal credits allowed against the regular tax are generally allowed against the alternative minimum tax. An AMT is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year.[44] For 2024, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $232,600 ($116,300 in the case of married filing separately)[45] and (2) 28 percent of the remaining taxable excess.[46] The taxable excess is so much of the alternative minimum taxable income ("AMTI") as exceeds the exemption amount. AMTI is the taxpayer's taxable

---

41 For this purpose, modified adjusted gross income is adjusted gross income increased by any amount excluded from gross income under sections 911, 931 or 933.

42 Families with three or more children may determine the additional child tax credit by taking the greater of (1) the earned income formula, or (2) the alternative formula, *i.e.,* the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income tax credit.

43 Sec. 32.

44 Sec. 55.

45 The breakpoint between the 26-percent and 28-percent brackets is indexed for inflation.

46 The maximum tax rates on net capital gain and dividends used in computing the regular tax are also used in computing the tentative minimum tax.

income increased by the taxpayer's tax preferences[47] and adjusted by determining the tax treatment of certain items[48] in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

For taxable years beginning in 2024, the exemption amount is $133,300 for married individuals filing jointly and surviving spouses, $85,700 for other unmarried individuals, $66,650 for married individuals filing separately, and $29,900 for estates or trusts. The exemption amount is phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds $1,218,700 for married individuals filing jointly and surviving spouses, $609,350 for other individuals, and $99,700 for estates or trusts. These amounts are indexed annually for inflation.

Among the tax preferences and adjustments included in AMTI are accelerated depreciation on certain property used in a trade or business, circulation expenditures, research and experimental expenditures, certain expenses and allowances related to oil and gas, certain expenses and allowances related to mining exploration and development, certain tax-exempt interest income, and a portion of the gain excluded with respect to the sale or disposition of certain small business stock. The standard deduction, and certain itemized deductions, such as the deduction for State and local taxes, are not allowed to reduce AMTI.

The Joint Committee staff estimates that for the 2024 taxable year, approximately 0.2 million taxpayers will pay the alternative minimum tax, representing approximately $6.3 billion in tax revenue.

---

47 Sec. 57.

48 Secs. 56 and 58.

B. Corporate Income Tax

Taxable income

In general

Corporations organized under the laws of any of the 50 States or the District of Columbia generally are subject to the U.S. corporate income tax on their U.S.-source and certain foreign-source income.[49] Foreign corporations generally are subject to the U.S. corporate income tax only on income that is effectively connected with a U.S. trade or business.

The taxable income of a corporation generally is its gross income less allowable deductions, computed based on the corporation's methods of accounting. Gross income generally is income derived from any source, including gross profit from the sale of goods and services to customers, rents, royalties, interest (other than interest from certain indebtedness issued by State and local governments), dividends, gains from the sale of business and investment assets, and other income. Large C corporations[50] (*i.e.*, those with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that exceed $30 million (for 2024)) generally are required to use an accrual method of accounting.[51] Under the accrual method of accounting, items of income generally accrue when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy, but no later than the taxable year in which such income is included as revenue for book purposes.[52] Items of expense generally may not be deducted prior to when all the events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[53]

Allowable deductions include ordinary and necessary business expenditures,[54] such as salaries, wages, contributions to qualified retirement plans and certain other employee benefit programs, repairs, write offs for bad debts, taxes (other than Federal income taxes), contributions to charitable organizations (subject to an income limitation), advertising, interest expense (subject to limitation), certain losses, selling expenses, and other expenses. In the event these deductions exceed gross income, a net operating loss ("NOL") deduction may be allowed in

---

[49] Under subchapter S of the Code, a small business corporation may elect not to be subject to the corporate income tax (*i.e.*, may make an "S corporation election"). If an S corporation election is made, the income of the corporation flows through to the shareholders and is taxable directly to them.

[50] The term "C Corporation" refers to a corporation subject to the default Federal tax rules governing corporations, which are found in subchapter C of the Code.

[51] Sec. 448. Special methods of accounting that provide an exception to the all events test may apply (*e.g.*, special methods for long term contracts subject to section 460).

[52] Sec. 451.

[53] Sec. 461.

[54] Sec. 162, *et seq.*

other years.[55] Deductions are also allowed for certain amounts despite the lack of a direct expenditure by the taxpayer. For example, a deduction is allowed for a percentage of certain dividends received by a corporation from another corporation (provided certain ownership requirements are satisfied).[56]

Expenditures that produce benefits in future taxable years for a taxpayer's business or income-producing activities (such as the purchase of plant and equipment) generally are capitalized[57] and recovered over time through depreciation, amortization, or depletion allowances.[58] In some instances, taxpayers can recover their costs more quickly than under the general rules. An additional first-year depreciation deduction is allowed equal to up to 60 percent (for 2024) of the adjusted basis of qualified property.[59] Also, a taxpayer may elect to deduct (or "expense") up to $1,220,000 of the cost of section 179 property placed in service during the 2024 taxable year.[60]

Certain expenditures may not be deducted, such as dividends paid to shareholders, expenses associated with earning tax-exempt income,[61] certain meal and entertainment expenses,[62] certain qualified transportation fringe and commuter benefits,[63] certain highly compensated employee remuneration in excess of $1 million per year, a portion of the interest on certain high-yield debt obligations that resemble equity, as well as fines, penalties, bribes,

---

[55] The net operating loss deduction is limited to 80 percent of taxable income and excess losses generally may be carried forward. Sec. 172.

[56] Sec. 243.

[57] Sec. 263.

[58] See, *e.g.*, Secs. 167, 168, and 197.

[59] The portion of basis allowable as additional first-year depreciation depends on both the date the qualified property is acquired and the year the qualified property is placed in service. See sec. 168(k)(6) and (8). Used property acquired in arms-length transactions may qualify for the additional first-year depreciation deduction. Generally, property used by businesses not subject to the limitation on interest expense (*e.g.*, regulated public utilities and electric cooperatives and taxpayers in a trade or business that has had floor plan financing indebtedness) is excluded from the definition of qualified property. Sec. 168(k)(9).

[60] This amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the year exceeds $3,050,000. These limits are indexed for inflation. Sec. 179.

[61] For example, the carrying costs of tax-exempt State and local obligations and the premiums on certain life insurance policies are not deductible. Secs. 265 and 264, respectively.

[62] Generally, deductions are prohibited for entertainment expenses, activities that constitute entertainment, and facilities used in connection with entertainment activities. A 50-percent deduction disallowance applies to expenses associated with providing meals and facilities that qualify as *de minimis* under section 132(e), including meals for the convenience of the employer under section 119, if the eating facility is either located on the business premises of the employer or is employer operated. See sec. 274(n) and Notice 2021-25, April 26, 2021.

[63] Employers are disallowed deductions for expenses associated with providing qualified transportation fringe benefits unless amounts are reported and properly included in employee compensation and are disallowed deductions for other commuter benefits generally. Sec. 274.

kickbacks, illegal payments, and settlements subject to nondisclosure agreements paid in connection with sexual harassment or abuse.[64]

Foreign activities of U.S. persons

In general, income earned directly by a U.S. person from the conduct of a foreign business is taxed currently, while income earned indirectly through certain related foreign legal entities is taxed either in the year earned or not at all. In particular, the indirect earnings from certain related foreign legal entities (*i.e.*, controlled foreign corporations ("CFCs")) may constitute income to U.S. shareholders under the rules of either subpart F or section 951A of the Code.[65] Subpart F income generally includes certain passive income and certain other related-party income that is readily movable from one jurisdiction to another. Under section 951A, U.S. shareholders of a CFC also may be subject to tax on their pro rata shares of certain other income of the CFC (referred to as global intangible low-taxed income ("GILTI")).[66] Subpart F income is taxed at full rates, while GILTI is taxed at preferential rates. Both subpart F income and GILTI are taxed without regard to whether the income is distributed to the U.S. shareholders. The preferential rate on GILTI is achieved by allowing corporations a 50-percent deduction (a "section 250 deduction") on their GILTI.[67] A foreign tax credit generally is available to offset, in whole or in part, the U.S. Federal income tax owed on foreign-source income.[68]

To ensure that income of CFCs is taxed either in the year earned or not at all, dividends received by corporate U.S. shareholders from their CFCs generally are eligible for a 100-percent dividends-received deduction.[69] In addition, certain U.S. corporations (both U.S. and foreign

---

[64] Sec. 261, *et seq.*

[65] Secs. 951-964. A CFC generally is defined as any foreign corporation in which U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only "U.S. shareholders," that is, U.S. persons that own at least 10 percent of the stock (measured by vote or value). Secs. 951(b), 957, and 958.

[66] Secs. 951-964. GILTI, with respect to any U.S. shareholder, is the excess of its pro rata share of certain CFC income over a 10-percent return (reduced by certain interest expense incurred by CFCs) on its pro rata share of the aggregate of the average quarterly adjusted bases in certain depreciable tangible property of each CFC with respect to which it is a U.S. shareholder.

[67] Sec. 250(a)(1)(B). The section 250 deduction for GILTI is available only for C corporations that are neither regulated investment companies ("RICs") nor real estate investment trusts ("REITs"). The section 250 deduction also applies with respect to foreign-derived intangible income ("FDII") of certain corporations, discussed in more detail below.

[68] Foreign tax credits not allowed in the current year generally may be carried back one year or forward 10 years. Sec. 904(c). In contrast with the general rules allowing carrybacks and carryovers of excess foreign tax credits, no carrybacks or carryovers of excess foreign tax credits are allowed in the GILTI foreign tax credit limitation category. In addition, a 20-percent foreign tax credit disallowance applies to foreign income taxes paid with respect to GILTI. Sec. 960(d). Foreign tax credits are not available for foreign taxes paid or accrued with respect to dividends qualifying for the 100-percent dividends-received deduction. Sec. 245A(d).

[69] Sec. 245A.

owned) with foreign affiliates are subject to a base erosion and anti-abuse tax (the "BEAT") that is in the nature of a minimum tax and payable in addition to all other tax liabilities.[70]

Tax liability

In general

Corporate income generally is taxed at 21 percent. While no separate rate structure exists for corporate capital gains, a corporation may not deduct the amount of capital losses in excess of capital gains for any taxable year.[71] Disallowed capital losses may be carried back three years or carried forward five years.

Corporations generally are taxed at lower rates on their foreign-derived intangible income ("FDII").[72] The preferential rate is achieved by allowing corporations a 37.5-percent deduction on their FDII.

Like individuals, corporations may reduce their tax liability by any applicable tax credits.[73] Unused credits generally may be carried back one year and carried forward 20 years.[74] The four largest dollar amount credits are (1) the research credit, which targets intangible investment, (2) the low-income housing credit, which targets real property investment, (3) the energy credit, which targets investment in certain renewable energy property, and (4) the renewable electricity production credit, which targets electricity production.[75]

The research credit is generally available with respect to incremental increases in qualified research.[76] A research credit is also available with respect to corporate cash expenses paid for basic research conducted by universities (and certain nonprofit scientific research

---

[70] Sec. 59A. The BEAT is discussed in more detail below.

[71] Sec. 1211(a).

[72] A corporation's FDII is its deemed intangible income multiplied by the percentage of its income (computed with certain exceptions) derived from serving foreign markets. A corporation's deemed intangible income is the excess of its income (computed with certain exceptions) over a 10-percent return on the aggregate of its average quarterly adjusted bases in certain depreciable tangible property. The deduction for FDII is not available for RICs or REITs. Sec. 250.

[73] General business credits also apply to the business income of individuals. Sec. 38, *et seq.*

[74] See rules for the general business credit, secs. 38 and 39.

[75] See Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2023-2027* (JCX-59-23), December 7, 2023.

[76] For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year. Sec. 41(a)(1). An alternative simplified research credit (with a 14 percent rate and a different base amount) may be claimed in lieu of this credit. Sec. 41(c)(5).

organizations) above a certain floor.[77] Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.[78]

Generally, low-income housing credits are provided to States annually and allocated by State or local housing credit agencies to taxpayers to subsidize the construction or rehabilitation of low-income residential rental property.[79] Low-income housing credits may be claimed over a 10-year period after a qualified low-income building is placed in service. The annual credit amount is equal to the applicable percentage[80] of the qualified basis of the qualified low-income building.[81]

The energy credit is allowed as a percentage of the cost of certain new energy property that is placed in service for use in the United States.[82] For this credit, energy property includes solar energy property, fiber optic solar property, geothermal heat pump property, fuel cell property or microturbine property, combined heat and power system property, small wind energy property, waste energy recovery property, energy storage technology, qualified biogas property, and microgrid controllers.[83] An election may also be made to treat property used in facilities eligible for the renewable electricity production credit (described below) as energy property in lieu of claiming such production credit.[84] The credit rate is increased if certain prevailing wage and apprenticeship requirements are met.[85] Additionally the credit rate may be further increased

---

[77] This 20-percent credit is available with respect to the excess of (1) corporate cash expenses (including grants or contributions) paid for basic research conducted by universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in nonresearch giving to universities by the corporation as compared to such giving during a fixed-base period adjusted for inflation. Secs. 41(a)(2) and (e).

[78] This separate credit computation commonly is referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount. Sec. 41(1)(3).

[79] Sec. 42.

[80] The applicable percentage for newly constructed or substantially rehabilitated housing that is not Federally subsidized is adjusted monthly by the IRS so that the ten annual installments have a present value of 70 percent of the building's qualified basis, but the applicable percentage cannot be less than nine percent. The applicable percentage for newly constructed or substantially rehabilitated housing that is Federally subsidized and for existing housing that is substantially rehabilitated is calculated to have a present value of 30 percent of the building's qualified basis, but the applicable percentage cannot be less than four percent. See sec. 42(b).

[81] Sec. 42(a).

[82] Sec. 48.

[83] Sec. 48(a)(3).

[84] Sec. 48(a)(5).

[85] The base credit rate is generally six or two percent depending on the type of energy property. These rates are multiplied by five, to 30 and 10 percent respectively, if certain prevailing wage and apprenticeship requirements are met. See section 48(a)(9).

if certain domestic content requirements[86] are met, if energy property is placed in an energy community,[87] or if an allocation is received from the Secretary of the Treasury (the "Secretary") for certain solar and wind projects placed in low-income communities.[88] The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed.[89]

The renewable electricity production credit is allowed for the domestic production of electricity from qualified energy resources at a qualified facility during the 10-year period beginning after such qualified facility is originally placed in service.[90] Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy.[91] Qualified facilities are, generally, facilities that generate electricity using qualified energy resources.[92] To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.[93] The credit rate is increased if certain prevailing wage and apprenticeship

---

[86] Sec. 48(a)(12).

[87] Sec. 48(a)(14).

[88] Sec. 48(e).

[89] Sec. 50(c)(3).

[90] Sec. 45. A credit for the production of Indian coal is also available under section 45.

[91] Sec. 45(c)(1).

[92] Under section 48(a)(5), a taxpayer may make an irrevocable election to have property used in certain qualified facilities eligible for the renewable electricity production tax credit be treated as energy property eligible for an investment credit under the energy credit. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit for power generated at that facility. A phaseout rule similar to the rule for the renewable electricity production credit applies to property for which an election has been made.

[93] Sec. 45(a)(2)(B).

requirements are met.[94] Additionally the credit rate may be further increased if certain domestic content requirements[95] are met or if the qualified facility is placed in an energy community.[96]

Other credits applicable to businesses include other investment tax credits[97] (such as for the rehabilitation of certain real property), the work opportunity credit (applicable to wages paid to individuals from certain targeted groups), the employer-provided child care credit (applicable to certain expenditures to provide child care for employees), the employer credit for paid family and medical leave (applicable to wages paid to employees on family and medical leave), the advanced manufacturing production credit (applicable to certain components and critical minerals), the credit for production of clean hydrogen, the zero-emission nuclear power production credit, and the disabled access credit (applicable to expenditures by certain small businesses to make the businesses accessible to disabled individuals), among others.[98]

The BEAT

The BEAT applies to a corporation (1) that is not a RIC or REIT, (2) that has average annual gross receipts of at least $500 million over the prior three taxable years, and (3) whose base erosion tax benefits exceed three percent of certain outlays made by the corporation.[99]

A corporation's BEAT liability generally is the excess, if any, of 10 percent of its modified taxable income[100] over an amount equal to its regular tax liability reduced (but not

---

[94] In general, the base credit amount is multiplied by five if certain prevailing wage and apprenticeship requirements are met. Additionally, the base credit is multiplied by five for facilities with a maximum net output of less than one megawatt. Sec. 45(b)(6).

For facilities placed in service after December 31, 2022, the base credit amount for calendar year 2023 is .55 cents per kilowatt-hour (2.75 cents per kilowatt-hour if certain prevailing wage and apprenticeship requirements are met) for wind, closed-loop biomass, geothermal energy, solar energy, qualified hydropower, and marine and hydrokinetic renewable energy facilities. For such year, the base credit amount is .3 cents per kilowatt-hour (1.5 cents per kilowatt-hour if certain prevailing wage and apprenticeship requirements are met) for open-loop biomass, landfill gas, and trash facilities. See Notice of Publication, 88 Fed. Reg. 40400, June 21, 2023. The inflation adjustment factor for this credit for calendar year 2024 has not yet been published.

[95] Sec. 45(b)(9).

[96] Sec. 45(b)(11).

[97] Sec. 46.

[98] Certain of these credits are scheduled to expire in 2024 or later. For more information on expiring provisions of the Code, see Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2024-2034* (JCX-1-24), January 11, 2024.

[99] Sec. 59A(e).

[100] A corporation's modified taxable income is its taxable income determined without regard to a certain portion of any NOL deduction allowed for the taxable year and without regard to any base erosion tax benefit with respect to certain items (*i.e.*, "base erosion payments"), including (1) certain deductible payments made to foreign related parties, (2) deductions allowed for depreciation (or amortization in lieu of deprecation) with respect to

below zero) by certain credits.[101] Special rules for computing the base erosion minimum tax apply to banks and securities dealers.

Affiliated group

Domestic corporations that are affiliated through 80 percent or more corporate ownership may elect to file a consolidated return in lieu of filing separate returns. Corporations filing a consolidated return generally are treated as a single corporation; thus, the losses of one corporation may offset the income (and thus reduce the otherwise applicable tax) of other affiliated corporations.

Book minimum tax

Large C corporations meeting certain requirements ("applicable corporations") are subject to an alternative minimum tax (known as the "book minimum tax") that is based on adjusted financial statement income ("AFSI"). The tax equals the excess (if any) of the corporation's tentative minimum tax over the corporation's regular tax[102] plus the corporation's BEAT liability for the taxable year.[103]

The tentative minimum tax for an applicable corporation for a taxable year is generally 15 percent of AFSI (as reduced by certain financial statement NOLs)[104] over the book minimum foreign tax credit.[105] The tentative minimum tax is zero for corporations that are not applicable

---

property acquired from foreign related parties, and (3) reinsurance premiums paid to foreign related parties. Sec. 59A(c).

[101] Credits that reduce regular tax liability (*i.e.*, increase the base erosion minimum tax amount, if any) are all section 38 credits except for (1) the research credit and (2) applicable section 38 credits. Applicable section 38 credits are the low-income housing credit, the renewable electricity production credit, and the energy investment credit. The exception for applicable section 38 credits generally may not reduce the base erosion minimum tax amount by more than 80 percent (determined without regard to the exception for applicable section 38 credits). Sec. 59A(b).

[102] This is generally the corporation's regular tax liability under section 26(b) reduced by the foreign tax credit allowable under section 27(a), with certain exceptions. See sec. 55(c).

[103] Sec. 55(a).

[104] Book income, or financial statement income, is modified to eliminate certain book-tax differences to arrive at AFSI. Sec. 56A.

[105] The taxpayer may elect to claim the book minimum tax foreign tax credit if the taxpayer does not take a deduction with respect to creditable foreign taxes against regular Federal income tax for a taxable year. Sec. 59(l).

corporations. Generally, an applicable corporation is a corporation[106] that exceeds $1 billion in average annual AFSI.[107]

General business credits (discussed above) generally may offset up to approximately 75 percent of the sum of a corporation's normal income tax and alternative minimum tax.[108] In addition, an applicable corporation is generally entitled for any taxable year to a credit against its Federal income tax in an amount equal to the minimum tax credit for such taxable year.[109]

The Joint Committee staff estimates that for the 2024 taxable year, approximately 150 corporations will have book income minimum tax liability, representing between $30 to $40 billion in tax revenue.

Treatment of corporate distributions

The taxation of a corporation generally is separate and distinct from the taxation of its shareholders. A distribution by a corporation to one of its shareholders generally is taxable as a dividend to the extent of the corporation's current or accumulated earnings and profits.[110] Thus, corporate income distributed as a dividend generally is taxed twice: once when the income is earned by the corporation and again when the dividend is distributed to the shareholder.[111] In contrast, some amounts paid as interest on corporate debt may be subject to only one level of tax (at the recipient level) since the corporation is allowed a deduction for part or all of the amount of interest expense paid or accrued.

Amounts received by a shareholder in complete liquidation of a corporation generally are treated as full payment in exchange for the shareholder's stock.[112] A liquidating corporation recognizes gain or loss on the distributed property as if such property were sold to the

[106] Other than an S corporation, a RIC, or a REIT.

[107] Aggregation rules and certain adjustments apply in determining AFSI for purposes of determining whether a corporation is an applicable corporation. Additionally, special rules apply for corporations which are members of a foreign-parented multinational group. Sec. 59(k).

[108] Sec. 38.

[109] Sec. 53(e).

[110] Secs. 301 and 316. A distribution in excess of the earnings and profits of a corporation generally is a tax-free return of capital to the shareholder to the extent of the shareholder's adjusted basis (generally, cost) in the stock of the corporation; such distribution is a capital gain if in excess of basis. A distribution of property other than cash generally is treated as a taxable sale of such property by the corporation and is taken into account by the shareholder at the property's fair market value. Sec. 311(b). A distribution of stock of the corporation generally is not a taxable event to either the corporation or the shareholder. Sec. 311(a).

[111] This double taxation is mitigated by a reduced tax rate generally applicable to the qualified dividend income of individuals.

[112] Sec. 331.

shareholders for its fair market value.[113] However, if a corporation liquidates a subsidiary corporation of which it has 80 percent or more control, no gain or loss generally is recognized by either the parent corporation or the subsidiary corporation.[114]

Accumulated earnings and personal holding company taxes

The accumulated earnings or personal holding company income of a corporation may be taxed at the top rate generally applicable to qualified dividend income (*i.e.*, 20 percent). The accumulated earnings tax may be imposed if a corporation retains earnings in excess of reasonable business needs.[115] The personal holding company tax may be imposed on the excessive passive income of a closely held corporation.[116] When they apply, the accumulated earnings tax and the personal holding company tax in effect impose the shareholder-level tax in addition to the corporate-level tax on accumulated earnings or undistributed personal holding company income.

---

[113] Sec. 336.

[114] Sec. 337.

[115] Sec. 531, *et seq.*

[116] Sec. 541, *et seq.*

C. Estate, Gift, and Generation-Skipping Transfer Taxes

The United States generally imposes a gift tax on any transfer of property by gift made by a U.S. citizen or resident, whether made directly or indirectly and whether made in trust or otherwise.[117] Nonresident aliens are subject to the gift tax with respect to transfers of tangible real or personal property where the property is located in the United States at the time of the gift. The gift tax is imposed on the donor and is based on the fair market value of the property transferred. Deductions are allowed for certain gifts to spouses and to charities. Annual gifts of $18,000 (for 2024) or less made by the donor to any person generally are not subject to tax.[118]

An estate tax also is imposed on the taxable estate of any person who was a citizen or resident of the United States at the time of death and on certain property belonging to a nonresident of the United States that is located in the United States at the time of death.[119] The estate tax is imposed on the estate of the decedent and generally is based on the fair market value of the property passing at death.[120] The taxable estate generally equals the worldwide gross estate less certain allowable deductions, including a marital deduction for certain bequests to the surviving spouse of the decedent and a deduction for certain bequests to charities.

The gift and estate taxes are unified such that a single graduated rate schedule and exemption apply to an individual's cumulative taxable gifts and bequests. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 40 percent on cumulative taxable transfers over $1,000,000. A unified credit of $5,389,800 (for 2024) is available with respect to taxable transfers by gift or at death. This credit effectively exempts a total of $13.61 million (for 2024)[121] in cumulative taxable transfers from the gift tax or the estate tax. The unified credit thus generally also has the effect of rendering the marginal rates below 40 percent inapplicable. Unused exemption as of the death of a spouse generally is available for use by the surviving spouse; this feature of the law sometimes is referred to as exemption portability.

---

[117] Sec. 2501, *et seq.*

[118] The gift tax annual exclusion is indexed for inflation.

[119] Sec. 2001, *et seq.*

[120] In addition to interests in property owned by the decedent at the time of death, the Federal estate tax also is imposed on: (1) life insurance that was either payable to the decedent's estate or in which the decedent had an incident of ownership at death; (2) property over which the decedent had a general power of appointment at death; (3) annuities purchased by the decedent or his employer that were payable to the decedent before death; (4) certain interests in jointly held property; (5) property transferred by the decedent before death in which the decedent retained a life estate or over which the decedent had the power to designate who will possess or enjoy the property; (6) property revocably transferred by the decedent before death; and (7) certain transfers taking effect at the death of the decedent.

[121] The basic exclusion amount is indexed for inflation. Sec. 2010(c)(3)(B).

A separate transfer tax is imposed on generation-skipping transfers in addition to any estate or gift tax that is imposed on such transfers.[122] This tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a beneficiary in more than one generation below that of the transferor. For 2024, the generation-skipping transfer tax is determined using a 40-percent rate and an exemption of $13.61 million.[123]

[122] Sec. 2601, *et seq.*

[123] The exemption amount for the generation-skipping transfer tax is the same as the basic exclusion amount used to calculate the unified credit. Sec. 2631.

D. Social Insurance Taxes

In general

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages.[124] The Federal Insurance Contributions Act ("FICA") imposes tax on employers and employees based on the amount of wages paid to an employee during the year. The tax imposed is composed of two parts: (1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2 percent of covered wages up to the taxable wage base ($168,600 in 2024); and (2) the Medicare hospital insurance ("HI") tax amount equal to 1.45 percent of covered wages with no wage cap.[125] In addition to the tax on employers, each employee's wages are subject to FICA taxes equal to the amount of tax imposed on the employer. The employee FICA taxes generally must be withheld and, along with employer FICA taxes, remitted to the Federal government by the employer.[126]

As a parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of self-employed individuals.[127] The rate of the OASDI portion of SECA taxes is equal to the combined employee and employer OASDI tax rates and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the sum of the combined employer and employee HI rates, and there is no cap on the amount of self-employment income to which the rate applies.[128]

In addition to FICA taxes, the Federal Unemployment Tax Act ("FUTA") imposes tax on employers equal to six percent of the total wages of each employee (up to $7,000) on covered employment.[129] Generally, employers are eligible for a Federal credit equal to 5.4 percent for State unemployment taxes paid by the employer, yielding a 0.6 percent effective tax rate. FUTA taxes are used to fund programs maintained by the States for the benefit of unemployed workers.

---

[124] Sec. 3101, *et seq.*

[125] FICA taxes also includes an additional hospital insurance tax. Sec. 3101(b)(2).

[126] Instead of FICA taxes, railroad employers, employees, and employee representatives are subject, under the Railroad Retirement Tax Act ("RRTA"), to taxes equivalent to the OASDI and HI taxes under FICA. Under RRTA, employers and employees are also subject to an additional tax, referred to as the "tier 2" tax, on compensation up to a certain amount. Sec. 3201, *et seq.*

[127] Sec. 1401, *et seq.*

[128] For purposes of computing net earnings from self-employment, taxpayers are permitted a deduction equal to the product of the taxpayer's earnings (determined without regard to this deduction) and one-half of the sum of the rates for OASDI (12.4 percent) and HI (2.9 percent), *i.e.*, 7.65 percent of net earnings. This deduction reflects the fact that the FICA rates apply to an employee's wages, which do not include FICA taxes paid by the employer, whereas a self-employed individual's net earnings are economically equivalent to an employee's wages plus the employer share of FICA taxes.

[129] Sec. 3301, *et seq.*

Additional hospital insurance tax on certain high-income individuals

The employee portion of the HI tax is increased by an additional tax of 0.9 percent on wages received in excess of a specific threshold amount.[130] Employers are required to withhold the additional 0.9 percent on wages of the employee in excess of $200,000. However, unlike the general 1.45 percent HI tax on wages, this additional tax is on the combined wages of the employee and the employee's spouse, in the case of a joint return. The threshold amount is $250,000 in the case of married filing jointly, $125,000 in the case of married filing separately, and $200,000 in any other case (unmarried individual, head of household or surviving spouse).[131] Any difference between the amount withheld on wages in excess of $200,000 and the applicable tax based on the thresholds is reconciled on the individual's personal income tax return.

The same additional HI tax applies to the HI portion of SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the applicable threshold amount.[132]

The Joint Committee staff estimates that for the 2024 taxable year, approximately 8.1 million taxpayers will pay the additional HI tax.

---

[130] Sec. 3101(b)(2).

[131] These threshold amounts are not indexed for inflation.

[132] Sec. 1402(b).

E. Major Excise Taxes

The Federal tax system imposes excise taxes on selected goods and services.[133] Generally, excise taxes are taxes imposed on a per unit or *ad valorem* (*i.e.*, percentage of price) basis on the production, importation, or sale of a specific good or service. Among the goods and services subject to U.S. excise taxes are motor fuels, alcoholic beverages, tobacco products, firearms, air and ship transportation, certain environmentally hazardous products (*e.g.*, ozone depleting chemicals, and crude oil and certain petroleum products to fund the Oil Spill Liability Trust Fund), coal, certain telephone communications (*e.g.*, local service), certain wagers, indoor tanning services, vehicles lacking in fuel efficiency, certain chemicals and substances, designated drugs of certain drug manufacturers,[134] and stock repurchases[135] of certain corporations.[136] Additionally, an annual fee is imposed on certain manufacturers and importers of branded prescription drugs.

Large excise taxes in terms of revenue, for fiscal year 2023, are those imposed on gasoline motor fuel ($23.5 billion),[137] diesel motor fuel ($11.0 billion),[138] domestic air tickets ($15.7 billion),[139] domestic and imported tobacco products ($10.3 billion),[140] and domestic and imported alcohol beverages ($11.1 billion).[141] Revenues from certain Federal excise taxes are dedicated to trust funds (*e.g.*, the Highway Trust Fund) for designated expenditure programs, and revenues from other excise taxes (*e.g.*, alcoholic beverages) go to the General Fund for general purpose expenditures.

---

133 See subtitles D and E of the Code.

134 Sec. 5000D. The tax applies to the price of drugs sold by certain drug manufacturers, producers, or importers during noncompliance periods using an applicable percentage ranging from 65 to 95 percent. This is equivalent to a tax exclusive rate on the price of drugs ranging from 186 to 1900 percent.

135 Sec. 4501. The tax is one percent of the fair market value of net repurchases of stock of a covered corporation.

136 For a historical description of various other Federal excise taxes, see Joint Committee on Taxation, *Present Law and Background Information on Federal Excise Taxes* (JCX-99-15), July 13, 2015.

137 U.S. Department of Treasury, "FY 2023 Highway Consolidated Reports," September 2023, pp. 10, available at https://treasurydirect.gov/ftp/dfi/tfmb/dfihw0923.pdf.

138 *Ibid.*

139 U.S. Department of Treasury, "FY 2023 Airport and Airways Reports," September 2023, pp. 7, available at https://www.treasurydirect.gov/ftp/dfi/tfmb/dfiaa0923.pdf.

140 U.S. Department of Treasury, Alcohol and Tobacco Tax and Trade Bureau, "Tax Collections, Cumulative Summary Fiscal Year 2023," December 5, 2023, available at https://www.ttb.gov/taxes/tax-audit/tax-collections.

141 *Ibid.*

Table 3.–2024 Federal Excise Tax Rates for Selected Products or Services

Gasoline Motor Fuel	18.3 cents per gallon[1]
Diesel Motor Fuel	24.3 cents per gallon[2]
Domestic Air Tickets	7.5 percent of fare, plus \$5.00 (2024) per domestic flight segment generally.[3]
Cigarettes[4]	\$50.33 per thousand small cigarettes;[5] \$105.69 per thousand large cigarettes.
Alcoholic Beverages[6]	\$3.50 to \$18.00 per barrel of beer;[7] \$0.07 to \$3.15 per gallon of still wine;[8] \$2.70 to \$13.50 per proof gallon of distilled spirits[9]

1 This rate does not include the additional 0.1 cent per gallon tax to fund the Leaking Underground Storage Tank Trust Fund.

2 This rate does not include the additional 0.1 cent per gallon tax to fund the Leaking Underground Storage Tank Trust Fund.

3 Generally, for international air passenger transportation that begins or ends in the United States, the tax is \$22.20 (2024) per arrival or departure.

4 Cigars, pipe tobacco, chewing tobacco, snuff, roll-your-own tobacco, cigarette papers, and cigarette tubes are also subject to Federal excise tax. Sec. 5701. https://www.ttb.gov/taxes/tax-audit/tax-and-fee-rates.

5 There is approximately \$1.01 in Federal excise tax imposed on a pack of cigarettes containing 20 cigarettes.

6 The rate of excise tax on alcoholic beverages may depend on a number of factors, including volume produced or imported, location of production, and alcoholic content. Artificially carbonated wine, sparkling wine, and hard cider are also subject to excise tax at various rates. Secs. 5001, 5041, and 5051. https://www.ttb.gov/taxes/tax-audit/tax-and-fee-rates.

7 There is approximately \$0.33 in Federal excise tax imposed on a six pack (72 oz) of beer, assuming an excise tax of \$18.00 per barrel.

8 There is approximately \$0.21 in Federal excise tax imposed on a 750 ml bottle of wine, assuming an excise tax of \$1.07 per gallon.

9 There is approximately \$2.14 in Federal excise tax imposed on a 750 ml bottle of 80-proof distilled spirits, assuming an excise tax of \$13.50 per proof gallon.

APPENDIX: FIGURES AND TABLES

Page

Table A-1.–Federal Receipts by Source, 1973-2023
(millions of dollars)

Fiscal Year	Individual Income Tax	Corporate Taxes	Social Insurance Taxes [1]	Excise Taxes	Estate and Gift Taxes	Other Receipts [2]	Total
1974	118,952	38,620	75,071	16,844	5,035	8,702	263,224
1975	122,386	40,621	84,534	16,551	4,611	10,387	279,090
1976	131,603	41,409	90,769	16,963	5,216	12,101	298,061
1977	157,626	54,892	106,485	17,548	7,327	11,681	355,559
1978	180,988	59,952	120,967	18,376	5,285	13,993	399,561
1979	217,841	65,677	138,939	18,745	5,411	16,690	463,303
1980	244,069	64,600	157,803	24,329	6,389	19,922	517,112
1981	285,917	61,137	182,720	40,839	6,787	21,872	599,272
1982	297,744	49,207	201,498	36,311	7,991	25,015	617,766
1983	288,938	37,022	208,994	35,300	6,053	24,256	600,563
1984	298,415	56,893	239,376	37,361	6,010	28,382	666,437
1985	334,531	61,331	265,163	35,992	6,422	30,598	734,037
1986	348,959	63,143	283,901	32,919	6,958	33,275	769,155
1987	392,557	83,926	303,318	32,457	7,493	34,536	854,287
1988	401,181	94,508	334,335	35,227	7,594	36,393	909,238
1989	445,690	103,291	359,416	34,386	8,745	39,576	991,104
1990	466,884	93,507	380,047	35,345	11,500	44,674	1,031,957
1991	467,827	98,086	396,015	42,402	11,138	39,519	1,054,987
1992	475,964	100,270	413,688	45,569	11,143	44,574	1,091,208
1993	509,680	117,520	428,299	48,057	12,577	38,201	1,154,334
1994	543,055	140,385	461,475	55,225	15,225	43,202	1,258,567
1995	590,244	157,004	484,473	57,484	14,763	47,822	1,351,790
1996	656,417	171,824	509,414	54,014	17,189	44,195	1,453,053
1997	737,466	182,293	539,371	56,924	19,845	43,333	1,579,232
1998	828,586	188,677	571,831	57,673	24,076	50,885	1,721,728
1999	879,480	184,680	611,833	70,414	27,782	53,263	1,827,452
2000	1,004,462	207,289	652,852	68,865	29,010	62,713	2,025,191
2001	994,339	151,075	693,967	66,232	28,400	57,069	1,991,082
2002	858,345	148,044	700,760	66,989	26,507	52,491	1,853,136
2003	793,699	131,778	712,978	67,524	21,959	54,376	1,782,314
2004	808,959	189,371	733,407	69,855	24,831	53,691	1,880,114
2005	927,222	278,282	794,125	73,094	24,764	56,124	2,153,611
2006	1,043,908	353,915	837,821	73,961	27,877	69,387	2,406,869
2007	1,163,472	370,243	869,607	65,069	26,044	73,550	2,567,985
2008	1,145,747	304,346	900,155	67,334	28,844	77,565	2,523,991
2009	915,308	138,229	890,917	62,483	23,482	74,570	2,104,989
2010	898,549	191,437	864,814	66,909	18,885	122,112	2,162,706
2011	1,091,473	181,085	818,792	72,381	7,399	132,336	2,303,466
2012	1,132,206	242,289	845,314	79,061	13,973	137,147	2,449,990
2013	1,316,405	273,506	947,820	84,007	18,912	134,456	2,775,106
2014	1,394,568	320,731	1,023,458	93,368	19,300	170,066	3,021,491
2015	1,540,802	343,797	1,065,257	98,279	19,232	182,523	3,249,890
2016	1,546,075	299,571	1,115,065	95,026	21,354	190,874	3,267,965
2017	1,587,120	297,048	1,161,897	83,823	22,768	163,528	3,316,184
2018	1,683,538	204,733	1,170,701	94,986	22,983	152,966	3,329,907
2019	1,717,857	230,245	1,243,113	98,914	16,672	156,563	3,463,364
2020	1,608,663	211,845	1,309,955	86,780	17,624	186,297	3,421,164
2021	2,044,377	371,831	1,314,088	75,274	27,140	214,401	4,047,111
2022	2,632,146	424,865	1,483,527	87,728	32,550	236,523	4,897,339
2023	2,176,481	419,584	1,614,456	75,802	33,668	120,956	4,440,947

[1] Social insurance taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad social security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Sources: Office of Management and Budget, Historical Tables, Budget of the U.S. Government, Fiscal Year 2025; Joint Committee on Taxation staff calculations.

Table A-2.–Federal Receipts by Source, as a Percentage of GDP, 1974-2023

Fiscal Year	Individual Income Tax	Corporate Taxes	Social Insurance Taxes [1]	Excise Taxes	Estate and Gift Taxes	Other Receipts [2]	Total
1974	8.0	2.6	5.1	1.1	0.3	0.6	17.8
1975	7.6	2.5	5.3	1.0	0.3	0.6	17.4
1976	7.4	2.3	5.1	0.9	0.3	0.7	16.7
1977	7.8	2.7	5.3	0.9	0.4	0.6	17.6
1978	8.0	2.6	5.3	0.8	0.2	0.6	17.6
1979	8.5	2.6	5.4	0.7	0.2	0.7	18.1
1980	8.7	2.3	5.7	0.9	0.2	0.7	18.5
1981	9.1	2.0	5.8	1.3	0.2	0.7	19.1
1982	9.0	1.5	6.1	1.1	0.2	0.8	18.6
1983	8.2	1.0	5.9	1.0	0.2	0.7	17.0
1984	7.6	1.4	6.1	0.9	0.2	0.7	16.9
1985	7.8	1.4	6.2	0.8	0.2	0.7	17.2
1986	7.7	1.4	6.3	0.7	0.2	0.7	17.0
1987	8.2	1.8	6.4	0.7	0.2	0.7	17.9
1988	7.8	1.8	6.5	0.7	0.1	0.7	17.7
1989	8.0	1.9	6.5	0.6	0.2	0.7	17.8
1990	7.9	1.6	6.4	0.6	0.2	0.8	17.5
1991	7.7	1.6	6.5	0.7	0.2	0.6	17.3
1992	7.4	1.6	6.4	0.7	0.2	0.7	17.0
1993	7.5	1.7	6.3	0.7	0.2	0.6	17.0
1994	7.6	2.0	6.4	0.8	0.2	0.6	17.5
1995	7.8	2.1	6.4	0.8	0.2	0.6	17.9
1996	8.3	2.2	6.4	0.7	0.2	0.6	18.3
1997	8.7	2.2	6.4	0.7	0.2	0.5	18.7
1998	9.3	2.1	6.4	0.6	0.3	0.6	19.3
1999	9.3	1.9	6.5	0.7	0.3	0.6	19.3
2000	9.9	2.0	6.5	0.7	0.3	0.6	20.0
2001	9.4	1.4	6.6	0.6	0.3	0.5	18.9
2002	7.9	1.4	6.5	0.6	0.2	0.5	17.1
2003	7.0	1.2	6.3	0.6	0.2	0.5	15.8
2004	6.7	1.6	6.1	0.6	0.2	0.4	15.6
2005	7.2	2.2	6.2	0.6	0.2	0.4	16.8
2006	7.7	2.6	6.1	0.5	0.2	0.5	17.6
2007	8.1	2.6	6.1	0.5	0.2	0.5	18.0
2008	7.7	2.1	6.1	0.5	0.2	0.5	17.1
2009	6.3	1.0	6.2	0.4	0.2	0.5	14.5
2010	6.0	1.3	5.8	0.4	0.1	0.8	14.5
2011	7.1	1.2	5.3	0.5	0.0	0.9	14.9
2012	7.0	1.5	5.2	0.5	0.1	0.9	15.2
2013	7.9	1.6	5.7	0.5	0.1	0.8	16.6
2014	8.0	1.8	5.9	0.5	0.1	1.0	17.3
2015	8.5	1.9	5.9	0.5	0.1	1.0	17.9
2016	8.3	1.6	6.0	0.5	0.1	1.0	17.5
2017	8.2	1.5	6.0	0.4	0.1	0.8	17.1
2018	8.2	1.0	5.7	0.5	0.1	0.7	16.3
2019	8.1	1.1	5.8	0.5	0.1	0.7	16.3
2020	7.6	1.0	6.2	0.4	0.1	0.9	16.1
2021	9.0	1.6	5.8	0.3	0.1	0.9	17.9
2022	10.4	1.7	5.9	0.3	0.1	0.9	19.4
2023	8.1	1.6	6.0	0.3	0.1	0.4	16.5
1950-2023 Avg	7.9	2.5	5.0	1.1	0.2	0.6	17.3

[1] Social insurance taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad social security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

Sources: Office of Management and Budget, Historical Tables, Budget of the U.S. Government, Fiscal Year 2025; Joint Committee on Taxation staff calculations.

Table A-3.–Federal Receipts by Source, as a Percentage of Total Revenues, 1974-2023

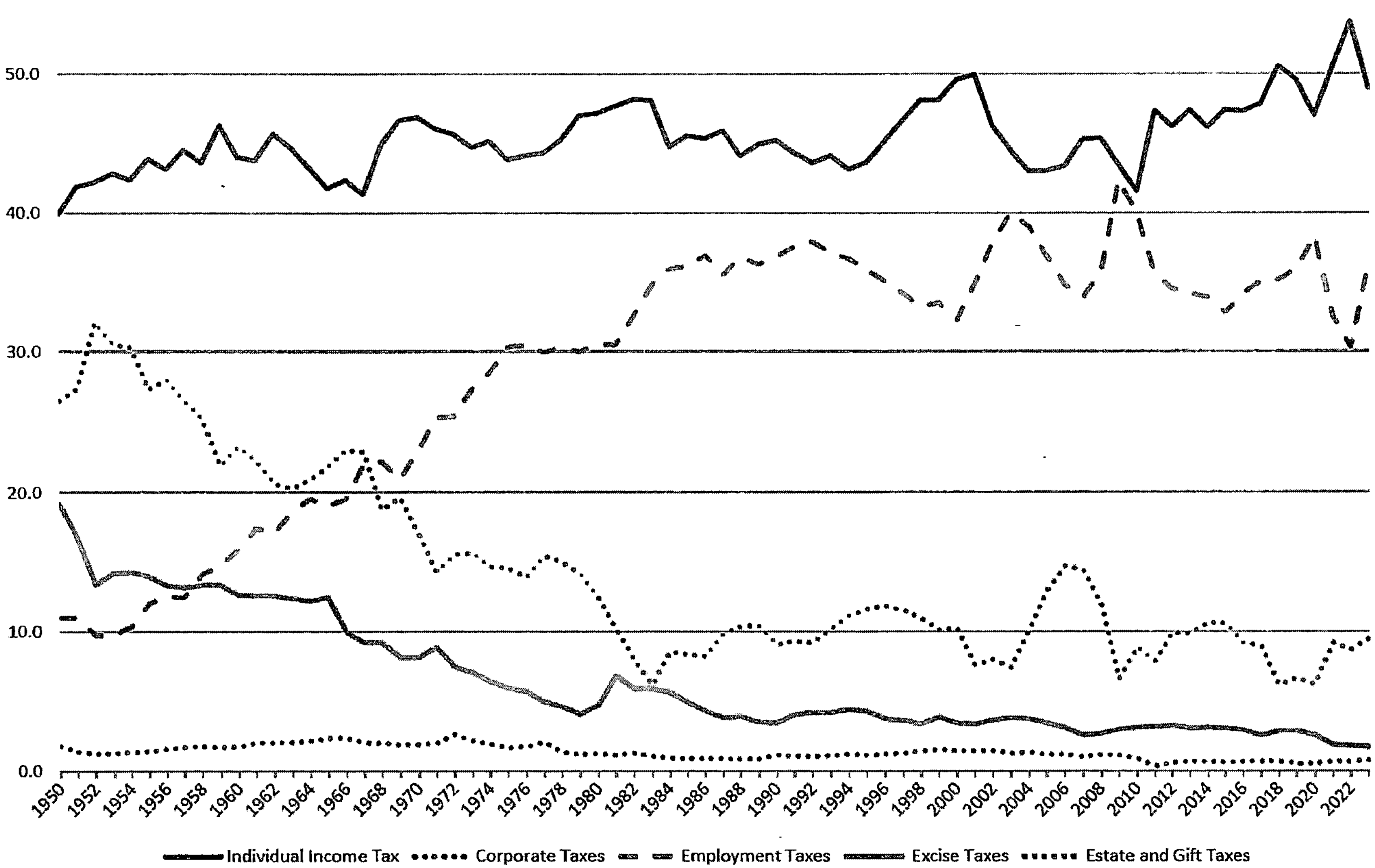
Fiscal Year	Individual Income Tax	Corporate Taxes	Social Insurance Taxes [1]	Excise Taxes	Estate and Gift Taxes	Other Receipts [2]
1974	45.2	14.7	28.5	6.4	1.9	3.3
1975	43.9	14.6	30.3	5.9	1.7	3.7
1976	44.2	13.9	30.5	5.7	1.7	4.1
1977	44.3	15.4	29.9	4.9	2.1	3.3
1978	45.3	15.0	30.3	4.6	1.3	3.5
1979	47.0	14.2	30.0	4.0	1.2	3.6
1980	47.2	12.5	30.5	4.7	1.2	3.9
1981	47.7	10.2	30.5	6.8	1.1	3.6
1982	48.2	8.0	32.6	5.9	1.3	4.0
1983	48.1	6.2	34.8	5.9	1.0	4.0
1984	44.8	8.5	35.9	5.6	0.9	4.3
1985	45.6	8.4	36.1	4.9	0.9	4.2
1986	45.4	8.2	36.9	4.3	0.9	4.3
1987	46.0	9.8	35.5	3.8	0.9	4.0
1988	44.1	10.4	36.8	3.9	0.8	4.0
1989	45.0	10.4	36.3	3.5	0.9	4.0
1990	45.2	9.1	36.8	3.4	1.1	4.3
1991	44.3	9.3	37.5	4.0	1.1	3.7
1992	43.6	9.2	37.9	4.2	1.0	4.1
1993	44.2	10.2	37.1	4.2	1.1	3.3
1994	43.1	11.2	36.7	4.4	1.2	3.4
1995	43.7	11.6	35.8	4.3	1.1	3.5
1996	45.2	11.8	35.1	3.7	1.2	3.0
1997	46.7	11.5	34.2	3.6	1.3	2.7
1998	48.1	11.0	33.2	3.3	1.4	3.0
1999	48.1	10.1	33.5	3.9	1.5	2.9
2000	49.6	10.2	32.2	3.4	1.4	3.1
2001	49.9	7.6	34.9	3.3	1.4	2.9
2002	46.3	8.0	37.8	3.6	1.4	2.8
2003	44.5	7.4	40.0	3.8	1.2	3.1
2004	43.0	10.1	39.0	3.7	1.3	2.9
2005	43.1	12.9	36.9	3.4	1.1	2.6
2006	43.4	14.7	34.8	3.1	1.2	2.9
2007	45.3	14.4	33.9	2.5	1.0	2.9
2008	45.4	12.1	35.7	2.7	1.1	3.1
2009	43.5	6.6	42.3	3.0	1.1	3.5
2010	41.5	8.9	40.0	3.1	0.9	5.6
2011	47.4	7.9	35.5	3.1	0.3	5.7
2012	46.2	9.9	34.5	3.2	0.6	5.6
2013	47.4	9.9	34.2	3.0	0.7	4.8
2014	46.2	10.6	33.9	3.1	0.6	5.6
2015	47.4	10.6	32.8	3.0	0.6	5.6
2016	47.3	9.2	34.1	2.9	0.7	5.8
2017	47.9	9.0	35.0	2.5	0.7	4.9
2018	50.6	6.1	35.2	2.9	0.7	4.6
2019	49.6	6.6	35.9	2.9	0.5	4.5
2020	47.0	6.2	38.3	2.5	0.5	5.4
2021	50.5	9.2	32.5	1.9	0.7	5.3
2022	53.7	8.7	30.3	1.8	0.7	4.8
2023	49.0	9.4	36.4	1.7	0.8	2.7
1950-2023 Avg	45.4	14.4	29.1	6.5	1.3	3.4

[1] Social insurance taxes comprise old-age and survivors insurance, disability insurance, hospital insurance, railroad retirement, railroad social security equivalent account, employment insurance, employee share of Federal employees retirement, and certain non-Federal employees retirement.

[2] Other receipts are primarily composed of (1) customs duties and fees, and (2) deposits of earnings by the Federal Reserve system.

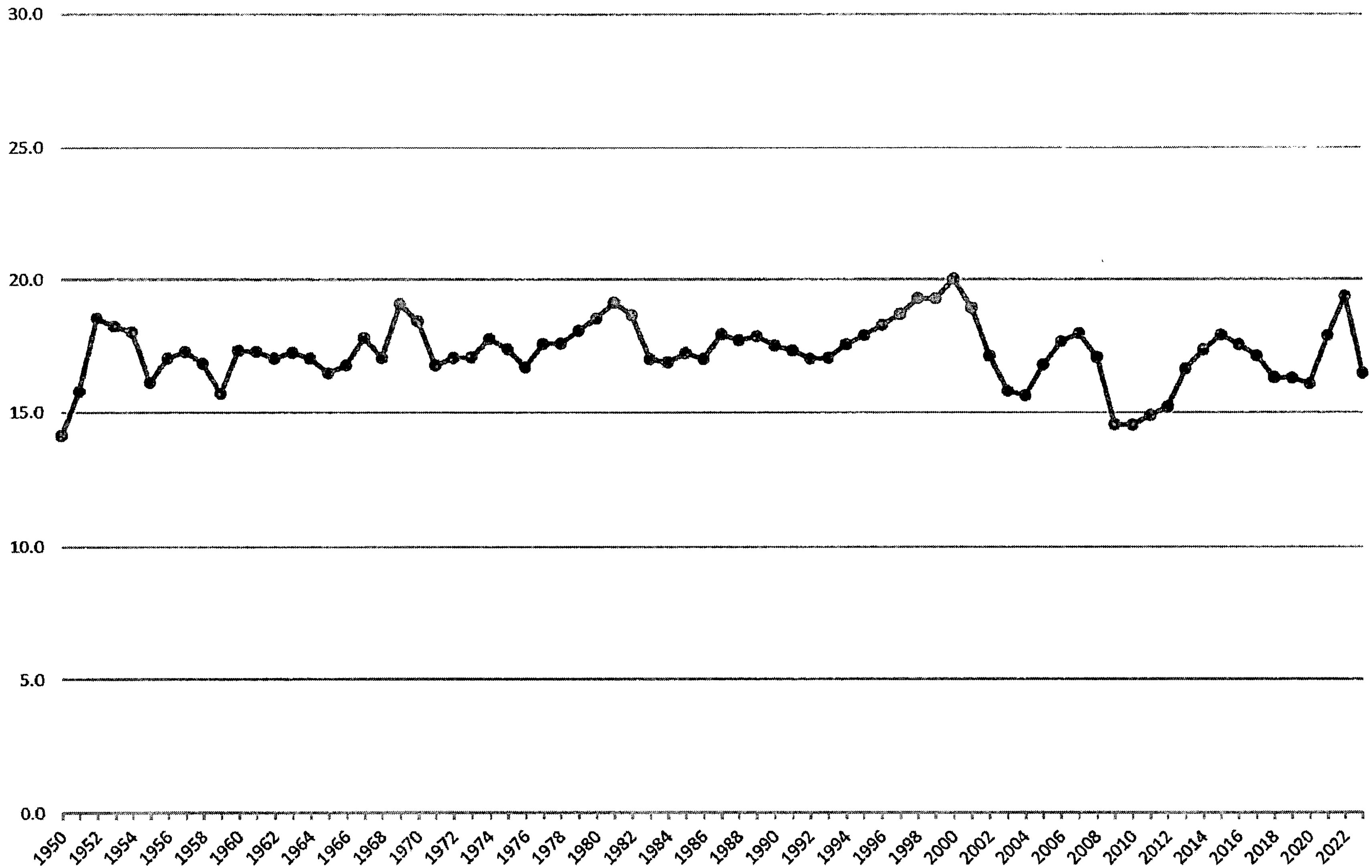
Sources: Office of Management and Budget, Historical Tables, Budget of the U.S. Government, Fiscal Year 2025; Joint Committee on Taxation staff calculations.

Figure A-1.–Federal Receipts by Source as Share of Total Receipts, 1950-2023



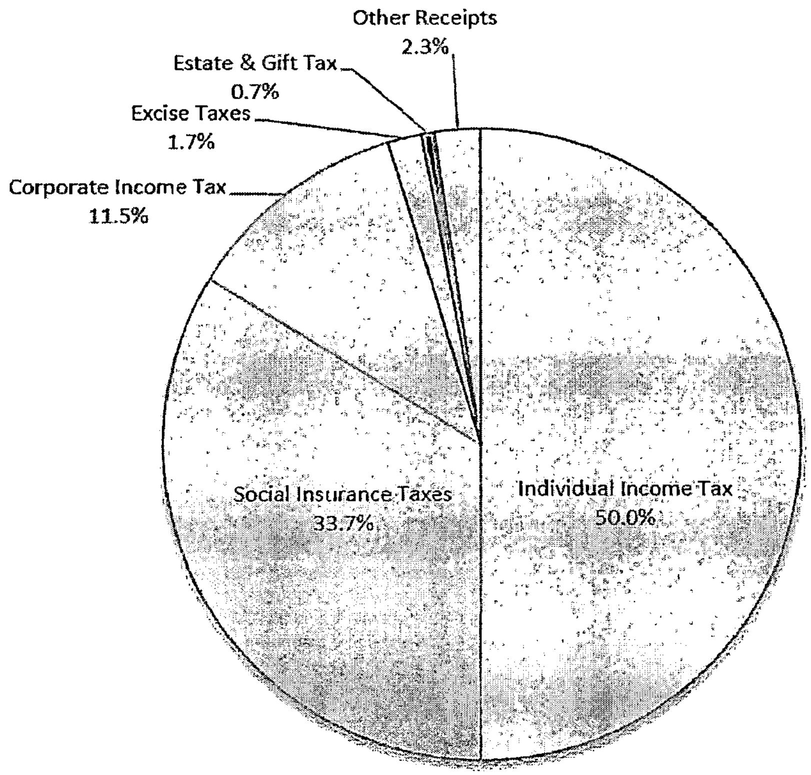
Sources: Office of Management and Budget, Historical Tables, Fiscal Year 2025; Joint Committee on Taxation staff calculations.

Figure A-2.–Federal Receipts as a Percentage of GDP, 1950-2023



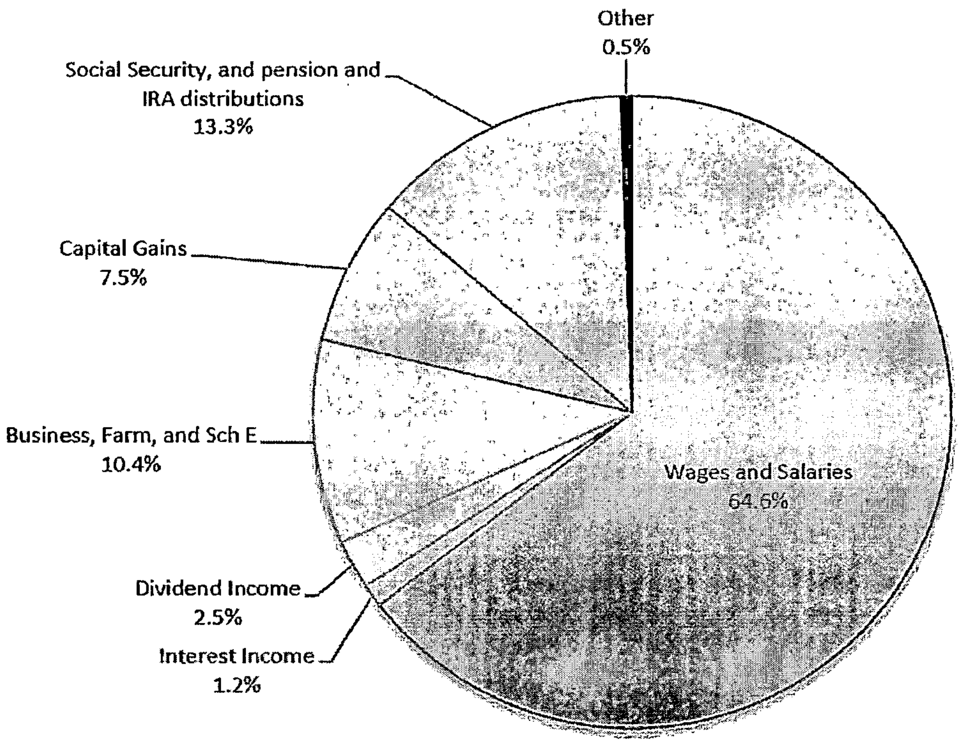
Sources: Office of Management and Budget, Historical Tables, Fiscal Year 2025; Joint Committee on Taxation staff calculations.

Figure A-3.–Federal Receipts by Source, 2024 (Projected)



Sources: Congressional Budget Office, January 2024 Baseline; Joint Committee on Taxation staff calculations.

Figure A-4.–Sources of Gross Income for Individual Taxpayers, 2024 (Projected)



Source: Joint Committe on Taxation staff estimates.

Table A-4.–Number of Business Returns by Type, 1978-2021

Year	Non-Farm Sole Props	C Corporations	S Corporations	Partnerships	Farm Sole Props	Total
1978	8,908,289	1,898,100	478,679	1,234,157	2,704,794	15,224,019
1979	9,343,603	2,041,887	514,907	1,299,593	2,605,684	15,805,674
1980	9,730,019	2,165,149	545,389	1,379,654	2,608,430	16,428,641
1981	9,584,790	2,270,931	541,489	1,460,502	2,641,254	16,498,966
1982	10,105,515	2,361,714	564,219	1,514,212	2,689,237	17,234,897
1983	10,703,921	2,350,804	648,267	1,541,539	2,710,044	17,954,575
1984	11,262,390	2,469,404	701,339	1,643,581	2,694,420	18,771,134
1985	11,928,573	2,552,470	724,749	1,713,603	2,620,861	19,540,256
1986	12,393,700	2,602,301	826,214	1,702,952	2,524,331	20,049,498
1987	13,091,132	2,484,228	1,127,905	1,648,035	2,420,186	20,771,486
1988	13,679,302	2,305,598	1,257,191	1,654,245	2,367,527	21,263,863
1989	14,297,558	2,204,896	1,422,967	1,635,164	2,359,718	21,920,303
1990	14,782,738	2,141,558	1,575,092	1,553,529	2,321,153	22,374,070
1991	15,180,722	2,105,200	1,696,927	1,515,345	2,290,908	22,789,102
1992	15,495,419	2,083,652	1,785,371	1,484,752	2,288,218	23,137,412
1993	15,848,119	2,063,124	1,901,505	1,467,567	2,272,407	23,552,722
1994	16,153,871	2,318,614	2,023,754	1,493,963	2,242,324	24,232,526
1995	16,423,872	2,321,048	2,153,119	1,580,900	2,219,244	24,698,183
1996	16,955,023	2,326,954	2,304,416	1,654,256	2,188,025	25,428,674
1997	17,176,486	2,257,829	2,452,254	1,758,627	2,160,954	25,806,150
1998	17,398,440	2,260,757	2,588,081	1,855,348	2,091,845	26,194,471
1999	17,575,643	2,210,129	2,725,775	1,936,919	2,067,883	26,516,349
2000	17,902,791	2,184,795	2,860,478	2,057,500	2,083,217	27,088,781
2001	18,338,190	2,149,105	2,986,486	2,132,117	2,027,643	27,633,541
2002	18,925,517	2,112,230	3,154,377	2,242,169	2,019,647	28,453,940
2003	19,710,079	2,059,631	3,341,606	2,375,375	2,017,879	29,504,570
2004	20,590,691	2,039,631	3,518,334	2,546,877	2,022,298	30,717,831
2005	21,467,566	1,987,171	3,684,086	2,763,625	2,002,088	31,904,536
2006	22,074,953	1,968,032	3,872,766	2,947,116	1,980,032	32,842,899
2007	23,122,698	1,878,956	3,989,893	3,096,334	2,013,681	34,101,562
2008	22,614,483	1,797,278	4,049,943	3,146,006	1,966,656	33,574,366
2009	22,659,976	1,729,984	4,094,562	3,168,728	1,947,670	33,600,920
2010	23,003,656	1,686,171	4,127,554	3,248,481	1,934,731	34,000,593
2011	23,426,940	1,664,553	4,158,572	3,285,177	1,894,910	34,430,152
2012	23,553,850	1,635,369	4,205,452	3,388,561	1,862,280	34,645,512
2013	24,031,243	1,629,895	4,257,909	3,460,699	1,848,973	35,228,719
2014	24,631,831	1,621,366	4,380,125	3,611,255	1,823,136	36,067,713
2015	25,226,245	1,632,229	4,487,336	3,715,187	1,841,542	36,902,539
2016	25,525,915	1,596,634	4,592,042	3,763,117	1,783,092	37,260,800
2017	26,426,406	1,599,430	4,725,684	3,905,335	1,817,386	38,474,241
2018	27,117,163	1,567,138	4,874,996	4,010,200	1,795,019	39,364,516
2019	27,817,189	1,533,396	4,940,351	3,821,470	1,757,822	39,870,228
2020	28,353,367	1,509,409	4,892,722	4,280,690	1,769,447	40,805,635
2021	29,309,596	1,570,179	5,120,552	4,467,584	1,755,016	42,222,927

Source: Internal Revenue Service, Statistics of Income, published and unpublished data.

Table A-5.–Social Security Taxable Wage Base and Rates of Tax, 1975-2024

Year	Annual Maximum Taxable Wage Base for OASDI	Contribution Rate for Both Employers and Employees (Percent of Covered Earnings)			Contribution Rate for Self-Employed Persons		
		Total	OASDI	HI	Total	OASDI	HI
1975 to 1977	$14,100 to $16,500	5.85	4.95	0.9	7.9	7.0	0.9
1978	$17,700	6.05	5.05	1.0	8.1	7.1	1.0
1979	$22,900	6.13	5.08	1.05	8.1	7.05	1.05
1980	$25,900	6.13	5.08	1.05	8.1	7.05	1.05
1981	$29,700	6.65	5.35	1.3	9.3	8	1.3
1982 to 1983	$32,400 to $35,700	6.7	5.4	1.3	9.35	8.05	1.3
1984 [1]	$37,800	7.0	5.7	1.3	14.0	11.4	2.6
1985	$39,600	7.05	5.7	1.35	14.1	11.4	2.7
1986 to 1987	$42,000 to $43,800	7.15	5.7	1.45	14.3	11.4	2.9
1988 to 1989	$45,000 to $48,000	7.51	6.06	1.45	15.02	12.12	2.9
1990 to 2010	$51,300 to $106,800	7.65	6.2	1.45	15.3	12.4	2.9
2011 to 2012 [2]	$106,800 to $110,100	7.65/5.65	6.2/4.2	1.45	13.3	10.4	2.9
2013 [3]	$113,700	7.65	6.2	1.45	15.3	12.4	2.9
2014 [3]	$117,000	7.65	6.2	1.45	15.3	12.4	2.9
2015 [3]	$118,500	7.65	6.2	1.45	15.3	12.4	2.9
2016 [3]	$118,500	7.65	6.2	1.45	15.3	12.4	2.9
2017 [3]	$127,200	7.65	6.2	1.45	15.3	12.4	2.9
2018 [3]	$128,400	7.65	6.2	1.45	15.3	12.4	2.9
2019 [3]	$132,900	7.65	6.2	1.45	15.3	12.4	2.9
2020 [3]	$137,700	7.65	6.2	1.45	15.3	12.4	2.9
2021 [3]	$142,800	7.65	6.2	1.45	15.3	12.4	2.9
2022 [3]	$147,000	7.65	6.2	1.45	15.3	12.4	2.9
2023 [3]	$160,200	7.65	6.2	1.45	15.3	12.4	2.9
2024 [3]	$168,600	7.65	6.2	1.45	15.3	12.4	2.9

[1] For 1984 only, employees were allowed a credit of 0.3 percent of taxable wages against heir FICA tax liability, reducing the effec ive rate to 6.7 percent.

[2] The Tax Relief, Unemployment Reau horization, and Job Creation Act of 2010 reduced he FICA tax rate for employees by two percentage Specifically, he employer OASDI rate remains at 6.2 while the employee rate is reduced points for 2011 to 4.2. Equivalent reduc ions were made to the SECA tax. Subsequent legisla ion extended that treatment to 2012.

[3] For 2013, and subsequent years, an addi ional employee HI tax of 0.9 percent applies to wages in excess of $250,000 for married taxpayers filing jointly ($125,000 for married taxpayers filing separately) and $200,000 in all other cases. Equivalent increases were made to the SECA tax. For wages in excess of he hreshold in these years, he HI contribution rate is 2.35 percent for employees and 3.8 percent for self-employed persons, and the total HI and OASDI contribu ion rate is 8.55 percent (not the corresponding rates reflected in the table).

Source: Social Security Administration.

Table A-6.–Distribution of Income and Taxes, and Average Tax Rates, 2024 (Projected)

Income Category [1]	Number of Returns [2] (Thousands)	Share of Returns	Income ($ Millions)	Share of Income	Combined Income, Employment, and Excise Taxes Under Present Law [3]			Individual Income Taxes			Employment Taxes		
					$ Billions	Percent share	Average Tax Rate [4]	$ Billions	Percent share	Average Tax Rate	$ Billions	Percent share	Average Tax Rate
Less than $15,000....................	20,550	10.8%	135,172	0.6%	2.9	0.1%	2.2%	-17.5	-0 8%	-13.0%	14.7	0.9%	10.9%
$15,000 to $30,000..................	23,444	12.4%	535,519	2.5%	11.3	0.3%	2.1%	-52.7	-2 5%	-9.8%	53.3	3.3%	10.0%
$30,000 to $40,000..................	17,162	9.1%	600,407	2.8%	34.4	0.8%	5.7%	-30.2	-1.4%	-5.0%	54.0	3.3%	9.0%
$40,000 to $50,000..................	14,408	7.6%	648,881	3.0%	53.6	1.2%	8.3%	-16.9	-0 8%	-2.6%	58.7	3.6%	9.1%
$50,000 to $60,000..................	13,263	7.0%	728,379	3.4%	77.5	1.8%	10.6%	-1.7	-0.1%	-0.2%	65.6	4.1%	9.0%
$60,000 to $80,000..................	22,675	12.0%	1,576,193	7.4%	200.9	4.7%	12.7%	30.5	1 5%	1.9%	140.5	8.7%	8.9%
$80,000 to $100,000................	16,075	8.5%	1,438,580	6.7%	211.8	4.9%	14.7%	56.2	2.7%	3.9%	126.1	7.8%	8.8%
$100,000 to $150,000..............	26,021	13.7%	3,187,697	14.9%	540.0	12.5%	16.9%	188.7	9 0%	5.9%	279.4	17.3%	8.8%
$150,000 to $200,000..............	14,089	7.4%	2,433,897	11.4%	475.4	11.0%	19.5%	191.3	9.1%	7.9%	221.4	13.7%	9.1%
$200,000 to $500,000..............	18,333	9.7%	5,194,674	24.3%	1,235.7	28.7%	23.8%	628.7	29 9%	12.1%	445.4	27.6%	8.6%
$500,000 to $1,000,000...........	2,415	1.3%	1,609,615	7.5%	456.9	10.6%	28.4%	305.2	14 5%	19.0%	90.0	5.6%	5.6%
$1,000,000 and over................	1,056	0.6%	3,312,045	15.5%	1,006.1	23.4%	30.4%	820.3	39 0%	24.8%	67.4	4.2%	2.0%
Total, All Taxpayers................	189,491	100.0%	21,401,059	100.0%	4,306.4	100.0%	20.1%	2,101.8	100 0%	9.8%	1,616.5	100.0%	7.6%

[1] The income concept used to place tax returns into size-adjusted income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2024 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

[3] Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from he analysis. Does not include indirect effects.

[4] The average tax rate is equal to Federal taxes described in footnote [3] divided by income described in footnote [1].

Source: Joint Committee on Taxation staff estimates.

Table A-7.–Distribution of Income and Taxes, and Average Tax Rates, Alternative Measure [1], 2024 (Projected)

Size-adjusted Income Category [2]	Number of Returns [3] (Thousands)	Share of Returns	Income ($ Millions)	Share of Income	Combined Income, Employment, and Excise Taxes Under Present Law [4]			Individual Income Taxes			Employment Taxes		
					$ Billions	Percent share	Average Tax Rate [5]	$ Billions	Percent share	Average Tax Rate	$ Billions	Percent share	Average Tax Rate
Bottom quintile (P0 to P20).....	37,898	20.0%	539,875	2.5%	-15.4	-0.4%	-2.8%	-90.5	-4.3%	-16.8%	60.6	3.7%	11.2%
2nd quintile (P20 to P40).........	37,898	20.0%	1,523,631	7.1%	102.6	2.4%	6.7%	-68.9	-3.3%	-4.5%	143.4	8.9%	9.4%
3rd quintile (P40 to P60)..........	37,898	20.0%	2,591,714	12.1%	313.9	7.3%	12.1%	41.5	2.0%	1.6%	225.7	14.0%	8.7%
4th quintile (P60 to P80)..........	37,899	20.0%	4,239,470	19.8%	706.6	16.4%	16.7%	232.2	11.0%	5.5%	384.6	23.8%	9.1%
P80 to P90..............................	18,948	10.0%	3,252,849	15.2%	672.9	15.6%	20.7%	293.7	14.0%	9.0%	297.2	18.4%	9.1%
P90 to P95..............................	9,476	5.0%	2,283,589	10.7%	537.1	12.5%	23.5%	267.8	12.7%	11.7%	201.1	12.4%	8.8%
P95 to P99..............................	7,579	4.0%	3,040,046	14.2%	801.9	18.6%	26.4%	481.1	22.9%	15.8%	211.1	13.1%	6.9%
P99 to P99.9...........................	1,705	0.9%	2,004,801	9.4%	613.0	14.2%	30.6%	463.8	22.1%	23.1%	70.7	4.4%	3.5%
Top 0.1%.................................	190	0.1%	1,925,084	9.0%	573.8	13.3%	29.8%	481.0	22.9%	25.0%	22.2	1.4%	1.2%
Total, All Taxpayers...............	189,491	100.0%	21,401,059	100.0%	4,306.4	100.0%	20.1%	2,101.8	100.0%	9.8%	1,616.5	100.0%	7.6%

[1] The alternative Joint Committee on Taxation distribution method uses proportional tax-unit groups and size-adjusted income. The proportional distribution means each quintile includes the same number of tax units. Size-adjusted income is calculated by dividing tax-unit income by the square root of the number of individuals in the tax unit and is only used to determine a tax unit's income category.

[2] The income concept used to place tax returns into size-adjusted income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad.

[3] Includes nonfilers, excludes dependent filers and returns with negative income.

[4] Federal taxes are equal to individual income tax (including the outlay portion of refundable credits), employment tax (attributed to employees), excise taxes (attributed to consumers), and corporate income taxes. The estimates of Federal taxes are preliminary and subject to change. Individuals who are dependents of other taxpayers and taxpayers with negative income are excluded from the analysis. Does not include indirect effects.

[5] The average tax rate is equal to Federal taxes described in footnote [4] divided by income described in footnote [2].

Source: Joint Committee on Taxation staff estimates.

Table A-8.—Tax Returns with Income or Employment Taxes, 2024 (Projected)

Income Category [1]	Number of Returns [2] (Millions)	Individual Income Taxes	Employment Taxes	Employment Taxes Less than Income Taxes	Employment Taxes Greater than Income Taxes	
		$ Billions	$ Billions	Returns (Millions)	Returns (Millions)	Fraction of Total Returns
Less than $15,000	20.6	-17.5	14.7	[3]	13.1	63.6%
$15,000 to $30,000	23.4	-52.7	53.3	0.2	18.3	78.1%
$30,000 to $40,000	17.2	-30.2	54.0	0.2	12.6	73.1%
$40,000 to $50,000	14.4	-16.9	58.7	0.4	11.0	76.6%
$50,000 to $60,000	13.3	-1.7	65.6	1.1	10.3	77.4%
$60,000 to $80,000	22.7	30.5	140.5	3.0	17.3	76.3%
$80,000 to $100,000	16.1	56.2	126.1	2.8	12.0	74.7%
$100,000 to $150,000	26.0	188.7	279.4	7.3	18.3	70.5%
$150,000 to $200,000	14.1	191.3	221.4	5.4	8.7	61.8%
$200,000 to $500,000	18.3	628.7	445.4	11.5	6.8	37.1%
$500,000 to $1,000,000	2.4	305.2	90.0	2.4	[3]	[4]
$1,000,000 and over	1.1	820.3	67.4	1.0	[3]	[4]
Total, All Taxpayers	189.5	2101.8	1616.5	35.4	128.4	67.8%

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2024 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

[3] Less than 50,000.

[4] Less than 2 percent.

Source: Joint Committee on Taxation staff estimates.

Table A-9.—Marginal Tax Rates on Labor and Long-Term Capital Gains, by Income Category, 2024 (Projected)

Income Category [1]	Labor Income			Long-Term Capital Gains Income
	Average Marginal Income Tax Rate [2]	Average Marginal Employment Tax Rate [2]	Average Combined Marginal Income and Employment Tax Rate [2]	Average Marginal Capital Gains Tax Rate [2]
Less than $15,000....................	-4.2%	14.2%	10.0%	1.8%
$15,000 to $30,000....................	3.8%	14.2%	18.0%	2.5%
$30,000 to $40,000....................	10.8%	14.2%	25.0%	2.4%
$40,000 to $50,000....................	12.9%	14.2%	27.1%	4.9%
$50,000 to $60,000....................	13.9%	14.2%	28.1%	7.7%
$60,000 to $80,000....................	14.2%	14.2%	28.5%	10.6%
$80,000 to $100,000..................	15.8%	14.2%	30.0%	11.6%
$100,000 to $150,000................	15.0%	14.2%	29.2%	13.9%
$150,000 to $200,000................	19.1%	13.9%	32.9%	13.2%
$200,000 to $500,000................	22.5%	11.4%	33.9%	17.9%
$500,000 to $1,000,000.............	32.1%	7.9%	39.9%	21.6%
$1,000,000 and over..................	34.6%	7.2%	41.9%	23.6%
Total, All Taxpayers..................	14.0%	13.6%	27.6%	21.8%

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2024 levels.

[2] For individual income and employment taxes, the average marginal tax rate is equal to the change in taxes from an additional $100 of wages to each spouse with positive wages. For long-term capital gain, the average marginal tax rate equals the change in taxes from an additional 1% increase in long-term capital gains to each taxpayer with positive long-term capital gains. Effective marginal rates may be higher or lower than statutory marginal rates due to certain provisions in the Code including the phasein and phaseout of certain exemptions or credits.

Source: Joint Committee on Taxation staff estimates.

Table A-10.—Distribution of Selected Sources of Income, 2024 (Projected)

Income Category [1]	Number of Returns [2] (Millions)	Wages	Long-Term Capital Gains in AGI	Dividend Income	Interest Income	Schedule C Income	Schedule E Income
		$ Billions	$ Billions	$ Billions	$ Billions	$ Billions	$ Billions
Less than $15,000........................	20.6	78.8	0.8	0.7	0.7	15.6	-1.7
$15,000 to $30,000......................	23.4	293.7	1.4	1.4	1.5	44.5	-1.0
$30,000 to $40,000......................	17.2	314.0	1.4	1.7	1.6	20.6	2.4
$40,000 to $50,000......................	14.4	343.0	2.2	2.4	2.2	19.2	1.4
$50,000 to $60,000......................	13.3	387.5	1.9	2.7	2.3	13.7	4.6
$60,000 to $80,000......................	22.7	840.7	7.1	6.7	5.4	26.7	6.2
$80,000 to $100,000....................	16.1	764.5	8.6	8.3	6.1	20.0	10.9
$100,000 to $150,000..................	26.0	1,726.0	28.9	25.5	17.0	44.5	28.2
$150,000 to $200,000..................	14.1	1,380.9	36.4	27.2	13.9	42.9	35.5
$200,000 to $500,000..................	18.3	3,035.4	163.1	98.2	38.1	117.8	200.2
$500,000 to $1,000,000...............	2.4	851.1	131.5	65.3	19.5	50.3	208.2
$1,000,000 and over.....................	1.1	934.6	884.7	185.3	90.1	57.1	815.9
Total, All Taxpayers...................	189.5	10,950.2	1,267.9	425.3	198.3	472.9	1,310.9

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2024 levels.

[2] Includes nonfilers, excludes dependent filers and returns with negative income.

Source: Joint Committee on Taxation staff estimates.

Table A-11.—Distribution of Selected Itemized Deductions, 2024 (Projected)

Income Category [1]	State and Local Income, Sales, and Personal Property Tax Deduction		Mortgage Interest Deduction		Charitable Contribution Deduction	
	Returns (Thousands)	$ Millions	Returns (Thousands)	$ Millions	Returns (Thousands)	$ Millions
Less than $15,000	100	433	46	1,701	32	34
$15,000 to $30,000	171	858	105	1,434	84	263
$30,000 to $40,000	240	1,181	122	1,371	150	722
$40,000 to $50,000	273	1,409	131	1,520	193	986
$50,000 to $60,000	379	2,293	219	2,441	250	1,250
$60,000 to $80,000	1,076	6,463	663	6,703	806	5,066
$80,000 to $100,000	1,217	8,308	867	8,986	946	5,658
$100,000 to $150,000	3,228	25,826	2,478	27,973	2,622	17,780
$150,000 to $200,000	2,323	20,667	1,811	23,541	1,978	18,313
$200,000 to $500,000	5,023	48,152	4,217	71,657	4,549	56,005
$500,000 to $1,000,000	1,257	12,576	1,023	22,536	1,175	30,225
$1,000,000 and over	757	7,797	528	12,857	724	133,917
Total, All Taxpayers	15,944	135,530	12,164	181,019	13,477	270,185

[1] The income concept used to place tax returns into income categories is adjusted gross income (AGI) plus: (1) tax-exempt interest, (2) employer contributions for health plans and life insurance, (3) employer share of FICA tax, (4) workers' compensation, (5) nontaxable Social Security benefits, (6) insurance value of Medicare benefits, (7) alternative minimum tax preference items, (8) individual share of business taxes, and (9) excluded income of U.S. citizens living abroad. Categories are measured at 2024 levels.

Source: Joint Committee on Taxation staff estimates.

American Federal Tax Reports

UNITED THERAPEUTICS CORP. v. COMM., Cite as 133 AFTR 2d 2024 -XXXX, (CA4), 06/24/2024

UNITED THERAPEUTICS CORPORATION, Petitioner - Appellant, v. COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellee.

Case Information:

Code Sec(s):	
Court Name:	UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT,
Docket No.:	No. 23-1718,
Date Argued:	01/25/**2024**
Date Decided:	06/24/**2024**.
Prior History:	
Disposition:	

HEADNOTE

Reference(s):

OPINION

ARGUED: Thomas Henderson Dupree, Jr., GIBSON, DUNN & CRUTCHER LLP, Washington, D.C., for Appellant. Sherra Tinyi Wong, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellee.

ON BRIEF: Lucas C. Townsend, Saul Mezei, John F. Craig, III, GIBSON, DUNN & CRUTCHER LLP, Washington, D.C., for Appellant. David A. Hubbert, Deputy Assistant Attorney General, Jacob Earl Christensen, Tax Division, UNITED STATES DEPARTMENT OF JUSTICE, Washington, D.C., for Appellee.

UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT,

Appeal from the United States Tax Court. (Tax Ct. No. 10210-21)

Affirmed by published opinion. Judge Harris wrote the majority opinion, in which Judge Thacker and Judge Rushing joined.

Before THACKER, HARRIS, and RUSHING, Circuit Judges.

Judge: PAMELA HARRIS, Circuit Judge:

PUBLISHED

A tax provision coordinating one tax credit with another prohibits double-counting. The Commissioner of Internal Revenue issued United Therapeutics a notice of deficiency on its 2014 tax return, claiming that it disregarded one of the provision's two commands, improperly shrinking its tax liability by over a million dollars. The company challenges the Commissioner's determination, arguing that the relevant half of the coordination provision lost effect in 1989 and has been moribund since. Like the tax court, we disagree: Construing the statute's terms by reference to their ordinary meaning gives effect to the full coordination provision. We therefore affirm.

I.

A.

This case sits at the intersection of two tax credits that seek to encourage research. The first, termed the "research credit," is codified at **I.R.C.** § 41.[1] As suggested by its formal title, "Credit for increasing research activities," its purpose is to incentivize taxpayers to increase their investment in research year over year. *See Geosyntec Consultants, Inc. v. United States*, 776 F.3d 1330, 1334 [115 AFTR 2d 2015-644] (11th Cir. 2015). The research credit has various components, but the one at issue here is for "qualified research expenses," and it pegs the amount of the credit to increases in such expenses over time: The more "qualified research expenses" a company incurs by comparison to prior years, the greater the credit. *See generally* **I.R.C.** §§ 41(a)(1), (b).

The second, termed the "orphan drug credit," is codified at **I.R.C.** § 45C. This credit encourages pharmaceutical companies to develop "orphan drugs" – drugs treating diseases so rare that companies would otherwise have little financial incentive to address them. *See Catalyst Pharm., Inc. v. Becerra*, 14 F.4th 1299, 1302 (11th Cir. 2021). In any given tax year, a company can elect to claim an orphan drug credit equal to a percentage of its "qualified clinical testing expenses" – a figure distinct from its § 41 "qualified research expenses." **I.R.C.** §§ 45C(a), (d)(4) (2014).[2] This credit is more generous than the § 41 research credit but generally applies to a smaller pool of expenses.

Given the similar goals of the § 41 research credit and the § 45C orphan drug credit, a company may have what we will call "overlapping expenses" – that is, expenses that are simultaneously "qualified research expenses" per § 41 and "qualified clinical testing expenses" per § 45C. Anticipating this overlap, Congress included a "coordination provision" in § 45C, instructing taxpayers on the credits' interaction:

Sec. 45C(c). Coordination with credit for increasing research expenditures.

> ((1)) In general. – Except as provided in paragraph (2), any qualified clinical testing expenses for a taxable year to which an election under this section applies shall not be taken into account for purposes of determining the credit allowable under section 41 for such taxable year.
>
> ((2)) Expenses included in determining base period research expenses. – Any qualified clinical testing expenses for any taxable year which are qualified research expenses (within the meaning of section 41(b)) shall be taken into account in determining base period research expenses for purposes of applying section 41 to subsequent taxable years.

I.R.C. § 45C(c).

This provision prohibits taxpayers from double-counting their overlapping expenses in two ways. Paragraph 1 is straightforward: If a company counts an overlapping expense as a "qualified clinical testing expense" in a given tax year, taking advantage of § 45C's more generous credit, it cannot simultaneously claim the expense as a "qualified research expense" eligible for the § 41 credit. *See* **I.R.C.** § 45C(c)(1). Paragraph 2 is just a little trickier: Excluding that overlapping expense altogether under § 41 would deflate the baseline against which § 41's year-over-year increase in research expenditures is measured and thus *inflate* the extent of any future increase and resulting research credit. To avoid this distortion, Paragraph 2 requires taxpayers that have elected the orphan drug credit to include in future years any overlapping expenses in calculating their baseline research spending under § 41: They must "take[] into account" those overlapping expenses "in determining base period research expenses for purposes of applying section 41 to subsequent taxable years." **I.R.C.** § 45C(c)(2). In other words, a company can elect § 45C's orphan drug credit for overlapping expenses, but it cannot also use those same expenses to increase its § 41 research credit – either by adding them to its credit-year research spending (Paragraph 1) or subtracting them from past spending (Paragraph 2). *See United Therapeutics Corp. v. Comm'r*, 160 T.C. No. 12, **2023** WL 3496208, at *3-6 (May 17, **2023**) (describing the relevant statutory provisions).[3]

B.

1.

United Therapeutics is a biotechnology company that develops products to address the unmet medical needs of patients with chronic and life-threatening conditions. In each tax year from 2011 through 2014, it claimed both the § 41 research credit and the § 45C orphan drug credit.

With respect to its expenses eligible only for the § 41 research credit, United Therapeutics claimed (naturally) only the § 41 research credit. Section 41 offers a menu of ways to calculate its credit. In 2014 – the year at issue – United Therapeutics elected the "alternative simplified method." *See* **I.R.C.** § 41(c)(5) (2014).[4] Under that method, the company's credit is equal to 14 percent "of so much of the qualified research expenses for the taxable year as exceeds 50 percent of the average qualified research expenses for the 3 taxable years preceding" the credit year. **I.R.C.** § 41(c)(5)(A).

With respect to its overlapping expenses, United Therapeutics elected to claim the more generous § 45C credit. That decision, all agree, triggered § 45C(c)'s coordination provision. The question in this case is whether United Therapeutics properly accounted for that provision.

When calculating its "qualified research expenses" for the 2014 tax year under § 41(c)(5)(A), United Therapeutics followed Paragraph 1 of the coordination provision, excluding the 2014 expenses it was claiming as qualified clinical testing expenses under § 45C. *See* **I.R.C.** § 45C(c)(1). So far, so good. But it also excluded the overlapping expenses it had treated as qualified clinical testing expenses for the three *preceding* tax years, 2011 through 2013, when it calculated its baseline "average qualified research expenses for the 3 taxable years preceding" 2014, see **I.R.C.** § 41(c)(5)(A). That made the company's past investment in research appear smaller – which in turn made its 2014 investment look like a more dramatic increase.

According to the Commissioner of Internal Revenue, this latter exclusion ran afoul of Paragraph 2 of the coordination provision, instructing taxpayers to "take[] into account" "[a]ny qualified clinical testing expenses ... which are qualified research expenses ... in determining base period research expenses for purposes of applying section 41 to subsequent taxable years." **I.R.C.** § 45C(c)(2). After auditing United Therapeutics, the Commissioner issued a notice of deficiency. *See generally* **I.R.C.** § 6212. The company's disregard for Paragraph 2, the Commissioner concluded, improperly inflated its § 41 research credit by about $1.2 million.

2.

United Therapeutics timely petitioned the United States Tax Court for a redetermination of the Commissioner's deficiency notice. *See generally* **I.R.C.** § 6213(a). The parties agreed on the facts, which they submitted fully stipulated to the tax court. They differed only on a narrow but critical question of statutory interpretation: United Therapeutics maintained that it calculated its 2014 tax liability correctly because changes to § 41 since its enactment rendered Paragraph 2 of the coordination provision, § 45C(c)(2), a dead letter.

That counterintuitive result, United Therapeutics argued, was compelled by 1989 amendments to § 41. Paragraph 2, again, instructs taxpayers to include overlapping expenses "in determining base period research expenses" for purposes of § 41. **I.R.C.** § 45C(c)(2). In 2014 as today, neither the coordination provision nor § 41 defined "base period research expenses." But an earlier version of § 41 did: It defined "base period research expenses" as "the average of the qualified research expenses for each year in the base period" and defined "base period" as "the 3 taxable years immediately preceding" the credit year. **I.R.C.** §§ 41(c)(1)-(2) (1986). Congress removed that definition in a 1989 overhaul of the provision. *See* Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7110(b)(1), 103 Stat. 2106, 2323-25 (1989); *United Therapeutics*, **2023** WL 3496208, at *11 n.33 (tax court's summary of § 41's evolution). And when it did so, United Therapeutics argued, Congress also intended – but forgot – to eliminate Paragraph 2 of the coordination provision.

3.

In a thorough and deeply reasoned opinion, the tax court rejected United Therapeutics' argument and resolved the case in favor of the Commissioner. *See generally United Therapeutics* , **2023** WL 3496208. Because we agree fully with the court's analysis, we describe it in some detail here.

The place to start in interpreting Paragraph 2 of the coordination provision, the court reasoned, was with a "careful examination of the ordinary meaning and structure of the law itself." *Id.* at *7 (quoting *Food Mktg. Inst. v. Argus Leader Media*, 588 U.S. 427, 436 (2019)). The critical phrase "base period research expenses" was undefined in the 2014 statute. But its ordinary meaning supported the Commissioner's reading, under which it applied to expenses incurred during the "3 [preceding] taxable years" § 41(c)(5)(A) uses as a benchmark in calculating the research credit.

The term "base period," the court explained, has consistently meant "a period of time used as a standard of comparison in measuring changes ... at other periods of time." *Id.* (quoting *Base Period, Webster's Encyclopedic Unabridged Dictionary of the English Language* (1989)). Moreover, that is how Congress has used the term in other tax-code contexts, including the one provision in which § 41 defines the term. *Id.* at *7 & n.24 (discussing **I.R.C.** § 41(e)(7)(B), which defines "base period" – for purposes of subsection (e) only – as "the 3-taxable-year period ending with the taxable year immediately preceding the 1st taxable year of the taxpayer"). So Paragraph 2's reference to "base period research expenses" means "research expenses that are incurred during the base period – i.e., the period of time section 41 employs as a standard of comparison." *Id.* at *7.

That plain-meaning definition, the court went on, fit nicely with the statutory scheme. *Id.* at *8. So defined, the phrase "base period research expenses" directs the taxpayer to whatever point of comparison is being used under § 41 to calculate its year-over-year increase in research expenses. *Id.* Here, where United Therapeutics elected § 41(c)(5)(A)'s alternative simplified method, that point of comparison is "the 3 taxable years preceding the" credit year. **I.R.C.** § 41(c)(5)(A). And so Paragraph 2 of the coordination provision, "interpreted according to its ordinary meaning," meant just what the Commissioner said: United Therapeutics was required to include in its § 41 calculation of research spending from "the 3 [preceding] taxable years" any overlapping expenses for which it had claimed the orphan drug credit. *United Therapeutics*, **2023** WL 3496208, at *8.

The court rejected United Therapeutics' arguments for "resist[ing] th[is] straightforward reading" of the coordination provision as applied to § 41(c)(5)(A). *Id.* The company's primary argument, the court explained, rested not on the 2014 text of either provision but instead on a prior version of § 41, which included a definition of "base period research expenses." It followed, United Therapeutics contended, that when Congress used that phrase in Paragraph 2 it meant to incorporate a statutory definition since repealed, leaving Paragraph 2 with no present effect.

That argument, the court concluded, was flawed in multiple respects. First, it contravened the Supreme Court's instruction that "[t]he starting point in discerning congressional intent is the existing statutory text, ... *and not the predecessor statutes.*" *Id.* at *9 (quoting *Lamie v. U.S. Tr.*, 540 U.S. 526, 534 (2004) (emphasis in tax court opinion)). Courts are to "interpret undefined terms in the *existing text* in accordance with their ordinary meaning," and so long as "that meaning is clear and produces a nonabsurd result, our analysis is finished." *Id.* Predecessor statutes, in other words, may not be used to manufacture ambiguity. *Id.* at *9-11.

Second, United Therapeutics' position would render Paragraph 2 of the coordination provision, § 45C(c)(2), entirely defunct – leaving half the coordination provision superfluous and effectuating a disfavored repeal by implication. *Id.* at *12. That result would be especially anomalous here, the court explained, where Congress had retained the purportedly moribund statutory language – both § 45C(c)(2) itself and the reference to it in § 45C(c)(1)[5] – through over a dozen amendments to § 41's research credit and § 45C's orphan drug credit. *Id.* at *12-13. "Congress had a number of opportunities to delete or modify the reference to base period research expenses in section 45C(c)(2) if it was in fact deadwood... . But with every amendment, Congress left section 45C(c)(2) intact." *Id.* At *13.

Finally, the tax court doubted the very premise of United Therapeutics' argument: that Paragraph 2's "base period research expenses" was originally intended as a statutorily defined term. In 1983, when the orphan drug credit and coordination provision were first adopted, Paragraph 2's predecessor instructed that

> [a]ny qualified clinical testing expenses for any taxable year which are qualified research expenses (within the meaning of section 44F(b)) shall be taken into account in determining base period research expenses for purposes of applying section 44F to subsequent taxable years.

I.R.C. § 44H(c)(2) (1983). When Congress intended to incorporate a statutory definition, the court reasoned, it said so, specifying that it was using "qualified research expenses" to mean the expenses falling "within the meaning of section 44F(b)." But when Congress – in the very same sentence – addressed "base period research expenses," it omitted any comparable citation to what was then the term's specific statutory definition, referring instead to the section wholesale. "Courts presume that when Congress includes certain language in one provision but omits it in another, the inclusion and exclusion are intentional." *United Therapeutics*, **2023** WL 3496208, at *11 (citing *Loughrin v. United States*, 573 U.S. 351, 358 (2014)). So even in 1983, "textual clues" suggested "base period research expenses" should be interpreted according to its ordinary meaning – which meant that "even on its own terms," United Therapeutics' backward-looking argument did not work. *Id.*

The court then addressed two regulations United Therapeutics had relied on in support of its position. First, the company pointed to a research-credit regulation covering, among other things, the calculation of "base period research expense[s]." *See* Treas. Reg. § 1.41-3A.[6] Promulgated in 1989, a few months before Congress repealed that term's statutory definition with its overhaul of § 41, and redesignated in 2001, the regulation specifies in a heading that it applies only to "Taxable Years Beginning Before January 1, 1990." United Therapeutics took the heading as confirmation that the phrase "base period research expense" lost meaning altogether after the amendments of 1989. The tax court disagreed. The limitation to taxable years preceding January 1990, the court explained, cabined the effect of the regulation itself; it did not purport to limit temporally any part of the statute. And, the tax court reasoned, "a predecessor regulation" could no more "cast doubt on the meaning of an existing statute's text" than a predecessor statute can. **2023** WL 3496208, at *9 n.30.

Finally, there was the "consistency rule" of Treas. Reg. § 1.41-9(c)(2), governing application of the alternative simplified research credit claimed here. That regulation requires that taxpayers calculate their qualified research expenses "for the three taxable years preceding the credit year ... on a basis consistent with the definition of [qualified research expenses] for the credit year, without regard to the law in effect for the three taxable years preceding the credit year." Treas. Reg. § 1.41-9(c)(2). According to United Therapeutics, the consistency rule renders Paragraph 2 inoperable, because it does not permit excluding overlapping expenses from qualified research expenses for the credit year (per Paragraph 1) while simultaneously including them for the preceding years (per Paragraph 2).

Again, the tax court disagreed. The consistency rule, the court explained, goes only to the "*definition* of qualified research expenses," instructing taxpayers to apply the same definition "to the credit year and the three preceding years even if there has been a change in law." **2023** WL 3496208, at *17. That interpretation accords with the regulation's text and with the Fifth Circuit's interpretation of the statutory consistency rule from which it derived. *Id.* (citing *Trinity Indus., Inc. v. United States* , 757 F.3d 400, 411-12 [114 AFTR 2d 2014-5075] (5th Cir. 2014)). So understood, the regulation is entirely consistent with Paragraph 2 of the coordination provision and has no bearing on this case, in which all agree on what counts as "qualified research expenses."

As the tax court summarized it, the question raised here is "whether we should give effect to section 45C(c)(2)" – Paragraph 2 of the coordination provision – "based on the ordinary meaning of its terms or whether we should ignore the provision altogether as a no-longer-effective rule that Congress neglected multiple times to remove from the Code." *Id.* at *1. For the reasons given above, the court took the first option, applying Paragraph 2 "in accordance with its ordinary meaning" and finding in favor of the Commissioner. *Id.*

United Therapeutics timely appealed.

II.

We have jurisdiction over appeals from the tax court under **I.R.C.** § 7482.[7] Our review of legal questions – the only sort at issue here – is de novo. *Pfister v. Comm'r* , 359 F.3d 352, 353 [93 AFTR 2d 2004-1113] (4th Cir. 2004). On appeal, the parties make substantially the same arguments they pressed before the tax court. And substantially for the reasons given by the tax court, we affirm its judgment. Indeed, we have little to add to that court's thorough and persuasive reasoning.

The crux of this dispute, as explained above, is over Paragraph 2 of § 45C(c)'s coordination provision, which requires that overlapping expenses claimed for § 45C's orphan drug credit be counted as "base period research expenses" for purposes of § 41's research credit. The tax court adopted the Commissioner's plain-meaning interpretation, reading "base period research expenses" as encompassing expenses incurred during the benchmark period set out in § 41(c)(5)(A): the "3 taxable years preceding" the credit year. But United Therapeutics, again, contends that "base period research expenses" is a defined term of art, anchored to a definition in a prior version of § 41 – and that once that definition was repealed in 1989, Paragraph 2 became a dead letter with no application to this or any case.

We agree with the tax court that our "starting point" is "the existing statutory text" and not a provision repealed in 1989. *United Therapeutics* , **2023** WL 3496208, at *10 (quoting *Lamie* , 540 U.S. at 534). We further agree that the ordinary meaning of the relevant text – "base period research expenses" – is clear enough to resolve the question in this case. The parties do not dispute the meaning of "research expenses." And dictionaries and common usage alike tell us that "base period" refers to a period of time used as "a standard of comparison" or a "reference point" to measure change over time. *See United Therapeutics*, **2023** WL 3496208, at *7 & n.23 (quoting dictionary definitions). That is an exact match for § 41(c)(5)(A)'s "3 [preceding] taxable years," a three-year period that functions as the benchmark against which change over time – here, subsequent increases in research expenditures – are measured.[8] And that interpretation is consistent not only with plain text but also with the statutory structure, enabling both halves of the coordination provision to operate according to their terms. *See id.* at *8.

Also like the tax court, we find support for this reading in § 41's only statutory definition of "base period," which likewise uses the term to mean a benchmark for comparison. *See id.* at *7. Subsection 41(e), governing a "basic research" component of the credit that is not at issue in this case, provides a specific definition of "base period" for "purposes of [that] subsection" alone. **I.R.C.** § 41(e)(7)(B). The tax court carefully detailed the operation of § 41(e). *See United Therapeutics* , **2023** WL 3496208, at *7 n.24. For present purposes, it is enough to say that § 41(e)(7)(B)'s "base period" also is a period of time "employ[ed] as a standard for comparison," consistent with the ordinary-meaning approach we take to Paragraph 2. *Id.*

On appeal, United Therapeutics argues that this is exactly the wrong lesson to take from the definition in § 41(e). According to the company, because Congress defined "base period" only for purposes of subsection § 41(e), Paragraph 2's reference to "base period research expenses" also must be read as applying only to the § 41(e) portion of the credit – and not to the § 41(c)(5)(A) credit for "qualified research expenses" at issue here. In other words, if Paragraph 2 – requiring consideration of overlapping expenses in the calculation of "base period research expenses" for "purposes of applying section 41," *see* **I.R.C.** § 45C(c)(2) – retains any meaning at all, it is only for purposes of applying § 41*(e).*

But that, of course, is not what either provision says. Paragraph 2 mandates accounting for overlapping expenses in applying § 41 *generally* to subsequent taxable years. *Id* .[9] And § 41(e) makes express that it defines "base period" only for the limited purpose of applying that subsection. **I.R.C.** § 41(e)(7). We do not see how the plain meaning of "base period" in Paragraph 2 can be overridden by a definition in a different Code provision that is limited to that provision alone.

As far as the statute goes, then, we agree with the tax court. Construed according to its ordinary meaning, Paragraph 2's reference to "base period research expenses" encompasses United Therapeutics' overlapping expenses during the three-year period used as a temporal comparison point by § 41(c)(5)(A). That reading is consistent with plain text and with statutory context and structure. And unlike United Therapeutics' position, under which Paragraph 2 is to be ignored altogether, it contravenes neither the presumption against repeal by implication nor the principle of interpretation giving effect, if possible, to "every clause and word" of a statute. *United Therapeutics*, **2023** WL 3496208, at *12 (quoting *Loughrin*, 573 U.S. at 358). That is enough – more than enough – to resolve this case, because we discern congressional intent by reference to "the existing statutory text, ... and not the predecessor statutes" on which United Therapeutics chiefly relies. *Id.* at *10 (quoting *Lamie*, 540 U.S. at 534).[10]

As for the regulations United Therapeutics points to for support, we may set to one side questions about the Treasury Department's authority to effectively repeal Paragraph 2, a statutory provision, by way of agency regulation. For the reasons given by the tax court, we read neither regulation to conflict with nor even to bear on Paragraph 2's plain meaning. That a regulation pertaining to "base period research expense[s]" under § 41 would apply only to "Taxable Years Beginning Before January 1, 1990," *see* Treas. Reg. § 1.41-3A, strikes us, as it did the tax court, as no more than an unremarkable acknowledgement that a regulation keyed specifically to § 41's statutory definition would expire along with that definition. It does nothing to limit the application or "constrain future interpretations" of § 45C(c)'s coordination provision. *United Therapeutics*, **2023** WL 3496208, at *9 n.30.[11] And the regulatory "consistency rule," as the tax court explained, does not in fact operate as United Therapeutics posits, forbidding a taxpayer from including overlapping expenses in its "base period research expenses" for prior years under Paragraph 2 while excluding those expenses from its current tax-year calculations under Paragraph 1. Instead, the regulation "says simply that taxpayers must apply the same *definition* of qualified research expenses to the credit year and the three preceding years," regardless of any change in that definition. *Id.* at *17. "Nothing in the regulation," in other words, "purports to override the coordination rule of section 45C(c)." *Id.*[12]

III.

For the foregoing reasons, the judgment of the tax court is affirmed.

AFFIRMED

---

1 **I.R.C.** refers to the Internal Revenue Code, found at Title 26 of the United States Code.

2 In 2014, the year at issue, the credit amount was equal to 50 percent of a taxpayer's "qualified clinical testing expenses." A subsequent amendment reduced that figure to 25 percent, where it sits today. *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13401, 131 Stat. 2054, 2134 (2017).

3 Our description of these tax provisions is necessarily somewhat abbreviated. For a more thorough discussion of this complex area, complete with examples, we commend the detailed analysis of the tax court.

4 The statute has since been amended and § 41(c)(5) is now § 41(c)(4). *See* Consolidated Appropriations Act, 2018, Pub. L. No. 115-141, § 101(c), 132 Stat. 348, 1160 (2018). Like the tax court, we refer to the version of the statute in effect in 2014. For our purposes, however, the changes are purely cosmetic, as the relevant parts of § 41 and the coordination provision continue to operate today as they did then.

5 Paragraph 1 of the coordination provision, § 45C(c)(1), begins with a preview of Paragraph 2: "*Except as provided in paragraph (2)*," overlapping expenses for which the orphan drug credit has been claimed are not taken into account in determining § 41's research credit. **I.R.C.** § 45C(c)(1) (emphasis added).

6 Treasury Regulations are found in Title 26 of the Code of Federal Regulations.

7 United Therapeutics maintains principal places of business in Silver Spring, Maryland and Durham, North Carolina, making venue proper in this court. *See* **I.R.C.** § 7482(b)(1)(B).

8 As the tax court explored, **2023** WL 3496208, at *9, because the tax provisions at issue were repeatedly renewed and extended, it is difficult to pinpoint the time of enactment for purposes of considering the text's ordinary meaning. *See Food Mktg. Inst.* , 588 U.S. at 434. But because the ordinary meaning of "base period" has not changed over the 30-odd years pertinent to this case, that is not a problem here.

9 Indeed, if Paragraph 2 applied only to § 41(e), it seems it would have no application at all. Section 45C(c)'s coordination provision instructs on the overlap between "qualified clinical testing expenses" (eligible for § 45C's orphan drug credit) and "qualified research expenses" (eligible for § 41's research credit). But "qualified research expenses" are relevant only to the portion of the research credit based, naturally enough, on "qualified research expenses," laid out at **I.R.C.** § 41(a)(1); they play no role in the portion based on

"basic research" payments, set out at § 41(a)(2) and defined in § 41(e). So a taxpayer directed by Paragraph 2 of the coordination provision to account for its "qualified research expenses" for purposes of applying § 41(e) would come up empty. On United Therapeutics' reading, in other words, § 45C(c)'s coordination provision has nothing to coordinate.

10 We also are inclined to agree with the tax court that even the pre-1989 version of the coordination provision likely used "base period research expenses" for its ordinary meaning and not as a statutorily defined term of art. At that time, it is true, what is now § 41 included a definition of "base period research expenses." But the predecessor to the coordination provision refers to "base period research expenses" without citing that definition – in stark contrast to its citation, in the very same sentence, to the statutory definition for "qualified research expenses." *See United Therapeutics*, **2023** WL 3496208, at *11. Even if United Therapeutics could "[m]anufacture [a]mbiguity" using a predecessor statute – which it cannot, *see id.* at *10 – the predecessor statute here seems not to bear the weight the company would assign it.

11 On appeal, United Therapeutics emphasizes the 2001 redesignation of this regulation, arguing that the redesignation reflects agency agreement that the concept of "base period research expenses," as used in Paragraph 2 of the coordination provision, no longer has any application. But that basic administrative step simply reordered the regulations in acknowledgment that the definition had been removed from the statute. In the years since 1990, "Treasury and the IRS simply have not spoken regarding the meaning of 'base period research expenses,'" and "[s]ilence by Treasury and the IRS is no concession as to the nature of the amended statute." *United Therapeutics*, **2023** WL 3496208, at *9 n.30.

12 To the extent United Therapeutics relies on the statutory consistency rule from which the regulation derives, *see* **I.R.C.** § 41(c)(6)(A) (now § 41(c)(5)(A), *see supra* note 4), that reliance is also unavailing. In its statutory form, the rule applies only in calculating a taxpayer's "fixed-base percentage," *id.*, a concept with no relevance to this case; it is only through regulation that the rule applies to the alternative simplified method of calculating the research credit at issue here. And in any event, the statutory consistency rule, too, has been construed by courts and agency alike to require only that the "definition of qualified research expenses, which Congress has changed over the years, be applied consistently across the credit year and the years in the reference period." *See United Therapeutics*, **2023** WL 3496208, at *9 (citing Treas. Reg. § 1.41-3(d)(1); *Trinity Indus.* , 757 F.3d at 411-12).

END OF DOCUMENT -

American Federal Tax Reports

IN RE: LEE, Cite as 133 AFTR 2d 2024 -XXXX, (Bktcy Ct SC), 06/05/2024

IN RE: William Cooper Lee and Tracy Quick Lee, Debtor(s).

Case Information:

Code Sec(s):	
Court Name:	UNITED STATES BANKRUPTCY COURT DISTRICT OF SOUTH CAROLINA,
Docket No.:	C/A No. 19-05186-HB,
Date Decided:	06/05/**2024**.
Disposition:	

HEADNOTE

•

Reference(s):

OPINION

UNITED STATES BANKRUPTCY COURT DISTRICT OF SOUTH CAROLINA,

ORDER OVERRULING OBJECTION TO CLAIM

Judge: Chief US Bankruptcy Judge District of South Carolina

Chapter 12

THIS MATTER came before the Court for a hearing on April 18, **2024**, to consider the Objection to Claim No. 6-4 (the "Objection to Claim") filed by Debtors William Cooper Lee ("Mr. Lee") and Tracy Quick Lee ("Ms. Lee")[1] and the Response thereto filed by the Internal Revenue Service of the U.S. Department of the Treasury (the "IRS").[2] Prior to the hearing, the parties filed a Joint Statement of Dispute (the "JSD"),[3] and Debtors filed a pre-trial brief.[4] Present at the hearing were Robert H. Cooper on behalf of Debtors, Malcolm M. Murray and Austin McCullough on behalf of the IRS, and Chapter 12 Trustee J. Kershaw Spong (the "Trustee").[5] At the hearing, the Court heard testimony and admitted exhibits into evidence. Debtors and the IRS filed post-trial briefs.[6] After carefully considering the evidence, applicable law, and arguments of counsel, the Court finds as follows.

FINDINGS OF FACT

On October 2, 2019, Debtors filed a petition for relief under Chapter 12 of the Bankruptcy Code to initiate the above-captioned case. The Trustee was appointed as Chapter 12 Trustee.

Mr. Lee has been a farmer for approximately thirty-seven (37) years and Ms. Lee is a Certified Public Accountant. At the core of this dispute is what Mr. Lee owes the IRS in taxes for the tax years 2006 through 2009 (the "Tax Years").[7] Debtors allege they filed tax returns jointly for the Tax Years, though there are no such returns or copies thereof in this record.[8] The IRS alleges it did not receive any such tax returns, so it prepared a substitute return for Mr. Lee for each year, estimating his income based on information reported to the IRS by third parties and allowing him statutory deductions, but not deductions for expenses incurred in his farming operations, as the IRS did not have records of such expenses. Debtors admit the amount and source of Mr. Lee's gross income for the Tax Years indicated by the IRS' tax transcripts for those years are accurate. However, Debtors argue it was improper for the IRS to not include deductions for Mr. Lee's expenses on the substitute returns. Though Debtors admit they do not have documentary evidence of Mr. Lee's expenses for the Tax Years, they contend that their testimony regarding such expenses is sufficient to estimate those expenses and reduce his tax liability by the amount of the estimate, relying on *Cohan v. Comm'r of Internal Revenue*, 39 F.2d 540 [8 AFTR 10552] (2d Cir. 1930).

On November 12, 2019, the IRS timely filed Claim No. 6-1.[9]

On January 2, 2020, Debtors filed a Chapter 12 plan.[10] Several objections to that plan were filed.[11] On February 6, 2020, the Court entered an order denying confirmation.[12] On April 1, 2020, Debtors filed a modified Chapter 12 plan that was not confirmed.[13]

On May 5, 2020, Debtors filed a *Motion to Value Secured Claim of Internal Revenue Service* requesting that the Court determine the value of the secured portion of the IRS' claim to be $861,788.49.[14] An order was entered on June 8, 2020 granting the motion.[15]

On June 9, 2020—having previously amended its claim on February 6, 2020 (Claim No. 6-2) and on April 6, 2020 (Claim No. 6-3)—the IRS amended its claim again (Claim No. 6-4). Claim No. 6-4 is for $2,955,714.89, with $861,788.49 claimed as secured by all of Debtors' right, title, and interest to property pursuant to 26 U.S.C. § 6321,[16] and $2,093,926.40 claimed as unsecured of which $21,279.46 is claimed as entitled to priority pursuant to 11 U.S.C. § 507(a)(8). The claimed tax liabilities of Mr. Lee for the Tax Years total (including interest) $1,630,292.93, with $503,155.97 claimed as secured and $1,127,136.96 claimed as general unsecured. An attachment to the claim indicates that on October 6, 2011, the IRS recorded a lien with the Clerk of Court for Marlboro County, South Carolina "upon all property and rights to property, whether real or personal" of Mr. Lee securing $1,603,874.39 in unpaid taxes for the tax years 2005 through 2008 pursuant to **IRC** § 6321 and the related regulations prescribing the procedure for providing notice of such lien.

On June 23, 2020, Debtors filed a modified Chapter 12 plan.[17] In the plan, Debtors proposed to make a number of payments to creditors, pay the IRS' secured claim in full, priority claim in full, and its general unsecured claim on a pro rata basis with other general unsecured claims, with general unsecured creditors receiving at least one percent (1%) on their claims. The plan further provided that, "in the event of any future default in payments due under the plan, which is not cured within 60 days, the trustee is authorized to liquidate additional property, subject to further notice and approval by the Court." On June 25, 2020, the Court approved a Consent Order Confirming Chapter 12 Plan which modified the payments due to the Trustee but otherwise confirmed the plan as filed. [18]

Debtors did not make payments due under the plan, so, pursuant to the terms of the confirmed plan, the Trustee sold property of the estate to make distributions to creditors.

On August 8, 2022, Debtors filed a modified Chapter 12 plan, which provided the same treatment for the IRS' claims as the prior confirmed plan.[19] That plan was confirmed on August 10, 2022.[20]

On February 1, **2023**, the Trustee filed a Motion to Dismiss this case based on Debtors' failure to make plan payments.[21] On February 20, **2023**, Debtors filed a timely objection to the Trustee's Motion to Dismiss.[22] The hearing on the Trustee's Motion to Dismiss was continued several times on the requests of the parties.

On May 2, **2023**, Debtors filed an Objection to Claim No. 6-4.[23] Debtors do not contend that the IRS' claim does not comply with the Federal Rules of Bankruptcy Procedure. Rather, they assert that the unsecured portion of its claim related to Mr. Lee's tax liabilities for the Tax Years should be disallowed to the extent it is excessive due to the IRS not reducing his taxable income by his expenses. On June 1, **2023**, the IRS filed a timely Response to Debtors' Objection to Claim.[24] The hearing on the Objection to Claim was continued several times on the requests of the parties.

On April 17, **2024**, the parties filed the JSD in which they stipulated to certain facts, set forth their respective positions in more detail, and framed the issues to be decided by the Court.[25] The IRS' position:

> The debtor failed to file tax returns for tax years 2006-2009. The IRS's amended proof of claim of June 9, 2020 is correct because the IRS followed proper procedures for determining the tax liability of a non-filer. In particular, the IRS took into account farming business income for 2006 through 2009 reported to it by third-party payors. Because Mr. Lee neither filed a return nor participated in the audits of those years to determine his liability, he was not allowed any deductions. And around the time this bankruptcy began, the Lees destroyed the documentation that would permit the accurate calculation of their deductions. As a result, Mr. Lee should not be permitted to claim deductions for 2006 through 2009. For 2009, the Lees sold two pieces of real property. The IRS calculated Mr. Lee's tax liability based on the gross proceeds from the two sales.

The Debtors' position:

> The IRS proof of claim is deficient, because although it was based on the amount of gross income the debtors made, and based on documents such as 1098s, 1099s, etc received by the IRS, it did not allow any deductions or expenditures for the debtors, which escalated the amount of tax allegedly owed substantially. Deductions, write offs, exemptions, expenditures, etc are the most promising manner in which any taxpayer, whether consumer or business, survives, as to disallow those things is to put the taxpayer out of business. Any taxpayer disallowed deductions owes taxes, based on straight gross income instead of on receiving taxes owed, based on gross income with no benefit of deductions, the business is doomed. One must ask how this frugal couple could possibly owe almost 3 million dollars in taxes when as seen by tax returns filed both prior to and after the years in question, they basically break even.

The Court held a hearing on this matter and the Trustee's Motion to Dismiss on April 18, **2024.** At the hearing, the Trustee stated Debtors are delinquent on payments due under the confirmed plan and therefore need to either catch up on payments or modify the plan. The Trustee indicated the IRS claim needs to be resolved before Debtors can modify the plan and requested the hearing on his Motion to Dismiss be continued until after the Objection to Claim is ruled upon, and without objection, the Court continued that hearing until June 13, **2024**.

Mr. Lee, Ms. Lee, and Deborah Estes, an Internal Revenue Agent with the Small Business/Self-Employed Division of the IRS, testified in connection with the Objection to Claim. Debtors testified that there are no longer any expense records for the Tax Years. Mr. Lee testified that his method for keeping records of expenses consisted of putting bills and receipts from vendors in a file in a cabinet in his home and that, at a certain point, he would put the contents of the file into a storage box in an office building he and Ms. Lee own. Mr. Lee testified that heavy rainfall from a storm that occurred around 2010 damaged the office building and the boxes containing his records of expenses for the Tax Years, rendering the records illegible. As a result, the records were thrown away. He said his actual tax returns for the Tax Years were spared from the damage, however, since they were in another part of the office.

Ms. Lee clarified that the office they owned suffered roof damage and flooding, and that the records of expenses for the Tax Years were in an area upstairs where most of the damage occurred. When the Court questioned Ms. Lee about the details of the roof damage, asking if an insurance claim was filed for damage to the office, she could not remember making an insurance claim. [26] She stated that, even if the damage had not occurred, she would have discarded the records by now. Ms. Lee testified that there are no other copies of the expense records for the Tax Years.

Since there are no expense records for the Tax Years, Mr. Lee presented testimony to try to estimate those expenses. Mr. Lee testified that during the Tax Years, he farmed cotton, peanuts, soybeans, and corn. He stated that he has had the same kinds of expenses in all the years he has farmed, consisting of lease payments for land, fuel, seed, fertilizer, chemicals, insecticides, herbicides, labor, harvesting, costs to transport the crops to market, repairs and maintenance on equipment, loan payments, and insurance. Mr. Lee also testified there are expenses particular to certain crops, such as having peanuts dried or cotton ginned. In attempting to estimate expenses for the Tax Years, Mr. Lee stated that he planted "thousands of acres," though he was not sure the exact number, leased "a couple thousand" acres, used about 22,500 gallons of diesel fuel, and used five (5) to six (6) laborers. He estimated the various inputs would have cost the following estimated amounts during the Tax Years: $80.00 per acre for seed; $60.00 – $100.00 per acre for fertilizer, depending on the crop; $400.00 – $500.00 per laborer per week, though wages would depend on the number of acres the laborers were assisting with; $30.00 – $60.00 per acre for chemicals, depending on the crop; $40.00 per acre for harvesting; $50.00 per leased acre; and the cost of transporting the crops to market would have depended on expenses related to the trucks that transported the crops. Ms. Lee concurred in Mr. Lee's testimony regarding expenses. The testimony was quite vague, uncorroborated, and did not provide an estimate of the total amount of expenses for any category or year at issue or any reasonable basis for the Court to make any remotely accurate calculation or estimate.

Mr. Lee generalized that a reasonable expectation for annual "profit" would be about ten percent (10%) or less, and that weather and market conditions might preclude any annual profit. He testified that he has made a profit about once every three (3) years while farming. Mr. Lee stated that his income has always—including during the Tax Years—either been less than his expenses or has exceeded expenses by no more than about ten percent (10%).

Debtors testified they file tax returns jointly. Ms. Lee testified that she, as a CPA, usually prepared joint tax returns for herself and Mr. Lee. Debtors testified they filed tax returns for the Tax Years, but provided little detail of preparation and filing. Mr. Lee stated they have rarely owed much income tax and have never owed any amount approaching what the IRS claims they owe for the Tax Years. Mr. Lee stated those returns showed three (3) years of losses and one (1) year of profit. As noted above, no such returns or even drafts of such returns are in the record. Mr. Lee testified that he did not recall seeing any letters from the IRS regarding his liabilities for the Tax Years, and that he would have done something if he had known there was an issue. Ms. Lee also testified that she did not recall receiving correspondence from the IRS regarding this matter.

Estes' testimony followed. She has been employed with the IRS since June of 2009, and her role is to examine small business taxpayers, compute tax liabilities, and assess tax. Estes testified she has reviewed various documents in the IRS' file for the Debtors and is familiar with relevant tax liabilities for the Tax Years. She stated that the Account Transcript for 2006 for Mr. Lee (the "2006 Transcript")[27] indicates that Mr. Lee did not file a tax return for that year as required. She testified that the "TXMODA"[28] —a transcript internal to the IRS—reflects that a written notice informing Mr. Lee that he was required to file a return and that the IRS had not received a return was sent to him on April 14, 2008. Estes testified the 2006 Transcript indicates Mr. Lee did not respond to that notice.

According to Estes, if a taxpayer does not respond to such a notice, the IRS uses information from third parties to prepare a substitute return, estimating the taxpayer's income, allowing the taxpayer his statutory deductions and filing status but—in accordance with IRS policy—not making elections such as treating certain transactions as a deductible expense on his behalf, and then computing the tax owed. She testified the 2006 Transcript indicates a substitute return was prepared by the IRS through which the IRS assessed and attempted to collect taxes owed from Mr. Lee for 2006. Estes testified that the substitute return for Mr. Lee for 2006[29] reflects his income was estimated from information received from third parties and he was allowed a deduction of one half (½) his self-employment tax, his personal exemption, and his standard deduction. However, there was no deduction for Mr. Lee's farming expenses as Debtors did not provide this information to the IRS in a filed return or otherwise. Estes further testified that the TXMODA for Mr. Lee indicates he did not respond to the substitute return, so the collection process began.

Estes testified that, once the collection process begins, notices are sent to the taxpayer informing him of his rights in the collection process and how to make financial disclosures. She said that the TXMODA reflects that at least six (6) notices were sent to Mr. Lee for the 2006 tax year, beginning with the April 14, 2008, notice that he was required to file a return and that the IRS had not received one and continuing until close to the end of 2019. Included in those notices was a letter entitled a "Notice of Deficiency" dated September 20, 2010, and addressed to William Cooper Lee, PO Box 357, Bennettsville, SC 29512 (the "Lee PO Box").[30] Estes testified that Notices of Deficiency are required to be sent by certified mail to the taxpayer's last known address of IRS record. In that Notice of Deficiency, Mr. Lee was advised of the amount he owed according to the substitute return, the procedure to file a petition with the U.S. Tax Court contesting that amount, that the IRS would assess and bill him the deficiency if he failed to file a petition, that he had the right to contact the Taxpayer Advocate, and the contact information for the Taxpayer Advocate and the IRS. Estes testified that neither the 2006 Transcript nor the TXMODA reflect any actions taken by Mr. Lee after the collection process began.

Estes' testimony regarding the 2007 through 2009 tax years was substantively identical to her testimony regarding the 2006 tax year, including that the Notice of Deficiency described above was sent to the Lee PO Box for each of those years. There is no evidence that the Lee PO Box did not belong to Debtors or that it was not their last known address of IRS record. Debtors also conceded in the JSD that the IRS issued a Notice of Deficiency to Mr. Lee for all the Tax Years.

Estes testified that the examination file for the 2009 tax year for Mr. Lee[31] reflects that his taxable income for that year included a capital gain of $862,000.00. Counsel for the IRS explained that that capital gain was based on three (3) sales of real property that occurred in 2009. The deeds evidencing those sales[32] reflect that Mr. Lee sold one (1) parcel of real property and Debtors together sold two (2) parcels, with the sales prices totaling $863,500.00. There is nothing in the deeds nor anything else in the record indicating his or their bases in the properties or how long he or they held those properties, and Debtors gave no credible testimony regarding the same.

CONCLUSIONS OF LAW

The parties state in the JSD that there are two (2) primary issues the Court must resolve in ruling on the Objection to Claim: (1) whether Debtors timely filed their federal income tax returns for the Tax Years; and (2) whether Mr. Lee is entitled to take deductions for expenses incurred in his farming operations for the Tax Years, and if so, in what amounts he should be so entitled.

Neither party has asserted that this Court lacks jurisdiction to resolve this dispute. Proceedings regarding "allowance or disallowance of claims against the estate" are core proceedings. 28

U.S.C. § 157(b)(2)(B). "A bankruptcy court generally has the authority to determine a debtor's tax liability and such a proceeding is a core proceeding." *In re N.C. Tobacco Int'l, LLC*, No. 17-51077, 2020 WL 4582282 [126 AFTR 2d 2020-5686], at *1 (Bankr. M.D.N.C. Aug. 10, 2020) (quoting *In re Starnes*, 159 B.R. 748, 749 [72 AFTR 2d 93-5797] (Bankr. W.D.N.C. 1993)). Bankruptcy courts "may determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction." 11 U.S.C. § 505(a)(1). "The Bankruptcy Code requires bankruptcy courts to defer to the tax court only where the claim was contested *and* adjudicated by the tax court *before* the commencement of the bankruptcy case." *U.S. v. Wilson*, 974 F.2d 514, 517 [70 AFTR 2d 92-5736] (4th Cir. 1992) (emphasis in original) (citing 11 U.S.C. § 505(a)(2)). That situation is not present here, and the parties have requested that this Court resolve the dispute.

"[T]he Bankruptcy Code imposes a 'burden shifting framework for proving the amount and validity of a claim.'" *Summit Cmty. Bank v. David*, 629 B.R. 804, 809 (E.D. Va. 2021) (quoting *In re Harford Sands Inc.*, 372 F.3d 637, 640 (4th Cir. 2004)). A proof of claim executed and filed in accordance with the Federal Rules of Bankruptcy Procedure "shall constitute *prima facie* evidence of the validity and amount of the claim." Fed. R. Bankr. P. 3001(f). "'The burden then shifts to the debtor to object to the claim,' and to 'introduce evidence to rebut the claim's presumptive validity.'" *Meral, Inc. v. Xinergy, Ltd.*, No. 7:16CV00059, 2016 WL 7235846, at *3 (W.D. Va. Dec. 13, 2016) (quoting *Harford Sands*, 372 F.3d at 640). "Such evidence 'must be sufficient to demonstrate the existence of a *true dispute* and must have probative force equal to the contents of the claim.'" *Id.* (emphasis in original) (quoting *In re Falwell*, 434 B.R. 779, 784 (Bankr. W.D. Va. 2009)). "[S]hould the debtor carry his burden...the burden then shifts back to the creditor, who must prove by a preponderance of the evidence the amount and validity of the claim." *David*, 629 B.R. at 810 (citing *Harford Sands*, 372 F.3d at 640).

The Supreme Court has held that "in the absence of modification expressed in the Bankruptcy Code[,] the burden of proof on a tax claim in bankruptcy remains where the substantive tax law puts it." *Raleigh v. Ill. Dep't of Revenue* , 530 U.S. 15, 26 (2000). In other words, if the law that gave rise to the tax claim places the burden of proof on the taxpayer to show that the claim is not valid, bankruptcy does not alter that burden of proof. The Fourth Circuit Court of Appeals has summarized the burden of proof that applies to tax claims:

> The burden of proof is on the Commissioner to show that the taxpayer received income. This burden is initially satisfied, however, by the fact that the Commissioner's deficiency determination is presumed correct. The burden is thus on the taxpayer to prove the incorrectness of the deficiency determination. This burden is procedural and is met if the taxpayer produces competent and relevant evidence from which it could be found that he did

> not receive the income alleged in the deficiency notice. If this burden is met, the burden of proof shifts back to the Commissioner to prove the existence and amount of the deficiency.

Cebollero v. Comm'r of Internal Revenue, 967 F.2d 986, 989 [70 AFTR 2d 92-5082] (4th Cir. 1992) (quoting *Foster v. Comm'r of Internal Revenue*, 391 F.2d 727, 735 [21 AFTR 2d 859] (4th Cir. 1968)). *See also* **IRC** § 7491(a) (providing for burden shifting to the IRS in certain circumstances). The taxpayer's burden cannot be satisfied merely by his own self-serving statements. *U.S. v. Brooks*, No. 6:17-cv-2010-TMC, 2019 WL 642917 [123 AFTR 2d 2019-769], at *3 (D.S.C. Feb. 15, 2019) (citing *Liddy v. Comm'r of Internal Revenue* , 808 F.2d 312, 315-16 [59 AFTR 2d 87-387] (4th Cir. 1986)).

The Court concludes that the result is the same regardless of whether the burden of proof for objections to claim or the burden of proof for tax claims outside bankruptcy is applied. In either case, the IRS' claim is presumed correct, the burden is on the Debtors to show it is incorrect, and if Debtors meet that burden, the burden shifts back to the IRS to show its claim is correct.

Regarding the first issue the Court must determine—there is no credible evidence in the record of Debtors' filing federal income tax returns for the Tax Years. Debtors did not produce copies of such returns or drafts thereof at trial, the IRS does not have such returns in its records, and all actions of the IRS detailed above are consistent with Debtors' failure to file returns for the Tax Years. Debtors' self-serving testimony regarding the filing of these returns was vague and unconvincing, and the Court is dubious of their testimony that none of the IRS notices reached them as early as 2008 and that they were never impacted by or aware of the 2011 tax lien. The Court therefore finds, after a careful review of the record and the opportunity to examine the credibility of the witnesses, that no returns were filed for the Tax Years.

Before addressing the second issue—whether Mr. Lee is entitled to deductions for expenses and if so, in what amount—the Court must address two (2) threshold issues. The first is Debtors' contention raised in their post-trial brief that the IRS is time-barred from collecting taxes owed for the Tax Years. If a taxpayer fails to file a required return, the IRS is required to prepare a substitute return based on information it has or can obtain. *See* **IRC** § 6020(b)(1). "In the case of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time." **IRC** § 6501(c)(3) (emphasis added). This means that, when a taxpayer fails to file a return, **IRC** § 6501(c)(3) allows the IRS to assess taxes or initiate a civil tax proceeding against a taxpayer at any time. *See Kaplan v. Comm'r of Internal Revenue* , 795 F.3d 808, 812 [116 AFTR 2d 2015-5430] (8th Cir. 2015) (citing **IRC** § 6501(c)(3)). *See also Kaplan v. Comm'r of Internal Revenue* , No. 25652–12, 2014 WL 988465 [2014 RIA TC Memo ¶2014-043], at *8 (T.C. Mar. 13, 2014) (citing 26 C.F.R. § 301.6501(b)–1(c)) ("A substitute for return prepared under section 6020(b) is not considered a return for the purposes of starting the assessment period."), *aff'd*, 795 F.3d 808 [116 AFTR 2d 2015-5430] (8th Cir. 2015). Accordingly, Debtors' argument is without merit.

The second is whether the IRS fulfilled its obligations under the **IRC** with respect to the Notices of Deficiency. If the IRS determines there is a deficiency in—among other taxes—income or estate and gift taxes, the IRS "is authorized to send notice of such deficiency to the taxpayer by certified mail or registered mail." **IRC** § 6212(a). A notice of deficiency in—among other taxes— income and gift taxes "if mailed to the taxpayer at his last known address, shall be sufficient for purposes of" the provisions of the **IRC** relating to such taxes. **IRC** § 6212(b)(1). The record indicates these procedures were complied with, so the Court rejects any assertion by Debtors that the Notices of Deficiency were not properly sent. Also, as stated above, testimony that none of the IRS notices reached them and that they were never impacted by or aware of the tax lien lacks credibility.

Finally, the Court will address whether Debtors have met their burden to show that Mr. Lee is entitled to deduct expenses from his taxable income for the Tax Years, resulting in disallowance of a portion of the IRS' claim. When a tax return is properly filed, the **IRC** allows deductions for certain ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. *See* **IRC** § 162. The **IRC** also allows individuals deductions for ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax. **IRC** § 212. The taxpayer must provide certain evidence substantiating expenses for traveling claimed under **IRC** §§ 162 and 212, any expense for gifts, or with respect to any listed property (as defined in **IRC** § 280F(d)(4)) in order to claim deductions or credits for those expenses. *See* **IRC** § 274(d).

IRS regulations clarify that such substantiation consists generally in "adequate records or...sufficient evidence corroborating [the taxpayer's] own statement." 26 C.F.R. § 1.274–5T(c)(1). However, "[w]here the taxpayer establishes that the failure to produce adequate records is due to the loss of such records through circumstances beyond the taxpayer's control, such as destruction by fire, flood, earthquake, or other casualty, the taxpayer shall have a right to substantiate a deduction by reasonable reconstruction of his expenditures or use." 26 C.F.R. § 1.274–5T(c)(5). "In order to take advantage of this exception, a taxpayer must prove that he had records which would have adequately substantiated his or her expenses and that those records were destroyed or lost in a casualty beyond the taxpayer's control." *Campbell v. Comm'r of Internal Revenue* , 164 F.3d 1140, 1143 [83 AFTR 2d 99-358] (8th Cir. 1999) (internal quotation marks and citation omitted).

It is a "'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'" *INDOPCO, Inc. v.*

Comm'r of Internal Revenue, 503 U.S. 79, 84 [69 AFTR 2d 92-694] (1992) (quoting *Interstate Transit Lines v. Comm'r of Internal Revenue*, 319 U.S. 590, 593 [30 AFTR 1310] (1943)). "[T]he burden is upon the taxpayer to establish the amount of a deduction claimed." *Helvering v. Taylor*, 293 U.S. 507, 514 [14 AFTR 1194] (1935) (citations omitted). *See also In re Landbank Equity Corp.*, 973 F.2d 265, 271 [70 AFTR 2d 92-5524] (4th Cir. 1992) (emphasis in original) (the IRS is not obligated "to determine and allow deductions to the taxpayer. As a matter of legislative grace, deductions may be claimed and are allowed to the extent *the taxpayer* can prove them, whether the taxpayer is a debtor in bankruptcy or not.").

"It is the taxpayer who bears the burden of establishing the basis for each transaction...and when a taxpayer fails to meet this burden, it is proper to assume that the asset has a zero basis[.]" *U.S. v. Brooks* , No. 6:17-cv-02010-TMC-JDA, 2018 WL 7568392 [123 AFTR 2d 2019-782], at *6 (D.S.C. Dec. 19, 2018) (citations omitted). *See also WMI Holdings Corp. v. U.S.*, 891 F.3d 1016, 1022 [121 AFTR 2d 2018-1958] (Fed. Cir. 2018) (quoting *Better Beverages, Inc. v. U.S.* , 619 F.2d 424, 428 [46 AFTR 2d 80-5219] n.4 (5th Cir. 1980)) ("Where the taxpayer fails to carry this burden to prove a cost basis in the item in question, the basis utilized by IRS, which enjoys a presumption of correctness, must be accepted even where...the IRS has accorded the item a zero basis."). Regarding any adjustment related to long-term capital gains, it is the taxpayer's burden to show entitlement to such favorable treatment. *See Ju v. U.S.*, 170 Fed. Cl. 266, 273 [133 AFTR 2d **2024** -988] (Fed. Cl. **2024**) (quoting *Free-Pacheco v. U.S.*, 117 Fed. Cl. 228, 292 [114 AFTR 2d 2014-5272] (Fed. Cl. 2014)) (the taxpayer "has the burden of proving that a section of the Internal Revenue Code applies to him, before he is able to benefit from its provisions.").

Taxpayers are required to keep records relevant to the determination of their tax liability. *See* **IRC** § 6001. Farmers are required to keep records related to their income that will enable the IRS to determine the correct amount of taxable income, and those records "shall be kept at all times available for inspection by authorized internal revenue officers or employees, and shall be retained so long as the contents thereof may become material in the administration of any internal revenue law." 26 C.F.R. § 1.6001–1(b), (e). IRS regulations provide documentary evidence, such as receipts, paid bills, or similar evidence sufficient to support an expenditure, is required for any expenditure for lodging while traveling away from home and any other expenditure of $75.00 or more except, for transportation charges, documentary evidence will not be required if not readily available. 26 C.F.R. § 1.274–5(c)(2)(iii).

As Debtors no longer have records of their expenses for the Tax Years, they rely on the testimony. They contend that Mr. Lee's tax liability for the Tax Years—and consequently the unsecured portion of the IRS' claim that relates thereto—should be reduced by the amount of their estimate of such expenses, citing the *Cohan* case noted above in support.

The *Cohan* case dealt with several tax issues arising for George M. Cohan, a theatrical producer and playwright. *Cohan,* 39 F.2d at 541. In producing his plays, Cohan spent a great deal of money traveling and entertaining others. *Id.* at 543. Cohan, however, did not keep records of these expenses, and the Second Circuit Court of Appeals concluded he "probably could not have done so." *Id.* At a trial before the U.S. Board of Tax Appeals, he estimated that he had had about $55,000.00 in entertainment and travel expenses. *Id.* The Board did not allow him to claim any of the $55,000.00 as a deductible expense because there were no details substantiating that estimate. *Id.*

The Second Circuit Court of Appeals concluded that Cohan's expenses, though not known exactly, were certainly "substantial." *Id.* The Court found that while the Board was entitled to "[bear] heavily...upon the taxpayer whose inexactitude is of his own making", it "should make as close an approximation [of expenses] as it can", drawing, if necessary, "upon the Board's personal estimates of the minimum of such expenses." *Id.* at 544. Accordingly, the Court required the Board to reconsider the evidence. *Id.*

In the years since the 1930 *Cohan* decision, record keeping has evolved and the **IRC** has been revised. "The substantiation requirements of [**IRC** § 274(d)] were intended to abolish the *Cohan* rule and require the taxpayer to prove the exact amount and circumstances of the deduction; otherwise it would be disallowed entirely." *Berkley Mach. Works & Foundry Co. v. Comm'r of Internal Revenue* , 623 F.2d 898, 902 [46 AFTR 2d 80-5055] (4th Cir. 1980) (citing H. R. Rep. No. 1477, 87th Cong., 2d Sess. 19 (1962-3 Cum. Bull. 405, 427)). *See also Charron v. U.S.*, 200 F.3d 785, 794 [84 AFTR 2d 99-7473] (Fed. Cir. 1999) ("the *Cohan* rule has been superseded by section 274(d) of the Internal Revenue Code, which now governs the deductibility of entertainment and travel expenses.").

However, to the extent courts have continued to apply *Cohan* to these deductions, they have imposed strict requirements. For the *Cohan* rule to apply, there must be evidence showing that the taxpayer is entitled to the deduction and "sufficient evidence in the record from which the Court may estimate the exact amount." *Trigon Ins. Co. v. U.S.*, 234 F. Supp. 2d 581, 588 [90 AFTR 2d 2002-7804] (E.D. Va. 2002). "[C]ourts have declined to apply *Cohan* in cases where there is no doubt that the taxpayer incurred some deductible expense, but the taxpayer failed to present evidence sufficient to allow the court to make an accurate finding on the amount of the deduction." *Id.* at 589-90 (citing cases). *See also Williams v. Comm'r of Internal Revenue*, No. 11290–92, 1994 WL 50462 [1994 RIA TC Memo ¶94,063], at *2 (T.C. Feb. 22, 1994) ("in order for this Court to apply the rationale of *Cohan*... to any particular disallowed expenditure, there must be sufficient evidence to permit us to make an estimation... . Self-serving, vague, and undocumented testimony is insufficient."). The Fourth Circuit Court of Appeals has found *Cohan* inapplicable "where the claimed but unsubstantiated deductions are of a sort for which the taxpayer could have and should have maintained the necessary records." *Pridgen v. Internal Revenue* , 2 F. App'x 264, 274-75

[87 AFTR 2d 2001-594] (4th Cir. 2001) (quoting *Lerch v. Comm'r of Internal Revenue Serv.*, 877 F.2d 624, 628 [64 AFTR 2d 89-5085] (7th Cir. 1989)). This contrasts with the *Cohan* court's finding that Cohan "probably could not have" maintained the necessary records. *Cohan*, 39 F.2d at 543.

Assuming, for the sake of argument, that the *Cohan* rule applies to this matter, the Court concludes that the evidence presented by Debtors here is simply insufficient. Debtors have failed to meet their burden to present evidence sufficient and reliable enough to allow the Court to make even an approximate guess on the amount of any deduction and thus have failed to show that the IRS' claim should be reduced. Even assuming Debtors did have records substantiating the relevant expenses, and that such records were destroyed in a flood beyond Debtors' control, their testimony is not a "reasonable reconstruction" of those expenses.

The only evidence in the record is testimony provided fifteen (15) to eighteen (18) years after the period in question, which was vague, self-serving, and uncorroborated by any documentation of expenses actually incurred or of expenses that would have been typical for the industry in the locale at the time. Debtors did not even provide a total dollar estimate of expenses, and although they asserted that they incurred similar types and amounts of expenses in the years prior and subsequent to the Tax Years, and that the returns for such years showed minimal liabilities or even refunds, they did not provide any such returns to the Court and any such returns would be of limited relevance in any event. This is not a sufficient basis on which the Court may make an estimate.

There are also no grounds on this record for the Court to reduce the tax liability in connection with the sales of real property in 2009. The burden is on Debtors to establish the bases in the properties and length of ownership, but there is nothing in the record regarding those issues.

The Court is compelled to agree with counsel for the IRS that this case "is an example of too little, too late."[33] Exceedingly too little, and monumentally tardy. Even to the extent *Cohan* is viable in this matter, Debtors have presented no principled basis for the Court to estimate expenses for the Tax Years.

IT IS, THEREFORE, ORDERED the Objection to Claim No. 6-4 filed by Debtors William Cooper Lee and Tracy Quick Lee on May 2, **2023**, is overruled.

FILED BY THE COURT 06/05/**2024**

Entered: 06/05/**2024**

Chief US Bankruptcy Judge

District of South Carolina

1 ECF No. 290, filed May 2, **2023**.

2 ECF No. 295, filed June 1, **2023**.

3 ECF No. 357, filed Apr. 17, **2024**.

4 ECF No. 358, filed Apr. 17, **2024**.

5 *See* Transcript of Hearing Held April 18, **2024** (ECF No. 367) (the "Hearing Transcript").

6 ECF Nos. 370 (IRS' brief) and 371 (Debtors' brief).

7 Not all the tax liabilities for the Tax Years are associated with Mr. Lee's Taxpayer ID Number on the attachments to the IRS' proof of claim, but Debtors appear to only object to the unsecured portion of the claim related to Mr. Lee's tax liabilities for the Tax Years. However, even to the extent Debtors object to the other tax liabilities for the Tax Years reflected on the attachments to the IRS' proof of claim, the result would be the same.

8 At the hearing, the parties agreed that Debtors had provided documents purporting to be tax returns for the Tax Years to the IRS. However, those documents are not in evidence.

9 Debtors filed an objection to this claim (ECF No. 40) but subsequently withdrew it (ECF No. 62).

10 ECF No. 35.

11 ECF Nos. 42, 44, 45, 47, and 48.

12 ECF No. 57.

13 ECF No. 68.

14 ECF No. 84.

15 ECF No. 100.

16 The Internal Revenue Code, Title 26 of the U.S. Code, will hereinafter be referred to as the "**IRC** ". The secured claim amount is consistent with Debtors' motion and the prior order.

17 ECF No. 107.

18 ECF No. 109.

19 ECF No. 245.

20 ECF No. 248.

21 ECF No. 270.

22 ECF No. 278.

23 ECF No. 290.

24 ECF No. 295.

25 ECF No. 357.

26 *See* Hearing Transcript, p. 51, lines 23-25, and p. 52, lines 1-21.

27 IRS Ex. A.

28 IRS Ex. B.

29 IRS Ex. C.

30 IRS Ex. C.

31 IRS Ex. I.

32 IRS Ex. J, K, and L.

33 Hearing Transcript, p. 12, lines 20-21.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
Federal Tax Decisions
American Federal Tax Reports
American Federal Tax Reports (Current Year)
2024
AFTR 2d Vol. 133
133 AFTR 2d 2024-1726 - 133 AFTR 2d 2024-1604
IN RE: TAMPA HYDE PARK CAFÉ PROPERTIES, LLC, 133 AFTR 2d 2024-1701, Code Sec(s) 6321; 6502; 6871; 7401; 7402, (Bktcy Ct FL), 06/05/2024

American Federal Tax Reports

IN RE: TAMPA HYDE PARK CAFÉ PROPERTIES, LLC, Cite as 133 AFTR 2d 2024 -1701, Code Sec(s) 6502; 7401; 7402; 6321; 6871, (Bktcy Ct FL), 06/05/2024

In Re: TAMPA HYDE PARK CAFÉ PROPERTIES, LLC, Debtor.

Case Information:

[pg. **2024** -1701]

Code Sec(s):	6502; 7401; 7402; 6321, 6871
Court Name:	U.S. Bankruptcy Court, Middle Dist. of Florida,
Docket No.:	Case No. 8:23-bk-00448-CED,
Date Decided:	06/05/**2024**.
Disposition:	Decision for Govt.

HEADNOTE

1. Tax claims in bankruptcy—objection to proof of claim—alter ego theory. Chap. 7 debtor/LLC's objection to IRS's authority to pursue alter ego claim against LLC for employment taxes owed by taxpayer/related LLC was overruled. Although debtor argued that IRS couldn't assert money damage claims against non-taxpayers, it appeared that Code Sec. 6502 , Code Sec. 7401 and Code Sec. 7402 authorized IRS to pursue generalized money damages claims against non-taxpayers who were allegedly alter ego or nominee of taxpayer. And even if those statutes didn't specifically authorize filing of such claims against non-taxpayers, Code Sec. 7402 clearly provided that judicial remedies listed therein were *in addition to any and not exclusive of* all of govt.'s enforcement remedies.

Reference(s): Code Sec. 6502;Code Sec. 7401;Code Sec. 7402;Code Sec. 6321

2. Bankruptcy court procedure—alter ego claims—standing. Chap. 7 trustee lacked standing to release IRS's alter ego claim against debtor/LLC as part of settlement and compromise order regarding sale of debtor's assets. While trustee could release alter ego claim if claim was common to all creditors and thus property of bankruptcy estate, that wasn't case here as alter ego claim was personal claim belonging to IRS, which sought to hold debtor liable for taxpayer/related LLC's employment tax debts.

Reference(s): Code Sec. 6871

OPINION

UNITED STATES BANKRUPTCY COURT MIDDLE DISTRICT OF FLORIDA TAMPA DIVISION,

ORDER DENYING DEBTOR'S MOTION FOR SUMMARY JUDGMENT ON SECOND AMENDED OBJECTION TO CLAIM NO. 8-1 (Doc. No. 363)

Judge: Caryl E. Delano, Chief United States Bankruptcy Judge

Chapter 7

www.flmb.uscourts.gov

The Internal Revenue Service ("IRS") filed an unsecured claim in this Chapter 7 case for unpaid taxes owed by Debtor's alleged alter ego, Tampa Hyde Park Café, LLC ("Hyde Park Caf é").

Debtor objected to the claim and moved for summary judgment on two grounds: (1) that the Internal Revenue Code does not authorize the IRS to pursue an unsecured claim based on an alter ego theory; and (2) even if the Internal Revenue Code provides such authorization, the Chapter 7 Trustee released any alter ego claim the IRS may have had against Debtor in a court-approved settlement agreement.

Having carefully considered the parties' arguments, the Court concludes that the Internal Revenue Code confers upon the IRS broad powers to collect taxes, including the right to initiate civil actions against non-taxpayers to collect taxes owed by a non-taxpayer's alter ego; and, because the IRS's alter ego claim alleges an injury to the IRS—not an injury to Debtor—the claim is not property of the estate and could not have been released by the Chapter 7 Trustee. Therefore, the Court will deny Debtor's summary judgment motion.

I. BACKGROUND

The facts are not in dispute.

Debtor and Hyde Park Café are Florida limited liability companies whose membership interests are owned by the same individuals. In 2002, Debtor purchased real property in Tampa, Florida (the "Property") that Debtor leased to Hyde Park Caf é. Hyde Park Café operated a nightclub on the Property, using a liquor license owned by Debtor. [pg. **2024** -1702]

Between 2010 and 2020, the IRS assessed more than $3 million in unpaid employment taxes against Hyde Park Café and recorded Notices of Federal Tax Lien against it.[1]

In February **2023**, Debtor filed a voluntary Chapter 11 bankruptcy petition. [2] On June 27, **2023**, the Court converted the case to a Chapter 7 case.[3] Angela Welch was appointed as the Chapter 7 Trustee (the "Trustee").[4]

Thereafter, the Trustee entered into a global settlement agreement (the "Settlement Agreement")[5] involving Debtor, Hyde Park Café, and two additional related entities: a similarly named entity, Hyde Park Café, LLC ("HPC"),[6] and CPT Acquisitions, LLC. The Settlement Agreement provided for (a) the resolution of disputes between the Trustee and the parties; (b) the Trustee to sell Debtor's assets to HPC (the "Sale of Assets"); and (c) the parties to the Settlement Agreement to execute mutual releases.

After notice to creditors and a hearing, the Court approved the Settlement Agreement and the Sale of Assets (the "Compromise Order.").[7] The Trustee's Sale of Assets to HPC closed on December 20, **2023**.[8]

In the meantime, before the Sale of Assets closed, the IRS filed a $1.7 million claim in Debtor's bankruptcy case for unpaid taxes. The proof of claim stated that the claim was secured by a lien on "[a]ll of debtor(s) right, title and interest to property–26 U.S.C. §§ 6321."[9] The IRS attached exhibits to the proof of claim that reflected that the tax debt was owed by Hyde Park Caf é.[10]

Debtor, believing that the IRS based its claim on the theory that Debtor held assets belonging to Hyde Park Café as Hyde Park Café's "nominee," objected to the IRS's proof of claim (the "Objection").[11] Debtor primarily argued (a) that the "nominee" theory fails because there is no evidence that Debtor held property belonging to Hyde Park Café; and (b) that the IRS's claim was not secured by any of Debtor's assets.[12]

In its response to the Objection, the IRS asserted that it seeks to impose Hyde Park Café's tax liability against Debtor, not on a "nominee theory," but on the theory that Debtor is Hyde Park Caf é's alter ego.[13]

Because the existence of the IRS's lien as asserted in its proof of claim was in bona fide dispute, the Court, under Bankruptcy Code § 363(f),[14] authorized the Sale of Assets free and clear of the IRS's lien, with the lien—if any—attaching to the sales proceeds.[15]

In Debtor's *Motion for Summary Judgment on Second Amended Objection to Claim No. 8-1* (the "Summary Judgment Motion"),[16] Debtor initially contended that the IRS's claim was not secured because the IRS failed to record Notices of Federal Tax Lien against Debtor and that all alter ego claims—including the IRS's alleged alter ego claim—are property of Debtor's bankruptcy estate that were released under the Settlement Agreement and Compromise Order.

After Debtor filed the Summary Judgment Motion, the IRS amended its claim to assert a $1.7 million unsecured claim.[17] Of that amount, the IRS claims $731,109.77 as a priority unsecured claim and $959,811.37 as a general unsecured claim.[18] In its response to the Summary Judgment Motion, the IRS acknowledges that its claim against Debtor is based solely on the theory that Hyde Park Caf é is Debtor's alter ego.[19]

In its *Reply in Support of Motion for Summary Judgment*, Debtor argued that the Internal Revenue Code does not authorize the IRS to [pg. **2024** -1703] pursue a claim for money damages against a non-taxpayer based on an alter ego theory.[20] In other words, Debtor argues that the Internal Revenue Code authorizes the IRS to proceed against a non-taxpayer only to recover the assets of a taxpayer that are in the hands of the non-taxpayer.

If the IRS's claim is allowed, the Trustee's distribution to unsecured creditors will include a significant distribution to the IRS; if the claim is disallowed, the case will be a "surplus asset case," and funds will be refunded to Debtor.

II. ANALYSIS

The issues before the Court on Debtor's Summary Judgment Motion are (a) whether the Internal Revenue Code authorizes the IRS to pursue an alter ego claim against Debtor; and (b) whether the IRS's alleged alter ego claim is property of Debtor's bankruptcy estate that was released by the Chapter 7 Trustee under the Settlement Agreement and the Compromise Order.

A. The Internal Revenue Code authorizes the IRS to pursue an unsecured alter ego claim against Debtor.

Debtor contends that the Internal Revenue Code only authorizes the IRS to pursue a non-taxpayer to the extent that the non-taxpayer holds property belonging to the taxpayer; in other words, the IRS is limited to an *in rem* remedy and may not assert a claim for money damages against a non-taxpayer.

Under Internal Revenue Code §§ 6321, if any person fails to pay a tax after demand is made, there "shall be a lien in favor of the United States upon all property and rights to property...belonging to such person."[21] The IRS perfects a tax lien by recording a Notice of Federal Tax Lien.[22] After a Notice of Federal Tax Lien is filed, the Internal Revenue Code authorizes the IRS to levy on a taxpayer's property, any of the taxpayer's rights to property, or any property on which the IRS holds a lien.[23]

But the Internal Revenue Code also confers on the IRS broad powers to collect taxes, including the authority to file civil actions. For example, if the IRS believes that a third-party, non-taxpayer is in possession of property belonging to the taxpayer, the IRS may file a Notice of Federal Tax Lien against the third party, with the lien applying not only to the taxpayer's assets in the hands of the non-taxpayer, but also to the non-taxpayer's assets.[24] Thus, in *United States v. Bogart*, the Third Circuit recognized the IRS's right to pursue all assets held by a non-taxpayer alter ego, saying, "[u]nder an alter ego theory...the Government may seize all of the assets of an alter ego corporation if the separate entity is merely a sham."[25]

Internal Revenue Code §§ 6502 specifically provides that "[w]here the assessment of any tax imposed by this title has been made within the period of limitation properly applicable thereto, such tax may be collected by levy *or by a proceeding in court*."[26] Section 7401 expressly provides that the IRS may authorize the filing of a judicial proceeding.[27] And § 7402 confers on federal district courts jurisdiction to issue such "orders and processes, and to render such judgments and decrees as may be necessary or appropriate for the enforcement of the internal revenue laws."[28]

Nothing in §§ 6502, 7401, or 7402 limits the IRS's authority to initiate civil actions to only civil actions against taxpayers. Thus, contrary to Debtor's contention, it appears Internal Revenue Code §§ 6502, 7401, and 7402 authorize the IRS to pursue generalized claims for money damages against third-party, non-taxpayers who are alleged to be the nominee or alter ego of the taxpayer.

But even if §§ 6502, 7401, and 7402 do not specifically authorize the filing of a civil action for money damages against a non-taxpayer, § 7402 makes clear that "[t]he remedies hereby [pg. **2024** -1704] provided are *in addition to and not exclusive of* any and all other remedies of the United States in such courts or otherwise to enforce such laws."[29] The Supreme Court recognized this explicit statutory authorization in *United States v. Rodgers*,[30] when the Court held there are "a number of distinct enforcement tools available to the United States for the collection of delinquent taxes," including the right to "simply sue for the unpaid amount, and, on getting a judgment, exercise the usual rights of a judgment creditor."[31]

Moreover, the cases that Debtor relies upon for the proposition that alter ego liability is strictly an *in rem* remedy do not stand for the proposition that the IRS is limited to pursuing an alter ego only for property of the taxpayer in the alter ego's hands.[32] For example, in *Shades Ridge Holding Co., Inc. v. U.S.* , although the Eleventh Circuit directly addressed the IRS's pursuit of property that the taxpayer had fraudulently transferred to its alter ego, it also noted that the alter ego's own property is subject to the collection of the taxpayer's tax liability.[33] The Fifth Circuit agreed with *Shades Ridge* in *Oxford Capital Corp. v. U.S.*, where it held that "[u]nder the alter ego doctrine, [ ] all the assets of an alter ego corporation may be levied upon to satisfy the tax liabilities of a delinquent taxpayer-shareholder."[34] And at least one bankruptcy court has allowed the IRS to assert an unsecured claim for tax debt owed by another. In *In re All Sorts of Services of America, Inc.*, the IRS filed an unsecured claim against the debtor, asserting that the debtor was the mere continuation of the taxpayer's business and therefore liable for the tax debt.[35] The bankruptcy court found the debtor and the taxpayer had engaged in a relay-style passing of the business "baton" and overruled the debtor's objection to the IRS's claim.[36]

The Court concludes that the IRS's assertion of an unsecured claim against Debtor as Hyde Park Café's alleged alter ego is consistent with its ability to levy on all of Debtor's assets.

B. The Trustee lacked standing to release the IRS's alter ego claim.

The elements of alter ego liability under Florida law are (1) the alleged alter ego was "dominated and controlled" to the extent it lacked an independent existence; (2) the alter ego's corporate form was used "fraudulently or for an improper purpose;" and (3) the "fraudulent or improper" use of the alter ego's corporate form caused harm.[37]

Whether a bankruptcy trustee has standing to release an alter ego claim turns on whether the claim is "general" or "personal." As the Eleventh Circuit explained in *In re Icarus Holding, LLC*, an alter ego claim is "general"—and therefore belongs to the estate—if (1) state law allows alter ego claims; and (2) the alter ego claim is a "general claim that is common to all creditors."[38] Thus, a trustee can release an alter ego claim only if the claim is common to all creditors.[39]

As the bankruptcy court explained in *In re Xenerga*,[40] an alter ego claim is "common to all creditors" when the injury is to the debtor and therefore suffered by all creditors:

> An alter ego claim is a general one when liability extends "to all creditors of the corporation without regard to the personal dealings between such officers and such creditors." In other words, if the injury alleged in the alter ego action is an injury to the corporation and thus suffered generally by all creditors, and is not an injury inflicted directly on any one creditor,

> the trustee has exclusive standing to bring such an alter ego action. Conversely, a trustee may not bring an alter ego claim if the alleged injury is specific to one creditor and not to the debtor corporation and creditors generally.[41]

In *Xenerga*, creditors sued the debtor and its principals, alleging that the debtor was a sham by which its principals secured huge deposits from customers and then made off with the deposits by transferring them to another company with the ultimate goal of defrauding the debtor's customers.[42] Based on those allega[pg. **2024** -1705] tions, the creditors sought to hold the principals liable for the debtor's debts for wrongfully depleting the debtor's assets. When the debtor filed for Chapter 7 bankruptcy, the Chapter 7 trustee contended that the creditors' alter ego claims actually belonged to the bankruptcy estate and, on behalf of the estate, entered into a settlement agreement with the debtor's principals.[43] The creditors objected to the proposed settlement.

The bankruptcy court noted that only the trustee has authority to "bring an alter ego claim on behalf of the general creditor body of a debtor corporation" and concluded that the principals' use of the debtor as a sham entity to wrongfully deplete the debtor's assets was a general claim that injured all the debtor's creditors.[44] Therefore, the bankruptcy court held that only the trustee had authority to settle the alter ego claims against the debtor's principals.

The facts in this case are distinguishable from those in *Xenerga* because the alleged alter ego claims here do not seek to hold a non-debtor—Hyde Park Café—liable for Debtor's debts. Rather, the IRS seeks the exact opposite—to hold Debtor liable for the debts of Hyde Park Café.

Although the IRS may not be able to prove its alter ego claim, on the facts alleged, it is the IRS—not Debtor—that is the injured party. Therefore, under the rationale of *Icarus Holding* and *Xenerga*, the IRS's alter ego claim is not a general claim that is common to all creditors and thus the property of the bankruptcy estate, but rather a personal claim belonging to the IRS.

Therefore, the Court finds that the Trustee did not release the IRS's alleged alter ego claim as part of the Compromise Order.

III. CONCLUSION

Because the Internal Revenue Code authorizes the IRS to sue for unpaid taxes and exercise the usual rights of a judgment creditor, the IRS has authority to pursue its unsecured claim based on an alter ego theory. And because Hyde Park Café's alleged use of an alter ego to avoid the payment of taxes injured the IRS and not Debtor, the Trustee lacked standing to release the alter ego claim.

Accordingly, it is

ORDERED that Debtor's *Motion for Summary Judgment on Second Amended Objection to Claim No. 8-1* (Doc. No. 363) is DENIED.

Clerk's Office to serve interested parties via CM/ECF.

---

1 The IRS did not file a Notice of Federal Tax Lien against Debtor, nor did it take any action prior to this bankruptcy case to collect the taxes from Debtor.

2 Doc. No. 1.

3 Doc. No. 170.

4 Doc. No. 175.

5 Doc. No. 297.

6 Tampa Hyde Park Café, LLC (referred to herein as Hyde Park Café), Hyde Park Caf é, LLC, and the Debtor in this case, Tampa Hyde Park Café Properties, LLC, were formed as three separate entities.

7 Doc. Nos. 337 and 338.

8 Doc. No. 379-1.

9 Claim No. 8-1, p. 2.

10 *Id.* at pp. 7-21.

11 Doc. No. 314.

12 *Id.* at pp. 4-7.

13 Doc. No. 340 at p. 3 ("The IRS Claim should be allowed because it imposes [Hyde Park Caf é's] tax liabilities [on Hyde Park Caf é 's] alter ego, the Debtor.").

14 11 U.S.C. § 363(f).

15 Doc. No. 337, ¶¶ 6, 7.

16 Doc. No. 363.

17 Claim No. 8-2.

18 *Id.*

19 Doc. No. 369.

20 Doc. No. 372, ¶¶ 5-7.

21 **I.R.C.** §§ 6321.

22 *Console v. Comm'r of Internal Revenue*, 291 F. App'x 234, 238 [102 AFTR 2d 2008-5864] (11th Cir. 2008) ("A federal tax lien generally arises when the amount of an unpaid tax is assessed, but a tax lien is not perfected against most third parties until notice is filed.") (citation omitted).

23 **I.R.C.** §§ 6331(a) ("If any person liable to pay any tax neglects or refuses to pay the same within 10 days after notice and demand, it shall be lawful for the Secretary to collect such tax (and such further sum as shall be sufficient to cover the expenses of the levy) by levy upon all property and rights to property (except such property as is exempt under section 6334) belonging to such person or on which there is a lien provided in this chapter for the payment of such tax.").

24 *Karcho-Polselli v. U.S.*, 2009 WL 3200045 [104 AFTR 2d 2009-6633], at *2 (E.D. Mich. Sept. 29, 2009).

25 715 F. App'x 161, 166 [120 AFTR 2d 2017-6389] n. 4 (3d Cir. 2017) (citing *Oxford Capital Corp. v. U.S.*, 211 F.3d 280, 284 [85 AFTR 2d 2000-1840] (5th Cir. 2000)).

26 **I.R.C.** §§ 6502(a) (emphasis added). But the proceeding must be filed within ten years of the assessment of the tax or within other applicable limitations periods. *Id.*

27 **I.R.C.** §§ 7401 ("No civil action for the collection or recovery of taxes, or of any fine, penalty, or forfeiture, shall be commenced unless the Secretary authorizes or sanctions the proceedings and the Attorney General or his delegate directs that the action be commenced.").

28 **I.R.C.** §§ 7402(a).

29 *Id.* (emphasis added).

30 461 U.S. 677 [52 AFTR 2d 83-5042], 103 S. Ct. 2132, 76 L. Ed. 2d 236 (1983).

31 *Id.* at 682.

32 Doc. No. 372, ¶ 6.

33 888 F.2d 725, 727-728 [64 AFTR 2d 89-5426] (11th Cir. 1989).

34 211 F.3d 280, 284 [85 AFTR 2d 2000-1840] (5th Cir. 2000).

35 631 B.R. 63, 77 [127 AFTR 2d 2021-2533] (Bankr. M.D. Fla. 2021).

36 *Id.* at 71-77.

37 *W.P. Prods., Inc. v. Tramontina U.S.A., Inc.*, **2024** WL 1984727, at *2 (11th Cir. May 6, **2024**); *see also Gasparini v. Pordomingo*, 972 So. 2d 1053, 1055 (Fla. 3d DCA 2008) (per curiam).

38 *Baillie Lumber Co. v. Thompson (In re Icarus Holding, LLC)*, 391 F.3d 1315, 1321 (11th Cir. 2004).

39 *In re AAA Bronze Statues & Antiques, Inc.*, 598 B.R. 27, 29 (Bankr. N.D. Fla. 2019).

40 449 B.R. 594 (Bankr. M.D. Fla. 2011).

41 *Id.* at 598-99 (citing *In re Icarus Holding*, 391 F.3d at 1321).

42 *Id.* at 596-97, 599.

43 *Id.* at 597-98.

44 *Id.* at 600.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
Federal Tax Decisions
American Federal Tax Reports
American Federal Tax Reports (Current Year)
2024
AFTR 2d Vol. 133
133 AFTR 2d 2024-1726 - 133 AFTR 2d 2024-1604
FRIEDMANN v. IRS, ET AL., 133 AFTR 2d 2024-1663, Code Sec(s) 7402; 7422; 7426; 7430; 7432; 7433, (DC WA), 05/31/2024

American Federal Tax Reports

FRIEDMANN v. IRS, ET AL., Cite as 133 AFTR 2d 2024 -1663, Code Sec(s) 7426; 7432; 7433; 7432; 7433, (DC WA), 05/31/2024

Michael FRIEDMANN, PLAINTIFF v. INTERNAL REVENUE SERVICE, ET AL., DEFENDANTS.

Case Information:

[pg. **2024** -1663]

Code Sec(s):	7426; 7432; 7433, 7432; 7433
Court Name:	U.S. District Court, Western Dist. of Washington,
Docket No.:	CASE NO. 3:23-cv-05075-TL,
Date Decided:	05/31/**2024**.
Prior History:	Earlier proceedings at (**2023**, DC WA) 132 AFTR 2d **2023** -6165; (**2023**, DC WA) 132 AFTR 2d **2023** -5628; and (**2023**, DC WA) 132 AFTR 2d **2023** -5129.
Tax Year(s):	Year 2018.
Disposition:	Decision for Govt.

HEADNOTE

1. Actions against IRS and IRS Commissioner—proper defendant—damages. U.S. was substituted for IRS and IRS Commissioner as proper defendant to taxpayer's Code Sec. 7426 , Code Sec. 7432 and Code Sec. 7433 claims. U.S. was only proper defendant to stated claims.

Reference(s): Code Sec. 7426;Code Sec. 7432;Code Sec. 7433

2. Damage actions against U.S.—failure to release lien; wrongful collection—exhaustion of administrative remedies. Taxpayer failed to show he properly exhausted his administrative remedies under Code Sec. 7432 and Code Sec. 7433 in respect to his claims that due to IRS's failure to release his return or refund, he and his minor children lost belongings and became homeless. Although taxpayer allegedly made countless phone calls to IRS, utilized Tax Advocacy Service, and submitted numerous Notices of Intent to File Lawsuit, neither his phone calls nor written notices included all information required for making valid administrative claim.

Reference(s): Code Sec. 7432;Code Sec. 7433

3. Actions by third parties—wrongful levy—standing. Taxpayer lacked standing to pursue Code Sec. 7426 wrongful levy claim against U.S. because that statute applied only in respect to damage claims by 3d parties, not taxpayers.

Reference(s): Code Sec. 7426

4. Actions against U.S.—Federal Tort Claims Act. Taxpayer's intentional tort or negligence claims against U.S., relating to IRS's refusal to release his return or refund for certain year, which allegedly caused him and his children to become homeless, were precluded under FTCA's tax bar.

Reference(s): Code Sec. 7402

5. Damage actions against U.S.—failure to release lien—limitations periods—failure to state claim for relief. Taxpayer's Code Sec. 7432 claims relating to IRS's refusal to release his return or refund for certain year, which allegedly caused him and his children to become homeless, were untimely filed outside Code Sec. 7432 's 2-year limitations period. Also, there was no allegation of lien that would bring these claims under Code Sec. 7432 in any event.

Reference(s): Code Sec. 7432

6. Damage actions against U.S.—wrongful collection—limitations periods—failure to state claim for relief. Taxpayer's Code Sec. 7433 claims relating to IRS's refusal to release his return or refund for certain year, which allegedly caused him and his children to become homeless, were untimely filed outside Code Sec. 7433 's 2-year limitations period. Also, while Code Sec. 7433 provided damages for wrongful collection, taxpayer didn't set out what **IRC** provision or regs he believed IRS violated. But he was given leave to amend these claims.

Reference(s): Code Sec. 7433

7. Administrative and litigation costs—prevailing party. Taxpayer's request to recover administrative and litigation costs, in suit against U.S. that was still at its outset, was rejected as premature. He could pursue costs following final disposition of this suit if he prevailed.

Reference(s): Code Sec. 7430

8. Refund actions—administrative claims. Taxpayer was advised that to extent he was seeking to sue U.S. for refund, for year for which IRS refused to release his return or refund and allegedly caused him and children to become homeless, he would need to meet administrative claim prerequisite under Code Sec. 7422 .

Reference(s): Code Sec. 7422

OPINION

UNITED STATES DISTRICT COURT WESTERN DISTRICT OF WASHINGTON,

OMNIBUS ORDER ON DEFENDANTS' MOTION TO DISMISS, PLAINTIFF'S MOTION FOR LEAVE TO AMEND, PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT, AND DEFENDANTS' MOTION UNDER RULE 56(D)

Judge: Tana Lin, United States District Judge

Plaintiff brings various claims relating to a 2018 tax refund he alleges he did not receive. This matter is before the Court on Defendants' Motion to Dismiss. Dkt. No. 25. Having considered the relevant record and finding oral argument unnecessary, the Court GRANTS Defendants' motion to dismiss. Because the Court dismisses Plaintiff's Complaint with leave to amend for the reasons stated in this Order, the Court DENIES AS MOOT Plaintiff's Motion for Leave to Amend (Dkt. No. 26), Plaintiff's Motion to Strike All Responsive Filings By Defendants and Motion for Summary Judgment (Dkt. No. 28), and Defendants' Motion Under [pg. **2024** -1664] Federal Rule of Civil Procedure 56(d) (Dkt. No. 32).

I. BACKGROUND

A. Factual Background

The facts alleged in Plaintiff's complaint, which the Court takes as true for purposes of this Order, are as follows: Plaintiff Michael Friedmann is a Washington resident and taxpayer. Dkt. No. 24 at 1, 4. In 2018, Mr. Friedmann filed his taxes and was entitled to a tax refund of $5,229 from the Internal Revenue Service ("IRS"), which he never received. *Id.* at 4.

Mr. Friedmann has made numerous attempts to obtain his 2018 tax refund from the IRS. He has made "countless" phone calls to the agency, "utilized the Tax Advocacy Service," "submitted more than one Notice of Intent to File Lawsuit," and submitted "an Administrative Claim" in attempts to secure the release of his 2018 tax return. *Id.* Mr. Friedmann alleges that the IRS is requiring him to prove that the two children he claimed on his 2018 tax return are his, despite claiming them both as dependents on his tax return without issue since their births in 2010 and 2014. *Id.* at 4–5.

Due to the IRS's failure to provide his tax return, Mr. Friedmann alleges, he and his minor children lost "belongings" and became homeless. *Id.* at 4. Mr. Friedmann brings claims under 26 U.S.C. §§ 7433 for the reckless, intentional, or negligent disregard of "the tax law," 26 U.S.C. §§ 7432 for failure to release a lien, and 26 U.S.C. §§ 7426 for various civil actions by persons other than taxpayers. *Id.* at 3. Mr. Friedmann also appears to allege an intentional tort or negligence claim, as well as a claim for costs. *See id.* at 4.

B. Procedural Background

Mr. Friedmann moved for leave to proceed in forma pauperis on January 29, **2023**. Dkt. No. 1. The Court granted Mr. Friedmann's motion (Dkt. No. 3), and Mr. Friedmann subsequently filed his complaint on February 6, **2023** (Dkt. No. 4).

Following Defendants' appearance, Defendant United States moved unopposed for an extension of time to answer Mr. Friedmann's complaint. Dkt. No. 19. The Court granted the extension (Dkt. No. 20), but Mr. Friedmann filed an amended complaint before the new deadline for Defendants' response (Dkt. No. 24). Defendants filed the instant motion to dismiss on January 30, **2024**. Dkt. No. 25. Mr. Friedmann subsequently filed a motion for leave to further amend his complaint and a motion for summary judgment. Dkt. Nos. 26, 28.

II. LEGAL STANDARD

A. Dismissal Under Rule 12(b)(1)

A motion to dismiss may be brought where subject matter jurisdiction is lacking. *See* Fed. R. Civ. P. 12(b)(1). The Court must dismiss a case if it determines that it lacks subject matter jurisdiction "at any time." Fed. R. Civ. P. 12(h)(3). When a Rule 12(b)(1) motion is filed together with other Rule 12 motions, the Court must generally resolve the question of subject matter jurisdiction before reaching other threshold issues or proceeding to the merits. *See Potter v. Hughes*, 546 F.3d 1051, 1056 n.2 (9th Cir. 2008) (citing *Sinochem Int'l Co. v. Malaysia Int'l Shipping Corp.*, 549 U.S. 422 (2007)); *Li v. Chertoff*, 482 F. Supp. 2d 1172, 1175–76 (S.D. Cal. 2007) ("When a motion to dismiss for lack of subject matter jurisdiction is filed in conjunction with other Rule 12 motions, the court should consider the Rule 12(b)(1) motion first." (citing *Ramming v. United States*, 281 F.3d 158, 161 (5th Cir. 2001))).

A motion to dismiss for lack of subject matter jurisdiction may be either a facial attack (challenging the sufficiency of the pleadings) or a factual attack (presenting evidence contesting the truth of the allegations in the pleadings). *See Wolfe v. Strankman* , 392 F.3d 358, 362 (9th Cir. 2004). "When reviewing a [facial] dismissal pursuant to Rule 12(b)(1)..., `we accept as true all facts alleged in the complaint and construe them in the light most favorable to plaintiff[ ], the non-moving party.'" *DaVinci Aircraft, Inc. v. United States*, 926 F.3d 1117, 1122 (9th Cir. 2019) (second alteration in original) (quoting *Snyder & Assocs. Acquisitions LLC v. United States*, 859 F.3d 1152, 1156–57 [119 AFTR 2d 2017-2210] (9th Cir. 2017)). However, "[i]f the moving party converts the motion to dismiss into a factual motion by presenting affidavits or other evidence properly brought before the court, the party opposing the motion must furnish affidavits or other evidence necessary to satisfy its burden of establishing subject matter jurisdiction." *Wolfe*, 392 F.3d at 362 (quotation and citation omitted). When addressing a factual attack, a court may consider evidence outside of the complaint without converting the motion to dismiss into a motion for summary judgment. *Am. Diabetes Ass'n v. U.S. Dep't of the Army*, 938 F.3d 1147, 1151 (9th Cir. 2019) (citing *Safe Air for Everyone v. Meyer*, 373 F.3d 1035, 1039 (9th Cir. 2004)). Thus, the district court has the power to dismiss for lack of subject matter jurisdiction on any of three bases: "(1) the complaint alone; (2) the complaint supplemented by undisputed facts evidenced in the record; or (3) the complaint supplemented by undisputed facts [pg. **2024** -1665] plus the court's resolution of disputed facts." *Schmidt v. Guyton* , 93 F.R.D. 399, 401 (D. Nev. 1982) (citing *Williamson v. Tucker*, 645 F.2d 404, 413 (5th Cir. 1981)).

B. Dismissal Under Rule 12(b)(6)

A defendant may also seek dismissal when a plaintiff fails to state a claim upon which relief can be granted. Fed. R. Civ. P. 12(b)(6). In reviewing a FRCP 12(b)(6) motion to dismiss, the Court takes all well-pleaded factual allegations as true and considers whether the complaint "state[s] a claim to relief that is plausible on its face." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007)). While "[t]hreadbare recitals of the elements of a cause of action, supported by mere conclusory statements" are insufficient, a claim has "facial plausibility" when the party seeking relief "pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Iqbal* , 556 U.S. at 672. "When reviewing a dismissal pursuant to Rule...12(b)(6), `we accept as true all facts alleged in the complaint and construe them in the light most favorable to plaintiff[ ], the non-moving party.'" *DaVinci Aircraft*, 926 F.3d at 1122 (alteration in original) (quoting *Snyder*, 859 F.3d at 1156–57).

"If a complaint is dismissed for failure to state a claim, leave to amend should be granted unless the court determines that the allegation of other facts consistent with the challenged pleading could not possibly cure the deficiency." *Or. Clinic, PC v. Fireman's Fund Ins. Co.*, 75 F.4th 1064, 1073 (9th Cir. **2023**) (citing *Schreiber Distrib. Co. v. Serv-Well Furniture Co.* , 806 F.2d 1393, 1401 (9th Cir. 1986)). A revised complaint would replace the current complaint. *Lacey v. Maricopa Cnty.*, 693 F.3d 896, 925 (9th Cir. 2012) (en banc) ("[T]he general rule is that an amended complaint supercedes the original complaint and renders it without legal effect."). "Unless it is absolutely clear that no amendment can cure the defect...a pro se litigant is entitled to notice of the complaint's deficiencies and an opportunity to amend prior to dismissal of the action." *Lucas v. Dep't of Corr.*, 66 F.3d 245, 248 (9th Cir. 1995).

III. DISCUSSION[1]

A. The United States is the Proper Defendant in this Action

Mr. Friedmann names the IRS and the former Commissioner of the IRS, Charles P. Rettig, as defendants in this action. Dkt. No. 24 at 2. Defendants contend that the IRS and Mr. Rettig should be dismissed as defendants, and that the United States should be substituted as the proper party defendant. Dkt. No. 25 at 3.

Defendants are correct that the United States is the proper defendant in an action seeking the recovery of a civil tax refund, as Mr. Friedmann seeks here. *See, e.g.*, *Grossman v. Comm'r of Internal Revenue*, 687 F. Supp. 1401, 1402 [61 AFTR 2d 88-1015] (N.D. Cal. 1987); *McNeil v. IRS*, No. C08-2432, 2010 WL 703058 [105 AFTR 2d 2010-1314], at 1 n.3 (E.D. Cal. Feb. 25, 2010). First, as Defendants note, in any lawsuit where the requested relief would "expend itself on the public treasury or domain," the United States is the proper party defendant. *Dugan v. Rank*, 372 U.S. 609, 620 (1963); Dkt. No. 25 at 3.

Second, the statutory bases for Mr. Friedmann's asserted claims only permit suits against the United States, not against the IRS or its agents. *See* 26 U.S.C., , §§ 7426, 7432, 7433; *see also Fisher v. U.S.*, 676 F. Supp. 2d 1165, 1168 [104 AFTR 2d 2009-7641] (W.D. Wash. 2009). Regardless of whether Mr. Friedmann has valid claims against the IRS or Mr. Rettig, he cannot pursue them via 26 U.S.C., , §§ 7426, 7432, or 7433.

The Court therefore DISMISSES the IRS and Mr. Rettig and SUBSTITUTES the United States in their stead.

B. The Court Lacks Subject-Matter Jurisdiction Over Plaintiff's Claims

Defendant first argues that the Court lacks jurisdiction over Mr. Friedmann's claims because Mr. Friedmann has not alleged that he exhausted all administrative remedies as to his statutory claims, Mr. Friedmann lacks standing for his Section 7426 claim because he is not a third party, and Mr. Friedmann has not identified a valid waiver of sovereign immunity as to his common law claims. Dkt. No. 25 at 4.

1. Exhaustion of Administrative Remedies

The statutory basis for each of Mr. Friedmann's claims includes a requirement that the plaintiff exhaust all administrative remedies before the Court may assert jurisdiction over [pg. **2024** -1666] the claim. *See Conforte v. U.S.*, 979 F.2d 1375, 1377 [71 AFTR 2d 93-339] (9th Cir. 1992) (finding that requirement to exhaust administrative remedies is jurisdictional).

a. Exhaustion Requirements

(1) 26 U.S.C. §§ 7426

To maintain a claim under Section 7426, a plaintiff's administrative remedies must be exhausted under the rules of Section 7433(d), which states that "[a] judgment for damages shall not be awarded...unless the court determines that the plaintiff has exhausted the administrative remedies available to such plaintiff within the Internal Revenue Service." 26 U.S.C., §§ 7426(h)(2), 7433(d)(1). There are two requirements to exhaust administrative remedies. First, an action to enforce liability under the section "may be brought only within 2 years after the date the right of action accrues." [2] 26 U.S.C. §§ 7433(d)(3); *see also* 26 C.F.R. § 301.7433-1(g).

Second, certain procedures must be followed. 26 C.F.R. § 301.7433-1(e) lays out the procedures for an administrative claim for a civil cause of action in connection with the collection of a federal tax. *See* 26 C.F.R. § 301.7433-1(a). It requires that the plaintiff send the claim in writing to the Area Director, Attn: Compliance Technical Support Manager of the area in which the taxpayer resides. 26 C.F.R. § 301.7433-1(e)(1). The claim must include:

> ((i)) The name, current address, current home and work telephone numbers and any convenient times to be contacted, and taxpayer identification number of the taxpayer making the claim;
>
> ((ii)) The grounds, in reasonable detail, for the claim (include copies of any available substantiating documentation or correspondence with the Internal Revenue Service);
>
> ((iii)) A description of the injuries incurred by the taxpayer filing the claim (include copies of any available substantiating documentation or evidence);
>
> ((iv)) The dollar amount of the claim, including any damages that have not yet been incurred but which are reasonably foreseeable (include copies of any available substantiating documentation or evidence); and
>
> ((v)) The signature of the taxpayer or duly authorized representative.

26 C.F.R. § 301.7433-1(e)(2).

(2) 26 U.S.C. §§7432

Similarly, to maintain a claim under Section 7432, a plaintiff must "exhaust[] the administrative remedies available to such plaintiff within the Internal Revenue Service." 26 U.S.C. §§ 7432(d)(1). Once again, there are two requirements to exhaust administrative remedies. First, an action to enforce liability under the section "may be brought only within 2 years after the date the right of action accrues." 26 U.S.C. §§ 7432(d)(3); *see also* 26 C.F.R. § 301.7432-1(i).

Second, certain procedures must be followed. 26 C.F.R. § 301.7426-1(f) lays out the procedures for an administrative claim for a civil cause of action for failure to release a lien. *See* 26 C.F.R. § 301.7426-1(a). It requires that the plaintiff send the claim in writing to the district director (marked for the attention of the Chief, Special Procedures Function) in the district in which the taxpayer resides or in the district in which the notice of federal tax lien was filed. 26 C.F.R.-1(f)(1). The claim must include:

((i)) The name, current address, current home and work telephone numbers and any convenient times to be contacted, and taxpayer identification number of the taxpayer making the claim;

((ii)) A copy of the notice of federal tax lien affecting the taxpayer's property, if available;

((iii)) A copy of the request for release of lien made in accordance with § 401.6325-1(f) of the Code of Federal Regulations, if applicable;

((iv)) The grounds, in reasonable detail, for the claim (include copies of any available substantiating documentation or correspondence with the Internal Revenue Service);

((v)) A description of the injuries incurred by the taxpayer filing the claim (include copies of any available substantiating documentation or evidence);

((vi)) The dollar amount of the claim, including any damages that have not yet been incurred but that are reasonably foreseeable (include copies of any available substantiating documentation or evidence); and

((vii)) The signature of the taxpayer or duly authorized representative.

26 C.F.R. § 301.7426-1(f)(2).

(3) 26 U.S.C. §§ 7433

Finally, to maintain a claim under Section 7433, a plaintiff must "exhaust[] the administrative remedies available to such plaintiff within the Internal Revenue Service." 26 [pg. **2024** -1667] U.S.C. §§ 7433(d)(1). As with the other two claims, there are two requirements to exhaust administrative remedies. First, an action to enforce liability under the section "may be brought only within 2 years after the date the right of action accrues." 26 U.S.C. §§ 7433(d)(3); *see also* 26 C.F.R. § 301.7433-1(g).

Second, certain procedures must be followed. 26 C.F.R. § 301.7433-1(e) lays out the procedures for an administrative claim for a civil cause of action in connection with the collection of a federal tax. *See* 26 C.F.R. § 301.7433-1(a). It requires that the plaintiff send the claim in writing to the Area Director, Attn: Compliance Technical Support Manager of the area in which the taxpayer resides. 26 C.F.R. § 301.7433-1(e)(1). The claim must include:

> ((i)) The name, current address, current home and work telephone numbers and any convenient times to be contacted, and taxpayer identification number of the taxpayer making the claim;
>
> ((ii)) The grounds, in reasonable detail, for the claim (include copies of any available substantiating documentation or correspondence with the Internal Revenue Service);
>
> ((iii)) A description of the injuries incurred by the taxpayer filing the claim (include copies of any available substantiating documentation or evidence);
>
> ((iv)) The dollar amount of the claim, including any damages that have not yet been incurred but which are reasonably foreseeable (include copies of any available substantiating documentation or evidence); and
>
> ((v)) The signature of the taxpayer or duly authorized representative.

26 C.F.R. § 301.7433-1(e)(2).

b. Application of Exhaustion Requirements to Plaintiff's Complaint

Mr. Friedmann asserts that he "submitted an administrative claim." Dkt. No. 24 at 4. Additionally, he argues that he made "countless phone calls," "utilized the Tax Advocacy Service," "submitted more than one Notice of Intent to File Lawsuit," and "contacted US District Attorneys [to] inform[] them a lawsuit would begin." *Id.* Defendants counter by arguing that Mr. Friedmann did not make any administrative claims for damages pursuant to 26 U.S.C., , §§ 7426, 7432, or 7433, and submit the sworn declaration of Eric Hall, a Technical Advisor of the Civil Enforcement Advice & Support Operations at the IRS, to testify to that effect. Dkt. No. 25 at 6; Dkt. No. 25-1. Mr. Friedmann responds that Mr. Hall perjured himself (Dkt. No. 27 at 2) but does not submit any evidence showing that he submitted administrative claims to the IRS for damages pursuant to 26 U.S.C., , §§ 7426, 7432, or 7433 (*see* Dkt. Nos. 27-1, 27-2).

Mr. Friedmann submits a number of exhibits in support of his assertion that he exhausted all administrative remedies available. Dkt. No. 27 at 4; *see* Dkt. Nos. 27-1, 27-2 (exhibits). However, none of these exhibits demonstrate the submission of administrative claims to the IRS that comport with the statutory requirements of 26 U.S.C., , §§ 7426, 7432, or 7433. At a minimum, Mr. Friedmann must allege that he included all the information required by 26 C.F.R. §§ 301.7432-1(f)(2) and 301.7433-1(e)(2) in the administrative claims that he sent to the IRS. For example, the notice must be submitted in writing. Therefore, the phone calls Mr. Friedman made do not satisfy the exhaustion requirement. The earliest written notice relating to his 2018 tax return that Mr. Friedmann submits with his response is dated January 23, **2023** (Dkt. No. 27-1 at 9), but it does not include required information such as, for example, Mr. Friedmann's taxpayer identification number or any substantiating documentation.

For this reason, the Court finds that Mr. Friedmann has not established that he exhausted all administrative remedies and therefore has not established subject matter jurisdiction over his claims. However, as Mr. Friedman is pro se and may not have fully understood what he needed to demonstrate with regard to the notice given to the government, the Court will allow Mr. Friedman one final opportunity to amend his complaint and provide any additional information showing that he properly exhausted his administrative remedies in a timely manner.[3]

2. Lack of Standing Under 26 U.S.C. §§ 7426

Mr. Friedmann brings a claim under 26 U.S.C. §§ 7426. Dkt. No. 24 at 3. Section 7426 permits four types of actions—actions for wrongful levy, surplus proceeds, substituted sale proceeds, or substitution of value. 26 U.S.C. § 7426(a)(1)–(4). Mr. Friedmann does not specify which action he is pursuing. As Mr. Friedmann does not allege any sale of property in connection with his 2018 tax return (meaning that there could be no surplus proceeds, sale proceeds, or substitution of value), the Court will construe Mr. Friedmann's Section [pg. **2024** -1668] 7426 claim as a claim for wrongful levy under 26 U.S.C. §§ 7426(a)(1). As Defendants note, Section 7426(a)(1) permits a third party to recover where the IRS levies upon property held by that third party in order to collect taxes owed by another person. 26 U.S.C. §§ 7426(a)(1); *see also Washington*, 2021 WL 199279 [127 AFTR 2d 2021-521], at *5 ("In other words, if the IRS levies upon property held by a third party to collect taxes owed by another, the third party, not the taxpayer, may bring a wrongful levy action against the United States pursuant to § 7426(a)(1)."). But Mr. Friedmann is the taxpayer here, not a third-party holder of any property levied upon. *See* Dkt. No. 24. Because Mr. Friedmann is the taxpayer, not a third party, he has no standing to bring a wrongful levy claim under Section 7426. *Washington*, 2021 WL 199279 [127 AFTR 2d 2021-521], at *5 (barring taxpayer from bringing a wrongful levy claim under Section 7426).

3. Waiver of Sovereign Immunity

"It is well settled that the United States, as sovereign, may not be sued without its consent, and that the terms of its consent define the court's jurisdiction." *Washington v. United States*, No. C20-5801, 2021 WL 199279 [127 AFTR 2d 2021-521], at *5 (N.D. Cal. Jan. 20, 2021) (citing *United*

States v. Dalm, 494 U.S. 596, 608 [65 AFTR 2d 90-1210] (1990)). "Waivers of sovereign immunity must be unequivocally expressed and are 'strictly construed' in favor of the government." *Id.* (quoting *United States v. Idaho Dep't of Water Res.*, 508 U.S. 1, 6–7 (1993)). Thus, no suit against the United States can be maintained *unless the claims are made in exact compliance with the terms of the statute* under which the United States has consented to be sued. *Id.* (emphasis added). Where the United States has not consented to be sued and there is no waiver of sovereign immunity, the Court lacks jurisdiction over the action and dismissal is required. *Id.* Mr. Friedmann appears to allege an intentional tort or negligence claim. Dkt. No. 24 at 4.

The Federal Tort Claims Act ("FTCA") waives the government's sovereign immunity over claims against the United States for personal injury resulting from the negligent or wrongful acts of its employees while acting within the scope of their employment (28 U.S.C. §§ 2671, *et seq.*). However, the FTCA expressly precludes claims arising "in respect of the assessment or collection of any tax," 28 U.S.C § 2680(c)—which is exactly the claim that Mr. Friedmann appears to allege here (Dkt. No. 24 at 4). "While [Section] 2680(c) is not limitless and 'does not confer absolute immunity on the IRS,' the provision nonetheless has been '"broadly construed"...to encompass actions taken during the scope of the IRS's tax assessment and collection efforts.'" *Hadsell v. United States*, No. C20-3512, 2021 WL 391299 [127 AFTR 2d 2021-808], at *6 (N.D. Cal. Feb. 3, 2021) (quoting *Snyder*, 859 F.3d at 1155, 1157), *aff'd*, No. C22-15760, **2023** WL 4418589 [132 AFTR 2d **2023** -5103] (9th Cir. July 10, **2023**); *see also Hutchinson v. U.S.*, 677 F.2d 1322, 1327 [50 AFTR 2d 82-5117] (9th Cir. 1982) ("the provisions of the Federal Tort Claims Act specifically exclude claims based upon the performance of a discretionary function by a government officer and claims arising with respect to the assessment and collection of any tax"). Because Mr. Friedmann's claims arise from the assessment and collection of his 2018 taxes (*see generally* Dkt. No. 24), any tort or negligence claims fall squarely within the Section 2680(c) exception. Therefore, the United States is immune from such claims under the FTCA.

For the foregoing reasons, the Court lacks subject matter jurisdiction over Mr. Friedmann's claims under 26 U.S.C., , §§ 7426, 7432, 7433, and common law claims.

C. Mr. Friedmann's Claims are Also Subject to Dismissal Under Rule 12(b)(6)

1. Claim Under 26 U.S.C. §§ 7426

As detailed above, supra Section III.B.2, Mr. Friedmann's claim under 26 U.S.C. §§ 7426 fails because it provides a cause of action for persons other than taxpayers. Therefore, Mr. Friedmann cannot state a claim under 26 U.S.C. §§ 7426, and the Court DISMISSES this claim without leave to amend.

2. Claim Under 26 U.S.C. §§ 7432

Mr. Friedmann's claim under 26 U.S.C. §§ 7432 for failure to release a lien (Dkt. No. 24 at 3) fails for two reasons.

First, Section 7432 requires "a plaintiff to bring a claim within two years after the date the right of action accrues." *Caudill v. United States*, No. C12-5065, 2012 WL 2688806 [109 AFTR 2d 2012-2562], at *2 (W.D. Wash. June 15, 2012) (citing 26 U.S.C. §§ 7432), *affirmed by Caudill v. U.S. Dept. of Treasury*, 584 Fed. Appx. 389 [114 AFTR 2d 2014-5535] (9th Cir. 2014); 26 U.S.C. §§ 7432(d)(3). The statutory filing period for actions brought under Section 7432 "accrues when the taxpayer has had a reasonable opportunity to discover all essential elements of a possible cause of action." *Kumpan v. U.S.* , 188 F.3d 513, *1 [84 AFTR 2d 99-5999] (9th Cir. 1999) (unpublished). Because Mr. Friedmann [pg. **2024** -1669] has not pleaded facts showing that he discovered all essential elements of his possible cause of action within two years of filing this lawsuit, Mr. Friedmann has not stated a claim for relief under 26 U.S.C. §§ 7432. *Caudill*, 2012 WL 2688806 [109 AFTR 2d 2012-2562], at *3.

Second, Section 7432 permits a civil claim by a taxpayer where "any officer or employee of the [IRS] knowingly, or by reason of negligence, fails to release a lien under 26 U.S.C. §§ 6325 on property of the taxpayer." 26 U.S.C. §§ 7432(a). A lien is a "legal right or interest that a creditor has in another's property, lasting...until a debt or duty that it secures is satisfied." Black's Law Dictionary (11th ed. 2019). A tax lien, specifically, is an interest on property imposed by the federal government for unpaid federal taxes. *U.S. v. Donahue Industries, Inc.*, 905 F.2d 1325, 1330 [66 AFTR 2d 90-5202] (9th Cir. 1990) ("A federal tax lien attaches to a taxpayer's property when unpaid taxes are assessed, and continues to attach until either the tax is paid or the lien becomes unenforceable because of lapse of time." (citing 26 U.S.C., §§ 6321, 6322)). Mr. Friedmann has made no allegations of a lien in this case. For this reason, even if Mr. Friedmann can demonstrate in an amended complaint that he exhausted administrative remedies, this claim will still fail. Therefore, the Court DISMISSES this claim without leave to amend.

3. Claim Under 26 U.S.C. §§ 7433

As to Mr. Friedmann's claim under 26 U.S.C. §§ 7433 (Dkt. No. 24 at 3), Section 7433 permits a claim where "in the collection of Federal tax with respect to a taxpayer, any officer or employee of the [IRS] recklessly or intentionally, or by reason of negligence, disregards any provision of this title, or any regulation promulgated under this title." 26 U.S.C. §§ 7433(a). This means that a taxpayer may sue the United States for damages "for tax collection activity that violates some provision of the Revenue Code or the regulations promulgated thereunder." *Clift v. IRS*, 118 AFTR 2d (RIA) 2016-6117 (W.D. Wash. 2016) (quoting *Shwarz v. United States* , 234 F.3d 428, 433 [86 AFTR 2d 2000-7191] (9th Cir. 2000)).

But again, Section 7433 requires a plaintiff to bring a claim "within two years after the date the right of action accrues." 26 U.S.C. §§ 7433(d)(3); *see also Tritz v. United States*, 698 F. App'x 342, 343 [120 AFTR 2d 2017-6064] (9th Cir. 2017) (holding that dismissal for lack of subject matter jurisdiction was proper where taxpayers did not file action under Section 7433 within two years of when their action accrued). The action accrues once Mr. Friedmann "had a reasonable opportunity to discover all essential elements of a possible cause of action." *Gottlieb v. IRS*, 4 Fed.Appx. 355, 356 [87 AFTR 2d 2001-960] (9th Cir. 2001). Because Mr. Friedmann has not pleaded facts showing that his claim for damages under Section 7433 is made in compliance with the terms of the statute (i.e., within the two-year statute of limitations), he has not stated a claim for relief under 26 U.S.C. §§ 7433. *Caudill*, 2012 WL 2688806 [109 AFTR 2d 2012-2562], at *3; *see also Gottlieb*, 4 Fed.Appx. at 356 ("Accordingly, we agree with the district court that Gottlieb's claim accrued, at the latest, on November 7, 1995, the date on which the IRS responded unfavorably to his request for administrative relief."). In addition, Mr. Friedmann has not stated what provision of the Revenue Code or the regulations have been violated. While the Court DISMISSES this claim, the Court will allow Mr. Friedmann an opportunity to amend his complaint as to this claim, if appropriate.

4. Common Law Claims

Mr. Friedmann appears to allege an intentional tort or negligence claim. Dkt. No. 24 at 4. The FTCA "allows a plaintiff to bring certain state-law tort claims against the United States for torts committed by federal employees acting within the scope of their employment." *Brownback v. King* , 592 U.S. 209, 209 (2021). However, as the Court has already explained, the FTCA expressly precludes claims arising from the assessment or collection of taxes. *See supra* Section III.B.3. For this reason, Mr. Friedmann has not stated an intentional tort or negligence claim, and the Court DISMISSES these claims without leave to amend. *Or. Clinic, PC*, 75 F.4th at 1073 (upholding dismissal without leave to amend where amendment would be futile).

5. Claim for Costs

Mr. Friedmann also appears to allege a claim for costs. Dkt. No. 24 at 5. Mr. Friedmann's complaint states that he has had "to undergo the arduous and burdensome process of obtaining court records from two different courts in two separate counties, one which will be via mail at a cost of $26.75," and has additionally had to spend $375 to serve Defendants "due to their efforts to evade service of process." Dkt. No. 24 at 5.

26 U.S.C. §§ 7430 permits limited claims for costs in connection with claims arising from the assessment or collection of taxes:

> In any administrative or court proceeding which is brought by or against the United States in connection with the determination, [pg. **2024** -1670] collection, or refund of any tax, interest, or penalty under this title, the prevailing party may be awarded a judgment or a settlement for —

((1)) reasonable administrative costs incurred in connection with such administrative proceeding within the Internal Revenue Service, and

((2)) reasonable litigation costs incurred in connection with such court proceeding.

26 U.S.C. §§ 7430(a). Thus, Mr. Friedmann must demonstrate that he is a "prevailing party" in order to recover costs. *U.S. v. Jones*, No. C09-5016, 2010 WL 1410699 [105 AFTR 2d 2010-1876], at *1 (W.D. Wash. Apr. 2, 2010). A prevailing party is any party in any tax proceeding who: "(i) has substantially prevailed with respect to the amount in controversy, or (ii) has substantially prevailed with respect to the most significant issue or set of issues presented." *Id.* As this litigation is at its outset, Mr. Friedmann's claim for costs is not yet ripe. He may seek the recovery of costs with an appropriate Application for Costs pursuant to 26 U.S.C. §§ 7430 following the final disposition of this action if he prevails.

D. Suits Involving Tax Refunds Should be Brought Under 26 U.S.C. §§ 7422

As the Government points out (Dkt. No. 25 at 2), Mr. Friedmann may bring his refund suit under 26 U.S.C. §§ 7422, which permits a claim for "the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected." 26 U.S.C. §§ 7422(a). To state a claim under Section 7422, Mr. Friedmann must also allege that he has filed a claim for refund or credit with the Secretary pursuant to the administrative requirements promulgated at 26 C.F.R. § 301.6402-2.

IV. CONCLUSION

For the reasons stated in this Order, the Court hereby:

(1.) GRANTS Defendants' motion to dismiss and dismisses without leave to amend as to his claims under 26 U.S.C. or §§ 7426 or 7432 or tort or negligence claims.

(2.) GRANTS Plaintiff one final opportunity to file an amended complaint consistent with this Order. If Plaintiff files an amended complaint, the amended complaint:

(a.) SHALL NOT include (1) the IRS and the former Commissioner of the IRS, Charles P. Rettig, as defendants or (2) claims under 26 U.S.C. or §§ 7426 or 7432 or tort or negligence claims;

(b.) SHALL Include facts concerning any written requests for Plaintiff's 2018 tax return made to the IRS as well as the date(s) of any such written communications; and

(c.) SHALL be filed by July 1, **2024.**

(3.) DENIES AS MOOT Plaintiff's Motion for Leave to Amend his complaint (Dkt. No. 26), Plaintiff's Motion to Strike All Responsive Filings By Defendants and Motion for Summary Judgment (Dkt. No. 28), and United States' Motion Under Federal Rule of Civil Procedure 56(d) (Dkt. No. 32).

Dated this 31st day of May **2024**.

Tana Lin

United States District Judge

---

1 Mr. Friedmann makes a number of ad hominem attacks against Defendants' counsel. Dkt. No. 27 at 7. While the Court declines to address the majority of these attacks, it notes that Defendants' counsel is properly admitted before the Court pursuant to Local Rule 83.1(b), which says that an attorney is eligible for admission if he or she is "a member in good standing of the bar of any state and employed by the United States or one of its agencies in a professional capacity and who, while being so employed may have occasion to appear in this court on behalf of the United States or one of its agencies." LCR 83.1(b)(2). Counsel is therefore not required to maintain a valid license to practice law in the State of Washington.

2 The time limitation will be discussed in Section III of this Order.

3 For the reason stated in the next section, even if Mr. Friedmann exhausted his administrative remedies, his claim under 26 U.S.C. §§ 7426 would fail.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
Federal Tax Decisions
American Federal Tax Reports
American Federal Tax Reports (Current Year)
2024
AFTR 2d Vol. 133
133 AFTR 2d 2024-1726 - 133 AFTR 2d 2024-1604
COBAI v. U.S., 133 AFTR 2d 2024-1636, Code Sec(s) 6402; 7422; 7433, (DC CA), 05/29/2024

American Federal Tax Reports

COBAI v. U.S., Cite as 133 AFTR 2d 2024 -1636, Code Sec(s) 7422; 6402; 7433, (DC CA), 05/29/2024

Gregory COBAI, PLAINTIFF v. UNITED STATES OF AMERICA, Department of the Treasury, Internal Revenue Service, DEFENDANT.

Case Information:

[pg. **2024** -1636]

Code Sec(s):	7422; 6402, 7433
Court Name:	U.S. District Court, Northern Dist. of California,
Docket No.:	Case No. 23-cv-01631-JD,
Date Decided:	05/29/**2024**.
Prior History:	Earlier proceeding at (**2023**, DC CA) 132 AFTR 2d **2023** -6708.
Tax Year(s):	Years 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2015, 2020, 2021.
Disposition:	Decision for Govt.

HEADNOTE

1. Refund actions—administrative claims. Pro se taxpayer's amended refund complaint was dismissed due to his repeat failure to show he met administrative claim prerequisite to suit. Although taxpayer did submit purported administrative claim, such didn't specify any legal or factual grounds for contesting his tax liability and instead just questioned IRS authority to tax him.

Reference(s): Code Sec. 7422;Code Sec. 6402

2. Damage actions against U.S.—wrongful collection—failure to exhaust administrative remedies; limitations periods. Pro se taxpayer's amended damages complaint, seeking to recover garnished wages, was dismissed due to his repeat failure to meet Code Sec. 7433 's administrative remedies exhaustion prerequisite or because suit wasn't timely.

Reference(s): Code Sec. 7433

OPINION

UNITED STATES DISTRICT COURT NORTHERN DISTRICT OF CALIFORNIA,

SECOND ORDER RE DISMISSAL

Judge: JAMES DONATO, United States District Judge

The Court dismissed the original complaint filed by pro se plaintiff Gregory Cobai for lack of subject matter jurisdiction "because Cobai did not adequately demonstrate that he filed a proper administrative claim with the IRS prior to filing suit." Dkt. No. 15 at 1 (citing 26 U.S.C. §§ 7422(a)). The ostensible refund claims did not adequately apprise the IRS of the basis for Cobai's objection to the tax assessments, and they were not verified by a declaration made under penalty of perjury. *See Boyd v. United States*, 762 F.2d 1369, 1371 [56 AFTR 2d 85-5266] (9th Cir. 1985); 26 C.F.R. § 301.6402-2(b)(1). The collections-related claim was dismissed because the complaint did not allege a statutory basis for relief, or that Cobai met the requirements to bring a damages claim pursuant to 26 U.S.C. §§ 7433. *See* Dkt. No. 15 at 2.

Dismissal was with leave to amend, and Cobai filed an amended complaint. Dkt. No. 16 (FAC). The FAC is virtually identical in sub[pg. **2024** -1637] stance to the dismissed complaint. Cobai re-alleges that the IRS lacks "evidence or facts to prove and/or support their claims that Plaintiff has an obligation to pay money to the IRS because it has jurisdiction over Plaintiff pursuant to the Internal Revenue Code (**IRC**)." *Id.* ¶ 3. Defendants ask to dismiss the FAC pursuant to Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6). Dkt. No. 21.

The FAC did not materially improve the shortfalls of the prior complaint. The ostensible refund claim attached to the FAC does not "specifically mention[]" any factual or legal basis to contest Cobai's tax liability. *Synergy Staffing, Inc. v. U.S. I.R.S.*, 323 F.3d 1157, 1161 [91 AFTR 2d 2003-1379] (9th Cir. 2003). It questions the IRS's authority to tax Cobai but says nothing beyond that. *See* Dkt. No. 16, Exh. A at ECF p. 19 (IRS has no "evidence or facts to prove and/or support their claims the Internal Revenue Code (**IRC**) applies to me, the laws apply to me, IRS has jurisdiction over me, and that I have an obligation to IRS to pay money."). This does not establish grounds on which to sue the IRS. *See* 26 C.F.R. § 301.6402-2(b).

For Count II, which seeks a refund of garnished wages, Cobai again invokes the refund statute. Dkt. No. 22 at 6. But the only monetary remedy for improper collections activity is provided by Section 7433. *See* 26 U.S.C. §§ 7433(a) ("Except as provided in section 7432, such civil action shall be the exclusive remedy for recovering damages resulting from such actions."). That section has its own exhaustion and timing requirements, which were cited in the prior order, and with which Cobai has not demonstrated compliance. *See* Dkt. No. 15 at 2 (citing 26 C.F.R. §§ 301.7433-1(e), (g)). The FAC alleges improper collection activity in 2018. *See* Dkt. No. 16 ¶¶ 63-66. The complaint, Dkt. No. 1, was not filed until April 5, **2023**, well-after the 2-year statute of limitations had expired. *See* 26 U.S.C. §§ 7433(d)(3); *see also Cornejo v. United States*, 585 Fed. App'x 373 [114 AFTR 2d 2014-6265] (9th Cir. 2014) (unpublished).

Cobai has been given multiple opportunities to establish the Court's jurisdiction and plausibly allege a claim. He has come up short. The Court has reviewed the pleadings with the generous reading afforded a pro se litigant. Further amendment is not warranted, and the complaint is dismissed with prejudice.

IT IS SO ORDERED.

Dated: May 29, **2024**

JAMES DONATO

United States District Judge

END OF DOCUMENT -

American Federal Tax Reports

AGUINALDO v. YEE, ET AL., Cite as 133 AFTR 2d 2024 -1604, Code Sec(s) 7402; 7402, (DC HI), 05/23/2024

Imelda Sevilleja AGUINALDO, PLAINTIFF v. Harry YEE, ET AL., DEFENDANTS.

Case Information:

[pg. **2024** -1604]

Code Sec(s):	7402, 7402
Court Name:	U.S. District Court, Dist. of Hawaii,
Docket No.:	Case No. 24-cv-00020-DKW-WRP,
Date Decided:	05/23/**2024**.
Disposition:	Decision for Govt.

HEADNOTE

1. Actions against U.S.—constitutional claims—sovereign immunity—Federal Torts Claims Act. Taxpayer's claims against federal judges, Assistant U.S. Attorneys and IRS employees, alleging constitutional violations incident to earlier judgment in tax collection suit, were barred by sovereign immunity insofar as asserted against defendants in their official capacities. Claims fell squarely under FTCA's tax bar.

Reference(s): Code Sec. 7402

2. Actions against federal officials—constitutional claims. Taxpayer's claims against federal judges, Assistant U.S. Attorneys and IRS employees, alleging constitutional violations arising from federal tax enforcement, were dismissed insofar as asserted against defendants in their individual capacities because *Bivens* relief wasn't available in this context.

Reference(s): Code Sec. 7402

OPINION

IN THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF HAWAI'I,

ORDER (1) GRANTING DEFENDANTS' MOTION TO DISMISS, (2) DENYING PLAINTIFF'S MOTION TO STRIKE, AND (3) DISMISSING THE COMPLAINT WITHOUT LEAVE TO AMEND

Judge: Derrick K. Watson, Chief United States District Judge

In January **2024**, Defendant Harry Yee removed this action from State Circuit Court. In the Complaint, Dkt. No. 1-2, Plaintiff Imelda Sevilleja Aguinaldo, proceeding without counsel, alleges numerous purported violations of her constitutional rights related to federal tax assessments and efforts to foreclose federal tax liens on Aguinaldo's property. Those claims are brought against various individuals connected with the federal government, including United States judges, Assistant United States Attorneys, and investigators and other employees of the Internal Revenue Service (IRS) (collectively, Defendants).

On February 27, **2024**, Defendants Yee, Jeremy Hendon, Isaac Hoenig, Senior U.S. District Judge J. Michael Seabright, U.S. Magistrate Judge Kenneth Mansfield, Venice Hochman, and Edwin Dean Curry[1] (collectively, Moving Defendants) moved to dismiss the Complaint on various grounds, including sovereign immunity, judicial immunity, and failure to state a claim. Dkt. No. 17. On April 4, **2024**, Aguinaldo responded by filing a motion to strike the motion to dismiss. Dkt. No. 25. Therein, Aguinaldo neither explains why the motion to dismiss should be stricken nor, more importantly, addresses any of the arguments for dismissal of this case. Instead, much like the Complaint, the motion to strike focuses upon the alleged impropriety of the tax assessments against Aguinaldo.

For the reasons set forth below, the motion to dismiss, Dkt. No. 17, is GRANTED. First, to the extent Aguinaldo's claims can be construed as brought against Defendants in their official capacities, the claims are treated as brought against the United States, and there is no allegation or basis to find a waiver of the government's sovereign immunity. Second, to the extent Aguinaldo's claims can be construed as [pg. **2024** -1605] brought against Defendants in their individual capacities as federal officers, they must be brought, if at all, under *Bivens v. Six Unknown Named Agents*, 403 U.S. 388 (1971). Here, though, there are no allegations that would permit Aguinaldo to pursue a *Bivens* claim against any Defendant consistent with Supreme Court guidance. Finally, although Aguinaldo is proceeding without counsel, and this is the first opportunity to apprise her of the deficiencies with her claims, given the nature of those claims, amendment would be futile. Therefore, the motion to dismiss is granted WITHOUT LEAVE TO AMEND.

STANDARDS OF REVIEW

Pursuant to Federal Rule of Civil Procedure 12(b)(1), a defendant may move for dismissal due to a lack of subject matter jurisdiction. When a defendant does so, "the plaintiff has the burden of proving jurisdiction in order to survive the motion." *Kingman Reef Atoll Investments, LLC v. United States*, 541 F.3d 1189, 1197 (9th Cir. 2008) (quotation omitted).[2]

A defendant may also move for dismissal under Federal Rule of Civil Procedure 12(b)(6). To survive such a motion, "a complaint must contain sufficient factual matter, accepted as true, to `state a claim to relief that is plausible on its face.'" *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (quoting *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007)).

Because Aguinaldo is proceeding without counsel, "[u]nless it is absolutely clear that no amendment can cure the defect...a pro se litigant is entitled to notice of the complaint's deficiencies and an opportunity to amend prior to dismissal of the action." *Lucas v. Dep't of Corr.*, 66 F.3d 245, 248 (9th Cir. 1995). A court, however, may deny leave to amend where, *inter alia*, amendment would be futile. *E.g.* , *Gardner v. Martino*, 563 F.3d 981, 990 (9th Cir. 2009); *Leadsinger, Inc. v. BMG Music Publ'g*, 512 F.3d 522, 532 (9th Cir. 2008).

DISCUSSION[3]

The Moving Defendants seek dismissal of all claims, whether asserted against them in their official or individual capacities.[4] Before addressing those arguments, as mentioned, Aguinaldo is proceeding without counsel. As a result, the Court liberally construes her Complaint. *Eldridge v. Block*, 832 F.2d 1132, 1137 (9th Cir. 1987). Liberal construction, however, does not mean *un*reasonable construction. Here, the only reasonable construction of the Complaint is that Aguinaldo seeks to circumvent and/or collaterally attack the result of a different case in this District.

That case—*United States v. Aguinaldo et al.*, Case No. 20-cv-434-JMS-KJM (Tax Case)—was brought by the United States to enforce federal tax liens against, and foreclose real property in Honolulu (Honolulu Property) held by, Aguinaldo and her husband. Tax Case, Dkt. No. 110. On October 6, 2022 and November 2, **2023**, the Tax Case Court granted summary judgment to the United States, such that the government's tax liens were reduced to judgment and a foreclosure sale of the Honolulu Property was authorized. *Id.*, Dkt. Nos. 158, 237. The Tax Case Court further denied Aguinaldo's motion to stay proceedings, instead allowing the sale of the Honolulu Property to proceed. *Id.*, Dkt. No. 237. On November 13, **2023**, Aguinaldo filed an interlocutory appeal of the Tax Case, which remains pending before the Ninth Circuit Court of Appeals. *Id.*, Dkt. No. 239.

In this case, the Complaint's sole purpose is to challenge the Tax Case, just as Aguinaldo is doing through her interlocutory appeal. Notably, all of Aguinaldo's claims concern alleged constitutional violations caused by the government's efforts to enforce its tax liens. Dkt. No. 1-2. Further, as relief, Aguinaldo seeks damages related to the enforcement of the government's tax liens and an injunction to prevent the sale of the Honolulu Property.

With that background in mind, the Court now addresses the government's arguments for dismissal.

1. Official Capacity Claims

The Moving Defendants contend that, to the extent the Complaint asserts official capacity claims, those claims must be considered to have been brought against the United States. As such, it is Plaintiff's burden to identify a waiver of sovereign immunity by the United States. Dkt. No. 17-1 at 17-18. The Moving Defendants further assert that the United States has not waived its immunity from Aguinaldo's [pg. **2024** -1606] claims, including under the Federal Tort Claims Act (FTCA) or the Internal Revenue Code (**IRC**). *Id.* at 18-21.

The Court agrees. First, any official capacity claims against the Moving Defendants (as well as the other named Defendants), as alleged officers or employees of the United States, are considered claims against the United States itself. *Balser v. Dep't of Justice, Office of U.S. Trustee*, 327 F.3d 903, 907 (9th Cir. 2003). Second, as a sovereign, the United States is "immune from suit unless it has waived its immunity." *Id.* Third, at no point in her briefing has Aguinaldo even addressed the Moving Defendants' argument concerning the United States' sovereign immunity. In other words, Aguinaldo has failed to identify any waiver of the United States' immunity. In addition, while certainly not their responsibility to do so, the Moving Defendants identify, in light of the Complaint's allegations, two of the most likely statutory provisions where a waiver, if any, might be found: the FTCA and the **IRC**. As the Moving Defendants explain, however, there is no such waiver under the facts here. *See* Dkt. No. 17-1 at 18-21. As a result, the Court lacks subject matter jurisdiction over any official capacity claims in this case. *Balser*, 327 F.3d at 907; *Nurse v. United States*, 226 F.3d 996, 1000 (9th Cir. 2000). Further, in light of the nature of Aguinaldo's claims discussed above, it would be futile for her to amend the same, as the Court can discern no amendment that would provide the subject matter jurisdiction that is evidently lacking.

2. Individual Capacity Claims

Liberally construed, Aguinaldo asserts claims alleging violations of her constitutional rights. Although the Complaint does not cite a source of authority to bring those claims, in *Bivens*, the Supreme Court "recognized for the first time an implied right of action for damages against federal officers alleged to have violated a citizen's constitutional rights." *Hernandez v. Mesa*, 137 S. Ct. 2003, 2006 (2017) (per curiam) (quotation marks and citation omitted). Specifically, *Bivens* allowed a plaintiff to sue individual federal agents for allegedly violating a Fourth Amendment right to be free from unreasonable searches and seizures. 403 U.S. at 389–90.

The Supreme Court has since severely restricted the *Bivens* doctrine. In fact, the Court has recognized the implied cause of action in other contexts only twice—once in *Davis v. Passman*, 442 U.S. 228 (1979), in which a U.S. Congressman was alleged to have discriminated against a staff member on the basis of her sex, in violation of the Fifth Amendment's Due Process Clause, and once in *Carlson v. Green*, 446 U.S. 14 (1980), in which federal prison officials were alleged to have failed to treat a prisoner's severe asthma, in violation of the Eighth Amendment's Cruel and Unusual Punishment Clause. "These three cases—*Bivens*, *Davis*, and *Carlson*—represent the only instances in which the Court" has placed its stamp of approval on a *Bivens* damages remedy, and the Court has "made clear that expanding the *Bivens* remedy is now a `disfavored' judicial activity." *Ziglar v. Abbasi*, 532 U.S. 120, 131, 135 (2017) (quoting *Iqbal*, 556 U.S. at 675).[5]

In 2017, in *Ziglar*, the Supreme Court articulated a two-part test for determining whether a *Bivens* remedy is available. *See Hernandez*, 140 S. Ct. 735, 743; *Ioane v. Hodges*, 939 F.3d 945, 951 [124 AFTR 2d 2019-5978] (9th Cir. 2018). At step one, the deciding court must "first inquire whether the request involves a claim that arises in a new context." *Id.* A case presents a new context if it "is different in a meaningful way from previous *Bivens* cases decided by [the Supreme Court]"—from *Bivens*, *Passman* , and *Carlson. See Ziglar*, 532 U.S. at 139. To help courts determine whether a case differs in a meaningful way from one of the *Bivens* trio, *Ziglar* offers the following non-exhaustive list of factors:

> A case might differ in a meaningful way because of the rank of the officers involved; the constitutional right at issue; the generality or specificity of the official action; the extent of judicial guidance as to how an officer should respond to the problem or emergency to be confronted; the statutory or other legal mandate under which the officer was operating; the risk of disruptive intrusion by the Judiciary into the functioning of other branches; or the presence of potential special factors that previous *Bivens* cases did not consider.

Id. at 139–40. If, after considering these factors, the case does *not* differ in any meaningful [pg. **2024** -1607] way from the *Bivens* trio of cases, the context is not "new," and the claim is cognizable.

Where the case *does* present a "new context," the deciding court proceeds to step two and considers (1) whether the plaintiff has any other alternative remedy for his injury and (2) whether there are any "special factors" that might lead the court to believe that Congress, instead of the Judiciary, is better suited to "weigh the costs and benefits" and authorize a right of action for damages. *Id.* at 136, 138, 149. If the answer to either question is "Yes," then *Bivens* cannot be extended to the new context.

Here, the premise of all of Aguinaldo's claims—that in some fashion, various officers or employees of the United States acted improperly in enforcing tax liens and ordering the foreclosure of the Honolulu property—is an entirely different context when compared to *Bivens* , *Passman*, and *Carlson*, none of which involved tax enforcement. Second, as the Moving Defendants explain in the motion to dismiss, Congress has provided taxpayers with alternative remedies to challenge alleged injuries arising from federal tax enforcement. *See* Dkt. No. 17-1 at 16 (citing 26 U.S.C. §§ 7422 (actions for a refund), 7432 (actions for damages from failing to release a lien), 7433 (actions for damages due to unauthorized tax collection)). Therefore, with a very different context and a pre-existing remedial scheme, *Bivens* cannot be extended to the claims here, and they must be dismissed for failure to state a claim. Further, in light of the foregoing inquiry under *Ziglar* and the nature of the allegations in the Complaint, leave to amend would be futile, as there is no amendment that could state a valid *Bivens* claim.[6] [7]

CONCLUSION

For the reasons set forth herein, Aguinaldo's claims against the Moving Defendants, as well as the other named Defendants, all of whom are allegedly federal officers or employees, either lack subject matter jurisdiction or fail to state a claim. In addition, leave to amend would be futile. Therefore, the motion to dismiss, Dkt. No. 17, is GRANTED and the motion to strike, Dkt. No. 25, is DENIED. The Complaint is DISMISSED IN FULL WITHOUT LEAVE TO AMEND.[8]

The Clerk is instructed to CLOSE this case.

IT IS SO ORDERED.

Dated: May 23, **2024** at Honolulu, Hawai'i.

Derrick K. Watson

Chief United States District Judge

1 In the Complaint, Defendant Curry's first and middle names are spelled "Ewdwin Oean". Dkt. No. 1-2 at 4. In the motion to dismiss, Defendants clarify the correct spelling is "Edwin Dean," Dkt. No. 17-1 at 1, which the Court uses herein.

2 A Rule 12(b)(1) motion can consist of a facial or factual attack on jurisdiction. *Safe Air for Everyone v. Meyer*, 373 F.3d 1035, 1039 (9th Cir. 2004). Here, the Moving Defendants appear to raise a facial attack, given that they challenge the sufficiency of the allegations in the Complaint. *See id.* ("In a facial attack, the challenger asserts that the allegations contained in a complaint are insufficient on their face to invoke federal jurisdiction. By contrast, in a factual attack, the challenger disputes the truth of the allegations that, by themselves, would otherwise invoke federal jurisdiction.")

3 To the extent necessary, relevant factual and procedural background is set forth in this Discussion section.

4 Aguinaldo, meanwhile, moves to strike the motion to dismiss. Dkt. No. 25. She provides no basis or reason to do so, though, and therefore the motion to strike is DENIED. Since Aguinaldo did not file any other document that even remotely resembles a response to Defendants' motion, the Court will construe the motion to strike as Aguinaldo's response or opposition to the motion to dismiss.

5 The Supreme Court has refused to extend *Bivens* to any new category of cases since *Carlson. See, e.g.*, *Bush v. Lucas*, 462 U.S. 367, 390 (1983) (First Amendment suit against a federal employer); *Chappell v. Wallace*, 462 U.S. 296, 297 (1983) (race-discrimination suit against military officers); *United States v. Stanley*, 483 U.S. 669, 671–72 (1987) (substantive due process suit against military officers); *Schweiker v. Chilicky* , 487 U.S. 412, 414 (1988) (procedural due process suit against Social Security officials); *FDIC v. Meyer*, 510 U.S. 471, 473–74 (1994) (procedural due process suit against a federal agency for wrongful termination); *Corr. Servs. Corp. v. Malesko*, 534 U.S. 61, 63 (2001) (Eighth Amendment suit against a private prison operator); *Wilkie v. Robbins*, 551 U.S. 537, 547–548, 562 (2007) (due process suit against officials from the Bureau of Land Management); *Minneci v. Pollard*, 565 U.S. 118, 120 (2012) (Eighth Amendment suit against prison guards at a private prison); *Ziglar*, 532 U.S. at 134–35 (Fifth Amendment suit against Department of Justice officials).

6 To the extent the Complaint can be construed as relying upon authority other than *Bivens* for the individual capacity claims, Aguinaldo failed to identify any such source–either in the Complaint or in her briefing on the motion to dismiss.

7 In discussing sovereign immunity and *Bivens* herein, the Court does not mean to suggest that the Moving Defendants do not have multiple other valid defenses to Aguinaldo's claims, such as personal immunity and collateral estoppel. The Court need not and does not reach those other defenses herein.

8 The Court notes that, apart from filing a Complaint, Aguinaldo has also filed a "Petition for Judicial Review of Agency Action" under 5 U.S.C. Section 702. Dkt. No. 9. Aguinaldo, however, cannot use this action as a vehicle to also petition review of agency action. Therefore, the Court does not further address or consider the Petition herein. Finally, on May 6, **2024**, Aguinaldo filed a motion for leave to sell real property and place into court the stated claim of debt owed upon the below terms (motion for sale), Dkt. No. 31, which appears to seek the exact same relief that was denied in the Tax Case. In any event, given the disposition of this case, the motion for sale is DENIED AS MOOT.

END OF DOCUMENT -

American Federal Tax Reports

U.S. v. EATON CORP., Cite as 133 AFTR 2d 2024 -1554, Code Sec(s) 7602; 482, (DC OH), 05/16/2024

UNITED STATES OF AMERICA, PETITIONER v. EATON CORPORATION, RESPONDENT.

Case Information:

[pg. **2024** -1554]

Code Sec(s):	7602; 482
Court Name:	U.S. District Court, Northern Dist. of Ohio,
Docket No.:	CASE NO. 1:23-mc-00037,
Date Decided:	05/16/**2024**.
Prior History:	District Court, (**2024**, DC OH) 133 AFTR 2d **2024** -352, rejected.
Tax Year(s):	Years 2017, 2018, 2019.
Disposition:	Decision for Govt.

HEADNOTE

1. Summons enforcement—procedure—legitimate purpose—comity. Magistrate judge's recommendation to deny govt.'s petition to enforce IRS summons on corp. for confidential performance evaluations for number of foreign employees relating to investigation of corp.'s transfer pricing methodology was rejected, and summons was enforced. While magistrate applied heightened/civil discovery relevance standard because summons involved employee personnel records, that was incorrect as IRS summons authority [pg. **2024** -1555] allowed IRS to request even potentially relevant documents; and govt. showed that evaluations could be relevant as they were likely to contain project-specific information about employees' work on intellectual property at issue in this IRS investigation. Taxpayer's arguments that evaluations weren't relevant to IRS's investigation and that IRS's failure to accept "less-intrusive alternatives" such as witness interviews constituted abuse of process were unavailing. Also, compliance with summons wouldn't violate foreign data privacy law; and balance of comity factors weighed in favor of disclosure.

Reference(s): Code Sec. 7602;Code Sec. 482

OPINION

UNITED STATES DISTRICT COURT NORTHERN DISTRICT OF OHIO,

OPINION & ORDER

Judge: JAMES S. GWIN, UNITED STATES DISTRICT JUDGE

[Resolving Docs. 1, 17, 18]

In this case, the government petitions the Court to enforce an Internal Revenue Service (IRS) administrative summons issued to Respondent Eaton Corporation. The Court referred the government's petition to a Magistrate Judge for a report and recommendation (R&R).

Before the Magistrate Judge issued his R&R, the parties reached an agreement over many of the summonsed documents. After reaching this agreement, only a single dispute remained: whether Eaton needed to produce certain foreign employees' performance evaluations.

Respondent Eaton argues that the government has not satisfied its IRS summons enforcement burden as to those foreign employees' performance evaluations. And according to Eaton, even if the government had met its burden, the European Union's (EU) privacy law—the General Data Protection Regulation (GDPR)—prohibits Eaton from producing those performance evaluations to the IRS. So, Eaton says, comity requires the Court to not enforce the IRS summons as to those evaluations.

The Magistrate Judge agreed with Eaton and recommended that the Court deny the government's petition. The government timely filed objections.

Because the government has met its burden to enforce the IRS summons and neither the GDPR nor comity prevent enforcement, the Court SUSTAINS the government's objections, REJECTS the R&R, and ENFORCES the IRS administrative summons as to the foreign employees' performance evaluations.

I. BACKGROUND

The IRS is conducting a federal income tax audit for the 2017–19 tax years. The tax audit centers on whether Respondent Eaton violated transfer pricing rules after Eaton assigned certain intellectual property rights to Eaton's Irish affiliate. Specifically, the IRS is investigating whether, after it transferred ownership rights to its Irish affiliate, Eaton improperly lowered its United States tax burden by paying inflated royalties to its Irish affiliate for the right to use the intellectual property.

To understand why transfer pricing can be a concern, consider what happens when a U.S. company purchases supplies from foreign company. By spending money on purchasing supplies, the U.S. company incurs costs. Those costs are deductible,[1] so the costs reduce the U.S. company's taxable income. By the same token, the money that the foreign company receives for those supplies is taxable income, so the foreign company's tax burden increases.

There is nothing concerning about such a business transaction when the transaction runs between two independent companies and is negotiated at arm's length. But there is abuse potential when a company internally transfers assets between its U.S. and foreign affiliates. Especially when the foreign affiliate operates in a jurisdiction with lower corporate tax rates.

Because the two affiliates are formally separate entities that pay taxes to different governments, the two affiliates must separately account for their profits and losses.

For example, if the U.S. affiliate pays royalties to use the foreign affiliate's intellectual property, those royalties are accounted for as costs to the U.S. affiliate (reducing tax burden) and profit to the foreign affiliate (increasing tax burden). Transfer price refers to this intracompany accounting.

However, the U.S. and foreign affiliate operate under the same corporate umbrella, so the profits and losses incurred by transferring assets between the two affiliates do not affect the parent company's bottom line. To save taxes for the parent company, the two affiliates could inflate transfer pricing to artificially reduce taxable income in high-tax countries while artificially increasing taxable income in low-tax countries. [pg. **2024** -1556]

Driven by these concerns, Congress enacted **I.R.C.** § 482.[2] Along with its implementing regulations, § 482 gives the IRS authority to adjust transfer price to what a "counterfactual arm's-length transaction `with an uncontrolled taxpayer'" would have yielded.[3]

In seeking to determine the hypothetical transfer price that an arm's length negotiation between Eaton and its Irish affiliate would have yielded, the IRS served administrative summons on Eaton. The summons requested employee performance evaluations from certain domestic and foreign Eaton employees.

The IRS says that these performance evaluations will allow it to assess how much domestic employees contributed to the intellectual property at issue as compared to how much foreign employees contributed.[4] This, the IRS says, will allow it to determine the appropriate way to allocate that intellectual property's value between Eaton and Eaton's Irish affiliate for transfer pricing purposes.

Eaton did not comply with the IRS's summons, so the government filed a petition to enforce the summons.[5] This Court referred the government's petition to a Magistrate Judge for an R&R.[6] While the referral was pending, the parties settled regarding domestic employee performance evaluations.[7]

But the parties continued to disagree on whether Eaton needed to produce foreign employee performance evaluations.

The parties briefed this issue to the Magistrate Judge.[8] The Magistrate Judge then issued an R&R recommending that the Court deny the government's enforcement petition as to Eaton's foreign employee performance evaluations.[9] The government timely objected,[10] and the parties fully briefed the government's objections.[11]

II. DISCUSSION

Respondent Eaton makes two arguments against enforcing the IRS summons. First, Eaton says that the government has failed to meet its burden for enforcing the IRS summons. Second, Eaton says that even if the government met its burden, the Court should not enforce the summons under comity principles because EU privacy law (the GDPR) prohibits Eaton from sending employee performance evaluations to the United States. Neither argument succeeds.

A. IRS Summons Enforcement

Congress has granted the IRS "expansive information-gathering authority" to determine if taxes have been properly paid.[12] Consistent with this information-gathering authority's expansiveness, the government must satisfy only a minimal burden before it can enforce an IRS summons.

Specifically, the government need only make a prima facie case showing "[1] that the investigation will be conducted pursuant to a legitimate purpose, [2] that the inquiry may be relevant to the purpose, [3] that the information sought is not already within the [IRS] Commissioner's possession, and [4] that the administrative steps required by the Code have been followed."[13]

The required prima facie showing is not very demanding.[14] Often, the government can make the necessary showing by simply submitting an affidavit from the IRS agent who issued the administrative summons.[15]

Once the government makes its prima facie showing, the burden shifts to the responding party. At this point, the responding party must show that enforcing the summons would be an "abuse of the court's process" in order to defeat enforcement.[16] In contrast to the govern[pg. **2024** -1557] ment's light burden, the responding party's burden is "a heavy one."[17]

1. Prima Facie Case

Respondent Eaton focuses its challenge solely on the prima facie case's relevance element. Eaton argues that the summonsed foreign employee performance evaluations are not relevant enough to the IRS's transfer pricing investigation to justify enforcing the IRS summons. The Magistrate Judge agreed. But in reaching that conclusion, the Magistrate Judge placed too high a burden on the government.

The Magistrate Judge applied a heightened relevance standard to the IRS's summons because the summons involved employee personnel records.[18] The Magistrate Judge required this heightened relevance standard in reliance upon a district court's decision in a previous IRS summons dispute between Eaton and the government—*Eaton I.*[19]

In *Eaton I*, Respondent Eaton argued that federal law requires a "*compelling* showing of relevance" before courts can order personnel records to be produced.[20] The *Eaton I* court accepted that argument, denying the IRS's request for employee performance evaluations because the IRS failed to "persuasively demonstrate[] the relevance of [an employee]'s performance evaluations."[21]

The Court disagrees with *Eaton I.* To justify the higher relevance standard, *Eaton I* cited to a non-binding district court case involving civil discovery.[22] And in defending the *Eaton I* standard, Respondent Eaton similarly relies on cases about civil discovery.[23]

Civil discovery, though, operates under a different framework than IRS summons enforcement actions. Congress has not provided the same "expansive" investigative authority to civil litigants that Congress gave to the IRS.

Civil litigants can only seek discovery that "is relevant...and proportional to the needs of the case."[24] Put differently, civil discovery weighs relevance against burden. By contrast, the IRS's summons authority is much broader.

For one, the IRS summons standard does not require a court to weigh relevance against burden. In fact, the Supreme Court has rejected a requirement that "the IRS must conduct its investigations in the least intrusive way possible."[25]

The IRS summons relevance standard is also less demanding than the civil discovery relevance standard. **I.R.C.** § 7602, which creates the IRS's summons authority, allows the IRS to request any documents that "*may* be relevant" to the IRS's investigation. [26] This means that "even *potential* relevance to an ongoing [IRS] investigation" justifies an IRS summons.[27] Put differently, the IRS "should not be required to establish that the documents it seeks are actually relevant in any technical, evidentiary sense."[28]

Given that IRS summons authority is broader than civil discovery, there is little reason to import civil discovery limitations into the IRS summons context. In fact, the opposite is true: courts should avoid bringing civil discovery limitations into IRS summons enforcement actions. That is because, "[w]hile § 7602 is subject to the traditional privileges and limitations, any other restrictions upon the IRS summons power should be avoided absent unambiguous directions from Congress."[29]

The Court is not aware of any an unambiguous Congressional instruction protecting employee personnel records from IRS summons, nor has Eaton pointed to one. And at least one court has explicitly rejected the argument that employee privacy concerns defeat an IRS summons.[30]

As that court observed, "IRS investigations `unquestionably involve some invasion of privacy.'"[31] The IRS regularly handles sensitive and private taxpayer financial information. It would be strange to carve out employee personnel records for greater protection from IRS summons authority while allowing equally (or [pg. **2024** -1558] more) sensitive financial records to be requested under the usual low IRS summons relevance bar.

Applying the correct "may be relevant" standard, the Court finds that the government has made a prima facie relevance showing.

Through an IRS agent declaration, the government explained that, according to multiple Eaton employee interviews, Eaton's employee performance evaluations are likely to contain information about employees' work on the intellectual property at issue in this IRS investigation.[32] Specifically, the performance evaluations might quantify how much an employee matured a technology, track technology project milestones, or document how successfully an employee completed her projects.[33]

The IRS agent said that this type of information could show how much control Eaton maintained over its intellectual property even after that intellectual property was transferred to Eaton's Irish affiliate.[34] In turn, information about Eaton's control level over the transferred intellectual property could help the IRS determine how much of that intellectual property's value should be attributed to Eaton.

The government did not need to establish relevance with any particular certainty. The government needed only to show that the performance evaluations sought *might* be relevant. The IRS's reasons for requesting those evaluations, backed by interviews, are enough to make out the necessary prima facie case.[35]

2. Burden Shifting

Respondent Eaton's two counterarguments against enforcement also do not meet Eaton's heavy burden to show an abuse of process.

To begin, Eaton argues that its employee performance evaluations are not relevant to the IRS's transfer pricing investigation. To make this argument, Eaton relies on affidavits from its Vice President of Tax. With those affidavits, Eaton's Vice President points to evidence suggesting that the requested performance evaluations do not contain the information that the IRS seeks.[36]

But Eaton's burden is not simply to negate the government's prima facie case.[37] Eaton must go further and show that there is an abuse of process. Perhaps a lack of relevance could support an abuse of process argument if the requested performance evaluations were so obviously irrelevant that the IRS's request would do nothing more than harass Eaton. That is not the case here.

At most, the competing IRS and Eaton declarations and affidavits show a legitimate disagreement about what information the evaluations contain and their relevance. Because § 7602 authorizes the IRS to summons even *potentially* relevant documents,[38] mere disagreement does not show an abuse of process. If the IRS has a good faith belief in the requested documents' relevance, § 7602 expressly allows the IRS to summons those documents even if the IRS's belief ends up being misplaced. As the Court discussed above, the government has met that low relevance bar.

Eaton's second counterargument fares no better. Eaton says that instead of producing the requested employee performance evaluations, Eaton is willing to make those employees available for interviews. Eaton suggests that the IRS's refusal to take Eaton's offer should defeat the government's enforcement action.

Again, this argument is not enough to show an abuse of process. The IRS has legitimate reasons to request the performance evaluations rather than employee interviews. Employee interviews might not be as useful as the contemporaneous employee performance evaluations because the employees' memories might have faded. And the performance evaluations might also help guide the IRS's questions during later employee interviews.

More fundamentally, the IRS does not need to conduct its investigation in the least intrusive way.[39] There is no abuse of process when the IRS turns down a potentially less intrusive avenue for investigation. [pg. **2024** -1559]

Perhaps if the IRS's chosen investigative methods were significantly more intrusive than reasonable alternatives, that fact might support an abuse of process finding. But that is not the case here.

In some ways, making employees available for interview is *more* intrusive than producing the employees' performance evaluations because such interviews distract the employees from their job duties. And those distractions multiply if Eaton needs to take the time to prepare the employees for interviews as well.

Producing a small set of documents, on the other hand, would take less time and would allow Eaton's employees to continue working on their responsibilities.

Respondent Eaton is effectively arguing that the IRS must follow Eaton's preferred investigatory methods. There is no authority justifying that stance.

***

The government has met its burden to show a prima facie case for enforcing the IRS summons at issue here. And Eaton has failed to rebut that showing by demonstrating enforcement would be an abuse of process. Therefore, the IRS can enforce its summons against Eaton.

B. Foreign Law Considerations

Next, Eaton argues that whether the government has met its enforcement burden, European privacy law blocks Eaton from producing the foreign employee performance evaluations.

However, "[f]oreign `blocking statutes' do not `deprive an American court of the power to order a party subject to its jurisdiction to produce evidence even though the act of production may violate that statute.'"[40]

Although foreign law may bar an American court from ordering a document production, foreign law does so only when (1) producing the requested documents would violate foreign law, and (2) comity analysis weighs in favor of denying the requested documents.[41] The party opposing production bears the burden of satisfying this two-part test.[42]

1. Foreign Privacy Law

Respondent Eaton says that producing the foreign employee performance evaluations would violate a European Union (EU) regulation known as the GDPR. [43]

The GDPR is a comprehensive privacy regulation that protects European citizens' personal data. The GDPR's scope is broad, covering "any information relating to an identified or identifiable natural person." [44] Employee performance evaluations are protected personal data under the GDPR's broad scope.

As relevant in this case, the GDPR generally prevents companies from transferring European citizens' personal data outside of EU member states. [45] This general prohibition on transfer includes transfers to the United States.[46]

So, unless a GDPR exception (known as a derogation) applies, Respondent Eaton would be violating the GDPR by producing its foreign employee performance evaluations to the IRS.

Here, the GDPR Article 49(1)(d) derogation applies, which permits personal-data transfers out of the EU when "the transfer is necessary for important reasons of public interest."[47]

The European Data Protection Board has promulgated guidance regarding this "important public interest derogation."[48] In its guidance, the Data Protection Board explains that this derogation has two elements: (1) that the transfer is necessary or legally required, and (2) that the transfer is based on important public interest grounds.[49]

In this case, producing the foreign employee performance evaluations is legally required because the government has satisfied its summons enforcement burden.

The remaining issue is whether such production is based on an important public interest. On this point, the Data Protection Board's guidance makes clear that "only public inter[pg. **2024** -1560] ests recognized in [European] Union law or in the law of the Member State to which the [personal data's] controller is subject can lead to the application of this derogation." [50]

It is not enough that an EU member state and the country seeking the European personal data share a common public interest in the abstract. [51] For example, the fact that both the United States and Ireland have an interest in accurately collecting taxes does not support applying the public interest derogation.

Rather, the public interest derogation applies only when "it can also be deduced from EU law or the law of the member state to which the controller is subject that such data transfers are allowed for important public interest purposes including in the spirit of reciprocity for international cooperation."[52] "The existence of an international agreement or convention which recognises a certain objective and provides for international cooperation to foster that objective can be an indicator when assessing the existence of a public interest...as long as the EU or the Member States are a party to that agreement or convention." [53]

Such an international convention exists between Ireland (the EU member state where Eaton's foreign affiliate is located) and the United States. Specifically, the two countries signed a tax convention in 1997.[54]

As the tax convention's preamble indicates, the convention's objective is "the prevention of fiscal evasion with respect to taxes on income and capital gains."[55] Significantly, Article 7 offers principles for how business profits should be attributed between affiliated U.S. and Irish entities,[56] the crux of the IRS's tax investigation in this case.

Moreover, Article 27 expressly provides for cooperation and information sharing between the United States and Ireland to achieve the tax convention's purposes.[57]

The U.S.-Ireland tax convention therefore satisfies the important public interest derogation. Eaton would not violate European law by producing foreign employee performance evaluations, and Eaton must produce those evaluations.

2. Comity Analysis

Even if producing the foreign employee performance evaluations would violate the GDPR, the comity analysis weighs in favor of enforcing the IRS summons. The comity analysis requires the Court to weigh five factors:

> ((1)) the importance to the litigation of the documents or other information requested;
>
> ((2)) the degree of specificity of the request;
>
> ((3)) whether the information originated in the United States;
>
> ((4)) the availability of alternative means of securing the information; and
>
> ((5)) the extent to which noncompliance with the request would undermine important interests of the United States, or compliance with the request would undermine important interest of the state where the information is located. [58]

Of these factors, balancing the relevant countries' national interests is the most important.[59] So, the Court begins with the countries' interests.

The United States has a paramount interest in collecting taxes, including investigating potential underpayment. That is because taxes and their collection are "the lifeblood of government."[60] So, compared to civil discovery, "[IRS] summonses appear to serve a more pressing national function."[61] And "[s]uch summonses are also more widely recognized in the international community than the broad civil discovery permitted in American courts."[62] [pg. **2024** -1561]

Along those lines, Ireland has little interest in blocking the United States' tax investigation. The U.S.-Ireland tax convention shows that Ireland has an interest in cooperating with the United States to ensure that taxes are appropriately allocated between the two countries.

True, the GDPR suggests that Ireland has an interest in protecting its citizens' private information, such as the performance evaluations at issue here. But Ireland's tax cooperation interest outweighs Ireland's privacy interest.

As discussed above, the GDPR's important public interest derogation allows European entities to send personal data abroad to serve interests found in an EU member state's treaty.[63] This shows that Ireland's specific treaty-based interests trump Ireland's general privacy interest.

Even if the public interest derogation did not formally apply, the derogation's existence suggests that Ireland's treaty-based interests at least significantly mitigate Ireland's privacy interest. So, the United States' tax collection interest in this case would still be far greater than Ireland's countervailing privacy interests.[64]

Therefore, the fifth factor—the countries' interests—weighs strongly in favor of enforcing the IRS summons.

However, the first four factors mostly cancel each other out.

The first factor weighs against enforcement because the performance evaluations are not particularly important to the IRS's investigation. Although the government has shown that the evaluations may be relevant to the IRS investigation, that relevancy showing is weak.

The second factor weighs in favor of enforcement because the IRS summons is requesting a discrete and narrow document set. The IRS requested 43 total performance evaluations over a three-year period.[65] Because that number includes U.S. employee evaluations, the number of European employee evaluations at issue here is even less.

The third factor weighs against enforcement because the performance evaluations were created in Europe, not in the United States.

And the fourth factor weighs in favor of enforcement. Although Eaton offers employee interviews as an alternative to producing performance evaluations, the Court explained above that interviews are not a perfect substitute.[66] And the parties have not identified any other potential alternative to the performance evaluations.

Because two of the first four comity factors weigh in favor of enforcement while two weigh against, the first four factors are roughly are roughly neutral when taken together. At best for Eaton, the four factors weigh slightly against enforcement.

But the fifth comity factor weighs strongly in favor of enforcement. Adding the fifth (and most important) comity factor into the mix tilts the weighing towards enforcement.

For these reasons, the comity analysis favors enforcing the IRS summons.

III. CONCLUSION

The Court GRANTS the government's petition to enforce the IRS summons. Because the government has offered to allow Eaton to redact some irrelevant but private information from the requested performance evaluations, the parties shall submit a stipulated protective order to the Court within fourteen (14) days of this Order. The stipulated protective order should specify the redaction scope and any other privacy limitations that the parties agree are appropriate. Eaton shall produce the requested foreign employee performance evaluations to the IRS within fourteen (14) days after the Court enters the parties' stipulated protective order.

IT IS SO ORDERED.

Dated: May 16, **2024**

s/ James S. Gwin

JAMES S. GWIN

UNITED STATES DISTRICT JUDGE

---

1 *Eaton Corp. & Subsidiaries v. Comm'r*, 47 F.4th 434, 437 [130 AFTR 2d 2022-5746] (6th Cir. 2022).

2 *Eaton Corp. & Subsidiaries*, 47 F.4th at 437.

3 *Id.* (quoting Treas. Reg. § 1.482-1(b)(1)).

4 Doc. 13-1 at ¶ 10.

5 Doc. 1.

6 Doc. 2.

7 Docs. 9, 11.

8 Docs. 12, 13, 16.

9 Doc. 17.

10 Doc. 18.

11 Docs. 19, 20-1.

12 *Byers v. U.S. Internal Revenue Serv.*, 963 F.3d 548, 552 [126 AFTR 2d 2020-5023] (6th Cir. 2020) (quoting *United States v. Arthur Young & Co.*, 465 U.S. 805, 816 [53 AFTR 2d 84-866] (1984)).

13 *Id.* (quoting *United States v. Powell*, 379 U.S. 48, 57–58 [14 AFTR 2d 5942] (1964)) (numberings added; other alterations in original).

14 *Id.* ("[T]his prima-facie burden 'isn't much of a hurdle.'") (quoting *2121 Arlington Heights Corp. v. I.R.S.*, 109 F.3d 1221, 1224 [79 AFTR 2d 97-1793] (7th Cir. 1997)).

15 *United States v. Monumental Life Ins. Co.*, 440 F.3d 729, 733 [97 AFTR 2d 2006-1337] (6th Cir. 2006); *Kondik v. United States* , 81 F.3d 655, 656 [77 AFTR 2d 96-1857] (6th Cir. 1996); *United States v. Will*, 671 F.2d 963, 966 [49 AFTR 2d 82-768] (6th Cir. 1982).

16 *Kondik*, 81 F.3d at 656 (citation omitted).

17 *Id.* (citing *United States v. LaSalle Nat'l Bank*, 437 U.S. 298, 316 [42 AFTR 2d 78-5198] (1978)).

18 Doc. 17 at 5–9.

19 *United States v. Eaton Corp.*, Nos. 12-mc-24, 12-mc-25, 12-mc-26, 12-mc-27, 2012 WL 3486910 [110 AFTR 2d 2012-5638] (N.D. Ohio Aug. 15, 2012) ("*Eaton I*").

20 *Id.* at *13.

21 *Id.* at *14.

22 *Id.* at *13 (citing *Miller v. Fed. Express Corp.*, 186 F.R.D. 376, 384–85 (W.D. Tenn. 1999)).

23 Doc. 19 at 5–6 (collecting cases).

24 Fed. R. Civ. P. 26(b)(1).

25 *Tiffany Fine Arts, Inc. v. United States*, 469 U.S. 310, 323 [55 AFTR 2d 85-491] (1985).

26 **I.R.C.** § 7602(a)(1) (emphasis added).

27 *Arthur Young*, 465 U.S. at 814.

28 *Id.*

29 *Arthur Young*, 465 U.S. at 816 (internal quotation marks and citations omitted).

30 *2121 Arlington Heights*, 109 F.3d at 1225.

31 *Id.* (quoting *United States v. Bisceglia*, 420 U.S. 141, 146 [35 AFTR 2d 75-702] (1975)).

32 Doc. 13-1 at ¶¶ 5–9.

33 *Id.*

34 Doc. 13-1 at ¶ 10.

35 Respondent Eaton did not contest the other three prima facie elements, and the Court notes that the government satisfied those elements through an IRS agent's declaration. *See* Doc. 1-1.

36 Doc. 16-1 at ¶¶ 6–7.

37 Parties cannot offer opposing evidence to defeat a prima facie case. *See Prima Facie Case*, *Black's Law Dictionary* (11th ed. 2019) (noting that the prima facie standard tests whether the proponent of the prima facie case has "produc[ed] enough evidence to allow the fact-trier to infer the fact at issue," not whether the opposing party has rebutted the proponent's argument with the opposing party's own evidence); *cf. Cline v. Cath. Diocese of Toledo*, 206 F.3d 651, 663 n.7 (6th Cir. 2000) (collecting cases holding that courts should not consider a defendant's opposing evidence at the prima facie stage of a Title VII *McDonnell Douglas* analysis). Rather, parties must show that the government's own affidavits and evidence are insufficient to establish a prima facie case. Therefore, Eaton's arguments based on Eaton's own opposing evidence go towards Eaton's burden to show abuse of process, not towards the government's prima facie burden.

38 **I.R.C.** § 7602(a)(1) (the IRS can summons documents that "may be relevant" to the IRS's investigation).

39 *Tiffany Fine Arts*, 469 U.S. at 323.

40 *Owen v. Elastos Found.*, 343 F.R.D. 268, 282 (S.D.N.Y. **2023**) (quoting *Sociét é Nationale Industrielle A é rospatiale v. U.S. Dist. Ct. for S. Dist. of Iowa*, 482 U.S. 522, 544 n.29 (1987)).

41 *Kashef v. BNP Paribas S.A.*, No. 16-cv-3228 (AKH) (JW), 2022 WL 1617489, at *2 (S.D.N.Y. May 23, 2022) (citations omitted).

42 *Knight Cap. Partners Corp. v. Henkel Ag & Co., KGaA*, 290 F. Supp. 3d 681, 689 (E.D. Mich. 2017) (citation omitted); *In re Air Crash at Taipei, Taiwan on Oct. 31, 2000*, 211 F.R.D. 374, 377 (C.D. Cal. 2002) (quoting *United States v. Vetco, Inc.*, 691 F.2d 1281, 1288 [47 AFTR 2d 81-1540] (9th Cir. 1981)).

43 The IRS requested performance evaluations for two Indian employees not covered by the GDPR. While Eaton says that India recently passed a GDPR-like privacy law, that privacy law has not yet come into effect. So, Eaton must produce the Indian employees' performance evaluations because the government has met its enforcement burden.

44 *In re Mercedes-Benz Emissions Litig.*, No. 16-cv-881 (KM) (ESK), 2020 WL 487288, at *1 (D.N.J. Jan. 30, 2020) (quoting GDPR Art. 4(1)).

45 *Id.*

46 *Id.*

47 GDPR Art. 49(1)(d).

48 Eur. Data Prot. Bd., *Guidelines 2/2018 on Derogations of Article 49 Under Regulation 2016/679* at 10–11, https://www.edpb.europa.eu/sites/default/files/files/file1/edpb_guidelines_2_2018_derogations_en.pdf [hereinafter *GDPR Guidance*].

49 *Id.* at 10.

50 *GDPR Guidance* 10.

51 *Id.*

52 *Id.*

53 *Id.*

54 *Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains*, S. Treaty Doc. No. 105-31, 1997 WL 602448 (July 28, 1997) ("*U.S.-Ireland Tax Convention*").

55 *Id.* at *4.

56 *U.S.-Ireland Tax Convention*, 1997 WL 602448 at *9–10.

57 *Id.* at *27–28.

58 *Sociét é Nationale*, 482 U.S. at 544 n.28 (citation omitted).

59 *In re Grand Jury Investigation of Possible Violations of 18 U.S.C. § 1956 & 50 U.S.C. § 1705*, 381 F. Supp. 3d 37, 77 (D.D.C. 2019) (holding that "the interests of the relevant countries" is the "most important factor"), *aff'd sub nom. In re Sealed Case*, 932 F.3d 915 (D.C. Cir. 2019); *Richmark Corp. v. Timber Falling Consultants*, 959 F.2d 1468, 1476 (9th Cir. 1992) (the "balance of national interests" is "the most important factor"); *Inventus Power v. Shenzhen Ace Battery*, 339 F.R.D. 487. 504 (N.D. Ill. 2021) (quoting *Wultz v. Bank of China Ltd.*, 910 F. Supp. 2d 548, 558 (S.D.N.Y. 2012)).

60 *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 350 [39 AFTR 2d 77-475] (1977) (quoting *Bull v. United States* , 295 U.S. 247, 259 [15 AFTR 1069] (1935)); *see also Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15, 21 (2000) (the government has a "vital interest...in acquiring its lifeblood, revenue").

61 *Vetco*, 691 F.2d at 1288.

62 *Id.* (citations omitted).

63 *Supra* Section II.B.1.

64 The government has also offered to allow Eaton to redact irrelevant but private information from the employee performance evaluations. Doc. 18 at 11 n.6. This further reduces Ireland's privacy interest in this case.

65 Doc. 1-1 at PageID #: 9–12.

66 *Supra* Section II.A.2.

END OF DOCUMENT -

American Federal Tax Reports

COGNIZANT TECHNOLOGY SOLUTIONS CORP. v. U.S., Cite as 133 AFTR 2d 2024 -1498, Code Sec(s) 7402, (DC NJ), 05/09/2024

COGNIZANT TECHNOLOGY SOLUTIONS CORPORATION, ET AL., PLAINTIFFS/MOVANTS v. UNITED STATES INTERNAL REVENUE SERVICE, ET AL., DEFENDANTS/RESPONDENTS.

Case Information:

[pg. **2024** -1498]

Code Sec(s):	7402
Court Name:	U.S. District Court, Dist. of New Jersey,
Docket No.:	Civil Action No. 23-3320 (PGS) (RLS),
Date Decided:	05/09/**2024**.
Disposition:	Decision for Plaintiffs.

HEADNOTE

1. District court procedure—qui tam suits—False Claims Act—subpoenas—Administrative Procedure Act. In qui tam suit brought by technology co.'s former employee, alleging that co. fraudulently misused certain work visas for foreign workers, magistrate judge determined that IRS's and Labor Dept.'s refusals to comply with records requests and subpoenas which co. served pursuant to IRS's and Labor Dept.'s respective administrative procedures were arbitrary and capricious, and accordingly granted co.'s motion to compel.

Reference(s): Code Sec. 7402

OPINION

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NEW JERSEY,

[pg. **2024** -1499]

MEMORANDUM OPINION AND ORDER

Judge: RUKHSANAH L. SINGH, UNITED STATES MAGISTRATE JUDGE

PRESENTLY before the Court is a Motion by Cognizant Technology Solutions Corporation and Cognizant Technology Solutions U.S. Corporation (collectively, "Cognizant") to compel the United States Internal Revenue Service (the "IRS") and the United States Department of Labor (the "DOL") (collectively, the "Agencies") to produce records responsive to requests and subpoenas served pursuant to the Agencies' respective administrative procedures.[1] On April 28, **2023**, Cognizant initiated the above-captioned matter in the United States District Court for the District of Columbia; on June 7, **2023**, the District of Columbia transferred this matter to this Court because the underlying action is pending here, at *Franchitti v. Cognizant Tech. Solutions Corp.*, Civ. No. 17-6317 (D.N.J.)[2] (the "Underlying Action").[3] The Court considers the Motion together with briefing related to the subpoenas that the parties previously filed in the Underlying Action, including the Agencies' respective Cross-Motions to Quash.[4] On March 11, **2024**, the Court heard oral argument on the Motions. For the reasons set forth below, and for good cause shown, Cognizant's Motion to Compel is hereby GRANTED and the Agencies' respective Cross-Motions to Quash are DENIED.

I. RELEVANT BACKGROUND AND PROCEDURAL HISTORY

As the facts are well-known to the parties and the Court, they are not set forth at length. Instead, only those facts and procedural history related to the instant Motions are discussed herein.

A. THE UNDERLYING ACTION

The above-captioned matter relates to a *qui tam* matter initiated on August 22, 2017 by Relator Jean-Claude Franchitti ("Relator"), whom Cognizant had previously employed. In general terms, Relator alleges that Cognizant fraudulently misused certain work visas to import and employ foreign workers in violation of the False Claims Act ("FCA"), 31 U.S.C. §§ 3729-3733.[5] The United States declined to intervene by way of Notice of Election publicly filed on July 17, 2020.[6] On January 27, 2021, Relator filed a First Amended Complaint ("FAC") in response to Cognizant's motion to dismiss.[7] On February 17, 2021, Cognizant moved to dismiss the FAC.[8] On August 17, 2021, the Court granted in part and denied in part Cognizant's motion to dismiss, sustaining Relator's reverse false claim brought pursuant to 31 U.S.C. § 3729(a)(1)(G) and dismissing Relator's FCA claims brought pursuant to 31 U.S.C. § 3729(a)(1)(A) and (B).[9]

On or about May 19, 2022, Cognizant served requests pursuant to *United States ex rel. Touhy v. Ragen*, 340 U.S. 462 (1951) ("*Touhy*"), together with a subpoena on the DOL, seeking the production of certain documents (the "DOL Subpoena").[10] Subsequently, on October 20, 2022, Cognizant served requests pursuant to *Touhy* and a subpoena on the IRS, seeking the production of certain documents (the "IRS Subpoena").[11]

B. THE DOL SUBPOENA AND TOUHY REQUESTS

Through the DOL Subpoena, Cognizant sought the following documents:

(a)) All requests under the Freedom of Information Act ("FOIA") received by the Department of Labor regarding Cognizant's payment of wages or other compensation to its employees, including non-citizen employees in the United States on a visa ("visa workers"), and including payment of prevailing wages;

(b)) Copies of any documents produced in response to the above-described FOIA requests;

(c)) All audits, analyses, or reviews of Cognizant's payment to its employees authorized to work in the U.S. under temporary visas and payment of prevailing wages undertaken by, or at the direction of, the Department of Labor; [pg. **2024** -1500]

(d)) All Department of Labor reports or analyses about payment of prevailing wages by employer sponsors under the H-1B program;[12] and

(e)) All communications to, or from, third parties about Cognizant's payment of visa workers and payment of prevailing wages, including but not limited to communications with Relator or Relator's agents.[13]

In the DOL Subpoena, Cognizant asserted that the sought-after documents relate to its defense under the Public Disclosure Bar and whether the alleged false statements were "material" within the FCA.[14]

Following service of the DOL Subpoena, Cognizant met and conferred with the DOL regarding the DOL Subpoena.[15] The DOL objected at that time to Request (d) based on overbreadth and undue burden and to Request (e) based on overbreadth.[16] Cognizant offered to consider narrowing Request (d) and provide a list of "Relator's agents" to narrow Request (e).[17] Cognizant also provided search terms for Requests (e)[18] and (d).[19] Subsequently, the DOL produced documents responsive to Requests (a), (b), (c), and, in part, (e). Relevant here, in response to Request (e), the DOL declined to search emails containing the term "Cognizant" on the basis of overbreadth and undue burden. In a letter dated October 7, 2022, the DOL advised Cognizant of its formal agency determination as to the DOL Subpoena and *Touhy* requests, re-asserting its previous objections and asserting new ones based on privilege.[20]

Thereafter, Cognizant and the DOL continued to meet and confer as to Request (d). In so doing, Cognizant provided search terms relating to seven similarly situated employers (the "Similarly Situated Employers"). Following a search using those terms, the DOL notified Cognizant in a letter dated February 17, **2023** that Cognizant failed to comply with the DOL's *Touhy* requirements by not sufficiently describing the relevance of the records sought in Request (d) and that review and production of responsive documents located in the course of the DOL's search would be unduly burdensome.[21] Primarily, the DOL disputed the merits of Cognizant's legal theory regarding the Public Disclosure Bar based on Third Circuit law, contending that public disclosures about comparator companies do not trigger the Bar.[22] The DOL also maintained that Cognizant failed to identify why DOL information as to competitors' visa practices would be material to the DOL's determination of whether there was "reasonable cause" to believe that Cognizant violated certain visa requirements.[23]

C. THE IRS SUBPOENA AND TOUHY REQUESTS

Through the IRS Subpoena, Cognizant sought documents responsive to the following requests:

(a)) All requests under the Freedom of Information Act ("FOIA") that the IRS has received from August 22, 2007 to present related to the use of the H-1, L-1, or B-1 visa programs by Cognizant, including the payment of payroll taxes to the IRS from the salaries of employees dependent upon such visa programs, and any documents produced in response to those FOIA requests;

(b)) All documents and communications related to analyses, audits, or reviews that IRS has performed related to Cognizant's payment of payroll taxes and/or prevailing wages to visa-dependent workers from August 22, 2007 to present, whether made available to the public or not;

(c)) All documents and communications related to actions, analyses, reports, audits, or reviews that IRS has undertaken of employer sponsors' classification of visa-dependent workers from August 22, 2007 to present, whether made available to the public or not;

(d)) All communications to, or from, third parties about Cognizant's payment of payroll taxes for visa workers, including but not limited to [pg. **2024** -1501] communications with Relator or Relator's agents from August 22, 2007 to present;

(e)) All agency analyses regarding the applicability of the Internal Revenue Code ("**IRC** ") to claims, complaints, suits, or investigations under the FCA;

(f)) All agency analyses regarding the obligation of the IRS to support or otherwise respond to suits or investigations under the FCA;

(g)) All documents and communications relating to any audits, reviews, analyses, or investigations of Cognizant's payment of payroll taxes for tax years between 2007 and 2021; and

(h)) All analyses or reports, and any documents or communications relating to such analyses or reports, regarding employer obligations to pay payroll taxes on wages paid to visa-dependent workers and/or prevailing wages to visa-dependent workers. Responsive documents should include, but may not be limited to:

(i.) any analyses or reports regarding payroll tax obligations of employers who are not compliant with Prevailing Wage Requirements;

(ii.) all communications between IRS and the Department of Labor regarding payment of payroll taxes by employers found to be noncompliant with Prevailing Wage Requirements; and

(iii.) draft or final reviews, investigations, reports, or findings that payroll taxes were underpaid because an employer failed to pay legally required wage amounts.[24]

Cognizant excludes from the IRS Subpoena "any information that qualifies as a return or return information as defined by 26 U.S.C. §§ 6103(b)," except where such information is "reasonably segregable." [25] In its *Touhy* requests to the IRS, Cognizant also analyzed the fourteen factors set forth in the Department of the Treasury's *Touhy* regulations.[26]

The IRS responded via letter dated December 14, 2022, declining to produce documents and requesting that Cognizant withdraw its subpoena.[27] The IRS broadly objected to the Subpoena on the basis that it was procedurally improper as seeking return information documents not subject to disclosure pursuant to 26 U.S.C. §§ 6103(b).[28] The parties met and conferred on the issues, but, ultimately, the IRS declined to produce any records responsive to the IRS Subpoena.

Through a February 17, **2023** letter, the IRS informed Cognizant of its final agency determination. The IRS contended that 26 U.S.C. §§ 6103(b)(1) precluded the disclosure of the sought-after information and documents because Cognizant sought "return information" relating to other taxpayers for use in a non-IRS matter without those other taxpayers' consent. The IRS also objected on the basis of overbreadth and undue burden.

D. THE MOTION TO COMPEL AND CROSS-MOTIONS TO QUASH

On January 27, **2023**, Cognizant filed in the Underlying Action a Motion to Compel the Agencies to respond to the respective subpoenas.[29] The Agencies opposed the Motion and each cross-moved to quash Cognizant's subpoenas.[30] On March 13, **2023**, Cognizant replied in support of its Motion and in opposition to each Cross-Motion.[31] On April 6, **2023**, the Court denied without prejudice both Cognizant's Motion and the Agencies' Cross-Motions as not properly presented before this Court pursuant to Federal Rules of Civil Procedure 37(a)(2) and 45(d)(3).[32]

On April 28, **2023**, Cognizant initiated the above-captioned matter through a Motion to Compel Discovery filed in the District Court for the District of Columbia.[33] On the same day, Cognizant filed a Consent Motion to Transfer this action to the District of New Jersey, citing the pending Underlying Action.[34] On June 7, **2023**, the District of Columbia transferred this action to this Court.[35]

With respect to the DOL, Cognizant emphasizes that "the remaining dispute...principally concerns" Requests (d) and (e).[36] Cognizant contends that the DOL's burden arguments are speculative and that DOL's failure to produce a privilege log renders its privilege assertions im[pg. **2024** -1502] proper.[37] The DOL maintains that Cognizant's requests are unduly burdensome and would require the agency to expend substantial time and resources disproportionate to the documents' importance to the underlying action.[38]

DOL also asserts that its privilege objections are properly raised without a privilege log, particularly in light of its descriptions of the documents sought.[39] In support of those privilege objections, DOL attached to its Opposition and Cross-Motion two declarations: the Declaration of Naixa C. Franquiz (the "Franquiz Declaration"), a Senior Advisor in the DOL's Wage and Hour Division, Office of Regional Enforcement; and the Declaration of Ann M. Marcellino (the "Marcellino Declaration"), an Attorney for FOIA and Information Law at the Office of the Solicitor within the DOL.[40] The Franquiz Declaration asserts that the DOL, claiming the Investigatory Files Privilege, withheld files related to open law enforcement matters which could reasonably be expected to interfere with the DOL's investigations.[41] According to that Declaration, investigatory case files "typically" contain pre-decisional, internal, non-public information about confidential informants that would be protected by the deliberative process and informant's privileges.[42] The Franquiz Declaration also concludes that the DOL Subpoena is unduly burdensome because they would require ten district offices to collect a substantial number of documents, requiring at least eight weeks of work to identify and retrieve the files in preparation for a privilege review.[43]

Through the Marcellino Declaration, the DOL details its efforts to meet and confer with Cognizant to narrow the DOL Requests consistent with the department's objections,[44] as well as the DOL's reasonable efforts to search for and review potentially responsive documents: From July 6, 2022 through September 2022, the DOL searched its FOIA system, Wage and Hour Division (WHD) investigatory files, and the DOL's email system for documents responsive to Cognizant's requests.[45] DOL ultimately produced several thousand pages of documents, including determination letters related to seven WHD investigations regarding Cognizant's alleged failure to pay prevailing wages, though DOL withheld the balance of those investigatory files as privileged under the deliberative process and informant's privileges.[46] DOL contends that if it were required to detail the precise documents contained in those files, it would reveal information regarding how DOL conducts its investigations as well as details pertaining to open investigations, each of which is protected by the investigatory privilege.[47]

Beginning in October 2022, the DOL reviewed documents potentially relevant to the list of Similarly Situated Employers provided by Cognizant in connection with Request (e), ultimately producing 571 pages of emails.[48] Notably, DOL did not search its email database for the term "Cognizant," asserting that such a search was overbroad, leading to results that would be unduly burdensome to review for responsiveness.[49] On January 20, **2023**, the DOL met and conferred with Cognizant, asserting that Request (d) was unduly burdensome; DOL ultimately provided a formal agency determination letter to that effect.[50] The DOL maintains that to the extent that it possesses records detailing its legal interpretations of visa programs and prevailing wage requirements, those documents would be protected under the deliberative process or attorney-client privileges, as well as the work product doctrine.[51]

For these reasons, the DOL asserts that its denial of Cognizant's *Touhy* request was not arbitrary and capricious and, alternatively, that the DOL Subpoena is unduly burdensome and therefore impermissible under Federal Rule of Civil Procedure 45. The DOL also cross-moves to quash the DOL Subpoena under Rule 45 based on Cognizant's failure to demonstrate the relevance of its requests, especially in light of the burden they would impose upon DOL.[52]

As to the IRS, Cognizant asserts that the IRS Subpoena specifically excludes protected "tax [pg. **2024** -1503] returns" or "return information," and so it seeks only relevant, non-return information in compliance with the Treasury Department's *Touhy* regulations.[53] Cognizant also asserts that even if the requested documents are "return information," the IRS must assert its objections in a privilege log.[54] The IRS responds that its denial of Cognizant's *Touhy* request was not arbitrary or capricious, as the documents sought constitute "return information" protected from disclosure by 26 U.S.C. §§ 6103, and, therefore, the IRS need not conduct a reasonable search for responsive documents.[55] In support of this position, the IRS attaches the Declaration of Sarah Tate, Associate Chief Counsel of the IRS (the "Tate Declaration"), which asserts that IRS Requests (a) through (d), (g), and (h) seek protected "return information," and Cognizant must obtain consent of the affected taxpayers before the IRS may disclose such documents.[56]

Even so, the IRS argues that Cognizant's failure to specify the volume of documents it is seeking violates the Treasury Department's *Touhy* regulations.[57] On that basis, the IRS requested on numerous occasions that Cognizant withdraw its subpoena.[58] Indeed, the IRS relies upon the Declaration of Lisa M. Rodriguez, Associate Area Counsel for the Office of Division Counsel, Large Business & International, in the IRS's Office of Chief Counsel (the "Rodriguez Declaration"), for the proposition that even Cognizant recognized that the IRS Requests were overbroad and too vague to satisfy regulatory requirements. Specifically, the Rodriguez Declaration notes that Cognizant's counsel "admitted" that Cognizant did "not know exactly what documents are sought" through the IRS Requests.[59]

The IRS also contends that responsive information could be subject to the work product doctrine and attorney-client and/or deliberative process privileges if the documents contain the IRS's interpretation or application of law relating to visa programs and/or wage requirements.[60] In support of these privilege arguments, the Tate Declaration asserts that "agency analyses of law that are internal and non-public are privileged" under those doctrines. [61] The Tate Declaration also states that any "generic or statistical information" responsive to the IRS Subpoena is protected by the deliberative process and attorney-client privileges, as well as the work product doctrine, because such information "reflect[s] legal advice" provided by the IRS's counsel.[62]

In further support of its privilege objections, the IRS proffers the Declaration of Richard Hatfield, Chief of the Public Contracts & Technology Law ("PCTL") branch of General Legal Services at the IRS's Office of Chief Counsel (the "Hatfield Declaration"). Through the Hatfield Declaration, the IRS asserts that Requests (e) and (f) seek analyses of the Internal Revenue Code with respect to FCA investigations, including the applicability of the "Tax Bar" pursuant to 31 U.S.C. § 3729(e). The Hatfield Declaration notes that the PCTL analyzes FCA claims in the context of Department of Justice requests for assistance in connection with litigation, and so PCTL conducts only case-specific analyses of the FCA's applicability to the Internal Revenue Code in connection with those litigation requests. [63]

The IRS also offers a Declaration of Daniel R. Lauer, Director of Examination, Specialty Tax, in the IRS's Small Business/Self-Employed Division (the "Lauer Declaration"). Mr. Lauer asserts that, based on his knowledge and experience, the IRS does not use visa-related information to identify employers for employment tax examination or locate non-taxpayer specific analyses, reviews, or reports concerning the classification of visa workers.[64] Mr. Lauer further avers that he is not aware of any "analyses or reports regarding employer obligations to pay payroll taxes on wages paid to visa-dependent workers and/or prevailing wages to visa-dependent workers that are not taxpayer specific and do not include taxpayer return information...."[65]

The IRS further argues in the alternative that the Court should quash the IRS subpoena under Federal Rule of Civil Procedure 45 because Cognizant seeks irrelevant internal agency doc[pg. **2024** -1504] uments.[66] It contends that any relevance of the documents sought is outweighed by the substantial burden that their collection and review would impose on the agency, given the sixteen-year time span of the IRS Subpoena and the belief that Requests (b), (d), (g), and (h) seek information already within Cognizant's possession or control.[67]

II. LEGAL STANDARDS

Generally, parties may seek discovery regarding any nonprivileged matter that is relevant to a party's claim or defense and that is "proportional to the needs of the case, considering the importance of the discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit." Fed. R. Civ. P. 26(b)(1). The information need not be admissible at trial. *Id.* The scope of discovery is broad but not limitless, and discovery cannot "be used as a general fishing expedition." *Burgess v. Galloway*, Civ. No. 20-6744, 2021 WL 2661290, at *2 (D.N.J. Jan. 28, 2021) (citation and internal quotation marks omitted); *see also* Fed. R. Civ. P. 26(b)(2)(C)(i).

A party may move to compel discovery from a non-party. Fed. R. Civ. P. 45(d)(2)(B)(i); *see also* Fed. R. Civ. P. 37(a). A party seeking to compel records from a non-party federal governmental agency may seek review either "through a separate action commenced pursuant to the [APA], or alternatively, in the Court from which the subpoena was served pursuant to Rule 45." *Aiken v. Eady*, Civ. No. 14-1811, 2016 WL 452135, at *5 n.2 (D.N.J. Feb. 4, 2016) (noting that while there is no binding authority on whether an ancillary action under the APA must be filed or whether the issue may be considered as a discovery dispute in the underlying case, "[t]he majority view seems to be to consider the dispute as a discovery matter in the underlying litigation" (citing *Johnson v. Folino*, 528 F. Supp. 2d 548, 550-51 (E.D. Pa. 2007))). A district court "has broad discretion regarding the enforcement of subpoenas." *Tattle Tale Portable Alarm Sys., Inc. v. Calfee, Halter & Griswold, LLP*, Civ. No. 11-7013, 2012 WL 1191214, at *3 (D.N.J. Apr. 10, 2012) (citation omitted).

Here, Cognizant and the Agencies dispute whether the applicable standard of review arises under Rule 45 of the Federal Rules of Civil Procedure or the APA.[68] The applicable standard in this context remains unresolved; accordingly, the Court addresses both the APA and Rule 45. *See Mickendrow v. Watner*, Civ. No. 20-007, 2021 WL 2821176, at *3 n.5, *5 (D.N.J. July 7, 2021) (after holding that agency's decision was not arbitrary and capricious, declining to conduct "the less deferential Rule 45 analysis" as "the result would be the same"); *Johnson*, 528 F. Supp. at 551 (applying Rule 45 where a motion to compel would not be granted under either standard); *see also Harris v. McDonald*, Civ. No. 21-1851, 2022 WL 3599394, at *2 (M.D. Pa. Aug. 23, 2022) (same); *Fermaintt v. McWane, Inc.*, Civ. No. 06-5983, 2008 WL 11383665, at *4 (D.N.J. Dec. 17, 2008).

A. THE APA

A party contesting government activity under the APA must show that the agency action was arbitrary and capricious. 5. U.S.C. § 706(2)(A). A court reviewing an agency action under the APA cannot substitute its own judgement but will narrowly view the action "based on a consideration of the relevant factors and whether there has been a clear error of judgment." *Dep't of Homeland Sec. v. Regents of the Univ. of Cal.* , 591 U.S.—, —, 140 S. Ct. 1891, 1905 (2020) (internal citations and editing and quotation marks omitted). The party challenging an agency action bears the burden of showing that the action was not rational, but rather was arbitrary and capricious. *See Am. Farm Bureau Fed'n v. E.P.A.*, 984 F. Supp. 2d 289, 309 (M.D. Pa. 2013), *aff'd*, 792 F.3d 281 (3d Cir. 2015) (citing *Forest Guardians v. U.S. Fish & Wildlife Serv.*, 611 F.3d 692, 704 (10th Cir. 2010); *Taggart v. GMAC Mortg., LLC*, Civ. No. 12-415, 2013 WL 4079655, at *3 n. 6 (E.D. Pa. Aug. 12, 2013)). As a result, a court will not set aside the Agencies' decisions as to the Subpoenas if the decisions were rational and based on the relevant applicable factors. *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.* , 463 U.S. 29, 42-43 (1983).

B. FEDERAL RULE OF CIVIL PROCEDURE 45

Pursuant to the Federal Rules of Civil Procedure, the Court may compel a non-party to produce documents or permit an inspection of records. *See* Fed. R. Civ. P. 34(c); Fed. R. Civ. P. 45(d), (e). The scope of discovery as defined by Rule 26 similarly applies to discovery sought via a Rule 45 subpoena on a non-party. *See in re Novo Nordisk Sec. Litig.* , 530 F. Supp. 3d 495, 501 (D.N.J. 2021); *accord E.S. [pg. **2024** -1505] by and through Sanchez v. Elizabeth Bd. of Educ.*, Civ. No. 20-1027, 2022 WL 2106382, at *2 (D.N.J. June 10, 2022). Nevertheless, "a non-party to litigation is afforded greater protection from discovery than a party." *Burgess*, 2021 WL 2661290, at *3 (citing *Chazanow v. Sussex Bank*, Civ. No. 11-1094, 2014 WL 2965697, at *2 (D.N.J. July 1, 2014)).

In certain instances, the Court has authority to modify a subpoena and "must quash or modify a subpoena that...requires disclosure of privileged or other protected matter, if no exception or wavier applies; or...subjects a person to undue burden." Fed. R. Civ. P. 45(d)(3)(A)(iii)-(iv); *see also Schmulovich v. 1161 Rt. 9 LLC*, Civ. No. 07-597, 2007 WL 2362598, at *2 (D.N.J. Aug. 15, 2007). An undue burden can exist when the subpoena is "unreasonable or oppressive." *In re Lazardis*, 865 F. Supp. 2d 521, 524 (D.N.J. 2011) (quoting *Schmulovich*, 2007 WL 2362598, at *4).

III. DISCUSSION

As a threshold matter, the Court recognizes that the Agencies, while technically non-parties to the Underlying Action, are not disinterested. Indeed, in the FCA context, the United States has an interest in and rights to this Underlying Action as a real party in interest. *See United States ex rel. Polansky v. Executive Health Resources, Inc.*, 599 U.S. 419, 430 (**2023**) ("Even as a non-party, the Government retains an interest in the suit, and possesses specified rights."); *United States ex rel. Eisenstein v. City of New York*, 556 U.S. 928, 930 (2009). While the United States declined to intervene, the United States may subsequently intervene, should it choose to do so. 31 U.S.C. § 3730(c)(3). Moreover, the Underlying Action asserts theories that relate to whether Cognizant ultimately failed to pay the taxes that would have otherwise been due to the United States had

Cognizant not violated the FCA. The IRS and DOL, therefore, have some interest in the outcome of the matter.

A. THE DOL SUBPOENA

As to the DOL, Cognizant's Motion focuses on Requests (d) and (e) of the DOL Subpoena. Applying the APA standard, which is more deferential to the Agencies, the Court concludes that the DOL arbitrarily and capriciously refused to search and produce any responsive documents.

1. The DOL'S Touhy Regulations

The DOL has promulgated its own set of *Touhy* regulations governing requests to produce records pursuant to 5 U.S.C. § 301 and *United States ex rel. Touhy v. Ragen* , 340 U.S. 462 (1951). A person requesting records from the DOL must submit a "written summary of the information sought and its relevance to the proceeding in connection with which it was served." 29 C.F.R. § 2.21. Absent approval of the Deputy Solicitor of Labor or a designee, DOL employees are prohibited from furnishing DOL materials or information in response to a subpoena or *Touhy* request. *See* 29 C.F.R. § 2.22. In determining whether to lift Section 2.22's prohibition, the Deputy Solicitor must weigh the requestor's need for the information sought against the DOL's public policy concerns, including "centralizing the dissemination of information of the agency (i.e. restricting investigators from expressing opinions on policy matters), minimizing governmental involvement in a controversial matters unrelated to official business and avoiding the expenditure of governmental time and money for private purposes." *Fermaintt*, 2008 WL 11383665, at *5 (quoting *Baker v. Dep't of Labor*, 31 F. Supp. 2d 985, 987 (S.D. Fla. 1998)) (internal quotation omitted). To overcome the DOL's public policy concerns, a requestor must show that: (1) the information is relevant and essential to its case; (2) the information is not available through alternative means; and (3) "that a significant injustice would ensue if the desired...records were not to be made available." *Ayres v. Chester Cty.*, Civ. No. 07-3328, 2008 WL 11515686, at *1 (E.D. Pa. Jan. 22. 2008) (internal quotation marks omitted) (quoting *Herr v. McCormick Grain-The Heiman Co.*, Civ. No. 92-1321, 1994 WL 324558, at *2 (D. Kan. June 28, 1994)).

2. Application of the APA

When considering whether an agency decision was arbitrary and capricious, "a court is not to substitute its judgment for that of the agency." *Dep't of Homeland Sec.*, 140 S. Ct. at 1905 (internal quotation marks and citation omitted); *accord Motor Vehicle Mfrs.*, 463 U.S. at 43. However, an agency must nevertheless base its decision on the factors available under the *Touhy* regulations to withstand scrutiny.

Here, Cognizant sufficiently complied with the DOL's *Touhy* requirements. *See* 29 C.F.R. § 2.21. In its formal agency decision dated October 7, 2022, the DOL did not argue that Cognizant failed to meet the *Touhy* regulations.[69] Rather, it was only after further meeting and conferring on the scope of Request (d) that DOL took the position that Cognizant failed to meet those regulations in its February 17, **2023** [pg. **2024** -1506] letter by contending that Cognizant only generally asserted the relevancy and need for the sought-after information, making "no attempt to substantively address the factors" of 29 C.F.R. § 2.21.[70] However, the DOL was well aware of Cognizant's proffer of relevancy: the parties discussed and exchanged discussions of case law as to whether the information was relevant to the Underlying Action.[71] As laid out in the DOL's February 17, **2023** letter, the issue was not that Cognizant did not address the balancing of the burden on DOL with the need for the information, but rather that the DOL took a different perspective on the case law regarding the triggering of the Public Disclosure Bar.[72] Thus, the Court finds that any decision to refuse to respond to the DOL Subpoena on the basis that Cognizant failed to meet the *Touhy* regulations was arbitrary and capricious.

Furthermore, Requests (d) and (e) are sufficiently relevant to the claims and defenses in the Underlying Action. Cognizant's narrowing of those Requests through the proffered search terms and limitations renders the DOL's decision to stand on its overbreadth objection arbitrary and capricious. Request (d) seeks information relevant to the issues relating to the Public Disclosure Bar and materiality under the FCA. Indeed, the Public Disclosure Bar requires dismissal of a FCA action where the Relator's allegations have been previously disclosed, *inter alia*, in a "Federal report, hearing, audit, or investigation[.]" 31 U.S.C. § 3730(e)(4)(A); *see, e.g.*, *United States ex rel. Carson v. Select Rehab., Inc.*, Civ. No. 15-5708, **2023** WL 5339605, at *12-13 (E.D. Pa. Aug. 18, **2023**) (discussing where allegations against entities in an industry may or may not trigger the Public Disclosure Bar). While the DOL contests whether the sought-after documents would be sufficient to trigger the Public Disclosure Bar, the Court need not make such a determination at this stage to find that the documents are relevant for discovery purposes in the Underlying Action. Request (d) also seeks documents that may weigh on the issue of materiality based on the nature of the claims asserted by the Relator in the Underlying Action. *See United States ex rel. Druding v. Care Alternatives*, 81 F.4th 361, 367 (3d Cir. **2023**) (citing *Universal Health Servs., Inc. v. United States ex rel. Escobar*, 579 U.S. 176, 193 n.5, 194-95 (2016)) (discussing factors to consider under materiality requirement of the FCA). Further, there can be no dispute that DOL emails relating to "Cognizant" (as sought through Request (e)) may be relevant to the Underlying Action.

In rejecting the Subpoena, the DOL appears to have supplanted Cognizant's view of the case law as to the Public Disclosure Bar and materiality with its own and, in doing so, failed to appropriately weigh the need for the information against any of the agency's public policy concerns. *See Fermaintt*, 2008 WL 11383665, at *5; *see also United States ex rel. Lewis v. Walker*, Civ. No. 06-16, 2009 WL 2611522, at *4 (M.D. Ga. Aug. 21, 2009) (concluding agency's relevance determination was based on "unsubstantiated and subjective" evidence, and thus arbitrary and capricious). Accordingly, a determination that the DOL need not respond to these requests based on overbreadth was arbitrary and capricious because the DOL clearly erred in failing to consider the potential relevancy of the requested documents as limited by Cognizant in the meet and confer process.

The DOL also asserts that its final agency decision is not arbitrary and capricious because responding in full to Requests (d) and (e) would be unduly burdensome on the agency and could invoke certain privileges. When balancing a requestor's need for documents against the DOL's public policy concerns, the DOL should consider its interest in limiting the expenditure of government resources unrelated to its official business and/or for merely private purposes. *See Fermaintt*, 2008 WL 11383665, at *5. The DOL proffers that responding to Request (d) even as limited by Cognizant and completing the "Cognizant" search in its emails in respond to Request (d) would involve multiple offices over the span of potentially at least eight weeks of work, with the number of "man hours" depending on the number and format of any responsive files.[73]

Burdens imposed through a *Touhy* request are a significant factor to be considered. However, here, considering the DOL's view on the lack of relevancy of the sought-after documents, it is not clear that the DOL considered its burden concerns in the context of this *qui tam* matter, where the United States and its agencies, including the DOL, may have an interest in the ultimate outcome. Such context matters where a search and production of potentially responsive documents is not merely for private purposes. *See, e.g.*, *Schroeder v. United States Dep't of Veterans Affairs*, 673 F. Supp. 3d 1204, 1227 (D. Kan. **2023**) (finding [pg. **2024** -1507] agency's denial of *Touhy* request arbitrary and capricious where it "failed to consider an important aspect of the problem": a party's need for discovery to defend against claims arising under the FCA (internal quotation marks omitted)).

Furthermore, while the DOL has proffered through declarations that certain investigatory files "typically" contain information that would be subject to various privileges, absent a privilege log or more information as to the specific documents at issue, the Court is unable to sustain the DOL's privilege objections to the Subpoena. *See United States ex rel. Franchitti v. Cognizant Tech. Sol. Corp.*, No. 17-6317, **2023** WL 2759075, at *7 (D.N.J. Apr. 3, **2023**). Accordingly, the DOL's denial to Requests (d) and (e) was arbitrary and capricious. For the same reasons, both the APA and the more lenient standard under Rule 45 warrant a grant of Cognizant's Motion to Compel and a denial of the DOL's Cross-Motion to Quash. *See Mickendrow*, 2021 WL 2821176, at *5.

B. THE IRS SUBPOENA

Turning to the IRS Subpoena, to determine if the IRS's final agency decision is arbitrary and capricious, the Court considers whether Cognizant seeks only protected "return information" and whether the IRS based its denial on the relevant facts under its *Touhy* regulations.

1. The IRS's Touhy Regulations

The Department of the Treasury has promulgated regulations pursuant to 5 U.S.C. § 301 and *United States ex rel. Touhy v. Ragen*, 340 U.S. 462 (1951), to apply to requests to produce its records. *See* 5 U.S.C. § 301; 26 C.F.R. § 301.9000-1 *et seq.* Accordingly, to obtain records in the possession of the Department of the Treasury, including the IRS, a person seeking the production of documents in a "non-IRS matter"[74] must submit a written statement that, in relevant part: (1) summarizes the proceeding and the issues involved, the information sought, the relevance of such information, and the "estimated volume" of documents requested; (2) indicates whether the documents sought are a "return" or "return information" as defined by 26 U.S.C.; and §§ 6103(b); and (3) indicates whether the information sought is available from alternative sources. *See* 26 C.F.R. § 301.9000-5(a). In determining whether it may produce records, the IRS must consider whether disclosure is precluded under 26 C.F.R. § 301.9000-2. *See* 26 C.F.R. § 301.9000-2(a)-(b) (requiring consideration of whether disclosure of IRS records would: be contrary to federal law; reveal sensitive or classified information; reveal investigatory information or interfere with investigatory proceedings; or reveal information protected by an applicable privilege); 26 C.F.R. § 301.9000-2(c) (requiring, in non-IRS matters, consideration of the potential effect of the matter on the administration of internal revenue laws; the importance of the legal issues involved; the availability of information sought from other sources; and whether the request is unduly burdensome).

In addition, 26 U.S.C. §§ 6103 prohibits disclosure, except as otherwise authorized by the Internal Revenue Code, of a "return"[75] or "return information."[76] To qualify as "return information," documents need not identify a specific taxpayer but contain information that is "unique to a particular taxpayer." *Cause of Action*, 125 F. Supp. 3d at 164 (internal quotations omitted). "When a record that is not itself 'return information' contains both return information and non-return information, the non-return information can be released if it is reasonably segregable." *Id.*; *see also Tax Analysts v. IRS*, 117 F.3d 607, 616 [80 AFTR 2d 97-5152], 620 (D.C. Cir. 1997) (holding that IRS could redact "true return information" from certain documents but that legal analyses therein did not qualify as "return information"); *but see Church of Scientology v. IRS*, 484 U.S. 9, 16 [60 AFTR 2d 87-5832] (1987) ("Congress did not intend [Section 6103] to allow the disclosure of otherwise confidential return information merely by the redaction of identifying details."). To obtain documents that [pg. **2024** -1508] contain "return information," the requestor must have an authorization from the relevant taxpayer, except where the information cannot be directly or indirectly associated with an individual taxpayer. 26 U.S.C. §§ 6103(c); 26 C.F.R. § 301.6103(c)-1.

2. Application of the APA

In response to the IRS Subpoena, the IRS argues that the requests seek "return information" that is protected from disclosure by the Internal Revenue Code and therefore it must deny the Requests. The IRS further asserts that any responsive non-return information would not be reasonably segregable from the protected return information because the IRS Subpoena seeks documents directly related to individual taxpayers.[77] The IRS also contends that even return information related to Cognizant itself cannot be disclosed in response to the IRS Subpoena because Cognizant has not furnished the taxpayer's consent as required pursuant to 26 C.F.R. § 301.6103(c)-1. The IRS further objects to the Subpoena based on overbreadth, as Cognizant seeks documents not relevant to the Underlying Action, and because it would unduly burden the agency.[78] In addition, the IRS contests that Cognizant failed to comply with the agency's *Touhy* regulations at 26 C.F.R. § 301.9000-5(a) because the Subpoena is not specific enough and did not identify the estimated volume of documents sought through the requests. The IRS further asserts that responsive documents would include those protected from disclosure through the work product doctrine and attorney-client and deliberative process privileges.

In response, Cognizant argues that it expressly carved out from its requests any "return information," except to the extent that such information is "reasonably segregable," as well as any information that would be subject to an applicable privilege or protection.[79] Cognizant further points out that its requests were specific enough to comply with the *Touhy* regulations, noting that it cannot plausibly estimate the volume of documents of which it is not aware or provide more specificity as to the agency's records that have not been disclosed.

With the IRS Subpoena, Cognizant's *Touhy* request set forth its assertions as to the various factors pursuant to 26 C.F.R. § 301.9000-2 and-5, noting that it would work with the IRS to limit the burden of the requests. Although the IRS and Cognizant had discussions regarding the Subpoena, it appears that the IRS did not assert the technical failure to comply with the *Touhy* regulations (by failing to set forth the "estimated volume of IRS records involved" or establish that some of the responsive documents could be available from other sources) until its February 17, **2023** agency decision letter.[80] Notably, the IRS may waive the strict compliance with a written statement under the *Touhy* regulations for good cause. 26 C.F.R. § 301.9000-5(b). Here, Cognizant provided as much information available to it. Denying the IRS Subpoena on the basis that Cognizant did not meet the *Touhy* regulations is elevating form over substance.[81] *See Philpott v. City of Mason City, Iowa*, Civ. No. 09-3062, 2010 WL 11450401, at *3 (N.D. Iowa Sept. 15, 2010); *see also Biear v. Attorney General of the United States*, 905 F.3d 151, 157 (3d Cir. 2018) (finding, in the FOIA context, that it would be "counterintuitive" to require a requestor to identify specific units of an agency that might have the sought-after records). Relying on such a justification, therefore, was arbitrary and capricious.

At the heart of the IRS objections, however, is the contention that Cognizant's requests seek "return information." What strikes the Court, however, is that the IRS asserts such an objection without having conducted any search whatsoever to determine if documents responsive to the IRS Subpoena do indeed contain such information as defined in the **IRC**. Without an identification of specific documents or categories of documents, a determination cannot be made that any document contains "return information" or whether such protected information can be reasonably segregable. Indeed, following a reasonable search, the IRS may find that some documents may not be produced as containing "return information." Yet, there is also the real possibility that responsive documents may be subject to disclosure as not containing "return information" or having non-return information that is reasonably segregable. Denying a *Touhy* request on a broad sweeping objection because, hypothetically, some responsive documents may not ultimately be subject to disclosure was arbitrary and capricious. *See, e.g., Schroeder*, 673 F. Supp. 3d at 1215 (finding agency's denial of *Touhy* request [pg. **2024** -1509] was arbitrary and capricious where agency denied request on basis that it purportedly sought identifying information but the request did not seek such information); *see also Kobach v. United States Election Assistance Comm'n*, 772 F.3d 1183, 1197 (10th Cir. 2014) (recognizing that a court applying the APA should consider if an agency "examined the relevant data and articulated a rational connection between the facts found and the decision made" (internal quotation marks and citation omitted)).

Further, the IRS's decision not to respond to the Subpoena on the bases that the requests are overbroad, unduly burdensome, and vague miss the mark. While the IRS contends that Cognizant did not sufficiently demonstrate how the requested documents are relevant to the Underlying Action, such a contention runs counter to the evidence before the agency through the *Touhy* request. *See Lewis*, 2009 WL 2611522, at *4 (concluding agency's relevance determination was based on "unsubstantiated and subjective" evidence, and thus arbitrary and capricious). Cognizant proffered sufficient information to the agency, showing the relevancy and importance of the sought-after records to the Underlying Action. The IRS's failure to process the requests on the basis that the requests sought irrelevant information, therefore, was arbitrary and capricious.

Further, Cognizant tried through the meet and confer process to clarify with the IRS its requests to address the IRS's concerns that the requests are vague. The IRS still refused to accept the clarifications and rather argues now that the Court should reject the IRS Subpoena because Cognizant has attempted to modify its requests. The agency, however, cannot have it both ways: seek a party to clarify its *Touhy* request but then reject a clarification for not being part of the original request. The IRS may indeed have valid concerns of burden; yet, based on the record presented, the IRS considered those burdens in the context of weighing them against its own assessment of the relevancy of the sought-after records.[82]

In addition, while the IRS's concerns as to privileges and protections may have merit, such assertions do not justify the wholesale denial, or quashing, of the IRS Subpoena.[83] Rather, such arguments should be raised in the context of specific documents, as discussed above. There is no indication that the IRS conducted any review of potentially responsive records to determine which specific privileges apply to any responsive documents, and, furthermore, Cognizant has repeatedly made clear that it did not intend to seek documents subject to such protections.

Accordingly, the Court finds that the IRS's denial of the IRS Subpoena and *Touhy* requests ws arbitrary and capricious. For that reason, the Court also finds that the Federal Rules of Civil Procedure warrant a grant of Cognizant's Motion to Compel and a denial of the IRS's Cross-Motion to Quash.

IV. CONCLUSION

For the reasons set forth above, the Agencies' decisions on the respective subpoenas and *Touhy* requests were arbitrary and capricious under the APA. As such, the Court further finds that Rule 45 justifies an order compelling the Agencies to respond to the Subpoenas. The Agencies have failed to meet their burden to quash the Subpoenas.

Accordingly, for good cause shown,

IT IS, THEREFORE, on this 8th day of May **2024** hereby

ORDERED that Cognizant's Motion to Compel (Doc. No. 1) is hereby GRANTED; and it is further

ORDERED that the Internal Revenue Service's Cross-Motion to Quash Cognizant's Subpoena (Civ. No. 17-6317, Doc. No. 128) is hereby DENIED; and it is further

ORDERED that the Department of Labor's Cross-Motion to Quash Cognizant's Subpoena (Civ. No. 17-6317, Doc. No. 129) is hereby DENIED; and it is further

ORDERED that the Clerk of Court is hereby directed to TERMINATE the Motion pending at Docket Entry No. 1; and it is further

ORDERED that the Clerk of Court shall hereby mark this matter CLOSED.

SO ORDERED.

RUKHSANAH L. SINGH

UNITED STATES MAGISTRATE JUDGE

---

1 Civ. No. 23-3320, Doc. No. 1-3 and-6.

2 Citations herein reference the respective Civil Action Numbers for both the above-captioned matter and the Underlying Action.

3 Civ. No. 23-3320, Doc. Nos. 1, 7.

4 *See* Civ. No. 17-6317, Doc. Nos. 108, 128, 129, 138, 139, and 166. On June 29, **2023**, counsel for Cognizant filed a letter on the docket in the Underlying Action requesting that the Court "consider the authorities submitted in the...briefing on the D.N.J. Motion[] to Compel instead of the authorities submitted in the briefing on the D.D.C. Motion[] to Compel." Civ. No. 17-6317, Doc. No. 166. The Agencies consented to Cognizant's letter and the requests raised therein. The Court thus considers the parties' briefs filed in the Underlying Action, including the Agencies' respective Cross-Motions. *See* Civ. No. 17-6317, Doc. Nos. 128, 129.

5 *See generally* Civ. No. 17-6317, Doc. No. 1.

6 *See* Civ. No. 17-6317, Doc. No. 4.

7 Civ. No. 17-6317, Doc. Nos. 16, 17.

8 Civ. No. 17-6317, Doc. No. 18.

9 *See generally* Civ. No. 17-6317, Doc. No. 32.

10 Civ. No. 23-3320, Doc. No. 1-6 at p. 5.

11 Civ. No. 23-3320, Doc. No. 1-3 at p. 10.

12 To aid with Request (d), Cognizant provided the DOL with the following search terms specifying the employer sponsors that are the subject of this Request: Tata Consultancy, Infosys, Deloitte, Capgemini, Accenture, Wipro, and IBM. Civ. No. 23-3320, Doc. No. 1-9 at pp. 2-3.

13 Civ. No. 23-3320, Doc. No. 1-6 at p. 3. To aid with Request (e), Cognizant provided the following search terms identifying Relator's "agents": Jonathan Rudnick; Daniel A. Kotchen; Daniel L. Low; Lindsey Frunert; Amanda Burns; Mark Hammervold; Karishma Shah; Michael con Klemperer; Navid Soleymani; Navid Yadegar; Yadegar, Minoofar & Soleymani LLP; The Law Office of Jonathan Rudnick LLC; and Kotchen & Low LLP.

14 Civ. No. 23-3320, Doc. No. 1-6 at p. 3.

15 Civ. No. 17-6317, Doc. No. 129-3 at ¶ 5.

16 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 5-6.

17 Civ. No. 17-6317, Doc. No. 129-3 at ¶ 5.

18 Civ. No. 23-3320, Doc. No. 1-7 at p. 2.

19 Civ. No. 23-3320, Doc. No. 1-9 at pp. 2-3.

20 Civ. No. 17-6317, Doc. No. 129-4.

21 *See* Civ. No. 17-6317, Doc. No. 129-5.

22 Civ. No. 17-6317, Doc. No. 129-5 at pp. 3-5.

23 Civ. No. 17-6317, Doc. No. 129-5 at p. 3.

24 Civ. No. 23-3320, Doc. No. 1-3 at pp. 3-4.

25 Civ. No. 23-3320, Doc. No. 1-3 at p. 3 (quoting *Cause of Action v. Internal Revenue Serv.*, 125 F. Supp. 3d 145, 164 [116 AFTR 2d 2015-5926] (D.D.C. 2015)).

26 *See* Civ. No. 23-3320, Doc. No. 1-3 at pp. 5-9.

27 Civ. No. 23-3320, Doc. No. 1-2 at pp. 3-4.

28 Civ. No. 23-3320, Doc. No. 1-4 at pp. 2-3.

29 *See* Civ. No. 23-3320, Doc. No. 1.

30 Civ. No. 17-6317, Doc. Nos. 128, 129.

31 Civ. No. 17-6317, Doc. Nos. 138, 139.

32 Civ. No. 17-6317, Doc. No. 150.

33 Civ. No. 23-3320, Doc. No. 1.

34 *See generally* Civ. No. 23-3320, Doc. No. 2.

35 Civ. No. 23-3320, Doc. No. 7.

36 Civ. No. 17-6317, Doc. No. 139 at pp. 6-7, 12-15.

37 Civ. No. 23-3320, Doc. No. 1 at pp. 30-32.

38 Civ. No. 17-6317, Doc. No. 129-1 at pp. 28-29.

39 Civ. No. 17-6317, Doc. No. 129-1 at pp. 30-31.

40 Civ. No. 17-6317, Doc. No. 129-3 and 129-6.

41 *See* Civ. No. 17-6317, Doc. No. 129-6 at ¶¶ 8-9.

42 Civ. No. 17-6317, Doc. No. 129-6 at ¶ 9.

43 Civ. No. 17-6317, Doc. No. 129-6 at ¶¶ 10-15.

44 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 6-7, 15, 19.

45 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 7-8; *see also* Civ. No. 23-3320, Doc. No. 1-7 at p. 2.

46 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 11-12.

47 Civ. No. 17-6317, Doc. No. 129-3 at ¶ 13, 22.

48 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 15-17.

49 Civ. No. 17-6317, Doc. No. 129-3 at ¶ 17.

50 Civ. No. 17-6317, Doc. No. 129-3 at ¶¶ 19, 21; *see also* Civ. No. 17-6317, Doc. No. 129-5.

51 Civ. No. 17-6317, Doc. No. 129-3 at ¶ 23.

52 Civ. No. 17-6317, Doc. No. 129-1 at pp. 35-38.

53 Civ. No. 23-3320, Doc. No. 1-1 at pp. 23-27.

54 Civ. No. 23-3320, Doc. No. 1-1 at p. 26.

55 Civ. No. 17-6317, Doc. No. 128-1 at pp. 18-24, 27-28.

56 Civ. No. 17-6317, Doc. No. 128-3 at ¶¶ 10, 15-17.

57 Civ. No. 17-6317, Doc. No. 128-1 at p. 26.

58 Civ. No. 17-6317, Doc. No. 128-5 at ¶¶ 5, 8-9.

59 Civ. No. 17-6317, Doc. No. 128-5 at ¶¶ 11-12.

60 Civ. No. 17-6317, Doc. No. 128-1 at p. 33.

61 Civ. No. 17-6317, Doc. No. 128-3 at ¶¶ 12-14.

62 Civ. No. 17-6317, Doc. No. 128-3 at ¶ 12.

63 Civ. No. 17-6317, Doc. No. 128-6 at ¶ 5.

64 Civ. No. 17-6317, Doc. No. 128-4 at ¶¶ 6-8.

65 Civ. No. 17-6317, Doc. No. 128-4 at ¶ 8.

66 Civ. No. 17-6317, Doc. No. 128-1 at pp. 30-32, 35-37.

67 Civ. No. 17-6317, Doc. No. 128-1 at pp. 35-37.

68 The parties do not dispute that the Motions are properly presented to this Court without the need to file an ancillary action under the APA.

69 Civ. No. 17-6317, Doc. No. 129-4.

70 Civ. No. 17-6317, Doc. No. 129-5 at p. 2.

71 *See* Civ. No. 17-6317, Doc. No. 129-5 at pp. 2-3.

72 Civ. No. 17-6317, Doc. No. 129-5 at pp. 2-4.

73 *See* Civ. No. 17-6317, Doc. No. 129-6 at ¶¶ 10-15, and Doc. No. 129-3 at ¶¶ 19, 21.

74 A "non-IRS matter" is any matter that is unrelated to official IRS business or "to any law administered by or concerning the IRS," as well as any matter not before Congress and unrelated to the administration of "internal revenue laws or other laws administered by or concerning the IRS, or to IRS records or information." Disclosure, Testimony, and Production of Documents, Internal Revenue Manual, at § 34.9.1.2(6)-(8) (2021).

75 A "return" is defined as "any tax or information return, declaration of estimated tax, or claim for refund required by, or provided for or permitted under, the provisions of th[e Internal Revenue Code] which is filed with the Secretary by, on behalf of, or with respect to any person, and any amendment or supplement thereto, including supporting schedules, attachments, or lists which are supplemental to, or part of, the return so filed." 26 U.S.C. §§ 6103(b)(1).

76 "Return information" includes, as relevant here, "a taxpayer's identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments, whether the taxpayer's return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary with respect to a return or with respect to the determination of the existence, or possible existence, of liability...of any person under this title for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense[.]" 26 U.S.C. §§ 6103(b)(2)(A). "Return information" may also include any portion of a "written determination or any background file document relating to such written determination...." 26 U.S.C. §§ 6103(b)(2)(B); *see also* 26 U.S.C. §§ 6110(b)(1)(A) (defining "written determination" as "a ruling, determination letter, technical advice memorandum, or Chief Counsel advice"). However, "return information" excludes any data which cannot directly or indirectly be associated with a particular taxpayer. 26 U.S.C. §§ 6103(b)(2).

77 Civ. No. 17-6317, Doc. No. 128-1 at p. 19.

78 Civ. No. 17-6317, Doc. No. 128-1 at pp. 30-33, 35-37.

79 *See* Civ. No. 23-3320, Doc. No. 1-3 (*Touhy* request to the IRS).

80 *See* Civ. No. 17-6317, Doc. No. 128-2.

81 Any argument by the IRS that Cognizant failed to meet the *Touhy* regulations because some responsive documents may be available from other sources misapplies the plain language of the *Touhy* regulations. 26 C.F.R. § 301.9000-5(a)(7) requires a requesting party to state *whether* the sought after records are available from other sources. Cognizant did that by stating that it was seeking records not available from other sources. *See Philpott*, 2010 WL 11450401, at *3.

82 *See* Civ. No. 17-6317, Doc. No. 128-1 at pp. 35-37.

83 Notably, the IRS did not assert any concerns relating to an applicable privilege in its February 17, **2023** final agency decision on Cognizant's *Touhy* request. Because these privilege assertions were not made in the context of a "final agency action," it is not clear that the decision to deny the IRS Subpoena on this basis is fully ripe for the Court's review under the APA. *See, e.g., COMSAT Corp. v. Nat'l Science Found.*, 190 F.3d 269, 275 (4th Cir. 1999) (assuming without deciding that agency reached a "final decision" not to comply with a subpoena based on counsel's representation during oral argument on pending motion). Nevertheless, the Court need not address that issue and considers the IRS's objections in the context of the IRS's Motion to Quash brought pursuant to Rule 45 of the Federal Rules of Civil Procedure.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
Federal Tax Decisions
American Federal Tax Reports
American Federal Tax Reports (Current Year)
2024
AFTR 2d Vol. 133
133 AFTR 2d 2024-977 - 133 AFTR 2d 2024-818
FOLEY v. COMM., 133 AFTR 2d 2024-958 (95 F.4th 740), Code Sec(s) 7463; 7482, (CA2), 03/13/2024

American Federal Tax Reports

FOLEY v. COMM., Cite as 133 AFTR 2d 2024 -958 (95 F.4th 740), Code Sec(s) 7482; 7463, (CA2), 03/13/2024

Joseph William FOLEY, PETITIONER-APPELLANT v. COMMISSIONER of Internal Revenue, RESPONDENT-APPELLEE.

Case Information:

[pg. **2024** -958]

Code Sec(s):	7482; 7463
Court Name:	U.S. Court of Appeals, Second Circuit,
Docket No.:	Docket No. 23-1296,
Date Decided:	03/13/**2024**.
Prior History:	Appeal from Tax Court dismissed.
Tax Year(s):	Years 2014, 2015.
Disposition:	Decision against Taxpayer.
Cites:	95 F.4th 740.

HEADNOTE

1. Appeals from Tax Court—jurisdiction—small tax case. Taxpayer's appeal from Tax Court decisions, which dismissed his untimely "small case" for lack of jurisdiction and denied his motion to vacate, was dismissed for lack of jurisdiction: Code Sec. 7463(b) 's bar on appellate review of decisions entered in small tax cases applied to *all* decisions in same, including jurisdictional dismissal decisions. Taxpayer's argument that Code Sec. 7463(b) only applied to decisions on merits was rejected accordingly. His alternate argument, that jurisdictional dismissal meant his case never became "small case" in first place and so still fell outside of Code Sec. 7463(b) , was also rejected.

Reference(s): Code Sec. 7482;Code Sec. 7463

OPINION

Audrey Patten & T. Keith Fogg, Harvard Tax Clinic, Jamaica Plain, MA; Carlton M. Smith, Esq., New York, NY, for Petitioner-Appellant.

David A. Hubbert, Deputy Assistant Attorney General, Michael J. Haungs, Isaac B. Rosenberg, U.S. Department of Justice, Tax Division, Washington, D.C., for Respondent-Appellee.

[pg. **2024** -959]

In the United States Court of Appeals For the Second Circuit,

Before: KEARSE, PARK, and ROBINSON, Circuit Judges.

Judge: PER CURIAM:

August Term, **2023**

Petitioner-Appellant Joseph William Foley appeals the dismissal of his deficiency protest as untimely by the United States Tax Court (Kerrigan, *C.J.*). Respondent-Appellee Commissioner of Internal Revenue moves to dismiss Foley's appeal for lack of appellate jurisdiction. We conclude that the Tax Court's decision dismissing Foley's petition as untimely is unreviewable under 26 U.S.C. §§ 7463(b). We thus GRANT the Commissioner's motion to dismiss.

Petitioner-Appellant Joseph William Foley appeals the dismissal of his deficiency protest as untimely by the United States Tax Court (Kerrigan, *C.J.*). The Commissioner of Internal Revenue moves to dismiss Foley's appeal, asserting that this Court lacks jurisdiction to review small tax case decisions under 26 U.S.C. §§ 7463(b), which provides that "[a] decision entered in any case in which the proceedings are conducted under this section shall not be reviewed in any other court...." Foley responds that because the Tax Court dismissed his petition on jurisdictional grounds, rather than on the merits, § 7463(b) is not an impediment to our appellate jurisdiction.

For the reasons set forth below, we agree with the Commissioner and GRANT the motion to dismiss.

BACKGROUND

The IRS issued a notice of deficiency to Joseph Foley in 2018 for taxes owed for the 2014 and 2015 tax years. Per 26 U.S.C. §§ 6213(a), he had 90 days to file a petition in the Tax Court for redetermination of the deficiency. Foley filed a petition disputing the deficiency in 2022, 1,393 days after the deadline, asserting that he never received notice of the deficiency. His petition, filed on a standard form of the United States Tax Court, reflects his election to have his petition reviewed under small tax case procedures.

A taxpayer can elect to seek redetermination of a deficiency under § 7463 if the deficiency amount is under $50,000. 26 U.S.C. §§ 7463. This process is less formal, and taxpayers often receive a "speedier disposition." *Guidance for Petitioners: About the Court*, United States Tax Court, https://www.ustaxcourt.gov/petitioners_about.html [https://perma.cc/SYY9-S27C] (last visited Feb. 26, **2024**); *see also* 5 Jacob Rabkin et al., *Federal Income, Gift and Estate Taxation* § 79.03 (**2023**) (describing that in a small tax case, which is "designed to enable taxpayers to represent themselves," "any evidence deemed by the court to have probative value is admissible" and "[n]either briefs nor oral argument are ordinarily required"). Underneath the checked box electing the small tax case process, the form included a note indicating that "[a] decision in a 'small tax case' cannot be appealed to a Court of Appeals" by either party. Admin. Record 5.

Upon the IRS's motion, the Tax Court dismissed Foley's petition for redetermination as untimely. In response to the dismissal of his petition, Foley moved to vacate or revise the decision pursuant to Tax Court Rule 162, arguing that he never received the notice. The Tax Court denied his motion, asserting that it lacked authority to extend the petition deadline.[1]

Foley now appeals to this Court, challenging the Tax Court's dismissal of his petition and its denial of his motion to vacate. The Commissioner has moved to dismiss Foley's appeal for lack of appellate jurisdiction in light of 26 U.S.C. §§ 7463(b).

DISCUSSION

The question presented by the IRS's motion is whether § 7463(b) precludes appellate review of jurisdictional dismissals of small tax cases. As set forth more fully below, we hold that it does. By its plain language, § 7463(b) precludes our appellate review. The authority Foley relies on to suggest otherwise is inapposite.

As noted above, § 7463(b) establishes that a "decision" under this section "shall not be reviewed in any other court and shall not be treated as a precedent for any other case." 26 U.S.C. ("**I.R.C.**")

§§ 7463(b). Contrary to Foley's assertions, the Tax Court's dismissal of his petition as untimely was a "decision." Other provisions of the Internal Revenue Code make clear that a "decision" of the Tax Court includes "a decision dismissing a proceeding for lack of jurisdiction." **I.R.C.** § 7459(c). That subsection expressly describes a dismissal for lack of jurisdiction as a "decision." *Id.* Thus, "decision" as it is used in the Internal Revenue Code, including § 7463(b), encompasses [pg. **2024** -960] jurisdictional dismissals like that entered by the Tax Court here.

Foley argues otherwise, contending that because the Tax Court dismissed his claim for lack of jurisdiction rather than on the merits, it is reviewable. He relies on this Court's holding in *Wapnick v. United States*, a case in which we concluded that a non-reviewability provision similar to that in § 7463(b) did not preclude a taxpayer from appealing a judgment dismissing the taxpayer's claim *on jurisdictional grounds.* 112 F.3d 74 [79 AFTR 2d 97-2518] (2d Cir. 1997).

But *Wapnick* is readily distinguishable. Wapnick sought district court review of an IRS jeopardy assessment against him pursuant to 26 U.S.C. §§ 7429. *Id.* at 74.[2] The district court dismissed his claim on jurisdictional grounds, concluding that he had failed to exhaust his administrative remedies and his district court action was untimely. *Id.* at 74–75. An issue in *Wapnick* was whether this Court had jurisdiction to entertain the appeal. *Id.* at 74.

We concluded that the statute's restriction on appellate review was limited to determinations "*on the merits* regarding the jeopardy assessment in question." *Wapnick*, 112 F.3d at 74 [79 AFTR 2d 97-2518] (citing *Hiley v. United States*, 807 F.2d 623, 626–28 [59 AFTR 2d 87-334] (7th Cir. 1986); *Schuster v. United States*, 765 F.2d 1047, 1049 [56 AFTR 2d 85-5554] (11th Cir. 1985)). That's because "determine" is a term of art under § 7429(b)(3)—it refers to a ruling as to the reasonableness of the jeopardy assessment. *See* **I.R.C.** § 7429(b)(3)(A) ("the court shall *determine* whether or not the making of the assessment...is reasonable...and the amount so assessed...is appropriate") (emphasis added). Accordingly, the restriction on appellate review in § 7429(f)—providing that "[a]ny *determination* made by a court under this section shall be final and conclusive and shall not be reviewed by any other court"—is limited to rulings as to the reasonableness of the jeopardy assessment (i.e., the merits). *Id.* § 7429(f) (emphasis added).

Accordingly, the limitation in § 7429(f) on appellate review of a district court's "determination" relates to the district court's ruling as to the reasonableness of an assessment, rather than *any* ruling resolving the taxpayer's case. As the Seventh Circuit explained in reaching the same conclusion, the government's position that § 7429(f) bars appellate review of district court jurisdictional rulings "would be more persuasive if § 7429(f) prohibited the review of, for example, all `decisions,' `actions,' or `orders' of a district court made pursuant to that section." *Hiley*, 807 F.2d at 628.

In contrast to the restriction on appellate review in *Wapnick*, the restriction at issue here, § 7463(b), *does* apply to all "decisions," including jurisdictional dismissals. Our holding in *Wapnick* that the restriction in § 7429(f) does not bar appellate review of jurisdictional rulings by the district court in taxpayer challenges to jeopardy assessments does not support Foley's argument that § 7463(b)'s restriction on appellate review is limited to Tax Court merits determinations.

Foley argues in the alternative that the Tax Court's jurisdictional dismissal means that his case never became a "small case," and thus falls outside of § 7463(b)'s appeal waiver. Again, we disagree. Foley commenced proceedings in the Tax Court with an affirmative request that his case be conducted under the small-case procedures. That election took effect immediately. Even after the Commissioner moved to dismiss his petition as untimely, Foley never moved to rescind his small-case election. When the Tax Court dismissed Foley's petition, it thus dismissed a case subject to small tax case procedures.

Accordingly, we lack jurisdiction to adjudicate Foley's appeal of the Tax Court's decisions dismissing his petition and denying reconsideration of that dismissal. Because we dismiss on this jurisdictional basis, we express no opinion on the merits of Foley's challenge. For the above reasons, we grant the Commissioner's motion and DISMISS Foley's appeal.

---

1 Whether § 6213(a)'s 90-day deadline is jurisdictional is the subject of a circuit split. *Compare Culp v. Comm'r*, 75 F.4th 196, 200–02 [132 AFTR 2d **2023** -5198] (3d Cir. **2023**) (not jurisdictional), *with, e.g., Tilden v. Comm'r*, 846 F.3d 882, 886–87 [119 AFTR 2d 2017-441] (7th Cir. 2017) (jurisdictional). We assume without deciding that the Tax Court correctly concluded that § 6213(a) is jurisdictional because Foley's argument that his appeal to this Court is not foreclosed by § 7463(b) rests on the assumption that the Tax Court dismissed his protest on a jurisdictional basis, rather than on the merits.

2 A jeopardy assessment is a procedure available to the IRS which allows for an immediate assessment or collection of a deficiency, when the Secretary "believes that the assessment or collection of a deficiency...will be jeopardized by delay." **I.R.C.** § 6861(a). It may include a deficiency notice, but is a distinct procedure subject in some circumstances to judicial review in the district court. **I.R.C.** § 7429(b)(2)(a). *See generally Hecht v. United States*, 609 F. Supp. 264, 267 [56 AFTR 2d 85-5580] (S.D.N.Y. 1985) ("the amount of tax due" is not to be determined in a challenge to a jeopardy assessment, as "the purpose of a jeopardy assessment [is] to keep the matter in *status quo* until the merits of the tax controversy can be...resolved").

END OF DOCUMENT -

Guam Society of CPAs
August 21, 2024
Federal Tax Update

1. Moore v. United States, 22-800 U.S. (2024)
2. Secure 2.0 provisions taking effect in 2023 and 2024
3. Overview of the Federal Tax System As In Effect For 2024—Joint Committee on Taxation
4. United Therapeutics v. Commissioner, 133 AFTR 2d 2024 (4th Cir.)—Research Tax Credit
5. In Re: Lee,133 AFTR 2d 2024 (Bankruptcy Court)—Tax Claims
6. In Re: Tampa Hyde Park Café Properties, 133 AFTR 2d 2024-1701 (Bankruptcy Court)—Tax claims-Objection to proof-Alter Ego Theory
7. Friedman v. IRS, 133 AFTR 2d 2024-1663 (Dist. Ct. Wash)—Actions against IRS and IRS Commissioner—proper defendant—damages
8. Cobai v United States, 133 AFTR 2d 2024-1636 (Dist. Ct. Calif)—Refund actions—administrative claims
9. Aguinaldo v. Yee, 133 AFTR 2d 2024-1604 (Dist. Hawaii)—Actions against U.S.—constitutional claims
10. United States v. Eaton Corp., 133 AFTR 2d 2024-1554 (Dist. Ct. Ohio)—Summons enforcement—procedure
11. Cognizant Technology Solutions v. United States, 133 AFTR 2d 2024-1498 (Dist. Ct. New Jersey)—District Court procedure—qui tam suits—False Claims Act—subpoenas—Administrative Procedure Act
12. Foley v. Commissioner, 95 F.4th 740 (2nd Cir. 2024)—Appeals from Tax Court—jurisdiction—small tax case
13. Farhy v. Commissioner, 133 AFTR 2d 2024-1462 (D.C. Cir.)—Information reporting penalties regarding foreign entities—assessment; IRS authority—collection due process
14. Watson v. Commissioner, 133 AFTR 2d 2024-1621 (10th Cir.)—Appeals from Tax Court—jurisdiction
15. United States v. Allahyari, 133 AFTR 2d 2024-1365 (9th Cir.)—Collection actions—lien foreclosure and priority—fraudulent transfers—appeals—jurisdiction
16. Notice 2023-42 Failure to pay corporate estimated tax penalties—corporate alternative minimum tax—waivers
17. Notice 2023-54 Employee benefit plans—required minimum distributions
18. Notice 2023-55 Foreign tax credit—determination of foreign income taxes—temporary relief
19. Notice 2023-59 Energy efficient home improvement credit—home energy audits—requirements and procedure for claiming credit
20. Notice 2023-62 Catch-up contributions—designation of contributions
21. Notice 2023-69 Gross income—leave-based donation programs—Hawaii wildfires

[File: H:\WS\LETTERS\9965-624 GUAM FEDERAL TAX UPDATE.DOCX]

22. Notice 2023-71 Authority to postpone certain deadlines by reason of terroristic or military actions
23. Notice 2024-2 Retirement and pension plans—guidance
24. Notice 2024-7 Failure to pay tax penalties—penalty relief for tax years 2020 and 2021
25. Notice 2024-8 Business use of auto—deductions—optional standard mileage rates for 2024
26. Notice 2024-11 Dividends—reduced capital gains tax rate—qualified foreign corps.—treaties
27. Notice 2024-16 Basis of stock in controlled foreign corps.—adjustments—liquidations and asset reorgs
28. Notice 2024-19 Penalties for failure to furnish correct payee statements—partnerships—sales or exchanges—unrealized receivables and inventory items
29. Notice 2024-31 U.S. taxpayers living abroad—income exclusions—foreign housing costs
30. Notice 2024-44 Tax on nonresident alien individuals—treatment of dividend equivalent payments
31. Notice 2024-54 Partnerships—related-party transactions; basis shifting; tax avoidance—compliance—organization of IRS
32. Notice 2024-55 10% additional tax on early retirement plan distributions—exceptions—emergency personal expenses; domestic abuse
33. Rev. Rul. 2024-10 Exempt orgs.—private foundations—governing instruments—state law
34. Rev. Rul. 2024-14 Partnerships—related-party transactions; basis shifting; tax avoidance—economic substance—accuracy related penalties
35. Rev. Proc. 2023-40 Accuracy-related penalties—adequate disclosure
36. Rev. Proc. 2024-13 Limitations on depreciation for auto owners and lessees
37. Lesson from The Tax Court: Temporary vs. Indefinite Commutes
38. Ledbetter v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-19
39. Lesson from The Tax Court: The IRS's Substantial Justification Defense to Sec. 7430 Fee Awards
40. Castillo v. Commissioner of Internal Revenue, 160 T.C. No. 15 (2023)
41. Lesson from The Tax Court: How to Calculate Insolvency for the Section 108 Exclusion
42. White v. Commissioner of Internal Revenue, T.C. Memo 2023-77
43. Lesson from The Tax Court: Freedom, Taxes, and Hobbies
44. Swanson v. Commissioner of Internal Revenue, T.C. Memo 2023-81
45. Lesson from The Tax Court: Deducting Graduate School Costs
46. Uchinzozo v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-21
47. Lesson from The Tax Court: Creating Your Best Administrative Record
48. Whittaker v. Commissioner of Internal Revenue, T.C. Memo 2023-59
49. Lesson from The Tax Court: Size Does Not Matter
50. Braen v. Commissioner of Internal Revenue, T.C. Memo 2023-85
51. Lesson from The Tax Court: An Object Lesson On Adequate Business Records

52. Ninke v. Commissioner of Internal Revenue, T.C. Memo 2023-88
53. Lesson from The Tax Court: Gotta Get Physical for Casualty Loss Deduction
54. Cleary v. Commissioner of Internal Revenue, T.C. Memo 2023-43
55. Lesson from The Tax Court: Tax Consequence for Discharge of Non-Recourse Debt
56. Parker v. Commissioner of Internal Revenue, T.C. Memo 2023-104
57. Lesson from The Tax Court: The DOI Downside to Disregarded LLC
58. Jacobowitz v. Commissioner of Internal Revenue, T.C. Memo 2023-107
59. Lesson from The Tax Court: The Boundary Waters of Equity
60. Evenhouse v. Commissioner of Internal Revenue, T.C. Memo 2023-113
61. Lesson from the Tax Court: Equitable Tolling During Government Shutdown
62. Organic Cannabis Foundation v. Commissioner of Internal Revenue, 161 T.C. No. 4 (2023)
    General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals ["Green Book"]
63. Reform Business Taxation
64. Reform International Taxation
65. Strengthen Taxation of High-Income Taxpayers
66. Modify Rules Relating to Retirement Plans
67. Support Workers, Families, and Economic Security
68. Modify Estate and Gift Taxation
69. Close Loopholes
70. Improve Tax Administration
71. Improve Tax Compliance
72. Treasury Decision 9980 Identifying numbers—fee for obtaining preparer tax identification number
73. Treasury Decision 9981 Private foundation defined—supporting orgs.
74. Treasury Decision 9984 Penalties for failure to file correct information returns or furnish correct payee statements—de minimis safe harbor—broker returns—final regs.
75. Treasury Decision 9996 Generation-skipping transfer taxes—elections and extensions—final regs.
76. Lesson from The Tax Court: The Designated Payment Rule
77. Edwards v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-29
78. Lesson from The Tax Court: The Limits of Collection Due Process
79. Olson v. Commissioner of Internal Revenue, T.C. Memo 2023-123
80. Lesson from The Tax Court: The Rules for Penalty Approval Depend on Geography
81. Kraske v. Commissioner of Internal Revenue, 161 T.C. No. 7 (2023)
82. Lesson from The Tax Court: Section 6662 Is Sometimes Multiple Penalties For Supervisory Approval Purposes But Sometimes Not
83. Kelley v. Commissioner of Internal Revenue, T.C. Memo 2023-126
84. Lesson from The Tax Court: Merely Winning Does Not Entitle Taxpayer to Attorney Fees

85. Champions Retreat Golf Founders v. Commissioner of Internal Revenue, T.C. Memo 2023-143

American Federal Tax Reports

FARHY v. COMM., Cite as 133 AFTR 2d 2024-1462, Code Sec(s) 6038; 6201; 6330, (CA Dist Col), 05/03/2024

Alon FARHY, APPELLEE v. COMMISSIONER of Internal Revenue, APPELLANT.

Case Information:

[pg. 2024-1462]

Code Sec(s):	6038; 6201; 6330
Court Name:	U.S. **Court** of **Appeals**, Dist. of Columbia Circuit,
Docket No.:	No. 23-1179,
Date Decided:	05/03/2024.
Prior History:	Tax Court, (**2023**) 160 TC No. 6 (opinion by Marvel J.), reversed and remanded.
Tax Year(s):	Years 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2010.
Disposition:	Decision for Govt.

HEADNOTE

1. Information reporting penalties regarding foreign entities—assessment; IRS authority—collection due process. Tax Court decision that IRS lacked statutory authority to assess and administratively collect Code Sec. 6038(b) penalties against taxpayer/foreign business owner, for his undisputed failure to report his control of foreign financial accounts and entities, was reversed and remanded. Contrary to Court's finding, IRS's Code Sec. 6201 authority to assess all "assessable penalties" encompassed authority to assess penalties imposed under Code Sec. 6038(b) . Although Code Sec. 6038(b) didn't explicitly say whether those penalties were as[pg. 2024-1463] sessable, appeals court found that when read in light of its text, structure, and function, Code Sec. 6038 was best interpreted as rendering Code Sec. 6038(b) penalties assessable and concluded that this was "buttressed by more than forty years of congressional acquiescence to the IRS's practice" of assessing these penalties.

Reference(s): Code Sec. 6038;Code Sec. 6201;Code Sec. 6330

OPINION

Francesca Ugolini, Attorney, U.S. Department of Justice, argued the cause for appellant. With her on the briefs were Jennifer M. Rubin and Robert J. Wille, Attorneys.

Edward M. Robbins argued the cause and filed the brief for appellee.

United States Court of Appeals FOR THE DISTRICT OF COLUMBIA CIRCUIT,

Appeal from the United States Tax Court

Before: PILLARD and WILKINS, Circuit Judges, and ROGERS, Senior Circuit Judge.

Opinion for the Court filed by Circuit Judge PILLARD.

Judge: PILLARD, Circuit Judge:

Section 6038(a) of the Internal Revenue Code requires U.S. persons to file information returns reporting their control of any foreign business. Alon Farhy acknowledges that he violated that statutory obligation when he failed to report to the Internal Revenue Service his ownership of Belizean corporations and thus owes the United States government nearly $500,000 in penalties under section 6038(b), which imposes a fixed-dollar penalty for failure to comply with the requirements of section 6038(a). Farhy disputes only the method by which the Internal Revenue Service sought to collect that sum: assessing the penalties owed and notifying Farhy that it will levy his property if he fails to pay them. He contends that the IRS lacks statutory authority for its decades-long practice of assessing and administratively collecting section 6038(b) penalties. As he reads the statute, the government must sue him in federal district court to collect what he owes under section 6038(b). The Tax Court agreed, concluding that the Code does not empower the

Service to assess and administratively collect section 6038(b) penalties. We hold that the text, structure, and function of section 6038 demonstrate that Congress authorized assessment of penalties imposed under subsection (b), and so reverse and remand to the Tax Court with instructions to enter decision in favor of the Commissioner.

BACKGROUND

A.

This case is a dispute over the process available to the IRS to enforce U.S. persons' obligations to file tax returns regarding their foreign interests. Can the penalty for failure to file be assessed by the Internal Revenue Service (IRS or Service), or must the Department of Justice sue and obtain a judgment from a federal district court before it can enforce the penalty? To appreciate what is at stake, it helps to understand that the Treasury Secretary's power of "assessment" is the cornerstone of the government's tax collection authority. An "assessment" is the "official recording" of the amount a taxpayer owes the federal government. *Polselli v. IRS*, 598 U.S. 432, 438 [131 AFTR 2d **2023** -1683] (**2023**); *see also* **I.R.C.** §§ 6203. The federal tax system largely relies on each taxpayer's self-assessment, meaning the taxpayer's calculation of the amount she owes in a tax return filed with the IRS along with the indicated tax payment. The Commissioner of the Service, to whom the Treasury Secretary's assessment authority is delegated, typically accepts the taxpayer's calculation and formally executes the assessment by "record[ing] the liability of the taxpayer" and crediting payments to that amount. *United States v. Galletti*, 541 U.S. 114, 122 [93 AFTR 2d 2004-1425] (2004); *accord Direct Mktg. Ass'n v. Brohl*, 575 U.S. 1, 9 (2015). When a taxpayer fails to file the requisite return or misstates the amount owed, the Commissioner determines the assessment: It "calculates the proper amount of liability and records it in the Government's books." *Galletti*, 541 U.S. at 122.

An assessment's unassuming form as a "bookkeeping notation," *Hibbs v. Winn*, 542 U.S. 88, 100 (2004) (quoting *Laing v. United States*, 423 U.S. 161, 170 [37 AFTR 2d 76-530] n.13 (1976)), belies its importance. "[I]t is the assessment, and only the assessment, that sets in motion the collection powers of the IRS, powers that include the seizure of assets, the freezing of bank accounts and the creation of liens, all without judicial process." *Phila. & Reading Corp. v. United States* , 944 F.2d 1063, 1064 [68 AFTR 2d 91-5501] n.1 (3d Cir. 1991). Within 60 days of the IRS's assessment of a liability not already paid, the Service must "give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof." **I.R.C.** §§ 6303(a). Then, if the amount remains unpaid, the IRS "can employ administrative enforcement methods to collect the tax," including liens and levies. *Galletti* , 541 U.S. at 122. An IRS assessment [pg. 2024-1464] thus serves as "the trigger for levy and collection efforts." *Hibbs*, 542 U.S. at 102.

It is the rare federal tax that can only be recovered through a government-initiated lawsuit. Generally, "all taxes" imposed under the Internal Revenue Code (**IRC** or Code) are assessable. **I.R.C.** §§ 6201(a). That includes "assessable penalties," *id.*, such as those authorized by Chapter 68 of the Internal Revenue Code (titled "Additions to the Tax, Additional Amounts, and Assessable Penalties"), *see* **I.R.C.** Ch. 68; *see also id.* § 6665(a)(1). Chapter 68 penalties cover a range of conduct such as the failure to include required reportable transactions on returns, *id.* § 6707A, and the failure to file information with respect to certain foreign trusts, *id.* § 6677(a). But not every tax-related penalty is assessable. The **IRC** specifies, for example, that civil penalties for willful failure to pay excise taxes related to tobacco products are "to be recovered, with costs of suit, in a civil action." *Id.* § 5761(a).

Collection actions ensuing from IRS assessments operate largely in the administrative realm with limited opportunities for taxpayers to seek judicial review. Generally, taxpayers can obtain judicial review of an assessed liability by paying the amount in full and then filing a refund suit in federal district court. *See Flora v. United States*, 362 U.S. 145, 157-58 [5 AFTR 2d 1046] (1960). Recognizing that the pay-first, challenge-later model put judicial review out of reach of taxpayers who could not pay, Congress provided for pre-collection review of assessments in two main circumstances.

First, if an unpaid tax is a "deficiency," the IRS is required to provide the taxpayer an opportunity for judicial review before assessment. The Code defines a deficiency as "the amount by which the [income, gift, estate, or excise] tax imposed...exceeds" the sum of "the amount shown as the tax by the taxpayer upon his return" plus any previous deficiency, less "the amount of rebates...made." **I.R.C.** §§ 6211(a). It thus "does not include all taxes owed by a taxpayer, but only those that are both owed and not reported." *Laing*, 423 U.S. at 173 n.18. Upon receipt of a notice of deficiency, a taxpayer generally has 90 days within which to petition the Tax Court for a redetermination of the deficiency. **I.R.C.** §§ 6213(a). Tax Court decisions are reviewable in federal **courts** of **appeals**. *Id.* § 7482(a)(1). The Service cannot assess the deficiency until the Tax Court's decision is final (or until expiration of the 90-day window to seek Tax Court review). *Id.* § 6213(a).

Many penalties, however, are not included in the statutory definition of "deficiency." Those exactions are not subject to deficiency procedures, so the IRS can assess them without awaiting judicial review. The IRS must notify the taxpayer of the amount due per its assessment and demand payment. **I.R.C.** §§ 6303(a). If the taxpayer fails to pay, the amount due "shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person." *Id.* § 6321. When the IRS files public notice of the federal tax lien on the taxpayer's property, it must again provide notice to the taxpayer. *Id.* § 6320(a). Similarly, if the IRS chooses to collect the liability by levying (*i.e.*, seizing) a taxpayer's property or rights to property, it must provide notice to the taxpayer. *Id.* § 6331(d).

Those lien and levy notices trigger the second main path to pre-collection judicial review. Upon notice of the IRS's filing of a lien or intention to levy property, the taxpayer is entitled to request a Collection Due Process (CDP) hearing, **I.R.C.** §§ 6320(b)(1), 6330(b)(1), the result of which the taxpayer may challenge in Tax Court, *id.* §§ 6320(c), 6330(d)(1). A CDP hearing proceeds before the IRS Office of Appeals, *id.* §§ 6320(b)(1), 6330(b)(1), and lacks the typical hallmarks of a judicial hearing. There are no formal discovery procedures, and the taxpayer has no right to subpoena documents or witnesses. *See* Treas. Reg. § 301.6330-1 (2006). The hearing may occur through written or oral correspondence rather than a single in-person event. *Id.* "Indeed, far from constituting a formal hearing," a CDP hearing simply provides the taxpayer "an opportunity for an informal oral or written conversation with the IRS before he must pay a tax." *Our Country Home Enters., Inc. v. Comm'r*, 855 F.3d 773, 780 [119 AFTR 2d 2017-1701] (7th Cir. 2017).

In a CDP hearing, the taxpayer may raise "any relevant issue relating to the unpaid tax or the proposed levy," including "appropriate spousal defenses," "challenges to the appropriateness of collection actions," and "offers of collection alternatives" to facilitate his payment of the amount due. **I.R.C.** §§ 6330(c)(2)(A). If the taxpayer had no prior opportunity to dispute the tax liability—such as through deficiency proceedings—she may also challenge the "existence or amount of the underlying tax liability." *Id.* § 6330(c)(2)(B). The appeals officer conducting a CDP hearing must consider (1) the verification from the Service that the agency followed applicable laws and procedures, (2) any challenges raised by the tax[pg. 2024-1465] payer, and (3) whether "any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the person that any collection action be no more intrusive than necessary." *Id.* § 6330(c)(3). An Appeals Office decision is appealable to the Tax Court and, from there, to a federal **court** of **appeals**. *Id.* §§ 6330(d)(1), 7482(a)(1).

B.

At issue in this case is section 6038(a), which requires U.S. persons to file information returns reporting their control of any foreign business. It is one of dozens of provisions across the Internal Revenue Code that require taxpayers and other third parties to file certain information returns with the IRS or face penalties. Those required disclosures facilitate the IRS's verification of taxpayers' income and tax liabilities and assist the Service in detecting tax evasion. *See* Michael I. Saltzman & Leslie Book, IRS PRACTICE & PROCEDURE ¶ 7B.10. Many required informational filings relate to U.S. taxpayers' foreign interests: Activities including the receipt of large gifts from foreign persons, transfers of property to foreign businesses or persons, ownership of foreign financial assets, and creation of foreign trusts all trigger reporting requirements enforceable with civil penalties—even if no taxes are owed in connection with the requisite information. *See* **I.R.C.** §§ 6039F, 6038B, 6038D, 6048. Those requirements are designed to inform the Service of activities not subject to withholding that might generate tax revenue. They deter the use of international schemes to evade taxes, which are estimated to cost the U.S. government over $100 billion per year. *See* Jane G. Gravelle, Cong. Rsch. Serv., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 1, 21, 29-30 (2022).

When Congress initially enacted section 6038 in 1960, the sole penalty for the failure to file the information required by section 6038(a) was a 10 percent reduction of the violator's foreign tax credit. *See* Act of Sept. 14, 1960, Pub. L. No. 86-780, § 6(a), 74 Stat. 1010, 1014-16 (initially applying the reporting requirement only to domestic corporations that controlled foreign businesses); *see also* Revenue Act of 1962, Pub. L. No. 87-834, § 20(a), 76 Stat. 960, 1059-60 (amending section 6038 to apply to all U.S. persons with control over a foreign business). Now codified at subsection 6038(c), the foreign tax credit reduction is assessable by the Service. Its assessability is intrinsic to how the subsection (c) penalty works: By reducing a taxpayer's foreign tax credit, it increases the amount of tax he owes. The penalty amount is thus necessarily reflected in a tax liability. Taxes are categorically assessable under section 6201(a), which states that "[t]he Secretary is authorized and required to make...assessments of all taxes...." Indeed, for this reason, Farhy concedes that subsection (c) penalties are assessable. *See* Oral Arg. Rec. 54:40-57.

In 1982, Congress amended section 6038 to bolster its enforcement. *See* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, Title III, § 338, 96 Stat. 324, 631. "Despite complaints about inadequate reporting with respect to controlled foreign corporations," enforcement of the penalty for failure to file was persistently lax. S. Rep. No. 97-494, vol. 1, at 299 (1982). At the time, the foreign tax credit penalty was overly "complicated" and rarely imposed. *Id.* The penalty could be "unduly harsh" in response to minor violations, even as it was "of no use" to penalize violators who paid no foreign income tax, so were due no credit in the relevant year. *Id.*

Congress responded by adding alongside subsection (c) a streamlined, uniform penalty for the same failure to file an informational return for a controlled foreign business: a flat $1,000 subsection (b) penalty, which it has since increased to $10,000. *See* § 338, 96 Stat. at 631; Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Title XI, § 1142(a), 111 Stat. 788, 982. The subsection (b) penalty escalates by standard increments in response to persistent and knowing non-payment to a maximum total of $60,000 per year. *See* **I.R.C.** §§ 6038(b)(1)- (b)(2). And section 6038 coordinates the penalties imposed under subsections (b) and (c) to avoid double-charging for the same violation. The amount of the subsection (c) penalty—the percentage-based reduction of the taxpayer's foreign tax credit—is itself offset by the amount of any fixed-dollar penalty authorized for the same period under subsection (b). *See id.* § 6038(c)(3).

C.

In 2004, U.S. permanent resident Alon Farhy developed a scheme to falsely underreport to the IRS his income from exercising certain stock options he received from his then-employer. Seeking to fabricate losses to reduce his U.S.-reportable income, he transferred more than $2 million to a sham foreign entity, which then transferred the funds to a bank account in the name of a Belize-based corporation Farhy created solely for that purpose. Farhy's scheme violated a variety of tax-related obligations beyond his duty to correctly report and pay the income tax he owed. Most relevant to this case, [pg. 2024-1466] he also failed to report to the IRS his control of foreign financial accounts and foreign corporations he used in the scheme. In 2012, Farhy signed a non-prosecution agreement with the Tax Division of the U.S. Justice Department that immunized him from criminal prosecution for his failure to disclose his offshore accounts, provided he cooperated fully and truthfully with tax enforcement efforts and paid all applicable taxes, interest, and penalties.

But the non-prosecution agreement did not absolve Farhy of civil liabilities arising from tax code violations. On February 9, 2016, the IRS mailed Farhy notice that, between 2003 and 2010, he had failed to file forms to disclose his ownership of the Belizean corporations, as required by **I.R.C.** §§ 6038(a). More than two years later, when Farhy still had not filed the required forms, the IRS assessed initial and continuation penalties pursuant to **I.R.C.** §§ 6038(b), totaling $60,000 per year of Farhy's non-compliance. After the IRS sent Farhy notice of its intent to levy his property to collect the penalties owed, Farhy requested a CDP hearing. The Appeals Office upheld the proposed levy of Farhy's property.

Farhy petitioned the Tax Court to invalidate the proposed levy, arguing only that the IRS was not authorized to assess penalties imposed under section 6038(b). He claimed that the IRS was instead required to collect liabilities for such penalties through a civil action brought in federal district court under 28 U.S.C. § 2461(a). Section 2461(a) establishes a general cause of action authorizing the government to sue to collect any civil penalty "prescribed for the violation of an Act of Congress."

The Tax Court granted Farhy's petition. *See Farhy v. Comm'r*, Dkt. No. 10647-21L, **2023** WL 2752459, at *1 (T.C. Apr. 3, **2023**). It held that the IRS could not proceed with its proposed levy because the Secretary lacked statutory authority to assess the penalties. *Id.* at *4. The court concluded that, although Congress explicitly authorized assessment with respect to many penalty provisions across the tax code, it did not do so for section 6038(b). *Id.* at *4-5. That meant that the IRS could collect section 6038(b) penalties only through a civil suit filed by the U.S. Department of Justice, not through the administrative collection methods that it had used to enforce the penalties for more than forty years. *Id.* at *5. The government appeals.

DISCUSSION

We review the Tax Court's legal rulings *de novo*. *Lissack v. Comm'r*, 68 F.4th 1312, 1322 [131 AFTR 2d **2023** -1834] (D.C. Cir. **2023**). The only question on appeal is what mechanism Congress authorized for the Secretary of the Treasury to collect the fixed-dollar penalties authorized in

I.R.C. §§ 6038(b) against a U.S. person who fails to file the requisite information returns regarding foreign businesses under her control.

The text of section 6038 does not explicitly say whether the penalties imposed for violating section 6038(a) are assessable. The parties principally argue from dueling presumptions that they contend generally apply to all penalties across the Internal Revenue Code. Each claims support from a distinct reading of **I.R.C.** §§ 6201(a), which grants the Treasury Secretary broad authority to assess "all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)." Although none of the terms in section 6201(a)'s parenthetical are defined by the statute, the three categories of penalties listed after "interest" in the text correspond with—but are not necessarily limited to—the penalties that are set out in **I.R.C.** Subtitle F, Chapter 68, which is titled "Additions to the Tax, Additional Amounts, and Assessable Penalties." All exactions in Chapter 68 are explicitly directed to "be assessed...in the same manner as taxes" by a subsection contained therein. **I.R.C.** §§ 6665(a)(1).

In relying on section 6201(a) to argue that the disputed penalty is assessable, the Service emphasizes that section's text as well as "its role in the Code, its history, and the absurdities that would result from a narrower interpretation." Reply Br. 2. The Service starts by treating the exactions listed in the section 6201(a)'s "including" parenthetical as both non-exhaustive and, together with "all taxes," illustrative of every type of exaction the tax code authorizes. It does not only claim that the term "assessable penalties" in the section 6201(a) parenthetical encompasses section 6038(b) penalties and others located "outside of Chapter 68." IRS Br. 18. Rather, the Service contends section 6201(a) is written to "cover the waterfront," Reply Br. 12, by making all exactions assessable as taxes unless the Code expressly requires a different process as to a given exaction. The Service explains that section 6201(a)'s parenthetical lists "interest" and three broad types of penalties that appear in the Code. Because the word "including" precedes that list, the Service contends that list is illustrative rather than exhaustive, and was meant to encompass penalties generally, thereby comfortably including section 6038(b) penalties. It claims support for that position in the immediate predecessor to section 6201(a), which empowered and obligated the Commissioner "to make the inquiries, determinations, and *assess[pg. 2024-1467] ments of all taxes and penalties* imposed by this title, or accruing under any former internal revenue law, where such taxes have not been duly paid...," **I.R.C.** §§ 3640 (1940) (emphasis added), which Congress recodified as 6201(a) with no apparent intention to circumscribe its applicability to all penalties.

For his part, Farhy interprets section 6201(a) to stand for the reverse presumption: He reads it to confirm that a penalty must be explicitly characterized as a "tax" or designated as "assessable" (or, presumably, an "additional amount" or "addition to the tax") elsewhere in the tax code for the Secretary to assess it per section 6201(a). Farhy reads section 6201(a)'s reference to "assessable penalties" to carry a negative implication that some penalties are *not* assessable, section 6038(b) penalties among them. More broadly, Farhy sketches out an exclusive schema of four overlapping ways the Code renders penalties assessable and insists penalties outside these categories are not assessable:

> *First*, "[s]ome penalties are designated as taxes for assessment purposes," thereby authorizing their assessment under section 6201(a). Farhy Br. 7 (emphasis omitted). This category encompasses all penalties contained in Subtitle F, Chapter 68 of the **IRC**, which states that those penalties "shall be assessed...in the same manner as taxes." **I.R.C.** §§ 6665(a)(1).
>
> *Second*, "[s]ome penalties have a stand[-]alone assessment authority" in the section of the tax code imposing them, Farhy Br. 7 (emphasis omitted), because they describe a penalty that "shall be assessed," *see, e.g.*, **I.R.C.** §§ 527(j)(1), or provide, through cross-reference to Chapter 68, that a statutory violation authorized outside that Chapter is subject to a penalty provided therein. Farhy Br. 7-8.
>
> *Third*, "[s]ome penalties have a group assessment authority," which occurs when the tax code "authorize[s] assessment of a penalty belonging in a designated group." *Id.* at 8 (emphasis omitted). Farhy again cites the penalties located in subchapter B of Chapter 68 (titled "Assessable Penalties"), which are explicitly directed to be "assessed and collected in the same manner as taxes," **I.R.C.** §§ 6671(a).
>
> *Fourth*, "[s]ome penalties result from a designated procedure," such as deficiency proceedings. Farhy Br. 8-9 (emphasis omitted).

Because section 6038(b)'s penalties fall into none of those categories, Farhy contends, they are not "assessable penalties" and section 6201(a) cannot be read to encompass them and thereby make them so.

We need not embrace either party's tax code-wide default rule to resolve this case. We accordingly do not pass on those broader theories beyond explaining why Farhy's does not preclude assessment of section 6038(b) penalties. Instead, we conclude that a narrower set of inferences suffices to show that Congress intended to render those penalties assessable. Read in light of its text, structure, and function, section 6038 itself is best interpreted to render assessable the fixed-dollar monetary penalties subsection (b) authorizes. As a result, the Commissioner's authority to assess all "assessable penalties" encompasses the authority to assess penalties imposed under section 6038(b).

A.

A close reading of section 6038 with an eye to the role of subsection (b) within it reveals that the Congress that amended the Code in 1982 intended the subsection (b) penalty to be assessable. For the same underlying failure to file, the section originally authorized only a percentage-based, assessable penalty imposed as a reduction of the taxpayer's foreign tax credit (now codified as subsection (c)). Two changes effected by the amendment are particularly relevant: First, in response to difficulties experienced in applying that original penalty, Congress added (as subsection (b)) a fixed-dollar penalty that could be more simply and consistently collected. Second, Congress required (in subsection (c)(3)) that the two penalties be coordinated. The subsection (b) penalty must be offset from any subsection (c) penalty in cases in which both penalties apply. All agree the IRS may assess subsection (c) penalties, and those two objectives of the amendment—that recovery of subsection (b) penalties be more streamlined than recovery of subsection (c) penalties, and that any subsection (c) penalty be reduced by the amount of the subsection (b) penalty—make plain that subsection (b) penalties must also be assessable. Section 6038's express authorization of the IRS rather than a district court to evaluate a taxpayer's defense to penalties imposed under the section reinforces that conclusion.

1.

Reading subsection (b) to require the government to sue taxpayers to collect its fixed-dollar penalty, as Farhy does, treats Congress as having enacted a supplemental penalty process that is less streamlined, not more, than the preexisting collection process for subsection (c) penalties. Again, the IRS may assess and collect a [pg. 2024-1468] subsection (c) penalty without entering a courtroom. All assessable exactions, including penalties under subsection (c), are subject to litigation only if a taxpayer opts for judicial review, such as by challenging a notice of deficiency in Tax Court pursuant to **I.R.C.** §§ 6213. If penalties imposed under subsection (b) are likewise assessable, as the government contends, the taxpayer may opt for judicial review of those penalties, too, by requesting a CDP hearing and, if dissatisfied with its result, obtaining Tax Court review under **I.R.C.** §§ 6330(d)(1).

If subsection (b) penalties are not assessable, the IRS cannot collect them at all without going first to court in each and every case. But it is unlikely the government will file lawsuits to recover from taxpayers the flat, $10,000 penalty authorized by subsection (b). Farhy concedes as much: As his counsel put it, the "Justice Department wouldn't touch that with a ten-foot pole." Oral Arg. Rec. 57:52-55. If subsection (b) penalties are that hard to recover, they may not be worth the candle. It would be "highly anomalous" for Congress to have responded to the identified problem of the underuse of subsection (c) penalties by promulgating a penalty that, while simpler to calculate, is much harder to enforce. IRS Br. 21; *see also* S. Rep. No. 97-494, vol. 1, at 299. Farhy has no persuasive rebuttal to that point. To the contrary, he suggests that Congress purposely made section 6038(b) penalties non-assessable—and therefore largely ornamental—because it wanted to "withhold the IRS's super-charged collection powers" that flow from assessment. Oral Arg. Rec.

44:32-42. That view is contradicted by the clear congressional purpose behind the enactment of subsection (b).

Further, the subsection (c)(3) coordination provision shows Congress contemplated that section 6038's tandem penalties could be imposed at the same time. When they are, treating the subsection (b) penalties as non-assessable would make recovering subsection (c) penalties even more, rather than less, complicated. That is because the amount by which the reduction of the taxpayer's foreign tax credit, calculated under section 6038(c)(1), should be offset per section 6038(c)(3) is set by subsection (b). It is thus fair to assume that Congress intended the subsection (b) penalty to be routinely assessed, but credited back in cases in which the Service also imposes a subsection (c) penalty. Under Farhy's reading, however, the subsection (b) penalty must await a federal court's entry of judgment. If both subsection (b) and subsection (c) penalties were sought in the same case, the Secretary would be forced to wait for the conclusion of the federal court action regarding the subsection (b) penalty before she could coordinate the subsection (b) and subsection (c) penalty amounts and then collect the correct subsection (c) penalty amount. To agree with that reading, we would have to conclude that, in enacting subsection (b), Congress not only failed in its avowed quest to streamline, but also counterproductively threw sand in the gears of section 6038's existing enforcement scheme.

2.

Another feature of the process contemplated in section 6038 drives home that Congress expected the IRS, not a federal district court, to assess subsection (b) penalties. Consider what section 6038 says about the determination of specified defenses to the penalties the section imposes. As with many penalties imposed across the tax code, penalties under sections 6038(b) and (c) are subject to a "reasonable cause" affirmative defense, which courts describe as requiring the taxpayer to establish that she "exercised ordinary business care and prudence" in attempting to adhere to her reporting obligations. *Flume v. Comm'r*, Dkt. No. 15772-14L, 2017 WL 394541 [2017 RIA TC Memo ¶2017-021], at *5 (T.C. Jan. 30, 2017) (quoting *United States v. Boyle*, 469 U.S. 241, 246 [55 AFTR 2d 85-1535] (1985)). And section 6038 empowers the Service—not a court—to grant or deny that defense. *See* **I.R.C**. §§ 6038(c)(4)(B) (requiring reasonable cause to be "shown to the satisfaction of the Secretary").

Various **IRC** provisions excuse taxpayers for conduct otherwise subject to penalty based on a showing of "reasonable cause" for the noncompliance. If a taxpayer experienced a debilitating health condition constituting "reasonable cause" severe enough to interfere with her ability to file, for example, the IRS could not impose penalties unless the taxpayer's non-compliance persisted once she had recovered. *See, e.g.* , *Remisovsky v. Comm'r*, Dkt. No. 11945-20L, 2022 WL 3755390 [2022 RIA TC Memo ¶2022-089], at *3-4 (T.C. Aug. 30, 2022). Putting the IRS in charge of determining whether a taxpayer has demonstrated reasonable cause only makes sense in circumstances in which it is the IRS that assesses the penalty. Where Congress requires the government to file a civil action to enforce a violation of the tax code, the court rather than the Service would decide whether the taxpayer proved that the defense excuses his or her violation.

Section 6038(c)(4)(B) expressly treats the reasonable cause showing for failure to file the relevant informational returns as within the purview of the Service. A taxpayer facing a sub[pg. 2024-1469] section (b) penalty may submit to the IRS a written statement attesting that reasonable cause excused the filing failure, *see* Treas. Reg. § 1.6038-2(k)(3)(ii), and "provide a reasonable cause narrative during the CDP hearing" to an IRS employee acting with delegated authority from the Secretary, who makes a determination that can be appealed to the Tax Court. *Flume*, 2017 WL 394541 [2017 RIA TC Memo ¶2017-021], at *6; *see* Treas. Reg. § 1.6038-2(k)(3)(ii). The 1982 Senate Report confirms that the reasonable-cause defense to subsection (b) penalties was intended to operate "[a]s under present law," meaning as under subsection (c); in either case, a showing made "to the satisfaction of the Secretary" would mean that "no penalty is due." S. Rep. No. 97-494, vol. 1, at 299.

If the subsection (b) penalty were not assessable, there would be no post-assessment administrative process in which the taxpayer could make a reasonable cause showing to the Secretary. On Farhy's reading, it would be for the district court rather than the Secretary to determine the taxpayer's liability for the penalty, subject to any reasonable-cause defense. It is hard to see what purpose would be served by the statutory requirement that the taxpayer's reasonable-cause defense be "shown to the satisfaction of the Secretary" if the claim subject to that defense must be decided in the first instance by a district court judge. **I.R.C.** §§ 6038(c)(4)(B).

Congress's specification that the Secretary, not the district court, evaluates taxpayers' assertions of reasonable-cause defenses to section 6038(b) penalties dovetails neatly with section 6201(a). In addition to empowering and requiring the Secretary to make assessments, section 6201(a) calls on the Secretary to "make the inquiries [and] determinations...of all taxes (including...assessable penalties)." As just discussed, one familiar set of secretarial "determinations" is whether a taxpayer has "shown to the satisfaction of the Secretary" that he had reasonable cause for failing to file required information, per **I.R.C.** §§ 6038(c)(4)(B). Farhy's insistence that section 6201(a) is inapplicable to section 6038(b) penalties would leave the Secretary without power under section 6201(a) regarding not only the assessment of section 6038(b) penalties, but "inquiries" and "determinations" into them as well. Section 6038's express contemplation that the Secretary will determine the reasonable-cause defense—whether penalty is sought under subsection (b) or (c)—supports treating both section 6038 penalties as assessable. The unworkability of rendering inquiry-and-determination authority not equally applicable to the penalties under those tandem subsections bolsters our conclusion that Congress intended both penalties to be assessable within the meaning of section 6201(a).

3.

Finally, the potential bifurcation of the review of penalties arising from the same violation underscores the anomalous implications of interpreting subsection (c), but not subsection (b), penalties to be assessable. Farhy's reading would create parallel and substantively overlapping judicial tracks for determination of twinned penalties for the same noncompliance: federal district court for the subsection (b) penalties, and Tax Court for the subsection (c) penalties. Interjecting a federal district court into a penalty process already subject to IRS administrative determinations reviewable by the Tax Court introduces an inexplicable asymmetry and potential for inconsistent doctrinal development. If both penalties were sought in the same case, it could even generate duplicative court proceedings on common issues. Both courts might have to decide, for example, whether the taxpayer who failed to disclose his controlling stake of the foreign businesses owned those businesses during the years for which the IRS seeks penalties, and review or decide whether the taxpayer had a reasonable-cause defense to the section 6038(a) violation.

Treating the subsection (b) penalty as non-assessable could also raise potential preclusion issues when both penalties are imposed for the same conduct. Provided other requirements of collateral estoppel are met, the first-issued judgment as to a common issue between the parallel proceedings would have binding effect on the other court. *See, e.g.*, *Burrows v. United States*, 945 F.2d 408 (9th Cir. 1991) (unpublished table decision). Reading section 6038 to call for dual-track subsection (b) and (c) judicial proceedings could stir concerns about gamesmanship, incentivizing parties to push forward more quickly in the forum they perceive to be more favorable.

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

B.

It is hardly anomalous that section 6038(b) penalties are assessable even though the text of section 6038 does not explicitly label them as such. Farhy's contention that Congress may only authorize assessment of a penalty by using certain formulations that he has identified over[pg. 2024-1470] looks the realities of the Internal Revenue Code—an ever-changing statutory patchwork that contains nearly 10,000 code sections. *See* NAT'L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 45 (2022). Scattered across the tax code are more than one hundred penalties applicable to diverse forms of noncompliance and set forth in varied ways. Discerning the operation of each penalty is necessarily a context-dependent exercise.

Farhy argues that, because the Internal Revenue Code has "explicitly authorized assessment regarding myriad penalty provisions in the Code" in the four ways he deems to be exclusive, Congress's putative failure to fit section 6038(b) penalties into his framework means they are non-assessable. Farhy Br. 9; *see Farhy*, **2023** WL 2752459, at *4. But Farhy is incorrect that Congress can only render a penalty assessable through the standardized methods he identifies.

Nothing establishes Farhy's categories as exhaustive of the ways the Internal Revenue Code designates penalties as assessable. Consider **I.R.C.** §§ 6038D, which requires U.S. persons to report to the IRS any interest exceeding $50,000 in certain foreign financial assets, such as financial accounts and foreign entities. Much like section 6038(b), section 6038D(d) imposes a fixed-dollar penalty of $10,000 for violating the statutory obligation. **I.R.C.** §§ 6038D(d)(1). And, like section 6038(b) penalties, penalties under section 6038D(d) escalate in response to continuing failure to comply after notice from the IRS. *Id.* § 6038D(d)(2). The penalty imposed under section 6038D(d) lacks all of the explicit indications of assessability Farhy insists are needed: Section 6038D is not within Chapter 68, all of which the Code explicitly renders assessable; it does not identify the penalty imposed therein as assessable; and it does not say its penalty corresponds to any penalties listed in Chapter 68. Consequently, Farhy urges that this penalty, too, is not assessable. *See* Farhy Br. 10 n.1.

But section 6038D(e) spells out a presumption, binding on the Commissioner "for purposes of *assessing* the penalties imposed under this section," that foreign financial assets not disclosed or sufficiently described meet the threshold amount required for the penalties to apply. **I.R.C.** §§ 6038D(e) (emphasis added). We do not rule on the point, as it is not before us, but specifying a default rule for the Commissioner to apply in penalty assessment would seem to make it quite plausible that section 6038D(d)'s penalties are assessable.

Section 45(b)(7)(B) provides another example of a provision that Farhy categorizes as not assessable within his schema, even though its text suggests that the penalty it authorizes is assessable. *See* Farhy Br. 10 n.1. That section imposes penalties for the failure to pay required wages to laborers who construct or repair renewable energy facilities. **I.R.C.** §§ 45(b)(7)(B)(i)(II). It does not appear in or cross-reference Chapter 68, or directly state that the penalty is assessable, as Farhy insists is required. It states only that deficiency proceedings "shall not apply with respect to *the assessment* or collection of any penalty imposed by this paragraph." *Id.* § 45(b)(7)(B)(ii) (emphasis added). Again, we make no holding on the point, but the implication is clear that, although the penalties imposed are not deficiencies, the Commissioner can summarily assess them. And Farhy ultimately concedes as much. Oral Arg. Rec. 49:10-20.

Thus, Congress renders penalties assessable in more ways than Farhy's proposed schema contemplates: The absence of the penalty from Chapter 68 and the lack of either a cross-reference to Chapter 68 or explicit language directing that the penalty "shall be assessed" is not determinative. Congress can make a penalty assessable by implication, and it did so here.

***

We conclude, based on the statute's text, structure, and function, that penalties imposed under section 6038(b), like the related penalties under section 6038(c), are assessable. This conclusion is buttressed by more than forty years of congressional acquiescence to the IRS's practice of assessing section 6038(b) penalties. "It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the `congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress.'" *Commodity Futures Trading Comm'n v. Shor*, 478 U.S. 833, 846 (1986) (quoting *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 274-75 (1974)); *see also Wash. All. of Tech. Workers v. U.S. Dep't of Homeland Sec.*, 50 F.4th 164, 182-85 (D.C. Cir. 2022). Since adding subsection (b) in 1982, Congress has amended section 6038 seven times; each time, it has left undisturbed the IRS's practice of assessing and administratively collecting penalties imposed under section 6038(b).

For the foregoing reasons, we reverse the judgment of the Tax Court and remand with in[pg. 2024-1471] structions to enter decision in favor of the Commissioner.

So ordered.

END OF DOCUMENT -

American Federal Tax Reports

WATSON v. COMM., Cite as 133 AFTR 2d 2024 -1621, Code Sec(s) 7482, (CA10), 05/29/2024

Michael J. WATSON; Tracey L. Watson; Watson Insurance Company; Watson Family Insurance Company; Watson Metals, PETITIONERS-APPELLANTS v. COMMISSIONER of Internal Revenue, RESPONDENT-APPELLEE.

Case Information:

[pg. **2024** -1621]

Code Sec(s):	7482
Court Name:	U.S. **Court** of **Appeals**, Tenth Circuit,
Docket No.:	No. 23-9001; (CIR No. [pg. **2024** -1622] 12220-21, 12223-21, 17350-21, 30612-21, 30613-21, and 30615-21) (U.S. Tax Court),
Date Decided:	05/29/**2024**.
Prior History:	Appeal from Tax Court dismissed.
Disposition:	Decision against Taxpayers.

HEADNOTE

1. Appeals from Tax Court—jurisdiction. Married taxpayers' and their cos.' appeal from Tax Court decision, which denied their motions to dismiss their deficiency petitions based on invalid deficiency notices, was dismissed: denial of motion to dismiss, even if based on jurisdictional grounds, wasn't final decision subject to immediate appellate review. Taxpayers' argument that 10th Cir. had jurisdiction based on collateral order doctrine was meritless.

Reference(s): Code Sec. 7482

OPINION

UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT,

ORDER[*]

Judge: Joel M. Carson III, Circuit Judge

Judge: Before CARSON, ROSSMAN, and FEDERICO, Circuit Judges.[**]

Petitioners Michael J. and Tracey L. Watson, the Watson Family Insurance Company, and the Watson Insurance Company filed separate but similar motions to dismiss for lack of jurisdiction before the United States Tax Court.[1] The Tax Court consolidated the cases and denied Petitioners' motions to dismiss. Petitioners filed an interlocutory appeal seeking immediate review of the Tax Court's denial. But before we may review an interlocutory decision from the Tax Court, we must first examine our own jurisdiction. Because we lack appellate jurisdiction to review the Tax Court's non-dispositive order in this case, we dismiss the appeal.

I.

In each case, we must ensure the existence of jurisdiction—"first, of this court, and then of the court from which the record comes." *Steel Co. v. Citizens for a Better Env't* , 523 U.S. 83, 94 (1998) (quoting *Great Southern Fire Proof Hotel Co. v. Jones*, 177 U.S. 449, 453 (1900)). Without appellate jurisdiction, we cannot proceed to the merits of the appeal, even if the merits include a jurisdictional challenge. *In re Lang*, 414 F.3d 1191, 1195 (10th Cir. 2005).

II.

Under **I.R.C.** §§ 7482(a)(1), we have jurisdiction to review the Tax Court's decisions "in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury."[2] Generally, we may review only the Tax Court's final decisions.[3] *Minemyer v. Comm'r* , 995 F.3d 781, 783 [127 AFTR 2d 2021-1749] (10th Cir. 2021) (quoting *Whitlock's Est. v. Comm'r* , 547 F.2d 506, 509 [39 AFTR 2d 77-439] (10th Cir. 1976)); *see also* 28 U.S.C. § 1291 ("The

courts of **appeals**...shall have jurisdiction of appeals from all final decisions of the district courts of the United States..."). A final decision "ends the litigation on the merits and leaves nothing for the court to do but execute the judgment." *Luna-Garcia v. Holder*, 777 F.3d 1182, 1185 (10th Cir. 2015) (quoting *Catlin v. United States*, 324 U.S. 229, 233 (1945)).

Petitioners contend that we have jurisdiction because the Tax Court denied their potentially dispositive motions to dismiss. But it is well-established, in cases before the district courts, that the denial of a motion to dismiss—even one based upon jurisdictional grounds—is not a final decision subject to immediate appellate review. *Eastwood v. Dep't of Corr.*, 846 F.2d 627, 629 (10th Cir. 1988) (citing 28 U.S.C. § 1291); *see also Catlin*, 324 U.S. at 236 ("[A] denial of a motion to dismiss, even when the motion is based upon jurisdictional grounds, is not immediately reviewable."). "By its very nature, the decision to deny a motion to dismiss is not final; rather than ending the litigation, it is a decision that [the litigation] will continue." *Conrad v. Phone Directories Co. Inc.*, 585 F.3d 1376, 1380 (10th Cir. 2009) (citing *Hatten- [pg.* ***2024*** *-1623] Gonzales v. Hyde*, 579 F.3d 1159, 1166 (10th Cir. 2009)). And because we review the Tax Court's decisions "in exactly the same circumstances in which we review decisions by the district courts," we conclude that the Tax Court's order denying Petitioners' motions to dismiss is not final. *See Minemyer*, 995 F.3d at 783 (quoting *Sheperd v. Comm'r.*, 147 F.3d 633, 634 [81 AFTR 2d 98-2466] (7th Cir. 1998)).

Petitioners also assert that we have jurisdiction based on the collateral order doctrine. But that argument lacks merit. For the collateral order doctrine to apply, the order must (1) conclusively determine the disputed question, (2) resolve an important issue completely separate from the merits, and (3) be effectively unreviewable on appeal from a final judgment. *Gray v. Baker*, 399 F.3d 1241, 1245 (10th Cir. 2005) (citing *Midland Asphalt Corp. v. United States*, 489 U.S. 794, 799 (1989)). The Supreme Court consistently has held that "the denial of a claim of lack of jurisdiction is not an immediately appealable collateral order" because the denial is effectively reviewable on appeal after the district court (or, in this instance, the Tax Court) enters a final judgment.[4] *E.g., Van Cauwenberghe v. Biard*, 486 U.S. 517, 527 (1988) (citing *Catlin*, 324 U.S. at 236). So Petitioners have not established jurisdiction under the collateral order doctrine, nor have Petitioners met their burden in establishing appellate jurisdiction.

APPEAL DISMISSED.

Entered for the Court

Joel M. Carson III

Circuit Judge

* This order is not binding precedent, except under the doctrines of law of the case, res judicata, and collateral estoppel. It may be cited, however, for its persuasive value consistent with Fed. R. App. P. 32.1 and 10th Cir. R. 32.1.

** After examining the briefs and appellate record, this panel has determined unanimously that oral argument would not materially assist in the determination of this appeal. *See* Fed. R. App. P. 34(a)(2); 10th Cir. R. 34.1(G). The case is therefore ordered submitted without oral argument.

1 The Commissioner of Internal Revenue sent Petitioners notices of deficiency for multiple tax years. When a taxpayer believes a deficiency notice is inaccurate—to avoid collection efforts by the Internal Revenue Service—he or she must petition the Tax Court for a redetermination of the deficiencies. **I.R.C.** §§ 6213(a) (West). But the Tax Court only has jurisdiction over valid deficiency notices. *Estate of Davenport v. Comm'r* , 184 F.3d 1176, 1182 [84 AFTR 2d 99-5144] n.2 (10th Cir. 1999) (citing *Miles Prod. Co. v. Comm'r*, 987 F.2d 273, 275 [71 AFTR 2d 93-2219] (5th Cir. 1993)); *see also* **I.R.C.** §§ 6212–6214. So here, Petitioners petitioned the Tax Court to prevent collections and then sought dismissal for lack of jurisdiction based on invalid deficiency notices.

2 Petitioners incorrectly assert that we have appellate jurisdiction under **I.R.C.** §§ 7481(c). Section 7481(c) addresses the Tax Court's jurisdiction over motions for redetermination of the amount of interest after the Tax Court issues a final decision. *Id.*

Petitioners also assert incorrectly that we have appellate jurisdiction under Federal Rules of Civil Procedure 3 and 4. Rule 3 addresses how an individual may commence a civil action before the district court. Fed. R. Civ. P. 3. Rule 4 governs the issue and service of summons. Fed. R. Civ. P. 4. Neither relates to appellate jurisdiction.

3 Under **I.R.C.** §§ 7482(a)(2)(A), we have discretion to review a Tax Court's order on interlocutory appeal when the order contains a certification that "a controlling question of law is involved with respect to which there is a substantial ground for difference of opinion and that an immediate appeal from that order may materially advance the ultimate termination of the litigation." The Tax Court's order here does not contain the requisite certification.

4 Petitioners still claim that the Ninth Circuit's decision in *Scar v. Comm'r*, 814 F.2d 1363 [59 AFTR 2d 87-950] (9th Cir. 1987), demonstrates that the Tax Court's denial of a motion to dismiss is effectively unreviewable on appeal after a final decision. But *Scar*, in our view, supports the opposite conclusion. *Id.* at 1366. There, Scar moved to dismiss for lack of jurisdiction, which the Tax Court denied. *Id.* at 1365–66. The case then proceeded before the Tax Court, which entered a final judgment against Scar. *Id.* at 1366. On appeal, the Ninth

Circuit reviewed the denial of Scar's Tax Court motion to dismiss for lack of jurisdiction. *Id.* at 1370. But the Ninth Circuit did so *after* the Tax Court issued a final decision. *Id.* The court, therefore, never addressed appellate jurisdiction. *Id.* So *Scar* supports the premise that we may effectively review the Tax Court's denial of a motion to dismiss for lack of jurisdiction on appeal from a final decision. *Id.* Our precedent similarly demonstrates that we may effectively review the denial of a motion to dismiss for lack of jurisdiction *after* the entry of a final judgment by the Tax Court. *E.g.*, *Katz v. Comm'r*, 335 F.3d 1121, 1125 [92 AFTR 2d 2003-5153] (10th Cir. 2003) (reviewing the Tax Court's denial of petitioner's motion to dismiss for lack of jurisdiction after the Tax Court issued a final decision).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
Federal Tax Decisions
American Federal Tax Reports
American Federal Tax Reports (Current Year)
2024
AFTR 2d Vol. 133
133 AFTR 2d 2024-1480 - 133 AFTR 2d 2024-1363
U.S. v. ALLAHYARI, 133 AFTR 2d 2024-1365, Code Sec(s) 6321; 7403, (CA9), 04/17/2024

American Federal Tax Reports

U.S. v. ALLAHYARI, Cite as 133 AFTR 2d 2024 -1365, Code Sec(s) 7403; 6321, (CA9), 04/17/2024

UNITED STATES OF AMERICA, PLAINTIFF-APPELLEE v. Shaun ALLAHYARI, DEFENDANT-APPELLANT and Komron M. ALLAHYARI, DEFENDANT.

Case Information:

[pg. **2024** -1365]

Code Sec(s):	7403; 6321
Court Name:	U.S. **Court** of **Appeals**, Ninth Circuit,
Docket No.:	No. 22-35422; D.C. No. 2:17-cv-00668-TSZ,
Date Decided:	04/17/**2024**.
Prior History:	Appeal from (2022, DC WA) 129 AFTR 2d 2022-1342, on remand from (2020, CA9) 126 AFTR 2d 2020-6869, reversing and remanding (2018, DC WA) 122 AFTR 2d 2018-5905, dismissed. Earlier proceedings at (2019, DC WA) 123 AFTR 2d 2019-1087; and (2018, DC WA) 122 AFTR 2d 2018-6482.

Tax Year(s):	Years 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007, 2008, 2009, 2011, 2012, 2013.
Disposition:	Decision for Govt.

HEADNOTE

1. Collection actions—lien foreclosure and priority—fraudulent transfers—appeals—jurisdiction. Taxpayer's father's appeal from non-final district court remand decision, which determined for lien foreclosure purposes that certain transfer/deed of trust purporting to secure taxpayer debts to father was fraudulent and subject to set aside, was dismissed for lack of jurisdiction. Notably, value of deed of trust had not yet been determined at time father filed his notice of appeal. While father argued that with district court's subsequent entry of order resolving value, his premature notice of appeal ripened into effective appeal of then-final judgment of foreclosure, he had not filed *new* notice of appeal within 60 days of order and premature notice of appeal, which was directed at original order that explicitly left amounts to be awarded from foreclosure sale unsettled and that asked for parties' submissions on that issue, was defective and couldn't be applied to subsequent order which resolved merits of that open issue. Also, subsequent order didn't constitute separate order for judicial sale as it confirmed that sale would be subject of further order and set forth no details how sale was to be conducted.

Reference(s): Code Sec. 7403;Code Sec. 6321

[pg. **2024** -1366]

OPINION

SUMMARY*

Tax

The panel dismissed an appeal for lack of jurisdiction, in an action by the government to reduce federal tax liens to judgment and foreclose on real property, because there was no final decision to appeal.

The order that taxpayer sought to appeal found that the government was entitled to foreclose on the tax liens, and to the sale of certain real property. However, the order was not final because the district court did not have sufficient information to enter an order for judicial sale. Instead, the district court ordered the parties to submit a Joint Status Report. Taxpayer filed his notice of appeal before the parties submitted the Joint Status Report and stipulated to the value of the property to be sold. The district court still has not entered an order for judicial sale.

Taxpayer contended that the district court's subsequent entry of an order resolving the value of the property ripened the premature notice of appeal into an effective appeal of what he contended was the then-final judgment of foreclosure. The panel first explained that, although a premature notice of appeal "filed after the court announces a decision or order—but before the entry of the judgment or order—is treated as filed on the date of and after the entry," Fed. R. App. P. 4(a)(2), this rule was inapplicable here. The rule was intended to protect unskilled litigants from failing to timely file a notice of appeal from what they reasonably believe to be a final judgment, such as where the only steps that remain to produce a final decision are essentially ministerial tasks. This rule could not be stretched to cover a premature notice of appeal directed at an order that explicitly deferred resolution of the quantification of a monetary award and that called for briefing from the parties on that issue. Taxpayer's premature notice of appeal thus would not have been effective to appeal any later final judgment if indeed there were one here. But the panel further held that, in any event, Taxpayer was wrong in contending that there was now a final judgment. The panel clarified that, for a decree of sale in a foreclosure suit to be considered a final decree for purposes of an appeal, it must settle all of the rights of the parties and leave nothing to be done but to make the sale and pay out the proceeds. Because that standard was not met in this case, there still was no final judgment. The panel therefore dismissed the appeal for lack of jurisdiction.

COUNSEL Rachel I. Wollitzer (argued) and Jacob Christensen, Attorneys; David A. Hubbert, Deputy Assistant Attorney General; Nicholas W. Brown, United States Attorney; United States Department of Justice, Tax Division, Appellate Section, Washington, D.C.; Morgan B. Hlinka, Trial Attorney; United States Department of Justice, Tax Division, Washington, D.C.; for Plaintiff-Appellee.

Curtis Isacke (argued) and Avi J. Lipman, McNaul Ebel Nawrot & Helgren PLLC, Seattle, Washington, for Defendant-Appellant.

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT,

Appeal from the United States District Court for the Western District of Washington Thomas S. Zilly, District Judge, Presiding

Before: Michael D. Hawkins, Ryan D. Nelson, and Daniel P. Collins, Circuit Judges.

OPINION

Judge: COLLINS, Circuit Judge:

FOR PUBLICATION

Shaun Allahyari appeals the district court's order concluding that a deed of trust granted in Shaun's favor by his son Komron Allahyari was a fraudulent transfer that lacks priority over the

Government's federal tax liens against Komron.[1] We conclude that the challenged order is not a final decision and that we therefore lack jurisdiction over this appeal under 28 U.S.C. § 1291. Accordingly, we dismiss this appeal for lack of jurisdiction.

I

In April 2005, Komron filed late tax returns for the years 1999–2002, and a tax return for 2004. Although these returns showed that Komron owed various amounts to the Internal Revenue Service ("IRS"), he did not include any payments with these returns. The IRS subsequently assessed unpaid income taxes, interest, and penalties against Komron.

In April 2017, the Government filed this action in which, *inter alia*, it sought to reduce the IRS's assessments to a judgment and to obtain foreclosure relief, in partial satisfaction of these liabilities, with respect to a residence owned by Komron in Mercer Island, Washington (the "Mercer Island Property"). Shaun was named as an additional Defendant with respect to the foreclosure-related claims, because he was the beneficiary of two deeds of trust that were recorded against the Mercer Island Property. In June 2018, Komron and the Government stipu[pg. **2024** -1367] lated to the entry of a partial judgment that fully resolved the IRS's claims for a monetary judgment concerning the amounts assessed.[2] Under the terms of that partial judgment, a monetary judgment was entered against Komron in the total amount of $3,910,470.35, plus "interest and statutory additions from June 14, 2018."

With that partial judgment in place, three claims in the Government's operative amended complaint against Komron and Shaun were left for resolution: (1) a request for a declaration that any mortgage or deed of trust granted by Komron in Shaun's favor was invalid or unenforceable and that Komron "owns the [Mercer Island] Property free and clear of Defendant Shaun Allahyari's purported interest"; (2) a request for an order declaring that any such deeds of trust were fraudulent transfers and setting them aside under Washington law; and (3) for an order, under Internal Revenue Code ("**I.R.C.**") § 7403(c), that would (i) foreclose on the various federal tax liens that had arisen from the IRS assessments and that the IRS had recorded against the Mercer Island Property beginning in 2005; and (ii) order the sale of the property, with the proceeds "to be applied toward satisfaction of the outstanding and unpaid tax assessments."[3]

These remaining claims challenged two distinct deeds of trust that had been granted by Komron in favor of Shaun. The first was a 2003 deed of trust on the Mercer Island Property that had initially been granted by Komron to the Boeing Employees' Credit Union ("BECU") as security for a $400,000 loan. After Komron defaulted on that loan, Shaun borrowed money in order to pay BECU the outstanding balance of the loan, and Shaun took an assignment of the BECU loan and the 2003 deed of trust. BECU's formal assignment of that deed of trust to Shaun was recorded on September 8, 2010. On the parties' cross-motions for summary judgment, the district court held that, as a matter of law, Shaun had "with respect to the amount he paid to BECU in exchange for the assignment ($383,044.74), the same priority position that BECU had as to its security interest in the real property at issue, which is senior to the Government's tax liens." The court, however, left for trial the question whether "any interest that has accrued with respect to the amount defendant Shaun Allahyari paid to BECU has priority over the Government's tax liens." At that subsequent bench trial, the district court ruled in Shaun's favor on this issue, holding that "Shaun is entitled to priority over the United States' federal tax liens with respect to interest that has accrued on the amount Shaun paid to BECU."

The second deed of trust that the Government challenged had been granted by Komron to Shaun on July 25, 2005 and formally recorded against the Mercer Island Property the next day. At the bench trial, the district court ultimately ruled for the Government on this claim. The court preliminarily agreed with Komron and Shaun that various "transfers" made by Shaun to Komron "beginning in 1991 through 2005 were bona fide loans, not gifts." Although the 2005 deed of trust was purportedly granted to secure Komron's performance with respect to such loans, the district court nonetheless held that the 2005 deed of trust did not take priority over the federal tax liens. The court relied on two alternative grounds in reaching this conclusion. First, the court held that the 2005 deed of trust did not meet the requirements of federal and Washington law to qualify as a "security interest" that would be entitled to priority over a later-recorded tax lien under **I.R.C.** § 6323(a). *See* **I.R.C.** § 6323(h)(1) (defining "security interest" in part based on incorporation of state law). Second, the court held that the 2005 deed of trust was "voidable under Washington's Uniform Fraudulent Transfer Act because Komron intended to `hinder, delay, or defraud' the United States" in granting the 2005 deed to Shaun. *See* REV. CODE WASH. § 19.40.041(1)(a).

On October 30, 2018, the district court entered a formal judgment in accordance with these findings, and that judgment specifically "foreclosed" the IRS's tax liens and ordered that the Mercer Island Property "shall be sold pursuant to 26 U.S.C. §§ 7403 and 28 U.S.C. § 2001, with the net proceeds to be disbursed as set forth" in a simultaneously filed "Order of Foreclosure and Judicial Sale." The latter order contained detailed instructions concerning the "terms and conditions of the sale," which was to be conducted by the U.S. Marshal or an IRS "Property Appraisal and Liquidation Specialist," and the order also contained detailed instructions concerning the distribution of the proceeds. [pg. **2024** -1368]

Both Shaun and the Government appealed, and we reversed and remanded. *United States v. Allahyari*, 980 F.3d 684 [126 AFTR 2d 2020-6869] (9th Cir. 2020). We concluded that the district court had applied the wrong legal standards in both of its alternative grounds for concluding that the 2005 deed of trust did not have priority over the federal tax liens. *Id.* at 689–92. We also held, in the Government's cross-appeal, that the district court failed to consider the effect of the Washington "statute of limitations when calculating the value of Shaun's senior lien under the BECU Deed of Trust." *Id.* at 694.

After receiving additional briefing on remand, the district court on March 31, 2022 issued an order again concluding that the 2005 deed of trust was a fraudulent transfer and that a foreclosure order in the Government's favor was warranted.

The district court noted that the only error that this court had identified with respect to the earlier fraudulent transfer finding was that the district court had applied the "preponderance of the evidence" standard rather than the "clear-and-satisfactory-proof standard" that applied under the relevant Washington law. *Allahyari*, 980 F.3d at 692. Accordingly, the district court re-evaluated the relevant factors under that standard and concluded that the Government had "met its burden to demonstrate that the 2005 Deed of Trust was a fraudulent transfer by clear and satisfactory proof." Because the court found that the 2005 deed was voidable as a fraudulent transfer, it explicitly declined to address, on remand, whether Shaun had adequately established a "security interest" within the meaning of **I.R.C.** § 6323.

As to the 2003 BECU deed of trust that had been assigned to Shaun and that had priority over the Government's liens, the district court on remand resolved certain legal issues between the parties as to how the statute of limitations applied. However, the court ultimately concluded that it did not have sufficient information or assistance from the parties to make what it believed to be the necessary calculations to determine the amounts secured by the BECU deed. Accordingly, the court ordered the parties to "meet and confer" and to "submit a Joint Status Report" setting forth their views as to five specified issues.

The district court further held that, although the court had "limited discretion to not order a foreclosure sale," Shaun had failed to show that a favorable exercise of such discretion was warranted here. Accordingly, the court concluded that "[t]he United States has established it has valid federal tax liens against the [Mercer Island] Property, and therefore the United States is entitled to judgment and to foreclose those liens, sell the [Mercer Island] Property, and apply the proceeds toward its tax liens."

The district court stated, however, that it would "delay entering an order for judicial sale until after it ha[d] received the requisite Joint Status Report from the parties and ha[d] determined how to calculate the value of the BECU Deed of Trust." On May 23, 2022, the parties submitted a Joint Status Report stating that they had "reached a tentative agreement regarding the value of the BECU Deed of Trust" and requesting additional time to "memorialize their agreement via stipulation."

On May 27, 2022, Shaun filed a notice of appeal from the March 31, 2022 order.

On June 2, 2022, the parties filed their stipulation regarding the value of the BECU Deed of Trust. The district court entered an order approving the stipulation on June 29, 2022. In the order, the court adopted the parties' stipulation that the "value of the BECU Deed of Trust as of May 1, 2022 is $620,000." The order also set forth how interest would be calculated on that sum. The final paragraph of the order provides as follows: "The parties' agreement does not impact or waive the United States' ability to seek a sale of the [Mercer Island Property]...or Shaun Allahyari's right to oppose such a sale." There are no further relevant subsequent entries on the district court's docket. In particular, the district court has not entered on remand, as it previously had in October 2018, an order for judicial sale.

II

At the threshold, the Government contends that we lack jurisdiction over this appeal under 28 U.S.C. § 1291 because the district court did not enter a final judgment and order of sale. We agree.

Under § 1291, the **courts** of **appeals** are authorized to hear "appeals from all final decisions of the district courts." 28 U.S.C. § 1291. "A final decision `ends the litigation on the merits and leaves nothing for the court to do but execute the judgment.'" *Hall v. Hall*, 584 U.S. 59, 64 (2018) (quoting *Ray Haluch Gravel Co. v. Central Pension Fund of Operating Eng'rs & Participating Emps.*, 571 U.S. 177, 183 (2014)). Finality in this sense "is to be given a practical rather than a technical construction," *Microsoft v. Baker*, 582 U.S. 23, 37 (2017) (quoting *Eisen v. Carlisle & Jacquelin*, 417 U.S. 156, 171 (1974)), and a judgment will be deemed final "if it fully adjudicates the issues and clearly evinces the district court's in[pg. **2024** -1369] tention that it be that court's final act in the matter." *Long Beach Area Chamber of Com. v. City of Long Beach*, 603 F.3d 684, 690 (9th Cir. 2010); *accord FirsTier Mortg. Co. v. Investors Mort. Ins. Co.*, 498 U.S. 269, 273–74 (1991). We conclude that, under these standards, Shaun's appeal was not taken from a final decision.

As an initial matter, at the time that Shaun filed his notice of appeal from the March 31, 2022 order, the district court had not yet determined the "value of the BECU Deed of Trust," which the court had held was senior to the Government's tax liens here. For that reason alone, the order appealed from was plainly not final at the time that this appeal was taken. The Supreme Court has squarely held that a foreclosure decree that referred to a special master the determination of "the extent and amount of all liens prior to said general mortgage upon the properties thereby covered" was not a "final decree within the meaning of that term as used in the statutes which provide for appeals to th[e] [Supreme] [C]ourt from the final decrees of the Circuit Courts in cases of equity jurisdiction." *Parsons v. Robinson*, 122 U.S. 112, 114 (1887). The decree in *Parsons* left several other substantive issues open as well, including key details as to the manner in which the foreclosure sale was to be conducted. *Id.* at 115. The Court held that, "[u]ntil the particulars of the prior liens are ascertained," and the additional issues concerning the manner of the sale resolved, "the rights of the parties will not have been sufficiently settled" so as to allow an appeal to be taken. *Id.* So too here, the March 31, 2022 order did not resolve the value of the senior BECU deed of trust, but instead directed the parties to provide their respective views concerning a variety of substantive issues on that score. On its face, the order did not "fully adjudicate[] the issues," nor did it "clearly evince[] the district court's intention that it be that court's final act in the matter." *Long Beach Area Chamber of Com.* , 603 F.3d at 690. The fact that, at the time the notice of appeal was filed, the parties had jointly reported to the district court that they had reached a tentative agreement on the open issues concerning the BECU deed of trust did not suffice to make the March 31, 2022 order final. Notwithstanding that joint report, the district court had neither been presented with, nor had it yet adopted, any substantive resolution of those issues at the time that Shaun filed his notice of appeal. In the absence of such a ruling, the district court unquestionably had not yet entered a final decision. At the time of its filing, Shaun's notice of appeal therefore was directed at a non-final, non-appealable order.

Shaun does not contest this point, but he insists that, with the district court's subsequent entry of the June 29, 2022 order resolving the value of the BECU deed of trust, his premature notice of appeal ripened into an effective appeal of the then-final judgment of foreclosure. However, if Shaun were correct that the June 29, 2022 order, without more, sufficed to produce a final, appealable decision, the result would be that Shaun would thereby now have *lost* his appellate rights with respect to the March 31, 2022 and June 29, 2022 orders. That is because (1) Shaun did not file a *new* notice of appeal within the 60-day statutory jurisdictional time limit after the entry of the June 29, 2022 order, *see* 28 U.S.C. § 2107(b); and (2) under our settled caselaw, Shaun's May 27, 2022 *premature* notice of appeal cannot be applied to what he posits is a June 29, 2022 final decision.

The latter point follows from our decision in *Kennedy v. Applause, Inc.* , 90 F.3d 1477 (9th Cir. 1996). There, the plaintiff filed a notice of appeal from a post-judgment order awarding attorney's fees, but that order explicitly left the amount to be awarded "undetermined," and the district court "requested further submissions from both parties in order to assist it in this determination." *Id.* at 1482–83. We held that the notice of appeal was "premature" and that it was not effective to place before this court the subsequent final order fixing the amount of attorney's fees. *Id.* In reaching this conclusion, we noted that, under Federal Rule of Appellate Procedure 4(a)(2), a premature notice of appeal "filed after the court announces a decision or order but before the entry of the judgment or order is treated as filed on the date of and after the entry." FED. R. APP. P. 4(a)(2) (1995) (quoted in *Kennedy*, 90 F.3d at 1482).[4] We observed that this rule "was intended to protect the unskilled litigant who files a notice of appeal from a decision that he reasonably but mistakenly believes to be a final judgment, while failing to file a notice of appeal from the actual final judgment." *Kennedy*, 90 F.3d at 1483 (quoting *FirsTier Mortg.*, 498 U.S. at 276). As we explained, this rule protects those who file a premature notice of appeal, when the only steps that remain to produce a final decision are essentially "ministerial task[s]." *Id.* (citation omitted); *see also Weston Family P'ship LLLP v. Twitter, Inc.*, 29 F.4th 611, 618 (9th Cir. 2022) (holding [pg. **2024** -1370] that, under Rule 4(a)(2), a subsequent district court order formally dismissing the case after the plaintiff declined to amend the complaint "cured the premature notice of appeal" directed to the prior order dismissing the plaintiff's complaint with leave to amend).

But we concluded in *Kennedy* that Rule 4(a)(2) could not be stretched to cover a premature notice of appeal directed at an order that explicitly deferred resolution of the quantification of a monetary award and that called for briefing from the parties on that issue. *Kennedy*, 90 F.3d at 1483. A litigant could not "reasonably" believe such an order to be final, and the tasks left to be completed by such an order were far from ministerial. *Id.* Because Shaun's premature notice of appeal was directed at a March 31, 2022 order that explicitly left the amounts to be awarded from the foreclosure sale unsettled and that asked for submissions from the parties on that issue, that notice of appeal was defective under *Kennedy* and cannot be applied to the subsequent order that provided the court's substantive resolution of the merits of that open issue.

Fortunately for Shaun, however, he is wrong in contending that the June 29, 2022 order, without more, was sufficient to produce a final judgment in this case. As our prior discussion indicates, the Supreme Court in *Parsons* further held that, in order for a foreclosure order to be considered final and appealable, that order must determine, not only the amount of any superior liens, but also "what the order of sale of said mortgage properties shall contain" so that the court's "ministerial officers can proceed to carry the decree into execution." *Parsons*, 122 U.S. at 115 (citation and internal quotation marks omitted). Thus, in order for a "decree of sale in a foreclosure suit" to qualify as "a final decree for the purposes of an appeal," the court's order must "settle[] all the rights of the parties and leave[] nothing to be done but to make the sale and pay out the proceeds." *Grant v. Phoenix Mut. Life Ins. Co.*, 106 U.S. 429, 431 (1882). Here, several aspects of the record make clear that, under these standards, the district court has not yet issued a sufficiently final order of sale that settles all of the rights of the parties and that can be ministerially executed without further substantive input from the court.

First, the district court expressly stated in its March 31, 2022 order that it intended to issue a separate and further "order for judicial sale," but that it would "delay entering" that order "until after it has received the requisite Joint Status Report from the parties and has determined how to calculate the value of the BECU Deed of Trust." The subsequent June 29, 2022 order does not constitute that separate "order for judicial sale," nor does it in any way indicate that the district court had changed its mind about issuing such a separate order. On the contrary, the June 29, 2022 order delimits Shaun's agreed-upon right to recover "sums under the BECU Deed of Trust" "in connection with a sale of the property, *if ordered*," and it further preserves "the United States' ability to *seek a sale* of the subject property" and "Shaun Allahyari's right *to oppose such a sale*" (emphasis added). On their face, the district court's orders do not "clearly evince[] the district court's intention that [they] be that court's final act in the matter." *Long Beach Area Chamber of Com.*, 603 F.3d at 690. By confirming that a sale would be the subject of a further order, they instead confirm the exact opposite.

Second, as in *Parsons*, the lack of a final decision is confirmed by the absence of any order specifying the necessary substantive requirements governing how the sale should be conducted and the proceeds distributed. This is not a minor matter. Among other things, nothing in the March 31, 2022 or June 29, 2022 orders contains the sort of needful details that were supplied in the district court's *previous* formal order of sale that was reversed by our opinion in the prior appeal. In particular, the prior order of sale clearly specified the sequence in which the funds obtained from a sale should be paid out: first to the IRS, but only "for allowed costs and expenses of sale"; second, to King County "for unpaid real property taxes or special assessments"; third, to Shaun for the amounts due in connection with the BECU deed of trust; and fourth to the IRS for the tax liens. Nothing in the March 31, 2022 or June 29, 2022 orders explicitly addresses this crucial subject. Although it might be reasonable to assume that the court would probably follow the same ruling it had previously made on that score, the fact remains that, after the case was remanded for new proceedings concerning the merits, the district court never did issue such an order. Moreover, in contrast to the prior formal order of sale, there is nothing in either of the 2022 orders that sets forth *any* details about how the sale is to be conducted. Again, it is perhaps reasonable to think that the district court would impose the same conditions that it did before the prior appeal, but it has not yet taken any action that can be said, even by implication, to have done so. With this many loose ends, the district court has neither "fully adjudicate[d] the issues," nor has it "clearly evince[d] [its] intention" that its two post-remand orders are "that court's final act in the [pg. **2024** -1371] matter." *Long Beach Area Chamber of Com.*, 603 F.3d at 690.

In arguing for a contrary conclusion, Shaun points to our decision in *Citicorp Real Estate, Inc. v. Smith*, 155 F.3d 1097 (9th Cir. 1998), but that case instead confirms the correctness of our holding. In *Citicorp Real Estate*, the district court *did* "order[] the property securing the loans to be sold at a judicial foreclosure sale," and no party contended that any further order of the district court was necessary to accomplish that sale. *Id.* at 1100. Instead, Citicorp argued that there was nonetheless no final, appealable decision under § 1291 because the district court had also entered deficiency judgments against the borrowers, with the precise amount of those judgments to be fixed after it was known exactly how much was left over from the proceeds of the sale. *Id.* at 1101. We held that this ministerial post-sale calculation did not detract from the fact that the district court's orders had "conclusively determine[d] the rights of the parties to the litigation." *Id.* In contrast to *Citicorp Real Estate*, the issue here is not a ministerial question about the post-sale application of funds in accordance with the court's pre-sale instructions. Rather, the problem here is that the district court has not issued the necessary pre-sale instructions in the first place.

In all events, we now clarify that, in accordance with more than 100 years of Supreme Court precedent, for "a decree of sale in a foreclosure suit" to be considered "a final decree for the purposes of an appeal" under § 1291, it must "settle[] all the rights of the parties and leave[] nothing to be done but to make the sale and pay out the proceeds" in accordance with the decree's terms. *Grant*, 106 U.S. at 431. For the reasons we have explained, that standard is not met in this case.

Shaun complains that adherence to such a rule is "inefficient" in this case, because it requires him to return to the district court and obtain a final decision and then "to pursue a new appeal." That may be so, but clear jurisdictional rules also have the countervailing benefit of avoiding traps for the unwary. Indeed, if we did not apply such a bright-line rule here, the supposedly efficient result would be that, as we have explained, Shaun would have no appeal at all.

III

For the foregoing reasons, this appeal is dismissed for lack of jurisdiction.

DISMISSED.

---

* This summary constitutes no part of the opinion of the court. It has been prepared by court staff for the convenience of the reader.

1 Because Shaun Allahyari and Komron Allahyari share the same last name, we will generally refer to them only by their respective first names.

2 Komron's ex-wife, Leslie Cover, was originally named as a co-defendant with respect to at least some of the amounts assessed, but in April 2018, the Government stipulated to Cover's dismissal from the case, without prejudice.

3 The Government had also initially named King County as an additional defendant because of the concern that it might assert an interest in the Mercer Island Property. But in July 2017, the Government stipulated to King County's dismissal from the suit, without prejudice. The stipulation between the Government and King County agreed that, pursuant to **I.R.C.** § 6323(b)(6), the Government would "include in any proposed order of sale a provision that any and all liens King County may have on the [Mercer Island] Property for unpaid real property taxes or special assessments at the time of sale be satisfied from the proceeds of sale prior to any distribution on the federal tax liens."

4 The current version of Rule 4(a)(2) is identical, except that the phrase "but before the entry of the judgment or order" is now set off by dashes.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2023
Notice 2023-42, 2023-26 IRB 1085 -- IRC Sec(s). 55; 6655, 06/07/2023

Notices

Notice 2023-42, 2023-26 IRB 1085, 06/07/2023, IRC Sec(s). 6655

Failure to pay corp. estimated tax penalties—corporate alternative minimum tax—waivers.

Headnote:

As announced in IR 2023-110, IRS is providing relief from failure to pay estimated income tax penalty in connection with CAMT. In light of challenges associated with determining whether corp. was subject to CAMT and amount of corp.'s CAMT liability under Code Sec. 55; for tax year beginning after 12/31/2022, and before 1/1/2024, IRS will waive Code Sec. 6655; penalty with respect to corp.'s CAMT liability under Code Sec. 55; for 2023. Instructions to Form 2220, Underpayment of Estimated Tax by Corporations, will be modified, as necessary, to clarify that no Code Sec. 6655; penalty will be imposed for 2023, and that taxpayers could exclude such amounts when calculating amount of their required annual payment on Form 2220.

Reference(s): ¶ 66,555.01(30); Code Sec. 6655; Code Sec. 55;

Full Text:

Part III – Administrative, Procedural, and Miscellaneous

Relief from Certain Additions to Tax for Corporation's Underpayment of Estimated Income Tax under Section 6655

1. OVERVIEW

This notice provides relief from the addition to tax under § 6655 of the Internal Revenue Code (Code)[1] in connection with the application of the new corporate alternative minimum tax (CAMT), as added to the Code by the enactment of § 10101 of Public Law 117-169 , 136 Stat. 1818 (August 16, 2022), commonly referred to as the Inflation Reduction Act of 2022 (IRA).

2. BACKGROUND

.01. CAMT under the IRA. Section 10101 of the IRA amended § 55 to impose the new CAMT based on the " adjusted financial statement income" (AFSI) of an applicable corporation for taxable years beginning after December 31, 2022. Pursuant to § 59(k)(1), in general, a corporation is an applicable corporation subject to the CAMT for a taxable year if it meets the average annual AFSI test for one or more taxable years that (i) are before that taxable year and (ii) end after December 31, 2021 (Applicable Corporation). Section 55(a) provides that, for the taxable year of an Applicable Corporation, the amount of CAMT imposed by § 55 equals the excess (if any) of (i) the tentative minimum tax for the taxable year, over (ii) the sum of the regular tax, as defined in section § 55(c), for the taxable year plus the tax imposed under § 59A. Section 55(b)(2)(A) provides that, in the case of an Applicable Corporation, the tentative minimum tax for the taxable year is the excess of (i) 15 percent of AFSI for the taxable year (as determined under § 56A), over (ii) the CAMT foreign tax credit for the taxable year (as determined under § 59(l)). In the case of any corporation that is not an Applicable Corporation, § 55(b)(2)(B) provides that the tentative minimum tax for the taxable year is zero. See section 2.01 of Notice 2023-7, 2023-7 I.R.B. 390, for a general description of the CAMT. Notice 2023-7 announced that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue forthcoming proposed regulations addressing the application of the CAMT and provided interim guidance that taxpayers may rely on until the issuance of the forthcoming proposed regulations. Notice 2023-20, 2023-10 I.R.B. 523, provided additional interim guidance that is intended to clarify further the application of the CAMT.

.02. Estimated taxes. Section 6655(c) and (d)(1)(A) generally provide that, in the case of a corporation, estimated income tax is required to be paid in four installments and the amount of any required installment is 25 percent of the required annual payment. Generally, under § 6655(d)(1)(B), the required annual payment is the lesser of two amounts described in § 6655(d)(1)(B)(i) and (ii). The amount described in § 6655(d)(1)(B)(i) is 100 percent of the tax shown on the return for the taxable year. The amount described in § 6655(d)(1)(B)(ii) is 100 percent of the tax shown on the taxpayer's return for the preceding taxable year, so long as the preceding taxable year was a full twelve months long and the return for such year showed a liability for tax. However, pursuant to § 6655(d)(2), in the case of a large corporation (as defined under § 6655(g)(2)), the amount described in § 6655(d)(1)(B)(ii) may be applied only for purposes of determining the first installment payment, while the amount described in § 6655(d)(1)(B)(i) must be applied for purposes of determining the required annual payment. Under § 6655(e), the amount of the required installment is the annualized income installment or adjusted seasonal installment for those taxpayers who establish that such amount is lower than 25 percent of the required annual payment determined under § 6655(d). Section 6655(a) imposes an addition to tax for failure to make a sufficient and timely payment of estimated income tax.

3. ESTIMATED TAXES

.01. Waiver of addition to tax. In light of challenges associated with determining whether a corporation is an Applicable Corporation and the amount of a corporation's CAMT liability under § 55 for a taxable year that begins after December 31, 2022, and before January 1, 2024 (Covered CAMT Year), and in the interest of sound tax administration, the IRS will waive the addition to tax under § 6655 with respect to a corporation's CAMT liability under § 55 for any Covered CAMT Year. Accordingly, for a corporation's Covered CAMT Year, the corporation's required installments of estimated tax need not include amounts attributable to its CAMT liability under § 55 to prevent the imposition of an addition to tax under § 6655. If a corporation fails to timely pay its CAMT liability under § 55 when due, other sections of the Code may apply; for example, additions to tax could be imposed under § 6651 if payment of the CAMT liability is not made by the due date (without regard to any extension) of the corporation's return.

.02. Instructions to be modified. The instructions to Form 2220, *Underpayment of Estimated Tax by Corporations*, will be modified, as necessary, to clarify that no addition to tax will be imposed under § 6655 based on a corporation's failure to make estimated tax payments of its CAMT liability under § 55 for any Covered CAMT Year, and that a taxpayer may exclude such amounts when calculating the amount of its required annual payment on Form 2220. If necessary, the modified instructions will be posted on https://www.irs.gov.

.03. Instructions to avoid penalty notice. Affected taxpayers must still file Form 2220 with their Federal income tax return, even if they owe no estimated tax penalty. The Form 2220 must be completed without including the CAMT liability from Schedule J of Form 1120, *U.S. Corporation Income Tax Return* (or other appropriate line of the corporation's income tax return in the Form 1120 series). Affected taxpayers must also include an amount of estimated tax penalty on Line 34 of their Form 1120 (or other appropriate line of the corporation's income tax return in the Form 1120 series), even if that amount is zero. Failure to follow these instructions could result in affected taxpayers receiving a penalty notice that will require an abatement request to apply the relief provided by this notice.

4. APPLICABILITY DATES

The waiver of the addition to tax imposed by § 6655 described in section 3.01 of this notice applies for any Covered CAMT Year.

5. DRAFTING AND CONTACT INFORMATION

The principal author of this notice is David Bergman of the Office of the Associate Chief Counsel (Procedure and Administration). Other personnel from the Treasury Department and the IRS participated in its development. For further information, please contact David Bergman at (202) 317-6845 (not a toll-free number).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Code.

END OF DOCUMENT -

Notices

Notice 2023-54, 2023-31 IRB 382, 07/14/2023, IRC Sec(s). 401

Employee benefit plans—required minimum distributions.

Headnote:

IRS has clarified that final regs regarding required minimum distributions (RMDs) won't apply earlier than 2024 calendar year, and has also provided relief to plan administrators and others payors who needed to update automated systems to reflect changes made to date of first-time RMDs in '23 by SECURE 2.0 Act '22 (P.L. 117-328; 12/29/2022).

Reference(s): ¶ 4015.15(2); Code Sec. 401;

Full Text:

Transition Relief and Guidance Relating to Certain Required Minimum Distributions

I. PURPOSE

This notice provides transition relief for plan administrators, payors, plan participants, IRA owners, and beneficiaries in connection with the change in the required beginning date for required minimum distributions (RMDs) under § 401(a)(9) of the Internal Revenue Code (Code) pursuant to § 107 of the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), enacted on December 29, 2022, as Division T of the Consolidated Appropriations Act, 2023, Pub. L. 117-328 , 136 Stat. 4459 (2022). This notice also provides guidance related to certain specified RMDs for 2023. In addition, this notice announces that the final regulations that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to issue related to RMDs will apply for purposes of determining RMDs for calendar years beginning no earlier than 2024.

II. BACKGROUND

A. *Section 401(a)(9)*

Section 401(a)(9) of the Code requires a stock bonus, pension, or profit-sharing plan described in § 401(a) (or an annuity contract described in § 403(a)) to make minimum distributions starting by the required beginning date (as well as minimum distributions to beneficiaries if the employee dies before the required beginning date). Individual retirement accounts and individual retirement annuities (IRAs) described in § 408(a) and (b), annuity contracts, custodial accounts, and retirement income accounts described in § 403(b) (§ 403(b) plans), and eligible deferred compensation plans under § 457(b), are also subject to the rules of § 401(a)(9) pursuant to §§ 408(a)(6) and (b)(3), 403(b)(10), and 457(d)(2), respectively, and the regulations under those sections.

B. *Required Beginning Date*

Section 107 of the SECURE 2.0 Act amended § 401(a)(9) of the Code to change the required beginning date applicable to § 401(a) plans and other eligible retirement plans, including IRAs. Rather than defining the required beginning date by reference to April 1 of the calendar year following the calendar year in which an individual attains age 72, the new required beginning date for an employee or IRA owner is defined by reference to April 1 of the calendar year after the calendar year in which the individual attains the applicable age (which is either age 73 or age 75, depending on the individual's date of birth). Thus, for example, an IRA owner who was born in 1951 will have a required beginning date of April 1, 2025, rather than April 1, 2024, (and the first distribution made to that IRA owner that will be treated as an RMD will be a distribution made for 2024, rather than 2023).

C. *RMD Distribution Period*

Section 401(a)(9) provides rules for RMDs from a qualified plan during the life of the employee in § 401(a)(9)(A) and after the death of the employee in § 401(a)(9)(B). In addition to setting forth a required beginning date for distributions, these rules identify the period over which the employee's entire interest must be distributed.

Specifically, § 401(a)(9)(A)(ii) provides that the entire interest of an employee in a qualified plan must be distributed, beginning not later than the employee's required beginning date, in accordance with regulations, over the life of the employee or over the lives of the employee and a designated beneficiary (or over a period not extending beyond the life expectancy of the employee and a designated beneficiary).

Section 401(a)(9)(B)(i) provides that, if the employee dies after distributions have begun, the employee's remaining interest must be distributed at least as rapidly as under the method of distributions being used by the employee under section 401(a)(9)(A)(ii) as of the date of the employee's death. Section 401(a)(9)(B)(ii) and (iii) provides that, if the employee dies before RMDs have begun, the employee's interest must either be: (1) distributed within 5 years after the death of the employee (5-year rule), or (2) distributed (in accordance with regulations) over the life or life expectancy of the designated beneficiary with the distributions beginning no later than 1 year after the date of the employee's death (subject to an exception in § 401(a)(9)(B)(iv) if the designated beneficiary is the employee's surviving spouse).

The rules of § 401(a)(9) are incorporated by reference in § 408(a)(6) and (b)(3) for IRAs, § 403(b)(10) for § 403(b) plans), and § 457(d) for eligible deferred compensation plans.

D. *Section 401(a)(9)(H) as added by the SECURE Act*

1. *Ten-year rule*

Section 401(a)(9) of the Code was amended by 401(a)(1) of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), enacted on December 20, 2019, as Division O of the Further Consolidated Appropriations Act, 2020, Pub. L. 116-94 , 133 Stat. 2534 (2019), to add § 401(a)(9)(H) to the Code. Generally, pursuant to § 401(a)(9)(H)(i), if an employee in a defined contribution plan has a designated beneficiary, the 5-year period under the 5-year rule is lengthened to 10 years (10-year rule) and the 10-year rule applies regardless of whether the employee dies before the required beginning date. In addition, pursuant to § 401(a)(9)(H)(ii), the § 401(a)(9)(B)(iii) exception to the 10-year rule (under which the 10-year rule is treated as satisfied if distributions are paid over the designated beneficiary's lifetime or life expectancy) applies only if the designated beneficiary is an eligible designated beneficiary, as that term is defined in § 401(a)(9)(E)(ii).

Section 401(a)(9)(H)(iii) provides that when an eligible designated beneficiary dies before that individual's portion of the employee's interest in the plan has been entirely distributed, the beneficiary of the eligible designated beneficiary will be subject to a requirement that the remainder of that individual's portion be distributed within 10 years of the eligible designated beneficiary's death. In addition, § 401(a)(9)(E)(iii) provides that when an eligible designated beneficiary who is a minor child of the employee reaches the age of majority, that child will no longer be considered an eligible designated beneficiary and the remainder of that child's portion of the employee's interest in the plan must be distributed within 10 years of that date.

2. *Section 401(a)(9)(H) effective date*

Section 401(b)(1) of the SECURE Act provides that, generally, the amendments made to § 401(a)(9)(H) of the Code apply to distributions with respect to employees who die after December 31, 2019. Pursuant to 401(b)(2) and (3) of the SECURE Act, later effective dates apply for certain collectively bargained plans and governmental plans (as defined in § 414(d) of the Code).

Section 401(b)(4) of the SECURE Act provides that § 401(a)(9)(H) of the Code does not apply to payments under certain annuity contracts under which payment commenced (or the manner of payments was fixed) before December 20, 2019. Section 401(b)(5) of the SECURE Act provides that if an employee who participated in a plan died before § 401(a)(9)(H) of the Code became effective with respect to the plan, and the employee's designated beneficiary died after that effective date, then that designated beneficiary is treated as an eligible designated beneficiary and § 401(a)(9)(H) applies to any beneficiary of that designated beneficiary.

E. *Excise tax under § 4974(a)*

Section 4974(a) provides that if the amount distributed during a year to a payee under any qualified retirement plan (as defined in § 4974(c)) or any eligible deferred compensation plan (as defined in § 457(b)) is less than that year's minimum required distribution (as defined in § 4974(b)), then an excise tax is imposed on the payee. Pursuant to 302 of the SECURE 2.0 Act, for taxable years beginning after December 29, 2022, this excise tax is equal to 25 percent of the amount by which the minimum required distribution for a year exceeds the amount actually distributed in that year. If a failure to take a minimum required distribution is corrected by the end of the correction window (generally, the end of the second year that begins after the year of the missed minimum required distribution), the excise tax is reduced from 25 percent to 10 percent.

F. *Section 401(a)(9) proposed regulations*

The Treasury Department and the IRS published proposed regulations regarding RMDs under § 401(a)(9) of the Code and related provisions in the Federal Register on February 24, 2022 (87 FR 10504), which provided that the regulations, when finalized, would apply beginning with the 2022 calendar year. Along with other matters, the proposed regulations address issues relating to the 10-year rule in § 401(a)(9)(H). Specifically, Prop. Reg. § 1.401(a)(9)-5(d)(1)(i) requires that, in the case of an employee who dies on or after the employee's required beginning date, distributions to the employee's beneficiaries for calendar years after the calendar year of the employee's death must satisfy § 401(a)(9)(B)(i). In addition, distributions to the employee's beneficiaries must also satisfy § 401(a)(9)(B)(ii) (or if applicable, § 401(a)(9)(B)(iii)), taking into account § 401(a)(9)(E)(iii), (H)(ii), and (H)(iii).

In order to satisfy § 401(a)(9)(B)(i), the beneficiary of an employee who died after the employee's required beginning date must take an annual RMD beginning in the first calendar year after the calendar year of the employee's death. In order to satisfy § 401(a)(9)(B)(ii) (applied by substituting "10 years" for "5 years"), the remaining account balance must be distributed by the 10th calendar year after the calendar year of the employee's death (subject to an exception under § 401(a)(9)(B)(iii), if applicable). In order to satisfy both of those requirements, the proposed regulations generally provide that, in the case of an employee who dies after the employee's required beginning date with a designated beneficiary who is not an eligible designated beneficiary (and for whom the § 401(a)(9)(B)(iii) alternative to the 10-year rule is not applicable), annual RMDs must continue to be taken after the death of the employee, with a full distribution required by the end of the 10th calendar year following the calendar year of the employee's death.

In the case of a designated beneficiary who is an eligible designated beneficiary, the proposed regulations include an alternative to the 10-year rule under which annual lifetime or life expectancy payments would be made to the beneficiary beginning in the year following the year of the employee's death, in accordance with § 401(a)(9)(B)(iii). Under the proposed regulations, if an eligible designated beneficiary of an employee is using the lifetime or life expectancy payment alternative to the 10-year rule, then the eligible designated beneficiary (and, after the death of the eligible designated beneficiary, the beneficiary of the eligible designated beneficiary) would need to continue to take annual RMDs after the death of the employee (with the employee's entire interest distributed by no later than the 10th year after the year of the eligible designated beneficiary's death). The proposed regulations provide for similar treatment (that is, continued annual RMDs with a requirement that the employee's entire interest be distributed no later than the 10th year after a specified event) in the case of a designated beneficiary who is a minor child of the employee (with the specified event being the child's reaching the age of majority).

G. *Comments received by the Treasury Department and the IRS*

The Treasury Department and the IRS provided a 90-day comment period for the proposed regulations. Some individuals who are owners of inherited IRAs or are beneficiaries under defined contribution plans submitted comments indicating that they thought the new 10-year rule would apply differently than it would under the proposed regulations. Specifically, these commenters expected that, regardless of when an employee died, the 10-year rule would operate like the 5-year rule, such that there would not be any RMD due for a calendar year until the last year of the 5- or 10-year period following the specified event (the death of the employee, the death of the eligible designated beneficiary, or the attainment of the age of majority for the employee's child who is an eligible designated beneficiary). Commenters who are heirs or beneficiaries of individuals who died in 2020 explained that they did not take an RMD in 2021 and were unsure of whether they would be required to take an RMD in 2022. Commenters asserted that, if final regulations adopt the interpretation of the 10-year rule set forth in the proposed regulations, the Treasury Department and the IRS should provide transition relief for failure to take distributions that are RMDs due in 2021 or 2022 pursuant to § 401(a)(9)(H) in the case of the death of an employee (or designated beneficiary) in 2020 or 2021.

In response to the comments received on the proposed regulations, the Treasury Department and the IRS issued Notice 2022-53, 2022-45 IRB 437. Notice 2022-53 announced that the final regulations will apply no earlier than the 2023 distribution calendar year and provided guidance regarding certain amounts that were not paid in 2021 or 2022. Specifically, Notice 2022-53 provided that a defined contribution plan will not fail to be qualified for failing to make a specified RMD (as defined in that notice) in 2021 or 2022 and the taxpayer who did not take a specified RMD will not be subject to the excise tax under § 4974 for failing to take the specified RMD.

H. *Eligible Rollover Distributions*

Section 402(c) generally provides that the payment of any portion of an employee's interest in a qualified trust to the employee or the employee's surviving spouse in an eligible rollover distribution is not includible in gross income if the distribution is rolled over to an eligible retirement plan described in § 402(c)(8) no later than the 60th day following the day of receipt. An eligible rollover distribution is defined in § 402(c)(4) as a distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified trust other than a distribution that is: (A) one of a series of substantially equal periodic payments made over a specified period; (B) a distribution required under § 401(a)(9)[1] ; or (C) a distribution made on account of the employee's hardship. Section 402(c)(3)(B) provides that the Secretary may waive the 60-day rollover deadline under certain circumstances. Section 402(c)(11) provides for the direct rollover of a deceased employee's interest in a qualified trust to an inherited IRA established for the deceased employee's nonspouse designated beneficiary.

Section 401(a)(31) provides that a trust does not constitute a qualified trust unless the plan of which the trust is a part provides that, if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan and specifies the eligible retirement plan to which the distribution is to be paid, the distribution will be made in the form of a direct trustee-to-trustee transfer. Within a reasonable period of time prior to making an eligible rollover distribution, the plan administrator of a plan qualified under § 401(a) is required to provide to the recipient the written explanation described in § 402(f)(1).

Rules similar to those described in the preceding two paragraphs apply to § 403(a) annuity plans, § 403(b) plans, and § 457 eligible governmental plans. See §§ 403(a)(4) and (5), 403(b)(8) and (10), and 457(d)(1)(C) and (e)(16).

If the recipient of an eligible rollover distribution does not elect in accordance with § 401(a)(31) to have the distribution paid directly to an eligible retirement plan described in § 402(c)(8), then under § 3405(c), the payor of the distribution is required to withhold from the distribution an amount equal to 20 percent of the distribution.

Section 408(d)(3) generally provides that an amount distributed from an IRA to the IRA owner, or to the surviving spouse of the IRA owner, is not included in gross income if the distribution is rolled over to an eligible retirement plan no later than the 60th day following the day of receipt. A distribution of an after-tax amount may only be rolled over to another IRA. Section 408(d)(3)(B) provides that an IRA owner may roll over only one IRA distribution in a 12-month period, and § 408(d)(3)(E) provides that an RMD may not be rolled over. Section 408(d)(3)(I) provides that the Secretary may waive the 60-day rollover deadline under certain circumstances.

III. APPLICABILITY DATE OF FINAL REGULATIONS

Final regulations regarding RMDs under § 401(a)(9) and related provisions will apply for calendar years beginning no earlier than 2024.

IV. RELIEF RELATING TO CHANGE IN REQUIRED BEGINNING DATE UNDER SECURE 2.0 ACT

Following enactment of the SECURE 2.0 Act, plan administrators and other payors indicated that automated payment systems would need to be updated to reflect the change in the required beginning date under § 401(a)(9)(C) pursuant to 107 of the SECURE 2.0 Act. They expressed concern that these revisions could take some time to implement and, as a result, plan participants and IRA owners who would have been required to begin receiving RMDs for calendar year 2023 but for § 107 of the SECURE 2.0 Act (i.e., those who will attain age 72 in 2023) and who receive distributions in 2023 could have had those distributions mischaracterized as RMDs (and therefore ineligible for rollover). This Section IV grants certain relief relating to certain distributions made during 2023 to individuals that were characterized as RMDs but are not actually RMDs as a result of the enactment of 107 of the SECURE 2.0 Act.

A. *Payor and plan administrator guidance related to SECURE 2.0 Act change to required beginning date.* A payor or plan administrator will not be considered to have failed to satisfy the requirements of §§ 401(a)(31), 402(f), and 3405(c) merely because of a failure to treat certain distributions as eligible rollover distributions. This relief applies with respect to any distribution made from a plan between January 1, 2023, and July 31, 2023, to a participant born in 1951 (or that participant's surviving spouse) that would have been an RMD but for the change in the required beginning date under § 107 of the SECURE 2.0 Act.

B. *Extension of 60-day deadline for rollover of certain distributions.* Pursuant to § 402(c)(3)(B), the Treasury Department and the IRS are extending the 60-day rollover period for any distribution described in section IV.A of this notice so that the deadline for rolling over such a distribution will be September 30, 2023. For example, if a participant who was born in 1951 received a single-sum distribution in January 2023, part of which was treated as ineligible for rollover because it was mischaracterized as an RMD, that participant will have until September 30, 2023, to roll over that mischaracterized part of the distribution.

C. *Relief relating to RMDs previously distributed from an IRA.* Pursuant to § 408(d)(3)(I), the Treasury Department and the IRS are extending the 60-day rollover period for certain IRA distributions made to an IRA owner (or the IRA owner's surviving spouse), so that the deadline for rolling over that portion of the distribution will be September 30, 2023. The distributions that are subject to this extension are distributions made from an IRA between January 1, 2023, and July 31, 2023, to an IRA owner born in 1951 (or that individual's surviving spouse) that would have been RMDs but for the change in the required beginning date under § 107 of the SECURE 2.0 Act. This rollover is permitted even if the IRA owner or surviving spouse has rolled over a distribution within the last twelve months. However, making such a rollover of the portion of an IRA distribution mischaracterized as an RMD will preclude the IRA owner or surviving spouse from rolling over a distribution in the next twelve months. In that case, that individual could still make a direct trustee-to-trustee transfer as described in Rev. Rul. 78-406, 1978-2 CB 157.

V. GUIDANCE FOR SPECIFIED RMDs FOR 2023

A. *Guidance for defined contribution plans that did not make a specified RMD.* A defined contribution plan that failed to make a specified RMD (as defined in section V.C of this notice) will not be treated as having failed to satisfy § 401(a)(9) merely because it did not make that distribution.

B. *Guidance for certain taxpayers who did not take a specified RMD.* To the extent a taxpayer did not take a specified RMD (as defined in section V.C of this notice), the IRS will not assert that an excise tax is due under § 4974.

C. *Definition of specified RMD.* For purposes of this notice, a specified RMD is any distribution that, under the interpretation included in the proposed regulations, would be required to be made pursuant to § 401(a)(9) in 2023 under a defined contribution plan or IRA that is subject to the rules of § 401(a)(9)(H) for the year in which the employee (or designated beneficiary) died if that payment would be required to be made to:

- a designated beneficiary of an employee under the plan (or IRA owner) if: (1) the employee (or IRA owner) died in 2020, 2021, or 2022, and on or after the employee's (or IRA owner's) required beginning date, and (2) the designated beneficiary is not using the lifetime or life expectancy payments exception under § 401(a)(9)(B)(iii); or
- a beneficiary of an eligible designated beneficiary (including a designated beneficiary who is treated as an eligible designated beneficiary pursuant to § 401(b)(5) of the SECURE Act) if: (1) the eligible designated beneficiary died in 2020, 2021, or 2022, and (2) that eligible designated beneficiary was using the lifetime or life expectancy payments exception under § 401(a)(9)(B)(iii) of the Code.

VI. DRAFTING INFORMATION

The principal author of this notice is Jessica Weinberger of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this notice, contact Jessica Weinberger at (202) 317-6349 (not a toll-free call).

---

1 Under § 1.402(c)-2, in determining which amounts are treated as eligible rollover distributions, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as RMDs to the extent that the total RMD under § 401(a)(9) for the calendar year has not been satisfied.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2023
Notice 2023-55, 2023-32 IRB 427 -- IRC Sec(s). 901; 903, 07/21/2023

Notices

Notice 2023-55, 2023-32 IRB 427, 07/21/2023, IRC Sec(s). 901

Foreign tax credit—determination of foreign income taxes—temporary relief.

Headnote:

[Caution: Secs. 3 and 4 of this notice have been modified by Notice 2023-80 , 2023-52 IRB .]

IRS announced temporary relief for taxpayers in determining whether foreign tax was eligible for foreign tax credit under Code Sec. 901; and Code Sec. 903; . To determine whether foreign taxes paid in relief period were foreign income taxes, taxpayers could apply former Reg § 1.901-2(a) and Reg § 1.901-2(b) , before it was amended by TD 9959 (1/4/2022), but subject to modification to nonconfiscatory gross basis tax rule as described in notice; and could apply existing Reg § 1.903-1 without applying jurisdiction to tax excluded income and attribution requirements. For purposes of this notice, relief periods referred to tax years beginning on or after 12/28/2021 and ending on or before 12/31/2023, and relief year referred to any tax year within relief period.

Reference(s): ¶ 9015.02(3); Code Sec. 901; Code Sec. 903;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Temporary Relief Under Sections 901 and 903 of the Internal Revenue Code

1. PURPOSE

This notice announces temporary relief for taxpayers in determining whether a foreign tax is eligible for a foreign tax credit under § § 901 and 903 of the Internal Revenue Code (Code). This temporary relief, as described in section 3 of this notice, applies with respect to § 1.901-2(a) and (b) (the definition of a foreign income tax and the net gain requirement) and to § 1.903-1(c)(1)(iv) (jurisdiction to tax excluded income) and § 1.903-1(c)(2)(iii) (source-based attribution requirement).[1]

2. BACKGROUND

Section 901 allows a credit for foreign income, war profits, and excess profits taxes, and § 903 provides that such taxes include a tax paid in lieu of a generally-imposed foreign income, war profits, or excess profits tax (collectively, foreign income taxes). On January 4, 2022, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published Treasury Decision 9959 in the Federal Register (87 FR 276) (2022 FTC final regulations), which contained final regulations under § § 901 and 903. Correcting amendments to the 2022 FTC final regulations were published in the Federal Register on July 27, 2022 (87 FR 45018 and 87 FR 45021). On November 22, 2022, the Treasury Department and the IRS published proposed regulations (REG-112096-22) in the Federal Register (87 FR 71271), which included proposed rules relating to the cost recovery requirement and the substitution requirement for covered withholding taxes. On April 17, 2023, the Treasury Department and the IRS published Notice 2023-31 in the Internal Revenue Bulletin (IRB 2023-16) relating to proposed § 1.903-1(c)(2)(iii)(B) (the single-country exception).

Following the publication of the 2022 FTC final regulations and subsequent guidance, the Treasury Department and the IRS received questions regarding the application of the 2022 FTC final regulations and requests to modify those regulations. The Treasury Department and the IRS continue to analyze issues related to the 2022 FTC final regulations and are considering proposing amendments to those regulations. As that analysis is ongoing, taxpayers may apply the temporary relief in section 3 of this notice during the relief period, as defined in section 4 of this notice. The Treasury Department and the IRS are considering whether, and under what conditions, to provide additional temporary relief beyond the relief period.

3. TEMPORARY RELIEF

To determine whether foreign taxes paid[2] in the relief period are foreign income taxes, a taxpayer may apply the following temporary relief. First, instead of applying existing § 1.901-2(a) and (b), taxpayers may apply § 1.901-2(a) and (b) as contained in 26 CFR part 1, revised as of April 1, 2021 (former § 1.901-2(a) and (b)), except that, for this purpose, the seventh and eighth sentences of former § 1.901-2(b)(4)(i) (flush language),[3] which describe the " nonconfiscatory gross basis tax rule," are deleted and replaced with the following: " No foreign tax whose base is gross receipts or gross income satisfies the net income requirement, except in the case of a foreign tax whose base consists solely of investment income that is not derived from a trade or business, or wage income (or both). " Second, taxpayers may apply existing § 1.903-1 without applying § 1.903-1(c)(1)(iv) (jurisdiction to tax excluded income) and § 1.903-1(c)(2)(iii) (source-based attribution requirement).

Under the temporary relief, a gross basis tax imposed on the gross receipts or gross income arising from the provision of digital services (DST) does not satisfy the net income requirement of former § 1.901-2(b)(4)(i), because the base of the tax is gross receipts or gross income and does not consist solely of investment income that is not derived from a trade or business, or wage income. In addition, under existing § 1.903-1, without taking into account § 1.903-1(c)(1)(iv) and § 1.903-1(c)(2)(iii), a foreign country's DST that applies by its terms to any income subject to that foreign country's net income tax remains not creditable as a tax in lieu of an income tax. See § 1.903-1(c)(1)(ii) and (c)(2)(ii); see also § 1.903-1(d)(1) (Example 1).

When applying the temporary relief, examples and cross-references in former § 1.901-2(a) and (b) and the existing Income Tax Regulations will be considered modified as appropriate. Appropriate modifications include the following. Examples 1-3 of former § 1.901-2(b)(4)(iv) analyze the nonconfiscatory gross basis tax rule and therefore are inapplicable. References in the existing Income Tax Regulations to a " foreign income tax" include a foreign tax that satisfies the requirements in former § 1.901-2(a) and (b), as modified in this section 3. Additionally, all cross-references in former § 1.901-2(a) and (b) to provisions in former § 1.901-2 (other than former § 1.901-2(a) and (b)) or other former Income Tax Regulations (such as § § 1.901-2A and 1.903-1) are construed, as applicable, as cross-references to the corresponding provisions (taking into account any renumbering of those provisions) of the existing Income Tax Regulations.

Taxpayers may apply this temporary relief to foreign taxes paid in any relief year, as defined in section 4 of this notice, provided that the taxpayer satisfies the following requirements. First, the taxpayer must apply the temporary relief to (1) all foreign taxes paid by the taxpayer in the taxpayer's relief year, and (2) all foreign taxes (i) that are paid by any other person in a taxable year that begins on or after December 28, 2021 and that ends with or within the taxpayer's relief year, and (ii) for which the taxpayer would be eligible to claim a credit, as provided in § 901 (determined without regard to the limitations described in § 1.901-1(b)), if the taxpayer applied the temporary relief to such foreign taxes. This includes foreign taxes paid by a controlled foreign corporation (CFC) of which the taxpayer is a United States shareholder (U.S. shareholder) in the CFC's taxable year that ends with or within the U.S. shareholder's relief year. Additionally, a member of a consolidated group may apply the temporary relief to a relief year only if all members of the consolidated group apply the temporary relief to the relief year. Finally, the taxpayer may not apply the temporary relief in a relief year to claim a credit, as provided under § 901, for any amount of foreign tax for which a deduction is allowed in the relief year or any other taxable year.

4. RELIEF PERIOD

For purposes of this notice, the relief period means taxable years beginning on or after December 28, 2021, and ending on or before December 31, 2023, and relief year means any taxable year within the relief period.

5. DRAFTING INFORMATION

The principal authors of this notice are Moshe Dlott and Teisha M. Ruggiero of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Dlott at (202) 317-4967 or Ms. Ruggiero at (646) 259-8116 (not toll-free calls).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

2 The term "paid" in this notice has the meaning in § 1.901-2(g)(5).

3 The seventh and eighth sentences in former § 1.901-2(b)(4)(i) (flush language) are the following: "A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). "

END OF DOCUMENT -

Notices

Notice 2023-59, 2023-34 IRB 564, 08/04/2023, IRC Sec(s). 25C

Energy efficient home improvement credit—home energy audits—requirements and procedure for claiming credit.

Headnote:

As proposed regs on this topic are forthcoming, IRS has issued guidance to be used by taxpayers to claim Code Sec. 25C; credit for home energy audits. Person performing audit would have to qualify as home energy auditor, but for 2023, auditor isn't required to be qualified as defined in this guidance as prerequisite for allowing credit. Proposed regs would apply to tax years ending after 12/31/2022, but this guidance may be relied on until proposed regs are issued. Amendments made to Code Sec. 25C; by Inflation Reduction Act '22 (P.L. 117-169; 8/16/2022) allow credit amount equal to 30% of amounts paid for home energy audits, up to $150 per tax year.

Reference(s): ¶ 25C5.01(10); Code Sec. 25C;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Guidance on Requirements for Home Energy Audits for Purposes of the Energy Efficient Home Improvement Credit under Section 25C

1. PURPOSE

This notice announces that the Department of the Treasury (the Treasury Department) and the Internal Revenue Service (IRS) intend to propose regulations (forthcoming proposed regulations) addressing the requirements for home energy audits with respect to the energy efficient home improvement credit under § 25C of the Internal Revenue Code (Code),[1] as amended by 13301 of Public Law 117-169 , 136. Stat. 1818 (August 16, 2022), commonly known as the Inflation Reduction Act of 2022 (IRA). Sections 2 and 3 of this notice provide relevant background and definitions, respectively, with respect to the energy efficient home improvement credit allowed under § 25C (§ 25C credit). Section 4 of this notice specifies the requirements that the forthcoming proposed regulations would set forth for qualifying as a home energy auditor for purposes of the § 25C credit. Sections 5 and 6 of this notice specify the substantiation requirement and transition rule, respectively, that the forthcoming proposed regulations would establish for taxpayers claiming the § 25C credit with respect to home energy audits. Section 7 addresses the application of the Paperwork Reduction Act to this notice. The Treasury Department and the IRS also intend to propose that the forthcoming proposed regulations would apply to taxable years ending after December 31, 2022. Until the issuance of the forthcoming proposed regulations, taxpayers may rely on the rules described in sections 3 through 6 of this notice.

2. BACKGROUND

.01. Energy Efficient Home Improvement Credit

Section 25C was originally enacted by § 1333(a) of the Energy Policy Act of 2005, Pub. L. 109-58 , 119 Stat. 594, 1026 (August 8, 2005), to provide a tax credit for the purchase and installation of certain energy efficient improvements in taxpayers' principal residences. Congress has amended § 25C several times since its original enactment, most recently under § 13301 of the IRA, which renamed this provision the " energy efficient home improvement credit" and provided that § 25C, as amended by the IRA, applies to property placed in service prior to January 1, 2033.

Section 13301(b) and (f) of the IRA amended § 25C(a) to allow a credit amount equal to 30 percent of the sum of the amounts that individual taxpayers pay or incur during a taxable year for (1) qualified energy efficiency improvements installed during the year, (2) residential energy property expenditures, and (3) home energy audits.

As amended by § 13301(c) of the IRA, the § 25C credit is generally limited to an annual cap of $1,200. Within this $1,200 limitation, § 25C(b) sets forth further annual caps for certain categories of improvements. The caps and categories of improvements under these limitations are as follows: $600 for any item of qualified energy property, as defined in § 25C(d)(2); $600 for exterior windows and skylights; $250 for any single exterior door and $500 in the aggregate for all exterior doors; and $150 for home energy audits. Section 25C(b) also provides that residential energy property expenditures for heat pumps, heat pump water heaters, biomass stoves, and biomass boilers are not subject to the annual cap of $1,200 or to the $600 limitation for any item of qualified energy property. Instead, residential energy property expenditures for these items are subject to a separate aggregate annual limitation of $2,000. Section 25C(d) provides that the term " residential energy property expenditures" includes expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of the property.

.02. Credit for Home Energy Audit Expenditures

Section 13301(f) of the IRA amended § 25C to expand the types of expenditures eligible for the § 25C credit to include expenditures for home energy audits. Section 25C(e) defines the term " home energy audit" as an inspection and written report with respect to a dwelling unit located in the United States and owned or used by the taxpayer as the taxpayer's principal residence (within the meaning of § 121). The audit must (1) identify the most significant and cost-effective energy efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement, and (2) be conducted and prepared by a home energy auditor that meets the certification or other requirements specified by the Secretary of the Treasury or her delegate (Secretary) in regulations or other guidance. The IRA also imposed two limitations on this credit. First, as described above, § 25C(b)(6)(A) limits the credit allowed for amounts paid or incurred by the taxpayer during the taxable year for home energy audits up to $150. Under this limit, for example, a taxpayer that pays $1000 for a home energy audit during the taxable year may only claim a $150 credit for such taxable year for this expenditure, and not the full 30 percent of the amount of the expenditure, even if the taxpayer does not have any other expenditures eligible for the § 25C credit during the taxable year. Second, § 25C(b)(6)(B) imposes a substantiation requirement, requiring taxpayers claiming the credit to include with their tax returns "such information or documentation as the Secretary may require" .

In Notice 2022-48, 2022-43 I.R.B. 305, the Treasury Department and the IRS requested comments on various questions arising from the IRA's energy efficiency provisions. Among other questions, the notice requested comments on what certification or other requirements the Treasury Department and the IRS should require for home energy auditors that conduct the inspection and provide the written report that constitutes a "home energy audit" that qualifies for the § 25C credit.

The Treasury Department and the IRS published a Fact Sheet (FS-2022-40) on December 22, 2022, addressing "frequently asked questions about energy efficient home improvements and residential clean energy property credits." This Fact Sheet provides that a qualifying home energy audit "must include an inspection of a dwelling, including condominiums and certain manufactured homes, located in the United States that is owned or used by the taxpayer as the taxpayer's principal residence. The home energy auditor must provide a written report (to the taxpayer) that identifies the most significant and cost-effective energy efficiency improvements for that dwelling, including an estimate of the energy and cost savings for each such improvement. The auditor must meet the certification or other requirements specified by the Department of the Treasury and the Internal Revenue Service in forthcoming guidance." The Fact Sheet also clarifies that the § 25C credit with respect to home energy audits may be claimed by a taxpayer renting a home as their principal residence provided such home is located in the United States.

3. DEFINITIONS

.01. Home Energy Audit Credit. The term "Home Energy Audit Credit" means the § 25C credit allowed to individuals by reason of § 25C(a)(3) equal to 30 percent of the amount paid or incurred for Home Energy Audits in the taxable year, up to $150 per taxable year.
.02. Home Energy Audit. The term "Home Energy Audit" means an inspection and written report (audit) with respect to a dwelling unit located in the United States and owned or used by the taxpayer as the taxpayer's principal residence (within the meaning of § 121) that meets each of the following requirements.

(1) The audit identifies the most significant and cost-effective energy efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement,

(2) The inspection is conducted either by a Qualified Home Energy Auditor or under the supervision of a Qualified Home Energy Auditor,

(3) The written report is prepared and signed by a Qualified Home Energy Auditor, and

(4) The audit is consistent with the most recent Department of Energy (DOE)-led and industry-validated Jobs Task Analysis.[2]

.03. Qualified Home Energy Auditor. The term " Qualified Home Energy Auditor" means an individual who is a home energy auditor that is certified by a Qualified Certification Program at the time of the Home Energy Audit.
.04. Qualified Certification Program. The term " Qualified Certification Program" means a certification program described in section 4.03 of this notice.

4. CERTIFICATIONS AND OTHER REQUIREMENTS FOR QUALIFIED HOME ENERGY AUDITORS.

.01. In General. Except as otherwise provided in section 6 of this notice, the forthcoming proposed regulations would provide that a taxpayer may claim the Home Energy Audit Credit for a taxable year only if the taxpayer pays or incurs amounts for a Home Energy Audit.

.02. Written Report. The forthcoming proposed regulations would require the Qualified Home Energy Auditor to provide the following information in the written report:

(1) The Qualified Home Energy Auditor's name and the relevant employer identification number (EIN) or other type of relevant taxpayer identifying number as referenced in § 301.6109-1(a)(1)(i) of the Procedure and Administration Regulations (26 CFR part 301) in lieu of an EIN,[3]

(2) An attestation that the Qualified Home Energy Auditor is certified by a Qualified Certification Program, and

(3) The name of such Qualified Certification Program.

.03. Qualified Certification Program. A Qualified Certification Program is a certification program that satisfies the criteria described in section 4.03(1) and (2) of this notice for certifying home energy auditors and that is included in the list described in section 4.04 of this notice.

(1) The certification program must be reviewed and evaluated through the most recent DOE-led and industry-validated Jobs Task Analysis, demonstrating substantial alignment with key duties, tasks, knowledge, skills, and abilities of home energy auditors.

(2) The certification program must satisfy one of following standards development processes:

(a) The credentials are developed and maintained in accordance with industry standards using criteria such as those cited in the Department of Labor (DOL) Training and Employment Notice No. 25-19[4] , Attachment I, section b., or the most recent guidance from DOL on characteristics of credentials; or

(b) The program is accredited by the American National Standards Institute (ANSI), International Accreditation Service, or other qualified accreditation bodies that are in compliance with ISO/IEC 17024:2012, Conformity assessment - General requirements for bodies operating certification of persons.

.04. Qualified Certification Programs List. The list of Qualified Certification Programs is maintained by the DOE at the following web address: https://www.energy.gov/eere/buildings/25c-energy-efficient-home-improvement-credit. The listed Qualified Certification Programs are the exclusive certification programs through which an auditor can qualify as a Qualified Home Energy Auditor, and that will allow a taxpayer to claim the Home Energy Audit Credit. DOE intends to update the list on a rolling basis as it identifies additional Qualified Certification Programs.

5. SUBSTANTIATION REQUIREMENT

The forthcoming proposed regulations would provide that taxpayers claiming the Home Energy Audit Credit would be in compliance with the substantiation requirement under § 25C(b)(6)(B) if they (1) maintain the written report signed by the Qualified Home Energy Auditor as a record, pursuant to the general recordkeeping and retention requirements under § 6001 and § 1.6001-1, and (2) comply with the instructions for Form 5695, *Residential Energy Credits*, or any successor form required by the IRS.

6. TRANSITION RULE

With respect to home energy audits conducted during taxable years ending after December 31, 2022, and conducted on or before December 31, 2023, a home energy auditor is not required to be a Qualified Home Energy Auditor as defined in section 3.03 of this notice. Therefore, taxpayers that paid or incurred expenses for a home energy audit that meets the requirements of § 25C, and that was conducted during taxable years ending after December 31, 2022, and conducted on or before December 31, 2023, may claim a Home Energy Audit Credit for such audit even if the auditor who conducted the home energy audit was not a Qualified Home Energy Auditor, as defined in section 3.03 of this notice, at the time of the home energy audit. However, taxpayers may not claim a Home Energy Audit Credit for home energy audits conducted after December 31, 2023, that were not conducted by a Qualified Home Energy Auditor.

7. PAPERWORK REDUCTION ACT

The Paperwork Reduction Act of 1995 (-) ("PRA") generally requires that a federal agency obtain the approval of the Office of Management and Budget (OMB) before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information contained in this notice includes recordkeeping requirements, as detailed in section 5 of this notice. These recordkeeping requirements are approved by OMB under 1545-0074.

Additionally, the notice includes a third-party disclosure requirement for Qualified Home Energy Auditors to provide a written report (to the taxpayer) that identifies the most significant and cost-effective energy efficiency improvements for that dwelling, including an estimate of the energy and cost savings for each such improvement. The disclosure of these reports is considered a usual and customary business practice provided during the normal course of business in conducting a Home Energy Audit. This customary business practice imposes no additional burden on respondents.

8. CONTACT INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact the Office of Associate Chief Counsel (Passthroughs & Special Industries) at (202) 317-6853 (not a toll-free call).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

2 The Single-Family Energy Auditor Job Task Analysis and a Multifamily Energy Auditor Job/Task Analysis and Report were developed by the National Renewable Energy Laboratory. Public comment informed the development of these documents. See Workforce Guidelines for Home Energy Upgrades, 75 FR 68781 (Nov. 9, 2010), available at: https://www.federalregister.gov/documents/2010/11/09/2010-28289/workforce-guidelines-for-home-energy-upgrades.

3 If the Qualified Home Energy Auditor is acting in his or her capacity as a partner in a partnership, or as an employee of any person, whether an individual, corporation, or partnership, the relevant EIN is the EIN of the partnership or the person who employs the Qualified Home Energy Auditor.

4 Employment & Training Administration Training and Employment Notice No. 25-19 (Jun. 08, 2020) available at: https://www.dol.gov/agencies/eta/advisories/training-and-employment-notice-no-25-19.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2023
Notice 2023-62, 2023-37 IRB 817 -- IRC Sec(s). 414, 08/25/2023

Notices

Notice 2023-62, 2023-37 IRB 817, 08/25/2023, IRC Sec(s). 414

Catch-up contributions—designation of contributions.

Headnote:

As announced in IR 2023-155 (8/25/2023) , to help with orderly transition in implementation of recent law changes applicable to catch-up contributions made by higher-income wage-earners, IRS will treat first two tax years beginning after 2023 as administrative transition period with respect to requirement under Code Sec. 414(v)(7)(A); that catch up contributions made on behalf of certain eligible participants be designated as Roth contributions. Additional guidance will be forthcoming, and comment on specific questions is sought before 10/24/2023.

Reference(s): ¶ 4145.36(7); Code Sec. 414;

Full Text:

I. Purpose

This notice provides guidance with respect to section 603 of Division T of the Consolidated Appropriations Act, 2023, Pub. L. 117-328 , 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0 Act). Among other changes, section 603 of the SECURE 2.0 Act requires that, in the case of certain eligible participants, catch-up contributions under section 414(v)(1) of the Internal Revenue Code (Code) must be designated as Roth contributions pursuant to an employee election.

This notice is not intended to provide comprehensive guidance as to section 603 of the SECURE 2.0 Act, but rather is intended to provide guidance on particular issues to assist in the implementation of that section. This notice also announces a 2-year administrative transition period with respect to the requirement under section 603 of the SECURE 2.0 Act that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have been made aware of taxpayer concerns with being able to timely implement section 603 of the SECURE 2.0 Act. The administrative transition period described in this notice is intended to facilitate an orderly transition for compliance with that requirement.

The Treasury Department and the IRS continue to work on implementation of section 603 of the SECURE 2.0 Act and intend to issue further guidance, as described in section V of this notice. The Treasury Department and the IRS invite comments on this notice and any other aspect of section 603 of the SECURE 2.0 Act.

II. Background

Section 414(v)(1) of the Code provides that an applicable employer plan (as defined in section 414(v)(6)(A)) will not be treated as failing to meet any requirement of the Code solely because the plan permits an eligible participant (as defined in section 414(v)(5)) to make additional elective deferrals under section 414(v) (catch-up contributions) in any plan year. Section 414(v)(3)(A)(i) further provides that a catch-up contribution is not, with respect to the year in which the contribution is made, subject to any otherwise applicable limitation contained in section 401(a)(30) (that is, the limitation on the exclusion of elective deferrals from gross income under section 402(g)(1)(A)), 403(b) (including the requirement under section 403(b)(1)(E) that a contract purchased under a salary reduction agreement satisfy the requirements of section 401(a)(30)), or 457(b)(2) (determined without regard to section 457(b)(3)), among other provisions.

Section 603(a) of the SECURE 2.0 Act amends section 414(v) of the Code to add section 414(v)(7). Section 414(v)(7)(A) generally provides that, in the case of an eligible participant whose wages (as defined in section 3121(a)) for the preceding calendar year from the employer sponsoring the plan exceed $145,000 (as adjusted under section 414(v)(7)(E)), section

414(v)(1) applies only if any catch-up contributions are designated Roth contributions (as defined in section 402A(c)(1)) made pursuant to an employee election.

Section 414(v)(7)(B) provides that, in the case of an applicable employer plan with respect to which section 414(v)(7)(A) applies to any participant for a plan year, section 414(v)(1) does not apply to the plan unless the plan provides that any eligible participant may make catch-up contributions as designated Roth contributions. Thus, if a plan provides that an eligible participant who is subject to the requirements of section 414(v)(7)(A) may make catch-up contributions as designated Roth contributions, then all eligible participants in the plan must be permitted to make catch-up contributions as designated Roth contributions.

Section 414(v)(7)(C) provides that section 414(v)(7)(A) does not apply in the case of an applicable employer plan described in section 414(v)(6)(A)(iv) (a SEP arrangement under section 408(k) or a SIMPLE IRA plan under section 408(p)). Thus, section 414(v)(7)(A) applies in the case of an applicable employer plan that is a qualified plan under section 401(a) (including a section 401(k) plan), a section 403(b) plan, or a section 457(b) plan maintained by an employer described in section 457(e)(1)(A) (an eligible governmental plan).

Section 414(v)(7)(D) provides that the Secretary (the Secretary of the Treasury or the Secretary's delegate) may provide by regulations that an eligible participant may elect to change the participant's election to make catch-up contributions if the participant's compensation is determined to exceed the limitation under section 414(v)(7)(A) after the election is made.

Section 603(b) of the SECURE 2.0 Act includes conforming amendments with respect to section 603(a). Section 603(b)(1) of the SECURE 2.0 Act strikes section 402(g)(1)(C) of the Code. Prior to that amendment, section 402(g)(1)(C) provided that an eligible participant's gross income does not include elective deferrals in excess of the applicable dollar amount under section 402(g)(1)(B)[1] to the extent that the amount of those elective deferrals does not exceed the applicable dollar amount under section 414(v)(2)(B)(i)[2] for the taxable year (without regard to the treatment of the elective deferrals by an applicable employer plan under section 414(v)).

Section 603(b)(2) of the SECURE 2.0 Act amends section 457(e)(18)(A)(ii) of the Code to replace " the applicable dollar amount for the taxable year determined under section 414(v)(2)(B)(i), or" with " the lesser of any designated Roth contributions made by the participant to the plan or the applicable dollar amount for the taxable year determined under section 414(v)(2)(B)(i), or" .

Section 603(c) of the SECURE 2.0 Act provides that the amendments made by section 603 apply to taxable years beginning after December 31, 2023.

III. Guidance On Section 603 Of The SECURE 2.0 Act

A. Catch-Up Contributions for Taxable Years Beginning After December 31, 2023

Pursuant to section 414(v)(1), an applicable employer plan is not treated as failing to meet any requirement of the Code solely because the plan permits an eligible participant to make catch-up contributions under section 414(v) in any plan year. Accordingly, for taxable years beginning after December 31, 2023, an applicable employer plan may permit an eligible participant to make elective deferrals under the plan that exceed the applicable dollar amount under section 402(g)(1)(B) (or deferrals under the plan that exceed the applicable dollar amount under section 457(e)(15)) if those contributions in excess of the applicable dollar amount satisfy the requirements under section 414(v) for catch-up contributions. The elimination of section 402(g)(1)(C) of the Code under section 603(b)(1) of the SECURE 2.0 Act does not change this result for taxable years beginning after December 31, 2023.[3]

If an eligible participant is subject to the requirements of section 414(v)(7)(A), then any catch-up contributions that are made to the plan on behalf of the participant must be designated as Roth contributions. However, if an eligible participant is not subject to the requirements of section 414(v)(7)(A), then any catch-up contributions that are made to the plan on behalf of the participant are not required to be designated as Roth contributions. In that case, any catch-up contributions under section 414(v) that are made to the plan on behalf of the participant that are not designated as Roth contributions are not includible in the participant's gross income under section 402(g)(1)(A) (and do not exceed the limitation in section 457(b)(2)) because, in accordance with section 414(v)(3)(A)(i), the limitations on elective deferrals under sections 401(a)(30) and 403(b) (and the limitation on deferrals under section 457(b)(2)) do not apply to those catch-up contributions.

B. Elective Deferrals Made to Two or More Plans

If an individual makes elective deferrals to two or more plans during a taxable year (including plans maintained by unrelated employers), then, under section 402(g)(1)(A), those elective deferrals are aggregated for purposes of determining whether the amount of the individual's elective deferrals exceeds the applicable dollar amount under section 402(g)(1)(B). Similarly, an eligible participant's elective deferrals made to two or more plans during a taxable year are also aggregated for purposes of applying the limitation on the amount of catch-up contributions under section 414(v)(2). The elimination of section 402(g)(1)(C) of the Code under section 603(b)(1) of the SECURE 2.0 Act does not change this result for taxable years beginning after December 31, 2023. [4]

IV. Administrative Transition Period

Under section 603(c) of the SECURE 2.0 Act, the provisions of section 603 apply to taxable years beginning after December 31, 2023. However, the first two taxable years beginning after December 31, 2023, will be regarded as an administrative transition period with respect to the requirement under section 414(v)(7)(A) of the Code that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions. Specifically, until taxable years beginning after December 31, 2025, (1) those catch-up contributions will be treated as satisfying the requirements of section 414(v)(7)(A), even if the contributions are not designated as Roth contributions, and (2) a plan that does not provide for designated Roth contributions will be treated as satisfying the requirements of section 414(v)(7)(B).

V. Guidance Under Consideration Regarding Section 603 Of The SECURE 2.0 Act

As noted in section I of this notice, the Treasury Department and the IRS intend to issue further guidance to assist taxpayers with the implementation of section 603 of the SECURE 2.0 Act. The guidance that the Treasury Department and the IRS anticipate issuing with respect to section 603 of the SECURE 2.0 Act, after taking into account any comments received, is expected to include:

1. Guidance clarifying that section 414(v)(7)(A) of the Code would not apply in the case of an eligible participant who does not have wages as defined in section 3121(a) (that is, wages for purposes of the Federal Insurance Contributions Act (FICA)) for the preceding calendar year from the employer sponsoring the plan. For example, under that guidance, if an eligible participant did not have any wages for purposes of FICA for the preceding calendar year because the individual was a partner (or other self-employed individual) receiving self-employment income or because the individual was a State or local government employee whose services were excluded from the definition of employment under section 3121(b)(7), then the eligible participant would not be subject to the requirements of section 414(v)(7)(A).

2. Guidance providing that, in the case of an eligible participant who is subject to section 414(v)(7)(A), the plan administrator and the employer would be permitted to treat an election by the participant to make catch-up contributions on a pre-tax basis as an election by the participant to make catch-up contributions that are designated Roth contributions.[5]

3. Guidance addressing an applicable employer plan that is maintained by more than one employer (including a multiemployer plan). The guidance would provide that an eligible participant's wages for the preceding calendar year from one participating employer would not be aggregated with the wages from another participating employer for purposes of determining whether the participant's wages for that year exceed $145,000 (as adjusted). For example, under that guidance, if an eligible participant's wages for a calendar year were: (1) $100,000 from one participating employer; and (2) $125,0000 from another participating employer, then the participant's catch-up contributions under the plan for the next year would not be subject to section 414(v)(7)(A) (even if the participant's aggregate wages from the participating employers for the prior calendar year exceed $145,000, as adjusted). The guidance also would provide that, even if an eligible participant is subject to section 414(v)

(7)(A) because the participant's wages from one participating employer in the plan for the preceding calendar year exceed $145,000 (as adjusted), elective deferrals made on behalf of the participant by another participating employer that are catch-up contributions would not be required to be designated as Roth contributions unless the participant's wages for the preceding calendar year from that other employer also exceed that amount.

VI. Request For Comments

The Treasury Department and the IRS invite comments and suggestions regarding the matters discussed in this notice and any other aspect of section 603 of the SECURE 2.0 Act. In particular, the Treasury Department and the IRS request comments on section V of this notice.

In addition, comments are requested with respect to whether the intended guidance should address a plan that permits eligible participants to make catch-up contributions under section 414(v) but does not include a qualified Roth contribution program. In particular, should the guidance provide that such a plan will not fail to satisfy section 414(v)(4) (which provides that all eligible participants must be allowed to make the same election with respect to catch-up contributions) or section 414(v)(7)(B), merely because the plan provides that eligible participants who are not subject to section 414(v)(7)(A) are permitted to make catch-up contributions while eligible participants who are subject to section 414(v)(7)(A) are prohibited from making catch-up contributions.[6]

Comments should be submitted in writing on or before October 24, 2023, and should include a reference to Notice 2023-62. Comments may be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov (type " IRS-2023-0039" in the search field on the Regulations.gov home page to find this notice and submit comments). Alternatively, comments may be submitted by mail to: Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2023-62), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket.

VII. Drafting Information

The principal author of this notice is the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in the development of this guidance. For further information regarding this notice, contact Kara M. Soderstrom at (202) 317-6799 (not a toll-free number).

---

1 The applicable dollar amount under section 402(g)(1)(B) is $22,500 for 2023.

2 The applicable dollar amount under section 414(v)(2)(B)(i) is $7,500 for 2023.

3 Proposed regulations, which were issued before the enactment in 2002 of section 402(g)(1)(C), permitted catch-up contributions in excess of the applicable dollar amount under section 402(g)(1)(B) or 457(e)(15) for purposes of section 414(v). See proposed 1.414(v)-1(a)(1) and (b)(1)(i), 66 FR 53555 (the 2001 NPRM).

4 Proposed 1.414(v)-1(g) of the 2001 NPRM also provided for aggregation of an eligible participant's elective deferrals made to two or more plans for purposes of section 414(v)(2).

5 Under section 402A(c)(1)(B), an employee may designate elective deferrals as Roth contributions at such time and in such manner as the Secretary may prescribe. Sections 1.401(k)-1(f)(1)(i) and 1.403(b)-3(c)(1) provide that a designation of an elective contribution as a Roth contribution must be made at the time of the cash or deferred election, and a similar rule applies to an eligible governmental plan.

6 Under section 402A(a), an applicable retirement plan may, but is not required to, include a qualified Roth contribution program. However, in the case of an eligible participant who is subject to section 414(v)(7)(A), the catch-up contribution provisions of section 414(v)(1) apply only if any catch-up contributions are designated as Roth contributions. Accordingly, if an applicable employer plan does not include a qualified Roth contribution program, then an eligible participant who is subject to section 414(v)(7)(A) would be prohibited from making catch-up contributions under the plan.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2023
Notice 2023-69, 2023-42 IRB 1079 -- IRC Sec(s). 61, 09/28/2023

Notices

Notice 2023-69, 2023-42 IRB 1079, 09/28/2023, IRC Sec(s). 61

Gross income—leave-based donation programs—Hawaii wildfires.

Headnote:

As announced in IR 2023-181 (9/28/2023) , IRS won't treat cash payments employers make to orgs. in exchange for employees' paid-time-off as gross income of employees if payments are made to victims of Hawaii wildfires that began on 8/8/2023 and are paid to said orgs. before 1/1/2025. Employees can't deduct value of paid-time-off donated as charitable contribution, but employers may claim deduction under Code Sec. 170; or Code Sec. 162; , provided all other requirements of applicable section are met. Finally, IRS won't assert that opportunity to make this election is constructive receipt of income.

Reference(s): ¶ 615.186(60); Code Sec. 61;

Full Text:

Part III — Administrative, Procedural, and Miscellaneous.

Treatment of Amounts Paid to Section 170(c) Organizations under Employer Leave-Based Donation Programs to Aid Victims of the Hawaii Wildfires that Began on August 8, 2023 (2023 Hawaii Wildfires).

TREATMENT OF LEAVE-BASED DONATION PAYMENTS

In response to the extreme need for charitable relief for victims of wildfires beginning on August 8, 2023, in the State of Hawaii (2023 Hawaii Wildfires), employers may have adopted or may be considering adopting leave-based donation programs. This notice provides guidance under the Internal Revenue Code (Code)[1] on the federal income and employment tax treatment of cash payments made by employers under leave-based donation programs for the relief of victims of the 2023 Hawaii Wildfires. This guidance is similar to the guidance provided in Notice 2001-69, 2001-46 IRB 491, as modified and superseded by Notice 2003-1, 2003-2 IRB 257, regarding charitable relief following the September 11, 2001, terrorist attacks.

EMPLOYER LEAVE-BASED DONATION PROGRAMS

Under employer leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for their employers making cash payments to charitable organizations described in section 170(c) (section 170(c) organizations). Cash payments made by an employer to section 170(c) organizations under an employer leave-based donation program are referred to as " employer leave-based donation payments."

TREATMENT OF QUALIFIED EMPLOYER LEAVE-BASED DONATION PAYMENTS

Employer leave-based donation payments made by an employer before January 1, 2025, to section 170(c) organizations to aid victims of the 2023 Hawaii Wildfires (qualified employer leave-based donation payments) will not be treated as gross income or wages (or compensation, as applicable) of the employees of the employer. Similarly, employees electing or with an opportunity to elect to forgo leave that funds the qualified employer leave-based donation payments will not be treated as having constructively received gross income or wages (or compensation, as applicable). Employers should not include the amount of qualified employer leave-based donation payments in Box 1, 3 (if applicable), or 5 of the electing employees' Forms W-2. Electing employees are not eligible to claim charitable contribution deductions under section 170 for the value of the forgone leave that funds qualified employer leave-based donation payments.

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

DRAFTING INFORMATION

For further information, please contact Clara L. Raymond of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 317-4718 (not a toll-free call).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Code.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2023
Notice 2023-71, 2023-44 IRB 1191 -- IRC Sec(s). 7508A, 10/13/2023

Notices

Notice 2023-71, 2023-44 IRB 1191, 10/13/2023, IRC Sec(s). 7508A

Authority to postpone certain deadlines by reason of terroristic or military actions.

Headnote:

As announced in IR 2023-188 (10/13/2023) , IRS concluded that attacks against state of Israel that began on 10/7/2023 amount to terroristic acts within meaning of Code Sec. 692(c)(2); , and so under authority provided in Code Sec. 7508A(a); , it has postponed due dates for various enumerated actions until 10/7/2024. Affected taxpayers are described, and time-sensitive acts (either by taxpayer or by govt.) covered by this relief are listed.

Reference(s): ¶ 75,085.01(60); Code Sec. 7508A;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Relief for Taxpayers Affected by the Terroristic Action in the State of Israel

I. PURPOSE

This notice provides relief under section 7508A of the Internal Revenue Code (Code)[1] for persons that the Secretary of the Treasury (Secretary) has determined to be affected by the terroristic action in the State of Israel beginning on October 7, 2023. The Department of the Treasury and the Internal Revenue Service (IRS) may provide additional relief in the future.

II. BACKGROUND

Section 7508A(a) provides the Secretary with authority to postpone the time (up to one year) for performing certain acts under the internal revenue laws for a taxpayer determined by the Secretary to be affected by a terroristic or military action as defined in section 692(c)(2). Section 692(c)(2) defines a terroristic action as " any terroristic activity which a preponderance of the evidence indicates was directed against the United States or any of its allies."

Section 4.01(1) of Revenue Procedure 2004-26, 2004-1 C.B. 890, provides that prior to publishing a determination that an event outside the United States constitutes a terroristic action within the meaning of section 692(c)(2), the Secretary will ascertain whether the Department of State and the Department of Justice believe that a preponderance of the evidence indicates that the event resulted from terrorist activity directed against the United States or its allies. In accordance with the procedures described in Revenue Procedure 2004-26, the Secretary has determined that the terrorist attacks beginning on October 7, 2023, against the State of Israel (October 7, 2023 Terrorist Attacks) constitute terroristic action within the meaning of section 692(c)(2).

III. GRANT OF RELIEF

With respect to taxpayers described in section III.A of this notice (affected taxpayers), this notice postpones the due dates for the actions described in section III.B of this notice (postponed acts) until October 7, 2024.

A. Affected Taxpayers

Section 301.7508A-1(d)(1) describes several types of " affected taxpayers" eligible for relief under section 7508A. The Secretary has determined that the following types of taxpayers are affected taxpayers with respect to the October 7, 2023 Terrorist Attacks eligible for the relief provided in this notice:

> Any individual whose principal residence, and any business entity or sole proprietor whose principal place of business, is located in the State of Israel, the West Bank or Gaza (covered area);

Any individual affiliated with a recognized government or philanthropic organization and who is assisting in the covered area, such as a relief worker;

Any individual, business entity or sole proprietor, or estate or trust whose tax return preparer or records necessary to meet a deadline for postponed acts are located in the covered area;

Any spouse of an affected taxpayer, solely with regard to a joint return of two married individuals; and

Any individual visiting the covered area who was killed, injured, or taken hostage as a result of the October 7, 2023 Terrorist Attacks.

The IRS automatically identifies taxpayers whose principal residence or principal place of business is located in the covered area based on previously filed returns and applies relief. Affected taxpayers whose principal residence or principal place of business is not located in the covered area should call the IRS disaster hotline at (866) 562-5227 to request relief. Alternatively, international callers may call (267) 941-1000.

B. Postponement of Due Dates with Respect to Certain Taxpayer Acts

Affected taxpayers have until October 7, 2024, to file tax returns, make tax payments, and perform certain time-sensitive acts listed in § 301.7508A-1(c)(1) and Rev. Proc. 2018-58, 2018-50 I.R.B. 990 (December 10, 2018), that are due to be performed on or after October 7, 2023, and before October 7, 2024. Any taxpayer acts that are due to be performed on or after October 7, 2023, and before October 7, 2024, are postponed until October 7, 2024. These acts include, but are not limited to:

Filing any return of income tax, estate tax, gift tax, generation-skipping transfer tax, excise tax (other than firearms tax), harbor maintenance tax, or employment tax;

Paying any income tax, estate tax, gift tax, generation-skipping transfer tax, excise tax (other than firearms tax), harbor maintenance tax, or employment tax, or any installment of those taxes;

Making contributions to a qualified retirement plan;

Filing a petition with the Tax Court;

Filing a claim for credit or refund of any tax; and

Bringing suit upon a claim for credit or refund of any tax.

This is not an exhaustive list. For further information, see § 301.7508A-1(c)(1) and Rev. Proc. 2018-58.

C. Postponement of Due Dates with Respect to Certain Government Acts

This notice also provides the IRS with additional time to perform certain time-sensitive actions with respect to affected taxpayers. Any government acts described in § 301.7508A-1(c)(2) that are due to be performed on or after October 7, 2023, and before October 7, 2024, are postponed until October 7, 2024. These acts include:

Assessing any tax;

Giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax;

Collecting by the IRS, by levy or otherwise, of the amount of any liability in respect of any tax; and

Bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and allowing a credit or refund of any tax.

IV. DRAFTING INFORMATION

The principal author of this notice is the Office of Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, you may call (202) 317-3400 (not a toll-free number).

---

1 Unless otherwise specified, all "Section" or "§" references are to sections of the Code or the Procedure and Administration Regulations (26 CFR part 301).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2024
Notice 2024-2, 2024-2 IRB 316 -- IRC Sec(s). 72; 401; 403; 408, 12/20/2023

Notices

Notice 2024-2, 2024-2 IRB 316, 12/20/2023, IRC Sec(s). 408

Retirement and pension plans—guidance.

Headnote:

IRS provided guidance in form of questions and answers regarding certain provisions of SECURE 2.0 Act '22 involving retirement and pension plans. Comments should be received by 2/20/2024.

Reference(s): ¶ 4085.06(10); Code Sec. 408; Code Sec. 72; Code Sec. 401; Code Sec. 403;

Full Text:

Miscellaneous Changes Under the SECURE 2.0 Act of 2022

I. PURPOSE

This notice provides guidance in the form of questions and answers with respect to certain provisions of Division T of the Consolidated Appropriations Act, 2023, Pub. L. 117-328 , 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0 Act). Specifically, this notice addresses issues under the following sections of the SECURE 2.0 Act: section 101 (expanding automatic enrollment in retirement plans), section 102 (modification of credit for small employer pension plan startup costs), section 112 (military spouse retirement plan eligibility credit for small employers), section 113 (small immediate financial incentives for contributing to a plan), section 117 (contribution limit for SIMPLE plans), section 326 (exception to the additional tax on early distributions from qualified plans for individuals with a terminal illness), section 332 (employers allowed to replace SIMPLE retirement accounts with safe harbor 401(k) plans during a year), section 348 (cash balance), section 350 (safe harbor for correction of employee elective deferral failures), section 501 (provisions relating to plan amendments), section 601 (SIMPLE and SEP Roth IRAs), and section 604 (optional treatment of employer contributions or nonelective contributions as Roth contributions).

This notice is not intended to provide comprehensive guidance as to the specific provisions of the SECURE 2.0 Act, but rather is intended to provide guidance on discreet issues to assist in commencing implementation of these provisions. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) continue to analyze the various provisions of the SECURE 2.0 Act and anticipate issuing further guidance, including regulations, as appropriate.

II. PROVISIONS OF THE SECURE 2.0 ACT

TABLE OF CONTENTS:

L - Section 604 of the SECURE 2.0 Act

A. SECTION 101 OF THE SECURE 2.0 ACT

Section 101 of the SECURE 2.0 Act amends the Internal Revenue Code (Code) to add new section 414A. Section 414A(a) generally provides that a cash or deferred arrangement (CODA) will not be treated as a qualified CODA described in section 401(k), and an annuity contract otherwise described in section 403(b) that is purchased under a salary reduction agreement will not be treated as described in section 403(b), unless the CODA or salary reduction agreement satisfies the automatic enrollment requirements of section 414A(b). Section 414A(b) requires the CODA or salary reduction agreement to be an eligible automatic contribution arrangement (as defined in section 414(w)(3)) that provides permissible withdrawals and satisfies certain additional requirements involving default elective contributions and default investments.
Section 414A(c) sets forth several exceptions to the application of section 414A(a). Among other exceptions, section 414A(c)(2)(A)(i) and (ii) provides that section 414A(a) does not apply to any qualified CODA established before the date of the enactment of section 101 of the SECURE 2.0 Act (December 29, 2022) or to any annuity contract purchased under a plan established before the date of the enactment of section 101 of the SECURE 2.0 Act. For purposes of this notice, a qualified CODA or section 403(b) plan that is established before December 29, 2022, is called a pre- enactment qualified CODA or pre-enactment section 403(b) plan. However, section 414A(c)(2)(B) of the Code provides that, in the case of an employer adopting a plan maintained by more than one employer after the date of the enactment of section 101 of the SECURE 2.0 Act, section 414(c)(2)(A) of the Code does not apply to that employer, and section 414A(a) applies with respect to that employer as if that plan were a single plan.
Section 101(c) of the SECURE 2.0 Act provides that the amendments made by section 101 apply to plan years beginning after December 31, 2024.
Q. A-1: When is a qualified CODA established for purposes of determining whether the qualified CODA is excepted under section 414A(c)(2)(A)(i) of the Code from the requirements related to automatic enrollment (that is, whether the qualified CODA is a pre-enactment qualified CODA)?
A. A-1: For purposes of section 414A(c)(2)(A)(i), a qualified CODA is established on the date plan terms providing for the CODA are adopted initially. This is the case even if the plan terms providing for the CODA are effective after the adoption date. For example, if an employer adopted a plan that included a qualified CODA on October 3, 2022, with an effective date of January 1, 2023, then the qualified CODA would have been established on October 3, 2022 (that is, before December 29, 2022), even though the qualified CODA was not effective until after December 29, 2022.
Q. A-2: If a single employer plan that includes a pre-enactment qualified CODA is merged with another plan that includes a pre-enactment qualified CODA, will the qualified CODA included in the ongoing plan after the merger be treated as a pre- enactment qualified CODA?

A. A-2: Yes. In the case of the merger of two single employer plans, each of which includes a pre-enactment qualified CODA, the treatment of the qualified CODA included in the ongoing plan as a pre-enactment qualified CODA is unaffected by the merger. The result is the same if a single employer plan that includes a pre-enactment qualified CODA is merged with a plan maintained by more than one employer that includes a pre-enactment qualified CODA.

Q. A-3: If a plan that includes a qualified CODA that is not a pre-enactment qualified CODA is merged with a plan that includes a pre-enactment qualified CODA, will the qualified CODA included in the ongoing plan be treated as a pre-enactment qualified CODA after the merger?

A. A-3: Generally, no. However, if, in connection with a transaction described in section 410(b)(6)(C), a single employer plan that includes a qualified CODA that is not a pre-enactment qualified CODA is merged with another single employer plan that includes a pre-enactment qualified CODA, and the plan that includes the pre-enactment qualified CODA is designated as the ongoing plan, then the qualified CODA included in the ongoing plan continues to be treated as a pre-enactment qualified CODA after the merger, provided that the merger occurs by the end of the section 410(b)(6)(C) transition period.

In addition, if a single employer plan that includes a qualified CODA that is not a pre-enactment qualified CODA is merged into a plan maintained by more than one employer that includes a pre-enactment qualified CODA, then the qualified CODA included in the ongoing plan would not be treated as a pre-enactment qualified CODA with respect to that employer. However, in that case, the merger would not affect whether the qualified CODA is treated as a pre-enactment qualified CODA with respect to other employers that participate in the ongoing plan.

Q. A-4: If a plan that includes a qualified CODA is spun-off from a plan that includes a pre-enactment qualified CODA, is the qualified CODA included in the new spun-off plan also treated as a pre-enactment qualified CODA?

A. A-4: Generally, yes. If the plan from which the new plan was spun-off was a single employer plan that included a pre-enactment qualified CODA, then the qualified CODA included in the spun-off plan is also treated as a pre-enactment qualified CODA. However, if the plan from which the new plan was spun-off was a plan maintained by more than one employer that was established before December 29, 2022, then the qualified CODA included in the spun-off plan is treated as a pre-enactment qualified CODA only if the qualified CODA in the plan maintained by more than one employer was treated as a pre-enactment qualified CODA with respect to the employer sponsoring the spun-off plan.

Q. A-5: How do the rules of section 414A(c)(2)(A)(ii) apply to section 403(b) plans?

A. A-5: In general, the rules of section 414A that apply to qualified CODAs also apply to section 403(b) plans. However, under section 414A(c)(2)(A)(ii), a section 403(b) plan is excepted from the requirements of section 414A(a) as a pre-enactment section 403(b) plan if it was established before December 29, 2022, without regard to the date of adoption of plan terms that provide for salary reduction agreements.

Q. A-6: For plan years beginning after December 31, 2024, does section 414A(a) apply to a starter 401(k) deferral-only arrangement described in section 401(k)(16)(B) or to a safe harbor deferral-only plan described in section 403(b)(16)(B) (which were added to the Code by section 121 of the SECURE 2.0 Act, applicable to plan years beginning after December 31, 2023)?

A. A-6: Generally, yes. Unless an exception set forth in section 414A(c) of the Code applies (for example, the exception for a new or small business under section 414A(c)(4)(A) or (B)), section 414A(a) applies to a starter 401(k) deferral-only arrangement or to a safe harbor deferral-only plan for plan years beginning after December 31, 2024. Although section 414A(c) sets forth several exceptions to the application of section 414A(a), section 414A(c) does not include a specific exception for a starter 401(k) deferral-only arrangement described in section 401(k)(16)(B) or for a safe harbor deferral-only plan described in section 403(b)(16)(B). Similarly, sections 401(k)(16) and 403(b)(16) do not provide that a starter 401(k) deferral-only arrangement or a safe harbor deferral-only plan is treated as satisfying the requirements of section 414A.

B. SECTION 102 OF THE SECURE 2.0 ACT

Section 102 of the SECURE 2.0 Act amends section 45E of the Code to provide, for an eligible employer within the meaning of section 408(p)(2)(C)(i)[1] : (1) an increased small employer pension plan startup cost credit for qualifying small employers with no more than 50 employees; (2) a new credit based on matching and nonelective contributions made by qualifying small employers with no more than 100 employees; and (3) revised rules for the disallowance of deductions for certain small employer plan startup costs and matching and nonelective contributions to take into account the new credit based on matching and nonelective contributions.

Section 102(a) of the SECURE 2.0 Act adds new paragraph (e)(4) to section 45E of the Code. Section 45E(e)(4) provides for an increase in the small employer pension plan startup cost credit provided under section 45E(a) (startup costs credit), so that the credit for an eligible employer with no more than 50 employees is increased from 50 percent to 100 percent of the qualified startup costs paid or incurred by the eligible employer (increased startup costs credit). A startup costs credit (including the increased startup costs credit) is available to an eligible employer for a first credit year and each of the two taxable years immediately following the first credit year (together, a 3-year startup costs credit period), as described in section 45E(b) and (d)(3) and is subject to a dollar limitation set forth in section 45E(b). Under section 45E(d)(3), the first credit year is (1) the taxable year that includes the date that the eligible employer plan to which such costs relate becomes effective with respect to the eligible employer, or (2) at the election of the eligible employer, the taxable year preceding the taxable year that the plan becomes effective.

Section 102(b) of the SECURE 2.0 Act adds new section 45E(f) to the Code. Section 45E(f) provides for an additional amount of credit under section 45E based on employer matching and nonelective contributions to an eligible employer plan other than a defined benefit plan (employer contributions credit). Under section 45E(f)(1), an eligible employer is entitled to a credit for a taxable year equal to a specified applicable percentage of aggregate employer contributions (other than any elective deferrals, as defined in section 402(g)(3)) made by the employer during the taxable year to an eligible employer plan (other than a defined benefit plan, as defined in section 414(j)). The amount of the credit under section 45E(f)(1) is limited, under section 45E(f)(2)(A), to no more than $1,000 with respect to any employee. In addition, under section 45E(f)(2)(C), contributions with respect to any employee who receives wages, as defined under section 3121(a) (that is, wages for purposes of the Federal Insurance Contributions Act (FICA) (chapter 21 of the Code)), from the employer for the taxable year in excess of $100,000 (indexed for inflation) are excluded from the credit amount calculation for the taxable year. Further, under section 45E(f)(2)(B), the amount determined under section 45E(f)(1) (after applying the section 45E(d)(2)(A) and (C) limitations) is reduced through a credit phase-in formula by 2 percent for each employee of the employer for the preceding taxable year in excess of 50 employees. For purposes of the credit formula in section 45E(f)(1), section 45E(f)(3) provides that the applicable percentage is 100 percent for the first taxable year during which the eligible employer plan is established with respect to the eligible employer (the first employer contributions credit taxable year), 100 percent for the second employer contributions credit taxable year, 75 percent for the third employer contributions credit taxable year, 50 percent for the fourth employer contributions credit taxable year, and 25 percent for the fifth employer contributions credit taxable year (together, a 5-year employer contributions credit period).

Section 102(c) of the SECURE 2.0 Act amends section 45E(e)(2) of the Code with respect to the disallowance of deductions for certain small employer plan startup costs and matching and nonelective contributions to take into account the new credit under section 45E(f), by providing that no deduction is allowed (1) for that portion of the qualified startup costs paid or incurred for the taxable year that is equal to so much of the portion of the credit determined under section 45E(a) as is properly allocable to such costs, and (2) for that portion of the employer contributions by the employer for the taxable year that is equal to so much of the credit increase determined under section 45E(f) as is properly allocable to such contributions.

Section 102(d) of the SECURE 2.0 Act provides that the amendments to section 45E of the Code made by section 102 of the SECURE 2.0 Act apply to taxable years beginning after December 31, 2022.

Q. B-1: Is the employer contributions credit under section 45E(f) of the Code treated as a separate credit that is in addition to the startup costs credit under section 45E(a)?

A. B-1: Yes. For example, an eligible employer might be eligible both for a startup costs credit calculated under section 45E(a) (as limited by the dollar limitation in section 45E(b)), and an additional employer contributions credit calculated under section 45E(f)(1) (as limited by the dollar, wage, and credit phase-in limitations in section 45E(f)(2), but not the dollar limitation in section 45E(b)).

Q. B-2: When is an eligible employer plan treated as being established, for purposes of determining the first (and subsequent) employer contributions credit taxable years during the 5-

year employer contributions credit period for which an eligible employer can claim an employer contributions credit under section 45E(f)?

A. B-2: An eligible employer plan is treated as being established, for purposes of determining the first (and subsequent) employer contributions credit taxable years during the 5-year employer contributions credit period for which an eligible employer is permitted to claim an employer contributions credit under section 45E(f), on the date the plan becomes effective with respect to the eligible employer. This determination of the first employer contributions credit taxable year during the 5-year employer contributions credit period is similar to the determination of the taxable year that is the first credit year during the 3-year startup costs credit period under section 45E(a), as defined in section 45E(d)(3), except that an employer is permitted to elect, under section 45E(d)(3)(B), for the first startup costs credit year to be the taxable year preceding the taxable year in which the plan becomes effective with respect to the eligible employer. Thus, an eligible employer may be able to claim both the startup costs credit and the employer contributions credit beginning with the taxable year in which the plan becomes effective with respect to the eligible employer. If an eligible employer elects, for purposes of the startup costs credit, for the taxable year preceding the taxable year in which the plan becomes effective with respect to the eligible employer to be the first startup costs credit year, then the 5-year employer contributions credit period begins with the second taxable year of the 3-year startup costs credit period.

Q. B-3: How does a change in an employer's status as an eligible employer under section 408(p)(2)(C)(i) due to a change in the number of the employer's employees who received at least $5,000 of compensation from the employer for the preceding taxable year affect the employer's eligibility for the employer contributions credit under section 45E(f) for taxable years during the employer's 5-year employer contributions credit period?

A. B-3: An employer is eligible for the employer contributions credit for a taxable year during the employer's 5-year employer contributions credit period only if (1) the employer was an eligible employer under section 408(p)(2)(C)(i)(I) for the first employer contributions credit taxable year during the employer's 5-year employer contributions credit period, and (2) the employer is an eligible employer under section 408(p)(2)(C)(i) for the taxable year with respect to which the employer contributions credit is claimed. Accordingly, if an employer had more than 100 employees for the taxable year preceding the first employer contributions credit taxable year during the employer's 5-year employer contributions credit period, the employer will not become eligible for the employer contributions credit for the first time in a subsequent taxable year, even if the number of employees who received at least $5,000 of compensation from the employer drops to 100 or fewer for a taxable year following the taxable year preceding the first taxable year in the employer's 5-year employer contributions credit period.

Q. B-4: How does a change in an employer's status as an eligible employer under section 408(p)(2)(C)(i) due to a change in the number of the employer's employees who received at least $5,000 of compensation from the employer for a taxable year that precedes a particular taxable year during the employer's 3-year startup costs credit period affect the employer's eligibility for (1) the startup costs credit under section 45E(a) for that particular taxable year or (2) the increased startup costs credit under section 45E(e)(4) for that particular taxable year?

A. B-4:

(1) An employer is eligible for the startup costs credit under section 45E(a) (disregarding the increased startup costs credit under section 45E(e)(4)) for a taxable year during the employer's 3-year startup costs credit period only if (a) the employer was an eligible employer under section 408(p)(2)(C)(i)(I) for the first taxable year during the employer's 3-year startup costs credit period, and (b) the employer is an eligible employer under section 408(p)(2)(C)(i) for the taxable year with respect to which the startup costs credit is claimed. Accordingly, if an employer had more than 100 employees for the taxable year preceding the first taxable year during the employer's 3-year startup costs credit period, the employer will not become eligible for the employer contributions credit for the first time in a subsequent taxable year, even if the number of employees who received at least $5,000 of compensation from the employer drops to 100 or fewer for a taxable year following the taxable year preceding the first taxable year during the employer's 3-year startup costs credit period.

(2) An employer is eligible for the increased startup costs credit under section 45E(e)(4) for a taxable year during the employer's 3-year startup costs credit period only if (a) the employer was an eligible employer under section 408(p)(2)(C)(i)(I), applied by substituting "50 employees" for "100 employees," for the first taxable year during the employer's 3-year startup costs credit period, and (b) the employer is an eligible employer under section 408(p)(2)(C)(i), applied by substituting "50 employees" for "100 employees," for the taxable year with respect to which the startup costs credit is claimed. Accordingly, if an employer had more than 50 employees for the taxable year immediately preceding the first taxable year during the employer's 3-year startup costs credit period, the employer will not become eligible for the increased startup costs credit under section 45E(e)(4) for the first time in a subsequent taxable year, even if the number of employees who received at least $5,000 of compensation from the employer drops to 50 or fewer for a taxable year following the taxable year preceding the first taxable year during the employer's 3-year startup costs credit period.

Q. B-5: Is it possible for an employer that was eligible for the startup costs credit under section 45E(a) for a taxable year that began on or before December 31, 2022, to be eligible for the increased startup costs credit under section 45E(e)(4) or the employer contributions credit under section 45E(f) for a taxable year that begins after December 31, 2022?

A. B-5: Yes. However, an employer that was eligible for the startup costs credit under section 45E(a) for a taxable year that began on or before December 31, 2022, can be eligible for the increased startup costs credit under section 45E(e)(4) or the employer contributions credit under section 45E(f) for a taxable year that begins after December 31, 2022, only if there is a taxable year during the employer's applicable 3- or 5-year credit period that begins after December 31, 2022. For example, for an eligible employer with a calendar year taxable year that maintains a plan that became effective on January 1, 2021: (1) the 5-year employer contributions credit period began with the eligible employer's 2021 taxable year and ends with the employer's 2025 taxable year; and (2) for the three employer contributions credit taxable years in the 5-year employer contributions credit period that begin after December 31, 2022, it is possible, if the employer meets the eligibility requirements described in Q&A B-3 of this notice, for the employer to be eligible for an employer contributions credit equal to the applicable percentage of aggregate employer contributions set forth in section 45E(f)(1) (75 percent for the 2023 taxable year, 50 percent for the 2024 taxable year, and 25 percent for the 2025 taxable year).

Q. B-6: Is an eligible employer permitted to take into account, for purposes of determining the employer contributions credit under section 45E(f) for a taxable year, contributions to an individual who does not have wages as defined in section 3121(a) in excess of the $100,000 (indexed for inflation) wage limitation set forth in section 45E(f)(2)(C) for the taxable year, even if the individual has earned income that is not wages as defined in section 3121(a) for the taxable year in excess of the $100,000 amount or the individual is a state or local government employee with remuneration in excess of the $100,000 amount whose services are excluded from employment under section 3121(b)(7)?

A. B-6: Yes. The $100,000 (indexed for inflation) wage limitation set forth in section 45E(f)(2)(C), under which no contributions with respect to any individual who receives wages from the employer for a taxable year in excess of $100,000 (indexed for inflation) may be taken into account for purposes of determining employer contributions credits for the taxable year, only applies with respect to an individual who has wages as defined in section 3121(a) that are in excess of the wage limitation for the taxable year. Accordingly, contributions with respect to an individual who does not have any wages as defined in section 3121(a) for a taxable year because the individual is self- employed (including a partner) or because the individual is a state or local government employee whose services are excluded from employment under section 3121(b)(7) (and, thus, does not have wages as defined in section 3121(a)) may be taken into account for purposes of determining employer contributions credits for the taxable year, even if the individual has earned income or remuneration from a state or local government in excess of the $100,000 wage limitation.

Q. B-7: In which taxable year of an eligible employer is a matching or nonelective contribution made by the employer to an eligible employer plan taken into account for purposes of the employer contributions credit under section 45E(f)?

A. B-7: A matching or nonelective contribution made by an eligible employer to an eligible employer plan is taken into account for purposes of the employer contributions credit for the same taxable year that a deduction under section 404(a) would apply with respect to the contribution. Thus, an employer is deemed to have made a matching or nonelective contribution on the last day of the preceding taxable year if the contribution is on account of that taxable year and is not made later than the time prescribed by law for filing the return for that taxable year (including extensions thereof). See section 404(a)(6).

C. SECTION 112 OF THE SECURE 2.0 ACT

Section 112 of the SECURE 2.0 Act amends the Code to add new section 45AA, which provides a military spouse retirement plan eligibility credit for small employers (section 45AA credit). This new credit provides a business credit under section 38 of the Code for an eligible employer that provides for participation and benefits to a military spouse under an eligible defined contribution plan or plans of the employer (as defined under section 45AA(e)) within two months after the military spouse's date of hire by the employer.

Section 45AA(a) provides that the section 45AA credit for the taxable year is equal to the sum of (1) $200 with respect to each military spouse who is an employee of the employer and who participates in an eligible defined contribution plan of the employer at any time during the taxable year, plus (2) so much of the contributions made by the employer (other than an elective deferral as defined in section 402(g)(3)) to all eligible defined contribution plans with respect to the employee during the taxable year as do not exceed $300.

Section 45AA(b) provides that, for purposes of the section 45AA credit, a military spouse is only taken into account for the taxable year which includes the date on which the spouse began participating in the eligible defined contribution plan of the employer and the two succeeding taxable years (3-year credit period).

Section 45AA(c) provides that the term “eligible small employer” means an eligible employer as defined in section 408(p)(2)(C)(i)(I), which requires that an employer have had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding taxable year.

Section 45AA(d) defines a military spouse as any individual who is married (within the meaning of section 7703 as of the first date that the employee is employed by the employer) to an individual who is a member of the uniformed services (as defined in section 101(a)(5) of title 10, United States Code) serving on active duty. For purposes of the credit, an employer may rely on an employee's certification that the employee's spouse is a member of the uniformed services if the certification provides the name, rank, and service branch of the spouse. However, section 45AA(d)(2) of the Code provides that a military spouse does not include any individual who is a highly compensated employee of the employer (within the meaning of section 414(q)).

Section 45AA(e) defines an eligible defined contribution plan as any defined contribution plan (as defined in section 414(i)) of the eligible small employer if, under the terms of the plan, (1) military spouses employed by the employer are eligible to participate in the plan not later than the date which is two months after the date on which the military spouse begins employment with the employer, and (2) military spouses who are eligible to participate in the plan (A) are immediately eligible to receive an amount of employer contributions under the plan which is not less than the amount of contributions that a similarly situated participant who is not a military spouse would be eligible to receive under the plan after two years of service, and (B) immediately have a nonforfeitable right to the employee's accrued benefit derived from employer contributions under the plan.

Section 45AA(f) provides that all persons treated as a single employer under section 414(b), (c), (m), or (o) will be treated as one employer for purposes of section 45AA.
Section 112(e) of the SECURE 2.0 Act provides that the section 45AA credit applies to taxable years of the employer beginning after December 29, 2022.
Q. C-1: May an employer claim the section 45AA credit with respect to a military spouse for any taxable year of the employer within the 3-year credit period for which the employer does not meet the requirements of section 408(p)(2)(C)(i)(I) of the Code?
A. C-1: No. Section 45AA(c) specifies that the employer must meet the requirements of section 408(p)(2)(C)(i)(I) to be eligible for the section 45AA credit for a taxable year. For example, if an employer had no more than 100 employees who received at least $5,000 of compensation from the employer for the taxable year preceding the 2024 taxable year but more than 100 such employees for the taxable year preceding both the employer's 2023 and 2025 taxable years, with respect to a military spouse whose 3-year credit period begins in the employer's 2023 taxable year and ends in the employer's 2025 taxable year, the employer is eligible for the section 45AA credit only for the employer's 2024 taxable year.
Q. C-2: May an eligible small employer claim the section 45AA credit with respect to a military spouse who participated in a defined contribution plan of the employer before the employer amends the plan to become an eligible defined contribution plan, or adopts another plan that is an eligible defined contribution plan in which the military spouse participates?
A. C-2: Yes. If an employer amends the plan (or adopts another plan) to become an eligible defined contribution plan, the employer is eligible for the section 45AA credit for the employer's taxable year that includes the later of the date on which the plan or amendment becomes effective and the date on which the military spouse began participating in the plan after it was amended (or adopted) to become an eligible defined contribution plan and any of the 2 succeeding taxable years during which the military spouse participates in the plan for any period (3-year credit period). A military spouse's 3-year credit period begins from the first date that the military spouse participates in any eligible defined contribution plan of the employer. For example, for an eligible small employer that uses the calendar year as the employer's taxable year and that amends a defined contribution plan, effective January 1, 2024, to provide the benefits enumerated in section 45AA(e) to all military spouses employed by the employer, with respect to a military spouse who began participating in the plan on June 15, 2020 (and who has not participated in any other eligible defined contribution plans of the employer), the employer may claim a section 45AA credit (of the applicable amount) for any of the employer's 2024, 2025, or 2026 taxable years during which the military spouse participates in the plan for any period.
Q. C-3: May an eligible small employer claim the section 45AA credit with respect to a military spouse whose 3-year credit period described in Q&A C-2 of this notice began during a taxable year of the employer beginning on or before December 29, 2022?
A. C-3: Yes. The employer is eligible for the section 45AA credit for any taxable year of the employer beginning after December 29, 2022 that remains within the military spouse's 3-year

credit period, as described in Q&A C-2 of this notice. For example, for an eligible small employer that uses the calendar year as the employer's taxable year and that adopted a defined contribution plan that provides the benefits enumerated in section 45AA(e) to all employees employed by the employer and that became effective as of January 1, 2021, with respect to a military spouse who began participating in the plan within 2 months of the spouse's date of hire by the employer on June 15, 2022, the employer may claim a section 45AA credit (of the applicable amount) for any of the employer's 2023 and 2024 taxable years during which the spouse participates in the plan for any period.

D. SECTION 113 OF THE SECURE 2.0 ACT

Section 401(k)(4)(A), prior to amendment by section 113(a) of the SECURE 2.0 Act, provided that "a cash or deferred arrangement of any employer shall not be treated as a qualified cash or deferred arrangement if any other benefit is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash. The preceding sentence shall not apply to any matching contribution (as defined in section 401(m) of the Code) made by reason of such an election." This provision is commonly referred to as the contingent benefit rule.

Section 403(b)(12)(A) describes nondiscrimination requirements that apply to section 403(b) plans under which employees participate pursuant to salary reduction agreements. Section 403(b)(12)(A)(ii), which is commonly referred to as the universal availability requirement, provides that a section 403(b) plan will satisfy the applicable nondiscrimination requirements if all employees of the organization may elect to have the employer make contributions of more than $200 pursuant to a salary reduction agreement if any employee of the organization may elect to have the organization make contributions for such contracts pursuant to such agreement.

Section 1.403(b)-5(b)(2) provides that an employee is not treated as being permitted to have section 403(b) elective deferrals contributed on the employee's behalf unless the employee is provided an effective opportunity that satisfies the requirements of that paragraph. An effective opportunity is not considered to exist if there are any other rights or benefits (other than matching contributions or other rights or benefits listed in § 1.401(k)-1(e)(6)(i)) that are conditioned (directly or indirectly) upon the participant making or failing to make a cash or deferred election with respect to a contribution to a section 403(b) contract.

Section 113(a) of the SECURE 2.0 Act amended section 401(k)(4)(A) of the Code to provide that a *de minimis* financial incentive (not paid for with plan assets) provided to employees who elect to have the employer make contributions under the arrangement in lieu of receiving cash will not violate the contingent benefit rule of section 401(k)(4)(A).

Section 113(b) of the SECURE 2.0 Act amended section 403(b)(12)(A) of the Code to provide that a plan does not fail to satisfy section 403(b)(12)(A)(ii) solely by reason of offering a *de minimis* financial incentive (not derived from plan assets) to employees to elect to have the employer make contributions pursuant to a salary reduction agreement.

Section 113(c) of the SECURE 2.0 Act amended section 4975(d) of the Code to add a new paragraph (24) under which the provision of a *de minimis* financial incentive described in section 401(k)(4)(A) is exempted from the tax on prohibited transactions. As a conforming change, section 113(d) of the SECURE 2.0 Act amended section 408(b) of the Employee Retirement Income Security Act of 1974, Pub. L. 93-406 , 88 Stat. 829, as amended (ERISA), to add a new paragraph (21) under which the provision of a *de minimis* financial incentive described in either section 401(k)(4)(A) or 403(b)(12)(A) of the Code is exempted from the ERISA prohibited transaction rules.

Section 113 of the SECURE 2.0 Act did not specify what would constitute a *de minimis* financial incentive described in section 401(k)(4)(A) or 403(b)(12)(A)(ii) of the Code. However, legislative history mentions gift cards in small amounts as an example of a *de minimis* financial incentive an employer might offer to boost employee participation in workplace retirement plans (*see* H. Rept. 117-283, Part 1 (117 Cong. 2d Sess.) at 86).

Section 113 of the SECURE 2.0 Act is effective for plan years beginning after December 29, 2022.

Q. D-1: Is there a limit on the value of a financial incentive for the incentive to be a *de minimis* financial incentive described in section 401(k)(4)(A) of the Code?

A. D-1: A financial incentive is a *de minimis* financial incentive described in section 401(k)(4)(A) only if it does not exceed $250 in value.

Q. D-2: Does the exception to the contingent benefit rule that is described in section 401(k)(4)(A) for a *de minimis* financial incentive provided to employees who elect to have the employer make contributions under a CODA apply to an employee for whom an election to defer is already in effect?

A. D-2: A *de minimis* financial incentive is described in section 401(k)(4)(A) only if it is offered to employees for whom no election to defer under the CODA is already in effect. Thus, for example, if an employer announces on February 1, 2024, that any employee for whom an election to defer under a CODA is not in effect on that date and who, within the next 90 days, makes an election to defer, will receive a $200 gift card, then the gift card is a *de minimis* financial incentive that does not cause the CODA to fail to be a qualified CODA on account of the contingent benefit rule of section 401(k)(4)(A). A financial incentive does not fail to be a *de minimis* financial incentive described in section 401(k)(4)(A) merely because the incentive is provided in the form of installments that are contingent on the employee's continuing to defer (even if those installments are paid over more than one plan year). Thus, if the employer in the preceding example provides a $100 gift card (instead of providing a $200 gift card) with a promise to provide an additional $100 gift card a year later, but only if the employee continues to defer at that later date, then the $200 total amount of gift cards is still a *de minimis* financial incentive within the meaning of section 401(k)(4)(A).

Q. D-3: Can a matching contribution within the meaning of section 401(m)(4) be a *de minimis* financial incentive described in section 401(k)(4)(A)?

A. D-3: No. A matching contribution cannot be a *de minimis* financial incentive described in section 401(k)(4)(A).

Q. D-4: Is the provision of a *de minimis* financial incentive described in section 401(k)(4)(A) subject to the rules under the Code that apply with respect to a plan contribution?

A. D-4: No. A *de minimis* financial incentive described in section 401(k)(4)(A) is not subject to the Code rules that apply to a plan contribution, including the qualification requirements of section 401(a) and the deductibility timing rules of section 404(a).

Q. D-5: What is an employee's tax treatment with respect to a *de minimis* financial incentive described in section 401(k)(4)(A) that is provided by an employer?

A. D-5: If an employer provides a *de minimis* financial incentive described in section 401(k)(4)(A) to an employee, that incentive constitutes remuneration that is includible in the employee's gross income and wages and is subject to applicable withholding and reporting requirements for employment tax purposes, unless the provision of the *de minimis* financial incentive satisfies an exception under the Code. For example, the $200 gift card described in Q&A D-2 of this notice is not excludable from the employee's gross income as a *de minimis* fringe benefit within the meaning of section 132(e) and § 1.132-6(c) because, as a cash equivalent, it is not eligible for that exclusion (and therefore the gift card is includible in the employee's gross income and wages and is a taxable fringe benefit for employment tax and reporting purposes unless another exception applies).

Q. D-6: Do the rules of Q&A D-1 through Q&A D-5 of this notice apply with respect to a *de minimis* financial incentive described in section 403(b)(12)(A) of the Code that is offered to employees to elect to have the employer make contributions to a section 403(b) plan on their behalf pursuant to a salary reduction agreement?

A. D-6: Yes. The statutory provisions that apply with respect to a *de minimis* financial incentive described in section 403(b)(12)(A) are generally the same as the statutory provisions that apply with respect to a *de minimis* financial incentive described in section 401(k)(4)(A). Accordingly, the rules of Q&A D-1 through Q&A D-5 of this part D of this notice also apply with respect to a *de minimis* financial incentive described in section 403(b)(12)(A).

E. SECTION 117 OF THE SECURE 2.0 ACT

A SIMPLE IRA plan under section 408(p) or a SIMPLE 401(k) plan under section 401(k)(11) is a plan under which employees may elect to have salary reduction contributions (or elective contributions, in the case of a SIMPLE 401(k) plan) made on their behalf, and which may only be sponsored by an eligible employer defined in section 408(p)(2)(C)(i) (that is, generally, an employer who has 100 or fewer employees who received at least $5,000 of compensation from the employer for the preceding year). Under a SIMPLE IRA plan or SIMPLE 401(k) plan, the employer generally is required to make either (1) a matching contribution equal to the employee's salary reduction contributions or elective contributions that do not exceed 3 percent of the employee's compensation or (2) a nonelective contribution of 2 percent of the employee's compensation (regardless of whether the employee elects to make contributions). Section 116 of the SECURE 2.0 Act amends sections 408(p) and 401(k)(11) of the Code to permit the employer to make additional nonelective contributions (up to 10 percent of compensation of each employee eligible to participate, but initially limited to $5,000 with respect to each employee). Under section 408(p)(2)(D), an employer generally cannot make contributions to a SIMPLE IRA plan or a SIMPLE 401(k) plan for a year if the employer maintained another qualified plan with respect to which contributions were made or benefits accrued for the period beginning with the year that the SIMPLE IRA plan or SIMPLE 401(k) plan was established and ending with the current year.

Notice 98-4, 1998-1 CB 269, provides guidance regarding SIMPLE IRA plans, such as guidance on the determination of the number of employees who received at least $5,000 of compensation for the preceding year and the required notifications to employees.

Section 117 of the SECURE 2.0 Act amends sections 408(p), 401(k)(11), and 414(v) of the Code to increase both the annual salary reduction contribution/elective contribution limit and the limit on additional catch-up contributions beginning at age 50 for a SIMPLE IRA plan or a SIMPLE 401(k) plan for certain eligible employers. For some of those eligible employers, the increased limits apply automatically; while other of those eligible employers must make an election for the increased limits to apply and must also make additional employer contributions. The increased limits are 110 percent of the otherwise applicable limits for 2024.[2]

Section 117(h) of the SECURE 2.0 Act provides that the amendments made by section 117 of the SECURE 2.0 Act apply for taxable years beginning after December 31, 2023.

Q. E-1: For which eligible employers do the increased limits under section 117 of the SECURE 2.0 Act apply?

A. E-1: The increased limits under section 117 of the SECURE 2.0 Act apply to an eligible employer described in section 408(p)(2)(E)(iv)[3] of the Code. An eligible employer is described in section 408(p)(2)(E)(iv) if, during the 3-taxable year period preceding the first year that the employer maintained the SIMPLE IRA plan or SIMPLE 401(k) plan, the employer (including any member of the employer's controlled group or any predecessor of the employer or any member) has not established or maintained a qualified plan under section 401(a), a section 403(a) annuity plan, or a section 403(b) plan under which contributions were made or benefits were accrued for substantially the same employees as are eligible to participate in the SIMPLE IRA plan or SIMPLE 401(k) plan.

Q. E-2: What are the differences in how the increased limits apply to eligible employers described in section 408(p)(2)(E)(iv) depending on the number of employees of the employer?

A. E-2: The increased limits apply automatically in the case of an eligible employer described in section 408(p)(2)(E)(iv) that has no more than 25 employees who received at least $5,000 of compensation for the preceding calendar year. For an employer that has more than 25 employees who received at least $5,000 of compensation for the preceding year, the increased limits apply only if the employer makes an election for the increased limits to apply. If the employer makes an election for the increased limits to apply, the employer must provide higher matching or nonelective contributions, as described in Q&A E-5 of this notice.

Q. E-3: How are the number of employees who received at least $5,000 of compensation for the preceding year determined?

A. E-3: The rules set forth in Q&A B-1 of Notice 98-4 apply for purposes of calculating the number of employees. Thus, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE IRA plan or SIMPLE 401(k) plan (including employees excludable under the rules of section 410(b)(3) or who have not met the plan's minimum eligibility requirements, as well as self-employed individuals described in section 401(c)(1) who received earned income from the employer during the year). For purposes of determining whether an employer has no more than 25 employees who received at least $5,000 of compensation for the preceding year, there generally is a 2-year grace period. Thus, if an employer that has no more than 25 employees increases the number of employees to more than 25, the employer will still be treated as having 25 employees for two years following the last year the employer had no more than 25 employees (unless the increase in the employer's number of employees was due to an acquisition, disposition, or similar transaction involving the eligible employer).

Q. E-4: How does an employer reflect the increased limits?

A. E-4: An employer that must make an election to apply the increased limits must take formal written action to make an election to reflect the increased limits and should maintain documentation of the election in the plan's records. An employer (including employers for whom the increased limits apply automatically) must reflect the increased limits in the plan terms (see section II.J. of this notice regarding plan amendment deadlines) and must notify employees of the increased limits (see Q&A E-6 of this notice).

Q. E-5: If an employer makes an election to apply the increased limits, what other contributions must be made?

A. E-5: If an employer makes an election under Q&A E-4 of this notice to apply the increased limits, the employer must make matching contributions equal to the employee's salary reduction contributions or elective contributions that do not exceed 4 percent (increased from 3 percent) of the employee's compensation or make a nonelective contribution of 3 percent (increased from 2 percent) of the employee's compensation (regardless of whether the employee elects to make contributions).

Q. E-6: Who must an employer notify of the increased limits?

A. E-6: The employer must notify employees of the increased limits. The notice must be included in the annual employer notification that informs employees of the opportunity to enter into a salary reduction agreement or to modify a prior agreement. In the case of an employer for whom the increased limits apply pursuant to an election, the employer also must notify employees of the increased matching contribution or increased nonelective contribution. The employer should also (1) notify the SIMPLE IRA plan's or SIMPLE 401(k) plan's financial institution and payroll provider of the increased limits, and (2) keep records of all actions concerning the increased limits. However, the employer does not need to notify the IRS of the election to apply the increased limits.

Q. E-7: What is the deadline for an employer to make the election to apply the increased limits for a year?

A. E-7: An employer election to apply the increased limits for a calendar year must be made before the employer provides the annual notice to each employee of the employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement for that calendar year, as provided in Q&A G-1 of Notice 98-4.

Q. E-8: For how long is an employer election to apply the increased limits effective?

A. E-8: An employer's election to apply the increased limits is effective until it is revoked by the employer. The employer must take formal written action to revoke the election before the employer provides the annual notice to each employee of the employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement for the next calendar year. The employer should maintain documentation of the revocation in the plan's records.

If an employer revokes a prior election to apply the increased limits, the employer must also amend the plan terms to reflect the revocation (see section II.J. of this notice regarding plan amendment deadlines) and notify employees of the applicable limits (*see* generally Q&A E-6 of this notice).

F. SECTION 326 OF THE SECURE 2.0 ACT

Section 72(t)(1) generally imposes a 10 percent additional tax on any distribution from a qualified retirement plan within the meaning of section 4974(c), unless the distribution qualifies for one of the exceptions listed in section 72(t)(2). Section 326 of the SECURE 2.0 Act amended section 72(t)(2) of the Code to add a new exception to the 10 percent additional tax for any distribution made to a terminally ill individual.

Section 72(t)(2)(L) permits an employee[4] who is a terminally ill individual to receive a distribution (terminally ill individual distribution) on or after the date on which the employee has been certified by a physician as having a terminal illness.

Section 72(t)(2)(L)(ii) provides that the term "terminally ill individual" has the same meaning given that term under section 101(g)(4)(A), except that "84 months" is substituted for "24 months."

Section 72(t)(2)(L)(iii) provides that, in order to be considered a terminally ill individual, an employee must furnish sufficient evidence to the plan administrator in the form and manner as the Secretary of the Treasury (Secretary) may require. A terminally ill individual distribution is includible in gross income but is not subject to the 10 percent additional tax under section 72(t)(1). Section 72(t)(2)(L)(iv) provides that a terminally ill individual distribution may be repaid following rules similar to repayment of qualified birth or adoption distributions in section 72(t)(2)(H)(v).

The amendment made to section 72(t)(2) by section 326 of the SECURE 2.0 Act applies to terminally ill individual distributions made after December 29, 2022.

The Treasury Department and the IRS intend to issue regulations under section 72(t) of the Code, including providing guidance on exceptions under section 72(t)(2) as added by the SECURE 2.0 Act (such as the exception to the 10 percent additional tax for an eligible distribution to a domestic abuse victim).

Questions and Answers Relating to Terminally Ill Individual Distributions

Q. F-1: What is a terminally ill individual distribution?

A. F-1: The term "terminally ill individual distribution" means any distribution from a qualified retirement plan to an employee (as defined in section 72(t)(5)) who is a terminally ill individual (within the meaning of Q&A F-4 of this notice) that is made on or after the date on which the employee has been certified by a physician as having a terminal illness. The certification must satisfy the content requirements in Q&A F-6 of this notice.

Q. F-2: Which types of plans are eligible to permit a terminally ill individual distribution?

A. F-2: Unlike qualified birth or adoption distributions in section 72(t)(2)(H), which uses the term "applicable eligible retirement plan" described in section 72(t)(2)(H)(vi)(I), section 72(t)(2)(L) does not include a special definition of retirement plan. Section 72(t)(1) provides that the 10 percent additional tax applies to any amount received from a qualified retirement plan within the meaning of section 4974(c). Therefore, for purposes of section 72(t)(2)(L), a terminally ill individual distribution may be made from a qualified retirement plan as defined in section 4974(c), which is defined as a section 401(a) qualified plan (including a defined benefit plan), section 403(a) annuity plan, section 403(b) annuity contract, or an individual retirement account described in section 408(a) or an individual retirement annuity described in section 408(b)[5]. Note that, for purposes of section 72(t)(2)(L), an eligible deferred compensation plan that is maintained by an eligible employer described in section 457(e)(1)(A) is not eligible to permit a terminally ill individual distribution because it is not a qualified retirement plan as defined in section 4974(c).

Q. F-3: Is a terminally ill individual distribution subject to the 10 percent additional tax under section 72(t)?

A. F-3: No. Although a terminally ill individual distribution is includible in gross income, it is not subject to the 10 percent additional tax under section 72(t)(1).

Q. F-4: Who is a terminally ill individual for purposes of the exception to the 10 percent additional tax under section 72(t)(2)(L)?

A. F-4: Section 72(t)(2)(L)(ii) provides that the term "terminally ill individual" has the same meaning as the term under section 101(g)(4)(A), except that "84 months" is substituted for "24 months." Thus, for purposes of the exception to the 10 percent additional tax under section 72(t)(2)(L), a terminally ill individual means an individual who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death in 84 months or less after the date of the certification.

Q. F-5: In determining who is a terminally ill individual, how is the term "physician" defined for purposes of section 72(t)(2)(L)?

A. F-5: The definition of terminally ill individual under section 72(t)(2)(L) is derived, in part, from the definition of terminally ill individual under section 101(g)(4)(A). For purposes of section 72(t)(2)(L), a physician capable of making a certification is a physician defined in section 101(g)(4)(D), which has the same meaning as the term used in section 1861(r)(1) of the Social Security Act (42 USC 1395x(r)(1)). Thus, for purposes of section 72(t)(2)(L) of the Code, the term "physician" generally means a doctor of medicine or osteopathy that is legally authorized to practice medicine and surgery by the State in which the doctor performs such function or action.[6]

Q. F-6: For purposes of section 72(t)(2)(L), what must be included in a certification of terminal illness from a physician?

A. F-6: A certification of terminal illness from a physician must include the following:

(1) A statement that the individual's illness or physical condition can be reasonably expected to result in death in 84 months or less after the date of certification;

(2) A narrative description of the evidence that was used to support the statement of illness or physical condition (as described in this F-6 (1));

(3) The name and contact information of the physician making the statement;

(4) The date the physician examined the individual or reviewed the evidence provided by the individual, and the date that the certification is signed by the physician; and

(5) The signature of the physician making the statement, and an attestation from the physician that, by signing the form, the physician confirms that the physician composed the narrative description based on the physician's examination of the individual or the physician's review of the evidence provided by the individual.

As provided in Q&A F-13 of this notice, for purposes of section 72(t)(2)(L)(iii), it is not sufficient evidence for an employee who is a physician to certify the physician's own terminal illness.

Q. F-7: May a certification be made after an employee receives a terminally ill individual distribution?

A. F-7: No. For a distribution to be a terminally ill individual distribution, for purposes of section 72(t)(2)(L) and Q&A F-1 of this notice, the distribution must be made on or after the date a physician makes the certification that the employee has a terminal illness.

Q. F-8: Is there a limit on the amount received as a terminally ill individual distribution?

A. F-8: In general, there is no limit on the amount that an employee is permitted to receive as a terminally ill individual distribution. However, see Q&A F-15 of this notice for rules on when an employee may elect to treat an otherwise permissible in-service distribution as a terminally ill individual distribution.

Q. F-9: May an employee recontribute a terminally ill individual distribution to a qualified retirement plan?

A. F-9: Yes. An employee may recontribute any portion of a terminally ill individual distribution (up to the entire amount of the terminally ill individual distribution) to a qualified retirement plan in which the employee is a beneficiary and to which a rollover can be made under sections 402(c), 403(a)(4), 403(b)(8), or 408(d)(3), as applicable. Rules similar to recontributions of qualified birth or adoption distributions in section 72(t)(2)(H)(v) apply for purposes of terminally ill individual distributions.[7]

Questions and Answers Relating to Qualified Retirement Plans Permitting Terminally Ill Individual Distributions

Q. F-10: Is a qualified retirement plan required to permit terminally ill individual distributions under section 72(t)(2)(L)?

A. F-10: No. It is optional for a qualified retirement plan, including an IRA, to permit terminally ill individual distributions pursuant to section 72(t)(2)(L). Plan amendments adopted to permit terminally ill individual distributions are discretionary amendments for purposes of the plan amendment rules discussed in section II.J. of this notice. To the extent that a qualified retirement plan does not permit terminally ill individual distributions, the employee is permitted to treat an otherwise permissible in- service distribution as a terminally ill individual distribution. See Q&A F-15 of this notice.

Q. F-11: If an employer chooses to amend its qualified retirement plan to permit terminally ill individual distributions, what is the deadline for adopting that amendment?

A. F-11: For information relating to the deadline for adopting plan amendments, see section II.J. of this notice.

Q. F-12: Do terminally ill individual distributions from a qualified retirement plan meet the distribution restriction requirements in sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), and 403(b)(11)?

A. F-12: No. Section 72(t)(2)(L) provides an exception to the 10 percent additional tax but does not provide an exception from the distribution restriction requirements in sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), and 403(b)(11). Therefore, for a plan that is subject to the distribution restriction requirements under sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), and 403(b)(11) to permit a terminally ill individual distribution to an employee and not violate the distribution restriction requirements, the employee must otherwise be eligible for a permissible in-service distribution. Thus, for example, a section 401(k) plan may distribute a terminally ill individual distribution to an employee who is otherwise eligible for a permissible in- service distribution and meets the requirements of that permissible in-service distribution, such as a hardship distribution or a disability distribution, without violating the distribution restriction requirements under section 401(k)(2)(B)(i). However, for the hardship distribution or disability distribution to also meet the requirements of a terminally ill individual distribution, the distribution must also meet the applicable requirements in this notice for a terminally ill individual distribution, including the content requirement for the certification described in Q&A F-6 of this notice, the timing requirement for the certification described in Q&A F-7 of this notice, and the documentation requirement described in Q&A F-13 of this notice.

recontribute the amount to a qualified retirement plan, the employee may recontribute the amount to an IRA.

For example, on May 15, 2024, Participant B, age 50, goes to the doctor and gets a certification of terminal illness that meets the requirements of Q&A

F-6 of this notice. Participant B's plan, a section 401(k) plan, does not permit terminally ill individual distributions but does permit hardship distributions. On June 10, 2024, Participant B applies for a hardship distribution in the amount of $15,000. When Participant B files his tax return, Participant B indicates on Form 5329 that the distribution is excepted from the 10 percent additional tax as a terminally ill individual distribution under section 72(t)(2)(L). Participant B retains the physician's certification, dated May 15, 2024, with Participant B's files as part of Participant B's tax returns for tax year 2024. Participant B does not owe the additional $1,500 (representing the 10 percent additional tax of the amount includible in gross income). Unlike a hardship distribution, Participant B may also recontribute the $15,000 to an IRA following rules similar to qualified birth or adoption distributions.

G. SECTION 332 OF THE SECURE 2.0 ACT

Under section 408(p)(2)(D), an employer that maintains a SIMPLE IRA plan for a calendar year generally is not permitted to maintain another plan, contract, pension, or trust described in section 219(g)(5)(A) or (B) to which contributions were made or benefits were accrued for service in the year. Also, prior to amendment by section 332 of the SECURE 2.0 Act, section 408(d)(3)(G) of the Code provided that if section 72(t)(6) applied to a distribution (that is, the distribution is from a SIMPLE IRA within the first two years of an individual's participation in the SIMPLE IRA plan), then the individual could only roll over the distribution to another eligible retirement plan if the other eligible retirement plan was a SIMPLE IRA.

Section 332(a) of the SECURE 2.0 Act amended section 408(p) of the Code by adding paragraph (11). Section 408(p)(11)(A) permits an employer to elect (in such form and manner as the Secretary may prescribe), at any time during a year, to terminate the qualified salary reduction arrangement under a SIMPLE IRA plan if the employer establishes and maintains a safe harbor section 401(k) plan to replace the terminated arrangement.

Section 408(p)(11)(B) provides a combined limit on the total of the salary reduction contributions under the terminated arrangement and elective contributions under the safe harbor section 401(k) plan for the transition year described in section 408(p)(11)(C) (that is, the period beginning after the termination date and ending on the last day of the calendar year during which the termination occurs). Under this limit, the total of those contributions must not exceed the time-weighted average of the limits that apply, on a full year basis, to a SIMPLE IRA plan (after the application of the catch-up provisions of section 414(v)) and a section 401(k) plan.

Section 332(b) of the SECURE 2.0 Act adds section 72(t)(6)(B) to the Code and amends section 408(d)(3)(G). Under the addition and amendment, the limitation on rollovers of a distribution from a SIMPLE IRA does not apply if an employer terminates the qualified salary reduction arrangement of a SIMPLE IRA plan and establishes a section 401(k) plan or section 403(b) plan, provided that the amount is paid in a rollover contribution described in section 408(d)(3) into a qualified trust under section 401(k) (but only if such contribution is subsequently subject to the rules of section 401(k)(2)(B)) or an annuity contract described in section 403(b) (but only if such contribution is subsequently subject to the rules of section 403(b)(12). [8]

Section 401(k)(12)(D) generally requires a CODA that is intended to satisfy the requirements of section 401(k)(12) to provide an annual notice to each eligible employee that is sufficiently accurate and comprehensive to apprise the employee of the employee's rights and obligations under the CODA. A similar notice requirement applies under section 401(k)(13)(E) to a CODA that is intended to satisfy the requirements of section 401(k)(13). Under section 401(k)(16)(B)(iii), a CODA that is intended to satisfy the notice requirements of section 401(k)(16) must satisfy the requirements of section 401(k)(13)(E).

Section 1.401(k)-3(d)(2)(ii) lists certain information that generally must be described in a notice for the notice to be considered sufficiently accurate and comprehensive under section 401(k)(12)(D) of the Code and subject to the additional information requirements under § 1.401(k)-3(k)(4)(ii) and under section 401(k)(13)(E) of the Code.

Section 332(c) of the SECURE 2.0 Act provides that amendments made by section 332 apply to plan years beginning after December 31, 2023.

Q. G-1: How does an employer terminate a SIMPLE IRA plan?

A. G-1: An employer terminates a SIMPLE IRA plan by taking formal written action that specifies the date as of which the plan is terminated (termination date).

Q. G-2: If an employer terminates a SIMPLE IRA plan, when do the contributions under the plan cease?

A. G-2: If an employer terminates a SIMPLE IRA plan, then no salary reduction contributions may be made under the plan with respect to compensation that would be paid after the termination date. However, the employer must make employer matching contributions under the plan attributable to salary reduction contributions or nonelective contributions, based on the employees' compensation earned through the termination date of the SIMPLE IRA plan.

Q. G-3: Who must the employer notify of the termination of a SIMPLE IRA plan?

A. G-3: The employer must notify employees of the termination of a SIMPLE IRA plan at least 30 days before the termination date. The notification must specify that no salary reduction contributions will be made to the plan with respect to compensation that would be paid after the termination date. The notice must also include a statement that employees will receive matching contributions attributable to salary reduction contributions or nonelective contributions based on the employees' compensation through the termination date of the SIMPLE IRA plan. The employer should also (1) notify the SIMPLE IRA plan's financial institution and the employer's payroll provider that the employer will cease making any SIMPLE IRA contributions, and (2) keep records of all actions concerning the termination of the SIMPLE IRA plan. However, the employer does not need to notify the IRS that the SIMPLE IRA plan has been terminated.

Q. G-4: If a participant takes a distribution from a terminated SIMPLE IRA plan within the first two years of participation under the plan, under what circumstances can that distribution be rolled over to another eligible retirement plan that is not a SIMPLE IRA?

A. G-4: If a participant takes a distribution from a terminated SIMPLE IRA plan within the first two years of participation under the plan, the distribution may be rolled over to an eligible retirement plan that is not a SIMPLE IRA only if the amount is rolled over to either: (1) a section 401(k) plan that is subject to the distribution limits of section 401(k)(2)(B) of the Code; or (2) a section 403(b) plan that is subject to the distribution limits of section 403(b)(11).

Q. G-5: Is the establishment of a safe harbor section 408(k) plan under section 408(p)(11) an exception to the rule in section 408(p)(2)(D)?

A. G-5: Yes. The rule under section 408(p)(11) that permits an employer to terminate a SIMPLE IRA plan and replace it with a section 401(k) safe harbor plan is an exception to the section 408(p)(2)(D) prohibition on an employer maintaining both a SIMPLE IRA plan and another plan, contract, pension, or trust described in section 219(g)(5)(A) or (B) in the same calendar year.

Q. G-6: When a SIMPLE IRA plan is replaced by a safe harbor section 401(k) plan mid-year, how are the elective contribution limits determined under the safe harbor section 401(k) plan?

A. G-6: When a SIMPLE IRA plan is replaced by the safe harbor section 401(k) plan mid-year, the total amount that may be contributed as salary reduction contributions under the terminated SIMPLE IRA plan and as elective contributions under the safe harbor section 401(k) plan may not exceed the weighted average of the salary reduction contribution and elective contribution limits for each of those plans (weighted by how many of the 365 days in the transition year each plan was in effect). Thus, the total amount that may be contributed as elective contributions to the safe harbor section 401(k) plan is equal to-

(1) The annual limit on salary reduction contributions under a SIMPLE IRA plan for the year (taking into account catch-up contributions described in section 414(v)), multiplied by a fraction equal to the number of days the SIMPLE IRA plan was in effect for that year divided by 365, plus

(2) The annual limit on elective contributions under a section 401(k) plan for the year, under section 402(g), multiplied by a fraction equal to the number of days the safe harbor plan was in effect for that year divided by 365, minus

(3) Any salary reduction contributions under the SIMPLE IRA plan for the year.

Q. G-7: If an employer elects during a year to terminate a qualified salary reduction arrangement under section 408(p)(2), and the employer establishes and maintains a safe harbor section 401(k) plan to replace the terminated arrangement, must the notice required under section 401(k)(12)(D), (13)(E), or (16)(B)(iii) for the year the safe harbor plan is established describe the limit on contributions to the safe harbor section 401(k) plan for the transition year pursuant to section 408(p)(11)(B)?

A. G-7: Yes. Under § 1.401(k)-3(d)(2)(ii)(D), a notice must accurately describe the type and amount of compensation that may be deferred under the plan for the notice to satisfy the requirements of section 401(k)(12)(D), (13)(E), or (16)(B)(iii) of the Code. Accordingly, the notice required under section 401(k)(12)(D), (13)(E), or (16)(B)(iii) for the transition year must describe the limit on contributions to the safe harbor section 401(k) plan for that year pursuant to section 408(p)(11)(B).

H. SECTION 348 OF THE SECURE 2.0 ACT

Under section 411(a), for a defined benefit plan to be qualified under section 401(a), it must satisfy the accrual requirements of section 411(b)(1). Section 411(b)(1)(A), (B), and (C) provide three alternative methods of demonstrating that the plan satisfies the accrual requirements, each of which limits the extent to which accruals under a defined benefit plan can be provided at a greater rate later in a participant's career (commonly referred to as backloading). Under each of these alternative methods, all relevant factors used to compute benefits are treated as remaining constant as of the current year for all years after the current year.

Section 348(a) of the SECURE 2.0 Act, which is titled "Cash Balance," amends section 411(b) of the Code to add paragraph (6), effective for plan years beginning after December 29, 2022. Section 411(b)(6) provides a special rule for applying the anti-backloading rules of section 411(b)(1)(A), (B), and (C) for applicable defined benefit plans, as defined in section 411(a)(13)(C). Under section 411(b)(6), for purposes of applying the rules of section 411(b)(1) in the case of an applicable defined benefit plan that provides variable interest crediting rates, the interest crediting rate that is treated as in effect and as the projected interest crediting rate is a reasonable projection of that variable interest crediting rate, not to exceed 6 percent. Section 348(b) of the SECURE 2.0 Act amends ERISA by adding corresponding provisions to ERISA section 204(b)(6).

Section 411(a)(13)(C)(i) of the Code defines the term "applicable defined benefit plan" as a defined benefit plan under which the accrued benefit (or any portion of the accrued benefit) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation. Under section 411(a)(13)(C)(ii), the Secretary is instructed to issue regulations that include in the definition of an applicable defined benefit plan any defined benefit plan (or any portion of such a plan) that has an effect similar to an applicable defined benefit plan.

Under section 411(b)(1)(H), a defined benefit plan does not satisfy the requirements of section 411(b)(1) if, under the plan, the employee's benefit accrual is ceased, or the rate of an employee's benefit accrual is reduced, because of the attainment of any age. Under section 411(b)(5)(B)(i)(I), an applicable defined benefit plan is treated as violating section 411(b)(1)(H) if any interest credit (or an equivalent amount) for any plan year is at a rate that is greater than a market rate of return.

Section 1.411(b)-1 provides rules for the application of section 411(b)(1)(A), (B), and (C) of the Code. Under that section, the rules generally providing that all relevant factors used to compute benefits are treated as remaining constant for all future years under the three alternative methods are interpreted as meaning that the factors are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years. Section 1.411(b)-1(b)(2)(ii)(G) (relating to the 133 ⅓ percent rule) provides that a plan that determines any portion of the participant's accrued benefit pursuant to a statutory hybrid benefit formula[9] that utilizes an interest crediting rate described in § 1.411(b)(5)-1(d) that is a variable rate that was less than zero for the prior plan year is not treated as failing to satisfy the requirements of § 1.411(b)-1(b)(2) for the current plan year merely because the plan assumes for purposes of § 1.411(b)-1(b)(2) that the variable rate is zero for the current plan year and all future plan years.

Section 1.411(b)(5)-1(d)(1)(i) provides that a statutory hybrid plan[10] satisfies the requirements of section 411(b)(1)(H) of the Code only if, for any plan year, the interest crediting rate with respect to benefits determined under a statutory hybrid benefit formula is not greater than a market rate of return. Under § 1.411(b)(5)-1(d)(1), an interest crediting rate is not in excess of a market rate of return only if the interest crediting rate is described in § 1.411(b)(5)-1(d)(3) through (5) (or is a rate that can never be in excess of one of those rates). Section 1.411(b)(5)-1(d)(3) provides for interest rates that are based on long-term investment grade corporate bonds.

Section 1.411(b)(5)-1(d)(4) provides for interest rates that are: (1) based on Treasury bonds, (2) based on changes in the cost of living, (3) based on short and mid-term investment grade corporate bonds, or (4) a fixed 6 percent. Section 1.411(b)(5)-1(d)(5) provides for investment-based interest crediting rates that are not greater than a market rate of return.

Section 1.411(b)(5)-1(d)(6) provides rules for determining whether a plan with an interest crediting rate that is equal to the greater of two or more interest crediting rates provides an effective interest crediting rate in excess of a market rate of return. Under those rules, an interest crediting rate based on investment-grade corporate bonds under § 1.411(b)(5)-1(d)(3) or (d)(4)(iv) may be combined with an annual floor of 4 percent and an interest crediting rate based on Treasury bonds or a cost-of-living index under § 1.411(b)(5)-1(d)(4)(ii) or (iii) may be combined with an annual floor of 5 percent. If the interest crediting rate is an investment-based rate, it is not permitted to be combined with any annual floor (but may be combined with a cumulative floor described in § 1.411(b)(5)-1(d)(6)(iii)).

Section 1.411(b)(5)-1(e)(3) provides that the right to future interest credits determined in the manner specified under the plan and not conditioned on future service is a factor that is used to determine the participant's accrued benefit, for purposes of section 411(d)(6). Thus, to the extent that benefits have accrued under the terms of a statutory hybrid plan that entitle the participant to future interest credits, an amendment to the plan to change the interest crediting rate must satisfy section 411(d)(6) if the revised rate under any circumstances could result in interest credits that are smaller as of any date after the applicable amendment date than the interest credits that would be provided without regard to the amendment.

Section 411(d)(6) provides generally that a plan is treated as not satisfying the requirements of section 411 if a plan amendment decreases the accrued benefit of a participant. For this purpose, a plan amendment that eliminates or reduces an early retirement benefit or retirement-type subsidy, or eliminates an optional form of benefit, with respect to benefits attributable to service before the amendment, generally is treated as reducing a participant's accrued benefit. As described in section II.J. of this notice, section 501 of the SECURE 2.0 Act sets forth provisions with respect to plan amendments adopted pursuant to a provision of the SECURE 2.0 Act or the regulations thereunder, including a provision specifying that, except as provided by the Secretary (or the Secretary's delegate), a retirement plan will not violate section 411(d)(6) of the Code because of an amendment made to the plan that is made pursuant to the SECURE 2.0 Act.

Q. H-1: What is the effect of the enactment of section 348 of the SECURE 2.0 Act for a cash balance plan[11] ?

A. H-1: For a cash balance plan that provides for pay credits to participants that increase with a participant's age or service and provides for a variable interest crediting rate, the effect of the enactment of section 348 of the SECURE 2.0 Act is that the plan no longer risks violating the accrual requirements of section 411(b)(1) of the Code if that interest crediting rate falls below a certain point. To prevent such a violation prior to the enactment of section 348 of the SECURE 2.0 Act, a plan of this type had to provide for a fixed annual minimum interest crediting rate as part of its interest crediting rate. With the enactment of section 348 of the SECURE 2.0 Act, the fixed annual minimum interest crediting rate is no longer needed to avoid a violation of section 411(b)(1) of the Code for this type of plan.

Q. H-2: Under what circumstances is an amendment to a cash balance plan made pursuant to section 348 of the SECURE 2.0 Act?

A. H-2: An amendment to a cash balance plan is made pursuant to section 348 of the SECURE 2.0 Act (and is therefore eligible for the treatment in section 501 of the SECURE 2.0 Act) only if: (1) the plan is currently providing for principal credits that increase with a participant's age or service, and the amendment is to change the plan's interest crediting rate, or (2) the plan is implementing such a pattern of principal credits as part of the amendment.

Q. H-3: Does the exception from section 411(d)(6) of the Code for certain amendments that is provided under section 501 of the SECURE 2.0 Act apply to an amendment that reduces a participant's accumulated benefit?

A. H-3: No, the exception from section 411(d)(6) of the Code under section 501 of the SECURE 2.0 Act does not apply to an amendment that reduces a participant's accumulated benefit determined as of the end of the interest crediting period that includes the applicable amendment date (as defined in § 1.411(d)-3(g)(4)) for the amendment. Thus, the exception from section 411(d)(6) of the Code applies with respect to an amendment that affects interest credits for interest crediting periods beginning after the later of the effective date of the amendment or the date the amendment is adopted, but not interest credits for interest crediting periods beginning before the later of the effective date of the amendment or the date the amendment is adopted.

Q. H-4: For which amendments affecting future interest crediting rates that are made pursuant to section 348 of the SECURE 2.0 Act does the exception from section 411(d)(6) of the Code apply?

A. H-4: The exception from section 411(d)(6) of the Code provided under section 501 of the SECURE 2.0 Act applies to a plan amendment affecting future interest crediting rates that is made pursuant to section 348 of the SECURE 2.0 Act only if: (1) the plan's interest crediting rate prior to the amendment is the greater of a fixed annual minimum rate or an interest rate described in § 1.411(b)(5)-1(d)(3) or (4), and the amendment either (a) reduces or eliminates the fixed minimum interest crediting rate while retaining the underlying interest rate described in § 1.411(b)(5)-1(d)(3) or (4), or (b) changes the interest crediting rate to an investment-based rate described in § 1.411(b)(5)-1(d)(5); or (2) the plan's interest crediting rate prior to the amendment is a permitted fixed rate described in § 1.411(b)(5)-1(d)(4)(v), and the amendment changes the interest crediting rate to any permitted variable rate, subject to a limitation that the amount by which the new variable interest crediting rate is less than the maximum variable interest crediting rate of the same type must not exceed the amount by which the pre-amendment fixed interest crediting rate was less than the maximum fixed interest crediting rate of 6 percent.

Q. H-5: Does the enactment of section 348 of the SECURE 2.0 Act have an impact on a statutory hybrid plan that is not a cash balance plan?

A. H-5: The Treasury Department and the IRS expect that a sponsor of a statutory hybrid plan that is not a cash balance plan will have no reason to apply section 411(b)(6) of the Code as added by section 348 of the SECURE 2.0 Act; accordingly, no amendment to the plan would be made pursuant to section 348 of the SECURE 2.0 Act.

I. SECTION 350 OF THE SECURE 2.0 ACT

Section 350(a) of the SECURE 2.0 Act adds new section 414(cc) to the Code. Section 414(cc) provides that, if certain conditions are satisfied, a plan or arrangement will not fail to be treated as described in section 401(a), 403(b), 408, or 457(b) solely by reason of a corrected reasonable administrative error made (1) in implementing an automatic enrollment or automatic escalation feature with respect to an eligible employee (or an affirmative election made by an eligible employee covered by such a feature), or (2) by failing to afford an eligible employee the opportunity to make an affirmative election because the employee was improperly excluded from the plan (implementation error).

Section 414(cc)(2)(B)(i) specifies that the date by which an implementation error with respect to elective deferrals must be corrected is the earlier of (1) the date of the first payment of compensation made by the employer to the employee on or after the last day of the 9½-month period after the end of the plan year during which the error with respect to the employee first occurred, or (2) in the case of an employee who notifies the plan sponsor of the error, the date of the first payment of compensation made by the employer to the employee on or after the last day of the month following the month in which the notification was made.

Section 414(cc)(2)(B)(ii) provides that, in the case of an employee who would have been entitled to additional matching contributions had any missed elective deferrals been made, the plan sponsor must make a corrective allocation of matching contributions to which the employee would have been entitled (adjusted to account for earnings) had the missed elective deferrals been made, and that the additional matching contributions must be allocated not later than the deadline for allocating corrective matching contributions specified by the Secretary in regulations, or other guidance of general applicability.

Section 414(cc)(2)(B)(iii) through (v) provides that the implementation error must be corrected for all similarly situated participants in a nondiscriminatory manner and that notice of the error that satisfies regulations or other guidance prescribed by the Secretary must be given to employees affected by the error within 45 days after the date on which correct deferrals begin.

Section 414(cc)(2) also provides that the correction described in section 414(cc)(2) may occur before or after the participant has terminated employment and may occur without regard to whether the error is identified by the Secretary.

Section 414(cc)(3) provides that if the requirements in section 414(cc)(2) are satisfied, an employer is not required to provide employees affected by the error with the missed amount of elective deferrals resulting from the error through a qualified nonelective contribution, or otherwise.

Section 414(cc)(4) provides that the Secretary will, by regulations or other guidance of general applicability, prescribe (i) the deadline for making a corrective allocation of matching contributions, (ii) the content of the required notice to affected employees, (iii) the manner in which the amount of the corrective matching allocation is determined, (iv) the manner of adjustment to account for earnings on matching contributions, and (v) such other rules as are necessary to carry out the purposes of the subsection.

Section 350(b) of the SECURE 2.0 Act provides that section 414(cc) of the Code applies with respect to any errors for which the date referred to in section 414(cc) is after December 31, 2023, and that, prior to the application of any regulations or other guidance prescribed under section 414(cc), taxpayers may rely upon their reasonable good faith interpretations of the provisions of section 414(cc).

Q. I-1: For purposes of determining the effective date of section 414(cc) with respect to an implementation error in accordance with section 350(b) of the SECURE 2.0 Act, what is "the date referred to in section 414(cc)"?

A. I-1: For purposes of determining the effective date of section 414(cc) of the Code with respect to an implementation error in accordance with section 350(b) of the SECURE 2.0 Act, "the date referred to in section 414(cc)" is the date by which an employer must implement correct deferrals in accordance with section 414(cc)(2)(B)(i) of the Code (or, with respect to a terminated employee, the date by which they would have been implemented but for the termination of employment). This date is the earlier of (1) the date of the first payment of compensation made by the employer to the employee on or after the last day of the 9½-month period after the end of the plan year during which an implementation error with respect to the employee first occurred, or (2) in the case of an employee who notifies the plan sponsor of the error, the date of the first payment of compensation made by the employer to the employee on or after the last day of the month following the month in which the notification was made. Accordingly, the effective date with respect to an implementation error may vary depending on, for example, the date the error occurs, the date compensation is paid, whether the employee notifies the plan sponsor of the error, and whether the plan year is a fiscal year or calendar year.

For example, Employer X sponsors a calendar year 401(k) plan that includes an automatic contribution enrollment feature. On January 1, 2023, Employer X fails to automatically enroll an eligible employee due to an implementation error. The employee does not inform Employer X of the error. Under section 414(cc)(2)(B), Employer X has until the date of the first payment of compensation made by the employer to the employee on or after October 15, 2024 (the last day of the 9½-month period after the end of the 2023 plan year) to begin corrected elective deferrals for the eligible employee. The date of the first payment of compensation made to the employee after October 15, 2024, is October 18, 2024. Because October 18, 2024, is after December 31, 2023, section 414(cc) applies with respect to the error that occurred on January 1, 2023.

Q. I-2. How may a plan sponsor correct, pursuant to section 414(cc), an implementation error to which section 414(cc) is applicable?

A. I-2. In general, the sponsor of a plan to which section 414(cc) applies may correct, pursuant to section 414(cc), an implementation error by following the safe harbor correction method set forth in Appendix A, section .05(8), of Rev. Proc. 2021-30, 2021-31 IRB 172, for failures related to automatic contribution features in a section 401(k) plan or a section 403(b) plan. However, see Q&A I-4 of this notice for rules regarding the deadline for making the allocation of matching contributions with respect to missed elective deferrals.

Q. I-3. Is section 414(cc) available for correcting an implementation error with respect to an individual even if the individual terminates employment before corrected deferrals would otherwise have begun?

A. I-3. Yes. In general, the sponsor of a plan to which section 414(cc) applies is permitted to correct an implementation error with respect to both active and terminated employees, by following, as described in Q&A I-2 of this notice, the correction method set forth in Appendix A, section .05(8), of Rev. Proc. 2021-30, for failures related to automatic contribution features in a section 401(k) plan or a section 403(b) plan, including by satisfying the notice requirement set forth in Appendix A, section .05(8)(c). However, the notice provided to a terminated employee is not required to include the following information set forth in Appendix A, section .05(8)(c): (1) a statement that appropriate amounts have begun to be deducted from compensation and contributed to the plan (or that appropriate deductions and contributions will begin shortly), or (2) an explanation that the affected terminated employee may elect an increased deferral percentage to make up for the missed deferral opportunity.

Q. I-4. If an individual affected by an implementation error would have been entitled to additional matching contributions had missed elective deferrals been made, what is the deadline for making a corrective allocation of matching contributions with respect to the missed elective deferrals?

A. I-4. A corrective allocation of matching contributions (adjusted for earnings) must be made within a reasonable period, as determined applying all relevant facts and circumstances, after the date on which the correct elective deferrals begin (or, with respect to a terminated employee, would have begun but for the termination of employment). A corrective allocation of matching contributions that is made by the last day of the sixth month following the month in which correct elective deferrals begin (or, with respect to a terminated employee, would have begun but for the termination of employment) will be treated as having been made within a reasonable period.

In addition, with respect to an automatic contribution error that begins on or before December 31, 2023, as described in the safe harbor correction method of Appendix A, section .05(8) of Rev. Proc. 2021-30, for failures related to automatic contribution features in a section 401(k) plan or a section 403(b) plan, a corrective allocation of matching contributions made by the end of the third plan year following the year in which the error occurred will be treated as having been made within a reasonable period.

J. SECTION 501 OF THE SECURE 2.0 ACT

Section 501 of the SECURE 2.0 Act provides, in general, that a retirement plan or annuity contract will be treated as being operated in accordance with the terms of the plan during a specified period (as described in paragraph (3) of this section II.J) and, except as provided by the Secretary of the Treasury (or the Secretary's delegate), a retirement plan will not fail to satisfy the anti-cutback requirements of section 411(d)(6) of the Code or section 204(g) of ERISA,[12] by reason of a plan amendment made pursuant to any amendment made by the SECURE 2.0 Act or pursuant to any regulation issued by the Secretary of the Treasury or the Secretary of Labor (or a delegate of either such Secretary) under the SECURE 2.0 Act, provided that:

(1) the amendment is adopted no later than the last day of the first plan year beginning on or after January 1, 2025, or, for an applicable collectively bargained plan (a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before December 29, 2022), or for a governmental plan (within the meaning of section 414(d) of the Code), the last day of the first plan year beginning on or after January 1, 2027, or such later date as the Secretary may prescribe (the section 501 date);

(2) the amendment applies retroactively to the effective date of the SECURE 2.0 Act provision or the regulations thereunder (or, in the case of an amendment not required by a provision of the SECURE 2.0 Act or the regulations thereunder, the effective date specified by the plan); and

(3) the plan or contract is operated as if the amendment were in effect during the period beginning on the effective date of the SECURE 2.0 Act provision or the regulations thereunder (or, in the case of an amendment not required by a provision of the SECURE 2.0 Act or the regulations thereunder, the effective date specified by the plan or contract) and ending on the section 501 date or, if earlier, the date the amendment is adopted.

Section 501(c) of the SECURE 2.0 Act modifies section 601(b)(1) of Division O of the Further Consolidated Appropriations Act, 2020, Pub. L. 116-94 , 133 Stat. 2534, known as the Setting

Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), sections 2202(c)(2)(A) and 2203(c)(2)(B)(i) of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act),[13] and section 302(d)(2)(A) of Title III of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Relief Act), enacted as Division EE of the Consolidated Appropriations Act, 2021, to extend plan amendment deadlines with respect to these sections to coordinate with the plan amendment deadlines under section 501 of the SECURE 2.0 Act, as applicable.[14]

Rev. Proc. 2022-40

Rev. Proc. 2022-40, 2022-47 IRB 487,[15] sets forth plan amendment deadlines for qualified plans and section 403(b) plans that apply except as otherwise provided by statute or in regulations or other guidance published in the Internal Revenue Bulletin. For example, for an individually designed qualified plan that is not a governmental plan (within the meaning of section 414(d) of the Code), the plan amendment deadline for a disqualifying provision with respect to a change in qualification requirements is the last day of the second calendar year that begins after the issuance of the Required Amendments List in which the change in qualification requirements appears, and the plan amendment deadline for a discretionary amendment is the end of the plan year in which the plan amendment is operationally put into effect. Rev. Proc. 2020-40 sets forth similar plan amendment deadlines for section 403(b) form defects first occurring after June 30, 2020, and for discretionary amendments made to section 403(b) plans with respect to plan years beginning on or after January 1, 2020. Although Rev. Proc. 2020-40 provides plan amendment deadlines, it does not provide relief from the anti-cutback requirements of section 411(d)(6) of the Code or section 204(g) of ERISA, if applicable, for amendments adopted by those deadlines.

Eligible governmental plans

Section 457(b) of the Code provides, generally, that a section 457(b) plan maintained by an employer described in section 457(e)(1)(A) (an eligible governmental plan) that is administered in a manner that is inconsistent with the requirements of section 457(b) is not treated as an eligible governmental plan as of the first plan year beginning more than 180 days after the date of notification by the Secretary of the inconsistency unless the employer corrects the inconsistency before the first day of such plan year.

IRAs

Under section 408(a), an IRA that is an individual retirement account is a trust created or organized in the United States for the exclusive benefit of an individual or his beneficiaries, provided that the written instrument creating the trust meets certain requirements. Under section 408(b), an IRA that is an individual retirement annuity is an annuity contract or endowment contract that is issued by an insurance company and that meets certain requirements.

Q. J-1: When must a retirement plan be amended to reflect the applicable provisions of the SECURE Act, section 104 of the Miners Act, section 2202 or 2203 of the CARES Act, section 302 of the Relief Act, and the SECURE 2.0 Act (collectively, the Acts), or any regulations thereunder?

A. J-1: The deadlines to amend an eligible retirement plan (including an IRA or annuity contract) for the applicable provisions of the Acts, or any regulations thereunder, which apply to both required and discretionary plan amendments,[16] are hereby extended as follows:

(a) Qualified plans

In general, the deadline to amend a qualified plan: (1) that is not a governmental plan within the meaning of section 414(d) of the Code or an applicable collectively bargained plan is December 31, 2026; (2) that is an applicable collectively bargained plan is December 31, 2028; or (3) that is a governmental plan within the meaning of section 414(d) is December 31, 2029.[17] See section II. H. of this notice relating to section 348 of the SECURE 2.0 Act for guidance that (1) addresses which cash balance plan amendments are made "pursuant to" section 348 of the SECURE 2.0 Act for purposes of applying section 501, and (2) sets forth the extent of anti-cutback relief for those plan amendments changing the interest crediting rate under the plan.

A sponsor of a qualified plan may amend its plan, in accordance with Rev. Proc. 2022-40, to reflect the Acts, or any regulations thereunder, after the dates set forth in the preceding paragraph. However, amendments made after the dates set forth in the preceding paragraph are not entitled, under Rev. Proc. 2022-40, to the anti-cutback relief from the requirements of section 411(d)(6) of the Code or section 204(g) of ERISA provided by section 501 of the SECURE 2.0 Act.

(b) Section 403(b) plans

In general, the deadline to amend a section 403(b) plan: (1) that is not maintained by a public school, as described in section 403(b)(1)(A)(ii) of the Code, is December 31, 2026; (2) that is an applicable collectively bargained plan of a tax-exempt organization described in section 501(c)(3) is December 31, 2028; or (3) that is maintained by a public school, as described in section 403(b)(1)(A)(ii), is December 31, 2029.

A sponsor of a section 403(b) plan may be entitled to amend its plan, in accordance with Rev. Proc. 2022-40, to reflect the Acts, as applicable, or any regulations thereunder, after the dates set forth in the preceding paragraph. Amendments to a section 403(b) plan that is subject to ERISA that are made after the dates set forth in the preceding paragraph are not entitled, under Rev. Proc. 2022-40, to the anti-cutback relief from the requirements of section 204(g) of ERISA provided by section 501 of the SECURE 2.0 Act.

(c) Eligible governmental plans

The deadline to amend an eligible governmental plan is the later of (1) December 31, 2029, or (2) if applicable, the first day of the first plan year beginning more than 180 days after the date of notification by the Secretary that the plan was administered in a manner that is inconsistent with the requirements of section 457(b) of the Code.

(d) IRAs

The deadline to amend the trust governing an IRA that is an individual retirement account or the contract issued by an insurance company with respect to an IRA that is an individual retirement annuity is December 31, 2026, or such later date as the Secretary prescribes in guidance.

In the case of a deemed IRA described in section 408(q), the deadline to amend the deemed IRA provisions is the deadline applicable to the plan under which the deemed IRA is established.

K. SECTION 601 OF THE SECURE 2.0 ACT

Section 601 of the SECURE 2.0 Act amends certain provisions of the Code to permit an employee who participates in a SIMPLE IRA plan or simplified employee pension (SEP) arrangement to designate a Roth IRA as the IRA to which contributions under the plan or arrangement are made.

Section 601(a) of the SECURE 2.0 Act amends section 408A of the Code by striking subsection (f). Prior to the deletion, section 408A(f) provided that (1) a SEP or SIMPLE IRA account could not be designated as a Roth IRA, and (2) contributions to any such SEP or SIMPLE IRA account would not be taken into account for purposes of the Roth IRA contribution limit of section 408A(c)(2)(B).

Section 601(b)(1) of the SECURE 2.0 Act amends section 408(k) of the Code by adding a new paragraph (section 408(k)(7)) that provides that a Roth IRA will not be treated as a SEP unless the employee elects for the Roth IRA to be so treated (at such time and in such manner as the Secretary may provide).

Section 601(c) of the SECURE 2.0 Act similarly amends section 408(p) of the Code by adding a new paragraph (section 408(p)(12)) that provides that a Roth IRA will not be treated as a simple retirement account unless the employee elects for the Roth IRA to be so treated (at such time and in such manner as the Secretary may provide).

Added by section 601(b) of the SECURE 2.0 Act, new subsection 402(h)(1)(C) of the Code provides that any contribution under a SEP which is made to a Roth IRA is not excludable from the employee's gross income. Section 402(k) provides that rules similar to the rules in section 402(h)(1) applies to contributions under a SIMPLE IRA plan. Therefore, any contribution under a SIMPLE IRA which is made to a Roth IRA is not excludable from the employee's gross income.

Section 601(e) of the SECURE 2.0 Act provides that these amendments apply to taxable years beginning after December 31, 2022.

Q. K-1: Is an employer required to offer an employee an election to designate a Roth IRA as the IRA to which SIMPLE IRA plan or SEP arrangement contributions are made (Roth contribution election)?

A. K-1: No. The employer is not required to offer an employee a Roth contribution election.

Q. K-2: If an employer offers a Roth contribution election, when may an employee make the election?

A. K-2: For a SIMPLE IRA plan, the employer must offer employees the same effective opportunity to make a Roth contribution election as the employees have to enter into a salary reduction agreement under the plan, the minimum requirements of which are provided in section 408(p)(5) of the Code, as described in Notice 98-4.

For a SEP arrangement with a Salary Reduction SEP (SARSEP) component, the employer must offer employees the same effective opportunity to make a Roth contribution election as the employees have to enter into a salary reduction agreement under the SARSEP arrangement.

For a SEP arrangement without a SARSEP component, the employer must offer employees an effective opportunity, as described in § 1.401(k)-1(e)(2)(ii), to elect that a SEP contribution is to be made to a Roth IRA.

In all cases, an election to have a contribution made to a Roth IRA must be made before the contribution is made.

Q. K-3: May an employer make SIMPLE IRA plan or SEP arrangement contributions to a Roth IRA without an employee's prior Roth contribution election, for example, under the terms of an automatic enrollment arrangement?

A. K-3: No. An employer can make contributions to a Roth IRA under a SIMPLE IRA plan or SEP arrangement only if the employee has affirmatively elected that contributions under the plan or arrangement are to be made to a Roth IRA.

Q. K-4: In which taxable year is a Roth IRA contribution includible in the employee's income?

A. K-4: A salary reduction contribution made to a Roth IRA is includible in the employee's gross income for the taxable year that includes the date on which the employee would otherwise have received the salary reduction contribution as wages or salary if the employee had not elected for the amount to be contributed to the SIMPLE IRA plan or SEP arrangement.

An employer matching or nonelective contribution made to a Roth IRA is includible in the employee's gross income for the taxable year that includes the date on which the contribution is made to the Roth IRA. The preceding sentence applies even if the employer matching contribution or nonelective contribution is treated as if it were made for the prior taxable year of the employer, as described in section 404(h)(1)(B) or (m)(2)(B).

Q. K-5: How is a contribution to a Roth IRA under a SIMPLE IRA plan or SEP arrangement reported?

A. K-5: The employer must report salary reduction contributions made to a Roth IRA on Form W-2, *Wage and Tax Statement*, Box 12, using Code F (for a SARSEP) or Code S (for a SIMPLE IRA), and include the same amount in Boxes 1,3, and 5.

The employer must report employer matching and nonelective contributions made to a Roth IRA on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.*, in the same manner as the reporting that would have applied if (1) there were no after-tax contributions made to any of the employee's IRAs, and (2) the matching or nonelective contributions were made to an IRA that was not a Roth IRA and then immediately converted to a Roth IRA. Thus, the contributions must be reported using Form 1099-R, for the year in which the contributions are made to the employee's Roth IRA, with the total reported in boxes 1 and 2a of Form 1099-R, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.

Q. K-6: Which amounts contributed to a Roth IRA under a SIMPLE IRA plan or SEP arrangement are subject to income tax withholding, FICA and the Federal Unemployment Tax Act (FUTA) (chapter 23 of the Code)?

A. K-6: The salary reduction contributions contributed to a Roth IRA under a SIMPLE IRA plan or SEP arrangement are subject to income tax withholding, FICA, and FUTA taxes.

Matching contributions and nonelective contributions that are made to an IRA under a SIMPLE IRA plan or SEP arrangement are excluded from wages under section 3401(a). Similarly, matching contributions and nonelective contributions that are made to a Roth IRA under a SIMPLE IRA plan or SEP arrangement are excluded from wages under section 3401(a). Accordingly, these matching contributions and nonelective contributions are not wages, as defined in section 3401(a), for purposes of federal income tax withholding under section 3402. However, an employee on whose behalf either type of contribution is made may need to increase the employee's withholding or make estimated tax payments to avoid an underpayment penalty.

Matching contributions and nonelective contributions that are made to an IRA under a SIMPLE IRA plan or SEP arrangement are excluded from wages under section 3121(a)(5)(C) and (H). Similarly, matching contributions and nonelective contributions that are made to a Roth IRA under a SIMPLE IRA plan or SEP arrangement are excluded from wages under section 3121(a)(5)(C) and (H) (and those contributions are not added back into wages under section 3121(v)(1)(A)). Accordingly, those contributions are not wages, as defined in section 3121(a), for purposes of FICA.

Matching and nonelective contributions that are made to an IRA under a SIMPLE IRA plan or SEP arrangement also are excluded from wages under section 3306(b)(5)(C) and (H). Similarly, matching contributions and nonelective contributions that are made to a Roth IRA under a SIMPLE IRA plan or SEP arrangement are excluded from wages under section 3306(b)(5)(C) and (H). Accordingly, those contributions are not wages, as defined in section 3306(b), for purposes of FUTA.

Q. K-7: How may an employer make SIMPLE IRA plan or SEP arrangement contributions to a Roth IRA prior to the amendment of IRS forms and Listings of Required Modifications?

A. K-7: An employer using any of Form 5304-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—Not for Use With a Designated Financial Institution*, Form 5305-SIMPLE, *Savings Incentive Match Plan for Employees of Small Employers (SIMPLE)—for Use With a Designated Financial Institution*, Form 5305-SEP, *Simplified Employee Pension—Retirement Accounts Contribution Agreement*, Form 5305A-SEP, *Salary Reduction Simplified Employee Pension—Individual Retirement Accounts Contribution Agreement*, or a prototype plan document approved by the IRS, may continue to use (or begin to use) the form or document without amendment, until the IRS issues new forms or provides new guidance on prototype plan documents.

Q. K-8: What is the effect of the deletion of section 408A(f)(2) on the Roth IRA contribution limit in section 408A(c)(2)(B)?

A. K-8: The deletion of section 408A(f)(2) will be addressed in future guidance.

L. SECTION 604 OF THE SECURE 2.0 ACT

Prior to amendment by section 604 of the SECURE 2.0 Act, section 402A of the Code generally permitted an applicable retirement plan (that is, a qualified plan under section 401(a), a section 403(b) plan, or a section 457(b) plan maintained by an employer described in section 457(e)(1)(A) (an eligible governmental plan)) to include a qualified Roth contribution program as defined in section 402A(b)(1). Prior to that amendment, a qualified Roth contribution program was a program under which an employee could elect to make designated Roth contributions in lieu of all or a portion of elective deferrals the employee was otherwise eligible to make under the applicable retirement plan. These contributions have been referred to as designated Roth contributions; however, for purposes of this notice, they are referred to as designated Roth elective contributions.

Prior to amendment by section 604 of the SECURE 2.0 Act, section 402A(a) of the Code provided that if an applicable retirement plan includes a qualified Roth contribution program, then (1) any designated Roth elective contribution made by an employee pursuant to the program is treated as an elective deferral for purposes of chapter 1 of the Code, except that the contribution "shall not be excludable from gross income," and (2) the plan (and any arrangement that is part of the plan) is not treated as failing to satisfy any requirement of chapter 1 of the Code solely by reason of including the program.

Section 604(a) of the SECURE 2.0 Act amends section 402A(a) of the Code to redesignate section 402A(a)(2) as section 402A(a)(4) and to add the following as section 402A(a)(2) and (3): "(2) any designated Roth contribution which pursuant to the program is made by the employer on the employee's behalf on account of the employee's contribution, elective deferral, or (subject to the requirements of section 401(m)(13)) qualified student loan payment shall be treated as a matching contribution for purposes of this chapter, except that such contribution shall not be excludable from gross income," and "(3) any designated Roth contribution which pursuant to the program is made by the employer on the employee's behalf and which is a nonelective contribution shall be nonforfeitable and shall not be excludable from gross income..."

Section 604(b) of the SECURE 2.0 Act makes a conforming change to the definition of a "qualified Roth contribution program" under section 402A(b)(1) of the Code. As amended, a "qualified Roth contribution program" means a program under which an employee may elect to make, or to have made on the employee's behalf, designated Roth contributions in lieu of all or a portion of elective deferrals the employee is otherwise eligible to make, or of matching contributions or nonelective contributions that may otherwise be made on the employee's behalf, under the applicable retirement plan.

Section 604(c) of the SECURE 2.0 Act amends the definition of a "designated Roth contribution" under section 402A(c)(1) of the Code to mean any elective deferral, matching contribution, or nonelective contribution that is excludable from gross income of an employee without regard to section 402A, and that the employee designates (at such time and in such manner as the Secretary may prescribe) as not being so excludable. For purposes of this notice, matching contributions and nonelective contributions that an employee designates as Roth contributions are referred to as designated Roth matching contributions and designated Roth nonelective contributions.

Section 604(d) of the SECURE 2.0 Act adds section 402A(f)(3) of the Code, which defines "matching contribution" for purposes of section 402A to mean any matching contribution described in section 401(m)(4)(A), and any contribution to an eligible governmental plan on behalf of an employee and on account of the employee's elective deferral under the plan, but only if the contribution is nonforfeitable at the time received.

Section 604(e) of the SECURE 2.0 Act provides that the amendments made by section 604 apply to contributions made after December 29, 2022.

Q. L-1: Do rules similar to the rules of § 1.401(k)-1(f) apply to designated Roth matching contributions and designated Roth nonelective contributions?

A. L-1: Yes. Rules similar to the rules for designated Roth elective contributions under § 1.401(k)-1(f) (other than § 1.401(k)-1(f)(4)(i) and (6)) apply to designated Roth matching contributions and designated Roth nonelective contributions. For example, similar to the rules under § 1.401(k)-1(f)(1) that apply to designated Roth elective contributions: (1) any designation of a matching contribution or nonelective contribution as a Roth contribution must be made by the employee no later than the time that the contribution is allocated to the employee's account and must be irrevocable, and (2) designated Roth matching contributions and designated Roth nonelective contributions are subject to inclusion treatment and separate accounting rules. In addition, to the extent a plan permits an employee to designate matching contributions or nonelective contributions as Roth contributions, an employee must have an effective opportunity to make (or change) that designation at least once during each plan year.

Q. L-2: If an employee designates a matching contribution or nonelective contribution as a Roth contribution, for which taxable year is that designated Roth matching contribution or designated Roth nonelective contribution includible in the individual's gross income?

A. L-2: A designated Roth matching contribution or designated Roth nonelective contribution is includible in an individual's gross income for the taxable year in which the contribution is allocated to the individual's account. The preceding sentence applies even if the designated Roth matching contribution or designated Roth nonelective contribution is deemed to have been made on the last day of the prior taxable year of the employer under section 404(a)(6) of the Code.

Q. L-3: May an employee designate a matching contribution or nonelective contribution as a Roth contribution if the employee is not fully vested in that type of contribution at the time the contribution is allocated to the employee's account?

A. L-3: No. Under section 402A(f)(3), a matching contribution may be designated as a Roth contribution only if the employee is fully vested in matching contributions at the time the contribution is allocated to the employee's account. Similarly, under section 402A(a)(3), a nonelective contribution may be designated as a Roth contribution only if the employee is fully vested in nonelective contributions at the time the contribution is allocated to the employee's account. For example, if at the time a matching contribution is allocated to the employee's account, the employee is only partially vested in the portion of the employee's account balance attributable to matching contributions, then the employee may not designate any part of that matching contribution as a Roth contribution.

Q. L-4: If matching contributions or nonelective contributions under an applicable retirement plan are subject to a vesting schedule, will the plan fail to satisfy section 401(a)(4) (if applicable) merely because the plan provides that an employee may designate a matching contribution or nonelective contribution as a Roth contribution only if the employee is fully vested in that type of contribution at the time the contribution is allocated to the employee's account?

A. L-4: Under § 1.401(a)(4)-4(e)(3)(i), the term "other right or feature" generally means any right or feature applicable to employees under the plan, except as provided in § 1.401(a)(4)-4(e)(3)(ii). Because there is no applicable exception under § 1.401(a)(4)-4(e)(3)(ii), an employee's right under a plan to designate a matching contribution or nonelective contribution that may otherwise be made on the employee's behalf under the plan as a Roth contribution is an "other right or feature" for purposes of § 1.401(a)(4)-4(e)(3).

However, pursuant to the authority in § 1.401(a)(4)-1(d) to issue additional guidance that is necessary or appropriate in applying the nondiscrimination requirements of section 401(a)(4) of the Code, a plan will not be treated as failing to satisfy section 401(a)(4) merely because the plan provides that an employee may designate a matching contribution or nonelective contribution as a Roth contribution only if the employee is fully vested in that type of contribution at the time the contribution is allocated to the employee's account (even if the right to make that designation is not currently available to a group of employees that would satisfy section 410(b) without regard to the average benefit percentage test of § 1.410(b)-5)).

Q. L-5: Are designated Roth matching contributions or designated Roth nonelective contributions included in wages, as defined in section 3401(a) of the Code, for purposes of federal income tax withholding under section 3402?

A. L-5: No. Matching contributions and nonelective contributions that are made to a qualified plan under section 401(a) (including a section 401(k) plan), a section 403(b) plan, or an eligible governmental plan are excluded from wages under section 3401(a). Similarly, designated Roth matching contributions and designated Roth nonelective contributions that are made to a qualified plan under section 401(a), a section 403(b) plan, or an eligible governmental plan are excluded from wages under section 3401(a). Accordingly, designated Roth matching contributions and designated Roth nonelective contributions are not wages, as defined in section 3401(a), for purposes of federal income tax withholding under section 3402. However, an employee who designates a matching contribution or nonelective contribution as a Roth contribution may need to increase the employee's withholding or make estimated tax payments to avoid an underpayment penalty.

Q. L-6: Are designated Roth matching contributions or designated Roth nonelective contributions that are contributed to a qualified plan under section 401(a) or to a section 403(b) plan included in wages, as defined in section 3121(a), for purposes of FICA, or as defined in section 3306(b), for purposes of FUTA?

A. L-6: No. Matching contributions and nonelective contributions that are contributed to a qualified plan under section 401(a) or to a section 403(b) plan are excluded from wages under section 3121(a)(5)(A) and (D). Similarly, designated Roth matching contributions and designated Roth nonelective contributions that are contributed to a qualified plan under section 401(a) or to a section 403(b) plan are excluded from wages under section 3121(a)(5)(A) and (D) (and those contributions are not added back to wages under section 3121(v)(1)(A)). Accordingly, those contributions are not wages, as defined in section 3121(a), for purposes of FICA.

Matching and nonelective contributions that are contributed to a qualified plan under section 401(a) or to a section 403(b) plan also are excluded from wages under section 3306(b)(5)(A) and (D). Similarly, designated Roth matching contributions and designated Roth nonelective contributions that are contributed to a qualified plan under section 401(a) or to a section 403(b) plan are excluded from wages under section 3306(b)(5)(A) and (D). Accordingly, those contributions are not wages, as defined in section 3306(b), for purposes of FUTA.

Q. L-7: Are designated Roth nonelective contributions that are contributed to an eligible governmental plan (including amounts that would be treated as matching contributions under section 401(m) if the plan were a qualified plan) included in wages, as defined in section 3121(a), for purposes of FICA?

A. L-7: Section 3121(a) defines wages as all remuneration for employment, unless specifically excluded. Section 3121(v)(2) includes special timing rules that apply in determining when amounts deferred under an eligible governmental plan (including employers' contributions) are required to be taken into account. Under these sections, an amount deferred under an eligible governmental plan is required to be taken into account for purposes of social security and Medicare taxes as of the later of when the services are performed or when there is no substantial risk of forfeiture of the rights to such amount. Because designated Roth nonelective contributions that are contributed to an eligible governmental plan (including amounts that would be treated as matching contributions under section 401(m) if the plan were a qualified plan) must be fully vested at the time the contribution is allocated to a participant's account, these contributions are subject to social security and Medicare taxes at that time. However, FICA tax applies to employees of state and local governments only if they are subject to social security or Medicare tax under section 3121(b)(7)(E) (relating to agreements entered into pursuant to section 218 of the Social Security Act) or another provision of the Code, such as section 3121(b)(7)(F) (relating to state and local government employees who are not members of a state or local retirement system), or section 3121(u) (relating to Medicare). *See also* Notice 2003-20, 2003-1 CB 894.

Q. L-8: Are designated Roth nonelective contributions that are contributed to an eligible governmental plan (including amounts that would be treated as matching contributions under section 401(m) if the plan were a qualified plan) included in wages, as defined in section 3306(b), for purposes of FUTA?

A. L-8: Section 3306(c)(7) generally provides a FUTA exemption for service performed in the employ of a state or any political subdivision thereof or any instrumentality of any one or more of the foregoing. In accordance with this provision, designated Roth nonelective contributions that are contributed to an eligible governmental plan (including amounts that would be treated as matching contributions under section 401(m) if the plan were a qualified plan) are excluded from wages under section 3306(c)(7). Accordingly, those contributions are not wages, as defined in section 3306(b), for purposes of FUTA. *See also* Notice 2003-20.

Q. L-9: If designated Roth matching contributions or designated Roth nonelective contributions are allocated to an individual's account in a taxable year, what reporting obligations apply to those contributions?

A. L-9: The reporting obligations that apply to a designated Roth matching contribution or designated Roth nonelective contribution are the same as if: (1) the contribution had been the only contribution made to an individual's account under the plan, and (2) the contribution, upon allocation to that account, had been directly rolled over to a designated Roth account in the plan as an in-plan Roth rollover. Thus, designated Roth matching contributions and designated Roth nonelective contributions to a qualified plan under section 401(a) or to a section 403(b) plan must be reported using Form 1099-R for the year in which the contributions are allocated to the individual's account. The total amount of designated Roth matching contributions and designated Roth nonelective contributions that are allocated in that year are reported in boxes 1 and 2a of Form 1099-R, and code "G" is used in box 7.

The same reporting applies to designated Roth nonelective contributions that are contributed to an eligible governmental plan (including amounts that would be treated as matching contributions under section 401(m) if the plan were a qualified plan).

Q. L-10: If a plan uses a safe harbor definition of compensation under § 1.415(c)-2(d)(3) or (4) for purposes of section 415 of the Code, are designated Roth matching contributions or designated Roth nonelective contributions included in that safe harbor definition of compensation?

A. L-10: No. In general, the safe harbor definition of compensation under § 1.415(c)-2(d)(3) includes wages within the meaning of section 3401(a) of the Code (for purposes of income tax withholding at the source), plus amounts that would be included in wages but for an election under section 125(a), 132(f)(4), 402(e)(3), 402(h)(1)(B), 402(k), or 457(b). However, as described in Q&A L-5 of this notice, designated Roth matching contributions and designated Roth nonelective contributions are not included in wages within the meaning of section 3401(a) (nor would those contributions have been included in wages but for an election to have those contributions made as Roth contributions).

Similarly, the safe harbor definition of compensation under § 1.415(c)-2(d)(4) generally includes amounts that are compensation under § 1.415(c)-2(d)(3), plus all other payments of compensation to an employee by his employer (in the course of the employer's trade or business) for which the employer is required to furnish the employee a written statement under sections 6041(d), 6051(a)(3), and 6052 of the Code. However, designated Roth matching contributions and designated Roth nonelective contributions are not payments of compensation to an employee by his employer for which the employer is required to furnish the employee a written statement under sections 6041(d), 6051(a)(3), and 6052.

Q. L-11: If an applicable retirement plan includes a qualified Roth contribution program, which types of designated Roth contributions must an employee be permitted to elect to make, or have made on the employee's behalf, under the program?

A. L-11: Pursuant to section 402A(b)(1), a qualified Roth contribution program may, but is not required, to include every type of designated Roth contribution. Thus, an employee generally may be permitted to designate an elective contribution as a Roth contribution without being permitted to designate a matching contribution or nonelective contribution as a Roth contribution. Similarly, an employee generally may be permitted to designate a matching contribution or nonelective contribution (or both) as a Roth contribution without being permitted to designate an elective contribution as a Roth contribution. However, the right to make designated Roth contributions is a right or feature subject to the requirements of section 401(a)(4). *See* § 1.401(k)-1(a)(4)(iv)(B) and Q&A L-4 of this notice.

Further, under sections 402(c)(8)(B) and 402A(c)(3)(A) of the Code, if any portion of an eligible rollover distribution is attributable to payments or distributions from a designated Roth account (as defined in section 402A), that portion is permitted to be rolled over only to another designated Roth account or to a Roth IRA. For purposes of sections 402(c)(8)(B) and 402A(c)(3)(A), the term "designated Roth account" includes a separate account that is established for designated Roth matching contributions or designated Roth nonelective contributions. Similarly, section 402A(c)(4)(B) requires an applicable retirement plan to include a qualified Roth contribution program in order for the plan to permit employees to make in-plan Roth rollovers. For purposes of section 402A(c)(4)(B), a qualified Roth contribution program includes a program under which an employee may designate a matching contribution or nonelective contribution as a Roth contribution, even if the employee is not permitted to designate an elective contribution as a Roth contribution.

III. REQUEST FOR COMMENTS

The Treasury Department and the IRS invite comments and suggestions regarding the matters discussed in this notice. In particular, the Treasury Department and the IRS request comments on:

- Section 113 of the SECURE 2.0 Act with respect to a *de minimis* financial incentive that is provided by a party other than the employer; and
- Section 348 of the SECURE 2.0 Act with respect to whether there are situations under which a plan with a statutory hybrid benefit formula within the meaning of § 1.411(a)(13)-1(d)(4) that is not described in Q&A H-2 of this notice would be amended pursuant to section 348 of the SECURE 2.0 Act, as described in section II.H of this notice.

Comments should be submitted in writing on or before February 20, 2024 and should include a reference to Notice 2024-2. Comments may be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov (type "IRS Notice 2024-2" in the search field on the Regulations.gov home page to find this notice and submit comments). Alternatively, comments may be submitted by mail to: Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2024-2), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket.

IV. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act (PRA) () under control number 1545-2317. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this notice are section II.E, section II.F, and section II.G of this notice. The information collection requirements in section II.E and section II.G of this notice are accounted for in OMB Control Number 1545-1502. The information collection requirements in section II.F will be submitted to OMB for review and approval in accordance with 5 CFR 1320.13.

Q&A F-1 of this notice provides that a "terminally ill individual distribution" is any distribution from a qualified retirement plan to an employee who is a terminally ill individual that is made on or after the date on which the employee has been certified by a physician as having a terminal illness. A certification of terminal illness must meet the content requirement for the certification described in Q&A F-6 of this notice, the timing requirement for the certification described in Q&A F-7 of this notice, and the documentation requirement described in Q&A F-13 of this notice.

The collection of information is required to obtain a benefit. The likely respondents are individual taxpayers who are requesting terminally ill distributions from a qualified retirement plan.

Estimated total annual reporting burden: 125 hours.

Estimated average annual burden per respondent: .25 hours.

Estimated number of respondents: 500.

Estimated frequency of responses: 1.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103 of the Code.

V. DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this notice, please contact Mr. Morgan at (202) 317-6700 (not a toll-free number).

---

1 Under section 408(p)(2)(C)(i)(I), an employer is an eligible employer with respect to any taxable year if the employer had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding taxable year. In addition, under section 408(p)(2)(C)(i)(II), an eligible employer that establishes and maintains a plan for one or more years will be treated as an eligible employer for the two years following the last year the employer was an eligible employer (unless the increase in the employer's number of employees was due to an acquisition, disposition, or similar transaction involving the eligible employer).

2 The annual salary reduction contribution/elective contribution limit for a SIMPLE IRA plan or SIMPLE 401(k) plan for 2023 is $15,500 and the limit on additional catch-up contributions beginning at age 50 for 2023 is $3,500.

3 Section 408(p)(2)(E)(i)(I) and (II) refer to "an eligible employer described in clause (iii). " There is no description of an eligible employer in clause (iii), but there is a description of eligible employer in clause (iv).

4 Section 72(t)(5) provides that, for purposes of section 72(t), the term “employee” includes any participant, and in the case of an individual retirement plan, an individual for whose benefit such plan was established.

5 For purposes of this notice, the term "IRA" includes both an individual retirement account described in section 408(a) and an individual retirement annuity described in section 408(b).

6 The definition of "State" for purposes of is in , which provides that the term "State" includes the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, and American Samoa.

7 Section 311 of the SECURE 2.0 Act amends section 72(t)(2)(H)(v)(I) of the Code to require that an individual who receives a qualified birth or adoption distribution may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, recontribute the qualified birth or adoption distribution to an applicable eligible retirement plan. Section 311 of the SECURE 2.0 Act is generally effective for qualified birth or adoption distributions made after December 29, 2022.

8 It should be noted that section 72(t)(6)(B) refers to section 403(b)(12). However, unlike section 401(k)(2)(B), section 403(b)(12) does not include distribution limitations. Instead, section 403(b)(11) includes distribution limitations that are comparable to section 401(k)(2)(B).

9 The term "statutory hybrid benefit formula" is defined in § 1.411(a)(13)-1(d)(4) to encompass the formulas used under applicable defined benefit plans described in section 411(a)(13)(C)(i) or (ii).

10 The term "statutory hybrid plan" is defined in § 1.411(a)(13)-1(d)(5) as a defined benefit plan that contains a statutory hybrid benefit formula.

11 For purposes of this notice, a cash balance plan is a plan with a lump sum-based benefit formula (as defined in § 1.411(a)(13)-1(d)(3)) under which the accumulated benefit (within the meaning of § 1.411(a)(13)-1(d)(2)) for a participant is the current balance of a hypothetical account.

12 As described in section II.H of this notice, section 411(d)(6) generally prohibits plan amendments that decrease accrued benefits. Section 204(g) of ERISA provides parallel rules to the rules of section 411(d)(6) of the Code. The Secretary has interpretive authority over section 204(g) of ERISA pursuant to Reorganization Plan No. 4 of 1978, 5 U.S.C. App.

13 Section 2202 of the CARES Act is modified by section 280 of the COVID-related Tax Relief Act of 2020, which was enacted as Subtitle B, Title II, Division N, of the Consolidated Appropriations Act, 2021, Pub. L. 116-260 , 134 Stat. 1182 (2020). References in section II.J of this notice to section 2202 of the CARES Act are to section 2202 of the CARES Act as modified. Notice 2020-51, 2020-29 IRB 73, which sets forth guidance relating to a waiver of

2020 required minimum distributions under section 2203 of the CARES Act, provides that an IRA does not have to be amended to reflect the waiver and provides a sample amendment for defined contribution plans that plan sponsors may adopt to implement section 401(a)(9)(I) of the Code. The notice provides that, although employers may adopt amendments pursuant to section 2203 of the CARES Act other than those provided in the sample amendment, the Treasury Department and the IRS are exercising their authority under section 2203(c) of the CARES Act to deny Code section 411(d)(6) relief for a plan amendment that eliminates an optional form of benefit.

14 Section G of Notice 2020-68, 2020-38 IRB 567, extended the deadline to amend a plan to reflect section 104 of Division M of the Further Consolidated Appropriations Act, 2020, known as the Bipartisan American Miners Act of 2019 (Miners Act), to coordinate with the plan amendment deadlines provided in section 601 of the SECURE Act.

15 See Part III of Rev. Proc. 2016-37, 2016-29 IRB 136, as modified by Rev. Proc. 2017-41, 2017-29 IRB 92, Rev. Proc. 2018-21, 2018-14 IRB 467, Rev. Proc. 2018-42, 2018-36 IRB 424, Rev. Proc. 2020-10, 2020-2 IRB 295, Notice 2020-35, 2020-25 IRB 948, Rev. Proc. 2020-40, 2020-38 IRB 575, and Rev. Proc. 2021-38, 2021-38 IRB 425, with respect to qualified pre-approved plans, and Part III of Rev. Proc. 2019-39, 2019-42 IRB, 945, as modified by Notice 2020-35, Rev. Proc. 2020-40, and Rev. Proc. 2021-37, 2021-38 IRB 385, with respect to section 403(b) pre-approved plans. The Treasury Department and the IRS anticipate updating the provisions of Part III of Rev. Proc. 2016-37 and Part III of Rev. Proc. 2019-39 in future guidance relating to qualified pre-approved plans and section 403(b) pre-approved plans, respectively.

16 With respect to pre-approved plans, the extended plan amendment deadlines apply to both interim (required) and discretionary amendments. It is anticipated that the cumulative list for the fourth remedial amendment cycle for pre-approved defined contribution plans (pre-approved plans for which the opinion letter application submission window falls between February 1, 2024, and January 31, 2025) will include certain provisions of the Acts. Accordingly, it is anticipated that the pre-approved defined contribution plans submitted for that cycle will need to include provisions that reflect the applicable provisions of the Acts.

17 It is anticipated that this date will accommodate the needs of states without annual legislative sessions, which will not be required to amend their plans before 90 days after the close of the third regular legislative session of the legislative body with the authority to amend the plan that begins after 2023 (the year in which this notice is published).

END OF DOCUMENT -

Notices

Notice 2024-7, 2024-2 IRB 355, 12/20/2023, IRC Sec(s). 6651

Failure to pay tax penalties—penalty relief for tax years 2020 and 2021.

Headnote:

As announced in IR 2023-244, IRS is providing relief from Code Sec. 6651(a)(2); and Code Sec. 6651(a)(3); penalties for certain eligible taxpayers who were given initial balance due notices, but stopped receiving collection reminder notices during COVID-19 pandemic-related suspension (temporary suspension of mailing of certain automated reminder notices). Relief is limited to said penalties, not interest, and to certain eligible taxpayers and returns. And it doesn't apply to other penalties, including Code Sec. 6651(f); or Code Sec. 6663; penalties or penalties in accepted OICs, in settlement agreements, or finally determined in judicial proceedings.

Reference(s): ¶ 66,515.01(3); Code Sec. 6651;

Full Text:

Relief from Additions to Tax for Certain Taxpayers' Failure to Timely Pay Income Tax for Taxable Years 2020 and 2021

I. PURPOSE

This notice provides relief for certain taxpayers from additions to tax for the failure to pay income tax with respect to certain income tax returns for taxable years 2020 and 2021. These additions to tax for the failure to pay income tax will be waived or, to the extent previously assessed or paid, will be abated, refunded, or credited to other outstanding tax liabilities, as described in section III of this notice. Section III.D of this notice describes situations in which the relief provided in this notice does not apply.

II. BACKGROUND

Section 6651(a)(2) of the Internal Revenue Code (Code)[1] generally imposes an addition to the tax owed by a taxpayer for the failure to pay the amount shown as tax on a return required to be filed by the taxpayer, on or before the date prescribed for payment of such tax, including any extension of time for payment. Section 6651(a)(3) generally imposes an addition to the tax owed by the taxpayer for the failure to pay the amount required to be shown on a return that is not so shown within 21 calendar days from the date of notice and demand or 10 business days if the amount in the notice and demand is $100,000 or greater. Sections 6651(a)(2) and 6651(a)(3) apply to returns required to be filed under the authority of any provision of subchapter A of chapter 61 of the Code, (for example, §§ 6012 through 6017 requiring the filing of income tax returns) and do not apply to information returns required to be filed or furnished under part III of such subchapter (that is, §§ 6031 through 6056 of the Code). Sections 6651(a)(2) and 6651(a)(3) do not apply if the taxpayer can show that the failure to pay the tax shown or required to be shown on the return is due to reasonable cause and not due to willful neglect.

When a taxpayer does not fully pay a tax liability, the Internal Revenue Service (IRS) sends an initial balance due notice, which includes Notices CP14 and CP161.[2] An initial balance due notice informs the taxpayer of the amount of tax owed and instructs the taxpayer how to pay the tax liability. If the taxpayer does not pay the tax liability after receiving the initial notice, the IRS normally sends the taxpayer certain automated reminder notices.

On March 13, 2020, the President of the United States declared a national emergency in response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic.[3] The same day, the President also issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act, et seq. (Emergency Declaration).[4] The Emergency 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 . " In response, the

Department of the Treasury (Treasury Department) and the IRS issued a series of notices and other guidance to provide relief to affected taxpayers.

On February 9, 2022, the IRS announced in IRS News Release IR-2022-31 (IR-2022-31) the temporary suspension of the mailing of certain automated reminder notices. The IRS did not suspend the mailing of initial balance due notices. The additions to tax for the failure to pay taxes owed under §§ 6651(a)(2) and 6651(a)(3) continued to accrue for taxpayers who did not fully pay their balance due.

The IRS will fully resume issuing automated reminder notices in calendar year 2024 for balances due for taxable years 2021 and earlier, thereby resuming the normal notice process for these taxable years. The Treasury Department and the IRS have determined that the relief described in section III of this notice will help certain taxpayers, who were not sent reminder notices during the temporary suspension of certain automated reminder notices, meet their Federal tax obligations.

III. GRANT OF RELIEF

Taxpayers described in section III.A of this notice (eligible taxpayers) who have filed tax returns specified in section III.B of this notice (eligible returns) will have the accrual of additions to tax for the failure to pay taxes owed for taxable year 2020 or 2021 waived for the relief period described in section III.C (relief period) or, to the extent previously assessed or paid, will have such additions to tax automatically abated, refunded, or credited to other outstanding tax liabilities, as appropriate, for the relief period. There is no need for taxpayers to request this relief. The IRS will issue a notice to each eligible taxpayer that reflects the updated amount owed and any refund or credit resulting from the automatic abatement. The relief granted in this notice applies to additions to tax under §§ 6651(a)(2) and 6651(a)(3) for the failure to pay taxes owed, but does not apply to any amount of interest that accrues as a result of any underpayment.

A. Eligible Taxpayers

The relief granted in this notice is available only to eligible taxpayers for accruals of additions to tax under §§ 6651(a)(2) and 6651(a)(3) for the failure to pay during the relief period. An "eligible taxpayer" is any taxpayer:

- Whose assessed income tax for taxable year 2020 or 2021, as of December 7, 2023, is less than $100,000, excluding any applicable additions to tax, penalties, or interest;
- Who was issued an initial balance due notice (including, but not limited to Notice CP14 or Notice CP161) on or before December 7, 2023, for taxable year 2020 or 2021; and
- Who is otherwise liable during the relief period for accruals of additions to tax for the failure to pay under § 6651(a)(2) or 6651(a)(3) with respect to an eligible return for taxable year

2020 or 2021.

B. Eligible Returns

The relief granted in this notice is available only to eligible taxpayers who have filed an eligible return. An "eligible return" is one of the following income tax returns:

1. Income Tax Returns of Individuals:

- Form 1040, *U.S. Individual Income Tax Return*
- Form 1040-C, *U.S. Departing Alien Income Tax Return*
- Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*
- Form 1040-PR, *Declaracion de la Contribucion Federal sobre el Trabajo por Cuenta Propia*
- Form 1040-SR, *U.S. Tax Return for Seniors*
- Form 1040-SS, *U.S. Self-Employment Tax Return*

2. Income Tax Returns of Trusts, Estates, Certain Taxable Corporations, and Certain Tax-Exempt Organizations:

- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*
- Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*
- Form 1120-FSC, *U.S. Income Tax Return of Foreign Sales Corporation*
- Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*
- Form 1120-L, *U.S. Life Insurance Company Income Tax Return*
- Form 1120-ND, *Return for Nuclear Decommissioning Funds and Certain Related Persons*
- Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*
- Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*
- Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*
- Form 1120-RIC, *U.S. Income Tax Return for Regulated Investment Companies*
- Form 1120-S, *U.S. Income Tax Return for an S Corporation*
- Form 1120-SF, *U.S. Income Tax Return for Settlement Funds (Under Section 468B)*
- Form 1041, *U.S. Income Tax Return for Estates and Trusts*
- Form 1041-N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts*
- Form 1041-QFT, *U.S. Income Tax Return for Qualified Funeral Trusts*
- Form 990-T, *Exempt Organization Business Income Tax Return*

C. Relief Period

For purposes of the relief granted in this notice, the "relief period" is the period that begins on the date the IRS issued an initial balance due notice to the eligible taxpayer, or February 5, 2022, whichever is later, and ends on March 31, 2024. Eligible taxpayers will remain liable for any addition to tax for the failure to pay tax that accrued before or after the relief period. Eligible taxpayers will also remain liable for interest that accrues during the relief period as a result of any underpayment of tax for taxable year 2020 or 2021.

D. Exceptions to Relief

The relief described in this notice does not apply to any addition to tax, penalty, or interest that is not specifically listed in the grant of relief under section III of this notice. In addition, the relief described in section III of this notice is not available with respect to any return for which the penalty for fraudulent failure to file under § 6651(f) or the penalty for fraud under § 6663 applies. The relief described in section III of this notice also does not apply to any addition to tax for the failure to pay in an offer in compromise under § 7122 that is accepted by the IRS because acceptance of the offer conclusively settles all of the liabilities in the offer under § 301.7122-1(e)(5) of the Procedure and Administration Regulations (26 CFR part 301). Finally, the relief described in section III of this notice does not apply to any addition to tax for the failure to pay that is settled in a closing agreement under § 7121 or finally determined in a judicial proceeding.

IV. DRAFTING INFORMATION

The principal author of this notice is Jamie Song of the Office of the Associate Chief Counsel (Procedure and Administration). For further information regarding this notice, contact Jamie Song at (202) 317-6845 (not a toll-free number).

---

1 Unless otherwise specified, all "Section" or "§" references are to sections of the Code.

2 Notice CP14, Notice of Tax Due and Demand for Payment, Balance Due $5 or More, No Math Error, is issued to a taxpayer who owes money on unpaid taxes, states the amount of tax owed, including interest and penalties, and requests payment within 21 days. Notice CP161, Balance Due - Request for Payment or Notice of Unpaid Balance, is issued to a taxpayer who has an unpaid balance due, and explains how the IRS calculated the amount due, and states the taxpayer should contact the IRS within 10 days if the taxpayer believes the IRS has made a mistake or to contact the IRS to make a payment arrangement.

3 Proclamation 9994, 85 F.R. 15337 (March 18, 2020).

4 March 13, 2020, letter from the President to Secretaries of the Departments of Homeland Security, the Treasury, and Health and Human Services and the Administrator of the Federal

Emergency Management Agency, available at https://trumpwhitehouse.archives.gov/briefings-statements/letter-president-donald-j-trump-emergency-determination-stafford-act/.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2024
Notice 2024-8, 2024-2 IRB 356 -- IRC Sec(s). 162; 170; 213; 217, 14/12/2023

Notices

Notice 2024-8, 2024-2 IRB 356, 14/12/2023, IRC Sec(s). 162

Business use of auto—deductions—optional standard mileage rates for 2024.

Headnote:

IRS released optional standard mileage rates for 2024. Rates are to be used for determining deductible costs of operating auto for business (67¢ per mile), charitable (14¢ per mile), or medical/moving (21¢ per mile) purposes in 2024; although IRS reminds taxpayers that TCJA '17 (PL 115-97, 12/22/2017) suspended miscellaneous itemized deductions, as well as moving expense deductions other than those allowed under Code Sec. 217(g); for certain members of Armed Forces, for post-2017 and pre-2026 tax years. IRS also set out amount taxpayers must use in calculating reductions to basis for depreciation taken under business standard mileage rate; maximum automobile cost for purposes of computing allowance under fixed and variable rate plan ($62,000); and, for purposes of fleet-average or vehicle-cents-per-mile valuation rule under Reg § 1.61-21(d)(5)(v) or Reg § 1.61-21(e) , respectively, maximum FMV of automobiles first made available to employees in 2024 ($62,000). Notice 2023-3 , 2023-3 IRB is superseded.

Reference(s): ¶ 1625.157(3); Code Sec. 162; Code Sec. 170; Code Sec. 213; Code Sec. 217;

Full Text:

2024 Standard Mileage Rates

1. PURPOSE

This notice provides the optional 2024 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate (FAVR) plan. Additionally, this notice provides the maximum fair market value (FMV) of employer-provided automobiles first made available to employees for personal use in calendar year 2024 for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile valuation rule in § 1.61-21(e). [1]

2. BACKGROUND

Rev. Proc. 2019-46, 2019-49 I.R.B. 1301, provides rules for computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes, and for substantiating, under § 274(d) and § 1.274-5, the amount of ordinary and necessary business expenses of local transportation or travel away from home. Taxpayers using the standard mileage rates must comply with Rev. Proc. 2019-46. However, a taxpayer is not required to use the substantiation methods described in Rev. Proc. 2019-46, but instead may substantiate using actual allowable expense amounts if the taxpayer maintains adequate records or other sufficient evidence.

An independent contractor conducts an annual study for the Internal Revenue Service of the fixed and variable costs of operating an automobile to determine the standard mileage rates for business, medical, and moving use reflected in this notice. The standard mileage rate for charitable use is set by § 170(i).

Longstanding regulations under § 61 provide special valuation rules for employer-provided automobiles. The amount that must be included in the employee's income and wages for the personal use of an employer-provided automobile generally is determined by reference to the automobile's FMV. If an employer chooses to use a special valuation rule, the special value is treated as the FMV of the benefit for income tax and employment tax purposes. Section 1.61-21(b)(4). Two such special valuation rules, the fleet-average valuation rule and the vehicle cents-per-mile valuation rule, are set forth in § 1.61-21(d)(5)(v) and § 1.61-21(e), respectively. These two special valuation rules are subject to limitations, including that they may be used only in connection with automobiles having values that do not exceed a maximum amount set forth in the regulations.

3. STANDARD MILEAGE RATES

The standard mileage rate for transportation or travel expenses is 67 cents per mile for all miles of business use (business standard mileage rate). See section 4 of Rev. Proc. 2019-46. However, §11045 of Public Law 115-97 , 131. Stat. 2054 (December 22, 2017), commonly known as the Tax Cuts and Jobs Act (TCJA) suspends all miscellaneous itemized deductions that are subject to the two-percent of adjusted gross income floor under § 67, including unreimbursed employee travel expenses, for taxable years beginning after December 31, 2017, and before January 1, 2026. Thus, the business standard mileage rate provided in this notice cannot be used to claim an itemized deduction for unreimbursed employee travel expenses during the suspension. Notwithstanding the foregoing suspension of miscellaneous itemized deductions, deductions for expenses that are deductible in determining adjusted gross income are not suspended. For example, members of a reserve component of the Armed Forces of the United States (Armed Forces), state or local government officials paid on a fee basis, and certain performing artists are entitled to deduct unreimbursed employee travel expenses as an adjustment to total income on line 12 of Schedule 1 of Form 1040 (2023), *U.S. Individual Income Tax Return*, not as an itemized deduction on Schedule A of Form 1040 (2023), and therefore may continue to use the business standard mileage rate.

The standard mileage rate is 14 cents per mile for use of an automobile in rendering gratuitous services to a charitable organization under § 170. See section 5 of Rev. Proc. 2019-46.

The standard mileage rate is 21 cents per mile for use of an automobile: (1) for medical care described in § 213; or (2) as part of a move for which the expenses are deductible under § 217(g). See section 5 of Rev. Proc. 2019-46. Section 11049 of the TCJA suspends the deduction for moving expenses for taxable years beginning after December 31, 2017, and before January 1, 2026. However, the suspension does not apply to members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. Thus, except for taxpayers to whom § 217(g) applies, the standard mileage rate provided in this notice is not applicable for the use of an automobile as part of a move occurring during the suspension.

4. BASIS REDUCTION AMOUNT

For automobiles a taxpayer uses for business purposes, the portion of the business standard mileage rate treated as depreciation is 27 cents per mile for 2020, 26 cents per mile for 2021, 26 cents per mile for 2022, 28 cents per mile for 2023, and 30 cents per mile for 2024. See section 4.04 of Rev. Proc. 2019-46.

5. MAXIMUM STANDARD AUTOMOBILE COST

For purposes of computing the allowance under a FAVR plan, the standard automobile cost may not exceed $62,000 for automobiles (including trucks and vans). See section 6.02(6) of Rev. Proc. 2019-46.

6. MAXIMUM VALUE OF EMPLOYER-PROVIDED AUTOMOBILES

For purposes of the fleet-average valuation rule in § 1.61-21(d)(5)(v) and the vehicle cents-per-mile valuation rule in § 1.61-21(e), the maximum FMV of automobiles (including trucks and vans) first made available to employees in calendar year 2024 is $62,000.

7. EFFECTIVE DATE

This notice is effective for: (1) deductible transportation expenses paid or incurred on or after January 1, 2024; (2) mileage allowances or reimbursements paid to a charitable volunteer or a member of the Armed Forces to whom § 217(g) applies: (a) on or after January 1, 2024, and (b) for transportation expenses the charitable volunteer or such member of the Armed Forces pays or incurs on or after January 1, 2024; and (3) for purposes of the maximum FMV of employer-provided automobiles for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile rule in § 1.61-21(e), automobiles first made available to employees for personal use on or after January 1, 2024.

8. EFFECT ON OTHER DOCUMENTS

Notice 2023-03 is superseded.

DRAFTING INFORMATION

The principal author of this notice is Christian Lagorio of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information on this notice regarding the use of an employee-provided automobile, contact Mr. Lagorio at (202) 317-7005 (not a toll-free number). For further information on this notice regarding the use of an employer-provided automobile, contact Stephanie Caden of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes), at (202) 317-4774 (not a toll-free number).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Internal Revenue Code (Code) or the Income Tax Regulations (26 CFR part 1).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2024
Notice 2024-11, 2024-2 IRB 360 -- IRC Sec(s). 1, 12/28/2023

Notices

Notice 2024-11, 2024-2 IRB 360, 12/28/2023, IRC Sec(s). 1

Dividends—reduced capital gains tax rate—qualified foreign corps.; treaties.

Headnote:

IRS provided updated list of current treaties between U.S. and various countries that meet Code Sec. 1(h)(11)(C)(i)(II); requirements for reduced capital gains rate for dividends paid to individual shareholders from "qualified foreign corporation." Treaty with Chile, which entered into force 12/19/2023, is added to the list. Also, treaties with Russia and Hungary are removed from the list because: Hungary treaty terminated on 1/8/2023, so no longer satisfies Code Sec. 1(h)(11)(C)(i)(II); ; and Russia treaty no longer has exchange of information program required byCode Sec. 1(h)(11)(C)(i)(II); . Further, former U.S.S.R treaty (applicable to certain former Soviet republics), Bermuda treaty, and Netherlands Antilles treaty, although still in effect, otherwise failed Code Sec. 1(h)(11)(C)(i)(II); requirements. Notice 2011-64 , 2011-37 IRB 231 is amplified and superseded.

Reference(s): Code Sec. 1;

Full Text:

United States Income Tax Treaties That Meet the Requirements of Section 1(h)(11)(C)(i)(II)

1. SUMMARY

Under section 1(h)(11), a dividend paid to an individual shareholder from either a domestic corporation or a "qualified foreign corporation" generally is subject to tax at the reduced rates applicable to certain capital gains. A qualified foreign corporation includes certain foreign corporations that are eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for purposes of this provision and that includes an exchange of information program. This notice updates the list of treaties that meet the requirements of section 1(h)(11)(C)(i)(II). It adds the treaty with Chile, which entered into force on December 19, 2023. The list no longer includes the treaties with Russia and Hungary because both have ceased to meet the requirements of section 1(h)(11) after the publication of Notice 2011-64.

2. ANALYSIS

Section 1(h)(1) of the Internal Revenue Code (the Code) generally provides that a taxpayer's "net capital gain" for any taxable year will be subject to a maximum tax rate of 20 percent (or 15 percent in the case of certain taxpayers). See also section 1411 (imposing a 3.8 percent tax on certain taxpayers' net investment income).

Section 1(h)(11) provides that net capital gain for purposes of section 1(h) means net capital gain (determined without regard to section 1(h)(11)) increased by "qualified dividend income." Qualified dividend income means dividends received during the taxable year from domestic corporations and "qualified foreign corporations." Section 1(h)(11)(B)(i). Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty with the United States that the Secretary determines is satisfactory for purposes of this provision and that includes an exchange of information program (the treaty test). Section 1(h)(11)(C)(i).

A foreign corporation that does not satisfy either of these two tests is treated as a qualified foreign corporation with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States. Section 1(h)(11)(C)(ii). See Notice 2003-71, 2003-2 C.B. 922, for the definition, for taxable years beginning on or after January 1, 2003, of "readily tradable on an established securities market in the United States."

A qualified foreign corporation does not include any foreign corporation that for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297). Section 1(h)(11)(C)(iii). A dividend from a qualified foreign corporation is also subject to the other limitations in section 1(h)(11). For example, a shareholder receiving a dividend from a qualified foreign corporation must satisfy the holding period requirements of section 1(h)(11)(B)(iii).

The appendix to this notice provides the current list of U.S. income tax treaties that meet the requirements of section 1(h)(11)(C)(i)(II). The list has been updated to include the treaty with Chile, which entered into force on December 19, 2023, and to remove two treaties that have ceased to meet the requirements of section 1(h)(11)(C)(i)(II) since the publication of Notice 2011-64: the treaty with Hungary and the treaty with Russia.

The treaty between Hungary and the United States (the Hungary treaty) terminated on January 8, 2023. Consequently, the Hungary treaty has ceased to meet the requirements of section 1(h)(11)(C)(i)(II).

On April 5, 2022, a Department of the Treasury (Treasury) spokesperson announced that the IRS paused assistance to Russian tax authorities through exchange of information under the treaty between Russia and the United States (the Russia treaty). Therefore, the Russia treaty does not have an exchange of information program as required by section 1(h)(11)(C)(i)(II).

Three other U.S. income tax treaties still in effect do not meet the requirements of section 1(h)(11)(C)(i)(II). They are the U.S.-U.S.S.R. income tax treaty (which was signed on June 20, 1973, and currently applies to certain former Soviet Republics), and the tax treaties with Bermuda and the Netherlands Antilles.

Treasury and the IRS intend to continue to update this list, as appropriate. Situations that may result in changes to the list include the entry into force of new income tax treaties and the amendment or renegotiation of existing tax treaties. Further, Treasury and the IRS continue to study the operation of each U.S. income tax treaty, including the implications of any change in the domestic laws of the treaty partner, to ensure that the treaty accomplishes its intended objectives and continues to be satisfactory for purposes of this provision.

3. EFFECTIVE DATE

This notice is effective with respect to Chile for dividends paid on or after December 19, 2023. This notice is effective with respect to Hungary for dividends paid on or after January 8, 2023. This notice is effective with respect to Russia for dividends paid on or after January 1, 2023.

This notice is effective with respect to Bulgaria for dividends paid on or after December 15, 2008. This notice is effective with respect to Malta for dividends paid on or after November 23, 2010.

This notice is effective with respect to Bangladesh for dividends paid on or after August 7, 2006. This notice is effective with respect to Barbados for dividends paid on or after December 20, 2004. This notice is effective with respect to Sri Lanka for dividends paid on or after July 12, 2004. This notice is effective with respect to all other U.S. income tax treaties listed in the Appendix for taxable years beginning after December 31, 2002.

4. EFFECT ON OTHER DOCUMENTS

Notice 2011-64 is amplified and superseded.

5. DRAFTING INFORMATION

The principal author of this notice is Sarah Stein of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Sarah Stein at (202) 317-4917 (not a toll-free call)

APPENDIX

U.S. INCOME TAX TREATIES SATISFYING THE REQUIREMENTS OF SECTION 1(h)(11)(C)(i)(II)

Australia	France	Luxembourg	Spain
Austria	Germany	Malta	Sri Lanka
Bangladesh	Greece	Mexico	Sweden
Bulgaria	Iceland	Morocco	Switzerland
Barbados	India	Netherlands	Thailand
Belgium	Indonesia	New Zealand	Trinidad and Tobago
Canada	Ireland	Norway	Tunisia
Chile	Israel	Pakistan	Turkey
China	Italy	Philippines	Ukraine
Cyprus	Jamaica	Poland	United Kingdom
Czech Republic	Japan	Portugal	Venezuela
Denmark	Kazakhstan	Romania	

Egypt	Korea	Slovak Republic
Estonia	Latvia	Slovenia
Finland	Lithuania	South Africa

END OF DOCUMENT -

Notices

Notice 2024-16, 2024-5 IRB 622, 12/28/2023, IRC Sec(s). 961

Basis of stock in controlled foreign corps.—adjustments—liquidations and asset reorgs.

Headnote:

IRS announced that it intends to issue "additional" prop regs regarding Code Sec. 961(c); basis in certain covered inbound transactions, in which domestic corp. acquires CFC stock in certain Code Sec. 332; liquidations or Code Sec. 368(a)(1); asset reorgs. Additional prop regs are expected to provide that in case of covered inbound transaction, domestic acquiring corp.'s adjusted basis of stock of acquired CFC determined under Code Sec. 334(b); or Code Sec. 362(b); is determined as if transferor CFC's Code Sec. 961(c); basis were adjusted basis (but subject to limitations). Taxpayers may rely on rules described in section 3 of this notice for covered inbound transactions completed on or before date that forthcoming additional prop regs are published in federal register. Also, before applying section 3 rules, taxpayers which maintained Code Sec. 961(c); basis in currency other than U.S. dollar must translate same into U.S. dollar under reasonable method, consistently applied to all acquired CFCs in any covered inbound transaction undertaken by one or more domestic acquiring corps. Comments are requested by 2/26/2024.

Reference(s): Code Sec. 961;

Full Text:

Guidance Related to Section 961 and Certain Inbound Nonrecognition Transactions

1. PURPOSE

This notice announces that the Department of the Treasury (the "Treasury Department") and the Internal Revenue Service (the "IRS") intend to issue proposed regulations addressing the treatment of basis provided under section 961(c) in certain transactions in which a domestic corporation acquires stock of a controlled foreign corporation (as defined in section 957(a), a "CFC") in a liquidation described in section 332 or an asset reorganization described in section 368(a)(1). [1] Section 2 of this notice provides background on section 961 and other relevant Code provisions. Section 3 of this notice describes the regulations that the Treasury Department and the IRS intend to issue. Section 4 of this notice permits taxpayers to rely on the rules described in section 3 of this notice. Section 5 of this notice requests comments and provides contact information.

2. BACKGROUND

Section 961(a) provides that, under regulations prescribed by the Secretary, the basis that a United States shareholder (as defined in section 951(b)) has in stock of a CFC, and the basis of property of a United States shareholder by reason of which the shareholder is considered under section 958(a)(2) as owning stock of a CFC, is increased by the amount required to be included in its gross income under section 951(a) with respect to such stock or with respect to such property, as the case may be, but only to the extent to which such amount was included in the gross income of such United States shareholder. Section 951A(f)(1) and §1.951A-5(b)(1) provide that an amount included in a United States shareholder's gross income as a GILTI inclusion amount is treated in the same manner as an amount included under section 951(a) for purposes of applying section 961.

Section 961(b) provides that, under regulations prescribed by the Secretary, the basis of stock or other property with respect to which a United States shareholder or a United States person receives an amount that is excluded from gross income under section 959(a) is reduced by the amount so excluded. Section 961(b)(1). To the extent that an amount excluded from gross income under section 959(a) exceeds the basis of the stock or other property with respect to which it is received, the amount is treated as gain from the sale or exchange of property. Section 961(b)(2).

Section 961(c) provides that, under regulations prescribed by the Secretary, if a United States shareholder is treated under section 958(a)(2) as owning stock in a CFC that is owned by another CFC, then adjustments similar to the adjustments provided by section 961(a) and (b) are made to the basis of such stock, and the basis of stock in any other CFC by reason of which the United States shareholder is considered under section 958(a)(2) as owning the stock of the first mentioned CFC, but only for the purpose of determining the amount included under section 951 in the gross income of such United States shareholder. Section 961(c) further provides that the adjustments described in section 961(c) do not apply with respect to any stock to which a basis adjustment applies under section 961(a) or (b).

Sections 1.961-1 and 1.961-2 implement sections 961(a) and (b), respectively. Those regulations were issued in 1965, before section 961(c) was enacted in 1997, and have not been modified since their issuance.[2]

In a transaction in which a domestic corporation ("domestic acquiring corporation") acquires all of the stock of a CFC ("acquired CFC") from another CFC ("transferor CFC") in a liquidation described in section 332 or an asset reorganization described in section 368(a)(1) ("inbound nonrecognition transaction"), the domestic acquiring corporation generally obtains a basis of the stock of the acquired CFC that is determined by reference to the basis of the stock in the hands of the transferor CFC pursuant to section 334(b) or 362(b), as applicable. Before such an inbound nonrecognition transaction, the transferor CFC may have increased the basis of the stock of the acquired CFC under section 961(c) (such basis, "section 961(c) basis"), but the section 961(c) basis in the stock of the acquired CFC would apply only for the purpose of determining an amount included under section 951 in the gross income of a United States shareholder.

A domestic acquiring corporation may recognize gain on a subsequent distribution of previously taxed earnings and profits ("PTEP") from the acquired CFC under section 961(b)(2) or recognize gain attributable to PTEP on a disposition of stock in the acquired CFC if the domestic acquiring corporation's adjusted basis[3] in the stock of the acquired CFC does not reflect the section 961(c) basis that the transferor CFC had in the stock of the acquired CFC before the inbound nonrecognition transaction. The Treasury Department and the IRS are of the view that, in certain cases, this result may prevent taxpayers from engaging in such transactions and would be inconsistent with one of the purposes of section 961, which is to prevent double taxation of the same CFC earnings.[4] Accordingly, pursuant to the grant of regulatory authority under section 961, the Treasury Department and the IRS intend to issue regulations described in section 3 of this notice.

3. REGULATIONS TO BE ISSUED

.01. *Treatment of section 961(c) basis in covered inbound transactions*

As announced in Notice 2019-1 (2019-2 I.R.B. 275), the Treasury Department and the IRS expect to issue proposed regulations providing substantially comprehensive rules under sections 959 and 961. This notice announces that the Treasury Department and the IRS expect to issue additional proposed regulations (the "forthcoming regulations") that will provide that, in the case of a covered inbound transaction, a domestic acquiring corporation's adjusted basis of the stock of an acquired CFC determined under section 334(b) or 362(b) is determined as if the transferor CFC's section 961(c) basis were adjusted basis. The transferor CFC's section 961(c) basis is taken into account for purposes of the preceding sentence, however, only to the extent the section 961(c) basis is with respect to a domestic corporation described in section 3.02(1) or (2) of this notice, as applicable (that is, the section 961(c) basis resulted from inclusions in gross income of the domestic corporation under section 951(a) or section 951A(a), or the section 961(c) basis was inherited by the domestic corporation under section 961(c)'s successor rules in an acquisition by the domestic corporation of stock of the transferor CFC from another person).

.02. *General definition of covered inbound transaction*

Under the forthcoming regulations, except as provided in section 3.03 or 3.04 of this notice, a covered inbound transaction would be defined, with respect to an acquired CFC, to mean the following transactions in which a domestic acquiring corporation acquires all of the stock of the acquired CFC from a transferor CFC that, immediately before the transaction and any related transactions, owns (directly or indirectly under section 958(a)(2)) all of the stock of the acquired CFC.

(1) Section 332 liquidation or upstream asset reorganization. A liquidation described in section 332, a reorganization described in section 368(a)(1)(A) (but not section 368(a)(2)(D) or 368(a)(2)(E)) ("nontriangular A reorganization"), or a reorganization described in section 368(a)(1)(C) (determined without regard to the parenthetical) ("nontriangular C reorganization"), in which all of the stock of the transferor CFC is owned directly by the domestic acquiring corporation immediately before the transaction.

(2) Other asset reorganization. A nontriangular A reorganization, a nontriangular C reorganization, a reorganization described in section 368(a)(1)(D) (that satisfies the requirements of section 354(b)(1)(A) and (B)), or a reorganization described in section 368(a)(1)(F), in which all of the stock of the transferor CFC is owned directly by a single domestic corporation (or by members of the same consolidated group) immediately before the transaction, and that same domestic corporation (or members of the same consolidated group) directly owns all of the stock of the domestic acquiring corporation immediately after the transaction and any related transactions.

.03. *De minimis rules for stock ownership*

A transaction otherwise described in section 3.02(1) or (2) of this notice would not fail to be a covered inbound transaction solely because, immediately before the transaction, one or more persons other than the domestic corporation (or members of a consolidated group, as applicable) described in section 3.02(1) or (2) of this notice own (in the aggregate) one percent or less of the total fair market value of the stock of the transferor CFC. Solely for purposes of determining whether a transaction is a covered inbound transaction, stock of the acquired CFC owned by one or more persons other than the transferor CFC immediately before the transaction and any related transactions that represents (in the aggregate) one percent or less of the total fair market value of the stock of the acquired CFC is disregarded, provided that any such person must continue to own its stock of the acquired CFC after the transaction and any related transactions if the person is not related (within the meaning of section 267(b) or 707(b)(1)) to a domestic corporation described in section 3.02(1) or (2) of this notice.

.04. *Limitations on the scope of covered inbound transactions*

(1) De minimis boot. In general, a reorganization would not be a covered inbound transaction if money or other property is received as described under section 356(a). However, a reorganization would not fail to be a covered inbound transaction if the amount of money or other property received as described under section 356(a) represents no more than one percent of the total fair market value of the stock of the transferor CFC.

(2) Loss in stock of acquired CFC. A transaction would not be a covered inbound transaction if, immediately before the covered inbound transaction, the total amount of the transferor CFC's basis in the stock of the acquired CFC (that is, the aggregate amount of adjusted basis and section 961(c) basis) exceeds the total fair market value of such stock of the acquired CFC.

(3) Transfers described in section 368(a)(2)(C) or §1.368-2(k)(1). A transaction would not be a covered inbound transaction if stock of the acquired CFC is transferred pursuant to section 368(a)(2)(C) or §1.368-2(k)(1), unless the transferee is (i) a member of the same consolidated group that includes the domestic acquiring corporation and wholly owned by one or more members of that same consolidated group, or (ii) the common parent of that consolidated group.

(4) Other subsequent transfers. A transaction would not be a covered inbound transaction if, pursuant to a plan (or series of related transactions), stock of the acquired CFC is transferred to a partnership or foreign corporation in connection with a covered inbound transaction. A plan to transfer the stock of the acquired CFC would be deemed to exist if stock of the acquired CFC is subsequently transferred to a partnership or a foreign corporation within the two-year period beginning at the time the covered inbound transaction is completed.

(5) Certain types of domestic acquiring corporations. A transaction would not be a covered inbound transaction if the domestic acquiring corporation is a regulated investment company

as defined in section 851, a real estate investment trust as defined in section 856, or an S corporation as defined in section 1361.

If the stock of multiple acquired CFCs is transferred by a single transferor CFC in a transaction described in section 3.02 of this notice, the limitations in sections 3.04(2), 3.04(3), and 3.04(4) of this notice apply separately with respect to each acquired CFC.

4. RELIANCE ON RULES DESCRIBED IN THIS NOTICE

A taxpayer may rely on the rules described in section 3 of this notice for transactions completed on or before the date proposed regulations governing the basis consequences of covered inbound transactions are published in the Federal Register, provided the taxpayer and its related parties (within the meaning of sections 267(b) and 707(b)(1)) follow the rules in their entirety and in a consistent manner.

No inference is intended with regard to the treatment of section 961(c) basis as a result of transactions other than covered inbound transactions. The Treasury Department and the IRS will consider in future guidance the extent to which basis provided under section 961(c) in stock of a CFC may be taken into account as adjusted basis by a domestic corporation that acquires stock of the CFC in a transaction other than a covered inbound transaction.

A taxpayer relying on this notice that has maintained section 961(c) basis in a currency that is not the U.S. dollar must, before applying the rules described in section 3 of this notice, translate section 961(c) basis into U.S. dollars, under a reasonable method consistently applied to all acquired CFCs in any covered inbound transaction undertaken by one or more domestic acquiring corporations. For this purpose, a reasonable method must use an exchange rate that reflects the original U.S. dollar inclusion amounts of the United States shareholder that gave rise to the section 961(c) basis, reduced as appropriate, including to take into account distributions of PTEP on such stock. Moreover, distributions of PTEP are treated as reducing the section 961(c) basis as so translated by the U.S. dollar basis of the PTEP.

5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS request comments on all aspects of this notice, including whether the rules described in section 3 of this notice should apply to transactions other than covered inbound transactions and whether additional limitations should apply in those cases.

Comments should be submitted by February 26, 2024. Comments may be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2024-16 in the search field on the regulations.gov homepage to find this notice and submit comments). Alternatively, comments may be submitted by mail to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2024-16), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket.

The principal authors of this notice are Karen Li and Brady Plastaras of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Ms. Li or Mr. Plastaras at (202) 317-6937 (not a toll-free number).

---

1 Unless otherwise specified, all "section" or "§" references are to sections of the Internal Revenue Code (the "Code") or the Income Tax Regulations (26 CFR part 1).

2 *See* TD 6850 , 30 Fed. Reg. 11854 (1965). Section 961(c) was added to the Code by the Taxpayer Relief Act of 1997, Pub. L. No. 150-34 § 1112(b) , 111 Stat. 788, 969 (1997).

3 For purposes of this notice, the term "adjusted basis" does not include section 961(c) basis.

4 *See* H.R. Rep. No. 1447 at A106 (1962) ("To prevent doubling up of tax where stock in a controlled foreign corporation is sold at a gain which reflects the retained earnings already taxed to United States persons, the basis of stock would be adjusted.").

END OF DOCUMENT -

Notices

Notice 2024-19, 2024-5 IRB 627, 01/11/2024, IRC Sec(s). 6722

Penalties for failure to furnish correct payee statements—partnerships—sales or exchanges—unrealized receivables and inventory items.

Headnote:

IRS announced that it's providing relief from Code Sec. 6722; payee statement penalties regarding certain Code Sec. 751(a); exchanges (as described herein) during calendar year 2023. Specifically, IRS states that it won't impose Code Sec. 6722; penalties in respect to said exchanges solely due to failure to furnish Part IV of Form 8308 by Reg § 1.6050K-1(c)(1) due date if partnership (1) timely and correctly furnishes to transferor and transferee copy of Parts I, II, and III of Form 8308, or statement that includes same information, by later of 1/31/2024 or 30 days after partnership is notified of Code Sec. 751(a); exchange, and (2) furnishes to transferor and transferee copy of complete Form 8308 that includes Part IV, or statement that includes same information and any additional information required under Reg § 1.6050K-1(c) , by later of Form 1065 due date, including extensions, or 30 days after partnership is notified of Code Sec. 751(a); exchange. Taxpayers are cautioned that this relief applies only with respect to furnishing correct payee statements to transferor and transferee; it doesn't apply to filing Form 8308 as attachment to partnership's Form 1065 (doesn't provide relief from Code Sec. 6721; penalties for failure to file correct information returns).

Reference(s): Code Sec. 6722; Code Sec. 751; Code Sec. 6050K;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Additional Time for Partnerships to Provide Complete Forms 8308 for Section 751(a) Exchanges Occurring in Calendar Year 2023

I. PURPOSE

This notice provides relief from penalties under § 6722 of the Internal Revenue Code[1] for failures to furnish correct payee statements solely for failure of a partnership with unrealized receivables or inventory items described in § 751(a) (§ 751 property) to furnish Part IV of Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, to the transferor and transferee in a § 751(a) exchange (described in section II of this notice) that occurred in calendar year 2023 by the due date specified in § 1.6050K-1(c)(1). This relief applies only if the partnership furnishes to the transferor and transferee by the due dates specified in section III of this notice (1) a correct copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, and (2) a correct copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under § 1.6050K-1(c).

II. BACKGROUND

Generally, § 6050K and § 1.6050K-1 require a partnership with § 751 property to provide information to each transferor and transferee that are parties to a sale or exchange of an interest in the partnership (or portion thereof) in which any money or other property received by a transferor from a transferee in exchange for all or part of the transferor's interest in the partnership is attributable to § 751 property (§ 751(a) exchange). Section 1.6050K-1(a)(2) provides that partnerships are required to report each § 751(a) exchange on Form 8308. Generally, § 1.6050K-1(f)(1) provides that a partnership is required to file Form 8308 as an attachment to its Form 1065, *U.S. Return of Partnership Income*, for the taxable year of the partnership that includes the last day of the calendar year in which the § 751(a) exchange took place. Form 8308 is due at the time for filing the partnership return, including extensions.

In addition, § 1.6050K-1(c)(1) provides that each partnership that is required to file a Form 8308 must furnish a statement to the transferor and transferee by the later of (a) January 31 of the year following the calendar year in which the § 751(a) exchange occurred, or (b) 30 days after the partnership has received notice of the exchange as specified under § 6050K and § 1.6050K-1. A partnership must use a copy of the completed Form 8308 as the required statement unless the Form 8308 contains information for more than one § 751(a) exchange. Section 1.6050K-1(c)(1) provides that if the partnership does not use the Form 8308 as the required statement, the partnership must furnish a statement that includes the information required to be shown on the Form 8308 with respect to the § 751(a) exchange to which the person to whom the statement is furnished is a party.

Section 6722 imposes a penalty for failure to furnish correct payee statements on or before the required date, and for any failure to include all of the information required to be shown on the statement or the inclusion of incorrect information. For these purposes, payee statements include statements required to be furnished to transferors and transferees under § 6050K. *See* § 6724(d)(2)(P). Section 6724 provides an exception to the imposition of a penalty under § 6722 if it is shown that the failure is due to reasonable cause and not to willful neglect.

On November 30, 2020, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published T.D. 9926 , 85 FR 76910, which amended § 1.6050K-1(c)(2) to require a partnership to furnish to a transferor partner the information necessary for the transferor to make the transferor partner's required statement in § 1.751-1(a)(3). Among other items, § 1.751-1(a)(3) requires a transferor partner in a § 751(a) exchange to submit with the transferor partner's income tax return a statement setting forth the amount of gain or loss attributable to § 751 property. In October 2023, the IRS released a revised version of Form 8308. Consistent with the requirements in § 1.6050K-1(c)(2), new Part IV of the 2023 Form 8308 requires a partnership to report, among other items, the partnership's and the transferor partner's share of § 751 gain and loss, collectibles gain under § 1(h)(5), and unrecaptured § 1250 gain under § 1(h)(6).

Since the issuance of the revised Form 8308, concerns have been expressed to the Treasury Department and the IRS that many partnerships will be unable to furnish the information required in Part IV of the 2023 Form 8308 to transferors and transferees by the January 31, 2024 due date, because, in many cases, partnerships will not have all of the information required by Part IV of the 2023 Form 8308 by January 31, 2024.

III. GRANT OF RELIEF

With respect to § 751(a) exchanges during calendar year 2023, the IRS will not impose penalties under § 6722 solely for failure to furnish Form 8308 with a completed Part IV by the due date specified in § 1.6050K-1(c)(1) for a partnership that (1) timely and correctly furnishes to the transferor and transferee a copy of Parts I, II, and III of Form 8308, or a statement that includes the same information, by the later of (a) January 31, 2024, or (b) 30 days after the partnership is notified of the § 751(a) exchange, and (2) furnishes to the transferor and transferee a copy of the complete Form 8308, including Part IV, or a statement that includes the same information and any additional information required under § 1.6050K-1(c), by the later of (a) the due date of the partnership's Form 1065 (including extensions), or (b) 30 days after the partnership is notified of the § 751(a) exchange.

The relief provided in this notice applies only with respect to furnishing Form 8308 to the transferor and transferee. This notice does not provide relief with respect to filing Form 8308 as an attachment to a partnership's Form 1065; as such, this notice does not provide relief from penalties under § 6721 for failure to file correct information returns.

IV. DRAFTING INFORMATION

The principal authors of this notice are Jeremy M. Brown and Benjamin H. Weaver of the Office of Associate Chief Counsel (Partnerships and Special Industries). Other personnel from the Treasury Department and IRS participated in its development. For further information please call (202) 317-5279 (not a toll-free number).

---

1 Unless otherwise specified, all “section” or “§” references are to sections of the Internal Revenue Code or to the Income Tax Regulations (26 CFR part 1).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2024
Notice 2024-31, 2024-15 IRB 869 -- IRC Sec(s). 911, 03/20/2024

Notices

Notice 2024-31, 2024-15 IRB 869, 03/20/2024, IRC Sec(s). 911

U.S. taxpayers living abroad—income exclusions—foreign housing costs.

Headnote:

For purposes of foreign housing cost income exclusion under Code Sec. 911(a); , IRS provided table which identifies locations in countries with high housing costs compared to U.S. and sets out adjusted limitation on housing expenses for qualified individuals incurring expenses in listed locations in 2024. Without adjustment, applicable limit for 2024 tax year is $37,950. Also, if adjusted limitation is higher for 2023 tax year than adjusted limitation provided in Notice 2023-26 , 2023-13 IRB 577 , qualified taxpayers may apply applicable adjusted limitation for 2024 to their 2023 tax year. Notice 2023-26 , 2023-13 IRB 577 is superseded.

Reference(s): Code Sec. 911;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Determination of Housing Cost Amounts Eligible for Exclusion or Deduction for 2024

1. PURPOSE

This notice provides adjustments to the limitation on housing expenses for purposes of section 911 of the Internal Revenue Code for specific locations for 2024. These adjustments are based on geographic differences in housing costs relative to housing costs in the United States.

2. BACKGROUND

Section 911 allows a qualified individual to elect to exclude from gross income the foreign earned income and to exclude or deduct the housing cost amount of such individual.

The term "housing cost amount" is generally the total of the housing expenses for the taxable year minus a base housing amount. See § 911(c)(1). For this purpose, the base housing amount for the taxable year is limited to an amount that is tied to the maximum foreign earned income exclusion amount of the qualified individual, which is $126,500 for 2024. See § 911(c)(1)(B). Specifically, the base housing amount is 16 percent of the maximum foreign earned income exclusion amount (computed on a daily basis), multiplied by the number of days in the applicable period that fall within the taxable year. Assuming that the entire taxable year of a qualified individual is within the applicable period, the base housing amount for 2024 is $20,240 ($126,500 x .16).

Similarly, the housing expense amount is also limited, based on a percentage of the maximum foreign earned income exclusion amount. Specifically, the limit on such housing expenses generally equals 30 percent of the maximum foreign earned income exclusion amount (computed on a daily basis), multiplied by the number of days in the applicable period for which the taxpayer is a qualified individual. See § 911(c)(2)(A) and (d)(1). Thus, under this general limitation, a qualified individual whose entire taxable year is within the applicable period is limited to maximum housing expenses of $37,950 ($126,500 x .30) for 2024. However, section 911(c)(2)(B) authorizes the Secretary to issue regulations or other guidance to adjust the percentage under section 911(c)(2)(A)(i) (which determines the limit on housing expenses) based on geographic differences in housing costs relative to housing costs in the United States. Pursuant to this authority, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) have published annual notices concerning the limitation on the section 911 housing cost amounts since the 2006 taxable year.

For more background on the foreign housing exclusion, see https://www.irs.gov/individuals/international-taxpayers/foreign-housing-exclusion-or-deduction.

3. TABLE OF ADJUSTED HOUSING LIMITATIONS FOR 2024

The following table provides adjusted limitations on housing expenses (in lieu of the otherwise applicable limitation of $37,950) for 2024. All amounts are in U.S. dollars.

Country	Location	Limitation on Housing Expenses (full year)	Limitation on Housing Expenses (daily/366 days)
Angola	Luanda	84,000	229.51
Argentina	Buenos Aires	56,500	154.37
Australia	Melbourne	41,500	113.39
Australia	Sydney	67,000	183.06
Bahamas, The	Nassau	49,700	135.79
Bahrain	Bahrain	48,300	131.97
Belgium	Brussels	40,000	109.29
Bermuda	Bermuda	90,000	245.90
Brazil	Sao Paulo	56,600	154.64
Canada	Calgary	39,500	107.92
Canada	Montreal	54,000	147.54
Canada	Ottawa	48,100	131.42
Canada	Toronto	61,900	169.13
Canada	Vancouver	61,000	166.67
Canada	Victoria	42,200	115.30
Cayman Islands	Grand Cayman	48,000	131.15
China	Beijing	68,000	185.79
China	Hong Kong	114,300	312.30
China	Shanghai	57,001	155.74
Colombia	Bogota	58,700	160.38
Colombia	All cities other than Bogota	49,400	134.97
Democratic Republic of the Congo	Kinshasa	42,000	114.75
Denmark	Copenhagen	43,704	119.41
Dominican Republic	Santo Domingo	45,500	124.32
Ecuador	Quito	38,200	104.37
Estonia	Tallinn	46,600	127.32
France	Garches	68,600	187.43

France	Paris	68,600	187.43
France	Sevres	68,600	187.43
France	Suresnes	68,600	187.43
France	Versailles	68,600	187.43
Germany	Berlin	41,100	112.30
Germany	Boeblingen	41,000	112.02
Germany	Bonn	42,000	114.75
Germany	Cologne	56,200	153.55
Germany	Gelnhausen	42,400	115.85
Germany	Hanau	42,400	115.85
Germany	Ingolstadt	48,100	131.42
Germany	Kaiserslautern and Landkreis	41,300	112.84
Germany	Ludwigsburg	41,000	112.02
Germany	Mainz	46,000	125.68
Germany	Munich	48,100	131.42
Germany	Nellingen	41,000	112.02
Germany	Pirmasens	41,300	112.84
Germany	Sembach	41,300	112.84
Germany	Stuttgart	41,000	112.02
Germany	Wahn	42,000	114.75
Germany	Wiesbaden	46,000	125.68
Germany	Zweibrucken	41,300	112.84
Guatemala	Guatemala City	42,000	114.75
Guinea	Conakry	51,300	140.16
Holy See, The	Holy See, The	45,700	124.86
India	Mumbai	67,920	185.57
India	New Delhi	56,124	153.34
Ireland	Dublin	39,700	108.47
Israel	Beer Sheva	54,800	149.73
Israel	Jerusalem	49,000	133.88
Israel	Tel Aviv	50,800	138.80
Israel	West Bank	49,000	133.88
Italy	Genoa	41,800	114.21
Italy	La Spezia	40,400	110.38
Italy	Milan	68,300	186.61
Italy	Naples	46,900	128.14
Italy	Rome	45,700	124.86
Italy	Vicenza	38,100	104.10
Jamaica	Kingston	41,200	112.57

Japan	Gifu	74,300	203.01
Japan	Komaki	74,300	203.01
Japan	Nagoya	74,300	203.01
Japan	Okinawa Prefecture	44,800	122.40
Japan	Osaka-Kobe	90,664	247.72
Japan	Tokyo	73,100	199.73
Japan	Yokohama	39,000	106.56
Japan	Yokosuka	42,000	114.75
Kazakhstan	Almaty	48,000	131.15
Korea	Camp Colbern	54,200	148.09
Korea	Camp Market	49,200	134.43
Korea	Camp Mercer	54,200	148.09
Korea	K-16	49,200	134.43
Korea	Kimpo Airfield	49,200	134.43
Korea	Seoul	49,200	134.43
Korea	Suwon	49,200	134.43
Kuwait	Kuwait City	64,400	175.96
Kuwait	All cities other than Kuwait City	57,700	157.65
Malaysia	Kuala Lumpur	46,200	126.23
Malta	Malta	55,100	150.55
Mexico	Mexico City	47,900	130.87
Mexico	All cities other than Ciudad Juarez, Cuernavaca, Guadalajara, Hermosillo, Matamoros, Mazatlan, Merida, Metapa, Mexico City, Monterrey, Nogales, Nuevo Laredo, Tijuana, and Veracruz 39,400 107.65 Mozambique Maputo	39,400	107.65
Mozambique	Maputo	39,500	107.92
Netherlands	Amsterdam	52,900	144.54
Netherlands	Aruba	39,300	107.38
Netherlands	Hague, The	54,500	148.91
Netherlands	Schiphol	52,900	144.54
Netherlands Antilles	Curacao	45,800	125.14
Oman	Muscat	41,300	112.84
Panama	Panama City	39,500	107.92
Peru	Lima	39,100	106.83
Poland	Warsaw	56,500	154.37
Portugal	Alverca	41,800	114.21
Portugal	Lisbon	41,800	114.21
Qatar	Doha	45,888	125.38
Romania	Bucharest	41,200	112.57

Russia	Moscow	108,000	295.08
Russia	Saint Petersburg	60,000	163.93
Saudi Arabia	Riyadh	40,000	109.29
Singapore	Singapore	84,100	229.78
Slovenia	Ljubljana	47,900	130.87
South Africa	Pretoria	39,300	107.38
Spain	Barcelona	40,600	110.93
Spain	Madrid	55,700	152.19
Switzerland	Bern	75,500	206.28
Switzerland	Geneva	107,400	293.44
Switzerland	Zurich	39,219	107.16
Taiwan	Taipei	46,188	126.20
Tanzania	Dar Es Salaam	44,000	120.22
Thailand	Bangkok	59,000	161.20
Trinidad and Tobago	Port of Spain	54,500	148.91
Ukraine	Kiev	72,000	196.72
United Arab Emirates	Abu Dhabi	49,687	135.76
United Arab Emirates	Dubai	57,174	156.21
United Kingdom	Basingstoke	41,099	112.29
United Kingdom	Bath	41,000	112.02
United Kingdom	Bracknell	62,100	169.67
United Kingdom	Caversham	73,800	201.64
United Kingdom	Cheltenham	47,300	129.23
United Kingdom	Farnborough	54,700	149.45
United Kingdom	Gibraltar	44,616	121.90
United Kingdom	Harrogate	43,200	118.03
United Kingdom	High Wycombe	62,100	169.67
United Kingdom	Lakenheath	44,300	121.04
United Kingdom	London	67,000	183.06
United Kingdom	Loudwater	54,300	148.36
United Kingdom	Menwith Hill	43,200	118.03
United Kingdom	Mildenhall	44,300	121.04
United Kingdom	Reading	62,100	169.67
United Kingdom	Southampton	44,200	120.77
United Kingdom	Surrey	48,402	132.25
Venezuela	Caracas	57,000	155.74
Vietnam	Hanoi	46,800	127.87

Vietnam	Ho Chi Minh City	42,000	114.75

4. OPTION TO APPLY 2024 ADJUSTED HOUSING LIMITATIONS TO 2023 TAXABLE YEAR

For some locations, the limitation on housing expenses provided in Section 3 of this notice may be higher than the limitation on housing expenses provided in the "Table of Adjusted Limitations for 2023" in Notice 2023-26, 2023-13 I.R.B. 577. A qualified individual incurring housing expenses in such a location during 2023 may apply the adjusted limitation on housing expenses provided in Section 3 of this notice for 2024 in lieu of the amounts provided in the "Table of Adjusted Limitations for 2023" in Notice 2023-26 (and as set forth in the Instructions to Form 2555, *Foreign Earned Income*, for 2023).

The Treasury Department and the IRS anticipate that future annual notices providing adjustments to housing expense limitations will make a similar option available to qualified individuals that incur housing expenses in the immediately preceding year. For example, when adjusted housing expense limitations for 2025 are issued, it is expected that taxpayers will be permitted to apply those adjusted limitations to the 2024 taxable year.

5. EFFECT ON OTHER DOCUMENTS

This notice supersedes Notice 2023-26, 2023-13 I.R.B. 577.

6. EFFECTIVE DATE

This notice is effective for taxable years beginning on or after January 1, 2024. However, as provided in Section 4, taxpayers may apply the 2024 adjusted housing limitations contained in Section 3 of this notice to taxable year beginning in 2023.

7. DRAFTING INFORMATION

The principal author of this notice is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Kate Y. Hwa at (202) 317-5001 (not a toll-free call).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Notices (1980 to Present)
2024
Notice 2024-44, 2024-25 IRB 1737 -- IRC Sec(s). 871; 1441, 05/22/2024

Notices

Notice 2024-44, 2024-25 IRB 1737, 05/22/2024, IRC Sec(s). 871

Tax on nonresident alien individuals—treatment of dividend equivalent payments.

Headnote:

IRS provided taxpayers with additional guidance for complying with final regs with respect to dividend equivalents under Code Sec. 871(m); , Code Sec. 1441; , Code Sec. 1461; , and Code Sec. 1473; in 2025, 2026 and 2027.

Reference(s): Code Sec. 871; Code Sec. 1441;

Full Text:

Extension of the Phase-in Period for the Enforcement and Administration of Section 871(m)

I. PURPOSE

This Notice provides taxpayers with additional guidance for complying with the final regulations with respect to dividend equivalents under sections 871(m), 1441, 1461, and 1473 of the Internal Revenue Code (the Code) (collectively referred to as the section 871(m) regulations) in 2025,[1] 2026, and 2027. Specifically, this Notice extends the transition relief provided in Notice 2022-37, 2022-37 I.R.B. 234, for two years, as described in more detail below. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to amend the section 871(m) regulations to delay the effective/applicability date of certain rules in those final regulations.

The anti-abuse rule provided in §1.871-15(o) will continue to apply during the phase-in years described in this Notice. As a result, a transaction that would not otherwise be treated as a section 871(m) transaction (including as a result of this Notice) may be a section 871(m) transaction under §1.871-15(o).[2]

II. BACKGROUND

On June 14, 2010, the Treasury Department and the IRS published Notice 2010-46, which addresses potential overwithholding in the context of securities lending and sale-repurchase agreements. Notice 2010-46 provides a two-part solution to the problem of overwithholding on a chain of dividends and dividend equivalents. First, it provides an exception from withholding for payments to a qualified securities lender (QSL). Second, it provides a proposed framework to credit forward prior withholding on a chain of substitute dividends paid pursuant to a chain of securities loans or stock repurchase agreements. The QSL regime requires a person that agrees to act as a QSL to comply with certain withholding and documentation requirements. The Treasury Department and the IRS permitted withholding agents to rely on transition rules described in Notice 2010-46, Part III, until guidance was developed that would include documentation and substantiation of withholding.

On September 18, 2015, the **Federal Register** published final regulations and temporary regulations (TD 9734 , 80 FR 56866) (2015 final regulations and 2015 temporary regulations, respectively). The 2015 final regulations finalized a portion of a 2013 notice of proposed rulemaking (78 FR 73128). The 2015 temporary regulations were based on comments received with respect to the 2013 notice of proposed rulemaking and were accompanied by a notice of proposed rulemaking cross-referencing the 2015 temporary regulations (80 FR 56415). The Treasury Department and the IRS stated in the preamble to the 2015 temporary regulations that the final qualified derivatives dealer ("QDD") regulations would supplant the proposed regulatory framework described in Notice 2010-46. 80 FR at 56878.

On July 18, 2016, the Treasury Department and the IRS published Notice 2016-42, 2016-29 I.R.B. 67, which contained the proposed qualified intermediary agreement (QI Agreement) that included provisions relating to the QDD regime and reiterated the intent to replace the proposed regulatory framework described in Notice 2010-46 with the QDD regime.

On December 19, 2016, the Treasury Department and the IRS published Notice 2016-76, which provided for the phased-in application of certain provisions of the section 871(m) regulations to allow for the orderly implementation of those final regulations and announced that taxpayers may continue to rely on Notice 2010-46 until January 1, 2018.

On January 17, 2017, the Treasury Department and the IRS published Revenue Procedure 2017-15, 2017-3 I.R.B. 437, which sets forth the final QI Agreement (2017 QI Agreement), including the requirements and obligations applicable to QDDs, and provided that taxpayers may continue to rely on Notice 2010-46 during 2017. The 2017 QI Agreement expired on December 31, 2022.

On January 24, 2017, the **Federal Register** published final regulations and temporary regulations (TD 9815 , 82 FR 8144) (2017 final regulations and 2017 temporary regulations, respectively, and together, the 2017 regulations). The 2017 final regulations finalized the 2015 notice of proposed rulemaking (80 FR 56415) that was issued in conjunction with the 2015 temporary regulations. On the same day, the **Federal Register** also published a notice of proposed rulemaking cross-referencing the 2017 temporary regulations (82 FR 8172), with correcting amendments published in the **Federal Register** on October 26, 2017 (82 FR 49508) (together, the 2017 proposed regulations).

The effective/applicability dates in the 2017 regulations reflect the phased-in application described in Notice 2016-76. See Treas. Reg. §1.871-15(r). Also, consistent with Notice 2016-76 and other announcements, the "Effect on Other Documents" section of the preamble to the 2017 regulations obsoleted Notice 2010-46 as of January 1, 2018. In response to a comment requesting that the QSL regime remain, the preamble to the 2017 regulations noted that "[w]hile the Treasury Department and the IRS understand that the QSL regime was administratively more convenient for taxpayers than the QI regime, it created administrability problems, particularly with respect to verification, for the IRS. That regime is being replaced by incorporating the QDD rules into the existing QI framework, including the specific rules for pooled reporting on Form 1042-S, and the QI requirements for compliance review and certification." 82 FR at 8153.

On August 21, 2017, the Treasury Department and the IRS published Notice 2017-42, 2017-34 I.R.B. 212, which extended certain transition relief.

On February 5, 2018, the Treasury Department and the IRS published Notice 2018-5, 2018-6 I.R.B. 341, which permitted withholding agents to apply the transition rules from Notice 2010-46 in 2018 and 2019.

On October 1, 2018, the Treasury Department and the IRS published Notice 2018-72, 2018-40 I.R.B. 522, which further extended certain transition relief and permitted withholding agents to apply the transition rules from Notice 2010-46 in 2020.

On December 17, 2019, the **Federal Register** published final regulations (TD 9887 , 84 FR 68790), which finalized the 2017 proposed regulations.

On January 13, 2020, the Treasury Department and the IRS published Notice 2020-2, 2020-3 I.R.B. 327, which extended the phase-in period described in Notice 2018-72 through 2022.

On September 12, 2022, the Treasury Department and the IRS published Notice 2022-37, 2022-37 I.R.B. 234, which extended the phase-in period described in Notice 2020-2 through 2024.

On December 27, 2022, the Treasury Department and the IRS published Revenue Procedure 2022-43, 2022-52 I.R.B. 570, which sets forth the new QI Agreement (2023 QI Agreement), including the requirements and obligations applicable to QDDs and the relevant transition rules for the phase-in period in Notice 2022-37 applicable to QDDs and to QIs acting as QSLs in 2023 and 2024.

This Notice further extends the phase-in period described in Notice 2022-37 through 2026.

The Treasury Department and the IRS continue to evaluate the section 871(m) regulations and will take into account comments already received, and welcome any additional comments regarding tax policy considerations, legal authority for, and the IRS administrative feasibility of any suggested modifications to the section 871(m) regulations. The Treasury Department and the IRS intend to provide sufficient time for taxpayers and withholding agents to implement any changes to the section 871(m) regulations.

III. EXTENSION OF THE PHASE-IN YEAR FOR DELTA-ONE AND NON-DELTA-ONE TRANSACTIONS

This section describes the extension to the phased-in application of the section 871(m) regulations to delta-one and non-delta-one transactions. This Notice does not apply to any transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(1) (providing that before January 1, 2017, a notional principal contract (NPC) is a specified NPC if certain factors are present).

The Treasury Department and the IRS have determined that it is appropriate for taxpayers and withholding agents to delay the implementation of certain provisions in the section 871(m) regulations for non-delta-one transactions, including transactions that are combined transactions under §1.871-15(n). Therefore, the Treasury Department and the IRS intend to revise the effective/applicability date for §1.871-15(d)(2) and (e) to provide that these rules will not apply to any payment made with respect to any non-delta-one transaction issued before January 1, 2027. As noted in Part I of this Notice, the anti-abuse rule continues to apply to the phased-in application of the section 871(m) regulations, including for the purpose of determining whether a transaction is a delta-one transaction.

Notice 2016-76 provided that the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations with respect to delta-one transactions in 2017 and non-delta-one transactions in 2018 when it enforces the section 871(m) regulations. As a result of extensions in Notice 2017-42, Notice 2018-72, Notice 2020-2, and Notice 2022-37 (together, the Prior Notices), the good faith effort standard applies to (1) any delta-one transaction in 2017 through 2024, and (2) any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e) in 2025. This Notice further extends the periods during which the enforcement standards provided by Notice 2022-37 will apply. Consistent with this extension, the IRS will take into account the extent to which the taxpayer or withholding agent made a good faith effort to comply with the section 871(m) regulations in enforcing the section 871(m) regulations for (1) any delta-one transaction in 2017 through 2026, and (2) any non-delta-one transaction that is a section 871(m) transaction pursuant to §1.871-15(d)(2) or (e) in 2027.

Similarly, for purposes of the IRS's enforcement and administration of the QDD rules in the section 871(m) regulations and the relevant provisions of the 2023 QI Agreement, this Notice extends through 2026 the period during which the IRS will take into account the extent to which the QDD made a good faith effort to comply with the section 871(m) regulations and the relevant provisions of the 2023 QI Agreement. In addition, the IRS will consider a QDD to satisfy the obligations that apply specifically to a QDD under its 2023 QI Agreement for years before 2027 provided that the QDD makes a good faith effort to comply with the relevant provisions of the 2023 QI Agreement, to the extent applicable to the QDD.

IV. EXTENSION OF THE SIMPLIFIED STANDARD FOR DETERMINING WHETHER TRANSACTIONS ARE COMBINED TRANSACTIONS

Notice 2016-76 and the Prior Notices provided a simplified standard for withholding agents to determine whether transactions are combined transactions entered into in 2017 through 2024. Specifically, a withholding agent is required to combine transactions entered into in those years for purposes of determining whether the transactions are section 871(m) transactions only when the transactions are over-the-counter transactions that are priced, marketed, or sold in connection with each other. Withholding agents are not required to combine any transactions that are listed securities entered into in those years.

This Notice further extends the period during which this simplified standard for combined transactions applies to include 2025 and 2026. Transactions that are entered into in 2017 through 2026 that are combined under this simplified standard will continue to be treated as combined transactions for future years and will not cease to be combined transactions as a result of applying §1.871-15(n) or disposing of less than all of the potential section 871(m) transactions that are combined under this rule. Transactions that are entered into in 2017 through 2026 that are not combined under this simplified standard will not become combined transactions as a result of applying §1.871-15(n) to these transactions in future years, unless a reissuance or other event causes the transactions to be retested to determine whether they are section 871(m) transactions. See §1.871-15(g)(2) (providing that the delta of a potential section 871(m) transaction generally is determined on the earlier of when the transaction is (1) priced or (2) issued); see also §1.871-15(a)(6) (defining the term "issue" to include "an issuance as a result of a deemed exchange pursuant to section 1001"). This simplified standard applies only to withholding agents and does not apply to taxpayers that are long parties to potential section 871(m) transactions. As noted in Part I of this Notice, the anti-abuse rule continues to apply to the phased-in application of the section 871(m) regulations, including for the purpose of determining whether multiple transactions should be combined.

V. EXTENSION OF PHASE-IN RELIEF FOR QUALIFIED DERIVATIVES DEALERS

Section 1.871-15T(q)(1) of the 2015 temporary regulations provided that when a QDD received a dividend or dividend equivalent payment and the QDD was contractually obligated to make an offsetting dividend equivalent payment on the same underlying security in an amount that was less than the dividend and dividend equivalent amount received, the QDD would be liable for tax under section 871(a) or section 881 for the difference. The 2015 final regulations provided that a withholding agent who made a payment of a dividend to a qualified intermediary acting as a QDD was not required to withhold on that payment if the withholding agent reliably associated the payment with a valid qualified intermediary withholding form containing a certification described in §1.1441-1(e)(3)(ii)(E). See §1.1441-1(b)(4)(xxii) of the 2015 final regulations.

Comments requested that the Treasury Department and the IRS adopt a different method of determining a QDD's tax liability. Those comments generally requested that this method be based on the QDD's net delta exposure for each underlying security. The Treasury Department and the IRS agreed that the net delta exposure method was an administrable and accurate method for a QDD to determine its residual exposure to underlying securities, and the 2017 final regulations adopted the net delta exposure method.

In adopting the net delta exposure method, the Treasury Department and the IRS were concerned that the exemption from withholding on dividends paid to a QDD, when combined with the net delta exposure method, could result in U.S. source dividends escaping U.S. tax completely in certain circumstances. Therefore, the 2017 final regulations revised §§1.871-15(q)(1) and 1.1441-1(b)(4)(xxii) to provide that a QDD remains liable for tax under section 881(a)(1) and subject to withholding under chapters 3 and 4 on dividends. However, to allow taxpayers time to implement the net delta exposure method, the 2017 QI Agreement and the 2017 final regulations provided that dividends and dividend equivalents received by a QDD in its equity derivatives dealer capacity in 2017 would not be subject to tax under section 881(a)(1) or subject to withholding under chapters 3 and 4.

The Prior Notices announced that the Treasury Department and the IRS intend to amend §§1.871-15(q)(1) and (r)(3), and 1.1441-1(b)(4)(xxii)(C) to provide that a QDD will not be subject to tax on dividends and dividend equivalents received in 2017 through 2024 in its equity derivatives dealer capacity or withholding on those dividends (including deemed dividends). This Notice announces that the Treasury Department and the IRS intend to amend those provisions to provide that a QDD will not be subject to tax on dividends and dividend equivalents received in 2025 and 2026 in its equity derivatives dealer capacity or withholding on those dividends (including deemed dividends) as well.

Section 4.01(1) of Rev. Proc. 2017-15 provided that a QDD would be required to compute its section 871(m) amount using the net delta exposure method beginning in 2018. The Prior Notices provided that a QDD would be required to compute its section 871(m) amount using the net delta exposure method beginning in 2025. The 2023 QI Agreement retains this rule in section 3.09(A). This Notice provides that a QDD will be required to compute its section 871(m) amount using the net delta exposure method beginning in 2027.

A QDD will remain liable for tax under section 881(a)(1) on dividends and dividend equivalents that it receives in any capacity other than as an equity derivatives dealer, and on any other U.S. source FDAP payments that it receives (whether or not in its equity derivatives dealer capacity). In addition, a QDD is responsible for withholding on dividend equivalents it pays to a foreign person on a section 871(m) transaction, whether acting in its capacity as an equity derivatives dealer or otherwise.

Finally, section 10.01(C) of the 2017 QI Agreement provided that: "For calendar year 2017, a QDD is not required to perform a periodic review with respect to its QDD activities (as otherwise required by section 10.04 of this Agreement) or provide the factual information specified in Appendix I." The Prior Notices provided that a QDD is not required to perform a periodic review with respect to its QDD activities for 2017 through 2024. Section 10.01(C) of the 2023 QI Agreement provides that: "For calendar years 2023 and 2024, a QDD is not required to perform a periodic review with respect to its QDD activities (as otherwise required by section 10.04 of this Agreement) or provide factual information in Appendix I with respect to its QDD activities." This Notice provides that a QDD is not required to perform a periodic review or provide factual information in Appendix I with respect to its QDD activities for 2025 or 2026. The Treasury Department and the IRS will consider incorporating into the 2023 QI Agreement the waiver of a QDD's periodic review and the other transitional provisions for QDDs for 2025 and 2026.

VI. EXTENSION OF TRANSITION RULES FROM NOTICE 2010-46

Notice 2018-5, Notice 2018-72, Notice 2020-2, and Notice 2022-37 provided that notwithstanding the preamble to the 2017 regulations, withholding agents may apply the QSL transition rules described in Notice 2010-46, Part III, for payments made in 2018 through 2024. This Notice provides that withholding agents may also apply the QSL transition rules described in Notice 2010-46, Part III, for payments made in 2025 and 2026.

VII. TAXPAYER RELIANCE

Before the promulgation of the amendments to the section 871(m) regulations or the issuance of other guidance, taxpayers and withholding agents (including QIs for purposes of the 2023 QI Agreement) may rely on the provisions of this Notice regarding the proposed amendments described in sections III and V. Withholding agents may rely on the simplified standard for determining whether transactions are combined transactions as described in section IV and may apply the QSL transition rules described in section VI.

VIII. DRAFTING INFORMATION

The principal authors of this Notice are Karen Walny and Peter Merkel of the Office of Associate Chief Counsel (International). For further information regarding this Notice, contact Karen Walny or Peter Merkel at (202) 317-6938 (not a toll-free call).

---

1 Unless otherwise provided, all references to years refer to calendar years.

2 The terms used in this Notice have the meanings provided in the section 871(m) regulations.

END OF DOCUMENT -

Notices

Notice 2024-54, , 06/17/2024, IRC Sec(s). 732

Partnerships—related-party transactions; basis shifting; tax avoidance—compliance—organization of IRS.

Headnote:

IRS announced its intention to publish 2 sets of prop regs addressing certain basis shifting transactions involving partnerships and related parties. First set of prop regs, Proposed Related-Party Basis Adjustment Regulations under Code Sec. 732; , Code Sec. 734(b); , Code Sec. 743(b); , and Code Sec. 755; , would provide rules and requirements regarding 1) method of recovering adjustments to bases of property held by partnership, property distributed by partnership, or both, arising from covered transactions as described herein; (2) determination of gain or loss on disposition of such basis-adjusted property; and (3) tax-indifferent parties. Second set of prop regs, Proposed Consolidated Return Regulations under Code Sec. 1502; , would provide for single-entity treatment of members that are partners in a partnership such that covered transactions couldn't shift basis among group members and distort group income. IRS requests written comments by 7/17/2024.

Reference(s): Code Sec. 732; Code Sec. 734; Code Sec. 743; Code Sec. 1502;

Full Text:

Part III - Administrative, Procedural, and Miscellaneous

Forthcoming Guidance Regarding Certain Partnership Related-Party Transactions

1. PURPOSE

.01. This notice announces that the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) intend to publish two sets of forthcoming proposed regulations that would address certain basis-shifting transactions involving partnerships and related parties. These transactions, referred to as "covered transactions" in this notice, (1) involve partners in a partnership and their related parties, (2) result in increases to the basis of property under § 732, § 734(b), or § 743(b) of the Internal Revenue Code (Code),[1] and (3) generate increased cost recovery allowances or reduced gain (or increased loss) upon the sale or other disposition of the basis-adjusted property.

First, the Treasury Department and the IRS intend to propose regulations under §§ 732, 734(b), 743(b) and 755 (forthcoming Proposed Related-Party Basis Adjustment Regulations) that would (1) provide the required method of recovering adjustments to the bases of property held by a partnership, property distributed by a partnership, or both, arising from the covered transactions described in section 3 of this notice, (2) provide rules governing the determination of gain or loss on the disposition of such basis-adjusted property, and (3) include similar transactions involving tax-indifferent parties (for example, certain foreign persons, a tax-exempt organization, or a party with tax attributes that make it tax-indifferent) rather than related parties.

Second, the Treasury Department and the IRS intend to propose regulations under § 1502 (forthcoming Proposed Consolidated Return Regulations) to clearly reflect the taxable income and tax liability of a consolidated group (as defined in § 1.1502-1(h)) whose members own interests in a partnership. More specifically, the Treasury Department and the IRS anticipate that the forthcoming Proposed Consolidated Return Regulations would provide for single-entity treatment of members that are partners in a partnership, so that covered transactions cannot shift basis among group members and distort group income.

.02. Section 2 of this notice provides a summary of relevant law. Section 3 of this notice provides an overview of the need for the forthcoming proposed regulations[2] and a description of the covered transactions. Sections 4 and 5 of this notice describe the forthcoming Proposed Related-Party Basis Adjustment Regulations and the forthcoming Proposed Consolidated Return Regulations, respectively. Section 6 of this notice describes the proposed applicability dates of the forthcoming proposed regulations. Section 7 of this notice contains a request for comments.

2. BACKGROUND

.01. Basis adjustments under subchapter K

(1) In general. Under subchapter K of chapter 1 of the Code (subchapter K), a distribution by a partnership of the partnership's property (partnership property) or a transfer of an interest in a partnership (partnership interest) may result in an adjustment to the basis of the distributed property, partnership property, or both.

A distribution of partnership property may result in an adjustment to the basis of the distributed property under § 732(a), (b), or (d). In the case of a distribution of partnership property to a partner by a partnership with an election under § 754 (§ 754 election) in effect, or with respect to which there is a substantial basis reduction as described in § 734(d), the distribution may also result in an adjustment to the basis of the partnership's remaining partnership property under § 734(b).

If a partnership interest is transferred by sale or exchange or on the death of a partner, and the partnership either has a § 754 election in effect or has a substantial built-in loss with respect to the transfer of the partnership interest as described in § 743(d), the transfer may result in an adjustment to the basis of partnership property under § 743(b) with respect to the transferee partner.

Section 754 provides that if a partnership makes an election in accordance with regulations prescribed by the Secretary of the Treasury or her delegate (Secretary), the basis of partnership property shall be adjusted, in the case of a distribution of property, in the manner provided in § 734, and in the case of a transfer of a partnership interest, in the manner provided in § 743. Unless the election is revoked in accordance with the regulations under § 754, the § 754 election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent taxable years.

(2) Basis adjustments under § 732. Section 732 governs a distributee partner's basis in distributed property other than money. In the case of a current distribution, and except as provided under § 732(a)(2), § 732(a)(1) provides that the distributee partner's basis in distributed property (other than money) is equal to the partnership's adjusted basis in the distributed property immediately before the distribution. Under § 732(a)(2), however, a distributee partner's basis in distributed property is limited to the adjusted basis of the distributee partner's partnership interest reduced by any money distributed to such partner in the same transaction.

In the case of a liquidating distribution, § 732(b) provides that the distributee partner's basis in distributed property (other than money) is equal to the adjusted basis of the distributee partner's partnership interest reduced by any money distributed to such partner in the same transaction.

In the case of a distribution of more than one property from a partnership, the basis of the distributed properties to which § 732(a)(2) and (b) apply must be allocated among the distributed properties under the rules of § 732(c) and the regulations thereunder.

(3) Basis adjustments under § 734. In the case of a distribution of property by a partnership with a § 754 election in effect, and for which either the distributee partner recognizes gain or loss on the distribution, or for which the basis of the distributed property in the distributee partner's hands, as determined under § 732, differs from the partnership's adjusted basis in the distributed property immediately before the distribution, § 734(b) requires the partnership to increase or decrease (as applicable) the basis of its remaining partnership property. Also, in the case of a distribution of property by a partnership that results in a substantial basis reduction under § 734(d), the basis of remaining partnership property must be adjusted under § 734(b), even if the partnership does not have a § 754 election in effect.

Section 734(b)(1) requires a partnership to increase the basis of its remaining property if a distribution of property by the partnership results in the distributee partner recognizing gain under § 731(a)(1), or if property (other than money) to which § 732(a)(2) or (b) applies is distributed to the distributee partner and the property's adjusted basis to the partnership immediately before the distribution is greater than the distributee partner's basis in the distributed property as determined under § 732. Section 731(a)(1) requires a distributee partner to recognize gain in a current or liquidating distribution to the extent that any money distributed to that partner in the distribution exceeds the adjusted basis of that partner's partnership interest immediately before the distribution. The amount of the basis increase to the partnership's remaining property under § 734(b)(1) following a distribution of partnership property to a partner is equal to the amount of gain recognized by the distributee partner in the distribution under § 731(a)(1) and the excess of the partnership's adjusted basis in the distributed property immediately before the distribution over the distributee partner's basis in the distributed property as determined under § 732.

Section 734(b)(2) requires a partnership to decrease the basis of its remaining property if a distribution of property by the partnership results in the distributee partner recognizing loss under § 731(a)(2), or if property (other than money) to which § 732(b) applies is distributed to the distributee partner in a distribution and the property's adjusted basis to the partnership immediately before the distribution is less than the distributee partner's basis in the distributed property as determined under § 732. Under § 731(a)(2), a distributee partner may recognize a loss in a liquidating distribution of that partner's interest in the partnership to the extent that such partner received only money, unrealized receivables described in § 751(c), or inventory items described in § 751(d) in the distribution. In such a case, the distributee partner is required to recognize a loss to the extent that such partner's adjusted basis in the partnership interest exceeds the sum of any money distributed to that partner in the distribution and the basis to the distributee partner (determined under § 732) of any unrealized receivables or inventory received by that partner in the distribution. The amount of the basis decrease to the partnership's remaining property under § 734(b)(2) following a distribution of partnership property to a partner is equal to the amount of loss recognized by the distributee partner in the distribution under § 731(a)(2) and the excess of the distributee partner's basis in the distributed property as determined under § 732 over the partnership's adjusted basis in the distributed property immediately before the distribution.

A partnership without a § 754 election in effect is subject to a mandatory basis adjustment under § 734(b)(2) if there is a substantial basis reduction with respect to a distribution of partnership property. Under § 734(d), a substantial basis reduction with respect to a distribution of partnership property occurs if the sum of the amount of loss recognized to the distributee partner on the distribution, plus any increase in basis in the distributed property to the distributee partner under § 732(b), exceeds $250,000.

(4) Basis adjustments under § 743(b). Generally, if a partnership interest is transferred in a sale or exchange or on the death of a partner, the transferee partner's basis in the transferred partnership interest is determined under § 742 and the basis of partnership property is determined under § 743(a). Section 742 provides that the transferee partner's basis in a partnership interest acquired other than by contribution is determined under part II of subchapter O of chapter 1 of the Code, beginning at § 1011 and following. Thus, for example, a transferee partner's basis in a partnership interest acquired by purchase generally is cost basis under § 1012.

Section 743(a) provides that, in the case of a transfer of a partnership interest by sale or exchange or on the death of a partner, the basis of partnership property is not adjusted unless either the partnership has a § 754 election in effect or the partnership has a substantial built-in loss with respect to the transfer of the partnership interest.

Under § 743(b), in the case of a transfer of a partnership interest by sale or exchange or on the death of a partner, a partnership with a § 754 election in effect or that has a substantial built-in loss with respect to the transfer of the partnership interest must increase or decrease (as applicable) the adjusted basis of partnership property with respect to the transferee partner.

Section 743(b)(1) provides that the adjusted basis of partnership property is increased by the excess of the transferee partner's basis in the transferred partnership interest over the transferee partner's proportionate share of the adjusted basis of partnership property.

Section 743(b)(2) provides that the adjusted basis of partnership property is decreased by the excess of the transferee partner's proportionate share of the adjusted basis of partnership property over the transferee partner's basis in the transferred partnership interest.

A partnership without a § 754 election is subject to a mandatory basis adjustment under § 743(b) with respect to a transfer of a partnership interest if the partnership has a substantial built-in loss with respect to the transfer of the partnership interest. Under § 743(d)(1), a partnership has a substantial built-in loss with respect to a transfer of an interest in the partnership if either the partnership's adjusted basis in its property exceeds the fair market value of such property by more than $250,000, or the transferee partner would be allocated a loss of more than $250,000 if the partnership assets were sold for cash equal to their fair market value immediately after the transfer.

Under regulations prescribed by the Secretary, a basis adjustment under § 743(b) is an adjustment to the basis of partnership property with respect to the transferee partner only. The transferee partner's proportionate share of the partnership's adjusted basis in its property generally is determined in accordance with the transferee partner's interest in the partnership's previously taxed capital (including the transferee partner's share of partnership liabilities) under regulations prescribed by the Secretary.

(5) Allocation of § 734(b) or § 743(b) basis adjustments. Section 734(c) states that a basis adjustment under § 734(b) is allocated among partnership properties under the rules of § 755. Section 743(c) states that a basis adjustment under § 743(b) is allocated among partnership properties under the rules of § 755.

Section 755(a) generally requires basis adjustments under § 734(b) or § 743(b) to be allocated in a manner that has the effect of reducing the difference between the fair market value and the adjusted basis of partnership properties or in any other manner permitted by regulations. In addition, § 755(b) requires these basis adjustments to be allocated to partnership property of a like character or to subsequently acquired partnership property of a like character if such property is not available or has insufficient basis at the time of the basis adjustment (because a decrease in the adjusted basis of the property would reduce the basis of such property below zero). Section 755(c) provides a special rule that prohibits allocating a basis decrease under § 734(b) to the stock of a corporation that is a partner of the partnership (or that is related to a partner of the partnership within the meaning of § 267(b) or § 707(b)(1)).

(6) Common terminology for bases with respect to a partnership interest. A partner's adjusted basis in its partnership interest commonly is referred to as the partner's "outside basis" in its partnership interest. A partnership's adjusted basis in its property commonly is referred to as the "inside basis" of the partnership's property. Each partner has a share of inside basis. For ease of explanation, this terminology is used in section 3 of this notice.

.02. Affiliated group of corporations filing a consolidated return. Section 1501 grants an affiliated group of corporations the privilege of making a consolidated return, in lieu of separate returns, for Federal income tax purposes. Section 1502 authorizes the Secretary to prescribe consolidated return regulations for an affiliated group of corporations that join in filing (or that are required to join in filing) a consolidated return (that is, a consolidated group as defined in § 1.1502-1(h)) to clearly reflect the Federal income tax liability of the consolidated group and to prevent avoidance of such tax liability (§ 1502 regulations). For purposes of carrying out those objectives, § 1502 also permits the Secretary to prescribe rules that may be different from the provisions of chapter 1 of the Code that would apply if the corporations composing the consolidated group filed separate returns. Terms used in the § 1502 regulations generally are defined in § 1.1502-1. The § 1502 regulations provide rules to clearly reflect the Federal income tax liability of both the consolidated group and each of its members. Therefore, these regulations reflect a mix of single- and separate-entity treatment. For example, the intercompany-transaction rules in § 1.1502-13(c) generally respect the existence of intercompany transactions between the separate members but recompute and redetermine the members' tax items from the transaction to produce the same effect on the group as if the transacting members were divisions of a single corporation.

.03. Basis-adjustment reporting for consolidated groups

Form 1120, *U.S. Corporation Income Tax Return*, includes a new question on Schedule K, Question 31, applicable to certain large, consolidated groups for any taxable year ending on or after December 31, 2023. This question asks consolidated groups with gross receipts or sales of $1 billion or more to report certain subchapter K basis adjustments, as described in the Instructions to the 2023 Form 1120 (released for public comment on December 20, 2023). The intent of this question is for taxpayers to identify certain related-party basis adjustment transactions that were entered into by members of the consolidated group in consolidated years ending on or after December 31, 2023.

3. COVERED TRANSACTIONS

.01. Overview of the need for the forthcoming proposed regulations.

The Treasury Department and the IRS are aware of related persons using partnerships to engage in transactions that inappropriately exploit the basis-adjustment provisions of subchapter K applicable to distributions of partnership property or transfers of partnership interests discussed in section 2 of this notice. This awareness results from the IRS's review of various partnership transactions involving related parties in which basis adjustments were created to artificially generate or regenerate Federal income tax benefits that resulted in significant tax savings without a corresponding economic outlay. These transactions were carefully structured to exploit the mechanical basis-adjustment provisions of subchapter K to produce significant tax benefits with little or no economic impact on the related parties, and in a manner that would not be a likely arrangement between partners negotiating at arm's-length.

Generally, in a covered transaction, partnership property is distributed to a partner who is related to one or more other partners, and that distribution results in a person related to the distributee partner, the distributee partner, or both, receiving all or a share of a basis increase in the distributed property or remaining partnership property under § 732 or § 734(b) (as applicable); alternatively, a partnership interest is transferred between related persons or to a transferee partner who is related to an existing partner in the partnership, and that transfer results in an increase to the inside basis in partnership property with respect to the transferee partner under § 743(b).

The covered transactions generally are structured so that, under the applicable allocation rules (§ § 732(c), 734(c), 743(c), and 755), the basis increase is allocated to property that is eligible for cost recovery allowances (or eligible for a shorter cost recovery period) or that the partnership or the distributee partner disposes of in a taxable sale or exchange. Accordingly, the basis increase results in related partners decreasing their overall taxable income through additional or accelerated cost recovery allowances or decreasing their taxable gain or increasing their taxable loss on the subsequent taxable disposition of the property subject to the basis increase.

The related partners receive these tax benefits directly in the case of a distribution of property in which the basis of the distributed property is increased in the distributee partner's hands under § 732(b) or § 732(d). They receive these benefits indirectly in the case of a transfer of a partnership interest in which the inside basis of partnership property is increased for the transferee partner under § 743(b) or in the case of a distribution of property that results in an increase to the common basis of partnership property under § 734(b). Whether the tax benefits are received directly or indirectly, the resulting decrease in taxable income or gain (or increase in taxable loss) benefits the related-party group as a whole. Further, because the partners are related, the distributions or transfers may have little or no effect on the overall economic ownership of the property yet produce significant tax benefits shared by the related partners.

A related partner's partnership interest must have certain characteristics to create the opportunity for a covered transaction. In general, these characteristics are (1) a partner's outside basis in its partnership interest that is low compared to the partnership's basis in property it distributes to such partner, (2) a partner's outside basis in its partnership interest that is high compared to such partner's share of the partnership's basis in the partnership property (that is, the partner's share of inside basis), or (3) a partner's outside basis in its partnership interest that is high compared to the partnership's basis in property it distributes to such partner in liquidation of the partner's interest. Partnerships with related parties can create these characteristics through orchestrated contributions and distributions, as well as allocations under § 704(b) and (c). In most commercial transactions involving unrelated parties, the opportunity for abuse is limited because each party has separate, and often competing, economic and tax interests, and the parties transact at arm's length. In contrast, for related parties, basis can be manipulated to provide a material net tax benefit to the related parties. Such basis shifting is contrary to congressional intent in enacting subchapter K. Congress intended that the provisions of subchapter K apply to transactions between partnerships and their partners to preserve parity between inside and outside basis "so as to prevent any unintended tax benefit or detriment to the partners." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954). Congress also expressed its desire to prevent related parties from exploiting the rules of subchapter K to avoid tax "through the realization of fictitious losses or increasing the basis of property for purposes of depreciation." H.R. Rep. No. 1337, at A226; S. Rep. No. 1622, at 386-87.

.02. Covered transactions under § 734(b).

In a covered transaction under § 734(b), a partnership with a § 754 election in effect and two or more partners that are related to each other makes a current or liquidating distribution of property to one or more of the related partners. Immediately before the distribution, the partnership's basis in the distributed partnership property exceeds the distributee partner's basis in its partnership interest (that is, the partnership distributes property with a relatively high inside basis to a distributee partner with a relatively low outside basis). Under § 732(a)(2) or (b), the low-outside basis partner takes a basis in the distributed property that is lower than the inside basis of the property immediately before the distribution.

As a result of the basis decrease to the distributed property in the hands of the distributee partner under § 732(a)(2) or (b), the partnership increases the basis of its remaining properties under § 734(b) by an amount equal to the excess of the partnership's basis in the distributed property immediately before the distribution over the basis of the distributed property in the hands of the distributee partner immediately after the distribution. Under § § 734(c) and 755, the partnership allocates this basis increase among remaining partnership properties.

.03. Covered transactions under § 743(b).

In a covered transaction under § 743(b), (1) a partner transfers an interest in a partnership that has a § 754 election in effect or a substantial built-in loss immediately after such transfer (2) to a related transferee or a transferee that is related to one or more of the partners (3) in a nonrecognition transaction within the meaning of § 7701(a)(45) in which the gain recognized, if any, and for which tax imposed by subtitle A of the Code (subtitle A) is required to be paid, is less than the aggregate amount of the increase(s) in the basis of partnership property with respect to the transferee partner under § § 743(b) and 755.

In order for the transfer to give rise to a basis adjustment under § 743(b), the transferee partner must have an inside-outside basis disparity with respect to its partnership interest so that the transferee partner's outside basis does not equal the transferee partner's share of inside basis. Because a § 754 election is in effect for the taxable year of the transfer or the partnership or a substantial built-in loss immediately after such transfer, a basis adjustment is made under § 743(b) or (d) to partnership property with respect to the transferee partner to eliminate the inside-outside basis disparity of the transferee partner. As a result of the transfer, the partnership allocates one or more basis increases to partnership property with respect to the transferee partner under § § 743(c) and 755.

.04. Covered transactions under § 732.

In a covered transaction under § 732, a partner (distributee partner) receives a liquidating distribution of property resulting in a basis increase in the distributed property under § 732(b) and (c), and either—

(1) The partnership liquidates and distributes the partnership's remaining partnership property to one or more parties related to the distributee partner (related distributee partner) resulting in a basis adjustment that reduces the basis (basis decrease) of such property to the related distributee partners under § 732(b) and (c), or

(2) The partnership continues, and a related party to the distributee partner is a continuing partner (related continuing partner) that has a share of the partnership's basis decrease under § 734(b) or (d) resulting from the liquidating distribution or would have had a share of the partnership's basis decrease under § 734(b) if the partnership had a § 754 election in effect.

4. FORTHCOMING PROPOSED RELATED-PARTY BASIS ADJUSTMENT REGULATIONS

.01. In general. The forthcoming Proposed Related-Party Basis Adjustment Regulations would provide special rules that would apply to the cost recovery of basis adjustments arising from the covered transactions described in section 3 of this notice, as well as rules that would govern whether and how a basis adjustment arising from a covered transaction would be taken into account upon the disposition of such basis-adjusted property. These proposed regulations would be mechanical rules applicable to all covered transactions without regard to the taxpayer's intent and without regard to whether the transactions could be abusive or lacking in economic substance. Additionally, these proposed regulations would apply only if, and to the extent that, property has been allocated a basis increase. If, and to the extent, property has been allocated a basis decrease, the proposed rules would not apply.

.02. Related persons; cost recovery. In general, for purposes of the forthcoming Proposed Related-Party Basis Adjustment Regulations, partners and other persons would be considered as related if they have a relationship described in § 267(b) (without regard to § 267(c)(3)) or § 707(b)(1) immediately before or immediately after a transaction. For purposes of the forthcoming Proposed Related-Party Basis Adjustment Regulations, the term " cost recovery" means an allowance for depreciation, amortization, or depletion under subtitle A.

.03. Related-party basis adjustments; cost recovery and disposition rules. Based on the authority provided in § § 482, 732, 734(b), 743(b), 755, and 7805, as well as the provisions of the Code that otherwise permit cost recovery allowances with respect to basis increases under subchapter K, the forthcoming Proposed Related-Party Basis Adjustment Regulations would provide that a basis increase allocated to property retained or distributed by a partnership following a covered transaction (related-party basis adjustment, or RPBA) would be subject to specific rules providing the required method of recovering the basis adjustment and the treatment of the basis adjustment upon the disposition of the property to which the adjustment applies.

.04. Treatment of basis adjustments resulting from covered transactions under § 734(b).

The forthcoming Proposed Related-Party Basis Adjustment Regulations would provide that an RPBA arising from a covered transaction described in section 3.02 of this notice (§ 734(b) RPBA) would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding distributed property that gave rise to such § 734(b) RPBA. In addition, the partnership would not be eligible to take the § 734(b) RPBA into account upon the sale or other disposition of partnership property to which a § 734(b) RPBA applies, subject to the rules described below. After a qualifying disposition of a corresponding distributed property, the basis adjustment would cease to be a § 734(b) RPBA. A qualifying disposition would mean a disposition of a corresponding distributed property to an unrelated person in an arm's-length transaction in which taxable gain or loss is fully recognized. Except as otherwise provided, if a basis adjustment ceases to be a § 734(b) RPBA, the remaining basis attributable to the former RPBA would be treated as giving rise to newly placed in service property that is subject to the cost recovery period and method of the property to which it was allocated, to the extent the property is eligible for cost recovery allowances, and the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property. These rules would not apply to the share of any § 734(b) basis adjustment of a partner that is unrelated to the distributee partner. For purposes of this rule, a partner's share of a basis adjustment under § 734(b) would be determined under principles similar to those in § 1.197-2(h)(12)(iv)(D).

If a partnership distributes to a partner property with respect to which there is a § 734(b) RPBA in place, the partner would take into account the § 734(b) RPBA in determining the basis of the property in the partner's hands and the partner's outside basis in the partnership, and the basis adjustment would remain a § 734(b) RPBA until the basis adjustment ceases to be a § 734(b) RPBA, as described above.

If a partnership disposes of property to which a § 734(b) RPBA applies (other than in a distribution to a partner) or a partner disposes of property to which a § 734(b) RPBA applies, the amount of the § 734(b) RPBA would be reallocated to other property of the partnership or the partner (under rules similar to the rules of § 1.755-1(c)) and would remain a § 734(b) RPBA. If the partnership or partner cannot reallocate a § 734(b) RPBA to any asset under the preceding sentence because the partnership or partner does not own property of a like character, the reallocation would be made when property of a like character is subsequently acquired.

.05. Treatment of basis adjustments resulting from covered transactions under § 743(b).

The forthcoming Proposed Related-Party Basis Adjustment Regulations would provide that an RPBA arising from a covered transaction described in section 3.03 of this notice (§ 743(b) RPBA) would be ineligible for cost recovery until the transferee partner becomes unrelated to both the transferor partner and to all existing partners as described below. In addition, the transferee partner would not be eligible to take the § 743(b) RPBA into account upon the sale or other disposition of partnership property to which a § 743(b) RPBA applies, subject to the rules described below. If a transferee partner that has a § 743(b) RPBA in place ceases to be related to both the transferor and all persons who were partners immediately before or immediately after the covered transaction, then the basis adjustment would cease to be a § 743(b) RPBA. Except as otherwise provided, if a basis adjustment ceases to be a § 743(b) RPBA, the basis attributable to the former RPBA would be treated as giving rise to newly placed in service property that is subject to the cost recovery period and method of the property to which it was allocated, to the extent the property is eligible for cost recovery allowances, and the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property.

If a partnership distributes to a transferee partner property with respect to which there is a § 743(b) RPBA in place, the transferee partner would take into account the § 743(b) RPBA in determining the basis of the property in the partner's hands as well as in determining the partner's outside basis in the partnership, and the basis adjustment would remain a § 743(b) RPBA until the basis adjustment ceases to be a § 743(b) RPBA, as described above. That is, the § 743(b) RPBA would be taken into account for purposes of applying § 732 but would remain ineligible for cost recovery and would not be used in computing gain or loss on the sale or disposition of the distributed property by the transferee partner.

If a partnership disposes of property to which a § 743(b) RPBA applies (other than in a distribution to the transferee partner) or a transferee partner disposes of property to which a § 743(b) RPBA applies, then the amount of the § 743(b) RPBA would be reallocated to other property (under rules similar to the rules of § 1.755-1(c)) and would remain a § 743(b) RPBA. If the partnership or transferee partner cannot reallocate a § 743(b) RPBA to any asset under the preceding sentence because the partnership or transferee partner does not own property of a like character, the reallocation would be made when property of a like character is subsequently acquired. If any gain is recognized in a covered transaction described in section 3.03 of this notice, and tax imposed by subtitle A is required to be paid on such gain, the portion of each basis increase attributable to the gain would not be treated as a § 743(b) RPBA.

.06. Treatment of basis adjustments resulting from covered transactions under § 732.

The forthcoming Proposed Related-Party Basis Adjustment Regulations would generally require that a basis increase to distributed property under § 732(b) and (c) be treated as a § 732 RPBA to the extent such increase corresponds to a basis decrease of a related partner (or the basis decrease a related partner would have had if the partnership had a § 754 election in effect). In the case of a covered transaction described in section 3.04(1) of this notice (complete liquidation of the partnership), if a partnership makes liquidating distributions to all partners, a basis increase under § 732(b) and (c) to property distributed to the distributee partner would be treated as one or more § 732 RPBAs to the extent of a basis decrease under § 732(b) and (c) to property distributed to a related distributee partner. In the case of a covered transaction described in section 3.04(2) of this notice (continuation of the partnership), if a partnership makes a liquidating distribution to one partner and there is a resulting basis decrease under § 734(b), including a basis decrease that is suspended under § 1.755-1(c)(4) (or there would have been if the partnership had a § 754 election in effect), a basis increase under § 732(b) and (c) to property distributed to the distributee partner would be treated as one or more § 732 RPBAs to the extent of a related continuing partner's share of a resulting basis decrease under § 734(b) (or the basis decrease under § 734(b) that would have resulted if the partnership had a § 754 election in effect).

The forthcoming Proposed Related-Party Basis Adjustment Regulations would require that a § 732 RPBA arising from a covered transaction described in section 3.04(1) of this notice resulting in a basis increase under § 732(b) and (c) to the property of the distributee partner would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which a related distributee partner reduced. In addition, the distributee partner would not be eligible to take the § 732 RPBA into account upon the sale or other disposition of the property to which the § 732 RPBA applies, subject to the rules described below. These rules would not apply to any portion of the basis increase that corresponds to a basis decrease to property distributed to an unrelated partner.

The forthcoming Proposed Related-Party Basis Adjustment Regulations would require that a § 732 RPBA arising from a covered transaction described in section 3.04(2) of this notice and resulting in a basis increase under § 732(b) and (c) to the property of the distributee partner would be recovered using the cost recovery method and remaining recovery period, if any, of the corresponding property the basis of which the partnership reduced under § 734(b), or would have reduced under § 734(b) if the partnership had a § 754 election in effect. In addition, the distributee partner would not be eligible to take the § 732 RPBA into account upon the sale or other disposition of the property to which the § 732 RPBA applies, subject to the rules described below. These rules would not apply to any portion of the basis increase that corresponds to the share of any basis decrease under § 734(b) of a partner unrelated to the distributee partner (or the unrelated partner's share of a basis decrease under § 734(b) if the partnership had a § 754 election in effect). For purposes of this rule, a partner's share of a basis decrease under § 734(b) would be determined under principles similar to those in § 1.197-2(h)(12)(iv)(D).

For purposes of all covered transactions described in section 3.04 of this notice, in the case of multiple distributed properties, the proposed regulations would treat each distributed property as having a separate § 732 RPBA with respect to each basis decrease to corresponding property.

The amount of a § 732 RPBA would be proportional to the share of the basis decrease to that § 732 RPBA's corresponding property out of the aggregate basis decrease to all corresponding property. A § 732 RPBA would be recovered using the cost recovery method and remaining recovery period, if any, of that § 732 RPBA's corresponding property. For purposes of this section 4.06, " corresponding property" would mean, in the case of a covered transaction described in section 3.04(1) of this notice, property distributed to a related distributee partner and allocated a basis decrease under § 732(b) and (c) and, in the case of a covered transaction described in section 3.04(2) of this notice, property allocated a basis decrease under § 734(b) of which a related continuing partner has a share (or would have a share if the partnership had a § 754 election in effect). In addition, the partner would not be eligible to take the § 732 RPBA into account upon the sale or other disposition of property to which a § 732 RPBA applies, subject to the rules described below.

For purposes of all covered transactions described in section 3.04 of this notice, upon a qualifying disposition of a corresponding property, any § 732 RPBA to which that property corresponds would cease to be a § 732 RPBA. If a basis adjustment ceases to be a § 732 RPBA, the remaining basis attributable to the former RPBA would be treated as giving rise to newly placed in service property that is subject to the cost recovery period and method of the distributed property, to the extent the property is eligible for cost recovery allowances, and the basis adjustment would be taken into account in computing gain or loss upon the sale or other disposition of the property. A qualifying disposition would mean a disposition of property to an unrelated person in a fully taxable, arm's-length transaction.

.07. Special rules and tax-indifferent parties. Special rules in the forthcoming Proposed Related-Party Basis Adjustment Regulations would apply to covered transactions that involve other related subchapter K provisions, such as § 732(d) and (f), and additional steps, as well as to tiered-partnership structures. The forthcoming Proposed Related-Party Basis Adjustment Regulations would also treat as a covered transaction certain partnership arrangements involving taxable and tax-indifferent parties that would otherwise be a covered transaction if the relatedness requirement of section 3.02, 3.03, or 3.04 of this notice were satisfied. For example, if a partnership, in which no partners are related, makes a distribution to an organization exempt from tax imposed by subtitle A by reason of § 501(a) of property that results in a basis increase to remaining partnership property under § 734(b)(1), this transaction would be treated as a covered transaction described in section 3.02 of this notice. For purposes of the forthcoming Proposed Related-Party Basis Adjustment Regulations, a tax-indifferent party would be defined as a person that is either not liable for Federal income tax because of its tax-exempt or, in certain cases, foreign status or, also in certain cases, to which gain from the transaction would not result in Federal income tax liability for the person's taxable year within which such gain is recognized.

5. FORTHCOMING PROPOSED CONSOLIDATED RETURN REGULATIONS

.01. In general. As a result of the interplay between the § 1502 regulations and the rules of subchapter K, a consolidated group's income from investments in partnerships often is not clearly reflected in the group's consolidated taxable income (as determined under § 1.1502-11 and other applicable § 1502 regulations) and consolidated tax liability (as determined under § 1.1502-2 and other applicable § 1502 regulations). In particular, anomalous results arise in certain situations in which the group's ownership interest in a partnership is split among members of the group, or in which a partnership interest is transferred from one member to another.

The Treasury Department and the IRS are concerned that some consolidated groups have attempted to alter consolidated taxable income or consolidated tax liability through basis adjustments to the property of partnerships owned by a group's members simply by: (i) transferring partnership interests from one member to another; or (ii) separating the group's ownership interest in a partnership between different members and causing the partnership to distribute property to one or more of the member partners. Such an alteration of consolidated taxable income or consolidated tax liability does not clearly reflect the income of the group, which files a single tax return for each taxable year and generally reports its income and tax liability as if it were a single corporation. See § § 1501 and 1502.

To prevent distortion of a consolidated group's income from investments in partnerships, the forthcoming Proposed Consolidated Return Regulations would apply a single-entity approach with respect to interests in a partnership held by members of a consolidated group. It is intended that the forthcoming Proposed Consolidated Return Regulations would prevent direct or indirect basis shifts among the members of the group resulting from the covered transactions described in section 3 of this notice. This approach would avoid many of the anomalous results that arise from split ownership of partnership interests among members of the group or from intercompany transfers of partnership interests.

6. PROPOSED APPLICABILITY DATES

.01. The Treasury Department and the IRS intend to propose that the Treasury decision that adopts the Proposed Related-Party Basis Adjustment Regulations described in section 4 of this notice as final regulations would apply to taxable years ending on or after June 17, 2024. That is, once finalized, the regulations would govern the availability and amount of cost recovery deductions and gain or loss calculations for taxable years ending on or after June 17, 2024 even if the relevant covered transaction was completed in a prior taxable year.

.02. The applicability date for the Treasury decision that adopts the forthcoming Proposed Consolidated Return Regulations described in section 5 of this notice will not relate to the issuance of this notice but will be proposed in the notice of proposed rulemaking containing the forthcoming Proposed Consolidated Return Regulations.

7. REQUEST FOR COMMENTS AND SUBMISSION INFORMATION

.01. Request for comments. The Treasury Department and the IRS request comments on the approaches to addressing distortions of income from partnership related-party basis shifting transactions described in sections 4 and 5 of this notice.

.02. Procedures for submitting comments.

(1) Deadline. Written comments should be submitted by July 17, 2024. However, consideration will be given to any written comments submitted after July 17, 2024, if such consideration will not delay the issuance of the proposed regulations.

(2) Form and manner. The subject line for the comments should include a reference to Notice 2024-54. All commenters are strongly encouraged to submit comments electronically. However, comments may be submitted in one of two ways:

(a) Electronically via the Federal eRulemaking Portal at https://www.regulations.gov (type IRS-2024-XXXX in the search field on the regulations.gov homepage to find this notice and submit comments); or

(b) By mail to: Internal Revenue Service, CC:PA:01:PR (Notice 2024-54), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C., 20044.

(3) Publication of comments. The Treasury Department and the IRS will publish for public availability any comment submitted electronically and on paper to its public docket on https://www.regulations.gov.

8. DRAFTING INFORMATION

The principal authors of this notice are Kevin I. Babitz and Anthony P. Sacco of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Elizabeth V. Zanet at (202) 317-6007 or Anthony P. Sacco at (202) 317-5805. Regarding the forthcoming Proposed Consolidated Return Regulations, contact Jeremy Aron-Dine at (202) 317-6847.

---

1 Unless otherwise noted, all “section” or “§” references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

2 References in this notice to the “forthcoming proposed regulations” are references to the forthcoming Proposed Related-Party Basis Adjustment Regulations and the forthcoming Proposed Consolidated Return Regulations, collectively.

END OF DOCUMENT -

Notices

Notice 2024-55, 2024-28 IRB, 06/21/2024, IRC Sec(s). 72

10% additional tax on early retirement plan distributions—exceptions—emergency personal expenses; domestic abuse.

Headnote:

IRS issued guidance on emergency personal expense and domestic abuse victim distribution exceptions (as added by Secure 2.0 Act) to Code Sec. 72(t); 's 10% additional tax on early distributions from qualified retirement plans. This guidance includes Q&A sections that define emergency personal expense and domestic abuse victim distributions, set out dollar limits and repayment options for same, explain which types of plans are eligible to permit said distributions (applicable eligible retirement plan), clarify that such plans may but aren't *required* to permit said distributions, and more. Also, IRS stated that it anticipates issuing regs under Code Sec. 72(t); and invites written comments on above matters as well as other aspects of Code Sec. 72(t); by 10/7/2024.

Reference(s): Code Sec. 72;

Full Text:

Certain Exceptions to the 10 Percent Additional Tax Under Code Section 72(t)

I. PURPOSE

This notice provides guidance on the application of the exceptions to the 10 percent additional tax under section 72(t)(1) of the Internal Revenue Code (Code) for emergency personal expense distributions and domestic abuse victim distributions. The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) anticipate issuing regulations under section 72(t) of the Code, and section IV of this notice solicits public comments with respect to all aspects of section 72(t).

II. BACKGROUND

Section 72(t)(1) of the Code generally provides for a 10 percent additional tax on a distribution from a qualified retirement plan, as defined in section 4974(c), unless the distribution qualifies for one of the exceptions listed in section 72(t)(2). The 10 percent additional tax applies only to the portion of the distribution that is includible in gross income. For purposes of section 72(t), the term "qualified retirement plan," as defined in section 4974(c), means a plan described in section 401(a) that includes a trust exempt from tax under section 501(a), an annuity plan described in section 403(a), an annuity contract described in section 403(b), an individual retirement account described in section 408(a), or an individual retirement annuity described in section 408(b). [1]

Section 72(t)(2) provides several exceptions to the 10 percent additional tax imposed by section 72(t)(1), including, for example, exceptions for distributions:

- made on or after the date on which the employee[2] attains age 59 ½;
- made to a beneficiary (or to the estate of the employee) on or after the death of the employee;
- attributable to the employee being disabled within the meaning of section 72(m)(7);
- that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary; and
- made, if the distributions are not made from an IRA, to an employee after separation from service after attainment of age 55.

On December 29, 2022, Division T of the Consolidated Appropriations Act, 2023, Public Law 117-328 , 136 Stat. 4459 (2022), known as the SECURE 2.0 Act of 2022 (SECURE 2.0 Act), was enacted. Sections 115 and 314 of the Secure 2.0 Act amended section 72(t) of the Code to add exceptions to the 10 percent additional tax, and this notice provides guidance on those sections.

III. PROVISIONS OF THE SECURE 2.0 ACT

A. SECTION 115 OF THE SECURE 2.0 ACT — EMERGENCY PERSONAL EXPENSE DISTRIBUTIONS

Section 115 of the SECURE 2.0 Act amended section 72(t)(2) of the Code by adding section 72(t)(2)(I), which provides a new exception to the 10 percent additional tax for a distribution from an applicable eligible retirement plan to an individual for emergency personal expenses. An emergency personal expense distribution is includible in gross income but is not subject to the 10 percent additional tax under section 72(t)(1).

Section 72(t)(2)(I)(iv) provides that the term "emergency personal expense distribution" means any distribution made from an applicable eligible retirement plan to an individual for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses. Section 72(t)(2)(I)(iv) also provides that the term "applicable eligible retirement plan" has the same meaning as in section 72(t)(2)(H)(vi)(I), where the term is defined as an eligible retirement plan described in section 402(c)(8)(B) other than a defined benefit plan.

Emergency personal expense distributions are subject to three limitations. First, section 72(t)(2)(I)(ii) provides that not more than one distribution per calendar year is permitted to be treated as an emergency personal expense distribution by any individual. Second, section 72(t)(2)(I)(iii) permits an individual to treat a distribution as an emergency personal expense distribution in any calendar year in an amount up to a maximum of $1,000.[3] Third, section 72(t)(2)(I)(vii) provides rules that limit taking subsequent emergency personal expense distributions.

Section 72(t)(2)(I)(iv) provides that an administrator of an applicable eligible retirement plan may rely on an employee's written certification that the employee satisfies the conditions for an emergency personal expense distribution. The Secretary may provide by regulations for exceptions to the rule regarding a plan administrator's reliance on an employee's certification, and for procedures for addressing cases of employee misrepresentation.

Section 72(t)(2)(I)(v) provides that if a distribution from an applicable eligible retirement plan to an individual would be an emergency personal expense distribution (without regard to the limitations in section 72(t)(2)(I)(ii) and (iii)), a plan will not be treated as failing to meet any requirement under the Code merely because the plan treats the distribution as an emergency personal expense distribution, unless the aggregate amount of the distributions from all plans maintained by the employer (and any member of any controlled group[4] that includes the employer) to that individual exceeds the limitations described in section 72(t)(2)(I)(ii) and (iii).

Section 72(t)(2)(I)(vi) provides that the rules relating to repayment of emergency personal expense distributions should follow the rules for repayment of qualified birth or adoption distributions in section 72(t)(2)(H)(v). Therefore, an individual generally may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay an emergency personal expense distribution (not to exceed the aggregate amount of the emergency personal expense distribution) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made.

Section 72(t)(2)(I)(viii) provides that the special rules in section 72(t)(2)(H)(vi)(II) and (IV) (for qualified birth or adoption distributions) also apply for emergency personal expense distributions. Thus, an emergency personal expense distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules under section 401(a)(31), the notice requirement under section 402(f), or the mandatory withholding rules under section 3405. In addition, emergency personal expense distributions are treated as meeting the distribution requirements of sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A). The amendment made to section 72(t)(2) by section 115 of the SECURE 2.0 Act applies to emergency personal expense distributions made after December 31, 2023.

Questions and Answers Relating to Individuals Receiving Emergency Personal Expense Distributions

Q. A-1: What is an emergency personal expense distribution?

A. A-1: An emergency personal expense distribution is a distribution made from an applicable eligible retirement plan to an individual for purposes of meeting unforeseeable or immediate financial needs relating to necessary personal or family emergency expenses. An emergency personal expense distribution is includible in gross income, but it is not subject to the 10 percent additional tax under section 72(t)(1).

Q. A-2: How does an individual determine whether an expense is an unforeseeable or immediate financial need relating to necessary personal or family emergency expenses?

A. A-2: Whether an individual has an unforeseeable or immediate financial need relating to necessary personal or family emergency expenses is determined by the relevant facts and circumstances for each individual. Factors to be considered include, but are not limited to, whether the individual (or a family member of the individual) has expenses relating to —

(a) medical care (including the cost of medicine or treatment that would be deductible under section 213(d), determined without regard to the limitations in section 213(a)),

(b) accident or loss of property due to casualty,

(c) imminent foreclosure or eviction from a primary residence,

(d) the need to pay for burial or funeral expenses,

(e) auto repairs, or

(f) any other necessary emergency personal expenses.

For purposes of determining whether an individual has an unforeseeable or immediate financial need, the administrator may rely on an employee's written certification that the employee is eligible for an emergency personal expense distribution. See Q&A A-9 of this notice.

Q. A-3: Which types of plans are eligible to permit an emergency personal expense distribution?

A. A-3: An emergency personal expense distribution may be made from an applicable eligible retirement plan, which means an eligible retirement plan described in section 402(c)(8)(B) other than a defined benefit plan. Therefore, generally, a section 401(a) qualified defined contribution plan (such as a section 401(k) plan), a section 403(a) annuity plan, a section 403(b) annuity contract, a governmental section 457(b) plan, or an IRA is eligible to permit an emergency personal expense distribution.

Q. A-4: How frequently can an individual treat a distribution from an applicable eligible retirement plan as an emergency personal expense distribution?

A. A-4: An individual is permitted to treat only one distribution per calendar year as an emergency personal expense distribution.

Q. A-5: Is there a dollar limitation on the amount that an individual may treat as an emergency personal expense distribution under section 72(t)(2)(I)(iii)?

A. A-5: The amount that may be treated as an emergency personal expense distribution by an individual in any calendar year shall not exceed the lesser of $1,000 or an amount equal to the excess of —

(a) the individual's total nonforfeitable accrued benefit under the plan (in the case of an IRA, the individual's total interest in the IRA), determined as of the date of each such distribution, over

(b) $1,000.

For example, Plan C is a section 401(k) plan that permits emergency personal expense distributions, and Employee A is a participant in Plan C. On July 1, 2025, Employee A has a vested account balance of $1,500 in Plan C. On July 1, 2025, Employee A requests an emergency personal expense distribution of $500 from Plan C. Employee A has not previously received an emergency personal expense distribution. The excess of Employee A's nonforfeitable interest in Plan C over $1,000 is $1,500 - $1,000, or $500. Employee A is permitted to treat $500 from Plan C as an emergency personal expense distribution (the lesser of $1,000 or the amount equal to $1,500 - $1,000 ($500)).

Q. A-6: Once an individual treats a distribution as an emergency personal expense distribution, how soon can that individual take a subsequent emergency personal expense distribution?

A. A-6: Notwithstanding the limitation in Q&A A-4 of this notice, if an individual treats a distribution as an emergency personal expense distribution in any calendar year with respect to an applicable eligible retirement plan, no amount of any subsequent distribution can be treated as an emergency personal expense distribution during the immediately following 3 calendar years with respect to that plan unless —

(a) the previous emergency personal expense distribution is fully repaid to the plan, or

(b) the aggregate of the individual's elective deferrals and employee contributions to the plan (in the case of an IRA, the total amounts that the individual contributed to the IRA) after the previous emergency personal expense distribution is at least equal to the amount of the previous emergency personal expense distribution that has not been repaid.

For example, consider the same facts as Q&A A-5 of this notice (Employee A requests from Plan C an emergency personal expense distribution of $500 on July 1, 2025). Employee A does not repay the emergency personal expense distribution but continues to make elective deferrals to Plan C. On August 1, 2027, Employee A has an account balance in the amount of $5,000. With respect to the $5,000 account balance, Employee A contributed $3,500 in elective deferrals since the July 1, 2025, distribution. On August 1, 2027, Employee A requests an emergency personal expense distribution (which meets the requirements of Q&A A-1 of this notice) of $1,000 from Plan C. This distribution meets the limitation requirements in Q&A A-4 (annual limitation), Q&A A-5 (dollar limitation), and Q&A A-6 (limitation on subsequent distributions) of this notice.

Q. A-7: May an individual repay an emergency personal expense distribution to an applicable eligible retirement plan?

A. A-7: An individual may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay any portion of an emergency personal expense distribution (up to the entire amount of the emergency personal expense distribution) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made under section 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16), as applicable.

Questions and Answers Relating to Applicable Eligible Retirement Plans Permitting Emergency Personal Expense Distributions.

Q. A-8: Is an applicable eligible retirement plan required to permit emergency personal expense distributions under section 72(t)(2)(I)?

A. A-8: It is optional for an applicable eligible retirement plan to permit emergency personal expense distributions pursuant to section 72(t)(2)(I). Plan amendments adopted to permit emergency personal expense distributions are discretionary amendments for purposes of the plan amendment rules discussed in Section II.J. of Notice 2024-02, 2024-02 IRB 316. For information relating to the deadline for adopting plan amendments, see the plan amendment rules discussed in Section II.J. of Notice 2024-02.

If an applicable eligible retirement plan does not permit emergency personal expense distributions, the individual is permitted to treat an otherwise permissible distribution[5] as an emergency personal expense distribution. See Q&A A-15 of this notice.

Q. A-9: May an administrator rely on a written certification from an employee that the employee is eligible for an emergency personal expense distribution?

A. A-9: In determining whether an employee is eligible for an emergency personal expense distribution, an administrator of an applicable eligible retirement plan is permitted to rely on an employee's written certification that the employee is eligible for an emergency personal expense distribution.[6] For this purpose, an administrator is a plan administrator as defined in section 414(g), or an IRA trustee, custodian, or issuer.

Q. A-10: Do emergency personal expense distributions from an applicable eligible retirement plan meet the distribution restriction requirements in sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A)?

A. A-10: Emergency personal expense distributions are treated as meeting the distribution restrictions for qualified cash or deferred arrangements under section 401(k)(2)(B)(i), custodial accounts under section 403(b)(7)(A)(i), annuity contracts under section 403(b)(11), and governmental deferred compensation plans under section 457(d)(1)(A). Thus, for example, an employer may expand the distribution options under its plan to allow an amount attributable to elective, qualified nonelective, qualified matching, or safe harbor contributions under a section 401(k) plan to be distributed as an emergency personal expense distribution.

Q. A-11: Is an emergency personal expense distribution treated by an applicable eligible retirement plan as an eligible rollover distribution for purposes of the direct rollover rules, section 402(f) notice requirements, and the mandatory withholding rules?

A. A-11: An emergency personal expense distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules under section 401(a)(31), the notice requirement under section 402(f), and the mandatory withholding rules under section 3405. Thus, the plan is not required to offer an individual a direct rollover with respect to an emergency personal expense distribution. In addition, the administrator is not required to provide a section 402(f) notice. Finally, the administrator or payor of the emergency personal expense distribution is not required to withhold an amount equal to 20 percent of the distribution, as generally is required in section 3405(c)(1). However, an emergency personal expense distribution is subject to the withholding requirements of section 3405(b) and § 35.3405-1T of the withholding tax regulations.

Q. A-12: If an applicable eligible retirement plan permits emergency personal expense distributions, is the plan required to accept a repayment of that distribution to the plan?

A. A-12: An applicable eligible retirement plan must accept the repayment of an emergency personal expense distribution from an individual if the following apply:

(a) the plan permits emergency personal expense distributions;

(b) the individual received an emergency personal expense distribution from that plan; and

(c) the individual is eligible to make a rollover contribution to that plan at the time the individual wishes to repay the emergency personal expense distribution to the plan.

Q. A-13: Is a repayment of an emergency personal expense distribution from an applicable eligible retirement plan other than an IRA treated as the direct transfer of an eligible rollover distribution as defined in section 402(c)(4)?

A. A-13: In the case of a repayment of an emergency personal expense distribution from an applicable eligible retirement plan other than an IRA, an individual is treated as having received the distribution as an eligible rollover distribution (as defined in section 402(c)(4)) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.

Q. A-14: Is a repayment of an emergency personal expense distribution from an IRA treated as the direct transfer of a distribution described in section 408(d)(3)?

A. A-14: In the case of a repayment of an emergency personal expense distribution from an IRA, an individual is treated as having received the distribution as a distribution described in section 408(d)(3) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.

Q. A-15: If an applicable eligible retirement plan does not permit emergency personal expense distributions, may an individual treat an otherwise permissible distribution as an emergency personal expense distribution?

A. A-15: If an applicable eligible retirement plan does not permit emergency personal expense distributions and an individual receives an otherwise permissible distribution that meets the requirements of an emergency personal expense distribution (as defined in Q&A A-1 of this notice), the individual may treat the distribution on the individual's federal income tax return as an emergency personal expense distribution to the extent the distribution meets the various limitations on an emergency personal expense distribution (see Q&As A-4 through A-6 of this notice). As part of the individual's tax return, the individual will claim on Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, that the distribution is an emergency personal expense distribution, in accordance with the form's instructions. The distribution, while includible in gross income, is not subject to the 10 percent additional tax under section 72(t)(1) pursuant to section 72(t)(2)(I). If the individual decides to repay the amount to an eligible retirement plan, the individual may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay the amount to an IRA.

B. SECTION 314 OF THE SECURE 2.0 ACT — DOMESTIC ABUSE VICTIM DISTRIBUTIONS

Section 314 of the SECURE 2.0 Act amended section 72(t)(2) by adding section 72(t)(2)(K), which provides a new exception to the 10 percent additional tax for an eligible distribution to a domestic abuse victim (domestic abuse victim distribution). A domestic abuse victim distribution is includible in gross income but is not subject to the 10 percent additional tax under section 72(t)(1). A "domestic abuse victim distribution" is defined in section 72(t)(2)(K)(iii)(I) as any distribution from an applicable eligible retirement plan to a domestic abuse victim if made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner. The term "domestic abuse" is defined in section 72(t)(2)(K)(iii)(II) as physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

Section 72(t)(2)(K)(ii) permits an individual to receive a distribution from an applicable eligible retirement plan of up to $10,000 (indexed for inflation) without application of the 10 percent additional tax if the distribution meets the requirements to be a domestic abuse victim distribution.

An "applicable eligible retirement plan" is defined in section 72(t)(2)(K)(vi)(I) as an eligible retirement plan (as defined in section 402(c)(8)(B)) other than a defined benefit plan or a plan to which sections 401(a)(11) and 417 apply.

Section 72(t)(2)(K)(iv) provides that if a distribution from an applicable eligible retirement plan to a domestic abuse victim would be a domestic abuse victim distribution (without regard to the limitation in section 72(t)(2)(K)(ii)), a plan will not be treated as failing to meet any requirement under the Code merely because the plan treats the distribution as a domestic abuse victim distribution, unless the aggregate amount of the distributions from all plans maintained by the employer (and any member of any controlled group that includes the employer) to the domestic abuse victim exceeds the limitation described in section 72(t)(2)(K)(ii).

Section 72(t)(2)(K)(v) provides that the rules relating to repayment of domestic abuse victim distributions should follow the rules in section 72(t)(2)(H)(v) (the rules for repayment of qualified birth or adoption distributions). Therefore, an individual generally may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay a domestic abuse victim distribution (not to exceed the aggregate amount of the domestic abuse victim distribution) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made.

Section 72(t)(2)(K)(vi)(II) provides that a domestic abuse victim distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules under section 401(a)(31), the notice requirement under section 402(f), or the mandatory withholding rules under section 3405.

Section 72(t)(2)(K)(vi)(III) provides that any distribution that the employee or participant certifies as a domestic abuse victim distribution shall be treated as meeting the distribution requirements of sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A).

The amendment made to section 72(t)(2) by section 314 of the SECURE 2.0 Act applies to domestic abuse victim distributions made after December 31, 2023.

Questions and Answers Relating to Individuals Receiving Domestic Abuse Victim Distributions

Q. B-1: What is a domestic abuse victim distribution?

A. B-1: A domestic abuse victim distribution is a distribution from an applicable eligible retirement plan to a domestic abuse victim made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse by a spouse or domestic partner. A domestic abuse victim distribution is includible in gross income but is not subject to the 10 percent additional tax under section 72(t)(1).

Q. B-2: How is domestic abuse defined for the purposes of a domestic abuse victim distribution?

A. B-2: The term "domestic abuse" means physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

Q. B-3: Which types of plans are eligible to permit a domestic abuse victim distribution?

A. B-3: A domestic abuse victim distribution may be made from an applicable eligible retirement plan, which is defined in section 72(t)(2)(K)(vi)(I) as an eligible retirement plan described in section 402(c)(8)(B), other than a defined benefit plan or a plan to which the spousal consent requirements of sections 401(a)(11) and 417 apply. In general, the spousal consent requirements of sections 401(a)(11) and 417 apply to certain qualified retirement plans, including defined benefit plans, money purchase pension plans, and defined contribution plans that (1) do not provide 100 percent death benefits for surviving spouses, (2) provide benefits in the form of a life annuity, or (3) are direct or indirect transferees of a defined benefit or money purchase pension plan. See section 401(a)(11)(B) and §§1.401(a)-20, Q&A-3.

Q. B-4: Is there a dollar limitation on the amount that an individual may treat as a domestic abuse victim distribution under section 72(t)(2)(K)?

A. B-4: The aggregate amount that an individual may treat as a domestic abuse victim distribution cannot exceed the lesser of —

(a) $10,000 (indexed for inflation), or

(b) 50 percent of the present value of the nonforfeitable accrued benefit (vested accrued benefit) of the employee under the plan.

For example, Plan E is a section 403(b) plan that permits domestic abuse victim distributions, and Taxpayer D is a participant in Plan E. On August 15, 2024, Taxpayer D is eligible to receive a domestic abuse victim distribution from Plan E because Taxpayer D was a victim of domestic abuse on January 15, 2024. August 15, 2024, is less than one year after the January 15, 2024, incident. On August 15, 2024, Taxpayer D has a $15,000 vested account balance in Plan E ($7,500 is 50 percent of Taxpayer D's vested account balance). Taxpayer D requests a $7,500 domestic abuse victim distribution from Plan E. Taxpayer D is permitted to take a domestic abuse victim distribution of $7,500 from Plan E (the lesser of $7,500 (50 percent of Taxpayer D's vested account balance) and $10,000).

Q. B-5: How are the cost-of-living adjustments made to the dollar limit for domestic abuse victim distributions?

A. B-5: For taxable years beginning in a calendar year after 2024, the $10,000 amount will be increased annually by an amount equal to -

(a) The $10,000 dollar limitation, multiplied by

(b) The cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting calendar year 2023, for calendar year 2016 in section 1(f)(3)(A)(ii).

If any amount after adjustment under section 72(t)(2)(K)(vii) is not a multiple of $100, the amount will be rounded to the nearest multiple of $100. The adjusted amounts will be provided in future guidance issued in the Internal Revenue Bulletin.

Q. B-6: May an individual repay a domestic abuse victim distribution to an applicable eligible retirement plan?

A. B-6: An individual may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay any portion of a domestic abuse victim distribution (up to the entire amount of the domestic abuse victim distribution) to an applicable eligible retirement plan in which the individual is a beneficiary and to which a rollover can be made under section 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16), as applicable.

Questions and Answers Relating to Applicable Eligible Retirement Plans Permitting Domestic Abuse Victim Distributions

Q. B-7: Is an applicable eligible retirement plan required to permit domestic abuse victim distributions under section 72(t)(2)(K)?

A. B-7: It is optional for an applicable eligible retirement plan to permit domestic abuse victim distributions pursuant to section 72(t)(2)(K). Plan amendments adopted to permit domestic abuse victim distributions are discretionary amendments for purposes of the plan amendment rules discussed in Section II.J. of Notice 2024-02. For information relating to the deadline for adopting plan amendments, see Section II.J of Notice 2024-02.

If an applicable eligible retirement plan does not permit domestic abuse victim distributions, the individual is permitted to treat an otherwise permissible distribution as a domestic abuse victim distribution. See Q&A B-14 of this notice.

Q. B-8: Do domestic abuse victim distributions from an applicable eligible retirement plan meet the distribution restriction requirements in sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A)?

A. B-8: If the employee or participant certifies that the employee or participant is eligible to receive a domestic abuse victim distribution, then the distribution is treated as meeting the distribution restrictions for qualified cash or deferred arrangements under section 401(k)(2)(B)(i), custodial accounts under section 403(b)(7)(A)(i), annuity contracts under section 403(b)(11), and governmental deferred compensation plans under section 457(d)(1)(A). Thus, for example, an employer may expand the distribution options under its plan to allow an amount attributable to elective, qualified nonelective, qualified matching, or safe harbor contributions under a section 401(k) plan to be distributed as a domestic abuse victim distribution.

Q. B-9: What are the certification requirements for a domestic abuse victim distribution?

A. B-9: Pursuant to section 72(t)(2)(K)(vi)(III), any distribution that an employee or participant certifies as a domestic abuse victim distribution will be treated as meeting the distribution restriction requirements under the Code for the applicable eligible retirement plan. To meet the certification requirements of section 72(t)(2)(K)(vi)(III), the employee or participant could check the box on the distribution request form to certify that (1) the employee or participant is eligible for a domestic abuse victim distribution and (2) the distribution is made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse. The certification must be provided in writing and the employee or participant may use the electronic delivery rules in §1.401(a)-21(d) to provide the certification.

Q. B-10: Is a domestic abuse victim distribution treated by an applicable eligible retirement plan as an eligible rollover distribution for purposes of the direct rollover rules, section 402(f) notice requirements, and the mandatory withholding rules?

A. B-10: A domestic abuse victim distribution is not treated as an eligible rollover distribution for purposes of the direct rollover rules under section 401(a)(31), the notice requirement under section 402(f), and the mandatory withholding rules under section 3405. Thus, the plan is not required to offer an individual a direct rollover with respect to a domestic abuse victim distribution. In addition, the administrator is not required to provide a section 402(f) notice. Finally, the administrator or payor of the domestic abuse victim distribution is not required to withhold an amount equal to 20 percent of the distribution, as generally is required in section 3405(c)(1). However, a domestic abuse victim distribution is subject to the withholding requirements of section 3405(b) and § 35.3405-1T.

Q. B-11: If an applicable eligible retirement plan permits domestic abuse victim distributions, is the plan required to accept a repayment of that distribution to the plan?

A. B-11: An applicable eligible retirement plan must accept the repayment of a domestic abuse victim distribution from an individual if the following apply:

(a) the plan permits domestic abuse victim distributions;

(b) the individual received a domestic abuse victim distribution from that plan; and

(c) the individual is eligible to make a rollover contribution to that plan at the time the individual wishes to repay the domestic abuse victim distribution to the plan.

Q. B-12: Is a repayment of a domestic abuse victim distribution from an applicable eligible retirement plan other than an IRA treated as the direct transfer of an eligible rollover distribution as defined in section 402(c)(4)?

A. B-12: In the case of a repayment of a domestic abuse victim distribution from an applicable eligible retirement plan other than an IRA, an individual is treated as having received the distribution as an eligible rollover distribution (as defined in section 402(c)(4)) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.

Q. B-13: Is a repayment of a domestic abuse victim distribution from an IRA treated as the direct transfer of a distribution described in section 408(d)(3)?

A. B-13: In the case of a repayment of a domestic abuse victim distribution from an IRA, an individual is treated as having received the distribution as a distribution described in section 408(d)(3) and as having transferred the amount to an applicable eligible retirement plan in a direct trustee-to-trustee transfer within 60 days of the distribution.

Q. B-14: If an applicable eligible retirement plan does not permit domestic abuse victim distributions, may an individual treat an otherwise permissible distribution as a domestic abuse victim distribution?

A. B-14: If an applicable eligible retirement plan does not permit domestic abuse victim distributions and an individual receives an otherwise permissible distribution that meets the requirements of a domestic abuse victim distribution (as defined in Q&A B-1 of this notice), the individual may treat the distribution as a domestic abuse victim distribution on the individual's federal income tax return to the extent the distribution meets the limitation on a domestic abuse victim distribution (see Q&A B-4 of this notice). As part of the individual's tax return, the individual will claim on Form 5329 that the distribution is a domestic abuse victim distribution, in accordance with the form's instructions. The distribution, while includible in gross income, is not subject to the 10 percent additional tax under section 72(t)(1) pursuant to section 72(t)(2)(K). If the individual decides to repay the amount to an eligible retirement plan, the individual may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay the amount to an IRA.

IV. REQUEST FOR COMMENTS

The Treasury Department and the IRS invite comments on all matters discussed in this notice. In particular, the Treasury Department and the IRS invite comments on whether the Secretary should adopt regulations providing exceptions to the rule that a plan administrator may rely on an employee's certification relating to emergency personal expense distributions and procedures to address cases of employee misrepresentation.

In addition, as mentioned in the Purpose section of this notice, the Treasury Department and the IRS anticipate issuing regulations under section 72(t) and invite general comments on section 72(t). In particular, because the anticipated proposed regulations would address repayments of certain distributions under section 72(t)(2) (for example, qualified birth or adoption distributions under section 72(t)(2)(H), emergency personal expense distributions under section 72(t)(2)(I), domestic abuse victim distributions under section 72(t)(2)(K), and terminal illness distributions under section 72(t)(2)(L)), the Treasury Department and the IRS request comments relating to repayments. For example, comments are requested on the implementation of the requirement that any repayment made within the 3-year period beginning on the day after the date the distribution was received will be treated as a direct trustee-to-trustee transfer within 60 days of the distribution. Comments are also requested on procedures for determining whether a repayment meets the applicable requirements under section 72(t)(2), particularly whether it would be helpful if the anticipated proposed regulations would permit an administrator to rely on an individual's certification that any requested repayment meets the requirements under section 72(t)(2), is made within the applicable 3-year time period,[7] and does not exceed the amount of the distribution with respect to which a repayment is being made.

Comments should be submitted in writing on or before October 7, 2024,and should include a reference to Notice 2024-55. Comments may be submitted electronically via the Federal eRulemaking Portal at www.regulations.gov (type "IRS Notice 2024-55" in the search field on the Regulations.gov home page to find this notice and submit comments). Alternatively, comments may be submitted by mail to: Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2024-55), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

The Treasury Department and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket.

V. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act (PRA) () under control number 1545-2317. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. The information collection requirements in section III.A and B will be submitted to OMB for review and approval in accordance with 5 CFR 1320.10.

Pursuant to section 72(t)(2)(I)(iv), Q&A A-9 of this notice provides that, in determining whether an employee is eligible for an emergency personal expense distribution, an administrator of an applicable eligible retirement plan is permitted to rely on an employee's written certification that the employee is eligible for an emergency personal expense distribution.

Q&A B-9 of this notice provides that, to meet the certification requirements of section 72(t)(2)(K)(vi)(III), an individual could check the box on the distribution request form to certify that (1) the employee or participant is eligible for a domestic abuse victim distribution and (2) the distribution is made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse. The certification must be provided in writing and the employee or participant may use the electronic delivery rules in §1.401(a)-21(d) to provide the certification.

According to the Bureau of Labor and Statistics, determined as of March 2023, approximately 45 percent of civilian workers in the United States participated in defined contribution plans. The population of civilian workers represented by the March 2023 National Compensation Survey (NCS) was 145,300,100. Using 45 percent of the population reported in the NCS survey, approximately 65,385,045 civilian workers participated in defined contribution plans in March 2023.

Sections 115 and 314 of the SECURE 2.0 Act became effective January 1, 2024. The IRS does not have all the data necessary for determining paperwork for certifications of emergency personal expense and domestic victim abuse distributions. At this point, the IRS does not know how many applicable eligible retirement plans will offer these distributions or how many employees will request these distributions from applicable eligible retirement plans. Therefore, the paperwork burden is based on an estimated range of the number of employees who would apply for either an emergency personal expense distribution or a domestic abuse victim distribution from an applicable eligible retirement plan that permits such distributions.

The collection of information is required to obtain a benefit. For Q&A A-9 of this notice, the likely respondent is an individual who is requesting an emergency personal expense distribution from an applicable eligible retirement plan, as described in section 72(t)(2)(I)(iv), and self-certifying that the individual is eligible for an emergency personal expense distribution.

Estimated total annual reporting burden: 3,750 to 7,500 hours.

Estimated average annual burden per respondent: 3 minutes.

Estimated number of respondents: 75,000 to 150,000 respondents.

Estimated frequency of responses: 1 per distribution request.

For Q&A B-9 of this notice, the likely respondent is an individual who is requesting a domestic abuse victim distribution from an applicable eligible retirement plan, as defined in section 72(t)(2)(K)(vi)(I), and self-certifying that the individual is eligible for a domestic abuse victim distribution and that the distribution is made during the 1-year period beginning on any date on which the individual is a victim of domestic abuse.

Estimated total annual reporting burden: 3,750 to 7,500 hours.

Estimated average annual burden per respondent: 3 minutes.

Estimated number of respondents: 75,000 to 150,000 respondents.

Estimated frequency of responses: 1 per distribution request.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103 of the Code.

VI. DRAFTING INFORMATION

The principal authors of this notice are Naomi Lehr, Vernon Carter, and Pamela R. Kinard of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this notice, please contact Mr. Vernon Carter at (202) 317-6799, Ms. Naomi Lehr at (202) 317-4102, or Ms. Pamela Kinard at (202) 317-6000 (not toll-free numbers).

1 For purposes of this notice, the term "IRA" includes an individual retirement account described in section 408(a) and an individual retirement annuity described in section 408(b).

2 The term "employee" includes any participant in an employee retirement plan, and in the case of an IRA, the individual for whose benefit the IRA was established. See generally section 72(t)(5).

3 This $1,000 amount is not indexed for inflation.

4 Section 72(t)(2)(I)(v) applies the controlled group definition in section 72(t)(2)(H)(iv)(II), which defines "controlled group" as any group treated as a single employer under section 414(b), (c), (m), or (o).

5 For purposes of this notice, a "permissible distribution" means a distribution that meets the distribution restriction requirements in sections 401(k)(2)(B)(i), 403(b)(7)(A)(i), 403(b)(11), and 457(d)(1)(A) and is permissible under the plan. Thus, for example, a participant in a plan that does not permit emergency personal expense distributions may meet the requirements for a hardship distribution if the plan permits hardship distributions. In addition, a participant who terminated service with an employer with an accrued benefit under a section 401(k) plan that does not permit emergency personal expense distributions may meet the distribution restrictions for severance from employment.

6 The written certification may be provided using the electronic delivery rules in §1.401(a)-21(d).

7 But see section 311(b)(2) of the SECURE 2.0 Act for a special temporary rule on the effective date of the 3-year rule for repayments relating to qualified birth or adoption distributions made on or before the date of enactment of the SECURE 2.0 Act.

END OF DOCUMENT -

Revenue Rulings

Rev. Rul. 2024-10, 2024-22 IRB 1240, 05/24/2024, IRC Sec(s). 508

Exempt orgs.—private foundations—governing instruments—state law.

Headnote:

IRS obsoleted Rev. Rul. 75-38 , 1975-1 CB 161 which identified state laws and circumstances that IRS previously concluded would permit orgs. to satisfy Code Sec. 508(e); private foundation governing instruments requirements. Many of state laws identified in Rev. Rul. 75-38 , 1975-1 CB 161 materially changed, and rev ruls can't be relied on to extent predicated on state laws which materially changed.

Reference(s): Code Sec. 508;

Full Text:

Part I

Section 508.—Special Rules with Respect to Section 501(c)(3) Organizations

26 CFR 1.508-3: Governing instruments.

This revenue ruling obsoletes Rev. Rul. 75-38, 1975-1 C.B. 161, which identified the State laws and circumstances that the Internal Revenue Service (IRS) previously concluded would permit an organization to satisfy the private foundation governing instrument requirements of § 508(e) of the Internal Revenue Code (Code). [1] A number of the State laws identified in Rev. Rul. 75-38 have materially changed, and a revenue ruling cannot be relied upon to the extent it is predicated on State law and that State law has materially changed. *See* Rev. Proc. 89-14,1989-1 C.B. 814.

LAW AND ANALYSIS

Section 508(e) provides that a private foundation will not be exempt from Federal income taxation under § 501(a) unless its governing instrument includes provisions the effects of which are to require its income for each taxable year to be distributed at such time and in such manner as not to subject the private foundation to tax under § 4942 and to prohibit the private foundation from engaging in any act of self-dealing (as defined in § 4941(d)), from retaining any excess business holdings (as defined in § 4943(c)), from making any investments in such manner as to subject the private foundation to tax under § 4944, and from making any taxable expenditures (as defined in § 4945(d)). Section 1.508-3(a) provides a general rule that is consistent with § 508(e).

Section 1.508-3(d)(1) provides, however, that a private foundation's governing instrument will be deemed to satisfy the requirements of § 1.508-3(a) if valid provisions of State law have been enacted that:

(1) Require it to act or refrain from acting so as not to subject the private foundation to the taxes imposed by § § 4941, 4942, 4943, 4944, and 4945; or

(2) Treat the required provisions as contained in the private foundation's governing instrument.

Rev. Rul. 75-38 identified 48 States and the District of Columbia as jurisdictions with statutory provisions in effect at the time of its publication that satisfied the requirements of § 508(e). Rev. Rul. 75-38 also noted exceptions included in those statutory provisions, such as cases in which a court determines that the provisions do not apply to a particular private foundation or in which a private foundation expressly opts out of the statutory provisions through a provision in its governing instrument.

Section 7.01(5) of Rev. Proc. 89-14 cautions taxpayers, IRS personnel, and others concerned to determine whether a revenue ruling on which they seek to rely has been revoked, modified, declared obsolete, distinguished, clarified, or otherwise affected by subsequent legislation, treaties, regulations, revenue rulings, revenue procedures, or court decisions. Section 7.01(6) of Rev. Proc. 89-14 provides that if the conclusion of a revenue ruling is predicated upon a certain provision or interpretation of law other than Federal tax law, taxpayers, IRS personnel, and others generally must determine whether such relevant non-Federal tax law has changed materially from that used in the revenue ruling on which they seek to rely. Therefore, under section 7.01(5) and (6) of Rev. Proc. 89-14, a revenue ruling cannot be relied upon to the extent it is predicated on State law and that State law has materially changed.

A number of the statutory provisions considered in Rev. Rul. 75-38 have since been amended, repealed, or replaced. Rev. Rul. 75-38 therefore no longer provides an accurate list of the jurisdictions with statutory provisions that satisfy the requirements of § 508(e) or of the exceptions to those statutory provisions.

In addition, Rev. Rul. 75-38 does not address potential differences in the State statutory provisions that apply depending on whether an organization is formed as a charitable trust or as a not-for-profit (or nonstock) corporation. While most States have enacted statutory provisions having the effects described in § 508(e) for both charitable trusts and not-for-profit corporations, there are a small number of States with statutory provisions that satisfy the requirements of § 508(e) for charitable trusts or not-for-profit corporations but not both.

For the foregoing reasons, this revenue ruling is being published to obsolete Rev. Rul. 75-38.

A private foundation is responsible for verifying whether the requirements of § 508(e) are satisfied by applicable State law if its governing instrument does not include the provisions described in § 508(e). A private foundation can ensure that it satisfies the requirements of § 508(e) by including the provisions described in § 508(e) in its governing instrument. Publication 557, *Tax-Exempt Status for Your Organization* (currently available at: https://www.irs.gov/pub/irs-pdf/p557.pdf), provides samples of governing instrument provisions that a private foundation may include in its governing instrument to satisfy the requirements of § 508(e).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 75-38, 1975-1 C.B. 161, is obsoleted as of May 24, 2024.

DRAFTING INFORMATION

The principal author of this revenue ruling is Christopher Hyde of the Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). For further information regarding this revenue ruling, contact Mr. Hyde at (202) 317-5800 (not a toll-free call).

1 Unless otherwise specified, all "section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Revenue Rulings (1954 to Present)
2024
Rev. Rul. 2024-14 -- IRC Sec(s). 732; 734; 743; 6662; 7701, 06/17/2024

Revenue Rulings

Rev. Rul. 2024-14, , 06/17/2024, IRC Sec(s). 732

Partnerships—related-party transactions; basis shifting; tax avoidance—economic substance—accuracy-related penalties.

Headnote:

IRS ruled that the economic substance doctrine as codified under Code Sec. 7701(o); applied to disallow tax benefits from certain related-party partnership transactions involving basis shifting. Specifically, in situations described herein, involving related parties which "engaged in a concerted effort to create disparities between inside and outside basis" and then exploited same via basis shifting transfers, IRS ruled that economic substance was lacking and resulting basis adjustments under Code Sec. 743(b); , Code Sec. 732(b); , and/or Code Sec. 734(b); would be disregarded for tax purposes (and Code Sec. 6662(b)(6); or Code Sec. 6662(i); penalties would apply). IRS noted that this ruling doesn't address Code Sec. 7701(o); 's applicability to transactions involving unrelated partners, but that such may apply to same, depending on specific facts involved.

Reference(s): Code Sec. 732; Code Sec. 734; Code Sec. 743; Code Sec. 7701; Code Sec. 6662;

Full Text:

Part I

Section 7701(o). —Clarification of economic substance doctrine

(Also §§ 732, 734, 743, 754, 755)

ISSUE

Does the economic substance doctrine apply to disallow tax benefits associated with a series of transactions involving a related-party partnership, through which the parties first generate a disparity between inside basis and outside basis and then trigger a basis adjustment to property under § 732(b), § 734(b), or § 743(b),[1] which generates increased cost recovery deductions with respect to the property or reduced gain (or increased loss) upon a sale of the property?

FACTS

C is a domestic corporation engaged in operating a trade or business, including through several subsidiary entities commonly managed by C or in which C directly or indirectly holds controlling financial interests (C Subsidiaries) such that C is related to each of the C Subsidiaries under § 267(b) or § 707(b)(1). The C Subsidiaries include, among other entities, Sub 1, Sub 2, Sub 3, Partnership A, Partnership B, Partnership C, and Partnership D, each of which is indirectly owned by C through one or more C Subsidiaries. The C Subsidiaries own various depreciable or amortizable assets used in, and have incurred various liabilities as part of, the conduct of C's trade or business. C issues financial statements for its trade or business that report these assets and liabilities of the C Subsidiaries (C Financial Statements).

Situation 1. C indirectly owns more than 50 percent of the stock of each of Sub 1, Sub 2, and Sub 3, all domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership A with each holding a 50 percent interest in the capital, profits, and losses of Partnership A. Sub 1 and Sub 3 are the only partners in Partnership B with each holding a 50 percent interest in the capital, profits, and losses of Partnership B.

Prior to Date 1, Partnership A had a valid election in place under § 754. Also prior to Date 1, Sub 1's share of the adjusted tax basis of Partnership A's property (that is, Sub 1's share of Partnership A's inside basis) was equal to $20x and the adjusted tax basis of Sub 1's interest in Partnership A (that is, Sub 1's outside basis) was $100x. This $80x disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A prior to Date 1 resulted from Sub 1 and Sub 2 making contributions to Partnership A, and Partnership A making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A.

On Date 1, Sub 1 transfers its interest in Partnership A to Partnership B in a contribution that qualifies for nonrecognition of gain or loss under § 721(a) (Sub 1 Contribution). The stated business purpose for the Sub 1 Contribution is to achieve cost savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Sub 1 Contribution, Partnership B's outside basis in its interest in Partnership A is $100x under § 723 while its share of Partnership A's inside basis is $20x (without regard to § 743(b)). Under § 743(b), Partnership A increases the adjusted basis of its property by $80x (the excess of Partnership B's $100x outside basis over its $20x proportionate share of inside basis) with respect to Partnership B only.[2] Partnership A allocates substantially all of this $80x basis increase to its depreciable or amortizable property (Basis-Adjusted Property) under § 755 and § 1.755-1(b)(5). The Sub 1 Contribution on Date 1 was undertaken with a view to exploiting the disparity between Sub 1's share of Partnership A's inside basis and Sub 1's outside basis in Partnership A created before Date 1 and increasing Partnership B's share of Partnership A's inside basis in the depreciable or amortizable property.

The cost savings resulting from the Sub 1 Contribution are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Partnership A's basis in the Basis-Adjusted Property, which results in Partnership B being allocated increased amounts of deductions for depreciation or amortization or reduced amounts of gain (or increased amounts of loss) upon the sale of the Basis-Adjusted Property. C reports the relatively small cost savings in the C Financial Statements.

Situation 2. C indirectly owns more than 50 percent of the stock of Sub 1 and Sub 2, both domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership C with each having a 50 percent interest in the capital, profits, and losses of Partnership C. Partnership C owns 100 percent of the stock of Sub 3, a domestic corporation, a depreciable asset, and $100x of money deposited in a bank account.

Prior to Date 2, Partnership had a valid election in place under § 754. Also prior to Date 2, Partnership C held the Sub 3 stock with an adjusted basis of $90x and fair market value of $100x and held the depreciable asset with an adjusted basis of $10x and fair market value of $100x. Also, Sub 1's outside basis in Partnership C was $100x and Sub 2's outside basis in Partnership C was $10x as a result of Sub 1 and Sub 2 making contributions to Partnership C, and Partnership C making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Sub 2's outside basis and Partnership C's inside basis in the Sub 3 stock.

On Date 2, Partnership C distributes all of the Sub 3 stock to Sub 2 other than in liquidation of Sub 2's interest in Partnership C (Sub 3 Stock Distribution). The stated business purpose for the Sub 3 Stock Distribution is to achieve costs savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Sub 3 Stock Distribution, Sub 2's adjusted basis in the Sub 3 stock is $10x under § 732(a)(2), the same as Sub 2's outside basis in Partnership C prior to the Sub 3 Stock Distribution. In addition, the Sub 3 Stock Distribution reduces Sub 2's outside basis in Partnership C from $10x to zero under § 733(2). Following the Sub 3 Stock Distribution, Partnership C increases the inside basis of its assets by $80x under § 734(b)(1)(B). Under § 755 and § 1.755-1(c)(2)(i), Partnership C increases the adjusted basis of its remaining depreciable asset from $10x to $90x.[3] The Sub 3 stock Distribution on Date 2 was undertaken with a view to exploiting the disparity between Sub 2's outside basis in Partnership C and Partnership C's inside basis in the Sub 3 stock created before Date 2 and transferring basis from nondepreciable Sub 3 stock to Partnership C's remaining depreciable asset.

The cost savings resulting from the Sub 3 Stock Distribution are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Partnership C's inside basis in the remaining depreciable asset, which results in Sub 1 and Sub 2 being allocated increased amounts of deductions for depreciation or reduced amounts of gain (or increased amounts of loss) upon the sale of Partnership C's remaining depreciable asset. C reports the relatively small cost savings in the C Financial Statements.

<u>Situation 3</u>. C indirectly owns more than 50 percent of the stock of Sub 1 and Sub 2, both domestic corporations. Sub 1 and Sub 2 are the only partners in Partnership D with each having a 50 percent interest in the capital, profits, and losses of Partnership D.

Prior to Date 3, Partnership D owned two assets: a depreciable asset with an adjusted basis of $20x and a fair market value of $100x and nondepreciable land with an adjusted basis of $90x and fair market value of $100x. Also prior to Date 3, Sub 1's outside basis in Partnership D was $100x, and Sub 2's outside basis in Partnership D was $20x as a result of Sub 1 and Sub 2 making contributions to Partnership D, and Partnership D making distributions to Sub 1 and Sub 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with § 704(b) and (c). Such contributions, distributions, and allocations were undertaken with a view to creating a disparity between Partnership D's inside basis in the depreciable asset and Sub 1's outside basis in Partnership D.

On Date 3, Partnership D liquidates by distributing the depreciable asset to Sub 1 and the nondepreciable land to Sub 2 (Partnership D Liquidation). The stated business purpose for the Partnership D Liquidation is to achieve cost savings for C and the C Subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after the Partnership D Liquidation, Sub 1's adjusted basis in the depreciable asset is $100x under § 732(b), the same as Sub 1's outside basis in Partnership D prior to the Partnership D Liquidation, reflecting an increase of $80x to the adjusted basis of the depreciable asset in the hands of Sub 1. Also immediately after the Partnership D Liquidation, Sub 2's adjusted basis in the nondepreciable land is $20x under § 732(b), the same as Sub 2's outside basis in Partnership D prior to the Partnership D Liquidation, reflecting a decrease of $70x to the adjusted basis of the nondepreciable land in the hands of Sub 2. The distribution of the depreciable asset to Sub 1 as part of the Partnership D Liquidation on Date 3 was undertaken with a view to exploiting the disparity between Partnership D's inside basis in the depreciable asset and Sub 1's outside basis in Partnership D created before Date 3 and transferring basis from nondepreciable land distributed to Sub 2 to the depreciable asset distributed to Sub 1.

The cost savings resulting from the Partnership D Liquidation are insubstantial in relation to the reduction in the aggregate Federal income tax liability of the C Subsidiaries resulting from the $80x increase in Sub 1's adjusted basis in the depreciable asset, which results in increased deductions for depreciation or reduced amounts of gain (or increased amounts of loss) upon the sale of the depreciable asset for Sub 1. C reports the relatively small cost savings in the C Financial Statements.

LAW

Section 267(a) generally disallows deductions in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of § 267(b), other than any loss of a distributing corporation (or the distributee) in the case of a distribution in complete liquidation. Section 267(b)(3) provides that two corporations that are members of the same controlled group (as defined in § 267(f)) have a relationship referred to in § 267(a). Section 267(f)(1) provides that a controlled group has the meaning given by § 1563(a), except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in § 1563(a), and the determination is made without regard to § 1563(a)(4) and (e)(3)(C). In addition, § 267(b)(10) provides that a corporation and a partnership owned by the same persons have a relationship referred to in § 267(a) if the same persons own more than 50 percent of both the value of the outstanding stock of the corporation and the capital interest, or the profits interest, in the partnership.

Section 707(b)(1)(A) disallows any deduction for losses from sales or exchanges of property (other than an interest in the partnership) directly or indirectly, between a partnership and a partner owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership. Section 707(b)(1)(B) disallows any deduction for losses from sales or exchanges of property (other than an interest in the partnership) directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners on the contribution of property to the partnership in exchange for an interest in the partnership. Section 723 provides that the basis of property contributed to a partnership by a partner is the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount of gain (if any) recognized under § 721(b) to the contributing partner at such time.

Section 731(b) provides that no gain or loss is recognized to a partnership on the distribution to a partner of property, including money. Section 732(a)(1) generally provides that the basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partner's interest is its adjusted basis to the partnership immediately before the distribution. However, § 732(a)(2) limits the basis to the distributee partner to the adjusted basis of that partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(b) provides that the basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest equals the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction. Section 732(c) provides rules for the allocation of basis among properties received in a distribution to which § 732(a)(2) or § 732(b) applies.

Section 733 provides that the adjusted basis of a distributee partner's interest in a partnership following a non-liquidating distribution is reduced (but not below zero) by (1) the amount of any money distributed to the partner, and (2) the adjusted basis of distributed property (other than money), as determined under § 732.

Section 734(a) provides that the basis of partnership property is not adjusted as the result of a distribution of property to a partner unless an election provided in § 754 is in effect or there is a substantial basis reduction (as defined in § 734(d)) with respect to such distribution. Section 734(b) provides that a partnership, with respect to which an election provided in § 754 is in effect or with respect to which there is a substantial basis reduction, increases or decreases the adjusted basis of partnership property to take into account the gain or loss recognized by a distributee partner under § 731(a) or changes in the basis of distributed property under § 732. Under § 734(b)(1)(B), in the case of distributed property to which § 732(a)(2) applies, the amount of increase includes the excess of the adjusted basis of the distributed property immediately before the distribution over the basis of the distributed property to the distributee. If § 734(b) is applicable, § 734(c) provides that the allocation of basis among partnership properties is made in accordance with the rules provided in § 755. Section 734(d) provides that there is a substantial basis reduction with respect to a distribution if, had an election provided in § 754 been in effect, there would be a negative net basis adjustment to partnership property of more than $250,000.

Section 743(a) provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in a partnership by sale or exchange or on the death of a partner unless an election provided in § 754 is in effect or there is a substantial built-in loss (as defined in § 743(d)) immediately after such transfer. Section 743(b) provides that, in the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which an election provided in § 754 is in effect or a partnership that has a substantial built-in loss immediately after such transfer, increases the adjusted basis of the partnership property by the excess of the basis to the transferee partner of the transferee partner's interest in the partnership over such partner's proportionate share of the adjusted basis of the partnership property, or decreases the adjusted basis of the partnership property by the excess of the transferee partner's proportionate share of the adjusted basis of the partnership property over the basis of such partner's interest in the partnership. Section 743(b) further provides that, under regulations prescribed by the Secretary of the Treasury or her delegate (Secretary), such increase or decrease constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. If § 743(b) is applicable, § 743(c) provides that the allocation of basis among partnership properties is made in accordance with the rules provided in § 755.

Section 754 provides, in part, that if a partnership files an election, in accordance with the regulations prescribed by the Secretary, the basis of partnership property is adjusted, in the case of a distribution of property, in the manner provided in § 734, and, in the case of a transfer of a partnership interest, in the manner provided in § 743. A § 754 election applies with respect to all distributions of property by the partnership and to all transfers of interests in the partnership during the taxable year with respect to which the election was filed and all subsequent taxable years.

Section 755(a) provides that a basis adjustment under § 734(b) or § 743(b) is allocated among partnership properties in a manner that reduces the difference between the fair market values and adjusted bases of those properties or in any other manner permitted by the regulations prescribed by the Secretary. Section 755(b) provides that in applying the allocation rules of § 755(a), increases or decreases in the adjusted basis of partnership property arising from a distribution of, or a transfer of an interest attributable to, capital assets and property described in § 1231(b), or any other property of the partnership, are allocated to partnership property of like character. The allocation of basis adjustments under § § 743(b) and 734(b) among partnership property is provided in § 1.755-1(b) and (c), respectively.

Section 7701(o)(1) provides that, in the case of any transaction to which the economic substance doctrine is relevant, the transaction is treated as having economic substance only if (i) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (ii) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. For this purpose, achieving a financial accounting benefit is not taken into account as a purpose for entering into a transaction if the origin of such financial accounting benefit is a reduction of Federal income tax. Section 7701(o)(4).

Section 7701(o)(5)(A) provides that the "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A of the Code with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

Section 7701(o)(5)(C) provides that the determination of whether the economic substance doctrine is relevant to a transaction is made in the same manner as if § 7701(o) had never been enacted.

Section 7701(o)(5)(D) provides that the term "transaction" includes a series of transactions.

Section 7701(o)(2)(A) provides that if a taxpayer relies on profit potential to help prove that a transaction has economic substance, profit potential will only be taken into account if the present value of the reasonably-expected pretax profit of that transaction is substantial in relation to the present value of the expected net tax benefits of the transaction that would be allowed if the Federal income tax effects of the transaction were not disregarded.

Section 6662(b)(6) provides that a 20 percent penalty applies to an underpayment attributable to a transaction lacking economic substance under § 7701(o) or failing to meet the requirements of any similar rule of law. Under § 6662(i), the penalty is increased to 40 percent or any portion of an underpayment that is attributable to one or more nondisclosed noneconomic substance transactions. Under § 6664(c)(2), there is no reasonable cause exception to the penalties described in § 6662(b)(6) or (i).

ANALYSIS

The basis adjustment rules under § § 732(b), 734(b), and 743(b) are intended to reduce disparities between inside and outside basis that would otherwise result from a distribution of property or transfer of a partnership interest. In each of Situations 1-3, however, the parties engaged in a concerted effort to create disparities between inside and outside basis through various methods, such as the contribution or distribution of property with specific Federal income tax attributes or the allocation of Federal income tax items in accordance with § 704(b) and (c). They then exploited the created disparities by engaging in transfers resulting in basis adjustments under the mechanical rules of § 732(b), 734(b), or 743(b) to inappropriately reduce taxable income through increased deductions or reduced gain (or increased loss).

In Situation 1, the actions of the parties creating a disparity between Sub 1's outside basis and share of Partnership A's inside basis, the transfer of Sub 1's interest in Partnership A to Partnership B in the Sub 1 Contribution, and the resulting positive basis adjustment to Partnership B's share of inside basis of Partnership A's property under § 743(b) were undertaken with a view to increasing Partnership B's share of Partnership A's inside basis in depreciable or amortizable property by $80x while avoiding recognition of gain or loss under § 721(a) through a nonrecognition transaction. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings to C and the C Subsidiaries.

In Situation 2, the actions of the parties creating a disparity between Sub 2's outside basis and Partnership C's inside basis in the Sub 3 stock, the distribution of Sub 3 stock (a high-inside basis asset) to Sub 2 (a partner with a low outside basis in its partnership interest) and the resulting adjustment to the inside basis of Partnership C's remaining property were undertaken with a view to transferring $80x of basis from nondepreciable Sub 3 stock to Partnership C's remaining depreciable asset while avoiding recognition of gain or loss under § 731 through a nonrecognition distribution. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings.

In Situation 3, the actions of the parties creating a disparity between Sub 1's outside basis and Partnership D's adjusted basis in the depreciable asset, the liquidating distribution of the depreciable asset (a low-inside basis asset) to Sub 1 (a partner with a high outside basis in its partnership interest) in the Partnership D Liquidation and the resulting adjustment to the adjusted basis of the depreciable asset to Sub 1 under § 732(b) were undertaken with a view to transferring basis from nondepreciable land distributed to Sub 2 to the depreciable asset distributed to Sub 1 while avoiding recognition of gain or loss under § 731 through a nonrecognition distribution. Additionally, the $80x basis increase was relatively large in amount compared to the cost savings to C and the C Subsidiaries.

Situations 1-3 all involve persons related to each other under § 267(b) or § 707(b)(1). A transaction among related parties to avoid Federal income tax by generating inflated basis adjustments falls outside the plain intent of § § 732(b), 734(b), 743(b), and 754. While the differing economic interests of unrelated parties generally make it less likely that unrelated partners will engage in transactions such as those in Situations 1-3, partnerships composed of related partners have no such disincentive.[4]

Congress intended that the provisions of subchapter K apply to transactions between partnerships and their partners to preserve parity between inside and outside basis "so as to prevent any unintended tax benefit or detriment to the partners." H.R. Rep. No. 1337, 83d Cong., 2d Sess. A225 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 384 (1954). Congress also expressed its desire to prevent related parties from exploiting the rules of subchapter K to avoid tax "through the realization of fictitious losses or increasing the basis of property for purposes of depreciation." H.R. Rep. No. 1337, at A226; S. Rep. No. 1622, at 386-87.

Congress did not intend that taxpayers be able to *avoid or indefinitely defer taxation* altogether by creating basis disparities through contributions or distributions of property or through allocations of tax items by reason of a § 743(b) basis adjustment after a nonrecognition transaction, such as the Sub 1 Contribution in Situation 1; by reason of a § 734(b) basis adjustment after distribution of property, such as the Sub 3 Stock Distribution in Situation 2; or by reason of a § 732(b) basis adjustment after a liquidating distribution of property, such as the Partnership D Liquidation in Situation 3. The shared economic interests of related parties make them more likely than unrelated parties to attempt to generate such tax benefits in a manner not intended by Congress by entering into transactions with no meaningful economic change.

Unless a "meaning plainly appears" that Congress intended a provision to grant a tax benefit to transactions without economic substance or business purpose, such an intent "will not [be] attribute[d] to Congress." Knetsch v. United States, 364 U.S. 361, 367-69 [6 AFTR 2d 5851] (1960). The economic substance doctrine is intended to apply "despite literal compliance with the statute." Coltec Indus., Inc. v. United States , 454 F.3d 1340, 1354 [98 AFTR 2d 2006-5249] (Fed. Cir. 2006); see Gregory v. Helvering, 293 U.S. 465, 470 [14 AFTR 1191] (1935). The economic substance doctrine was developed to address transactions such as these, which follow the literal words of the Code but lie outside of Congress's plain intent. Gregory, 293 U.S. at 469-470.

Each series of transactions described in Situations 1-3 lacks economic substance. In each of those situations, the economic substance doctrine is applied to basis adjustments generated by the following series of connected transactions involving related parties, which may occur over the course of several taxable years: (i) the parties generate basis disparities through various methods, such as contributions of property with specific Federal income tax attributes to the partnership, the allocation of Federal income tax items in accordance with § 704(b) and (c), or distributions of property with specific attributes to the partners, and (ii) either (1) a partner transfers its partnership interest in a nonrecognition transaction while there exists an inside/outside basis disparity, or (2) the partnership distributes property with specific Federal income tax attributes (for example, high inside basis) to one or more partners with specific Federal income tax attributes (for example, low outside basis) in a current or liquidating distribution. The resulting basis adjustments, if allowed, would permit the parties to shift basis in a manner that enables the parties to claim increased cost recovery deductions or reduced gain (or increased loss) upon the sale of the basis-adjusted property.

In applying the conjunctive test of § 7701(o)(1), each of two prongs must be met for the transactions described in Situations 1-3 to have economic substance. First, under § 7701(o)(1)(A), the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position. Second, under § 7701(o)(1)(B), the taxpayer must have had a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

With respect to the first prong under § 7701(o)(1)(A), the transactions in Situations 1-3 have a negligible effect on C's economic position because the transactions shift ownership of property among commonly controlled entities without "effect[ing] any real change in the 'flow of economic benefits,' or provid[ing] any real 'opportunity to make a profit' . . . ." Coltec, 454 F.3d at 1360; see Reddam v. Commissioner, 755 F.3d 1051, 1060-62 [113 AFTR 2d 2014-2549] (9th Cir. 2014). The transactions fail to "*appreciably* affect the [taxpayer's] beneficial interest except to reduce ... tax" ; that is, the transactions do not appreciably affect C's beneficial interests in the C Subsidiaries or their assets, except to reduce the aggregate Federal income tax liability of the related persons involved. Knetsch, 364 U.S. at 366 (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 [52 AFTR 634] (2d Cir. 1957) (Learned Hand, J., dissenting)) (emphasis added). The only potential economic gains are derived from purported cost savings from cleaning up intercompany accounts between the C Subsidiaries, reducing administrative complexity, and achieving administrative efficiencies. However, any such cost savings do not change C and the C Subsidiaries' economic position in a meaningful way because any economic benefits attributable to purported cost savings (apart from the Federal income tax effects) are insubstantial compared to the $80x in Federal income tax benefits from the basis adjustments attributable to these transactions. The basis increases of $80x resulting from the transactions in Situations 1-3 can be used to reduce taxable income of the C Subsidiaries through depreciation, amortization, or other deductions or reduce gain recognized upon the sale of the property. The transactions were "designed to generate" basis increases, and those basis increases "would always ... have overshadowed" the economic gain, including gain derived from cost savings. Reddam, 755 F.3d at 1061-62. Even if there had been "some prospect of profit" from transferring a partnership interest or partnership property among related parties, the calculable Federal income tax benefits would have "far exceeded any independent potential for economic return." Bank of New York Mellon Corp. v. Commissioner, 801 F.3d 104, 117-18 [116 AFTR 2d 2015-6014], 120 (2d Cir. 2015); Salem Fin., Inc. v. United States, 786 F.3d 932, 949 [115 AFTR 2d 2015-1835] (Fed. Cir. 2015) (citing Knetsch, 364 U.S. at 365-66). Thus, any change in economic position (apart from the Federal income tax effects) in the transactions described in Situations 1-3 is not meaningful within the meaning of § 7701(o)(1)(A).

With respect to the second prong of the conjunctive test under § 7701(o)(1)(B), the transactions described in Situations 1-3 demonstrate a lack of any substantial purpose (apart from Federal income tax effects) to enter into these transactions. The stated business purpose of achieving cost savings from cleaning up intercompany accounts between the C Subsidiaries, reducing administrative complexity, and achieving administrative efficiencies may be a legitimate nontax economic purpose. However, any such business purpose is not substantial compared to the Federal income tax purposes the transactions were designed to carry out. See Reddam, 755 F.3d at 1061. Many of the facts in these transactions demonstrating a lack of meaningful change in economic position (apart from Federal income tax effects) also demonstrate a lack of substantial purpose (apart from Federal income tax effects) for these related parties to enter into these transactions. Reasonable inferences into a taxpayer's purpose for entering a transaction can be drawn from the facts and circumstances surrounding such transaction, including results from a transaction that the taxpayer could have reasonably anticipated as well as results from a transaction that were by design. The fact that the cost savings were insubstantial compared to relatively large basis increases of $80x, that there was no appreciable effect on the parties' economic ownership of the property allocated the basis increases, and that the transactions were structured to guarantee basis increases of $80x to depreciable or amortizable property while carrying a *de minimis* risk of economic loss compared to the designed Federal income tax benefit, Altria Grp., 658 F.3d at 290-91, "indicate[] that the taxpayer's true motivation for the transaction is tax avoidance." See Bank of New York Mellon Corp. v. United States, 140 T.C. 15, 38 (2013). Therefore, C lacked a substantial purpose (apart from Federal income tax effects) for causing its subsidiaries to enter into the transactions described in Situations 1-3 within the meaning of § 7701(o)(1)(B).

If a transaction or series of transactions lacks economic substance, it may be disregarded for Federal income tax purposes. See Gregory, 293 U.S. 465 [14 AFTR 1191]; Coltec, 454 F.3d at 1352; ACM P'ship v. Commissioner, 157 F.3d 231, 247-48 [82 AFTR 2d 98-6682] (3d Cir. 1998). While a transaction might meet the literal requirements of the Code, courts will not recognize a transaction that is not within the intent of the Code. Gregory, 293 U.S. at 469-70. The series of transactions described in Situations 1-3—related-party contributions or distributions of property or allocations of tax items and the subsequent transfer of a partnership interest or distribution of property to generate a basis adjustment to property that is eligible for cost recovery (or is held for future sale)—failed both prongs under § 7701(o)(1) and, therefore, lack economic substance. As a result, their Federal income tax effects must be disregarded. The transactions did not change in a meaningful way (apart from Federal income tax effects) the economic position of C or the C Subsidiaries within the meaning of § 7701(o)(1)(A), and C lacked a substantial business or other purpose (apart from Federal income tax effects) for causing the C Subsidiaries to enter into these transactions within the meaning of § 7701(o)(1)(B).

In addition, under § 6662(b)(6), the transactions described in Situations 1-3 give rise to a 20 percent penalty applicable to an underpayment attributable to a transaction lacking economic substance under § 7701(o). The penalty is increased to 40 percent on any portion of the underpayment attributable to one or more nondisclosed noneconomic substance transactions. See § 6662(i). Under § 6664(c)(2), a reasonable cause exception to the penalties described in § 6662(b)(6) and (i) may not be asserted.

The series of transactions described in Situations 1-3 may also be subject to the partnership anti-abuse rule under § 1.701-2 or the § 704(c) anti-abuse rule under § 1.704-3(a)(10). Other anti-abuse doctrines including, but not limited to, the substance-over-form doctrine and step-transaction doctrine may apply, depending on the facts and circumstances of a specific transaction or series of transactions.

HOLDING(S)[5]

(1) The series of transactions in Situations 1-3 lack economic substance under § 7701(o). The transactions did not change the economic position of C or the C Subsidiaries in a meaningful way (aside from the Federal income tax effects). Additionally, neither C nor the C Subsidiaries had a substantial purpose for entering the transactions (aside from Federal income tax effects).

(2) In Situation 1, the basis adjustment under § 743(b) is disregarded. As a result, Partnership B is not entitled to an increase of $80x in its share of the inside basis of Partnership A's assets, and Partnership B's share of the inside basis of Partnership A's assets remains $20x.

(3) In Situation 2, the basis adjustment under § 734(b) is disregarded. As a result, Partnership C is not entitled to an increase of $80x to the inside basis of the remaining depreciable asset, and the inside basis of the depreciable asset remains $10x.

(4) In Situation 3, the basis adjustment to Sub 1 under § 732(b) is disregarded. As a result, Sub 1 is not entitled to an increase of $80x to the adjusted basis of the depreciable asset, and the adjusted basis of Sub 1's depreciable asset remains $20x.

(5) C and/or the C Subsidiaries, as applicable, are subject to the 20 percent penalty under § 6662(b)(6) or the 40 percent penalty under § 6662(i) for a nondisclosed noneconomic substance transaction, as applicable.

DRAFTING INFORMATION

The principal author of this revenue ruling is Anthony P. Sacco of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Anthony P. Sacco at (202) 317-5805.

---

1 Unless otherwise specified, all "Section" or "§" references are to sections of the Code or the Income Tax Regulations (26 CFR part 1).

2 This section shows a mechanical application of the rules of subchapter K of chapter 1 of the Code (subchapter K). The tax effect will be disregarded if the economic substance doctrine applies. Later sections of this revenue ruling address whether the economic substance doctrine applies.

3 The distribution of Sub 3 stock (controlled corporation) to Sub 2 (corporate partner) meets the requirements of § 732(f) because Partnership C s adjusted basis in the Sub 3 stock prior to the Sub 3 Stock Distribution exceeds the adjusted basis of the stock in the hands of the corporate partner (Sub 2). Under § 732(f), the aggregate adjusted bases of Sub 3 s property must be reduced by $80x, subject to the limitations in § 732(f)(3). Additionally, this revenue ruling does not address the application of § 751(b) to the facts of Situations 2 and 3.

4 This revenue ruling does not address the application of § 7701(o) to transactions among unrelated partners. Depending on the specific facts, § 7701(o) may apply to transactions among unrelated partners.

5 This revenue ruling makes no interpretations regarding which audit procedures (for example, the application of subchapter C of chapter 63 of the Code) might apply to effectuate the substantive interpretations of the Holdings section. Any such interpretations would require facts that are outside the scope of this revenue ruling.

END OF DOCUMENT -

Checkpoint Contents
Federal Library
Federal Source Materials
IRS Rulings & Releases
Revenue Rulings & Procedures, Notices, Announcements, Executive & Delegation Orders, News Releases & Other IRS Documents
Revenue Procedures (1955 to Present)
2023
Rev. Proc. 2023-40, 2023-51 IRB 1553 -- IRC Sec(s). 6662, 12/15/2023

Revenue Procedures

Rev. Proc. 2023-40, 2023-51 IRB 1553, 12/15/2023, IRC Sec(s). 6662

Accuracy-related penalties—adequate disclosure.

Headnote:

IRS updated Rev. Proc. 2022-41 , 2022-50 IRB 527 and identified circumstances under which disclosure on taxpayer's income tax return is adequate, for purpose of reducing understatement under Code Sec. 6662(d); and for purpose of avoiding return preparer penalty under Code Sec. 6694(a); . This applies to return filed on 2023 tax forms for tax year beginning in 2023 as well as return filed on 2023 form for short tax year beginning in 2024.

Reference(s): ¶ 66,625.01(20); Code Sec. 6662;

Full Text:

1. PURPOSE

This revenue procedure updates Rev. Proc. 2022-41, 2022-50 I.R.B. 527, and identifies circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or position is adequate for the purpose of reducing the understatement of income tax under section 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the tax return preparer penalty under section 6694(a) (relating to understatements due to unreasonable positions) with respect to income tax returns. This revenue procedure does not apply with respect to any other penalty provisions (including but not limited to the disregard provisions of the section 6662(b)(1) accuracy-related penalty, the section 6662(i) increased accuracy-related penalty in the case of nondisclosed noneconomic substance transactions, and the section 6662(b)(7) and (j) increased accuracy-related penalty in the case of undisclosed foreign financial asset understatements). If this revenue procedure does not include an item or position, disclosure is adequate with respect to that item or position 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. *See* Treas. Reg. § 1.6664-2(c) for information about qualified amended returns.

This revenue procedure applies to any income tax return filed on 2023 tax forms for a taxable year beginning in 2023, and to any income tax return filed in 2024 on 2023 tax forms for short taxable years beginning in 2024.

2. CHANGES FROM REV. PROC. 2022-41

Changes have been made in order to update the taxable years to which this revenue procedure applies. No substantive changes have been made.

3. BACKGROUND

.01. If section 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount generally equal to 20 percent of the portion of the underpayment is added to the tax. Under section 6662(b)(2), the penalty applies to the portion of any underpayment of tax that is attributable to a substantial understatement of income tax. The penalty rate increases to 40 percent in the case of gross valuation misstatements under section 6662(h), nondisclosed noneconomic substance transactions under section 6662(i), or undisclosed foreign financial asset understatements under section 6662(j).

.02. Generally, there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of (i) 10 percent of the amount of tax required to be shown on the return for the taxable year or (ii) $5,000. Section 6662(d)(1). Section 6662(d)(1)(C) provides a special rule for taxpayers claiming a section 199A deduction. In the case of any taxpayer who claims any deduction allowed under section 199A for the taxable year, there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of (i) 5 percent of the amount of tax required to be shown on the return for the taxable year or (ii) $5,000. Section 6662(d)(1)(B) provides a special rule for corporations. A corporation (other than an S corporation or a personal holding company) has a substantial understatement of income tax if the amount of the understatement exceeds the lesser of (i) 10 percent of the tax required to be shown on the return for a taxable year (or, if greater, $10,000) or (ii) $10,000,000. Generally, an understatement is the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate, where the excess is determined without regard to items to which the reportable transaction understatement penalty under section 6662A applies. Section 6662(d)(2)(A). For purposes of determining whether an understatement is substantial, the understatement determined under the general rule is increased by the aggregate amount of any reportable transaction understatements relating to the return. Section 6662A(e)(1)(A).

.03. In the case of an item not attributable to a tax shelter, if the taxpayer has a reasonable basis for the tax treatment of the item, the amount of the understatement is reduced by the portion of the understatement attributable to the item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return. Section 6662(d)(2)(B)(ii).

.04. Section 6694(a) imposes a penalty on a tax return preparer who prepares a return or claim for refund reflecting an understatement of liability due to an "unreasonable position" if the tax return preparer knew (or reasonably should have known) of the position. A position (other than a position with respect to a tax shelter or a reportable transaction to which section 6662A applies) is generally treated as unreasonable unless (i) there is or was substantial authority for the position, or (ii) the position was properly disclosed in accordance with section 6662(d)(2)(B)(ii)(I) and had a reasonable basis. If the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, the position is treated as unreasonable unless it is reasonable to believe that the position would more likely than not be sustained on the merits. *See* Notice 2009-5, 2009-3 I.R.B. 309, for interim penalty compliance rules for tax shelter transactions.

.05. 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.

.06. This revenue procedure may apply to a return for a fiscal tax year that begins in 2023 and ends in 2024. This revenue procedure may also apply to a short year return for a period beginning in 2024 if the return is to be filed before the 2024 forms are available. (Note that individuals are generally not put in this position.) The most frequent situation in which a short year arises is when filing a decedent's final return for a fractional part of a year. In that situation, the 2024 form will be available because the final return is due the fifteenth day of the fourth month following the close of the 12-month period that began with the first day of such fractional part of the year (meaning the due date is not accelerated). *See* Treas. Reg. § 1.6072-1(b). In the case of fiscal year and short year returns, the taxpayer must take into account any tax law changes that are effective for tax years beginning after December 31, 2023, even though these changes are not reflected on the form or instructions.

.07. This document does not take into account the effect of tax law changes effective for tax years beginning after December 31, 2023. If a line referenced in this revenue procedure is affected by such a change and requires additional reporting, a taxpayer may have to file Form 8275, *Disclosure Statement*, or Form 8275-R, *Regulation Disclosure Statement*, until the Service prescribes criteria for complying with the requirement.

.08. 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.

4. PROCEDURE

.01. General

(1) Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under section 6662(d) (except as otherwise provided in section 4.02(3) concerning Schedules M-1 and M-3), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions.

(2) The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can prove the origin of the amount (even if that number is not ultimately accepted by the Service) and the taxpayer can show good faith in entering that number on the applicable form.

(3) The disclosure of an amount as provided in section 4.02 below is not adequate when the understatement arises from a transaction between parties who are related within the meaning of section 267(b). If an entry may present a legal issue or controversy because of a related-party transaction, then that transaction and the relationship must be disclosed on a Form 8275 or Form 8275-R.

(4) When the amount of an item is shown on a line that does not have a preprinted description identifying that item (such as on an unnamed line under an "Other Expense" category), the taxpayer must clearly identify the item by including the description on that line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C (Form 1040 or 1040-SR) that shows the amount of the bad debt. Also, for Schedule M-3 (Form 1120), Part II, line 25, Other income (loss) items with differences, or Part III, line 38, Other expense/deduction items with differences, the entry must

provide descriptive language; for example, "Cost of non-compete agreement deductible not capitalizable," and the description must be provided on an attachment. Similarly, for other forms, if space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

(5) Although a taxpayer may literally meet the disclosure requirements of this revenue procedure, the disclosure will have no effect for purposes of the section 6662 accuracy-related penalty if the item or position on the return (1) does not have a reasonable basis as defined in Treas. Reg. § 1.6662-3(b)(3); (2) is attributable to a tax shelter item as defined in section 6662(d)(2)(C)(ii); or (3) is not properly substantiated or the taxpayer failed to keep adequate books and records with respect to the item or position.

(6) Disclosure also will have no effect for purposes of the section 6694(a) penalty as applicable to tax return preparers if the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies.

.02. Items

(1) Form 1040, Schedule A, *Itemized Deductions*:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 7, supplying all required information. Line 6 must list each type of tax and the amount paid.

(c) Interest Expenses: Complete lines 8 through 10, supplying all required information. This section 4.02(1)(c) does not apply to (i) amounts disallowed under section 163(d) unless Form 4952, *Investment Interest Expense Deduction*, is completed, or (ii) amounts disallowed under section 265.

(d) Charitable Contributions: Complete lines 11 through 14, supplying all required information and attaching all related forms required pursuant to statute or regulation.

(e) Casualty and Theft Losses: Complete Form 4684, *Casualties and Thefts*, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section, the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.02(1)(e) must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or non-deductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Officers' Compensation: Complete Form 1125-E, *Compensation of Officers*, when its instructions require completion. You must express the "percent of time devoted to business" as a numerical percentage, rather than as a non-numerical description such as "part" or "as needed." This section does not apply to "excess parachute payments," as defined in section 280G. This section does not apply to the extent that remuneration paid or incurred exceeds an applicable employee-remuneration deduction limitation under section 162(m).

(e) Repair Expenses: The amount claimed must be stated. This section does not apply, however, to any amount properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Differences in book and income tax reporting:

For Schedule M-1 and all Schedules M-3, including those listed in (a)-(f) below, the information provided must reasonably apprise the Service of the potential controversy concerning the tax treatment of the item. If the information provided does not so apprise the Service, a Form 8275 or Form 8275-R must be used to adequately disclose the item (*see* Part II of the instructions for those forms).

Note: An item reported on a line with a pre-printed description, shown on an attached schedule or "itemized" on Schedule M-1, may represent the aggregate amount of several transactions producing that item (*i.e.*, a group of similar items, such as amounts paid or incurred for supplies by a taxpayer engaged in business). In some instances, a potentially controversial item may involve a portion of the aggregate amount disclosed on the schedule. The Service will not be reasonably apprised of a potential controversy by the aggregate amount disclosed. In these instances, the taxpayer must use Form 8275 or Form 8275-R regarding that portion of the item.

Combining unlike items, whether on Schedule M-1 or Schedule M-3 (or on an attachment when directed by the instructions), will not constitute an adequate disclosure.

Additionally, taxpayers that file the Schedule M-3 (Form 1120), *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*, may be required to complete Schedule B (Form 1120), *Additional Information for Schedule M-3 Filers*. For further information, see Who Must File in the General Instructions for Schedule B (Form 1120). Taxpayers that file the Schedule M-3 (Form 1065), *Net Income (Loss) Reconciliation for Certain Partnerships*, may be required to complete Schedule C (Form 1065), *Additional*

Information for Schedule M-3 Filers. For further information, see Who Must File in the General Instructions for Schedule C (Form 1065). When required, these schedules are necessary to constitute adequate disclosure:

(a) Form 1065. Schedule M-3 (Form 1065), *Net Income (Loss) Reconciliation for Certain Partnerships*:

Part II (reconciliation of income (loss) items)	Column (a), *Income (Loss) per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Income (Loss) per Tax Return*
Part III (reconciliation of expense/deduction items)	Column (a), *Expense per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Deduction per Tax Return*

(b) Form 1120. (i) Schedule M-1, *Reconciliation of Income (Loss) per Books With Income per Return*.

(ii) Schedule M-3 (Form 1120), *Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More*:

Part II (reconciliation of income (loss) items)	Column (a), *Income (Loss) per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Income (Loss) per Tax Return*
Part III (reconciliation of expense/deduction items)	Column (a), *Expense per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Deduction per Tax Return*

(c) Form 1120-L. Schedule M-3 (Form 1120-L), *Net Income (Loss) Reconciliation for U.S. Life Insurance Companies With Total Assets of $10 Million or More*:

Part II (reconciliation of income (loss) items)	Column (a), *Income (Loss) per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Income (Loss) per Tax Return*
Part III (reconciliation of expense/deduction items)	Column (a), *Expense per Income Statement*; Column (b), *Temporary Difference*;

	Column (c), *Permanent Difference*; and Column (d), *Deduction per Tax Return*

(d) Form 1120-PC. Schedule M-3 (Form 1120-PC), *Net Income (Loss) Reconciliation for U.S. Property and Casualty Insurance Companies With Total Assets of $10 Million or More*:

Part II (reconciliation of income (loss) items)	Column (a), *Income (Loss) per Income Statement*; Column (b), *Temporary Difference;* Column (c), *Permanent Difference*; and Column (d), *Income (Loss) per Tax Return*
Part III (reconciliation of expense/deduction items)	Column (a), *Expense per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Deduction per Tax Return*

(e) Form 1120-S. Schedule M-3 (Form 1120-S), *Net Income (Loss) Reconciliation for S Corporations With Total Assets of $10 Million or More*:

Part II (reconciliation of income (loss) items)	Column (a), *Income (Loss) per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Income (Loss) per Tax Return*
Part III (reconciliation of expense/deduction items)	Column (a), *Expense per Income Statement*; Column (b), *Temporary Difference*; Column (c), *Permanent Difference*; and Column (d), *Deduction per Tax Return*

(f) Form 1120-F. Schedule M-3 (Form 1120-F), *Net Income (Loss) Reconciliation for Foreign Corporations With Reportable Assets of $10 Million or More*:

Part II (reconciliation of income (loss) items)	Column (b), *Temporary Differences*; Column (c), *Permanent Differences*; and Column (d), *Other Permanent Differences for Allocations to Non-ECI and ECI*
Part III (reconciliation of expense/deduction items)	Column (b), *Temporary Differences*; Column (c), *Permanent Differences*; and Column (d), *Other Permanent Differences for Allocations to Non-ECI and ECI*

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, *International Boycott Report*; Schedule A, *International Boycott Factor (Section 999(c)(1))*; Schedule B, *Specifically Attributable Taxes and Income (Section 999(c)(2))*; and

Schedule C, *Tax Effect of the International Boycott Provisions*, must be completed when required by their instructions.

(b) Treaty-Based Return Position: Transactions and amounts under section 6114 or section 7701(b) as disclosed on Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, must be completed when required by its instructions.

(5) Other:

(a) Moving Expenses: Complete Form 3903, *Moving Expenses*, and attach to the return.

(b) Employee Business Expenses: Complete Form 2106, *Employee Business Expenses (for use only by Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and employees with impairment-related work expenses)*, and attach to the return. This section does not apply to club dues or to travel expenses for any non-employee accompanying the taxpayer on the trip.

(c) Fuels Credit: Complete Form 4136, *Credit for Federal Tax Paid on Fuels*, and attach to the return.

(d) Investment Credit: Complete Form 3468, *Investment Credit*, and attach to the return.

5. EFFECTIVE DATE

This revenue procedure applies to any income tax return filed on a 2023 tax form for a taxable year beginning in 2023 and to any income tax return filed on a 2023 tax form in 2024 for a short taxable year beginning in 2024.

6. DRAFTING INFORMATION

The principal author of this revenue procedure is Vincent Liu of the Office of the Associate Chief Counsel (Procedure & Administration). For further information regarding this revenue procedure, contact Branch 2 of Procedure and Administration at (202) 317-6844 (not a toll free number).

END OF DOCUMENT -

Revenue Procedures

Rev. Proc. 2024-13, 2024-9 IRB 678, 02/07/2024, IRC Sec(s). 280F

Limitations on depreciation for auto owners and lessees.

Headnote:

IRS provided owners and lessees of passenger automobiles (including trucks, vans, and electric automobiles) with tables detailing limitations on depreciation deductions for passenger automobiles first placed in service during calendar year 2024 and amounts to be included in income for passenger automobiles first leased during calendar year 2024.

Reference(s): Code Sec. 280F;

Full Text:

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.

(Also Part I, §§ 280F; 1.280F-7.)

1. PURPOSE

This revenue procedure provides: (1) two tables of limitations on depreciation deductions for owners of passenger automobiles placed in service by the taxpayer during calendar year 2024; and (2) a table of dollar amounts that must be used to determine income inclusions by lessees of passenger automobiles with a lease term beginning in calendar year 2024. These tables reflect the automobile price inflation adjustments required by § 280F(d)(7) of the Internal Revenue Code. For purposes of this revenue procedure, the term "passenger automobiles" includes trucks and vans.

2. BACKGROUND

.01. For owners of passenger automobiles, § 280F(a) imposes dollar limitations on the depreciation deduction for the year the taxpayer places the passenger automobile in service and for each succeeding year. For passenger automobiles placed in service after 2018, § 280F(d)(7) requires the Internal Revenue Service to increase the amounts allowable as depreciation deductions by a price inflation adjustment amount that is determined using the automobile component of the Chained Consumer Price Index for All Urban Consumers published by the Department of Labor (C-CPI-U).

.02. Section 168(k)(1) provides that, in the case of qualified property, the depreciation deduction allowed under § 167(a) for the taxable year in which the property is placed in service includes an allowance equal to the applicable percentage of the property's adjusted basis, referred to as "§ 168(k) additional first year depreciation deduction" hereinafter. Pursuant to § 168(k)(6)(A), the applicable percentage is 100 percent for qualified property acquired and placed in service after September 27, 2017, and placed in service before January 1, 2023, and is phased down 20 percent each year for property placed in service through December 31, 2026. Accordingly, the applicable percentage for qualified property acquired after September 27, 2017, and placed in service after December 31, 2023, and before January 1, 2025, is 60 percent. Pursuant to § 168(k)(8)(D)(i), no § 168(k) additional first year depreciation deduction is allowed or allowable for qualified property acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after 2019. For qualified property acquired and placed in service after September 27, 2017, § 168(k)(2)(F)(i) increases the first-year depreciation allowed under § 280F(a)(1)(A)(i) by $8,000.

.03. Tables 1 and 2 of this revenue procedure provide depreciation limitations for passenger automobiles placed in service by the taxpayer during calendar year 2024. Table 1 provides depreciation limitations for passenger automobiles acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during calendar year 2024, for which the § 168(k) additional first year depreciation deduction applies. Table 2 provides depreciation limitations for passenger automobiles placed in service by the taxpayer during calendar year 2024 for which no

§ 168(k) additional first year depreciation deduction applies. The § 168(k) additional first year depreciation deduction does not apply for 2024 if the taxpayer: (1) did not use the passenger automobile during 2024 more than 50 percent for business purposes; (2) elected out of the § 168(k) additional first year depreciation deduction pursuant to § 168(k)(7) for the class of property that includes passenger automobiles; (3) acquired the passenger automobile used and the acquisition of such property did not meet the acquisition requirements in § 168(k)(2)(E)(ii) and § 1.168(k)-2(b)(3)(iii) of the Income Tax Regulations; or (4) acquired the passenger automobile before September 28, 2017, and placed it in service after 2019.

.04. Section 280F(c)(2) requires a reduction to the amount allowable as a deduction to the lessee of a leased passenger automobile. Pursuant to § 280F(c)(3), the reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of passenger automobiles. Under § 1.280F-7(a), this reduction is accomplished by requiring the lessee to include in gross income an amount determined by applying a formula to a dollar amount obtained from a table.

.05. Table 3 of this revenue procedure provides the dollar amount used by lessees of passenger automobiles with a lease term beginning in 2024 to determine the income inclusion amount for those passenger automobiles. The table provides dollar amounts for a range of fair market values.

3. SCOPE

.01. The limitations on depreciation deductions in Tables 1 and 2 in section 4.01(2) of this revenue procedure apply to passenger automobiles, other than leased passenger automobiles, that are placed in service by the taxpayer in calendar year 2024, and continue to apply for each taxable year that the passenger automobile remains in service.

.02. The dollar amounts in Table 3 of this revenue procedure apply to leased passenger automobiles with a lease term beginning in calendar year 2024, and continue to apply for each taxable year during the lease.

.03. *See* Rev. Proc. 2019-26, 2019-24 I.R.B. 1323, for passenger automobiles placed in service or leased during calendar year 2019; Rev. Proc. 2020-37, 2020-33 I.R.B. 381, for passenger automobiles placed in service or leased during calendar year 2020; Rev. Proc. 2021-31, 2021-34 I.R.B. 324, for passenger automobiles placed in service or leased during calendar year 2021; Rev. Proc. 2022-17, 2022-13 I.R.B. 930, for passenger automobiles placed in service or leased during calendar year 2022; and Rev. Proc. 2023-14, 2023-6 I.R.B. 466, for passenger automobiles placed in service or leased during calendar year 2023.

4. APPLICATION

.01. Limitations on Depreciation Deductions for Certain Automobiles.

(1) Amount of the inflation adjustment. Under § 280F(d)(7)(B)(i), the automobile price inflation adjustment for any calendar year is the percentage (if any) by which the C-CPI-U automobile component for October of the preceding calendar year exceeds the automobile component of the CPI (as defined in § 1(f)(4)) for October of 2017, multiplied by the amount determined under § 1(f)(3)(B). The amount determined under § 1(f)(3)(B) is the amount obtained by dividing the new vehicle component of the C-CPI-U for calendar year 2016 by the new vehicle component of the CPI for calendar year 2016, where the C-CPI-U and the CPI for calendar year 2016 means the average of such amounts as of the close of the 12-month period ending on August 31, 2016. Section 280F(d)(7)(B)(ii) defines the term "C-CPI-U automobile component" as the automobile component of the Chained Consumer Price Index for All Urban Consumers as described in § 1(f)(6). The product of the October 2017 CPI new vehicle component (144.868) and the amount determined under § 1(f)(3)(B) (0.694370319) is 100.592. The new vehicle component of the C-CPI-U released in November 2023 was 124.743 for October 2023. The October 2023 C-CPI-U new vehicle component exceeded the product of the October 2017 CPI new vehicle component and the amount determined under § 1(f)(3)(B) by 24.151 (124.743 - 100.592). The percentage by which the C-CPI-U new vehicle component for October 2023 exceeds the product of the new vehicle component of the CPI for October of 2017 and the amount determined under § 1(f)(3)(B) is 24.009 percent (24.151/100.592 x 100%), the automobile price inflation adjustment for 2024 for passenger automobiles. The dollar limitations in § 280F(a) are therefore multiplied by a factor of 0.24009, and the resulting increases, after rounding to the nearest $100, are added to the 2018 limitations to give the depreciation limitations applicable to passenger automobiles for calendar year 2024. This adjustment applies to all passenger automobiles that are placed in service in calendar year 2024.

(2) Amount of the limitation. Tables 1 and 2 of this revenue procedure contain the depreciation limitation for each taxable year for passenger automobiles a taxpayer placed in service during calendar year 2024. Use Table 1 for a passenger automobile to which the § 168(k) additional first year depreciation deduction applies that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during calendar year 2024; use Table 2 for a passenger automobile for which no § 168(k) additional first year depreciation deduction applies.

REV. PROC. 2024-13 TABLE 1

DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES ACQUIRED AFTER SEPTEMBER 27, 2017, AND PLACED IN SERVICE DURING CALENDAR YEAR 2024, FOR WHICH THE § 168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES

Tax Year	Amount
1st Tax Year	$ 20,400

2^{nd} Tax Year	$ 19,800
3^{rd} Tax Year	$ 11,900
Each Succeeding Year	$ 7,160

REV. PROC. 2024-13 TABLE 2
DEPRECIATION LIMITATIONS FOR PASSENGER AUTOMOBILES PLACED IN SERVICE DURING CALENDAR YEAR 2024 FOR WHICH NO § 168(k) ADDITIONAL FIRST YEAR DEPRECIATION DEDUCTION APPLIES

Tax Year	Amount
1^{st} Tax Year	$ 12,400
2^{nd} Tax Year	$ 19,800
3^{rd} Tax Year	$ 11,900
Each Succeeding Year	$ 7,160

.02. Inclusions in Income of Lessees of Passenger Automobiles.

A taxpayer must follow the procedures in § 1.280F-7(a) for determining the inclusion amounts for passenger automobiles with a lease term beginning in calendar year 2024. In applying these procedures, lessees of passenger automobiles should use Table 3 of this revenue procedure.

REV. PROC. 2024-13 TABLE 3
DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2024

Fair Market Value of Passenger Automobile Over	Fair Market Value of Passenger Automobile Not Over	1^{st} Tax Year During Lease	2^{nd} Tax Year During Lease	3^{rd} Tax Year During Lease	4^{th} Tax Year During Lease	5^{th} Tax Year During Lease & Later
$62000	$64000	7	16	24	28	32
64,000	66,000	21	47	69	82	94
66,000	68,000	35	77	114	136	157
68,000	70,000	49	107	159	191	219
70,000	72,000	62	138	204	245	281
72,000	74,000	76	168	250	298	344
74,000	76,000	90	199	294	353	406
76,000	78,000	104	229	340	406	469
78,000	80,000	118	259	385	461	531
80,000	85,000	142	313	463	556	640
85,000	90,000	177	388	577	690	797
90,000	95,000	211	465	689	826	952
95,000	100,000	246	541	802	961	1,108
100,000	110,000	298	655	971	1,163	1,343

110,000	120,000	367	807	1,196	1,435	1,655
120,000	130,000	437	958	1,423	1,704	1,968
130,000	140,000	506	1,111	1,647	1,975	2,280
140,000	150,000	575	1,263	1,873	2,245	2,592
150,000	160,000	645	1,414	2,099	2,516	2,904
160,000	170,000	714	1,566	2,325	2,786	3,216
170,000	180,000	783	1,719	2,549	3,057	3,529
180,000	190,000	852	1,871	2,775	3,327	3,841
190,000	200,000	922	2,022	3,001	3,598	4,153
200,000	210,000	991	2,175	3,226	3,868	4,465
210,000	220,000	1,060	2,327	3,452	4,138	4,778
220,000	230,000	1,130	2,478	3,678	4,409	5,089
230,000	240,000	1,199	2,631	3,902	4,680	5,402
240,000	and over	1,268	2,783	4,128	4,950	5,714

5. EFFECTIVE DATE

This revenue procedure applies to passenger automobiles placed in service during calendar year 2024 or with a lease term beginning in calendar year 2024.

6. DRAFTING INFORMATION

The principal author of this revenue procedure is C. Dylan Durham of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Durham at (202) 317-7005 (not a toll-free number).

END OF DOCUMENT -

Guam Society of CPAs
August 21, 2024
Federal Tax Update

1. Moore v. United States, 22-800 U.S. (2024)
2. Secure 2.0 provisions taking effect in 2023 and 2024
3. Overview of the Federal Tax System As In Effect For 2024—Joint Committee on Taxation
4. United Therapeutics v. Commissioner, 133 AFTR 2d 2024 (4th Cir.)—Research Tax Credit
5. In Re: Lee,133 AFTR 2d 2024 (Bankruptcy Court)—Tax Claims
6. In Re: Tampa Hyde Park Café Properties, 133 AFTR 2d 2024-1701 (Bankruptcy Court)—Tax claims-Objection to proof-Alter Ego Theory
7. Friedman v. IRS, 133 AFTR 2d 2024-1663 (Dist. Ct. Wash)—Actions against IRS and IRS Commissioner—proper defendant—damages
8. Cobai v United States, 133 AFTR 2d 2024-1636 (Dist. Ct. Calif)—Refund actions—administrative claims
9. Aguinaldo v. Yee, 133 AFTR 2d 2024-1604 (Dist. Hawaii)—Actions against U.S.—constitutional claims
10. United States v. Eaton Corp., 133 AFTR 2d 2024-1554 (Dist. Ct. Ohio)—Summons enforcement—procedure
11. Cognizant Technology Solutions v. United States, 133 AFTR 2d 2024-1498 (Dist. Ct. New Jersey)—District Court procedure—qui tam suits—False Claims Act—subpoenas—Administrative Procedure Act
12. Foley v. Commissioner, 95 F.4th 740 (2nd Cir. 2024)—Appeals from Tax Court—jurisdiction—small tax case
13. Farhy v. Commissioner, 133 AFTR 2d 2024-1462 (D.C. Cir.)—Information reporting penalties regarding foreign entities—assessment; IRS authority—collection due process
14. Watson v. Commissioner, 133 AFTR 2d 2024-1621 (10th Cir.)—Appeals from Tax Court—jurisdiction
15. United States v. Allahyari, 133 AFTR 2d 2024-1365 (9th Cir.)—Collection actions—lien foreclosure and priority—fraudulent transfers—appeals—jurisdiction
16. Notice 2023-42 Failure to pay corporate estimated tax penalties—corporate alternative minimum tax—waivers
17. Notice 2023-54 Employee benefit plans—required minimum distributions
18. Notice 2023-55 Foreign tax credit—determination of foreign income taxes—temporary relief
19. Notice 2023-59 Energy efficient home improvement credit—home energy audits—requirements and procedure for claiming credit
20. Notice 2023-62 Catch-up contributions—designation of contributions
21. Notice 2023-69 Gross income—leave-based donation programs—Hawaii wildfires

[File: H:\WS\LETTERS\9965-624 GUAM FEDERAL TAX UPDATE.DOCX]

22. Notice 2023-71 Authority to postpone certain deadlines by reason of terroristic or military actions
23. Notice 2024-2 Retirement and pension plans—guidance
24. Notice 2024-7 Failure to pay tax penalties—penalty relief for tax years 2020 and 2021
25. Notice 2024-8 Business use of auto—deductions—optional standard mileage rates for 2024
26. Notice 2024-11 Dividends—reduced capital gains tax rate—qualified foreign corps.—treaties
27. Notice 2024-16 Basis of stock in controlled foreign corps.—adjustments—liquidations and asset reorgs
28. Notice 2024-19 Penalties for failure to furnish correct payee statements—partnerships—sales or exchanges—unrealized receivables and inventory items
29. Notice 2024-31 U.S. taxpayers living abroad—income exclusions—foreign housing costs
30. Notice 2024-44 Tax on nonresident alien individuals—treatment of dividend equivalent payments
31. Notice 2024-54 Partnerships—related-party transactions; basis shifting; tax avoidance—compliance—organization of IRS
32. Notice 2024-55 10% additional tax on early retirement plan distributions—exceptions—emergency personal expenses; domestic abuse
33. Rev. Rul. 2024-10 Exempt orgs.—private foundations—governing instruments—state law
34. Rev. Rul. 2024-14 Partnerships—related-party transactions; basis shifting; tax avoidance—economic substance—accuracy related penalties
35. Rev. Proc. 2023-40 Accuracy-related penalties—adequate disclosure
36. Rev. Proc. 2024-13 Limitations on depreciation for auto owners and lessees
37. Lesson from The Tax Court: Temporary vs. Indefinite Commutes
38. Ledbetter v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-19
39. Lesson from The Tax Court: The IRS's Substantial Justification Defense to Sec. 7430 Fee Awards
40. Castillo v. Commissioner of Internal Revenue, 160 T.C. No. 15 (2023)
41. Lesson from The Tax Court: How to Calculate Insolvency for the Section 108 Exclusion
42. White v. Commissioner of Internal Revenue, T.C. Memo 2023-77
43. Lesson from The Tax Court: Freedom, Taxes, and Hobbies
44. Swanson v. Commissioner of Internal Revenue, T.C. Memo 2023-81
45. Lesson from The Tax Court: Deducting Graduate School Costs
46. Uchinzozo v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-21
47. Lesson from The Tax Court: Creating Your Best Administrative Record
48. Whittaker v. Commissioner of Internal Revenue, T.C. Memo 2023-59
49. Lesson from The Tax Court: Size Does Not Matter
50. Braen v. Commissioner of Internal Revenue, T.C. Memo 2023-85
51. Lesson from The Tax Court: An Object Lesson On Adequate Business Records

52. Ninke v. Commissioner of Internal Revenue, T.C. Memo 2023-88
53. Lesson from The Tax Court: Gotta Get Physical for Casualty Loss Deduction
54. Cleary v. Commissioner of Internal Revenue, T.C. Memo 2023-43
55. Lesson from The Tax Court: Tax Consequence for Discharge of Non-Recourse Debt
56. Parker v. Commissioner of Internal Revenue, T.C. Memo 2023-104
57. Lesson from The Tax Court: The DOI Downside to Disregarded LLC
58. Jacobowitz v. Commissioner of Internal Revenue, T.C. Memo 2023-107
59. Lesson from The Tax Court: The Boundary Waters of Equity
60. Evenhouse v. Commissioner of Internal Revenue, T.C. Memo 2023-113
61. Lesson from the Tax Court: Equitable Tolling During Government Shutdown
62. Organic Cannabis Foundation v. Commissioner of Internal Revenue, 161 T.C. No. 4 (2023)

    General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals ["Green Book"]
63. Reform Business Taxation
64. Reform International Taxation
65. Strengthen Taxation of High-Income Taxpayers
66. Modify Rules Relating to Retirement Plans
67. Support Workers, Families, and Economic Security
68. Modify Estate and Gift Taxation
69. Close Loopholes
70. Improve Tax Administration
71. Improve Tax Compliance
72. Treasury Decision 9980 Identifying numbers—fee for obtaining preparer tax identification number
73. Treasury Decision 9981 Private foundation defined—supporting orgs.
74. Treasury Decision 9984 Penalties for failure to file correct information returns or furnish correct payee statements—de minimis safe harbor—broker returns—final regs.
75. Treasury Decision 9996 Generation-skipping transfer taxes—elections and extensions—final regs.
76. Lesson from The Tax Court: The Designated Payment Rule
77. Edwards v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-29
78. Lesson from The Tax Court: The Limits of Collection Due Process
79. Olson v. Commissioner of Internal Revenue, T.C. Memo 2023-123
80. Lesson from The Tax Court: The Rules for Penalty Approval Depend on Geography
81. Kraske v. Commissioner of Internal Revenue, 161 T.C. No. 7 (2023)
82. Lesson from The Tax Court: Section 6662 Is Sometimes Multiple Penalties For Supervisory Approval Purposes But Sometimes Not
83. Kelley v. Commissioner of Internal Revenue, T.C. Memo 2023-126
84. Lesson from The Tax Court: Merely Winning Does Not Entitle Taxpayer to Attorney Fees

85. Champions Retreat Golf Founders v. Commissioner of Internal Revenue, T.C. Memo 2023-143

Monday, June 5, 2023

Lesson From The Tax Court: *Temporary vs. Indefinite Commutes*

By Bryan Camp

When I worked in downtown Washington D.C. I had a 50+ minute commute from my home in Wheaton Md. But I did not have to drive. I walked 15 minutes to Wheaton metro, had a 30+ minute metro ride to Federal Triangle, and then a 5 minute walk to my office. That was a lovely commute. Longish but low-stress.

Now I work at Texas Tech University in Lubbock. This is not a town for walking. So I drive to work. But it's only 4-6 minutes from my home. Sweet! I really cannot complain.

Lots of folks, however, have the worst of both worlds: they have a long commute and they have to drive it. That can be stressful. And expensive.

It is not surprising that folks with really long drive commutes might think they should be able to deduct their commuting costs, especially if they are at a job where continued employment may be uncertain. To them, their work seems temporary because they know it *might* end at any time. But in *Joseph Michael Ledbetter and Ashley Jones Ledbetter v. Commissioner*, T.C. Summ. Op. 2023-19 (May 25, 2023) (Judge Paris), we learn that just because work *might* end at any time does not make it temporary. It makes it indefinite. And while travel to a temporary work location outside the area where the taxpayer lives may be deductible, travel to an indefinite work location is not. Details below the fold.

<u>Law: Deductible Travel vs. Non-Deductible Commute</u>

Section 162(a) allows deductions for *"traveling expenses...while away from home in the pursuit of a trade or business."* That is part of the general Congressional policy to tax income after permitting taxpayers to first deduct the costs of producing the income. When business makes a taxpayer travel away from home, that is a deductible expense.

Taken literally, §162(a) would permit deduction for the cost of going to work each day. Especially now that more employers are permitting remote work, you can understand why many taxpayers might see the costs of fighting rush hour as an expense that is incurred "away from home" in order to produce income.

But §162(a) has never been read literally. That is because §262 denies deductions for *"personal, living, or family expenses."* The choice of where to live is a personal choice. That makes the expenses of getting to work from your home personal expenses. That is why Treas. Reg. 1.262-1(b)(5) says: *"The taxpayer's costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses."* And that is why the Supreme Court has told us not to take §162 literally. *"More than a dictionary is...required to understand the provision here involved, and no appeal to the 'plain language' of the section can obviate the need for further statutory construction." United States v. Correll*, 389 U.S. 299, 304 (1967).

If you cannot take §162 literally, then you have to distinguish between non-deductible commuting and deductible travel away from home. Over the years the IRS and courts have built up a robust body of guidance on that subject. Over 24 years ago the IRS issued Rev. Rul. 99-7 that synthesized much of the prior law. I think it's great guidance and is worth your time to read and master. Even though it does not have the same authority as a statute or regulation, it has turned out to be very influential on the Tax Court's approach to the issue and its concepts have become embedded in Tax Court precedent.

One recurring issue is what happens when a taxpayer's work location changes but they don't move their personal residence. The IRS and the courts deal with that through a timing concept: if the change in work locations is temporary, and to a place outside of the area the taxpayer lives, then those costs can be deductible travel away from home. I like how Judge Panuthos framed this issue in *Hirsch v. Commissioner*, T.C. Summ. Op. 2016-37: *"the purpose for allowing deductions for travel to and from a temporary business location is to assist a taxpayer who must temporarily be away from his residence for an employment-based need, when it would be unreasonable to expect him to move indefinitely."*

The trick is to draw the line between "temporary" and "indefinite." Temporary work generates the deduction. Indefinite work does not. That is, once you are working somewhere for long enough, your decision to not move any closer becomes a personal choice, transforming the expenses of getting to work from "travel away from home" to "commuting." *See e.g. Walker v. Commissioner*, 101 T.C. 537, 549-550 (1993). We got a lesson on that in Lesson From The Tax Court: *How A New Work Location Becomes A Tax Home*, TaxProf Blog (July 29, 2019).

How long is long enough? Rev. Rul. 99-7 adopts a 1-year "realistic expectation" test:

*"If employment at a work location is **realistically expected** to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of **facts and circumstances** indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary.... If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as not temporary after that date."* (emphasis supplied).

As alert readers will see from the emphasized language, the 1-year rule is not a hard and fast rule but is instead highly contingent on the taxpayer's particular facts and circumstances.

So let's take a look at the facts and circumstances relevant to Mr. and Ms. Ledbetter.

Facts:

The tax years at issue are 2015 and 2016. During those years Mr. Ledbetter, a union craft sheet metal worker, was employed by a company called Day & Zimmermann. His employer had a contract to provide services for the

Tennessee Valley Authority's Browns Ferry Nuclear Plant in Alabama. It is not entirely clear from the opinion but apparently the contract was a year-to-year deal. Plus, the services provided by the employer may not always require sheet metal workers. Thus, *"Day & [Zimmermann] did not hire sheet metal workers on a permanent basis. Rather, the length of employment varied with the size of the project and the availability of funds."* Op. at 2. And Mr. Ledbetter's contract with Day & Zimmermann explicitly provided that *"[a]ll contract work is considered temporary assignments."* Op. at 7.

Mr. Ledbetter had to drive 92 miles to get to his job: an 184 mile round-trip. In 2015 he worked at Browns Ferry 235 days. In 2016 he worked there 252 days. Mr. Ledbetter also had to drive while on site.

For both 2015 and 2016 the Ledbetters took deductions for both (1) Mr. Ledbetter's mileage driving to Browns Ferry and (2) his on-site driving. On audit, the IRS disallowed the deduction for (1) but allowed a deduction for (2).

The Ledbetters timely filed a petition in Tax Court which takes us to ....

Lesson: Indefinite is Not Temporary

Mr. Ledbetter pointed to the language in his Day and Zimmermann contract to argue that his work assignments at Browns Ferry were temporary assignments to a location outside of his home area. He explained that the TVA contractors had changed over time and that between 2012 and 2019 he had been employed by five different contractors, the last one being Day and Zimmermann. Op. at 7. The assignments were always contingent on funding and there was always the possibility of work stoppages.

Judge Paris was not persuaded. She notes that Mr. Ledbetter had worked at Browns Ferry steadily from 2012 through 2019. During all that time there was only one four month layoff and after 2014 there was *"no substantial break in his employment."* Op. at 7. Moreover for the two years at issue *"the longest break between workdays was 9 days."* Op. at 3.

Those facts and circumstances made it unrealistic for Mr. Ledbetter, in 2015 and 2016, to think his employment at Browns Ferry would last less than one year. Writes Judge Paris: *"While it is true that Mr. Ledbetter's work assignments were indefinite in length, it cannot be said that his employment at the Browns Ferry Nuclear Plant was temporary as that term is defined by the caselaw. *** The Court therefore concludes that Mr. Ledbetter's employment...was indefinite and not temporary."* Op. at 7.

Bottom Line: Indefinite work is when you have no reason to think the work will end at any particular time. In contrast, temporary work is when you have a realistic expectation that it *will* end, and end within one year. Yes, all employment is temporary, but only in the same sense that life itself is temporary. Knowing that you will die someday is quite different than being diagnosed with a fatal disease and being told that you cannot realistically expect to live more than a year.

Coda: Mr. Ledbetter's one-way travel was 92 miles. That is definitely a long commute but nothing compared to Hector Baca's 300 mile trips from El Paso to Midland, TX, which trips Judge Holmes found to be a non-deductible commute, using much the same approach as Judge Paris here. *See Baca v. Commissioner*, T.C. Memo. 2019-78.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

https://taxprof.typepad.com/taxprof_blog/2023/06/lesson-from-the-tax-court-temporary-vs-indefinite-commutes.html

Worker's Travel Expenses Are Nondeductible Commuting Expenses

MAY 25, 2023

Joseph Michael Ledbetter et al. v. Commissioner

JOSEPH MICHAEL LEDBETTER AND ASHLEY JONES LEDBETTER,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed May 25, 2023

Joseph Michael Ledbetter and Ashley Jones Ledbetter, pro sese.

Zachary T. King and *Jerrika C. Anderson*, for respondent.

SUMMARY OPINION

PARIS, *Judge*: This case was heard pursuant to the provisions of section 7463[1] of the Internal Revenue Code in effect when the Petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this Opinion shall not be treated as precedent for any other case.

By notice of deficiency dated February 6, 2019, respondent determined deficiencies in federal income tax of $4,008 and $5,638 for petitioners' 2015 and 2016 tax years, respectively. The issue for decision is whether petitioners are entitled to deduct unreimbursed mileage expenses of $23,855 and $22,539 reported on Schedule A, Itemized Deductions, of their 2015 and 2016 tax returns, respectively.

Background

I. Petitioners' Background and Employment

Petitioners are husband and wife who filed joint federal income tax returns for their 2015 and 2016 tax years (years at issue). They resided in Alabama when they filed the Petition.

Mr. Ledbetter is a union craft sheet metal worker and has worked in the sheet metal trade since approximately 2000. He has been a member of the local sheet metal workers union since entering the trade and, as a member, receives all of his work assignments through the union.

During the years at issue he was employed as a head foreman[2] by Day & Zimmerman, NPS, a government contractor for the Tennessee Valley Authority (TVA) Browns Ferry Nuclear Plant, near Athens, Alabama. Day & Zimmerman did not hire sheet metal workers on a permanent basis. Rather, the length of employment varied with the size of the project and the availability of funds.

In his line of work, Mr. Ledbetter would experience two types of work stoppages: layoffs and furloughs. A furlough typically involved a short-term work stoppage during a period without funding. The worker would remain employed by the contractor and could claim unemployment benefits but could not seek other sheet metal work. When funding became available again, the worker would resume under the same arrangement as before. During a layoff the worker was no longer employed by the contractor and was permitted to seek other union sheet metal work.

Mr. Ledbetter was first assigned to the Browns Ferry Nuclear Plant in 2005 while employed by a different contractor. He was laid off from the plant later that year, then worked there again for approximately six months during 2007. From 2012 through 2019 Mr. Ledbetter worked at the Browns Ferry Nuclear Plant as an employee of Day & Zimmerman, NPS. During that period Mr. Ledbetter experienced no work stoppage that lasted longer than four months.

During the years at issue Mr. Ledbetter resided in Attalla, Alabama, and drove to and from work at the Browns Ferry Nuclear Plant each day he worked. The round-trip distance between his personal residence and the plant was 184.2 miles. In 2015 he worked a total of 235 days, and in 2016 he worked 252 days. During either year the longest break between workdays was

9 days. Mr. Ledbetter was not reimbursed for the cost of driving from his residence to the plant during the years at issue.

II. Tax Return and Examination

On their timely filed 2015 joint income tax return, petitioners reported adjusted gross income of $102,486 and claimed itemized deductions totaling $39,275 and exemptions totaling $8,000. On Schedule A they reported, among other items, taxes paid totaling $4,454, including real estate taxes of $158, and unreimbursed employee expenses totaling $32,918 (before application of the 2% floor of section 67(a)), including vehicle expenses of $26,344. On Form 2106-EZ, Unreimbursed Employee Business Expenses, petitioners calculated the vehicle expenses using business mileage of 45,816. The reported business miles included Mr. Ledbetter's drive to and from the Browns Ferry Nuclear Plant each day, as well as miles that he drove at the worksite. Petitioners reported taxable income of $55,211 and total tax of $7,361.

On their timely filed 2016 joint income tax return, petitioners reported adjusted gross income of $120,992 and claimed itemized deductions totaling $36,014 and exemptions totaling $8,100. On Schedule A they reported, among other items, unreimbursed employee expenses totaling $31,945 (before application of the 2% floor of section 67(a)), including vehicle expenses of $24,443. On Form 2106-EZ, petitioners calculated the vehicle expenses using business mileage of 45,264. The reported business miles again included Mr. Ledbetter's drive to and from the Browns Ferry Nuclear Plant, as well as miles driven on site. Petitioners reported taxable income of $76,878, claimed a residential energy credit of $200, and reported total tax of $10,561.

Respondent examined petitioners' returns and disallowed $23,902 and $22,539 of the reported mileage expenses for 2015 and 2016, respectively. Respondent allowed the portions of the mileage expenses related to Mr. Ledbetter's onsite miles but disallowed the portion attributable to his transportation to and from the Browns Ferry Nuclear Plant. Respondent issued the Notice of Deficiency, and petitioners timely petitioned this Court for redetermination.[3]

Discussion

I. Burden of Proof

The Commissioner's determination set forth in a notice of deficiency is presumed correct, and taxpayers bear the burden of proving that the determination is in error. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).[4] Deductions are a matter of legislative grace, and taxpayers bear the burden of proving that they are entitled to any deduction claimed. *See* Rule 142(a); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

Section 274(d) prescribes more stringent substantiation requirements to be met before a taxpayer may deduct certain categories of expenses, including expenses with respect to listed property as defined by section 280F(d)(4), which includes passenger automobiles. *See Sanford v. Commissioner*, 50 T.C. 823, 827 (1968), *aff'd per curiam*, 412 F.2d 201 (2d Cir. 1969). To meet the heightened substantiation requirements, taxpayers must substantiate by adequate records or by sufficient evidence corroborating their own statements (1) the amount of the expense, (2) the time and place of the expense or use of listed property, (3) the business purpose of the expense or use, and (4) the business relationship. §274(d). Petitioners provided excellent records detailing Mr. Ledbetter's daily travel, including times, locations, and business purpose.

II. Legal Principles

Section 162(a) allows a deduction for "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business." Performing services as an employee may constitute a "trade or business." *See Primuth v. Commissioner*, 54 T.C. 374, 377 (1970); *Ayria v. Commissioner*, T.C. Memo. 2022-123, at *4. Generally, taxpayers may deduct unreimbursed employee expenses as ordinary and necessary business expenses under section 162. *Lucas v. Commissioner*, 79 T.C. 1, 6 (1982).

The deduction for unreimbursed employee expenses is a miscellaneous itemized deduction. §§67(b), 63(d)(1), 62. Miscellaneous itemized deductions are allowed only to the extent that, in the aggregate, they exceed 2% of adjusted gross income.[5] §67(a).

Taxpayers may deduct vehicle mileage expenses that are substantiated by adequate records or sufficient evidence. §§274(d)(4), 280F(d)(4)(A)(i) and (ii). Commuting expenses, however, are generally nondeductible personal expenses, regardless of the distances involved. *See Fausner* *v. Commissioner*, 413 U.S. 838, 839 (1973); *Commissioner v. Flowers*, 326 U.S. 465, 473-74 (1946); Treas. Reg. § 1.162-2(e).

There are three exceptions to the general rule that commuting expenses are nondeductible. *See Bogue v. Commissioner*, T.C. Memo. 2011-164, *aff'd*, 522 F. App'x 169 (3d Cir. 2013). The first exception is that expenses incurred traveling between a taxpayer's residence and a place of business are deductible if the residence is the taxpayer's principal place of business. *Id.* Petitioners do not argue and the evidence does not show that petitioners' residence was Mr. Ledbetter's principal place of business. This exception is inapplicable in the present case.

The remaining two exceptions apply where, as petitioners argue here, the commuting involves a temporary work location. *See Bogue*, T.C. Memo. 2011-164, slip op. at 14-15. One exception permits a taxpayer to deduct transportation expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer normally lives and works. *See Gorokhovsky v. Commissioner*, T.C. Memo. 2013-65; *Bogue*, T.C. Memo. 2011-164, slip op. at 15; Rev. Rul. 99-7, 1999-1 C.B. 361. The final exception is that travel expenses between a taxpayer's residence and temporary work locations, regardless of the distance, are deductible if the taxpayer also has one or more regular work locations away from the taxpayer's residence. *See Bogue*, T.C. Memo. 2011-164, slip op. at 15.

A work location is temporary if it is realistically expected to last (and does in fact last) for one year or less. *See* §162(a) (flush language) ("For purposes of [section 162(a)] paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year."); *see also Bogue*, T.C. Memo. 2011-164, slip op. at 24-25; Rev. Rul. 99-7. Work is temporary only if it can be expected to end within a short time. *Norwood v. Commissioner*, 66 T.C. 467, 469 (1976). In contrast a work location is not temporary if it is a location at which the taxpayer works or performs services regularly. *Bogue*, T.C. Memo. 2011-164, slip op. at 30. A work location is either a regular work location or a temporary work location; it cannot be both at the same time. *Id.* If the taxpayer realistically expects employment at the work location to last for one year or less, and if the employment at the location actually does last for less than one year, the employment is considered temporary in the absence of facts indicating otherwise. *See* Rev. Rul. 99-7.

The fact that employment lacks permanence does not make that employment temporary. *Hicks v. Commissioner*, T.C. Memo. 1986-255. Rather, employment is considered "indefinite" unless termination is actually foreseeable within a short time. *Michel v. Commissioner*, 629 F.2d 1071 (5th Cir. 1980), *aff'g* T.C. Memo. 1977-345; *Hicks*, T.C. Memo. 1986-255. Whether employment is temporary or indefinite is a question of fact. *Kasun v. United States*, 671 F.2d 1059, 1061 (7th Cir. 1982). Brief interruptions of work at a particular location do not, standing alone, cause employment which would otherwise be indefinite to become temporary. *Blatnick v. Commissioner*, 56 T.C. 1344, 1348 (1971). Employment that is temporary may become indefinite through the passage of time if the employment extends beyond the short term. *Kasun*, 671 F.2d at 1061; *see also* Rev. Rul. 99-7.

III. Analysis

Petitioners argue that they are entitled to deduct the claimed mileage expenses because Mr. Ledbetter's employment at the Browns Ferry Nuclear Plant was a temporary assignment to a location outside of his metropolitan area. Petitioners rely primarily on the fact that work assignments from the union were indefinite in duration, contingent on the availability of funding, and prone to work stoppages. In support of their position, petitioners provided a copy of Mr. Ledbetter's Temporary Employment Agreement with Day & Zimmerman, NPS, as well as a letter from Day & Zimmerman, NPS, stating that "[a]ll contract work is considered temporary assignments."

While it is true that Mr. Ledbetter's work assignments were indefinite in length, it cannot be said that his employment at the Browns Ferry Nuclear Plant was "temporary" as that term is defined by the caselaw. Mr. Ledbetter was continuously employed at the Browns Ferry Nuclear Plant from 2012 until 2019, albeit with different contractors. From 2012 through 2019 he faced no period of layoff exceeding four months. During the years at issue specifically, Mr. Ledbetter worked 235 days in 2015 and 252 days during 2016. The longest break between workdays during either of those years was 9 days. Mr. Ledbetter's employment at the Browns Ferry Nuclear Plant was consistent throughout the years at issue, and at no point during 2014 through 2016 was Mr. Ledbetter not employed at the plant.

The nature or title of the contracts between Day & Zimmerman, NPS, or other contractors and the TVA does not change the Court's factual analysis. Work in the construction industry is, by its very nature, impermanent, and workers often move from job to job or seek employment at some distance from their homes. *Kasun*, 671 F.2d at 1062. Nevertheless, the Court applies the same standard as in other industries in determining whether employment is temporary. *Id.*

Mr. Ledbetter was employed by five separate contractors during his time at the Browns Ferry Nuclear Plant, and the employers' contracts with the TVA varied in duration. Nevertheless, Mr. Ledbetter was consistently employed without layoff at that location from 2014 through 2016 and, during the years at issue, had no substantial break in his employment. The Court therefore concludes that Mr. Ledbetter's employment at the Browns Ferry Nuclear Plant was indefinite and not temporary.

Because Mr. Ledbetter's employment at the Browns Ferry Nuclear Plant was not "temporary," his vehicle expenses constitute nondeductible commuting expenses.

The Court has considered all of the arguments made by the parties, and to the extent they are not addressed herein, they are considered moot, irrelevant, or otherwise without merit.

To reflect the foregoing,

Decision will be entered for respondent.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2]The evidence variously refers to Mr. Ledbetter's position as "head foreman," "general foreman," and "lead foreman." These titles all refer to the same position, a role which involved both supervising other workers and working on the line.

[3]Respondent also disallowed $47 of petitioners' deduction for a qualified mortgage insurance premium for 2015. This adjustment is computational, and the Court will not further address it. On brief, respondent additionally asserts that petitioners' entitlement to the residential energy credit for 2016 is at issue. Respondent's assertion appears to be based on a misreading of the Notice of Deficiency; the credit was not disallowed. To the extent

respondent seeks to increase the deficiency by disallowing the claimed credit, this issue represents a new matter raised for the first time on brief, and the Court will not consider it. *See, e.g., Suriel v. Commissioner*, 141 T.C. 507, 532 (2013); *Alta V. Ltd. P'ship v. Commissioner*, T.C. Memo. 2020-8, at *38.

[4]Pursuant to section 7491(a), the burden of proof may shift to the Commissioner if the taxpayer introduces credible evidence with respect to any factual issues relevant to ascertaining the taxpayer's tax liability. The Court concludes that section 7491(a) does not apply because petitioners have not produced any evidence that they have satisfied the preconditions for its application.

[5]The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §11045, 131 Stat. 2054, 2088, amended section 67 by suspending miscellaneous itemized deductions for any taxable year beginning after December 31, 2017, and before January 1, 2026.

END FOOTNOTES

TaxProf Blog

Monday, June 12, 2023

Lesson From The Tax Court: *The IRS's Substantial Justification Defense To §7430 Fee Awards*

By Bryan Camp

Getting an award under §7430 is hard, even if the taxpayer totally wins. The major stumbling block is a statutory escape hatch called substantial justification. If the IRS' shows that its position was substantially justified at the relevant time, the taxpayer is not entitled to fees and costs even if the taxpayer wins on the merits. But the relevant time may be different depending on whether the taxpayer is seeking recovery of administrative costs or litigation costs. In *Josefa Castillo v. Commissioner*, 160 T.C. No. 15 (June 5, 2023) (Judge Kerrigan), we learn that the IRS must be able to show substantial justification at two different points in the process. There, the Court found the IRS was substantially justified at the litigation stage. But the IRS may not have been substantially justified at the administrative stage. That may be why the IRS conceded a §7430 award as to administrative costs, even while successfully resisting an award of litigation costs. The ultimate result reflects well on the taxpayer's representative, Professor Elizabeth A. Maresca and her team at the Fordham Low Income Taxpayer Clinic.

This case involves the time period in §6330(d)(1) for taxpayers to seek Tax Court review of an adverse Collection Due Process (CDP) decision. For decades the IRS and Tax Court believed that 30-day period was a jurisdictional requirement. The Tax Court simply did not have the power to hear a late-filed petition. The Supreme Court, however, held otherwise in *Boechler v. Commissioner*, 596 U.S. ___ (2022). Today's lesson concerns the consequences of the *Boechler* decision on the recovery of costs and attorneys fees under §7430. It's a surprisingly nuanced lesson.

Alert readers should note that this is a potentially important lesson for deficiency petitions. That is because the IRS and Tax Court have a similar long-standing belief that the 90-day period in §6213 for NOD petitions is jurisdictional. And that position, too, may be soon be rejected, at least by the Third Circuit. The case to watch for is *Culp v. Commissioner*. In this recent oral argument before the Third Circuit, the taxpayer was fortunate to have the terrific advocacy skills of Oliver Roberts and Professor Keith Fogg. While one never knows until the opinion issues, one gets a sense that the Circuit Court panel was quite sympathetic to the argument that §6213 is not jurisdictional. The panel even went to the extraordinary length of asking Professor Fogg to give additional oral argument! For more on the *Culp* case, see Carl Smith's post here over at Procedurally Taxing. But for the lesson on how substantial justification works, the details are below the fold.

Law: General Operation of §7430

Section 7430(a) permits a court to award costs (including attorneys fees) to any person who is a prevailing party in *"any proceeding which is brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title."* Costs are broken into those incurred in two distinct stages: (1) the administrative, pre-litigation, stage of a controversy; and (2) the litigation stage.

Pursuing awards under §7430 takes some doing. For details on all the hoops and hurdles and barriers to recovery, you cannot do better than read Maria Dooner and Linda Galler's excellent treatment in Chapter 18 of that overflowing cornucopia of tax practice wisdom, Effectively Representing Your Client Before the IRS (8th ed., Christine Speidel and Patrick Thomas, eds.).

The first and perhaps most important hoop is that party seeking costs and fees must be a prevailing party. That is a term of art. To be a prevailing party, a taxpayer must first convince a court that they substantially prevailed with respect to either the amount in controversy or the most significant issues presented. Even if they do that, however, they are not a prevailing party if the Government's position was substantially justified. *See* §7430(c)(4). Treas. Reg. 301.7430–5(a).

As to substantial justification, the government's position will be substantially justified *"if it has a reasonable basis in both fact and law and is justified to a degree that could satisfy a reasonable person." Huffman v. Commissioner*, 978 F.2d 1139, 1147 n.8 (9th Cir. 1992).

But the test comes at two points in time. The statute itself distinguishes the pre-litigation administrative process from the litigation process. Specifically, §7430(c)(4)(B)(1) says that *"A party shall not be treated as the prevailing party...if the United States establishes that the position of the United States in the proceeding was substantially justified."* And §7430(c)(7) defines the term *"position of the Unites States"* to mean: *"(A) the position taken by the United States in a judicial proceeding..., and (B) the position taken in an administrative proceeding ... as of the earlier of— (i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Independent Office of Appeals, or (ii) the date of the notice of deficiency."*

Note that the government bears the burden to prove substantial justification at both of the relevant times. The Tax Court has explained: *"the United States can take two positions in a particular case, one position in the prelitigation administrative proceedings and another position in the judicial proceedings, and each position must be evaluated separately to determine whether it was substantially justified." Estate of White v. Commissioner*, T.C. Memo. 2007-54. And in fact in the *Huffman* case, the Tax Court found found the government was substantially justified in litigation even when it was not at the administrative phase.

The reason for the bifurcation between administrative and judicial proceedings is likely because litigation brings with it a change in institutional representatives. You also see this implied by §7430(d) which says that administrative costs get paid from one source but litigation costs get paid from a different source. During the administrative process, it is the decision of the IRS Office of Appeals that is generally the testing point for substantial justification. But once the case gets into court, it will be either the IRS Office of Chief Counsel or the DOJ Tax Division that sets the position of the United States. Thus, that position must be evaluated for reasonableness separately than the Office of Appeals. Keith

Fogg has a very nice discussion in this Procedurally Taxing post. Section 7430 did not used to be bifurcated and there was considerable litigation over what point in time to test the government's position. The 9th Circuit explains this and gives the legislative history in *Huffman*, supra.

Finally, even if the taxpayer *is* a prevailing party, §7430 contains other requirements. While not relevant to today's lesson, I would be remiss in not making you aware of them. Basically, the taxpayer must show that they: (1) exhausted all administrative remedies available to them; (2) did not unreasonably protract the proceedings; and (3) are not worth over $2 million (if they are individuals). §7430(b). *Then* they must also show the reasonableness of the costs and attorneys fees they want. §7430(c)(1). Whew! It's a slog.

Today's lesson is to see how the government's position is tested for substantial justification at two different points. It is thus possible that the IRS might not be able to establish that its position was substantially justified at the administrative level even if its litigating position was so justified. It all depends on the facts.

So let's take a look at the facts.

Facts

The year at issue is 2014. For that year, Ms. Castillo filed a return showing some $12,000 of income. However, the IRS received information returns from payment cards and third party networks showing payments of over $127,000.

The next action given in the opinion was the issuance of a Notice of Deficiency whereby the IRS proposed to assess a deficiency of $44,000 plus penalties and interest. The opinion is unclear on how the IRS got from the matching program to the NOD, but I would guess the IRS used the Automated Underreporter program (AUR), described in IRM 4.19.3. One of the key features of AUR is *supposed* to be that a human tax examiner looks at any inventory selected by the AUR programming.

But once a taxpayer's case is green-lighted, AUR operates the same as with all other IRS automated processes. If the taxpayer does not respond in a way that gets human attention, the process churns on by making operational presumptions that the taxpayer's return is incorrect and that the payments reported on third-party information returns should be counted as income. We might question the robustness of that operational presumption—see Lesson From The Tax Court: *The Inherent Unreliability Of Third-Party Reporting*, TaxProf Blog (Mar. 3, 2023)—but I think that is the basic reason that the IRS sent Ms. Castillo an NOD: an operational presumption based on her failure to respond to whatever notices or letters AUR spit out.

That is just my supposition, but it is strengthened by the facts of the case as reported in the opinion. The critical fact was that Ms. Castillo did not respond to the NOD either. Judge Kerrigan tells us that *"The deficiency notice was mailed to petitioner's last known address. The United States Postal Service attempted delivery of the notice once, but the correspondence was unclaimed and returned to respondent."* Op. at 3.

So the IRS assessed the tax and penalties and started down the collection road. Eventually, that led to an NFTL CDP notice. The opinion does not tell us whether it was sent to the same address as the NOD. However, Ms. Castillo actually did receive it because, amazingly enough, she caught the CDP Butterfly and went to Appeals for a CDP hearing.

At the CDP hearing Ms. Castillo contested the tax liability, explaining that the third party information returns were just wrong. They were apparently using her TIN to report payments to a business she had once owned but had sold several years before 2014. The payments had not been made to her but to that business, Castillo Seafood. The Settlement Officer (SO) refused to consider her argument, believing she had received the NOD since the Post Office had returned the NOD as unclaimed, not as undeliverable.

The SO issued a Notice of Determination to proceed with the levy on December 11, 2018. It is not clear whether or when Ms. Castillo received the Notice of Determination. She filed a Tax Court petition on October 8, 2019 and claimed the SO did not properly send her the Notice of Determination. The IRS moved to dismiss, providing evidence of mailing and alleging the Tax Court lacked jurisdiction over a late-filed petition. The Tax Court agreed with the IRS and entered an order dismissing the case on March 25, 2020. Ms. Castillo appealed to the Second Circuit. I doubt any of this would have happened had Ms. Castillo been proceeding *pro se*.

The Second Circuit held off on deciding the jurisdictional issue until the Supreme Court decided *Boechler*. After *Boechler*, the Second Circuit summarily reversed the Tax Court and remanded for further proceedings. By that time, Professor Maresca and her team had managed to get someone at the IRS to actually consider Ms. Castillo's basic argument on why the information returns were simply wrong. I am guessing they probably used the audit reconsideration process.

However it happened, on remand the IRS totally conceded that Ms. Castillo owed no tax and owed no penalty! Professor Maresca then asked for the government to pay both the administrative costs and fees, and also the litigation costs and fees. Since Ms. Castillo obviously prevailed, both as to the amount and as to the most important issue, the debate was whether the government was substantially justified, either at the time Appeals issued its Notice of Determination or at the time the government moved to dismiss for lack of jurisdiction.

So we get to our lesson:

Lesson: The Two Time Periods to Test For Substantial Justification

Ms. Castillo sought two awards under §7430: she asked for $5,601 for her administrative costs and $129,750 for her litigation costs.

The government conceded the award of administrative costs. I think that's a pretty big deal because it reflects the Chief Counsel attorney's determination that the position of the SO in Appeals was *not* substantially justified. Or at least the Chief Counsel did not think that fight had much chance of success.

As to litigation costs, however, the government established that its litigation position was substantially justified. Judge Kerrigan tells us that a litigation position *"is generally established at the time the Government files its answer in the judicial proceeding."* Op. at 4 (citations omitted). Here, when the IRS filed its Answer, it said it was going to file a Motion to Dismiss for lack of jurisdiction. At that time the *Boechler* case had not been decided. Tax Court precedent was solid that the 30-day period to seek review of an adverse CDP hearing was jurisdiction. Hence, the litigating position was substantially justified.

That would seem to be the end of it. However, it appears that Ms. Castillo wanted to argue that (1) the SO failed to follow some provision of the IRM (not given in the opinion) and, therefore, (2) that failure to follow the IRM during the administrative process tainted the judicial proceeding as well. The argument likely relied on §7430(c)(4)(B)(ii) which says that *"the position of the United States shall be presumed not to be substantially justified if the Internal Revenue Service did not follow its applicable published guidance in the administrative proceeding."* That statutory language is ambiguous as to the effect of a failure to follow applicable published guidance.

Judge Kerrigan rejects the argument, however, for a different reason. She holds that the IRM is not "applicable published guidance" for §7430 purposes, citing to the definition of applicable published guidance given in §7430(c)(4)(B)(iv).

Alert readers will thus see the lesson we do *not* learn in today's case: if the position of the IRS is deemed not substantially justified because of a failure to follow applicable published guidance at the administrative level, does that failure preclude the IRS from being substantially justified in subsequent litigation? My instinct is that it would not, but I have not researched that question and would welcome comments from any reader who knows!

Bottom Line: If you are seeking to recover costs, do not neglect to bifurcate your administrative costs and your litigation costs. If you actually win on either the dollars or the most important legal issue, then the IRS must show that it had a substantially justified position both at the administrative stage and then at the litigation stage.

Comment: I have seen Ms. Castillo's fact pattern happen all too often: a taxpayer gets slammed with a huge tax, based on wildly inaccurate information returns, and then struggles to find someone in the IRS to actually help them. That is why it frustrates me no end to hear stupid comments like this one from this Congressman: *"The IRS should never be weaponized against American taxpayers. Rather, it should be focused on providing quality service to taxpayers. Rescinding the funding for 87,000 new IRS agents is a great first step in that direction, and I was happy to vote 'yes' on this legislation!" Really? As Bugs Bunny would say: "what a maroon!"* Dude, it's the *computer systems* that hurt taxpayer service, not IRS employees. The IRS actually needs *more* employees—and more well-trained employees—to work the cases because no matter how good your computer systems are, even a small percentage error applied to hundreds of millions of taxpayers is still a lot of hurt taxpayers. And they need human help. More IRS employees is what the agency **actually** needs to provide quality service.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

https://taxprof.typepad.com/taxprof_blog/2023/06/lesson-from-the-tax-court-the-irss-substantial-justification-defense-to-7430-fee-awards.html

IRS Filing Deadline Position Justified; Litigation Costs Denied

JUN. 5, 2023

Josefa Castillo v. Commissioner

JOSEFA CASTILLO,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed June 5, 2023

P late filed her Petition for review of a collection due process (CDP) determination. R moved to dismiss the case for lack of jurisdiction, arguing that the I.R.C. §6330(d)(1) 30-day deadline to file a petition for review of a CDP determination was jurisdictional. The Court granted that Motion. P appealed the Order of Dismissal to the U.S. Court of Appeals for the Second Circuit. The appeal was held in abeyance pending the Supreme Court's decision in *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493 (2022).

The Supreme Court held that the I.R.C. §6330(d)(1) 30-day deadline was nonjurisdictional. In the light of that holding, the Second Circuit vacated this Court's Order of Dismissal and remanded the case for further consideration. On remand R conceded the case in full. P moved for an award of costs pursuant to I.R.C. §7430. R opposed the Motion, arguing that R was substantially justified in R's legal position that this Court lacked jurisdiction to hear the matter at the time the Petition was filed.

Held: R was substantially justified in R's legal position that the Court lacked jurisdiction to hear the case because at the time the Petition was filed, the caselaw was clear that the I.R.C. §6330(d)(1) 30-day deadline was jurisdictional and not subject to equitable tolling. For that reason, P was not treated as the prevailing party for purposes of I.R.C. §7430. P's Motion for Reasonable Litigation Costs will be denied.

Elizabeth A. Maresca, for petitioner.

Kevin R. Oveisi, *Francesca M. Ugolini*, *Thomas A. Deamus*, and *Mimi* M. *Wong*, for respondent.

OPINION

KERRIGAN, *Chief Judge*: This case is before the Court on petitioner's Motion for Reasonable Litigation or Administrative Costs. The U.S. Court of Appeals for the Second Circuit vacated this Court's Order of Dismissal in this case and remanded it for further proceedings in the light of the Supreme's Court decision in *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493 (2022). Mandate, *Castillo v. Commissioner*, No. 20-1635 (2d Cir. Sept. 23, 2022).

On remand respondent conceded the case in full. The issue remaining for consideration is petitioner's Motion in which she requests administrative and litigation costs of $5,601 and $129,750, respectively, pursuant to section 7430(a).[1] Respondent has conceded the administrative costs. We will consider only whether petitioner is entitled to litigation costs of $129,750.

Background

The following facts are derived from the parties' pleadings and Motion papers, including the Declarations and the Exhibits attached thereto. Petitioner resided in New York when she filed her Petition.

On November 28, 2016, respondent issued petitioner a notice of deficiency for 2014. The notice determined that petitioner had income of $139,274 from payment card and third-party network transactions. Since petitioner reported $11,900, respondent determined that she had unreported income of approximately $127,374 and a deficiency of $44,427. Respondent also determined that petitioner was liable for a section 6662(a) and (b)(2) accuracy-related penalty of $8,885 for an underpayment attributable to a substantial understatement of income tax.

The deficiency notice was mailed to petitioner's last known address. The United States Postal Service attempted delivery of the notice once, but the correspondence was unclaimed and returned to respondent. On April 17, 2017, respondent assessed the deficiency and the penalty. On February 13, 2018, respondent issued petitioner a Notice of Federal Tax Lien (NFTL) Filing and Your Right to a Hearing Under Section 6320. On March 2, 2018, petitioner filed a request for a collection due process (CDP) hearing.

At the CDP hearing, petitioner argued that she had not received the deficiency notice and was not liable for the deficiency, interest, or penalty. She argued that the income attributed to her in the deficiency notice was instead attributable to Castillo Seafood, a business she allegedly sold in 2009.

The settlement officer informed petitioner that because the notice of deficiency was properly mailed but unclaimed, the underlying liability could not be disputed unless petitioner could demonstrate that she was out of the country during that time. Petitioner did not make that showing but maintained that the determination was incorrect.

On December 11, 2018, respondent issued petitioner a notice of determination for the 2014 taxable year, which sustained the filing of the NFTL. It was mailed to petitioner's last known address. The 30-day period for filing a petition with the Tax Court expired on January 10, 2019. Petitioner filed her Petition on October 8, 2019. Respondent stated in the Answer that "respondent intends on filing a motion to dismiss for lack of jurisdiction."

On January 6, 2020, respondent moved to dismiss petitioner's case for lack of jurisdiction on the ground that the Petition was not timely filed. On March 25, 2020, we granted that Motion. On May 19, 2020, petitioner filed a Notice of Appeal with the Second Circuit. That case was held in abeyance pending the Supreme Court's decision in *Boechler.*

On April 21, 2022, the Supreme Court decided *Boechler*, holding that the section 6330(d)(1) 30-day deadline to file a petition for review of a CDP determination is nonjurisdictional and subject to equitable tolling. *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501. On August 2, 2022, the Second Circuit vacated the Tax Court's Order of Dismissal in this case and remanded it for further proceedings in accord with the Supreme Court's decision in *Boechler*. On November 8, 2022, the parties filed a Stipulation of Settled Issues, stating that petitioner was not liable for the unreported income, penalty, or interest determined in the deficiency notice. On January 5, 2023, petitioner filed the Motion now at issue.

Discussion

Section 7430(a) provides that the prevailing party may be awarded reasonable administrative or litigation costs for any proceedings brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty. To recover costs, the taxpayer must establish that (1) the taxpayer is the prevailing party, (2) he or she did not unreasonably protract the proceedings, (3) the amount of the costs requested is reasonable, and (4) he or she exhausted the administrative remedies available. *Friends of Benedictines in the Holy Land, Inc. v. Commissioner*, 150 T.C. 107, 111–12 (2018).

The section 7430 requirements are conjunctive, and the failure to satisfy any one of them will preclude an award of costs. *See Minahan v. Commissioner*, 88 T.C. 492, 497 (1987). As the moving party, petitioner has the burden of proving that she satisfies each requirement of section 7430. *See* Rule 232(e). The fact that respondent ultimately conceded the case in full is not determinative as to whether petitioner is entitled to an award of reasonable litigation costs. *See Sokol v. Commissioner*, 92 T.C. 760, 767 (1989).

Respondent conceded that petitioner has satisfied three of the section 7430 requirements: She did not unreasonably protract the proceedings, the amount of the costs requested is reasonable, and she exhausted the administrative remedies available. The parties disagree as to whether petitioner should be treated as the prevailing party.

To be the prevailing party, petitioner must have substantially prevailed with respect to the amount in controversy or have substantially prevailed with respect to the most significant issue or set of issues presented. *See* §7430(c)(4)(A)(i). The parties filed a Stipulation of Settled Issues agreeing that the notice of determination is not sustained, and petitioner is not liable for the deficiency, interest, or penalty determined in the deficiency notice. Petitioner has prevailed with respect to the amount in controversy.

The parties dispute the "most significant issue" on which petitioner prevailed. *See* §7430(c)(4)(A)(i)(II). Since petitioner was the prevailing party as to the amount in controversy, we do not need to decide this issue. Instead we must consider the exception provided in section 7430(c)(4)(B). A party is not treated as the prevailing party if the United States establishes that its position was "substantially justified." §7430(c)(4)(B)(i). Respondent contends that the exception is applicable here.

Respondent bears the burden of showing that respondent's position was substantially justified. *See* §7430(c)(4)(B)(i); Rule 232(e). Generally, the Government's position is substantially justified when its position is based on supportable interpretations of federal tax statutes and caselaw. *TKB Int'l, Inc. v. United States*, 995 F.2d 1460, 1468 (9th Cir. 1993). The litigation position of the United States is generally established at the time the Government files its answer in the judicial proceeding. *See* §7430(c)(7)(A); *Huffman v. Commissioner*, 978 F.2d 1139, 1148 (9th Cir. 1992), *aff'g in part, rev'g in part, and remanding* T.C. Memo. 1991-144; *Maggie Mgmt. Co. v. Commissioner*, 108 T.C. 430, 442 (1997). To be substantially justified respondent's position must have a reasonable basis in both fact and law. *See Pierce v. Underwood*, 487 U.S. 552, 565 (1988).

Respondent's litigation position — which was first raised in the Answer — was that the Court lacked jurisdiction because the Petition was not timely filed. There is no dispute that the Petition was filed late. Respondent argues that because the law was clear then that a timely filing was necessary to establish the Court's jurisdiction, the Commissioner was substantially justified in asserting that the Court lacked jurisdiction. We agree with respondent.

The notice of determination was mailed by certified mail in accordance with Treasury Regulation § 301.6330-1(e)(3) Q&A-E8 and sufficient to start the 30-day period for appeal under section 6330(d). *See Weber v. Commissioner*, 122 T.C. 258, 261–62 (2004). Until the Supreme Court's recent decision in *Boechler*, it was well established that the 30-day period to file a petition for review of a collection due process determination was jurisdictional. *See Kaplan v. Commissioner*, 552 F. App'x 77, 78 (2d Cir. 2014); *Guralnik v. Commissioner*, 146 T.C. 230, 235–36 (2016).

Before the Supreme Court's decision in *Boechler* neither the Tax Court nor the federal courts of appeals had held the 30-day period in section 6330(d)(1) to be nonjurisdictional. Because *Boechler* was a matter of first impression for the Supreme Court, respondent's position was substantially justified. *See Bontrager v. Commissioner*, T.C. Memo. 2019-45, at *6 ("The Commissioner generally is not subject to an award of litigation costs under section 7430 where the underlying issue is one of first impression." (quoting *Rowe v. Commissioner*, T.C. Memo. 2002-136, 2002 WL 1150776, at *11)). Petitioner then should not be treated as the prevailing party.

Petitioner argues that respondent's position should be presumed not to be substantially justified because respondent did not follow guidance provided in the Internal Revenue Manual (IRM). *See* §7430(c)(4)(B)(ii). The presumption in section 7430(c)(4)(B)(ii) does not arise here because the IRM is not "applicable published guidance" within the meaning of the statute. Section 7430(c)(4)(B)(iv) defines "applicable published guidance" exhaustively as "regulations, revenue rulings, revenue procedures, information releases, notices, and announcements, and . . . any of the following which are issued to the taxpayer: private letter rulings, technical advice memoranda, and determination letters." Since the IRM is not included in this list, the presumption does not arise.

We conclude that petitioner is not entitled to an award of litigation costs. We have considered all of petitioner's arguments, and to the extent not discussed above, we find them to be irrelevant, moot, or without merit.

To reflect the foregoing,

An appropriate order will be entered.

FOOTNOTES

[1]Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

END FOOTNOTES

TaxProf Blog

- Tax Law
  - News
  - Scholarship
  - Weekly Roundup
- Legal Education
  - News
  - Scholarship
  - Weekly Roundup
- About
  - Join the Network
  - Advertise
- Resources

Monday, June 26, 2023

Lesson From The Tax Court: *How To Calculate Insolvency For The §108 Exclusion*

By Bryan Camp

While not as certain as death and taxes, small businesses failures are highly probable events. This webpage from the Bureau of Labor Statistics goes into the gnarly.

When a small business fails, that often means it cannot repay loans. A lender will often write off the loan as a bad debt, discharging the borrower from the obligation to repay. That discharge is taxable income to the borrower, unless they qualify for an exclusion. Today's lesson involves the insolvency exclusion in §108(a). To qualify for that, one has to be (duh) insolvent! Insolvency is tested at the time of the discharge. Section 108(d)(3) defines insolvency as *"the excess of liabilities over the fair market value of assets."* But nothing in the statutes or regulations defines the term "liabilities."

Katrina E. White v. Commissioner, T.C. Memo. 2023-77 (June 21, 2023) (Judge Paris), teaches a lesson about what types of obligations count as liabilities in determining insolvency for §108(a) purposes. We learn that a liability which is legally enforceable, and due and owing at the time of the discharge, counts even if the lender takes no action to actually collect or enforce the debt. Details below the fold.

<u>Law: Loans Are Not Income, Loan Forgiveness Is</u>

A loan puts money in your pocket. Money that you can use to buy a home, buy a car, start a business. It sure seems like a loan is an accretion to wealth and thus constitutes gross income under §61 and the principles of *Commissioner v.*

Glenshaw Glass, 348 U.S. 426, 431 (1955) (anti-trust damages were income because they were *"undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."*).

Everyone agrees, however, that loan proceeds are not gross income because they are not, actually, an undeniable accession to wealth. Not everyone agrees on why that is so. Some say it is because your obligation to repay burdens your other assets, so the current-year you is not really any richer because of that. Your net worth balance sheet has not changed. *United States v. Kirby Lumber*, 284 U.S. 1 (1931). Others say it is because the obligation to repay comes from future income. So while the current-year you really *is* richer, it's only because you are buying stuff with future dollars; the future-year you will be poorer by the amount of the repayment. *Commissioner v. Tufts*, 461 U.S. 300 (1984). For a deeper dive into details *see* Lesson From The Tax Court: *The Phantom Of The Tax Code—Discharge Of Indebtedness*, TaxProf Blog (Feb. 19, 2018). But basically the first idea is based on the yearly accounting of income while the second idea takes a multi-year transactional view based on the life of the loan and assumes the future repayment nets out to zero increased wealth.

Everyone also agrees that if your obligation to repay is cancelled or discharged, then that constitutes income. Not everyone agrees on what to call this. Some call it Discharge of Indebtedness (DOI). Some call it Cancellation of Debt (COD). Judge Paris mashes those together to call it "cancellation-of-indebtedness." Op. at 1. LOL. I'll use DOI, 'cause that what's in the title of §108.

Whatever you call it, the reason DOI constitutes gross income is linked to whatever reason you thought made the loan proceeds not income in the first place. Again, I go into more detail in the *Phantom of the Tax Code* blog post above. It might be because the discharge frees up those burdened assets and that increases your wealth. I call that the balance-sheet theory. Or it might be because the future-year you won't have to re-pay which means we need to fix the now erroneous assumption that the loan would be repaid. I call that the error-correction theory.

Section 108(a)(1)(B) follows the balance sheet theory by allowing taxpayers to exclude DOI from gross income when they are insolvent and, further, limiting the exclusion to the amount of the insolvency at the time of the discharge. For example, if a taxpayer is discharged from $10,000 of debt at a time when the taxpayer is insolvent by $6,000, then the taxpayer can exclude $6,000 of the DOI from income but must report the remaining $4,000 as gross income, assuming no other exclusion applies. §108(a)(3).

Determining insolvency is seemingly simple: if the value of your liabilities is more than the value of your assets, you are insolvent! What counts as a liability, however, is not always clear. Courts generally agree that to count as a "liability" in the insolvency calculation, an obligation must actually burden assets. For example, in *Merkel v. Commissioner*, 109 T.C. 463 (1997), the taxpayers had guaranteed some loans and wanted those guarantees to count as liabilities for purposes of determining insolvency. The Tax Court disagreed, because that obligation was too speculative. See if you spot the balance sheet theory in this explanation the Court gave: *"an indiscriminate inclusion of obligations to pay in the... the statutory insolvency calculation...without any consideration of how speculative those obligations may be, would render meaningless any inquiry as to whether assets are freed upon the discharge of indebtedness. Logic dictates that an obligation to pay is a liability under the freeing-of-assets theory only if it can be said with a satisfactory degree of certainty that the obligation offsets assets."* Id. at 476.

Today we learn a lesson on the degree of certainty that must exist for an obligation to count in the insolvency calculation.

Facts

The tax year at issue is 2016. That year, Ms. White received DOI of $14,433 and the question was whether she could exclude that under §108(a)(1)(B).

The DOI arose from a failed business. In mid-2015 Ms. White started a body sugaring business in a suburb of Milwaukee, borrowing $15,000 from a local bank. She also entered into a 3-year lease for her business. The lease agreement provided that if she failed to pay her rent on time for two months in a row, *"the full amount on the remaining* *lease would be immediately due in full and had to be paid on the third month."* Op. at 2.

The business soured quickly. On January 15, 2016 she received a letter from the Lessor stating that she had breached her lease and now owed the full amount of remaining rent ($21,700). It appears she stopping making loan payments in February 2016. From the business's Facebook Page it appears that the business formally closed on May 2017, but it seems it had not been active since early 2016.

In November 2016, the lender gave up and wrote off the loan. And the lender sent Ms. White a 1099-C showing discharged debt of $14,433.

The Lessor, however, did not give any indication it was forgiving the unpaid rent. It did not send her a 1099-C. At the same time the Lessor gave no indication it was enforcing the obligation: it made no efforts to collect the unpaid rent. And the opinion is silent on whether the Lessor was able to re-let the property in 2015 at or before the November 2016 loan forgiveness.

Ms. White timely filed her 2016 returns. She did not report any DOI income. On audit, the IRS decided she should have reported the lender's DOI as income and sent her an NOD. Ms. White disagreed and petitioned the Tax Court.

Lesson: Contractual Obligation Can Be Bona Fide Liability Even If Not Enforced

To support her claim that she was insolvent when the Lender discharged the small business loan, Ms. White gave the Court a table of her assets and a table of her liabilities, *"as well as supporting documentation of the listed items."* Op. at 4. The IRS did not dispute her table of assets, which showed a total value of just over $32,000. But it did dispute her table of liabilities. Here's the table, slightly modified, from p. 4 of the Opinion:

Liability	**Amount**
Student Loans	$5,293.65
Accrued/Past Due Residential Utilities	$3,461.31
Judgments	$8,128.33
Business Debts	$14,433.00 (small business loan) $21,700.00 (lease breach)
Personal Debts	$8,911.78
Total	**$61,936.07**

The IRS argued that three of the liabilities should not count towards determining whether Ms. White was insolvent: all $21,700 of the claimed lease liability; $2,300 of the claimed utility liabilities; and $7,800 of the claimed personal debts. Judge Paris addresses only the first liability because once she decided it *did* count, that amount plus the undisputed liabilities made Ms. White's insolvency greater than the amount discharged. So the entire DOI could be excluded. Total win for this pro-se taxpayer.

The IRS's basic argument was that the $21,700 lease liability was not certain enough to count towards the insolvency calculation. The IRS noted that neither party treated the claimed obligation as a real obligation because the Lessor *"did not sue or otherwise take action to collect the amount due on the lease and because petitioner did not make any payments toward the amount due."* Op. at 5-6. It was just a paper obligation, not a real one. All form, no substance.

Judge Paris rejects that line of reasoning. Citing to *Merkel*, Judge Paris says that the issue did not turn on whether the obligation was actively being enforced, but rather on whether the obligation was *"legally enforceable at the time the $14,433 small business loan debt was discharged."* Op. at 6. She found that Ms. White had proved it was legally enforceable both by the terms of the lease agreement and the January 2016 letter from the Lessor asserting its right to the $21,700.

Bottom Line: Legally enforceable obligations will count, even if the creditor has not taken action to enforce at the time the other debt is forgiven. Here, if the Lessor had sent Ms. White a note saying basically "oh, nevermind" then not only would the rent obligations likely not count towards the insolvency calculations, but now Ms. White would have additional DOI in that amount!

Coda: Alert readers will note that Ms. White's victory here sets her up for some potential tax issues in later years. *First*, basis adjustment. Her exclusion of the $14,422 triggers operation of §108(b) which requires her to reduce various tax attributes. The most likely tax attribute here is basis in her assets. And then she need only reduce basis to the extent that her post-discharge basis exceeds her post-discharge liabilities. §1017. Here, Ms. White's largest asset listed was "real property" asserdedly worth $28,500. Someone needs to run the numbers at least when she sells that real property.

Second, more DOI! Since the Court accepts the rental obligation of $21,700 as a bona fide debt, then that sets up Ms. White for yet more DOI income in a later year, if and when that debt is discharged. As Judge Paris notes, the DOI does not occur just because someone sends Ms. White a Form 1099-C. Nope, rather *"the moment it because clear that a debt will never have to be paid, such debt must be viewed as having been discharged."* Op. at 4, note 2. Query whether it might have been better to concede that the $21,700 was not bona fide debt and take the DOI hit in 2015 rather than take a bigger DOI hit in some later year. But query also whether either of these issues will ever be raised.

Comment: I have my doubts about the bona fide nature of the rental debt. I would like to know whether the Lessor re-possessed the premises, or re-let the premises before the loan discharge, or whether the acceleration clause at least so required. I think for this to be a legal (and hence bona fide) obligation, the acceleration clause needed to ensure that the recoverable rents are reasonably adjusted—to account for time value of money or to account for the Lessor's mitigation by re-letting—so as to avoid a windfall to the Lessor. Otherwise, the clause might be an unenforceable liquidated penalty clause. That is, of course, a matter of state law. *See, e.g., United Leasing & Financial Services, Inc. v. R. F. Optical, Inc.*, 103 Wis.2d 488 (1981) (holding that, to be valid under Wisconsin law, an rental acceleration clause must discount to present value); *Frank Nero Auto Lease, Inc. v. Townsendv*, 411 N.E.2d 507 (1979) (not enforcing acceleration clause in a car lease because it did not account for, or require, resale or re-lease of the car upon repossession).

Bryan Camp *is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) for another* Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/06/lesson-from-the-tax-court-how-to-calculate-insolvency-for-the-108-exclusion.html

Individual's Cancellation of Debt Income Is Excludable, Court Says

JUN. 21, 2023

Katrina E. White v. Commissioner

KATRINA E. WHITE,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed June 21, 2023

Katrina E. White, pro se.

Frederic J. Fernandez, *Allison N. Kruschke*, and *Mark J. Miller*, for respondent.

MEMORANDUM OPINION

PARIS, *Judge*: By notice of deficiency dated May 14, 2018, respondent determined a deficiency of $4,931 in petitioner's 2016 federal income tax. The sole issue for decision is whether petitioner is entitled to exclude cancellation-of-indebtedness income of $14,433 under the insolvency exception under section 108(a)(1)(B).[1]

The parties submitted this case for decision without trial pursuant to Rule 122.

Background

The following facts are derived from the Stipulation of Facts, the First Supplemental Stipulation of Facts, and the jointly stipulated **[*2]** Exhibits contained therein. Petitioner resided in Wisconsin when she timely filed the Petition.

During 2015 petitioner owned and operated Professional Body Sugaring, LLC, in Menomonee Falls, Wisconsin. On June 17, 2015, petitioner signed a promissory note to First Bank Financial Centre for a small business loan of $15,000. Petitioner's business struggled and brought in little revenue. Between July 11, 2015, and February 3, 2016, petitioner made five payments on the loan totaling $661. Following the February 3 payment, petitioner failed to make any further payments toward the loan, and on November 23, 2016, the bank charged the loan off its books. First Bank Financial Centre issued petitioner a Form 1099-C, Cancellation of Debt, reporting discharge of debt totaling $14,433.

On April 20, 2015, petitioner had entered into a three-year lease with Leap Properties, LLC, for office space for her business beginning June 1, 2015, and terminating May 31, 2018. The lease included an acceleration clause stating that, if rent was late for more than two months, the full amount on the remaining lease would be immediately due in full and had to be paid on the third month. Petitioner breached her lease with Leap Properties, LLC, on January 15, 2016.

In November 2015 petitioner received $8,000 from her family, purportedly as a loan, to help with her struggling business. Petitioner did not enter into a written loan agreement or set a repayment schedule, and the record is unclear as to whether any interest was charged. Petitioner had made two payments of $100 each toward the loan at the time her small business loan debt was discharged.

Petitioner timely filed her 2016 Form 1040, U.S. Individual Income Tax Return. She reported as her only income for the year wage income of $29,140. She claimed a standard deduction of $9,300 and exemptions totaling $12,150 for a taxable income of $7,690. Petitioner did not report the discharge of indebtedness on her return.

Respondent examined petitioner's return and determined that the discharge of indebtedness represented gross income to petitioner. Respondent issued the Notice of Deficiency, and petitioner timely petitioned this Court for redetermination.

[*3] Discussion

I. Burden of Proof

In general, the Commissioner's determination set forth in a notice of deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is in error. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). While the parties submitted this case for decision under Rule 122, such a submission "does not alter the burden of proof, or the requirements otherwise applicable with respect to adducing proof, or the effect of failure of proof." Rule 122(b).

In cases appealable to the U.S. Court of Appeals for the Seventh Circuit, as this one is barring a written stipulation to the contrary, *see* §7482(b)(1)(A), (2), a taxpayer may rebut the presumption of correctness by demonstrating that an assessment is arbitrary and excessive or lacks a rational foundation, *Pittman v. Commissioner*, 100 F.3d 1308, 1313 (7th Cir. 1996), *aff'g* T.C. Memo. 1995-243. In cases involving unreported income, such as the present case, this showing is typically made "when the Commissioner makes no evidentiary showing at all but simply rests on the presumption or when the Commissioner's evidence completely fails to link the taxpayer to alleged unreported income." *Id.*

II. Discharge of Indebtedness Income and Insolvency Exception

A. Legal Principles

Section 61(a) defines gross income as "all income from whatever source derived" including income from discharge of indebtedness. §61(a)(12). Section 108(a) provides certain exceptions under which discharge-of-indebtedness income is excluded from income. One such exception arises where the taxpayer is insolvent immediately before the discharge. §108(a)(1)(B). Insolvent means that the taxpayer's liabilities exceed the fair market value of her assets. §108(d)(3). The amount of the exclusion is limited to the amount by which the taxpayer is insolvent, i.e., the amount by which the taxpayer's liabilities exceed the fair market value of her assets. §108(a)(3), (d)(3); *see also McAllister v. Commissioner*, T.C. Memo. 2013-96, at *7 ("The amount by which the taxpayer is insolvent is defined as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets.").

A taxpayer claiming the benefit of the insolvency exception must prove (1) with respect to any obligation claimed to be a liability, that, as **[*4]** of the calculation date, it is more probable than not that she will be called upon to pay that obligation in the amount claimed and (2) that the total liabilities so proved exceed the fair market value of her assets. *Merkel v. Commissioner*, 109 T.C. 463, 484 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

B. Analysis

Petitioner does not dispute that the loan was discharged in 2016.[2] Rather, she argues that the discharge of the debt should be excluded from income because she was insolvent at the time of discharge. Petitioner provided respondent and the Court with an insolvency worksheet that petitioner alleges shows her assets and liabilities at the time of the discharge of indebtedness, as well as supporting documentation of the listed items. Petitioner lists her assets and liabilities as follows:

Assets	**Value**
Real Property	$28,500.00
Cars and Vehicles	1,000.00
Household Goods	559.89
Clothing	2,000.00
Total	32,059.89

[*5] Liabilities	**Amount**
Student Loans	$5,293.65

[*5] Liabilities	Amount
Accrued or Past Due Residential Utilities	961.31 (water) 2,500.00 (estimated WE Energies)
Judgments[3]	8,128.33
Business Debts	14,433.00 (small business loan) 21,700.00 (lease breach)
Other liabilities	7,800.00 (family loan) 1,119.78 (furniture bill)
Total	61,936.07

Respondent argues that petitioner has not adequately substantiated that the family loan, the lease breach acceleration debt, or the estimated WE Energies bills were bona fide debts. Under respondent's calculation, petitioner's liabilities at the time of discharge totaled $29,936.07 against assets totaling $32,059.89. According to respondent, then, petitioner was solvent by $2,123.82 and the cancellation of petitioner's loan constitutes gross income.

With respect to the lease breach acceleration debt, respondent argues that petitioner has failed to demonstrate that the debt was a bona fide debt. Specifically, respondent contends that, because Leap Properties, LLC, did not sue or otherwise take action to collect the amount due on the lease and because petitioner did not make any **[*6]** payments toward the amount due, petitioner has failed to show that the debt was a bona fide debt.

The Court disagrees. Petitioner provided a copy of the lease agreement, as well as a letter from Leap Properties, LLC, stating that petitioner breached the lease on January 15, 2016. The terms of the agreement creating the obligation to pay generally determine whether and in what amount the taxpayer will be called upon to pay. *Merkel*, 109 T.C. at 476 n.10. Under the terms of the lease, the entire amount remaining on the lease would become immediately due. The lease agreement between petitioner and Leap Properties, LLC, was an arm's-length transaction for a multiyear lease on commercial real estate, and the obligation to pay was legally enforceable at the time the $14,433 small business loan debt was discharged. Nothing in the record suggests otherwise. The fact that Leap Properties, LLC, did not sue petitioner to collect the debt does not in and of itself mean, as respondent suggests, that it was not a bona fide debt. Respondent cites no authority for the requirement that, for the Court to determine insolvency under section 108(a)(1)(B), a creditor must bring legal action or the taxpayer's liabilities must be brought to judgment, and the Court is aware of none.

Taking into account the $21,700 liability for breach of the lease, petitioner's liabilities totaled $51,636.07,[4] while the value of her assets totaled $32,059.89. Petitioner's liabilities exceeded the value of her assets by $19,576.18. Accordingly, petitioner was insolvent at the time the small business loan was discharged, and the discharge-of-indebtedness income is excluded.

III. Conclusion

For the foregoing reasons, the discharge of petitioner's indebtedness of $14,433 is excluded from gross income under section 108(a)(1)(B). The Court has considered all of the arguments made by the parties, and to the extent they are not addressed herein, they are considered moot, irrelevant, or otherwise without merit.

[*7] To reflect the foregoing,

Decision will be entered for petitioner.

FOOTNOTES

[1]Unless otherwise indicated, section references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2]Petitioner maintains that she did not receive the Form 1099-C and was not aware that the debt had been discharged until she was contacted by respondent's revenue agent. "The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged." *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987). "The nonreceipt of a Form 1099 does not convert taxable income into nontaxable income." *Rinehart v. Commissioner*, T.C. Memo. 2002-71, 2002 WL 459098, at *2.

[3]In support of this amount, petitioner introduced copies of judgments, credit reports, and other documentation. These documents indicate that petitioner has also been known as Katrina Duckworth or Katrina Gray.

[4]This amount excludes the value of the alleged family loan and estimated WE Energies bills. Because petitioner meets the standard for insolvency with the inclusion of the liability for breach of lease, the Court does not consider respondent's arguments with respect to those items.

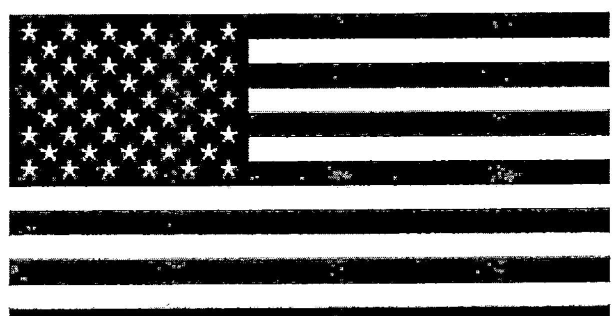
END FOOTNOTES

TaxProf Blog

Monday, July 3, 2023

Lesson From The Tax Court: *Freedom, Taxes, And Hobbies*

By Bryan Camp



We have great freedoms in this country. Freedom to express ourselves. Freedom to fish. Freedom to write blog posts. Freedom to pursue any lawful activity to make money. Truly ours is a great civilization well worth tomorrow's celebration.

But.

To riff on a well worn aphorism: with great freedom comes great responsibility. In particular, as the Sainted Justice Holmes told us: *"Taxes are what we pay for civilized society.... The constitutional right...to earn one's livelihood by any lawful calling certainly is consistent, as we all know, with the calling being taxed." Compania General de Tabacos v. Collectorv*, 275 U.S. 87, 100 (1927).

Three recent cases on Hobby Loss rules teach us about the responsibility of paying taxes to support our freedoms: you cannot lower your taxes by deducting the costs of your personal hobby. The basic lesson is the importance of record-keeping. That means more than keeping proper records. It means properly using the records in a business-like manner. In contrast, having "meticulous" records may just rescue a taxpayer who erroneously mashes up their hobby with a legitimate business activity on the same Schedule.

Two of the three cases present garden variety fact patterns where taxpayers attempt to disguise personal expenditures as business expenses. In *Donald E. Swanson v. Commissioner*, T.C. Memo. 2023-81 (June 29, 2023) (Judge Pugh), the taxpayer was an emergency room doctor and amateur musician who created a vanity website for his music. In

Joseph William Sherman v. Commissionerv, T.C. Memo. 2023-63 (May 17, 2023) (Judge Jones), the retired taxpayer was an avid fisherman who also sometimes hired himself out as a guide, generating some hobby income to reduce his hobby expenses.

The third case is twisty. In *Leslyn Jo Carson & Craig Carson v. Commissioner*, Dkt. No. 23086-21S (May 18, 2023) (Judge Morrison), the taxpayers mashed up a hobby activity (kids doing rodeos) with a business activity (ranching). What triggered the audit was that the ranch was owned by the taxpayer' wife's mom and they had an agreement that all ranching income would be allocated to Mom and all ranching expenses would be paid for and deducted by the taxpayers. So the taxpayers essentially reported massive ranching expenses against modest hobby income. However, these taxpayers' great recordkeeping overcame their poor reporting, winning a no-harm-no-foul ruling from the Tax Court.

Law: Hobby Loss Rules In §183

One of the fundamental tax lessons to teach students (and clients) is the difference between business and personal expenses. Business expenses can be deducted from business income because Congress recognizes that it takes money to make money. So Congress permits taxpayers to deduct the money it takes from the money they make. The centerpiece of that permission is §162 which permits a deduction of the ordinary and necessary expenses incurred to carry on a trade or business.

In contrast, Congress explicitly denies deductions for any *"personal, living, or family expenses."* §262(a). If Congress were to generally permit such deductions, then personal consumption would shelter income. Disney would be delighted. The federal fisc would flounder. By denying deductions for personal expenditures, Congress keeps the tax base broader.

Despite the broad rule in §262, Congress does permit deductions of some personal expenditures. Typical examples are medical expenses and contributions to charity. Hobby expenses are another example.

Section 183 governs the deductibility of hobby expenses. It mediates between permissive §162 and restrictive §262 by permitting deductions for hobby expenses but limiting those to the amount of hobby income. §183(b). That prevents a hobby from producing a net loss. That means the personal consumption represented by hobby expenses cannot be used to reduce other, non-hobby, income.

So whenever a taxpayer engages in an activity that produces some income but produces a net loss, the question is always whether the activity is a business or a hobby. If it's a business, the net loss can be used to shelter other income (subject to other restrictions such as the at-risk rules and the passive activity rules). You throw everything (income and deductions) on a Schedule C and stick the net profit or loss on the Schedule 1.

If the activity is a hobby, however, then you still report the income on Schedule 1. But you must take your allowable deductions on Schedule A because §183 deductions are §67(a) miscellaneous itemized deductions subject to a 2% floor. *Gregory v. Commissioner*, T.C. Memo. 2021-115. And, as we all know, Congress has eliminated those deductions through 2025. §67(g).

This proper reporting will be important in our third case, *Carson*.

An activity is a hobby when income it produces is incidental to the reason for engaging in the activity. The critical question that the IRS and the Courts ask is whether making a profit was the taxpayer's *"predominant, primary, or principal objective"* for engaging in the activity. *Wolf v. Commissioner*, 4 F.3d 709, 713 (9th Cir. 1993). This question about making a profit has nothing to do with the intensity of a taxpayer's feelings about the activity or the esteem with which the taxpayer is held by others engaged in that activity. A group of golfers may include some who are professional and some who are hobbyists. They all want to win, and they all value their reputations. But only the ones who play golf for profit can deduct a net loss from their golfing activity against non-golfing income.

Section 183(d) helps taxpayers by creating a presumption that if the taxpayer actually made money from the activity for three of the five years before the tax year in question, then the activity is a business and is not restricted by §183. The horse-racing industry has good lobbyists, however, and got Congress to give a more generous presumption for *"breeding, training, showing, or racing of horses." Id.* For those activities one need only show profit in two of the prior seven years to get the presumption.

Just because a taxpayer fails to meet the presumption, however, does not automatically make the activity a hobby. Taxpayers will have a more difficult time, however, showing the requisite profit-motive. Treas.Reg. 1.183-2 gives what I like to call a Wobbly Table of Factors (WTF) test that frames how to evaluates the profit motive. The nine factors are: (1) did the taxpayer carry on the activity in a business-like manner; (2) did the taxpayer have or seek to acquire expertise in the activity; (3) did the taxpayer put in the time and effort to show profit-making objective; (4) was there a reasonable expectation that assets used in the activity would appreciate in value; (5) had the taxpayer been successful in carrying on other similar activities; (6) what was the history of income and loss from the activity; (7) what was the size of occasional profits; (8) how reliant was the taxpayer on income from this activity; and (9) what elements of personal pleasure or recreation are involved in the activity.

What makes this a "Wobbly" Table of Factors is that *"no one factor is determinative,"* and *"it is not intended that only the factors described in this paragraph are to be taken into account in making the determination, or that a determination is to be made on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa." Id.*

Today's lesson presents two very typical fact patterns for the application of the hobby loss rules. The third case presents a very unusual fact pattern.

<u>Fact Pattern #1: The High-Earner Hobby</u>.
Sherman presents a typical situation where a high-income taxpayer tries to use large personal expenditures to reduce that income by claiming the expenditures were for a business. In this case a high-income doctor created this homemade website (Op. at 4) called "Songswell." At the bottom of the front page it says ***"Site created to showcase music to the world."*** And not just any music, but Dr. Sherman's music. Well, he has the freedom to do that. The site contains various short video clips of various water flows and audio clips of various water sounds. The showcase video is a man riding the "swell" of the ocean. Most of the video clips appear to feature Dr. Sherman playing the guitar and singing songs. The site appears to offer many of these clips for sale but when I clicked on the "buy" buttons I basically got a 404 error (page not found).

The year at issue is 2015. That year, Dr. Sherman worked as an emergency room physician, earning at least $143,000. He failed to file a tax return. In 2019 the IRS prepared a Substitute for Return based on third-party information returns and sent Dr. Sherman an NOD showing a tax deficiency of $60,000. That prompted him to file a return. It reported zero income from Songswell but some $105,00 in expenses, a big chunk of which was for specialized AV equipment, such as $51,000 for a "Alexa Mini Camera" and another $20,000 for "Alex[a] Mini Accessories." You can watch this YouTube video to see what that system looks like. It's pretty high-end.

Dr. Sherman petitioned the Tax Court (pro se) and claimed that the NOD was in error because (a) he should be allowed a deduction of $52,500 for expenses associated with his medical practice and (a) he should be allowed a deduction of $105,000 for the net loss he in incurred in Songswell, which he claimed was a business. The medical expense claims are not part of the lesson.

<u>Lesson #1: Keep Records, Have Income</u>
Judge Jones dutifully applies the WTF test and finds that each and every factor weighs against a finding that Songswell was a business. I recommend reading this opinion to get a good sense of how all the factors work. However, two factors were epic fails and give use our first lesson.

The first epic fail was that Dr. Sherman did not conduct the activity in a businesslike manner. That main problem was lack of adequate records. I mean, the man did not even keep basic receipts: *"Dr. Sherman was unable to produce any documentation or receipts for most of the expenses listed in the "other" category... Further, although Dr. Sherman purchased some camera equipment and accessories in 2015, the amounts on the receipts do not match the expenses reported on Schedule C. Additionally, many of his equipment purchases occurred outside the 2015 taxable year."* Op. at 6.

But even if he had receipts, a taxpayer needs more than receipts to show they are conducting an activity in a businesslike manner. They need basic records of the business activity. Here, Dr. Sherman had none. He had no records to show a business plan or even to show *"when Songswell activities began, nor precisely what activity occurred in taxable year 2015."* Op. at 11.

The second epic fail was the total lack of income from Songswell and his substantial income from being a doctor. Writes Judge Jones: *"His reported losses from Songswell—in addition to his medical practice expenses—would produce a substantial tax benefit, essentially zeroing out any tax obligation he owed."* Op. at 15.

Judge Jones concludes: *"This is not a difficult case... Aside from Dr. Sherman's self-serving testimony that the Songswell activity was conducted for profit, little else counsels in favor of finding a profit motive..."* Op. at 10.

Bottom Line #1: Your vanity website is not a business if you have zero sales over multiple years.

Fact Pattern #2: The Retirement Hobby

Swanson presents another typical situation: a retired taxpayer pursues a long-held hobby and find they can produce some income from it to offset its cost. That does not make it a business. Here, Mr. Swanson was a resident of Alaska who had retired in 2010. His retirement income came from his pension, from Social Security and from rents received on two properties he owned.

Mr. Swanson was apparently an avid fisherman. He had fished in Alaska for over 30 years. He liked fishing for halibut and he liked fishing from a town called Homer, the self-described "Halibut Fishing Capital of the World." But he lived in Anchorage, some 200 miles away.

After retirement he bought a boat *"designed to fish for halibut."* Op at 4. He was apparently able to store his boat and equipment for free in Homer because his *"life partner's children lived in Homer"* (Id.). He also bought a plane *"to shorten his travel time between Anchorage and Homer."* *Id.* He apparently was not already a pilot because Judge Pugh notes he held only a student license in the three years at issue (2014-2016). *Id.*

All of this cost money and Mr. Swanson decided offset his expenses by offering his boat for charter fishing under the name Happy Jack Charters (currently ranked #53 of 63 boat charters in Homer, AK on TripAdvisor). He made some money at it. During the three years at issue (2014-2016), he reported gross receipts of $1,500, $2,345, and $3,709, respectively. Op. at 7. But his reported expenses gave him net losses, totaling $131,000 over the three years.

Like Dr. Sherman, Mr. Swanson apparently was not very good at filing returns. He filed his 2016 return in June 2017 and his 2014 and 2015 returns in August 2017. It is not entirely clear from the opinion, but it appears he was prompted to file returns by an IRS audit. Apparently the IRS was concerned about unreported income. A Revenue Agent conducted a bank deposits analysis, finding deposits for each year exceeding reported income. That's not routine. The IRS sent him an NOD and Mr. Swanson hired a lawyer and petitioned the Tax Court.

Lesson #2: Don't Be "Lazy On Your Books"

Unlike Dr. Sherman, Mr. Swanson at least had some income from his chartering activity. And he kept records.

Mr. Swanson at least kept receipts that *"he would hand to his accountant at the end of the year 'to figure it out.'"* Op. at 10. But just having income and keeping receipts of expenses is not enough to show an activity is operated in a businesslike manner. Judge Pugh explains that *"the key question is not whether the taxpayer keeps records, but whether the taxpayer uses his records to improve profitability and take steps to control expenses and increase income."* Op. at 10 (emphasis in original).

What hurt Mr. Swanson here was his poor recordkeeping. One gets a sense of it from this TripAdvisor review from May 2017: *"We caught our limit of halibut. Only downside is he got ticketed by the water cops ... **lazy on his books they said**. Other than that, we really enjoyed the trip."*

Judge Pugh explains how Mr. Swanson was lazy on his books for tax purposes as well. He did not *use* his records to operate his activity like a business. *"Mr. Swanson did not explain whether and how he used the data about his income and expenses to make his activity profitable. *** Mr. Swanson did not have a business plan and made no significant changes to reduce expenses and generate income the entire time he operated Happy Jack Charters. *** Despite the apparent lack of clients and income, Mr. Swanson purchased an airplane and incurred significant expenses related to storing, maintaining, and operating it.. Over the seven years of operating Happy Jack Charters, Mr. Swanson never made changes that enhanced his prospect for making a profit."* Op. at 10-11.

Bottom Line #2: Don't be lazy on your books.

Fact Pattern #3: The Hobby-Business Mash-Up

Our third case, *Carson*, presents a very strange fact pattern. Ms. Carson's mom created a grantor trust and transferred mom's cattle ranch to it; Mom was trustee. Mom and stepdad were the life beneficiaries of the trust. Ms. Carson and her brother were the remaindermen. During the tax years at issue (2017-2018) Mom and stepdad were living.

Per written agreements, Ms. Carson was obligated to pay the expenses of the ranch. But she was not entitled to any of the income from ranch unless both she and her mom agreed to it. Thus between 2014 and 2019 *"[Ms.] Carson made substantial financial contributions to the ranch by paying its expenses. *** The ranch made money mainly by selling cattle. The receipts from the cattle sales were reported on the returns of [Ms.] Carson's mother."* Oral Transcript at 3. That's just weird. Normally parents try to assign income to their children, deductions!

It is not clear from the opinion but it appears that the Carsons lived on the ranch. At any rate Judge Morrison says that *"the Carson's two children lived at the ranch helping in the ranch's business of raising cattle for sale. For this purpose, the children used horses, some of which they also used to compete in cash-prize rodeos. The children also performed manual labor for neighbors of the ranch."*

For the tax years at issue (2017 and 2018) the Carson's filed a Schedule F, reporting a "livestock" business. However, the only income they reported each year was the cash prizes the kids won in rodeos and the money the kids made from neighbors: some $2,700 in 2017 (all from rodeo prizes) and some $8,000 in 2018 ($6,200 from rodeo prizes). Against that modest income they reported all the expenses Ms. Carson had agreed make: $139,000 in 2017 and $134,000 in in 2018.

This had been the pattern since 2014: *"During the six years 2014 to 2019, the Carson's reported cumulative losses of $502,742 on the schedules F. For each year, these losses not only dwarfed the gross income reported on the schedule F...but they largely offset the Carson's ordinary income [from] wages."* Yessir, assignment of deductions!

On audit, the IRS disallowed all the Schedule F deductions in excess of the Schedule F income because the IRS Revenue Agent thought that the Carsons had mis-labeled the activity and it should have been reported as a rodeo activity, not a ranching activity. And the rodeo activity was a hobby, not a business. The Carsons petitioned the Tax Court. I cannot tell whether they were represented.

Lesson #3: Hobby + Business = Business?

The basic problem, Judge Morrison decides, is that the IRS mis-analyzed how the Carsons messed up their return. The Carsons' error was mashing up the rodeo activity and ranching activity on the same Schedule. That led the IRS to mis-analyze the return by ignoring the documented arrangement between Ms. Carson. The IRS approach *"supposes that the Carsons lost approximately $120,000 per year entering their children in rodeos. *** [That] makes no sense in light of our view that the deductions reported on the Schedules F mainly related to ranching."* Transcript at 8.

Here, unlike our other two cases, the taxpayers kept good records. Transcript at 8. (Ms. Carson *"kept meticulous details of the expenses that were deducted on the Schedule F."*). Those records showed most expenses related to the ranching activity and only a *"relatively small part"* related to the rodeo activity. *Id.* Judge Morrison declines to parse the expenses because the IRS *"did not challenge the substantiation behind the deductions" id.* and thus he was not going to ding Ms. Carson for not bringing records with her to trial.

Bottom Line #3: Don't try this at home, but once Judge Morrison accepted that the ranching activity was legit, then mashing up the hobby and business was basically harmless error. Sure, the Carsons *should* have reported the rodeo income on Schedule 1 and not Schedule F. Sure, they *should* have reported the rodeo expenses on Schedule A (and, of course, for 2018 they would not have been able to deduct any rodeo expenses because of evil §67(g)). The proper reporting position, however, would not have affected their bottom lines very much if at all. The ranching net losses would have still been able to be used to offset the modest rodeo income they had as well as most of their wage income.

Coda: The real issue here—that the IRS just missed—was the assignment of deductions. Judge Morrison notes the weirdness of allocating all the ranching income to Ms. Carson's mom and allocating all the ranching expenses to Ms. Carson but tells us that a *"mismatch of income and deductions is not prohibited under the Code per se, but may be relevant in determining the appropriateness of accounting methods and in determining the appropriate allocation of income and deductions between partners. However, these legal issues are not before the court."*

Bryan Camp *is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) for another* Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

Charter Boat Operator Failed to Show He Was in it for the Money

JUN. 29, 2023

Donald E. Swanson v. Commissioner

DONALD E. SWANSON,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed June 29, 2023

Christopher S. Crago, Andrew Simister (student), and Greg Spurgetis (student), for petitioner.

Adriana E. Vargas, *Daniel G. Kempland*, and *Melissa D. Lang*, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PUGH, *Judge*: Respondent determined the following deficiencies, additions to tax, and accuracy-related penalties with respect to Donald Swanson's federal income tax for years 2014-16 (years in issue):

Year	Deficiency	Additions to Tax/Penalties	
		§6651(a)(1)	§6662(a)
2014	$16,135	$4,034	$3,227

Year	Deficiency	Additions to Tax/Penalties	
		§6651(a)(1)	§6662(a)
2015	38,762	9,691	7,752
2016	4,299	—	860

Deficiencies resulted largely from respondent's determination that Mr. Swanson's fishing charter activity was not a business for profit **[*2]** within the meaning of section 183[1] and that he was not entitled to business expense deductions. Respondent also made various other income adjustments and reduced or disallowed some itemized deductions.

In the Second Stipulation of Facts the parties conceded certain adjustments for each year in issue.

Tax Year 2014

Respondent conceded that Mr. Swanson (1) is Fot liable for an accuracy-related penalty of $3,227 and (2) is entitled to a noncash charitable contribution deduction of $199. Mr. Swanson conceded that he is not entitled to (1) a tax expense deduction of $2,288 (admitting that his deduction is $1,306 as determined in the notice of deficiency) and (2) a car and truck expense deduction of $1,993.

Tax Year 2015

Respondent conceded that Mr. Swanson is not liable for an accuracy-related penalty of $7,752. Respondent also conceded that Mr. Swanson is entitled to (1) a noncash charitable contribution deduction of $200; (2) a cash charitable contribution deduction of $1,362; (3) a supplies expense deduction of $1,389; and (4) an insurance expense deduction of $1,259. Mr. Swanson conceded that he is not entitled to (1) a mortgage interest expense deduction of $9,777; (2) a car and truck expense deduction of $1,250; (3) a utilities expense deduction of

$600; and (4) an advertising expense deduction of $640. Mr. Swanson also conceded that his gross receipts reported on Schedule C, Profit or Loss From Business, should be increased by $155 for income received for tax preparation services he provided.

Tax Year 2016

Respondent conceded that Mr. Swanson is not liable for an accuracy-related penalty of $860. He also conceded that Mr. Swanson is entitled to (1) a cash charitable contribution deduction of $670; (2) an insurance expense deduction of $1,244; (3) an advertising expense **[*3]** deduction of $2,256; and (4) an other expense deduction of $8,487. Mr. Swanson conceded that he is not entitled to (1) a charitable contributions carryover of $3,724; (2) a medical and dental expense deduction of $409; (3) a car and truck expense deduction of $1,714; and (4) a meals and entertainment expense deduction of $74.

In his Opening Brief respondent stated that after concessions, the issues for consideration are whether Mr. Swanson: (1) engaged in a fishing charter activity with the objective of making a profit within the meaning of section 183; (2) is entitled to deductions for expenses reported on the Schedules C attached to his federal income tax returns for the years in issue; (3) is entitled to deductions reported on Schedules A, Itemized Deductions, attached to his federal income tax returns for the years in issue; (4) had income in excess of the amounts reported on his federal income tax returns for the years in issue; (5) had capital gains from the sale of real property in excess of the amounts reported on his federal income tax return for 2015; (6) is entitled to charitable contribution deductions in amounts greater than allowed by respondent for the years in issue; (7) is entitled to expense deductions reported on Schedules E, Supplemental Income and Loss, in amounts greater than respondent allowed for 2014 and 2015; and (8) is liable for section 6651(a)(1) additions to tax for failure to timely file federal income tax returns for 2014 and 2015.

The two issues that Mr. Swanson challenged at trial and in his posttrial briefs are whether his fishing charter trip activity was a business or a hobby within the meaning of section 183 and whether he is entitled to deductions for certain expenses related to his activity in 2015 (boat and airplane expenses) and 2016 (boat expenses). Because one of the issues involves unreported income, on which respondent bears the burden of proof, we must decide whether respondent has met his burden. Respondent has the burden of production as to the additions to tax. *See* §7491(c). We deem Mr. Swanson to concede all other issues because he did not challenge them at trial or in his briefs, and we sustain respondent's determinations with respect to those issues. We make no separate findings of fact related to those conceded issues.

FINDINGS OF FACT

The facts we find are derived from the pleadings, the trial testimony, and the documents admitted into evidence and include the stipulated facts and documents. Mr. Swanson resided in Alaska when he timely filed his Petition.

[*4] I. Happy Jack Charters

Mr. Swanson is an avid fisherman and has been fishing in Alaska for more than 30 years. In 2010, after retiring from two jobs (loading cargo and driving a city bus), he decided to establish Happy Jack Charters and acquired a boat designed to fish for halibut. Mr. Swanson wanted to show people where to fish and how to fish. His boat, a 22-foot Boulton Sea skiff, was made in Oregon.

During the years in issue Mr. Swanson lived in Anchorage, Alaska, but his plan was to take people on halibut fishing trips in Homer, Alaska. His life partner's children lived in Homer, and they let Mr. Swanson store his boat, camper, truck, and other things on their property. This allowed Mr. Swanson to reduce his expenses. He hoped to retire eventually, buy a cabin, and fish in Homer. In 2015, to shorten his travel time between Anchorage and Homer, Mr. Swanson acquired a plane. Although he also wanted to use the plane to transport customers, he was not allowed to do that during the years in issue because he had only a student license.

Mr. Swanson did not own a commercial fishing permit for halibut fishing but rented one in 2015 and 2016. The State of Alaska requires fishermen to maintain a detailed log of fish caught daily. Because Mr. Swanson did not have a commercial fishing license in 2014, he did not take any fishing charter trips and did not file fishing logs with the Alaska Department of Fish and Game for that year. In 2015 and 2016 Mr. Swanson filed fishing logs with the Alaska Department of Fish and Game reporting five fishing charter trips in 2015: on June 10 and 14, and on July 15, 21, and 25; and six fishing charter trips in 2016: on July 2, 12, 14, 16, and 22, and on August 18. Mr. Swanson also took his boat for personal fishing trips. During the years in issue he sometimes used the personal fishing trips to photograph people catching fish for advertisements to promote Happy Jack Charters. The halibut fishing season lasts from May to September.

A cancer diagnosis and treatment restricted Mr. Swanson's physical activities in 2013, but during the years in issue he did not have to travel for cancer treatments. In 2015 he suffered a knee injury in an automobile accident, but he was able to perform the duties of a captain after the injury. A boat fire in 2016 took his boat out of service for the week or two that the repairs took to complete.

[*5] Mr. Swanson did not rely on the income from operating Happy Jack Charters. His main sources of income for the years in issue were Social Security, pension, and rental income from his two real estate properties. He did not have a separate bank account, accounting or recordkeeping system, or income and expense journals for Happy Jack Charters for the years in issue. But he did keep expense receipts for tax purposes.

In 2014 the Internal Revenue Service (IRS) audited Mr. Swanson's 2010 federal income tax return. Mr. Swanson explained that during the audit the IRS agent told him that he did not have "the right kind of insurance" and "the right kind of license." Following the audit, Mr. Swanson purchased "commercial insurance" and a "commercial license."[2] In addition, he started using an application called "Square" to track his business income, and he joined the Chamber of Commerce.

During the years in issue Mr. Swanson traveled to several trade shows hoping to attract customers for his fishing charter activity. He did not land any customers from the shows in the years in issue, but he still hoped that they would come later.

II. Business Expenses (Schedule C)

Mr. Swanson produced copies of receipts for boat and airplane expenses for 2015 and 2016:

2015 Boat Expenses		**2015 Airplane Expenses**		**2016 Airplane Expenses**	
Petro Marine	$174.06	Avionics	$95.00	Missionary	$55.44

2015 Boat Expenses		**2015 Airplane Expenses**		**2016 Airplane Expenses**	
Petro Marine	126.03	No Li Avionics	56.30	Smon	77.61
Petro Marine	164.51	No Li Avionics	99.90	Northern Lights	78.65
Petro Marine	125.43	No Li Avionics	32.05	Northern Lights	7.55
Petro Marine	8.22	No Li Avionics	12.95	Ace	73.38
Petro Marine	75.97	No Li Avionics	55.90	Ace	80.77
Petro Marine	107.12	No Li Avionics	39.90	Ace	69.27
Petro Marine	142.13	No Li Avionics	678.45	Crowley Fuels	62.92
Petro Marine	92.89	Ace	35.06	Crowley Fuels	44.82
Petro Marine	115.99	Ace	48.10	Ace	38.44
Petro Marine	47.22	Ace	70.27	Crowley Fuels	50.53
Petro Marine	82.23	Ace	44.16	Ace	35.75
Petro Marine	58.54	Ace	26.12	Ace	63.66
[*6] Petro Marine	81.41	Ace	48.66	Ace	57.75

2015 Boat Expenses		**2015 Airplane Expenses**		**2016 Airplane Expenses**	
Petro Marine	158.56	Ace	58.31	Ace	84.45
Petro Marine	29.71	Ace	64.03	Ace	40.81
Petro Marine	111.74	Ace	53.42	Ace	68.59
Petro Marine	90.96	Ace	39.20	Ace	41.17
Petro Marine	20.18	Ace	53.78	C2 Aviation	55.19
Petro Marine	39.53	Missionary	76.74	Seaplanes North	52.50
—	—	Ace	52.28	Ace	55.55
—	—	Ace	84.39	Crowley Fuels	46.44
—	—	Ace	61.21	Crowley Fuels	49.00
—	—	Ace	38.75	Crowley Fuels	9.28
—	—	C&J	20.00	Pathfinder	74.90
—	—	Ace	54.27	State of Alaska	210.00
—	—	Smokey Bay	45.49	LASA	165.00

2015 Boat Expenses		2015 Airplane Expenses		2016 Airplane Expenses	
—	—	Petro Marine	47.22	Sky Airports	35.00
—	—	Sky Airparts	61.68	Stoddards	8.00
—	—	Municipality	100.00	LASA	165.00
—	—	Bieg Big Studios	680.00	T&B Aircraft	715.00
—	—	Gary M	600.00	Seaplanes North	1,052.48
—	—	AMA	371.00	Seaplanes North	761.59
—	—	Ron Stafford	565.00	Seaplanes North	14.70
—	—	AMA	557.00	Seaplanes North	129.85
—	—	—	—	Seaplanes North	36.00
—	—	—	—	Seaplanes North	65.56
—	—	—	—	Avemco	612.75
—	—	—	—	Aviation Med.	173.40
—	—	—	—	Ron Stoffono	450.00

2015 Boat Expenses		2015 Airplane Expenses		2016 Airplane Expenses	
Total	**$1,852**		**$5,027**		**$5,969**

III. Rental Income

Mr. Swanson owned two rental properties in Anchorage. He received rental income during the years in issue from these properties. In 2015 Mr. Swanson sold one of the properties for $279,900.

IV. Bank Deposits Analysis

Respondent's revenue agent (RA) conducted a bank deposits analysis for the years in issue. For 2014 the RA reviewed the Denali Alaskan Federal account ending in 5879 (account 5879), the Alaska USA Federal account ending in 1643 (account 1643), and the Alaska USA Federal account ending in 1629 (account 1629). To determine Mr. **[*7]** Swanson's gross receipts for the years in issue the RA used only accounts 5879 and 1643 because account 1629 is a joint account. The RA determined that in 2014 the total amount of bank deposits in the two accounts was $116,435. In 2014 Mr. Swanson reported $75,785 of income on his federal income tax return; therefore, the RA concluded that in 2014 Mr. Swanson had unreported income of $40,650.

The RA determined that in 2015 the total amount of bank deposits was $265,919. In 2015 Mr. Swanson reported $241,966 of income; therefore, the RA concluded that in 2015 Mr. Swanson had unreported income of $23,953. The RA classified the unreported income into three categories: (1) unexplained unreported income of $18,983; (2) income reportable on Schedule E, Line 3, Rents Received, of $4,820; and (3) income reportable on Schedule C for income earned as a tax professional of $150.

The RA determined that in 2016 the total amount of bank deposits was $68,988. In 2016 Mr. Swanson reported $53,042 of income; therefore, the RA concluded that in 2016 Mr. Swanson had unreported income of $15,946. An error in the bank deposits analysis for 2016 resulted in an erroneous increase of $290 in the total deposits.

Mr. Swanson admitted that he received rental income and was paid as a tax professional for helping his friend to prepare a tax return on one occasion.

V. Federal Income Tax Returns

Mr. Swanson filed Forms 1040, U.S. Individual Income Tax Return, for 2014 and 2015 on August 15, 2017. He filed Form 1040 for 2016 on June 5, 2017.

For 2014 Mr. Swanson reported $1,500 of gross receipts and $1,993 of business expenses from his fishing charter activity. For 2015 he reported $2,345 of gross receipts and $36,960 of business expenses from his fishing charter activity. And for 2016 Mr. Swanson reported $3,709 of gross receipts and $25,631 of business expenses from his fishing charter activity. Mr. Swanson filed federal income tax returns reflecting income and business expense deductions for his fishing charter activity for 2010 and 2012 through 2016. He reported net business losses for each of those years, totaling $131,105.

[*8] OPINION

The main issue in this case is whether during any of the years in issue Mr. Swanson entered into or carried on his fishing charter activity for profit and whether the associated deductions were proper.

I. Burden of Proof

Generally, the taxpayer bears the burden of proving that the Commissioner's determinations are erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). Under section 7491(a)(1), "[i]f, in any court proceeding, a taxpayer introduces credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer for any tax imposed by subtitle A or B, the Secretary shall have the burden of proof with respect to such issue." *See Higbee v. Commissioner*, 116 T.C. 438, 442 (2001). Mr. Swanson does not contend that the burden of proof should shift to respondent under section 7491(a), and we conclude that section 7491(a) does not apply here.

In cases involving unreported income, the Commissioner must establish an evidentiary foundation connecting the taxpayer to the income-producing activity, *Weimerskirch v. Commissioner*, 596 F.2d 358, 361 (9th Cir. 1979), *rev'g* 67 T.C. 672 (1977), or demonstrate that the taxpayer actually received income, *Edwards v. Commissioner*, 680 F.2d 1268, 1270-71 (9th Cir. 1982). Once the Commissioner has met this threshold burden, the burden shifts to the taxpayer to show that the Commissioner's determination of income was arbitrary or erroneous. *Hardy v. Commissioner*, 181 F.3d 1002, 1004-05 (9th Cir. 1999), *aff'g* T.C. Memo. 1997-97.

II. For-Profit Business

Taxpayers are generally allowed deductions for business and investment expenses. *See* §§162, 212. Under section 183(a), individuals are not allowed a deduction attributable to an activity "if such activity is not engaged in for profit" except to the extent provided by section 183(b). Section 183(b) allows deductions that would have been allowable had the activity been engaged in for profit but only to the extent of gross income derived from the activity (reduced by deductions attributable to the activity that are allowable without regard to whether the activity was engaged for profit).

Section 183(c) defines an activity not engaged in for profit as "any activity other than one with respect to which deductions are allowable **[*9]** for the taxable year under section 162 or under paragraph (1) or (2) of section 212." For expenses to be fully deductible under section 162 or 212, taxpayers must show that they are engaged in the activity with the primary objective of making a profit. *Wolf v. Commissioner*, 4 F.3d 709, 713 (9th Cir. 1993), *aff'g* T.C. Memo. 1991-212; *see also Westbrook v. Commissioner*, 68 F.3d 868, 875 (5th Cir. 1995), *aff'g* T.C. Memo. 1993-634.

The expectation of a profit need not be reasonable, but the taxpayer must conduct the activity with the actual and honest objective of making a profit. *Keating v. Commissioner*, 544 F.3d 900, 904 (8th Cir. 2008), *aff'g* T.C. Memo. 2007-309. Greater weight is given to objective facts than to the taxpayer's self-serving statement of intent. *King v. Commissioner*, 116 T.C. 198, 205 (2001); Treas. Reg. § 1.183-2(a) and (b).

The regulations provide a nonexhaustive list of nine factors that should be considered: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or the taxpayer's advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Treas. Reg. § 1.183-2(b). Neither a single factor, nor the existence of even a majority of the factors is controlling; rather all the facts and circumstances should be evaluated. *See Golanty v. Commissioner*, 72 T.C. 411, 426-27 (1979), *aff'd without published opinion*, 647 F.2d 170 (9th Cir. 1981).

A. Manner in Which the Taxpayer Carries on the Activity

Carrying on an activity in a businesslike manner, as by maintaining complete and accurate books and records, conducting the activity in a manner similar to other activities of the same nature that are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods, is a factor that may indicate a profit objective. Treas. Reg. § 1.183-2(b)(1). Businesslike conduct is characterized by carefully and thoroughly investigating the profitability of a proposed venture, monitoring the venture's progress, and attending to problems that arise over time. *See Ronnen v. Commissioner*, 90 T.C. 74, 93 (1988); *Taube v. Commissioner*, 88 T.C. 464, 481-82 (1987). An important indication of whether an activity is **[*10]** being performed in a businesslike manner is whether the taxpayer implements methods for controlling losses, including efforts to reduce expenses and generate income. *See Foster v. Commissioner*, T.C. Memo. 2012-207, 2012 WL 3000350, at *6; *Dodge v. Commissioner*, T.C. Memo. 1998-89, 1998 WL 88175, at *5, *aff'd*, 188 F.3d 507 (6th Cir. 1999).

For section 183 purposes, the key question is not whether the taxpayer keeps records, but whether the taxpayer *uses* his records to improve profitability and take steps to control expenses and increase income. *See Golanty*, 72 T.C. at 430. Mr. Swanson explained that he kept various receipts for tax purposes that he would hand to his accountant at the end of the year "to figure it out." Mr. Swanson did not have a separate bank account for Happy Jack Charters; instead, he used Square to track his income from the fishing charter activity. Mr. Swanson did not explain whether and how he used the data about his income and expenses to make his activity profitable. Neither did he keep complete records of his Happy Jack Charters activity. His maintenance of receipts of various expenses is insufficient. *See Keating*, T.C. Memo. 2007-309 (holding that complete and accurate books and records are more than the mere maintenance of lists of, and receipts for, expenses). And we are skeptical about the accuracy of Mr. Swanson's income tracking using Square as respondent's bank deposits analysis demonstrated significant discrepancies between his reported income on his federal income tax returns and his deposits into his bank accounts.

Mr. Swanson did not have a business plan and made no significant changes to reduce expenses and generate income the entire time he operated Happy Jack Charters. He experienced significant losses not only during the years in issue but from the beginning of his fishing charter activity in 2010.

Mr. Swanson explained that he implemented some changes after respondent's audit of his 2010 federal income tax return. He explained that he obtained a fishing license and commercial insurance, started using Square, and engaged in advertising with the Chamber of Commerce. He also attended trade shows hoping eventually to land new clients. Some of these changes had nothing to do with increasing profitability or reducing expenses but instead were necessary to comply with applicable laws and regulations (maintaining a valid fishing license and commercial insurance). Advertising generally indicates a profit motive, but Mr. Swanson's explanation of how advertising helped him increase profitability of Happy Jack Charters was vague and unpersuasive. He mentioned that his first client from trade show **[*11]** advertising was in 2017. During the three years in issue Mr. Swanson had only 11 fishing trips. Despite the apparent lack of clients and income, Mr. Swanson purchased an airplane and incurred significant expenses related to storing, maintaining, and operating it. Over the seven years of operating Happy Jack Charters, Mr. Swanson never made changes that enhanced his prospect for making a profit.

Because Mr. Swanson did not maintain complete business records, did not have a business plan, and did not respond to losses by changing how he conducted his fishing charter activity, we find that he did not conduct the activity in a businesslike manner. Therefore, this factor weighs against Mr. Swanson.

B. The Expertise of the Taxpayer or His Advisers

The taxpayer's expertise, research, and study of an activity, as well as his consultation with experts, may be indicative of a profit motive. Treas. Reg. § 1.183-2(b)(2). The type and quality of advice that a taxpayer seeks is important to the analysis of the taxpayer's consultation with experts. *See Engdahl v. Commissioner*, 72 T.C. 659, 668 (1979) (noting that informal and continuous consultations with experts in the field demonstrate an intent to engage in a business for profit).

We do not doubt Mr. Swanson's fishing expertise, but he did not demonstrate to us that he had any expertise in running a business, much less a fishing charter business. When he first started, he did not have a commercial fishing license or commercial insurance; only after the IRS audit did he rectify these omissions. Mr. Swanson did not demonstrate how he prepared for running a fishing charter business, whether he did any research or study, or whether he consulted with experts or received any other advice about operating a fishing charter business.

Mr. Swanson testified that he joined the Chamber of Commerce but did not explain whether or how it better equipped him to run a profitable fishing charter business. He testified only that he viewed it as another avenue for advertising.

Because Mr. Swanson lacked expertise in running a fishing charter business and did not consult any advisers to compensate for his lack of business expertise, this factor weighs against him.

[*12] C. The Time and Effort Expended by the Taxpayer in Carrying On the Activity

The taxpayer's devotion of much of his personal time and effort to carrying on an activity may indicate a profit motive, particularly if the activity does not involve substantial personal or recreational enjoyment. Treas. Reg. § 1.183-2(b)(3).

Mr. Swanson did not take any charter fishing trips in 2014 and had only five and six trips in 2015 and 2016, respectively. He testified that health issues restricted his physical activities in 2013 but did not indicate how his health problems affected his activities in the years in issue. Rather, the main reason Mr. Swanson did not take any fishing trips in 2014 was that he did not have a commercial fishing license or commercial insurance. Mr. Swanson did not explain why he had only 11 trips in 2015 and 2016.

The limited time that Mr. Swanson spent on fishing charter trips in the years in issue indicates a lack of intent to make a profit from the fishing charter activity. We find that this factor weighs against Mr. Swanson.

D. Expectation that Assets Used May Appreciate in Value

An expectation that assets used in an activity will appreciate may indicate a profit motive even if the taxpayer derives no profit from current operations. *Id.* subpara. (4).

Mr. Swanson did not address this factor at trial or in posttrial briefs, and offered no other evidence to show any assets used in the fishing charter activity will appreciate in value. Accordingly, this factor is neutral.

E. The Success of the Taxpayer in Carrying On Similar or Dissimilar Activities

If a taxpayer has previously engaged in similar activities and made them profitable, this success may show that the taxpayer has a profit objective, even if the current activity is unprofitable currently. *Id.* subpara. (5).

Mr. Swanson did not address this factor at trial or in posttrial briefs, and offered no other evidence to establish his success in other businesses. Respondent notes that Mr. Swanson engaged in the **[*13]** management of rental properties which also generated losses for all years in issue. We find that this factor weighs against Mr. Swanson.

F. The Taxpayer's History of Income or Losses with Respect to the Activity

A history of continued losses in an activity may indicate the lack of a profit motive. *Id.* subpara. (6). While a series of losses during the startup stage of an activity may not necessarily indicate a lack of profit motive, a record of large losses over many years is persuasive evidence that a taxpayer did not have that motive. *See Golanty*, 72 T.C. at 426.

Mr. Swanson started Happy Jack Charters in 2010 and experienced a loss for every year through 2016. Over the course of these seven years he reported more than $130,000 in losses. Mr. Swanson contends that unforeseen circumstances caused him to experience losses.

We sympathize with Mr. Swanson's setbacks, but we do not think that those issues were the main reason his fishing charter activity was unprofitable. Mr. Swanson testified that despite his health problems he was able to perform the duties of a boat captain and that he did not have to travel for treatment during the years in issue. The 2015 automobile accident also did not keep Mr. Swanson from performing his fishing charter activity. He testified that despite the accident, he was able to work that season. Lastly, the 2016 boat fire interrupted Mr. Swanson's fishing charter activity for only a week or two, the time it took to make the necessary repairs.

Mr. Swanson's continuous and significant losses indicate a lack of a profit motive, and this factor weighs against him.

G. The Amount of Occasional Profits, if Any, Which Were Earned

A taxpayer's generation of some profits from an otherwise money-losing venture may support the existence of a profit motive. Treas. Reg. § 1.183-2(b)(7).

Mr. Swanson did not address this factor at trial or in posttrial briefs, and he stipulated that Happy Jack Charters experienced losses for the seven years from its launch through the years in issue. Neither did he attempt to show that there is potential for significant profit in the future. We find that this factor weighs against Mr. Swanson.

[*14] H. The Financial Status of the Taxpayer

Substantial income from sources other than the activity may indicate that the activity is not engaged in for profit. *Id.* subpara. (8).

Mr. Swanson did not rely on income from Happy Jack Charters as his main source of income, although he hoped that one day he would. Mr. Swanson received income from a retirement pension, Social Security retirement, and rental properties. He used his purported losses from the fishing charter activity to reduce his income from other sources. Because Mr. Swanson did not receive substantial income from his fishing charter activity, he was spending his income from other sources to fund it. This factor also weighs against Mr. Swanson.

I. Elements of Personal Pleasure or Recreation

The presence of personal motives for conducting an activity may indicate lack of a profit objective, especially if the activity involves personal or recreational aspects. *Id.* subpara. (9). An activity is not classified as a hobby simply because the taxpayer finds it pleasurable. *Jackson v. Commissioner*, 59 T.C. 312, 317 (1972). The analysis does not require that the activity be engaged in with the exclusive intent of deriving a profit or even maximizing profit. Treas. Reg. § 1.183-2(b)(9). That said, "where the possibility for profit is small . . . and the possibility for gratification is substantial, it is clear that the latter possibility constitutes the primary motivation for the activity." *Dodge v. Commissioner*, 1998 WL 88175, at *7 (quoting *Burger v. Commissioner*, T.C. Memo. 1985-523, *aff'd*, 809 F.2d 355 (7th Cir. 1987)).

We have no doubt that Mr. Swanson finds fishing pleasurable. Mr. Swanson used his boat for personal fishing trips. He denied some personal use and admitted some too. He could not adequately explain the number of times that he had to refuel the boat that had no corresponding charter booking. In addition Mr. Swanson testified that his retirement plan has been to retire to Homer and fish.

A review of the entire record and the testimony at trial persuades us that Mr. Swanson's personal motives and the recreational or personal aspects of his fishing charter activity outweighed his desire for profit. This factor weighs against Mr. Swanson.

[*15] J. Conclusion

While Mr. Swanson testified credibly about the time he spent on Happy Jack Charters and the obstacles he faced, he did not demonstrate that his fishing charter activity was more than a retirement hobby. Considering the evidence as a whole, we are convinced that Mr. Swanson wanted his fishing charter activity to succeed and he devoted time to it, but he was not operating it as a business.

We therefore find that during the years in issue Mr. Swanson did not operate his fishing charter activity with the requisite profit intent. Consequently, he is entitled to deductions attributable to that activity only to the extent allowed by section 183(b).

III. Unreported Income: Bank Deposits Analysis

Gross income includes "all income from whatever source derived." §61(a). A taxpayer must maintain books and records establishing the amount of his gross income. §6001. If a taxpayer fails to maintain and produce the required books and records, the Commissioner may determine the taxpayer's income by any method that clearly reflects income. *See* §446(b); *Petzoldt v. Commissioner*, 92 T.C. 661, 693 (1989); Treas. Reg. § 1.446-1(b)(1). The

Commissioner's reconstruction of income "need only be reasonable in light of all surrounding facts and circumstances." *Petzoldt*, 92 T.C. at 687.

The bank deposits method is a permissible method of reconstructing income. *See Clayton v. Commissioner*, 102 T.C. 632, 645 (1994); *see also Kudo v. Commissioner*, T.C. Memo. 1998-404, *aff'd*, 11 F. App'x 864 (9th Cir. 2001). Bank deposits constitute prima facie evidence of income. *See Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). The Commissioner need not show the likely source of a deposit treated as income but "must take into account any nontaxable source or deductible expense of which [he] has knowledge" in reconstructing income using the bank deposits method. *Clayton*, 102 T.C. at 645-46. He need not follow any "leads" suggesting that a taxpayer has deductible expenses. *DiLeo v. Commissioner*, 96 T.C. 858, 872 (1991), *aff'd*, 959 F.2d 16 (2d Cir. 1992). After the Commissioner reconstructs the taxpayer's income and determines a deficiency, the taxpayer bears the burden of proving that the bank deposits analysis is unfair or inaccurate. *See Clayton*, 102 T.C. at 645; *see also DiLeo*, 96 T.C. at 883. The taxpayer must prove that the reconstruction is in error and may do so by proving that all or part of a deposit is not taxable. *See Clayton*, 102 T.C. at 645. **[*16]** Because Mr. Swanson did not maintain books and records sufficient to establish his income and expenses, the RA reconstructed Mr. Swanson's income using the bank deposits method. To support the analysis, respondent produced bank records. Further, respondent proved at least a few likely sources of income — Mr. Swanson admitted that he received rental income as well as one payment for preparing a friend's tax return. Respondent's analysis is well supported, and we accept the reconstruction of income and expenses as reasonable and accurate. Thus, we conclude that respondent has met his burden of proof.

Mr. Swanson did not argue that respondent's reconstruction was unfair or inaccurate and thus did not meet his evidentiary burden. We therefore sustain respondent's determinations with respect to unreported income for the years in issue.

IV. Additions to Tax

Respondent determined additions to tax under section 6651(a)(1) for 2014 and 2015. Respondent bears the burden of production with respect to additions to tax and must produce evidence that they are appropriate. *See* §7491(c); *Higbee*, 116 T.C. at 446-47.

Section 6651(a)(1) imposes an addition to tax for failure to file a return on or before the due date (including extensions) unless the taxpayer can establish that such failure was "due to reasonable cause and not due to willful neglect." To demonstrate reasonable cause, a taxpayer must show that he exercised ordinary business care and prudence but was nevertheless unable to file on time. *United States v. Boyle*, 469 U.S. 241, 246 (1985); Treas. Reg. § 301.6651-1(c)(1).

Respondent produced evidence of late filing, which Mr. Swanson did not dispute. Neither did he argue that the failure to timely file his 2014 and 2015 tax returns was due to reasonable cause. Thus, we conclude that respondent met his burden of production with respect to the additions to tax.

To reflect the foregoing and respondent's concessions,

Decision will be entered under Rule 155.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure. We round all monetary amounts to the nearest dollar.

[2]The record does not indicate when Mr. Swanson bought the insurance, but we infer that it was after the IRS audit and before the years in issue.

END FOOTNOTES

TaxProf Blog

Monday, July 10, 2023

Lesson From The Tax Court: *Deducting Graduate School Costs*

By Bryan Camp

My desire to become a law professor crystalized during the four years I practiced law after my judicial clerkship. My academic mentors told me it would be very difficult to get a job in the legal academy because I had been "contaminated" by ... wait for it ... wait for it ... actually *practicing* law! They told me I needed to "recommit" myself to academia by going back to law school to get a graduate law degree, called an LLM (for Master of Laws).

So I went to Columbia. It was not cheap. As I packed up my office to go back to school, I remember discussing the tax implication with my boss at that time, John Quinn. John remains one of the attorneys I most deeply admire and respect. He still practices at his firm Quinn, Racusin & Gazzola. John and I debated whether I could, or should, deduct the costs of my LLM. His concern was that because the LLM seemed to qualify me for a new trade or business—being a law professor—its expenses would not be deductible. He advised me not to attempt a deduction. I did not follow that advice. And I got audited. More on that at the end of this post.

Today we learn why John's concern was well-founded. In *Ariana K. Uchinzozo v. Commissioner*, T.C. Summ. Op. 2023-21 (Judge Carluzzo), we learn that the cost of an MBA is not deductible under §162 when it gives the taxpayer skills for entry into a new business, even if the MBA is not a formal requirement for that new business. In today's case the taxpayer started a part-time MBA program in 2014 while working for a translation services company. She deducted her MBA expenses on her 2014 return. Through her MBA program she got an internship with Mattel and, eventually, a job. And even though her Mattel job did not require an MBA, the Tax Court still held she was not entitled to deduct the costs of the MBA because the skills she was learning enabled her to enter a different trade or business than the one she was in the year she took the deduction, 2014. Details below the fold.

<u>Law: Deducting Education Expenses Under §162</u>

Section 162(a) permits taxpayers to deduct *"all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business...."* That can include the costs of certain education.

To deduct education expenses under §162 a taxpayer must meet one of two "must" requirements and must avoid both of two "must not" barriers. The regulations explain.

First, Treas. Reg. 1.162-5(a) gives us the two "must" requirements. The education must either (1) maintain or improve the taxpayer's skills in their *current* trade of business or (2) be required to stay employed or keep an established status, such as a licensed professional.

The first "must" can be a bit tricky. It recognizes *"that education is both "ordinary and necessary" within the meaning of the statute if it is customary for other established members of the taxpayer's trade or business to undertake such education."* *Carlucci v. Commissioner*, 37 T.C. 695, 700 (1962). The tricky part, however, is that the education must have a sufficiently close relationship to the employment that the taxpayer is currently engaged in. For example, it would be very unusual for the cost of a college degree to be deductible. Almost always that is for the simple reason that few undergrads are carrying on a trade or business while going to college. But even those that are have a difficult time showing the needed relationship. *See Carroll v. Commissioner*, 51 T.C. 213 (1968)(*Denying deduction for costs of policeman's undergraduate education because "there is only a remote relationship between the study of Shakespeare's plays and the petitioner's work as a policeman."*). Similarly, if a taxpayer pursues a graduate degree that is not related to their current employment, they will not meet this requirement. *See Zhang v. Commissioner*, T.C. Summ. Op. 2003-58 (taxpayer's MBA was not sufficiently connected to his employment as an engineer to meet this first "must" requirements).

As you can see, this is a very fact-intensive inquiry.

The second "must" requirement is pretty straightforward. It is what permits lawyers, CPA's and Enrolled Agents to deduct the costs of the continuing professional education they must obtain each year in order to keep their various statuses. *See* Treas. Reg. 1.162-5(b)(3)(ii), Example 3.

Second, Treas. Reg. 1.162-5(b) gives us two "must nots" that will bar a deduction. The education must not either (1) meet the minimum requirements for employment in the taxpayer's trade, or business, or (2) qualify the taxpayer for a new trade or business. It's that second barrier that seems to be the more common problem.

For example, students who complete law school and obtain a J.D. cannot deduct the costs of law school because the J.D. degree qualifies them to sit for the Bar Examination and to become a lawyer. This is so even they have no intention of becoming a lawyer but simply went to law school to improve their skills in another type of business, such as financial planning or accounting. *See* Treas. Reg. 1.162-5(b)(3)(ii), Examples 1 & 2. For another example, *see Thompson v. Commissioner*, T.C. Memo. 2007-174 (2007) (costs of flight school were not deductible, even though the education improved taxpayer's ability as an aeronautical engineer, because completion of the flight school resulted in a commercial pilot's license).

Many folks think that if the education does not qualify one for a new trade or business, then it will not run into the buzz-kill of Treas. Reg. 1.162-5(b). Nope. Even if the education does not qualify the taxpayer for a new trade or business it will still be non-deductible if it is done primarily for advancement or promotion in the same line of work. The Tax Court put it this way: the *"cost of education undertaken primarily for the purpose of obtaining a new position or substantial advancement in position ... does not constitute deductible ordinary and necessary business expense."* *Carlucci v. Commissioner*, 37 T.C. 695, 700 (1962).

Once a taxpayer meets one of the "must" requirements, and avoids both of the "must not" barriers, then all costs reasonably related to the education are deductible. That means not only tuition but also transportation, room, and board, subject (of course) to the applicable restrictions in evil §274. But not all of §274 applies. For example, while §274(m)(2) disallows deductions for costs of travel *as* education (think the high school French teacher spending summers in France to improve language skills), the costs of travel *for* qualifying education is deductible. *See Jorgensen v. Commissioner*, T.C. Memo 2000-128 (high school English teacher allowed deduction for expenses to travel to Europe and Asia for summer courses sponsored by University of California that directly related to her teaching).

Enough with the law. Let's look at the facts and learn our lesson.

Facts

Ms. Jorgensen graduated from college in 2012 with a double major in Spanish and French. In the year at issue, 2014, she was working for a California company called Inline Translation Services (ITS). The company's business was providing written translations to customers. On the website I linked above, the company says *"We use a multistep process for our projects that ensures thorough, accurate, and complete translation. We always work with native speaking professional translators with degrees in translation and relevant certifications."*

It appears that ITS hired Ms. Jorgensen to work on translation projects. Natch. As I read her job description, reprinted in the opinion, she was basically a project manager. But it was a small company (this website says 4 employees, but this "our team" page from ITS says there are 5 project managers). Thus her job description, reprinted in the Opinion, lists a wide range of both high-level and low-level cradle to grave tasks, from handling customer inquiries and creating price quotes and written proposals, to selecting and managing translation project teams, to formatting final documents, managing desktop publishing, proofreading, and billing. She was *"also responsible for managing the budget for each of her projects."* Op. at 2.

In 2014 Ms. Jorgensen started a part-time MBA program at UCLA. While ITS reimbursed its employees for foreign language classes, it did not do that for business classes. So Ms. Jorgensen deducted the costs of the MBA on her 2014 tax return as an unreimbursed employee expenses on Schedule A. That's back before Congress got all grinchy in §67(g).

In 2016 Ms. Jorgensen left ITS to take a summer internship at Mattel as part of her MBA program. That turned into a full-time job in the fall of 2016 as a consumer insight analyst. She finished up her MBA in 2017.

The IRS audited Ms. Jorgensen's 2014 return and disallowed her deductions for her MBA expenses that year.

Lesson: Education Must Relate To The Job You Have, Not The Job You Want

To deduct her MBA expenses for 2014, Ms. Jorgenson needed to connect that education to her work at ITS, because that was the trade or business she was carrying on in 2014. Judge Carluzzo explains that the Court *"uses a 'commonsense approach' comparing the tasks and activities the taxpayer was qualified to perform before acquiring the degree at issue with those the taxpayer was qualified to perform afterwards."* Op. at 4.

She could not make the connection. *"The courses petitioner took as part of her M.B.A. program qualified her to perform tasks that were significantly different from the tasks she had performed in her employment with [ITS]. *** No doubt some of the courses might have refined and improved the skills necessary for petitioner's employment with Inline, insofar as a foundation in accounting, finance, and management could be helpful to anyone involved in the operation of a business. However, petitioner's M.B.A. studies were more specifically oriented towards the job for which she eventually left Inline."* Op. at 5.

Thus, the proper connection was not between her MBA and the job she had in 2014. It was between the MBA and the job she wanted to have—and later obtained—at Mattel. Judge Carluzzo sees the Mattel employment as a separate trade or business than the ITS employment. That is, while Ms. Jorgensen seemed to do similar work—project management—at both companies, the big difference was that at Mattel she was in charge of *research* projects, not *translation* projects. Different line of business.

The Mattel job required her to organize *"qualitative and quantitative research projects, including product development, brand strategy, communication, tracking, and usability research for Mattel brands.."* Op. at 3. Therefore, Judge Carluzzo concludes, *"petitioner's data and analysis coursework prepared her to perform her essential role with Mattel .... Simply put, without the M.B.A. degree petitioner would not have been otherwise qualified for her position with Mattel.* Op. at 5.

So no deduction in 2014. And same for 2015, but that year is now closed. However, note that 2016 was when Ms. Jorgensen began working for Mattel, first as an intern and then as a permanent hire. As Judge Carluzzo notes, that would not have happened but for her participation in the MBA program, even though Mattel did not require an MBA degree. So it seems that for 2016 and 2017 Ms. Jorgensen would indeed be entitled to deduct her MBA expenses because once she started working for Mattel, those courses became relevant to improving her job skills. Of course all of that is academic since those are now closed years. But it's still a lesson and, remember, I *am* an academic.

Coda 1: The Rest of My Story: I received my LLM from Columbia in May 1993 and returned to D.C. But I could not get a job in legal academia. So that fall I started work at the IRS Office of Chief Counsel. While it was a great job, I still wanted to teach and so kept on applying and writing articles to show my "commitment." After another eight years of applications and interviews, I finally found a school foolish enough to hire me: Texas Tech. It turns out that Texas Tech actually valued (and still does value) folks who have real world lawyering experience. Phew.

Coda 2: About That Audit: My 1992 return was selected for audit and not just because I was now an IRS employee. Yes, at that time every IRS employee's returns were reviewed for the 3 years before their hire date. But my 1992 return triggered the red-alert system because I claimed education expense deductions that totally wiped out my 1992 income from Quinn, Racusin & Gazzola. And I had also attached a letter to the return flagging the issue.

John Quinn's concern was shared by the Revenue Agent. She looked closely at the relationship between the LLM and my employment as a lawyer. I was able to convince her that I met the "must" requirement of enhancing my job skills as a practicing lawyer at the IRS, even though my LLM was not a Tax LLM! I was also able to convince her that the LLM did not qualify me for the new trade or business of teaching law. So I dodged the "must nots." Had she found a deficiency, however, I would have petitioned the Tax Court. And I may not have fared any better than Ms. Jorgensen if I had had to appear before Judge Carluzzo!

Bryan Camp *is the George H. Mahon Professor of Law at Texas Tech University School* of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each Lesson From The Tax Court and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/07/lesson-from-the-tax-court-deducting-graduate-school-costs.html

MBA Qualified Individual for New Trade; Expenses Not Deductible

JUN. 21, 2023

Ariana K. Uchizono v. Commissioner

ARIANA K. UCHIZONO,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed June 21, 2023

Larry D. Vince, for petitioner.

Samuel M. Warren and *Stephanie A. Kingsley*, for respondent.

SUMMARY OPINION

CARLUZZO, *Chief Special Trial Judge*: This case was heard pursuant to the provisions of section 7463[1] of the Internal Revenue Code in effect when the Petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this Opinion shall not be treated as precedent for any other case.

In a notice of deficiency dated October 17, 2017 (notice), respondent determined a deficiency in petitioner's 2014 federal income tax and a section 6662(a) accuracy-related penalty.

Respondent now concedes the accuracy-related penalty; the issue for decision is whether petitioner is entitled to deductions for education expenses incurred in 2014 while pursuing a master of business administration (M.B.A.) degree from University of California, Los Angeles (UCLA).

Background

Some of the facts have been stipulated and are so found. When the petition was filed, petitioner resided in California.

Petitioner graduated with a liberal arts degree in Spanish and French from Occidental College in 2012. Soon thereafter she began working for Inline Translation Services, Inc. (Inline), as a translation services coordinator.

The description of petitioner's position with Inline indicates that her duties were as follows:

> The incumbent handles customer inquiries, develops price quotes for written translations, prepares written proposals, evaluates and selectively extends credit to new clients, selects and manages translation project teams (translators, editors, typesetters), develops and maintains multilanguage technical glossaries, edits one or more foreign languages including Spanish, uses translation memory tools on larger projects and for repeat customers, and formats final documents, manages desktop publishing tasks, proofreads final copy and prepares invoices.

At Inline, petitioner was also responsible for managing the budget for each of her projects.

During 2014, while working at Inline, petitioner enrolled as a part-time student in an M.B.A. program at UCLA. Inline did not reimburse petitioner for her M.B.A. expenses, as there was a company policy that employees could receive reimbursement only for foreign language classes. Petitioner completed the M.B.A. program and received her degree in 2017. As relevant, petitioner completed the following courses in the M.B.A. program: Data and Decisions, Organizational Behavior, Leadership Foundation, Financial Accounting, Managerial Economics, Finance Foundations, Marketing Management, Operations Technology Management, Business Strategy, Customer Assessment and Analysis, Consumer Behavior, Negotiations Analyses, and Global Marketing Management.

Petitioner ended her employment with Inline in May 2016. The following month petitioner, as part of an M.B.A. course with the abbreviated name "Intr-Busnss Fld Std," began an internship at Mattel, Inc. (Mattel), as a global consumer insights intern. On LinkedIn, petitioner described her position as an intern with Mattel as:

> Designed and coordinated qualitative and quantitative research projects to answer brand and product questions posed by cross-functional teams throughout the organization. Presented research findings to brand and design teams. Wrote and internally distributed reports summarizing research findings and recommendations by telling stories with qualitative and quantitative data. Managed language quality for translations of international surveys and worked with vendors to ensure quality of international data.

Starting in October 2016, after completing the internship, petitioner was hired by Mattel as a senior consumer insight analyst. Mattel did not require an M.B.A. degree as a condition of employment. The job posting under which petitioner applied states that the senior consumer insight analyst's duties include:

> Executing qualitative and quantitative research projects, including product development, brand strategy, communication, tracking, and usability research for Mattel brands. Working with suppliers and internal research support services to plan and field primary consumer research projects for Mattel brands. Analyzing data that is gathered (qualitative and quantitative) from both primary research projects and from secondary sources.

Petitioner's primary duty as a senior consumer insight analyst for Mattel was to identify vendors with either qualitative or quantitative expertise to conduct online surveys related to the design and marketing of Mattel products. Petitioner used the data from the online surveys to prepare reports for internal clients in Mattel's design and marketing departments.

Petitioner's 2014 federal income tax return includes Schedule A, Itemized Deductions, on which she claimed an unreimbursed employee business expense deduction for the tuition, fees, and expenses associated with her M.B.A. program. That deduction was disallowed in the notice and is here in dispute.

Discussion

As a general rule, the Commissioner's determination of a taxpayer's federal income tax liability in a notice of deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is erroneous. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).[2]

As we have observed in countless opinions, deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any claimed deduction. Rule 142(a); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

Section 162(a) allows a deduction for ordinary and necessary business expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, expenditures made by an individual for education are deductible under section 162(a) if the education maintains or improves skills required by the individual in his or her employment or other trade or business, or meets the express requirements of the individual's employer. Treas. Reg. § 1.162-5(a). Educational expenditures that qualify the taxpayer for a new trade or business, however, are not deductible. *Id.* para. (b)(2) and (3).

If the education in question qualifies a taxpayer to perform tasks and activities significantly different from those he or she performed before the program, then it qualifies the taxpayer for a new trade or business. *See Robinson v. Commissioner*, 78 T.C. 550, 552 (1982). This is ultimately a question of fact. *Glenn v. Commissioner*, 62 T.C. 270, 277 (1974).

In considering whether a taxpayer has become qualified through an academic degree program for a new trade or business, the Court uses a "commonsense approach" comparing the tasks and activities the taxpayer was qualified to perform before acquiring the degree at issue with those the taxpayer was qualified to perform afterwards. *See Davis v. Commissioner*, 65 T.C. 1014, 1019 (1976); *Glenn*, 62 T.C. at 275. The relevant inquiry is whether the degree objectively qualified the taxpayer to engage in a new trade or business. *See Robinson*, 78 T.C. at 556-57; *Glenn*, 62 T.C. at 275.

In this case, the courses petitioner took as part of her M.B.A. program qualified her to perform tasks that were significantly different from the tasks she had performed in her employment with Inline. A number of those courses related to research and data analysis. No doubt some of the courses might have refined and improved the skills necessary for petitioner's employment with Inline, insofar as a foundation in accounting, finance, and management could be helpful to anyone involved in the operation of a business. However, petitioner's M.B.A. studies were more specifically oriented towards the job for which she eventually left Inline.

An individual who improves his or her skills in an existing trade or business may also become qualified for a new trade or business and cannot deduct the costs of that education. *Thompson v. Commissioner*, T.C. Memo. 2007-174, slip op. at 5. Petitioner acknowledges that she would not have felt comfortable making certain decisions required in her job with Mattel had it not been for her M.B.A. courses. Specifically, petitioner's data and analysis coursework prepared her to perform her essential role with Mattel, that is, orchestrating qualitative or quantitative online surveys and analyzing the resultant data. Simply put, without the M.B.A. degree petitioner would not have been otherwise qualified for her position with Mattel. For that reason, petitioner's education expenses here in dispute are not deductible.

To reflect the foregoing,

Decision will be entered for respondent with respect to the deficiency and for petitioner with respect to the section 6662(a) accuracy-related penalty.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure. Monetary amounts are rounded to the nearest dollar.

[2]Petitioner does not claim, and the record does not otherwise demonstrate, that the provisions of section 7491(a) need be applied here, and we proceed as though they do not.

END FOOTNOTES

TaxProf Blog

Monday, July 17, 2023

Lesson From The Tax Court: *Creating Your Best Administrative Record*

By Bryan Camp

When the Tax Court reviews an IRS Collection Due Process (CDP) decision about collection, it always uses an abuse of discretion standard of review. That is, it does not simply substitute its judgment for that of the Office of Appeals Settlement Officer (SO), but instead looks to see whether the SO committed an error of law or made a decision that was whacko.

However, in conducting its abuse-of-discretion review, the Tax Court does not always use the same information set. It depends on where the taxpayer would take an appeal. If the taxpayer would take an appeal to the 1st, 8th, or 9th Circuits, the Tax Court will base its review solely on the administrative record provided by the IRS. No new information will be allowed. However, for appeals to any other Circuit, the Tax Court will also consider any additional information the parties bring up at trial.

Today's case involves the administrative record review and teaches us what the practitioner can do during the CDP hearing to maximize chances in Tax Court if a petition becomes necessary. In *Duane Whittaker and Candace Whittaker v. Commissioner*, T.C. Memo. 2023-59 (May 15, 2023) (Judge Holmes), the taxpayers used their 2019 CDP hearing to submit an OIC. They not only provided detailed information but they also offered to provide additional substantiation if asked. Then COVID happened. In 2020 the taxpayers sent in additional information to show how their financial situation had deteriorated. Again, they offered to substantiate their claims if asked. They were not asked. That turned out to be key because it resulted in information gaps which, if filled, might have led the SO to a different conclusion.

It was these gaps in the administrative record that caused the Tax Court to find an abuse of discretion and remand the case back to Appeals to fill in the gaps. The Tax Court faulted the IRS for the gaps because the IRS had not asked for more information. Details below the fold.

Law: CDP As Information Gathering

Once the IRS assesses a tax liability against a taxpayer, it has broad and powerful administrative collection tools, notably the lien and levy powers. These tools allow it to collect the assessed liability without have to first sue in court. Bull v. United States, 295 U.S. 247, 260 (1935) (assessment has the force of a court judgment).

Collection is a process and can be a long one. After all, §6502 gives the IRS at least 10 years to collet an assessed tax. During that time the IRS hammers on taxpayers through its automated tax collection system the ACS. The system runs on the presumption that all delinquent taxpayers have the resources to pay their taxes but simply won't. Until taxpayers provide information on why they cannot pay, they are presumed to be "won't-pays."

It is hard for taxpayers to stop that process—to stop the train. They have to find an actual human at the IRS and convince that person they are "can't-pays" and not "won't-pays" such that they should receive some alternative to fully paying the tax. Such collection alternatives include an Offer In Compromise (OIC), an Installment Agreement (IA), a Partial Pay Installment Agreement (PPIA), or even relegation to Currently Not Collectible (CNC) status. Those are all alternatives to full collection. But finding a human at the IRS can be tricky.

The Collection Due Process (CDP) provisions in §6320 and §6330 attempt to help taxpayers get to a human, to pause the collection train and work out a collection alternative. Those sections require the IRS to give taxpayers an opportunity for a CDP hearing with the Office of Appeals, either before the IRS starts levying, or immediately after it files an NFTL.

Formally, the purpose of the CDP hearing is for Appeals to review the case and make sure that administrative collection actions are appropriate. Informally, the CDP hearing has other benefits that I discuss in Lesson From The Tax Court: *No Second Bite In CDP For Rejected OIC*, TaxProf Blog (Mar. 1, 2021). The biggest informal benefit is the ability for taxpayers to work out a deal with the IRS. They can propose alternatives to full use of the lien and levy collection tools. True, it is about as easy to get a CDP hearing as it is to catch a butterfly—see Lesson From Tax Court: *The CDP Butterfly*, TaxProf Blog (July 3, 2021). Even if a taxpayer misses the CDP butterfly, however, they still have up to a year to get in front of Appeals for a similar opportunity, called an Equivalent Hearing. Treas. Reg. 301.6330-1(i).

But taxpayers have to give proper information. Getting a CDP hearing does not help taxpayers get collection alternatives unless they provide solid information to show they qualify as "can't-pays." IRS employees deal with a high volume of taxpayers, many of whom do not give accurate or complete information and many of whom are just using CDP as Collection Delay Process. It is no surprise that probably the most common reason IRS employees give to keep a taxpayer classified as a "won't pay" is the taxpayer's failure to supply requested information in a way the IRS employee needs. One sees that frequently in Notices of Determination from the Office of Appeals in CDP cases. One even sees it sometimes in Tax Court cases, such as *Hernandez v. Commissioner*, T.C. Memo. 2018-163 (Sept. 25, 2018), where Judge Vasquez suspended trial to give the taxpayers four extra months to provide information regarding expenses, continued to warn them they needed give information when trial resumed, and ultimately bemoaned that *"petitioners refused to cooperate with the Court."* Yep. That story is all too familiar to many IRS employees both on the audit side and the collection side.

What we learn to today is that how savvy taxpayers can flip that script on the IRS. Read on.

Facts

The IRS sought to collect Mr. and Ms. Whittaker's unpaid tax liability of $33,000 for 2015 and sent them a CDP Notice sometime in 2018. The opinion is silent on the date but that does not appear important to the story.

What is important to the story is that the Whittakers timely requested a CDP hearing and, sometime in May of 2019 (a year later? six months later? not important!) submitted a request for an Offer in Compromise along with their financial information on a completed Form 433-A. Judge Holmes emphasizes that they gave the Office of Appeals a ton of information about their finances and tried really hard to do it right. For example, when told they had neglected to submit their 20% down-payment as required by §7122(c)(1) they then *"included a copy of a money order for an initial 20% payment of $325.80 for their OIC."* Op. at 3.

Judge Holmes is not entirely clear about what liability the OIC was intended to address. In the very first sentence of the opinion he says they "offered to settle their $33,000 tax bill for only $1,629." But then in footnote 2 he says they *"intended the $1,629 to satisfy their liabilities from 2004, 2005, 2006 and 2018."* And those totaled *"about $50,000."* And on page 7 he says again that *"the OIC proposed a settlement of their tax liabilities form 2004-06 and 2018 as well."* Well, if they could get a 5% OIC (on the $33k) or an even better 3% OIC (on the $50k) , then more power to them!

But OICs are not get-out-of-tax-free cards. The Centralized Offer in Compromise (COIC) folks figured the Whittakers' Reasonable Collection Potential (RCP) was $250,000. We learned about RCP in Lesson From The Tax Court: *The Proper Baseline For Offers In Compromise*, TaxProf Blog (Feb. 14, 2022). The Settlement Officer (SO) who handled the CDP hearing agreed, and *"pointed out, for instance, that the Whittakers could fully pay the liability [which liability?] with just one of the investment accounts, leaving the other investment and the equity in the home."* Op. at 4 (internal quotes omitted). The SO proposed to approve collection, but did offer a streamlined IA and *"gave their lawyer time to speak with the Whittakers to see if that was what they wanted."* Id.

Time. All of this took time, from the May 2019 submission to the September 2020 rejection of the OIC and the offer of a streamlined IA. In 2019 they had reported Mr. Whittaker as receiving a military pension and being self-employed full time as a personal trainer. They reported Ms. Whittaker being employed full time by a school district as well as working two part-time jobs. But that was then.

Time. The elephant in the room was the COVID Pandemic. In their September 2020 submission the Whittakers claimed that their economic situation had worsened because of the Pandemic in three material respects.

First, by September 2020 they both claimed to have retired—being in their mid-60's—and Ms. Whittaker *"was limited to working two weekends a month"* at a part-time job. Op. at 5. They said that since they were now retired, the SO should no longer count their retirement accounts (or Ms. Whittaker's pension), as lump sum assets but instead as a stream of future income. So that would reduce their RCP.

Second, relatedly, they argued that the Pandemic reduced their net monthly income to Mr. Whittaker's military pension and Mrs. Whittaker's part time job, and that was now less than their monthly expenses. So that would reduce their RCP.

Third, by September 2020 they claimed their home equity was far less than the $100,000 that was used to calculate their RCP. They claimed their home was so dilapidated that its actual value was waaaaay below the county tax appraisal. They also claimed their mortgage agreement prohibited or restricted refinancing to tap what equity they had.

They believed these changes justified their 3% OIC. The SO disagreed and approved the collection in a Notice of Determination (NOD). The Whittakers petitioned the Tax Court.

Lesson: Creating A Good Administrative Record

Judge Holmes was not happy with the SO's Notice of Determination, noting that *"the NOD issued by the Commissioner was sparse and contained little if any rationale behind the determination."* Op. at 14. In particular Judge Holmes was concerned that the NOD contained *"no mention of the retirement accounts, not mention of the equity in the home or its condition, and no mention of the pandemic."* Id. However, Judge Holmes notes that even if the NOD had more meat to it, he would still remand for further consideration because of problematic gaps in the administrative record.

First, there are gaps about the existence or size of various retirement accounts. Judge Holmes notes that there are only a couple of 1099-R's from Schwab, and they show distributions of only about $600. Op. at 5. Nor is there anything in the record establishing the size or availability of Mrs. Whittaker's pension. *"There's also no evidence of a pension for Mrs. Whittaker or its amount."* Id. It was the IRS's fault for not securing this information.

Second, there are gaps in the record about the Whittakers' continued employment. This was a big problem for Judge Holmes. The Whittakers claimed to both have retired by 2020, dropping their monthly income. Again, Judge Holmes faults the IRS for not putting information in the record showing their employment status. He notes that *"Adjusting those [income] calculations to reflect their income after the pandemic hit would show a net income deficit. The settlement officer's refusal to rework the worksheet despite the very considerable discrepancy in the calculation before and after the pandemic is a clear error and thus an abuse of discretion."* Op. at 14.

Finally, there are gaps about the home equity in the record. The Whittakers claimed the IRS was over-counting their home equity. And, *"although the Whittakers didn't submit such proof, **they said that they would and could if the settlement officer had only asked.**"* Op. at 12 (emphasis supplied). Therefore, *"we...find that the settlement office's conclusion about the Whittakers' ability to tap the equity in their home was clearly erroneous on this record."* Id. Once again, the onus is on the IRS to put information in the record showing it's decision was reasonable.

Putting this all together caused Judge Holmes to remand the case to Appeals to fill in the gaps with information and re-evaluate collection alternatives. And now that it is 2023, almost three years later, these taxpayers may have an even stronger case for an OIC. Or not! We don't know what the information will show. Meanwhile, their tax liabilities continue to grow. But that's what Collection Delay Process does.

Bottom Line: The taxpayers had great representation here. Their attorney, Caleb Smith, created an administrative record such that any gaps would work against the IRS, not the taxpayer. How? Well, that's our Lesson. He had his taxpayer make repeated offers to supply more information "if asked." That allowed him to argue that gaps in the administrative record should work against the IRS because the IRS never "asked." This is the opposite of most situations where it is the IRS repeatedly asking for information and never getting it.

Comment 1: Another lesson you might find here is that you want to draw Judge Holmes in CDP cases! In this opinion, and others, he shows a deep distrust of IRS collection personnel and process. You see that in two ways. First is his casually disparaging verbiage. E.g. *"The IRS usually **shuffles** the OICs that taxpayers send in to a centralized unit **unimaginatively** called the Centralized Offer in Compromise Unit."* Op. at 3; *"to use **IRS jargon**"* Id. (emphasis supplied). This is consistent with other of his CDP opinions. *See* Lesson From The Tax Court: *CDP Settlement Officer Must Work Previously Rejected OIC*, TaxProf Blog (May 24, 2021) (characterizing an RO's field visit to the taxpayer's home as *"nice-little-home-you-got-here-shame-if-something-happened-to-it field call."* Op. at 5. That likens the RO to a gangster running a protection racket!). I would note here that the SO in this case actually proposed a collection alternative to the taxpayers. That is not their job, as Judge Lauber reminded us in *Powell v. Commissioner*, T.C. Memo. 2023-48, *"it is the obligation of the taxpayer, not the reviewing officer, to start negotiations by making a specific proposal."* Should the Whittakers have taken the deal? I don't know. But as we recently learned, that may be the more prudent course of action. *See* Lesson From The Tax Court: *Better Deals With Appeals*, TaxProf Blog (May 1, 2023).

More importantly, the second way you see Judge Holmes' distrust of the IRS collection function is that in this case (and in that 2021 CDP case cited above) he seems to almost flip the abuse of discretion standard of review. Rather than requiring the taxpayer to show how the IRS *abused* its discretion, Judge Holmes reviews the record to see if agency has proved it properly *applied* its discretion. For example, here in their September 2022 submission the taxpayers claimed to have no equity in their home for various reasons, including claimed restrictions in their mortgage. Usually the person making a claim bears the burden to substantiate that claim. Rather than faulting the taxpayers for failing to substantiate these claims when made, Judge Holmes faults the IRS for not asking for that specific proof. Again, this approach to review demonstrates Judge Holmes' distrust of the IRS collection process. And it goes to the Lesson here of how to create a stronger administrative record for your client: volunteer to provide more information "if asked."

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. If you ask him, he can provide more information about that. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/07/lesson-from-the-tax-court-creating-your-best-administrative-record.html

CDP Case Sent Back to Appeals Because of IRS's Abuse of Discretion

MAY 15, 2023

Duane Whittaker et al. v. Commissioner

DUANE WHITTAKER AND CANDACE WHITTAKER,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed May 15, 2023

Caleb B. Smith, for petitioners.[1]

Lisa R. Jones and *Paul A. George*, for respondent.

MEMORANDUM OPINION

HOLMES, *Judge*: Duane and Candace Whittaker offered to settle their $33,000 tax bill for only $1,629.[2] The Whittakers argued that the Commissioner should accept such a low offer because they were both near retirement age and burdened with significant unpaid debt and loss of their jobs during the pandemic. The IRS's settlement officer rejected the offer because she concluded that the Whittakers had enough income and home equity to pay the tax bill in full.

[*2] The question in this case is whether this rejection was an abuse of discretion.

Background

The Whittakers are hardworking people — Mrs. Whittaker was a family and community-empowerment specialist for a local school district who also worked part time as a tutor and as a mall security guard. Mr. Whittaker is a veteran and self-employed personal trainer. The couple have faced financial hardship long before 2015. They have significant unpaid debts, including even unpaid student loans of more than $60,000, and other personal debt of about $10,000.

They also have tax troubles. They owe the IRS income tax for tax years 2004-06 and 2018. And they owe Minnesota about $9,700 for their 2015 tax year.

In 2018 the Commissioner sent them a notice of his intent to levy to collect their 2015 tax debt. The Whittakers timely asked for a collection due process (CDP) hearing under section 6330.[3] The Whittakers wanted to compromise their tax debt, which triggered the IRS to refer their case to an IRS offer examiner who told them that they needed to fill out and return IRS Form 433-A (OIC), Collection Information Statement for Wage Earners and Self-Employed Individuals, if they wanted her to consider an alternative to forced collection.

After a telephone conference between one of their lawyers and the examiner, the Whittakers submitted an offer-in-compromise (OIC) in May 2019. By the time they submitted the OIC, the Whittakers were in their mid-60s, and Mrs. Whittaker was less than a year away from retirement from the Northwest Suburban Integration School District.

The OIC included a completed Form 433-A, exhibits such as the mortgage statement for their home, their county property-tax statement, and a tax order from the Minnesota Department of Revenue. They also included a copy of a retirement letter for Mrs. Whittaker, her employment contract with the school district, her Social Security benefits statement, pay stubs from her jobs with the school district and **[*3]** the mall, and a list of her expenses that included her student-loan, health-care billing, and personal credit-card statements to paint the full picture of her financial situation. They included a copy of a money order for an initial 20% payment of $325.80 for their OIC.[4] The OIC also included a number of exhibits from Mr. Whittaker — a profit-and-loss statement for his personal-training business, business checking-account statements, and a military-pay letter from the Department of Defense. The Whittakers noted that they could provide additional information to support their claims in the OIC if the IRS so desired.

In their OIC, the Whittakers stressed that their age and difficult financial situation meant that they would very soon have to rely on their retirement savings as a source of income rather than as a nest egg. They also volunteered that they could not borrow against their home both because it was in disrepair and because the terms of their mortgage forbade it.

The IRS usually shuffles the OICs that taxpayers send in to a centralized unit unimaginatively called the Centralized Offer in Compromise Unit. This part of the IRS bureaucracy rejected the Whittakers' OIC in February 2020. Someone at the Unit calculated that the Whittakers could pay — or to use IRS jargon, had a reasonable collection potential (RCP) of — about $250,000. The case-activity record (the equivalent of timesheets for IRS employees) shows that the Whittakers' lawyer spoke with a settlement officer who explained that "the special circumstances [that the Whittakers raised] were considered; but did not warrant acceptance of the offer." There was, however, nothing in the activity record to suggest that the settlement officer asked the Whittakers about their ability to access their equity in their home.

When the Unit thinks it should reject a taxpayer's OIC, the IRS still allows an appeal to a different part of the IRS, the IRS Office of Appeals. (It has since been rechristened the IRS Independent Office of Appeals. Taxpayer First Act, Pub. L. No. 116-25, §1001, 133 Stat. 981, 983 (2019).) The Whittakers' timing couldn't have been worse — their appeal hit IRS Appeals just as the pandemic hit the country. After a hearing in March 2020, the record shows that the settlement officer **[*4]** reached out to one of the Whittakers' lawyers to schedule a second hearing.[5] But there were long gaps between her attempts to reach the Whittakers' lawyers, and their lawyers did not finally get in touch with the settlement officer until September 2020.

Their conversation seems to have been short. One of the lawyers spoke with the settlement officer and asked for a call back to discuss the case. Later that day, after looking through the files for about 15 minutes, the settlement officer did call back to say that she agreed with the rejection because the Whittakers had an RCP of about $250,000 against a total liability of about $50,000.[6] The settlement officer reiterated that the special circumstances that the Whittakers raised in their OIC were considered, but that she thought their offer was way too low because the Whittakers could fully pay without hardship. The settlement officer pointed out, for instance, that the Whittakers could fully pay the liability with "just one of the investment account[s,] leaving the other investment and the equity in the home." She did offer the Whittakers a streamlined installment agreement[7] and gave their lawyer time to speak with the Whittakers to see if that was what they wanted.

Remember, though, that this was in the middle of the worst part of the pandemic. The Whittakers responded with a five-page fax, in which they again argued that the IRS should accept their OIC, but also **[*5]** told the settlement officer that their circumstances had changed: Mr. Whittaker was by then completely retired, and Mrs. Whittaker was limited to working two weekends a month.

The settlement officer acknowledged the fax a few days later, but said it was not enough and that she "would not be accepting the offer as a collection alternative." She reiterated that she considered the Whittakers' ages but that they "did not warrant acceptance of the offer." She noted a small error that the Unit had made — calculating the family's monthly income as $740 instead of $764. She also observed that Mrs. Whittaker held a separate retirement account at Charles Schwab and speculated that she must be entitled to a pension from the school system. Here we come to a gap in the record: There are two Forms 1099-Rs from Schwab, that show a total distribution of around $600, but there is no other information about what these accounts are or how much was in them. There's also no evidence of a pension for Mrs. Whittaker or its amount. (Though we also note that the Whittakers don't deny that Mrs. Whittaker has earned a pension from her years with the school district.)

The settlement officer reasoned that Mrs. Whittaker's school pension would be more than the small pay she received from her part-time job. As for Mr. Whittaker, the settlement officer claimed that instead of the $1,394 per month pension that was reported, Mr. Whittaker's "true pension amount from the military and national finance is $2,253.00."[8] Because the Whittakers were neither living on a fixed income nor disabled, she concluded that they did not qualify for special circumstances under IRM 5.8.11.3.1(5), (6), and (7) (Oct. 4, 2019).[9] She did acknowledge that the pandemic had changed the Whittakers' circumstances, but she was willing to consider only a **[*6]** postponement of collection until after July 15, 2021,[10] and made no changes to the Unit's worksheets.

As for the Whittakers' argument that they were unable to borrow against the equity in their home because it was in serious disrepair and their mortgage wouldn't allow it, the settlement officer simply wrote that she "also reviewed IRM 5.8.5.10(4) and IRM 5.8.5.13(5)." The settlement officer also stated that if the Whittakers took money out of their retirement accounts, then the settlement officer would list the money as a dissipated asset since the Whittakers had been working in 2019.

All this meant that there would be no agreement. The settlement officer drafted a notice of determination that upheld the IRS's decision to proceed to forced collection. In the notice, she sustained the rejection by stating that there were no special circumstances to justify the Whittakers' failure to propose an adequate OIC.

The Whittakers lived in Minnesota when they filed their petition.[11] The parties agreed to submit the case for decision under Rule 122.

Discussion

CDP hearings often lead to settlements because they allow a taxpayer to suggest alternatives to the harsher methods the IRS can use to collect debts. *See* §6330(c)(2)(A)(iii). One such alternative is an offer in compromise, a taxpayer's request that the Commissioner settle old tax debt for less than its face value. "Offer in compromise" is a generic term that comes in three species: doubt as to liability, doubt as to collectibility, or promotion of effective tax administration. Treas. Reg. § 301.7122-1(b). The IRS may accept an OIC for doubt as to liability when there is a genuine dispute about the existence or amount of a taxpayer's debt. *Id.* subpara. (1). It may accept an OIC for doubt as to collectibility when a "taxpayer's assets and income are less than the full amount of [his] liability." *Id.* subpara. (2). And it may accept an OIC for effective tax administration when it might be able to collect in full but **[*7]** only by causing a taxpayer to suffer economic hardship. *Id.* subpara. (3).

The Whittakers' offer was based on doubt as to collectibility, which means that they were saying that their assets and income weren't enough to pay their tax debt in full. *See id.* para. (a)(1), (b)(2). The Commissioner has discretion to accept or reject the offer. *Id.* para. (c). We have jurisdiction to review any rejection of an OIC, even one that includes liabilities for tax years in addition to those that were the subject of the CDP hearing. *See, e.g., Sullivan v. Commissioner*, 97 T.C.M. (CCH) 1010, 1014-15 (2009). That was the situation here — the Whittakers' CDP hearing was about their 2015 tax debt, but their OIC proposed a settlement of their tax liabilities from 2004-06 and 2018 as well. Our decision, however, is confined to the tax year before us.

The Commissioner has guidelines to enable settlement officers to evaluate offers and maintain some reasonable degree of uniformity. The key concept under these guidelines is the calculation of a taxpayer's RCP, the IRS's analysis of how much it thinks a taxpayer can pay. A settlement officer's calculation of an RCP depends on his estimate of the taxpayers' assets and likely future income. *See* IRM 5.8.4.3.1 (Apr. 30, 2015). The IRS typically calculates likely future income by multiplying a taxpayer's monthly disposable income (gross income minus necessary living expenses) by a certain number of months. *See id.*

The Commissioner's discretion is very wide. We review his determination, at least in cases like this one in which the amount of tax owed is not in question, only for abuse of discretion. *Sego v. Commissioner*, 114 T.C. 604, 610 (2000). We find an abuse of discretion when a determination is based "on an erroneous view of the law or a clearly erroneous assessment of the facts." *See Fargo v. Commissioner*, 447 F.3d 706, 709 (9th Cir. 2006) (quoting *United States v. Morales*, 108 F.3d 1031, 1035 (9th Cir. 1997)), *aff'g* 87 T.C.M (CCH) 815 (2004). We also find an abuse of discretion when the Commissioner applies "the correct law to the facts which are not clearly erroneous but rule[s] in an irrational manner." *Trout v. Commissioner*, 131 T.C. 239, 245 (2008) (quoting *Indus. Inv. v. Commissioner*, T.C. Memo. 2007-93). The Eighth Circuit phrases the test a bit differently: We should disturb the Commissioner's determination only if it constituted "a clear abuse of discretion in the sense of clear taxpayer abuse and unfairness by the IRS." *Fifty Below Sales & Mktg., Inc. v. United States*, 497 F.3d 828, 830 (8th Cir. 2007). We are also limited in our review to the reasoning set out in the notice of determination and not what the IRS's lawyer or we **[*8]** ourselves might come up with. *See, e.g., Antioco v. Commissioner*, 105 T.C.M. (CCH) 1234, 1240 (2013); *Jones*, 104 T.C.M. (CCH) at 369; *Salahuddin v. Commissioner*, 103 T.C.M. (CCH) 1764, 1768 (2012).

In cases appealable to the Eighth Circuit, we also limit what we look at — our scope of review — to the administrative record, not a new record made in court after a trial *de novo*. *Robinette v. Commissioner*, 439 F.3d at 459.

In this case both parties make a great deal about various provisions in the IRS's IRM. The IRM *is* important here — it enables the IRS itself to put some bounds on its employees' exercise of discretion. But the IRM "does not have the force of law and does not confer rights on taxpayers." *Fargo v. Commissioner*, 447 F.3d at 713. Its guidance is usually quite reasonable, however, and we generally uphold a determination to reject an offer if the settlement officer has followed it. *Atchison v. Commissioner*, 97 T.C.M. (CCH) 1034, 1036 (2009).

The question here is whether the Commissioner abused his discretion by failing adequately to consider:

- The Whittakers' reliance on their retirement account for income;
- the special circumstances that they raised (i.e., their nearing retirement and inability to borrow against their home); and
- the change in the Whittakers' financial condition caused by the pandemic.

We address these issues in order.

I. Retirement Account

We first look at the question of how the Commissioner should look at the Whittakers' retirement accounts in calculating their RCP. The Whittakers argue that, because they are nearing retirement, the money in those accounts should be viewed as generating income over time, not as an asset to be liquidated to pay their tax debt. When the Whittakers submitted their OIC in May 2019, they reported that their monthly household income was $740 in gross wages; $1,895 in Social Security; $58 in other income for Mrs. Whittaker; $290 in net business income; and a $1,394 pension for Mr. Whittaker. Even though Mrs. Whittaker was earning $4,357 per month in gross wages from her primary job at **[*9]** the school district when they submitted their offer, she included only the wages she earned as a part-time mall security guard because her regular job was set to end when she retired in June 2019. If one doesn't include this income, the Whittakers monthly household expenses — which they said totaled up to $4,512 — would be higher than their projected income.

They argue that even while employed they had no disposable income, and that due to Mrs. Whittaker's imminent retirement, they would have even less monthly income in the future. They specifically cite IRM 5.8.5.10 (Mar. 23, 2018), which states that a taxpayer within one year of retirement may have his retirement accounts treated as income; and IRM 5.8.5.20(4) (Sept. 30, 2013), which states that taxpayers who are retiring may have their future income and expenses adjusted in calculating their RCP. They think these parts of the IRM should have made the IRS increase their projected income a bit, but taken the value of the accounts entirely off the asset-side of the RCP computation — changes that they also say would make their OIC more reasonable. They also point to an authority higher than the IRM that both the IRS and we have to follow — there's a Treasury Regulation that says that the IRS may compromise a tax debt if a taxpayer has a retirement account with sufficient funds to fully pay his liability, but who would be unable to pay for basic living expenses afterwards if he did so. Treas. Reg. § 301.7122-1(c)(3)(iii) (example 2).

The settlement officer here included the Whittakers' retirement accounts as assets that they could liquidate. The Commissioner emphasizes that neither the regulation nor the IRM *requires* a settlement officer to treat retirement savings only as a source of income. And he's right about that — they both say that when a taxpayer is within one year of retirement, the settlement officer *may* characterize retirement funds as income when the income is required to provide necessary living expenses. *See* Treas. Reg. § 301.7122-1(c)(3)(iii); IRM 5.8.5.10(4).

When taxpayers like the Whittakers make an OIC and argue that they have special circumstances, all agree that the IRS should consider additional factors beyond income and basic living expenses. *See* IRM 5.8.11.2.1(2) (Aug. 5, 2015). Those additional factors include age, employment status, the number and health of any dependents, their medical condition, and their ability to earn a living. *Id.* (5), (6), and (7). When specifically evaluating the taxpayer's medical condition, we have usually considered "medical catastrophe and . . . long-term illness . . . or **[*10]** disability that render a taxpayer incapable of earning a living." *Leago v. Commissioner*, 103 T.C.M. (CCH) 1210, 1215 (2012).

In her activity record, the settlement officer noted that the Whittakers "submitted the special circumstances," that those circumstances were "considered," but that they "did not warrant acceptance of the offer." She noted that the Whittakers did not have any long-term illnesses, were not disabled, and were not living on a fixed income.

We see here no erroneous view of the law and no clearly erroneous assessment of the facts. It looks like the settlement officer considered the additional factors noted in IRM 5.8.11.2.1(5), (6), and (7) that might affect a taxpayer's financial condition. The Commissioner is correct that the settlement officer is not *required* to consider retirement savings only as a source of income if a taxpayer is within one year of retirement. *See* IRM 5.8.5.10(4). But there may be a problem for the Commissioner — this reasoning didn't make it into the notice of determination, no matter that it is reasonably clear in the administrative record as a whole.

There is some ambiguity in the law here — we typically say that we confine our review to the reasoning in the notice of determination, but administrative-law cases more generally do let a reviewing court "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." *Bowman Transp., Inc. v. Ark.-Best Freight Sys., Inc.*, 419 U.S. 281, 286 (1974) (citing *Colo. Interstate Gas Co. v. FPC*, 324 U.S. 581, 595 (1945)).

II. Home Equity

We find less ambiguous problems with the exercise of discretion on the second issue that the Whittakers raise: the treatment of the equity in their home. In their OIC, the Whittakers explained that they bought their home in 1984 but refinanced it under the Home Affordability Refinance Program, which helps homeowners who owe more than their property is worth. That refinancing requires a balloon payment in 2034, and the Whittakers argue that this makes it impossible for them to borrow against the property. Though their OIC acknowledged that the county's assessed value of their home was $243,000, they also argued that its actual value was lower because of serious structural issues that require repair. They contended that their position meant that the value of their home in the RCP calculation should have been zero. They also offered to provide the IRS more **[*11]** information on the loan terms, the home's value, and the unwillingness of banks to refinance.

The Unit adopted the county's assessed value of the Whittakers' home in its analysis of the OIC. It figured that the quick sale value[12] of the home was $194,400. The Whittakers had a mortgage for $85,237, and so a net equity of $109,163. This analysis, however, ignored the Whittakers' contention that the home was worth less than its assessed value due to its condition as well as their contention that they are unable to tap that equity because of the restrictive terms of their mortgage. The settlement officer did not address these arguments, but disregarded them and adopted the Unit's valuation.

The Whittakers renew this argument here. And the IRM does specifically mention that a taxpayer's inability to borrow against equity is a special circumstance. IRM 5.8.11.2.1(6)(3.).

The Commissioner tries to tear it down. He first points to the Whittakers' mortgage-account statement. It shows an outstanding principal balance of $108,762.35 as of October 3, 2018. That balance, coupled with an assessed value of $243,000, the Commissioner argues, means that their home is no longer under water. He surmises that there is enough equity to fully pay their outstanding tax debt. To this the Whittakers reply that they can't refinance their home under their peculiar circumstances and that it's in such a state of disrepair that the assessed value doesn't reflect its fair market value. The Commissioner responds that refinancing both regular and deferred principal balances is not any more complicated than refinancing a loan with a first and second mortgage, and he urges us to find no abuse of discretion by the settlement officer in concluding that there was at least $50,000 worth of available equity to fully pay the liability. The Commissioner also argues that the Whittakers' allegation that this home has serious structural problems should be ignored for lack of specificity.

The IRS does need to take problems with possible refinancing a home seriously. For example, in *Antioco*, 105 T.C.M. (CCH) at 1236, the taxpayer submitted proof of her attempts to refinance after the settlement officer asked for such documents to help the officer make her determination. Here, although the Whittakers didn't submit such proof, **[*12]** they said that they would and could if the settlement officer had only asked. The Whittakers have a point — there's nothing in the administrative record that states or even suggests that the examiner at the Unit or the settlement officer during the CDP hearing asked for any information in addition to the appraised value. The settlement officer noted that she "advised [the Whittakers' lawyer] that the special circumstances were considered; but did not warrant acceptance of the offer" and that she "was not going to remove the equity for the investment because the taxpayers can fully pay with one of the retirement accounts; plus, the taxpayers have over $100,000 in equity in the home." There's no evidence in the record of any consideration of the Whittakers' arguments on this point.

We therefore find that the settlement officer's conclusion about the Whittakers' ability to tap the equity in their home was clearly erroneous on this record. This makes her reliance on that equity in her RCP calculations an abuse of discretion.

III. COVID-19 Pandemic

There is, however, a more serious problem with the determination here: While the OIC was before the IRS, the pandemic hit. As it did for so many Americans, the pandemic changed the Whittakers' fortunes. The record shows that the settlement officer received a fax from the Whittakers' lawyer specifying those changed circumstances — namely that Mr. Whittaker had completely retired, and Mrs. Whittaker was limited to working only two weekends a month. The settlement officer acknowledged receipt of the fax but explained that she "would not be accepting the offer as a collection alternative." The settlement officer instead offered to hold off on collection until July 2021. She reasoned that Mrs. Whittaker had enough pension income and that a slight delay in collection would be enough to reflect their changed circumstances brought on by the pandemic. As for Mr. Whittaker, the settlement officer reasoned that "his true pension amount from the military and national finance is $2,253." The Commissioner now concedes that the settlement officer was mistaken and that Mr. Whittaker had a military pension of only $1,394 per month. But he argues that the mistake is harmless since the settlement officer didn't substitute her higher numbers in the RCP calculation. The settlement officer reasoned that the Whittakers should still not receive an OIC because they were neither living on a fixed income nor disabled.

[*13] The Commissioner concedes that this response has not been "as well documented in the administrative file as the other issues," but suggests that the abrupt collapse in the Whittakers' income meant that "the [settlement officer] should not have focused [solely] on delayed collection" by "hold[ing] off on [the] collection until after 7/15/2[1]."[13] The Commissioner claims that the settlement officer's mistake was harmless. *See Watchman*, 103 T.C.M. (CCH) at 1624. Because the settlement officer still considered other factors, such as Mrs. Whittaker's pension accounts and Mr. Whittaker's actual military pension of $1,394 per month to conclude that their financial condition during the pandemic did not change, the calculus did not affect the ultimate determination, and thus her error is harmless.

Perhaps realizing the weakness of the settlement officer's reasoning on this issue, the Commissioner bolsters his argument by asking us to note that the Mall of America reopened after being closed for only three months. He also asks us to note that the lockdown inspired a nationwide surge in the demand for fitness equipment, and given that Mr. Whittaker's business website in personal fitness was still up and running as of May 2022, he may not in fact have been completely retired.

We must decline the Commissioner's suggestions. Evidence of reopening of the Mall of America or increased sales of personal fitness equipment during the pandemic aren't in the administrative record. We won't consider them.

Upholding the rejection of the Whittakers' offer because Mrs. Whittaker's mall job *may* have resumed or Mr. Whittaker *might* be able to run a training business using potential clients' possible pandemic purchases is entirely speculative. These *post hoc* rationalizations are precisely what *Chenery* bars. *See Antioco*, 105 T.C.M. (CCH) at 1240.

The settlement officer "did not think that the loss of the Whittakers wage income or self-employment income [due to the pandemic] sufficiently mattered to justify reworking the Offer Worksheet." Even in the Unit's analysis of their original OIC, however, the Whittakers' net monthly income was calculated to be only $255. Adjusting those calculations to reflect their income after the pandemic hit would show a net income deficit. The settlement officer's explicit **[*14]** refusal to rework the worksheet despite the very considerable discrepancy in the calculation before and after the pandemic is a clear error and thus an abuse of discretion.

IV. NOD

"[W]e can uphold the Appeals Office's determination only on grounds actually relied upon by the Appeals officer in the notice of determination." *Jones*, 104 T.C.M. (CCH) at 367 (citing *Salahuddin*, 103 T.C.M. (CCH) at 1768). The NOD issued by the Commissioner was sparse and contained little if any rationale behind the determination. It stated:

> After considering your [attorneys] statements by telephone and fax information, Appeals sustained the rejection of the offer because the tax is held to be legally due and an amount larger than the offer appears to be collectible. We have not found that an exceptional circumstance exists that allows our acceptance of your offer. We do not have authority of accept an offer in these circumstances.

No mention of the retirement accounts, no mention of the equity in the home or its condition, and no mention of the pandemic. Even though our own review of the record as a whole shows enough for us to conclude there were an abuse of discretion, the absence of reasoning on the basis of that record in the NOD itself might well be decisive all on its own.

It is another ground for us to find that the IRS abused its discretion.

V. Remedy

We can remand a CDP case to IRS Appeals when a settlement officer has abused her discretion in some way, *see Med. Prac. Sols., LLC v. Commissioner*, 98 T.C.M. (CCH) 242, 247 (2009); or didn't develop the record enough for us to properly review it, *see Hoyle v.*

Commissioner, 131 T.C. 197, 205 (2008); *Churchill v. Commissioner*, 102 T.C.M. (CCH) 116, 118 (2011).

We have also remanded where a taxpayer has experienced a material change in circumstances between the time of the CDP hearing and the time of trial in some way that affects the RCP calculation. *Leago*, 103 T.C.M. (CCH) at 1210 (remanding when the taxpayer developed **[*15]** medical issues); *Churchill*, 102 T.C.M. (CCH) at 116 (remanding when RCP changed due to divorce); *Harrell v. Commissioner*, 86 T.C.M. (CCH) 378 (2003) (remanding because of intervening Supreme Court decision).

The Whittakers lost their jobs in the middle of the CDP hearing. Because their current income was important to the RCP calculation, this was a material change of circumstances. On remand the Appeals Office is directed to consider updated financial information that they should provide to document any change in their ability to pay resulting from their loss of income due to the pandemic, as well as other factors in accord with this opinion.

An appropriate order will be issued.

FOOTNOTES

[1]The Whittakers were clients of the University of Minnesota Ronald M. Mankoff Tax Clinic, which gives students the opportunity to represent clients before the IRS and the courts. The Court thanks them for their work on this case.

[2]In addition to the $33,000 bill stemming from 2015, the Whittakers intended the $1,629 to also satisfy their liabilities from 2004, 2005, 2006, and 2018. Taken together, the Whittakers total outstanding liability was around $50,000 at the time of their offer. We focus on the sum from 2015 since that is the tax directly at issue.

[3]Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[4]The IRS requires taxpayers who want an OIC to pay an application fee and submit an initial partial payment. The Whittakers at first neglected to include the fee along with the partial

payment. After being notified of the error, the Whittakers' attorney sent the required sum.

[5]The activity record shows a call made in February 2020, and another one in September 2020. The notes from the voicemail left in September 2020 refer to a call made in May 2020. If such a call was made, however, it is not logged in. According to the activity record, the February 2020 call was not answered, but the settlement officer left her number for a call back. The September 2020 call was returned the same day.

The University of Minnesota Tax Clinic disputes that it received calls in either February 2020 or May 2020. It claims that the first contact it received from the settlement officer was September 2020, and it also states that in August 2020 it had checked in with the IRS offer examiner about the status of the case and was told that there was no activity log.

The record does show that the clinic supervisor, Professor Caleb Smith, wrote to the IRS offer examiner in December 2019. We do think that there was a failure to communicate, but the entire world wasn't operating under its standard procedures for much of 2020. And in the end these delays don't affect our analysis.

[6]This total includes $33,000 for 2015; the rest is from tax years 2004-06 and 2018.

[7]Streamlined installment agreements (SIAs) are installment agreements that can last up to 72 months and are available to taxpayers with liabilities of $50,000 or less. *Internal Revenue Manual* (IRM) 5.19.1.6.4(10) (Sept. 26, 2018).

[8]This is a mistake but it's harmless because the settlement officer did not substitute this higher number in the RCP calculation. *See Watchman v. Commissioner*, 103 T.C.M. (CCH) 1620, 1624 (2012) ("Error is harmless when it causes no prejudice or does not affect the ultimate determination.").

[9]Unless otherwise noted, the Court cites to the provisions of the IRM that were in effect November 2020, when the Appeals Office issued the notice of determination that we review here. *See Jones v. Commissioner*, 104 T.C.M. (CCH) 364, 370 (2012) (using IRM from year of the notice of deficiency (NOD)).

[10]The activity report states that the collection could be held off until July 15, 2020, but this entry is dated October 2020. We think this means that the IRS agreed to hold off collection

until July 2021.

[11]Appellate venue thus presumptively lies in the Eighth Circuit. *See* §7482(b)(1)(G).

[12]The IRS defines the quick sale value to be "[t]he amount that could be obtained if an asset is sold quickly, usually less than [fair market value]." IRM 5.8.1-1 (Nov. 8, 2018).

[13]As mentioned, the record states the promise to hold off collection was until July 7. For the reasons explained *supra* note 10 we presume this was intended to mean 2021.

END FOOTNOTES

Monday, July 24, 2023

Lesson From The Tax Court: *Size Does Not Matter*

By Bryan Camp

In *Janet R. Braen et al. v. Commissioner*, T.C. Memo. 2023-85 (July 11, 2023) (Judge Urda), we learn that there is no charitable deduction for a bargain sale done to settle a lawsuit, even though it was a huge bargain sale. There, the taxpayers claimed a $5.2 million charitable contribution deduction from a bargain sale they had made with a New York town called Ramapo. Judge Urda needs every one of 39 pages to explain the complex facts and apply them. But the basic Lesson I see in the case is this: even a big bargain sale to a charity requires donative intent. Without a donative intent, there is no §170 deduction, no matter how big the bargain. Intent is determined by objective facts surrounding the transaction. Here, those facts showed that the taxpayers' intent was not to be charitable; their intent was to settle a lawsuit they had filed against the town. By settling they avoided the risk of a more adverse outcome had the lawsuit proceeded, and they regained their right to develop the land they did not sell. I confess this is not quite the way Judge Urda sees the case. So see what you think. Details below the fold.

<u>Law: Deductions for Bargain Sales to Charities</u>

Generally speaking, a taxpayer cannot take a charitable deduction for payments to a charity when the charity gives them value in return. We call that quid pro quo. As the Supreme Court put it: *"[t]he sine qua non of a charitable contribution is a transfer of money or property without adequate consideration." United States v. American Bar Endowment*, 477 U.S. 105, 118 (1986) (emphasis supplied). Rev. Rul. 83-104 gives a lovely set of facts exploring what constitutes quid pro quo in private school settings. And the quid pro quo does not have to be in money or tangible goods; buying your way up the stairway to Heaven is not charitable. *Hernandez v. Commissioner*, 490 U.S. 680 (1989) (payments for spiritual sessions were not charitable donations).

As implied by the word "adequate" in the Supreme Court quote, taxpayers *can* take a deduction when the value of what they give the charity exceeds the value of what they get in return. We see that in bargain sales to charities. That's when a taxpayer sells property to a charity for much less than that property's fair market value (fmv). While the bargain sale looks like a single transaction, tax law treats it as two separate transactions: in part a sale and in part a gift.

For the sale part, the taxpayer uses the rules in §1001 to determine gain by treating the payment received from the charity as the amount realized for purposes of calculating gain. However, the taxpayer still needs to determine the basis to use for the sale part. Section 1011(b) tells us that *"the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property."* In other words, a taxpayer must divide the property into that which is sold and that which is donated and allocate basis accordingly. *See* Treas. Reg. 1.1011-2,

Just as the taxpayer must allocate basis for the sale part, the taxpayer must also allocate the fmv for the gift part. Treas. Reg. 1.170A-4(c) says that *"there shall be allocated to the contributed portion the amount of gain that is not recognized on the bargain sale but that would have been recognized **if** such contributed portion had been sold by the donor **at its fair market value** at the time of its contribution to the charitable organization."* (emphasis supplied)

The example I use in class is that of a taxpayer who buys property for $100. It's fmv increases to $200. At that point the taxpayer wants to give the property to a charity but also wants to get their basis back. So they sell the property to the charity for $100. This is a sale of half the property and a donation of the other half. Why? Think of it as the size of the bargain: $100 paid for $200 worth of property is a ratio of ½. Thus, the taxpayer allocates their basis of $100 by that ratio to each of the sale part and the gift part. The taxpayer thus has a gain of $50 on the transaction ($100 amount realized minus the allocated basis of $50) and has a donation of property with a fmv of $100 (the allocated portion of the entire property's fmv) and a basis of $50 (the allocated basis).

Under this fact pattern, the *amount* of the charitable contribution will depend on whether the taxpayer must reduce to basis under the rules in §170(e) and regulations cited above.

But whether the taxpayer can claim *a deduction* for whichever is the correct amount is a totally different question. The taxpayer must still have the requisite donative intent. That is really the first question to ask. It's the starting line. No donative intent, no §170 deduction. The starting line is still that *"[a] charitable gift or contribution must be a payment made for detached and disinterested motives. This formulation is designed to ensure that the payor's **primary purpose is to assist the charity and not to secure some benefit personal to the payor.**" Christiansen v. Commissioner*, 843 F.2d 418, 420 (10th Cir. 1988) (emphasis supplied).

In *Pollard v. Commissioner*, T.C. Memo. 2013-38, the taxpayer could not even get off the starting line. There the taxpayer donated an easement to a City but did so in order to induce the City to grant a zoning variance. The Tax Court echoed the opinions of many other courts when it explained that it would determine donative intent from objective factors and the taxpayer's subjective testimony of motivation: *"In ascertaining whether a given payment was made with the expectation of any quid pro quo, courts as well as the Commissioner examine the external features of the transaction in question. This avoids the need to conduct an imprecise inquiry into the motivations of individual taxpayers."* Op. at 20.

Pollard also illustrates what courts mean by objective factors: *"If it is understood that the taxpayer's contribution will not pass to the recipient unless the taxpayer receives a specific benefit in return, and if the taxpayer cannot receive such benefit unless he makes the required contribution, then the transaction does not qualify for the section 170 charitable contribution deduction."* Id. In that case, the taxpayer wanted some special zoning favors and granted the city a conservation easement to induce them to give the preferential zoning. *"The external features of the transaction herein demonstrate that petitioner's granting of both the first and second conservation easements to Boulder County was part of a quid pro quo exchange for Boulder County's approving his subdivision exemption request."* Id. at 20-21.

Donative intent is the driver. If there is no donative intent, then the *amount* of what would *otherwise* be a contribution simply does not matter. No matter how big.

That is what we learn today. Or at least it is what I learned. You may have a different conclusion.

Facts

This case involves a family business, Braen Commercial Holdings Corp. (Braen). Braen runs a long-established mining operation Here is their website. Braen is a pass-through entity and is owned by lots of different members of the Braen family.

The facts are messy and Judge Urda does a masterful job in clearly explaining them in the first 16 pages or so. For this Lesson I think we can boil it down as follows.

In 1998 Braen bought land just outside (445.5 acres) and just inside (38.5 acres) the town of Ramapo, NY, for $3.5 million. Braen had plans for that outside land! Quarrying plans! And it had plans for the inside land because that land was zoned for industrial use and was next to *"various solid waste and sludge composting facilities, and an electrical substation."* Op. at 2-3. Good neighbors!

But Braen's plans needed to clear multiple local, state and federal hurdles. Despite years of effort, Braen couldn't do it. In particular, Braen could not get the town of Ramapo to change some of its zoning restrictions. While the zoning had for 25 years permitted industrial use of the land, it also had explicitly prohibited quarrying, which is what Braen wanted to do on most of the land just outside Ramapo.

Ramapo did eventually change its zoning, but opposite of Braen wanted. In November 2004 it amended its zoning ordinances to no longer permit *any* industrial use, period. So now not only was quarrying explicitly prohibited, as it was when Braen bought the property, but the change to prohibit industrial use pretty much nixed Braen's other plans for some of the land. So Braen did what any buyer would do when the zoning it had relied upon got pulled out from under them: it sued the town!

The parties went to court-ordered mediation and came up with a deal. Ramapo was not going to permit quarrying. So Braen would sell most of that land to Ramapo for cheap. Really cheap. In exchange, Ramapo would restore the industrial use zoning for the land that Braen wanted to keep, the land near the composting facilities and electrical substation. The contract to sell the land explicitly provided that *"th[e zoning] lawsuit is being settled as part of the conveyance of the [p]roperty from [Braen] to the Town of Ramapo."* Op. at 10. Similarly, a later section also specified that the land sale was *"contingent on the settlement of"* the zoning litigation *"and the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto." Id.* Finally, the referenced Court Order explicitly provided that, for the property Braen was keeping, the zoning designation would *"immediately revert to its prior designation of [planned industrial]." Id.*

On its 2010 return, Braen took a weird position. It claimed a §170 deduction of only $5,222,000 and passed that through to the family members. What is weird is that, in an attachment, it claimed that it should be taking a deduction for $12,222,000, which represented the difference between the claimed fmv of the property sold ($17,472,000) and the bargain sales price of $5,250,000. It is not clear from the opinion why Braen was attempting to take a far, far smaller deduction. I am guessing that the return preparer did not know what value to associate with the zoning reversion that was part of the settlement. But as we shall soon see, that simply did not matter, at least in my view.

Lesson: It's Not The Size Of The Bargain, It's the Size of Your Heart

Braen claimed it sold property worth $17.5 million for a mere $5.2 million to the town of Ramapo. That's about a 70% discount. A huuuuge bargain! The parties fought hard about the size of the bargain partly because the taxpayer's appraisal of the property's fmv was a bit suspect but mostly because the IRS pushback was "yeah but you got the zoning changed back as well, so that was part of the consideration you received for the land." Judge Urda agreed with that.

For reasons I do not understand, Judge Urda says that his *"resolution of the...dispute hinges on two principal requirements to claim a charitable contribution deduction in connection with a bargain saile: (1) the fair market value of the property donated must exceed the value of any benefits received and (2) the taxpayer must supply a contemporaneous written acknowledgement from the recipient substantiating the contribution."* Op. at 16.

Judge Urda first explains how Braen was unable to prove the value of the zoning reset. Thus, because Braen was unable to prove *"the value of **all** consideration [it] received as part of the purported bargain sale...they are not entitled to the claimed charitable contribution deduction."* Op. at 18 (emphasis supplied).

Judge Urda next spends a long time discussing the failure to obtain a contemporaneous written receipt. Braen did not have one. Instead during the settlement process, the Braen CPA sent a blank Form 8283 to Ramapo, and the City Manager signed it at closing. Op. at 11. That was far from acceptable, leading Judge Urda to conclude that the *"failure to comply with requirements of section 170(f)(8) ... prohibits the Braens from claiming charitable contribution deductions."* Op. at 22.

I confess confusion. It seems Judge Urda wants to equate the size of the bargain with the size of the donative intent. But to me donative intent is a separate hurdle that goes to the ability to *take* a deduction. The size of the bargain just goes to the *amount* of the deduction. Judge Urda had already explained that *"deductibility does not depend on what type of benefit the taxpayer received"* and he explicitly noted the cases where *"we have found that a transfer of real property in exchange for development approvals ... precludes a finding of the requisite donative intent."* Op. at 17. Even if the value of the property transferred exceeds the fmv of the quid pro quo, that excess must be *"made with the intention of making a gift." Id.*

So I was really expecting that to be the basis of the opinion. After all, Judge Urda finds, as a matter of fact that *"The zoning reversion was central to the overall deal"* Op. at 19, and sets out how Braen was simply not going to settle without getting that zoning reset. That finding seems to me to vitiate any claim of donative intent. Braen did not want to be nice to Ramapo. Braen wanted Ramapo to behave! Winning the lawsuit was one way to force it to behave. But settling achieved the same goal. That seems to me to show that the primary purpose was not to help the town but was to secure a benefit personal to Braen. This seems really close to *Christiansen v. Commissioner*, 843 F.2d 418, 420 (10th Cir. 1988).

I invite comments from readers who are more perceptive than I am on why Judge Urda based the opinion on valuation and substantiation when I think the lesson here is about donative intent.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law, a small law school in a really big state. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/07/lesson-from-the-tax-court-size-does-not-matter.html

Charitable Deductions Denied for Bargain Sale of Property

JUL. 11, 2023

Janet R. Braen et al. v. Commissioner

JANET R. BRAEN, ET AL.,[1]

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed July 11, 2023

Kathleen M. Pakenham, *Adriana L. Wirtz*, and *Amanda L. Liverzani*, for petitioners.

Rachel G. Borden, *Cathy Fung*, *Tyler J. Rippon*, *Rachel M. Munyan*, and *Anna L. Boning*, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

URDA, *Judge*: In these deficiency cases, petitioners, who are various members of the Braen family (collectively, Braens), challenge the Internal Revenue Service's (IRS) disallowance of claimed charitable contribution deductions stemming from their family mining company, Braen Commercial Holdings Corp. (Holdings). In 1998 Holdings bought **[*2]** a 505-acre[2] plot of land (property) in the Town of Ramapo (Ramapo) in Rockland County, New York, with an eye to developing it into a granite quarry, adding to an existing stable of four quarries.

Years of delays and disputes with both the state and town followed, including litigation over a 2004 zoning change made by Ramapo. As part of a 2010 settlement of this lawsuit, Ramapo purchased 425.5 acres of the property for $5,250,000 and rezoned the remainder to its pre-2004 designation. Holdings' 2010 tax reporting treated the sale to Ramapo as a bargain sale that had generated a charitable contribution of $5,220,000, and the Braens claimed proportionate shares of this amount on their respective tax returns as deductions under section 170.[3] The IRS disallowed these deductions in full and determined accuracy-related penalties.

We will sustain the IRS's determinations. The Braens fail to show the value of all consideration received as part of the bargain sale and thus fall short of establishing the value (if any) of the underlying charitable contribution. The Braens accordingly are not entitled to claim any deductions with respect to the bargain sale to Ramapo.

FINDINGS OF FACT

Trial in these cases was held (via ZoomGov) from April 26 through April 30, 2021, during the Court's New York, New York, special trial session. The Braens lived in New Jersey when they timely filed the petitions in these cases.

[*3] I. Overview

A. Holdings

Holdings is a family-owned S corporation[4] founded in 1904. During the years at issue, seven members of the family had stock in Holdings, either directly or through trusts on their behalf.

Two family members held positions of particular importance: Janet Braen, who acted as chief executive officer, and her stepson Scott Braen, who served as president and chief operating officer. In these positions, they were responsible for running the company's daily operations and making major decisions.

Holdings' business centered on mining, growing over time to include four quarries in New Jersey, two asphalt plants, and masonry yards. As part of its operations, the company processed the materials that it mined for a variety of end uses, including asphalt, ready-mix concrete, paving stones, and housing veneers.[5]

B. The Property

In July 1996 Holdings entered into an option agreement to purchase the property for $3,500,000. To the Braens' trained eyes, the property bore all the indications of having significant deposits of granite and other minerals.

The property consisted of a 445.5-acre lot in an unincorporated portion of Ramapo and a 58.5-acre lot in the Village of Hillburn, an incorporated village within Ramapo. A mix of industry and parkland neighbored the property, with a capped landfill, various solid waste and **[*4]** sludge composting facilities, and an electrical substation nearby, as well as the New York State thruway and Harriman State Park (part of the Palisades Interstate Park System).

The property was located near Torne Valley Road, a rugged region marked by thick woods, steep inclines, and rocky outcroppings. The area is home to spring-fed streams that feed into the Ramapo River, a significant source for the major local aquifer. Timber rattlesnakes, a threatened species protected in New York, have taken up their abode in the area.

When Holdings signed the option agreement, the Ramapo portion of the property was zoned as "planned industrial," as it had been for the previous 25 years, while the Hillburn portion fell within that village's "R-60" rural residential zoning district. Quarrying was prohibited by law in Ramapo during all relevant times.

Holdings understood that various governmental authorizations were needed to establish a quarry on the property. Specifically, quarrying required an amendment to Ramapo's zoning law removing it as a prohibited use, as well as a conditional use permit that would affirmatively allow a quarry. A state mining permit was another important prerequisite. And a quarry demanded a host of other permits and approvals relating to concerns about water protection, air pollution, stormwater runoff, and wetlands.

II. Initial Applications and Purchase of the Property

A. First Steps

1. Filings

Holdings began the process to obtain the necessary approvals in the summer of 1997, petitioning Ramapo to amend its zoning law to permit quarrying. The petition asserted that a quarry would be consistent with the general industrial character of the area and that there would be limited negative impacts on surrounding residential and natural areas, such as the Ramapo River.

In late 1997 the New York State Department of Environmental Conservation (DEC) became involved, assuming authority of the environmental assessment required by New York state law because the project involved mining. DEC's arrival did not displace Ramapo or remove Holdings' need to "apply for and obtain all of the necessary Town **[*5]** approvals prior to commencing the action." Holdings nonetheless hoped that a successful resolution of the DEC review would facilitate the requested zoning change.

In February 1998 Holdings, represented by an attorney named Charles Bazydlo, submitted to DEC a mining permit application, environmental assessment form, and proposed quarry plan. DEC thereafter issued a positive declaration,[6] requiring the preparation of a draft environmental impact statement. DEC enumerated several concerns: (1) the "substantial, long-term physical impact to . . . land located adjacent to . . . the Palisades Interstate Park Commission," (2) the proximity to the Ramapo landfill, a "listed Inactive Hazardous Waste Site" undergoing remediation, (3) "protected and significant water courses" running through the property, and (4) known dens of the timber rattlesnakes in the vicinity. In an accompanying letter, DEC informed Holdings that its application was "incomplete" and no further action would be taken until the draft environmental impact statement and detailed plans for mining and reclamation had been received.

2. Public Scoping Hearing

DEC later convened a public "scoping" hearing at which the public vented concerns about the quarry. At the hearing public officials revealed that five villages near the proposed quarry site had passed resolutions against it.

In the course of voicing worries about the quarry's effects on the landfill, "a recently remediated Superfund site,"[7] the head of the Rockland County Conservation Association summarized the general tenor of the opposition: "[W]hile we hear that there are so many [industrial] projects in the valley . . . how much can you do to an area? How much impact can you really lay on it before you kill it entirely?"

[*6] Specific concerns also came to the fore. Multiple speakers worried about traffic, with a representative from Hillburn explaining that the addition of heavy trucks for quarry operations would worsen a tenuous road situation. Others fretted about effects on the aquifer, with an engineer from United Water of New York noting that the area was "a very, very key location for providing water." And the then executive director of the Palisades Interstate Park Commission emphasized the proximity of the site to parkland, including a hiking trail that passed less than a quarter mile from the site.

DEC later received letters from hearing attendees expanding upon these points. Groups not in attendance also sent letters in opposition, including the Village of Suffern, the owner of a gas pipeline running under the property, the County of Rockland Environmental Management Council, and a New Jersey public water provider.

B. Purchase of the Property

Undaunted by either the regulatory requirements or the public hearing, Holdings exercised its option to purchase the property in July 1998 for $3,500,000.

III. Impasse with DEC

Over the next eight years, Holdings attempted to obtain a state mining permit but made little headway. Holdings began by submitting proposed work plans in the fall of 1998 which identified various studies and analyses it would conduct to address DEC's concerns.

After Holdings submitted a revised site plan in January 2000, DEC requested that Holdings submit a new mining permit application and full environmental assessment form "to provide an accurate representation of the extent of [its] current mining proposal." Holdings did so, recognizing that "the previously determined potential environmental issues remain unchanged." Two topics would take prominence in the revised site plan: (1) local water sources and (2) timber rattlesnakes.

A. Water

During the three-year period from the initial proposed work plans in 1998 until the fall of 2001, Holdings attempted to secure DEC signoff on geologic and hydrogeologic studies needed for a mining permit. Despite multiple submissions of proposed work from several **[*7]** environmental engineering firms (including the Chazen Cos. (Chazen)), Holdings was unable to obtain approval to proceed with studies. United Water of New York (United Water), which took an interest because of the proposed quarry's proximity (200 feet) to the Ramapo River, repeatedly critiqued Holdings' proposed studies as "cursory-level" and insufficient. Meetings in 2001 between Chazen, DEC, and United Water did not resolve the matter, and DEC never authorized the studies.

B. Timber Rattlesnakes

Holdings also was unable to reach a resolution regarding timber rattlesnakes, a species protected under New York law. Holdings commissioned four studies from 1998 to 2004 about the snakes, their presence on adjacent lands, and their use of the property.

Accompanying the last of these reports was a request that DEC conduct a conceptual review[8] on the development's potential impact on the rattlesnakes. The request acknowledged that "specific plans for the development of the property have not been finalized" but asserted that plans "without an overall concurrence of the [DEC] on the nature and extent of timber rattlesnakes utilization of the property and potential degree of impact[ ] represents [a] significant undue burden."

DEC declined to conduct a conceptual review, and Holdings brought a lawsuit in 2006 to force them to do so. The state court sided with DEC, concluding "that a particular and more descriptive development plan was necessary" before a conceptual review would be required. No further progress was made on this issue.

IV. Exploratory Discussions To Sell the Property

While pursuing the mining permit, Holdings entertained the prospect of selling the property. In 1998 Holdings entered into an option agreement with American National Power, Inc. (American National), to sell 40 acres of the property for $4,000,000. American National, which **[*8]** intended to build a power plant on that portion of the property, never exercised its option.

Holdings revisited the possibility in 2004, discussing a bargain sale (and accompanying tax benefits) with the Trust for Public Land (Trust). During this discussion, Scott Braen made clear that a certain 60 acres of the property was not for sale because "it was the best piece for [Holdings] to keep" given its position next to the sludge plant and transfer station.

In furtherance of these discussions, Holdings commissioned the Albert Valuation Group New York, Inc., in 2006 to appraise the property, with a highest and best use of "seek[ing] approval of the necessary permits for use as a quarry for portions of the property with development of remainder portions." The appraisal determined a value of $17,500,000 by adding the value of the underlying land to the value of the mineral deposits, as instructed by counsel. As to the value of the land, the appraisal concluded that the property's per-acre value was $20,000 or $10,220,000 total. For the mineral value, the appraisal (1) relied on a mineral appraisal by a geologist named Mark Zdunczyk, who estimated that the deposits were worth $14,500,000 but (2) included a substantial discount (50%) given the uncertainty of governmental approvals.

Holdings offered to sell the property for $20,000,000, based upon the appraisal and approximately $2,500,000 of claimed carrying costs. The Trust did not take Holdings up on its offer.

V. Ramapo Zoning Change and Ensuing Litigation

A. 2004 Zoning Litigation

In November 2004 Ramapo passed a new comprehensive zoning law that, inter alia, changed the zoning of the Ramapo portion of the property from planned industrial to "R-40" low-density rural residential district. In its Comprehensive Plan — Draft Generic Environmental Impact Statement (Draft Comprehensive Plan), Ramapo observed that the Torne Valley Road area of Ramapo contained critical natural resources, such as the aquifer, and that "additional . . . industrial development . . . would have considerable potential to cause significant harm to these critical resources." The Draft Comprehensive Plan recommended the prohibition of "uses that have the greatest potential to cause environmental impact," such as "increase in stormwater **[*9]** runoff," "greater amount of traffic," and "greater amount of overall land disturbance."

In March 2005 Holdings filed a lawsuit in New York state court opposing the zoning change. Mr. Bazydlo represented Holdings in the lawsuit (as he had in the timber rattlesnake litigation).

B. Land Purchase Agreement and Court Settlement

1. Negotiations

The parties thereafter exchanged settlement terms as part of court-ordered mediation. Holdings' initial bid was for Ramapo to purchase the property for $12,000,000 as a "bargain sale," grant Holdings a right to grade and remove material, and guarantee an additional payment of $5,500,000 if it were not able to remove sufficient material within a fixed period. Ramapo countered with a price of $10,000 per acre (approximately $5,000,000 total), which was "somewhat in excess of recent purchases by the town of undeveloped property elsewhere in the Torne Valley."

The parties ultimately homed in on a deal whereby Ramapo would buy 425 acres of the property for $5,250,000, with the zoning on the remaining 80 acres adjacent to the solid waste management complex reverting to its former industrial designation. Holdings emphasized that "certain aspects of the proposed agreement must remain in order to make the deal come to a concise and timely consummation," i.e., the rezoning of the property Holdings retained. Ramapo twice passed resolutions authorizing the purchase of this land, with the second resolution describing the purchase "as part of a court ordered settlement of an action . . . challenging the rezoning of" the property.

As talks progressed, the deal grew to include the state of New York, which agreed to supply partial funding in exchange for some of the land. In 2008 the state commissioned two appraisals of the property, both of which determined a highest and best use of residential development. The first, conducted by Valuation Plus, Inc., determined a fair market value of $3,400,000 for the 425 acres. The second, conducted by the Hudson Valley Appraisal Corp., found a fair market value of $2,900,000.

[*10] 2. Agreement

Holdings and Ramapo ultimately signed a land purchase agreement on February 1, 2010, with Ramapo agreeing to pay $5,250,000 for 425.5 acres of the property. The agreement stated that Ramapo was "aware that the transfer of the property [was] being undertaken by [Holdings] as a [b]argain [s]ale."

In the "Seller's Representations & Warranties" section the agreement provided that "th[e zoning] lawsuit is being settled as part of the conveyance of the [p]roperty from [Holdings] to the Town of Ramapo." In a later section entitled "Subject to Court Approval and Settlement," the agreement specified that it was "contingent on the settlement of" the zoning litigation "and the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto."

The proposed order provided that (1) Ramapo would subdivide the property into six lots (four in Ramapo totaling 445.5 acres and two in Hillburn totaling 58.5 acres), (2) Holdings would then sell to Ramapo five of the lots (totaling 425 acres) for $5,250,000, and (3) Ramapo, in turn, would sell three of the lots to the state of New York for $2,625,000. The draft established that Holdings would retain the remaining lot, and its zoning designation would "immediately revert to its prior designation of [planned industrial]." Of the five lots sold to Ramapo, four were contiguous, with the remaining lot separated from its fellows by the lot retained by Holdings.

The land purchase agreement also addressed the side agreement between Ramapo and New York for the sale of a portion of the property that Ramapo would receive. In a section entitled, "Subject to State of New York's Contract and Performance," the agreement provided that Ramapo's "obligation hereunder is expressly conditioned upon the execution and all necessary approvals of the contract of sale between" Ramapo and New York and stated that the agreement would be "null and void" if the agreement between Ramapo and New York was not executed.

The court approved the parties' settlement of the zoning litigation on April 12, 2010, entering an order in all pertinent respects identical to the proposed order attached to the land purchase agreement.

The property sale closed on September 29, 2010. Before the closing, Holdings' certified public accountant, Rachel Votto, advised that **[*11]** a Ramapo representative would need to sign Form 8283, Noncash Charitable Contributions, so that Holdings might claim a charitable contribution deduction. Holdings accordingly sent Ramapo a Form 8283, which was blank except for the phrase "see attached qualified appraisal report" in the "description of donated property" section. Although no appraisal was attached, Ramapo's then city manager signed

Form 8283 at closing. Immediately following closing, Ramapo completed the sale to New York of three lots for $2,625,000.

VI. 2010 Tax Preparation

A. Prefiling Agreement

To prepare its 2010 tax return, Holdings retained RSM McGladrey, Inc. (McGladrey), led by Donna Aloise and Marvin Antman, McGladrey's tax director in real estate services and managing director, respectively, at that time. Holdings also secured the services of Mark Zdunczyk, who had prepared the 2005 mineral appraisal, and Robert Fader, a longtime real estate appraiser, to prepare qualified appraisals as would be required to claim a charitable contribution deduction.

In April 2011 McGladrey submitted to the IRS a request for a prefiling agreement (PFA) for Holdings's 2010 tax year, listing as "questions for determination" whether (1) Holdings had the requisite donative intent to claim a charitable contribution deduction under section 170 and (2) the transferred property's value was $26,245,000. The IRS accepted the PFA request, requiring Holdings to submit documentation related to the property and sale, including a contemporaneous written acknowledgment from Ramapo of the sale.

In the course of assisting Holdings to gather the information requested by the IRS, Mr. Bazydlo determined that Holdings had neither sought nor obtained a contemporaneous written acknowledgment from Ramapo. Mr. Bazydlo accordingly sent a draft statement prepared by Ms. Aloise to the Ramapo town attorney, asking him to "provide[ ] an acknowledgment that [Holdings] sold the lots to the Town for the stated price and that no other goods or services was [sic] provided for the sale."

The Ramapo attorney revised the statement to make clear that "it wasn't just a purchase of property, it was a purchase of property as part of the negotiated settlement of the lawsuit":

> **[*12]** This letter will confirm that on September 29, 2010 the Town of Ramapo . . . purchased from [Holdings] for the sum of $5.25 million . . . pursuant to contract of sale dated February 1, 2010, certain vacant lands in the Torne Valley area of the town, more particularly described in Schedule A enclosed.

> The Town did not provide to the Seller any goods or services, in whole or in part, as consideration for the sale. A lawsuit bearing Rockland County Index No. 1752/05 was settled incident to the sale and was approved by order of Hon. Margaret Garvey, Justice of the Supreme Court, dated April 7, 2010.

In addition to the acknowledgment McGladrey also obtained the signatures of Messrs. Fader and Zdunczyk on copies of the Form 8283 that the Ramapo city manager had signed at closing.

After receiving Holdings' supporting documentation, the IRS raised questions about the rezoning and the mineral value, and whether the appraisals were "qualified" under Treasury Regulation § 1.170A-13(c). Several months later, the IRS "withdr[ew] from further consideration of the issues described in [Holdings'] request for [a PFA]."

B. Holdings' 2010 Tax Return

Holdings timely filed its 2010 Form 1120S, U.S. Income Tax Return for an S Corporation, claiming a charitable contribution deduction of $5,222,000 arising out of the sale of the transferred property to Ramapo.

Holdings attached a "charitable contribution deduction explanation," which asserted a fair market value of $17,472,000 based on a mineral value of $14,554,000 for 175 acres and a land value of $2,918,263 for 212.5 acres on which no mining would be performed (with the remaining 38 acres reserved as a buffer). The explanation stated that, although Holdings "would be entitled to a charitable contribution deduction of $12,222,000," it "is only claiming a charitable contribution of $5,222,000" to avoid a dispute with the IRS over the value of the transferred property and a potential substantial or gross valuation misstatement penalty.

Holdings included with its return appraisals prepared by Messrs. Fader and Zdunczyk and three distinct copies of Form 8283. Neither **[*13]** appraisal included the settlement agreement that concluded the zoning litigation or the purchase agreement between Ramapo and New York.

In his appraisal Mr. Fader concluded that the 425-acre parcel had a fair market value of $5,845,000 based on the sales comparison approach and assuming a highest and best use of "residential vacant land." Mr. Fader did not rely on any mineral valuation but noted that his report would "be presented in conjunction with a mineral appraisal survey."

For his part, Mr. Zdunczyk opined that the fair market value of the mineral deposit on the property was $14,554,000 based upon the discounted cashflow method. Relying on Mr. Bazydlo's opinion that Holdings would prevail in the zoning litigation, Mr. Zdunczyk concluded the property's highest and best use was as a quarry. Mr. Zdunczyk stated that granite covered the entire property and that any 175 of the 500 acres would contain enough rock to support a 25-year valuation.

As to the three Forms 8283, Holdings submitted one copy with the signatures of the Ramapo city manager and Mr. Fader, one copy with the signatures of the Ramapo city manager and Mr. Zdunczyk, and one copy without signatures but with details about the property. The two signed copies each included the statement "see attached qualified appraisal report" and a checkmark in the "other real estate" box in the "description of donated property" section.

The final Form 8283 described the donated property as "425.5 acres of land in Ramapo," referred to "appraisals attached" for the summary of the property's physical condition and listed an appraised fair market value of $10,472,000. Under the column "For bargain sales, enter amount received," the Form 8283 reflected $5,250,000, and under the column "Amount claimed as a deduction" the form stated $5,222,000.

C. Shareholders' Individual 2010 Returns

On their 2010 individual tax returns, Holdings' shareholders claimed proportionate shares of the $5,222,000 deduction. Each of the returns included an unsigned (and in some cases, completely blank) Form 8283. These returns were prepared by the shareholders' longtime accountants, Frank Pawlowski and Mitchell Bredefeld, who relied on Schedules K-1, Shareholder's Share of Income, Deductions, and Credits, etc., provided by Holdings.

[*14] VII. IRS Audit and Notices of Deficiency

The IRS began an audit of Holdings' 2010 tax return, with Ms. Votto representing Holdings. The focus of the audit was Holdings rather than its shareholders, and the assigned revenue agent understood that any penalties would be assessed later.

In an email on Christmas Eve 2013, the revenue agent informed Ms. Votto that "[t]he issues including penalties are complete" but that he had to review "the RAR and 30 day letter before [he] send[s] that out." He further explained that he "wrote the entire penalties 886-A today so do need to review that before sending." He also offered the opportunity to "discuss it with [him] after [she had] a chance to read it."

In an email exchange with his team manager on January 22, 2014, the revenue agent wrote that he had "another unpleasant phone call . . . [while] discussing penalties." He reported that he informed Ms. Votto that he "was recommending negligence and substantial understatement on all the issues except [one] which they disclosed at the beginning of the audit (still recommending substantial understatement if applicable though)." The team manager responded that "[p]enalties certainly seem appropriate from what I understand about the case."

Later that day the revenue agent faxed Ms. Votto Form 5701, Notice of Proposed Adjustment, noting in a cover sheet that the "burden is on the shareholders to show that they were reasonable and acted in good faith" with respect to penalties. The revenue agent attached to the notice, inter alia, Form 886-A, Explanation of Items, addressing penalties.

In a section entitled "Government's Position (Argument)," the revenue agent explained penalty recommendations with respect to various adjustments to Holdings' 2010 tax, including the charitable contribution adjustment, a research and development adjustment, and a pension adjustment. With respect to the charitable contribution, the revenue agent outlined the "Government's position" that an accuracy-related penalty would apply to the shareholders based either on a substantial valuation misstatement, negligence, or a substantial understatement of income tax. A page of the Form 886-A entitled "Taxpayer's Position" was blank. Although the parties were slated to meet in February 2014, the revenue agent canceled the meeting, noting **[*15]** that "any conversation about any of the issues, including penalties is something that will need to be addressed with appeals."

The IRS sent the shareholders 30-day letters in March 2015 pertaining to their tax years 2010-12 (depending on whether the respective shareholder and spouse had carried forward the charitable contribution deduction). The letters proposed changes to the shareholders' tax but did not assert additions to tax or penalties except for a late-filing addition to tax under section

6651(a)(1) against Samuel and Maureen Braen. In September and October 2017 the IRS sent notices of deficiency consistent with the 30-day letters.

VIII. Tax Court Proceedings

The shareholders and their spouses (as applicable) timely petitioned this Court, arguing that the IRS was wrong to disallow the charitable contribution deductions. The Commissioner filed an answer in each of the consolidated cases, asserting various penalties under section 6662 and alleging that, in compliance with section 6751(b), those penalty determinations had been approved by Julia Cannarozzi, the immediate supervisor of Clare Darcy, the Commissioner's counsel in these cases (at that time). The answers were all signed by both Mses. Darcy and Cannarozzi.

OPINION

I. Burden of Proof

In general the Commissioner's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving that the determinations are in error. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). The taxpayer bears the burden of proving entitlement to any deduction claimed. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992). Thus, a taxpayer claiming a deduction on a federal income tax return must demonstrate that the deduction is provided for by statute and must maintain records sufficient to enable the Commissioner to determine the correct tax liability. *See* I.R.C. §6001; *Hradesky v. Commissioner*, 65 T.C. 87, 89-90 (1975), *aff'd per curiam*, 540 F.2d 821 (5th Cir. 1976); Treas. Reg. § 1.6001-1(a).

If, in any court proceeding, the taxpayer puts forth credible evidence with respect to any factual issue relevant to ascertaining the liability of the taxpayer and meets certain other requirements, the **[*16]** burden of proof shifts to the Commissioner. I.R.C. §7491(a)(1) and (2). When each party has satisfied its burden of production, then the party supported by the weight of the evidence will prevail, and thus a shift in the burden of proof has real significance only in the event of an evidentiary tie. *See Knudsen v. Commissioner*, 131 T.C. 185, 189 (2008), *supplementing* T.C. Memo. 2007-340.

We do not perceive an evidentiary tie in these cases and are able to decide the remaining issues on the preponderance of the evidence. *See, e.g., Bordelon v. Commissioner*, T.C. Memo. 2020-26, at *11.

II. Charitable Contribution Deduction

Section 170(a)(1) allows taxpayers a deduction for any charitable contribution made during the taxable year, so long as the taxpayer complies with "regulations prescribed by the Secretary." If the charitable contribution is of property other than money, the amount of the contribution is generally the fair market value of the property at the time of contribution. *See* Treas. Reg. § 1.170A-1(c)(1); *see also Triumph Mixed Use Invs. III, LLC v. Commissioner*, T.C. Memo. 2018-65, at *28; *Seventeen Seventy Sherman St., LLC v. Commissioner*, T.C. Memo. 2014-124, at *18.

Taxpayers also must meet several substantiation requirements to successfully claim a section 170 deduction. *See Cave Buttes, L.L.C. v. Commissioner*, 147 T.C. 338, 347-48 (2016); *Albrecht v. Commissioner*, T.C. Memo. 2022-53, at *3. As most relevant here, taxpayers must provide a contemporaneous written acknowledgment from the recipient of the contribution where the claimed value of the donated property exceeds $250. I.R.C. §170(f)(8)(A); *Triumph*, T.C. Memo. 2018-65, at *29.

Holdings did not make a charitable contribution or gift of property to Ramapo per se. Instead, the Braens argue that the sale of the 425.5 acres represented a "bargain sale" made with donative intent and that Holdings accordingly was entitled to deduct the difference between the fair market value of the portion of the property sold and the purchase price. Our resolution of the parties' dispute hinges on two principal requirements to claim a charitable contribution deduction in connection with a bargain sale: (1) the fair market value of the property donated must exceed the value of any benefits received and (2) the taxpayer must supply a contemporaneous written acknowledgment from the recipient substantiating the contribution. We will address each in turn.

[*17] A. Bargain Sale

1. Governing Standards

"Contributions of property 'generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return.'" *Seventeen Seventy*, T.C. Memo. 2014-124, at *19 (quoting *United States v. Am. Bar Endowment*, 477 U.S. 105, 116 (1986)); *see also Emanouil v. Commissioner*, T.C. Memo. 2020-120, at *45. According to the Supreme Court, the "relevant inquiry" focuses on "whether the transaction . . . is structured as a *quid pro quo* exchange." *Hernandez v. Commissioner*, 490 U.S. 680, 701-02 (1989). We do not inquire into the taxpayer's subjective motives, instead giving weight to "the external features of the transaction." *Costello v. Commissioner*, T.C. Memo. 2015-87, at *26-27. "If it is understood that the property will not pass to the charitable recipient unless the taxpayer receives a specific benefit, and if the taxpayer cannot garner that benefit unless he makes the required 'contribution,' the transfer does not qualify the taxpayer for a deduction under section 170." *Id.* at *27.

"The relevant question is whether the taxpayer expected a benefit in return for the payment; deductibility does not depend on what type of benefit the taxpayer received." *Triumph*, T.C. Memo. 2018-65, at *31 (quoting *Christiansen v. Commissioner*, 843 F.2d 418, 420 (10th Cir. 1988)); *see also Seventeen Seventy*, T.C. Memo. 2014-124, at *23-24 ("Medical, educational, scientific, religious, or other benefits can be consideration that vitiates charitable intent."). The benefit does not need to be financial, and we "have found that a transfer of real property in exchange for development approvals . . . is a benefit and precludes a finding of the requisite donative intent." *Triumph*, T.C. Memo. 2018-65, at *32; *see also Grinslade v. Commissioner*, 59 T.C. 566, 574-76 (1973); *Pollard v. Commissioner*, T.C. Memo. 2013-38; *Ackerman Buick, Inc. v. Commissioner*, T.C. Memo. 1973-224, 1973 Tax Ct. Memo LEXIS 64, at *9 ("Receipt of a desired zoning variance from a city which would or might not be available without making a dedication of land to the city has been held to be a direct economic benefit which would preclude a charitable deduction.").

"[A] taxpayer may still deduct a contribution of property if (1) the value of the property transferred . . . exceeds the fair market value of any goods or services received in exchange and (2) the excess payment is made 'with the intention of making a gift.'" *Triumph*, T.C. Memo. 2018-65, at *29 (quoting *Am. Bar Endowment*, 477 U.S. at 117); **[*18]** *Seventeen Seventy*, T.C. Memo. 2014-124, at *19; Treas. Reg. § 1.170A-1(h)(1). In that instance, taxpayers may deduct the difference between the fair market value of the contributed property and that of the goods or services provided by the charitable organization. *Boone Operations Co. v.*

Commissioner, T.C. Memo. 2013-101, at *15. Where a taxpayer, however, "fails to identify or value all of the consideration received in the transaction, the taxpayer is not entitled to any charitable contribution deduction." *Seventeen Seventy*, T.C. Memo. 2014-124, at *27; *see also Triumph*, T.C. Memo. 2018-65, at *35; *Boone*, T.C. Memo. 2013-101, at *48.

2. Value of Consideration Received

The Braens have not established the value of all consideration Holdings received as part of the purported bargain sale, and thus they are not entitled to the claimed charitable contribution deductions.

As an initial matter, the land purchase agreement and the settlement of the zoning litigation must be considered together as parts of an "inseparable package." *See Grinslade*, 59 T.C. at 574; *see also Boone*, T.C. Memo. 2013-101, at *23 ("When a taxpayer enters into a contractual arrangement with another party and claims that a bargain sale occurred, we consider the entire contractual arrangement in determining whether the taxpayer contributed money or property in excess of the value of the benefits received."). The land purchase agreement expressly notes that the zoning litigation "is being settled as part of the conveyance of the [p]roperty." It further specifies that the purchase was conditioned on "the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto." And the settlement agreement unambiguously references the land purchase agreement, which was included as an attachment.

We accordingly will examine both parts of the "integrated transaction." *See Derby v. Commissioner*, T.C. Memo. 2008-45, 2008 WL 540271, at *16. Holdings received two types of consideration: (1) $5,250,000 and (2) reversion of the zoning designation over the portion of the property Holdings retained "to its prior designation of [planned industrial]." *See, e.g., Grinslade*, 59 T.C. at 576 ("[T]he zoning variance was . . . an additional financial benefit anticipated by [the taxpayers] as a result of the conveyance. . . ."); *Triumph*, T.C. Memo. 2018-65, at *35-40; *Seventeen Seventy*, T.C. Memo. 2014-124, at *31-33; *Ackerman*, 1973 Tax Ct. Memo LEXIS 64, at *17.

[*19] The zoning reversion was central to the overall deal. Even before Ramapo's 2004 rezoning, Holdings had emphasized that, as part of any sale, it wanted to retain "for some development purpose" the portion of the property bordering the various industrial facilities.

During the court-ordered negotiations in the zoning litigation, Holdings injected the idea of rezoning and retaining that portion of the property in response to Ramapo's proposal to purchase the entirety. As the negotiations continued, Holdings made clear that rezoning a retained parcel was a sine qua non for settlement. In summary, the bargained-for zoning reversion was consideration that was required to be valued when claiming the deduction. *See Seventeen Seventy*, T.C. Memo. 2014-124, at *30-31; *see also Triumph*, T.C. Memo. 2018-65, at *41-42; Treas. Reg. § 1.170A-1(h)(1).

The Braens attempt to avoid this conclusion by arguing that Holdings was entitled to the zoning reversion as a matter of law and that the zoning litigation would have vindicated its entitlement. *Cf. Emanouil*, T.C. Memo. 2020-120, at *45 (explaining that "if the taxpayer cannot garner [a] benefit unless he makes the required 'contribution', then the transfer does not qualify the taxpayer" for a section 170 deduction). The Braens rely on the opinion of Mr. Bazydlo, who represented Holdings during the zoning litigation, and their own analysis of New York law.

We decline to give weight to Mr. Bazydlo's opinions. Although we do not doubt his sincerity, Mr. Bazydlo is by-and-large offering legal opinions, which are the province of the Court. *See In re Revel AC, Inc.*, 802 F.3d 558, 567 (3d Cir. 2015) ("[L]ikelihood of success . . . involves a purely legal determination."); *Cottillion v. United Refin. Co.*, 781 F.3d 47, 59 (3d Cir. 2015); *Alumax Inc. v. Commissioner*, 109 T.C. 133, 175 (1997), *aff'd*, 165 F.3d 822 (11th Cir. 1999). Further, Mr. Bazydlo represented Holdings in the zoning litigation (and in many other capacities in connection with the property), calling into question whether his opinion is that of an impartial expert or an advocate. *See Neonatology Assocs., P.A. v. Commissioner*, 115 T.C. 43, 86 (2000) ("An expert witness loses his or her impartiality when he or she is too closely connected with one of the parties."), *aff'd*, 299 F.3d 221 (3d Cir. 2002); *V.R. DeAngelis M.D.P.C. v. Commissioner*, T.C. Memo. 2007-360, 2007 WL 4257483, at *21-22, *aff'd*, 574 F.3d 789 (2d Cir. 2009).

In any event, the Braens' confidence in Holdings' ultimate success in the zoning litigation has no bearing on whether the rezoning achieved at settlement constituted a benefit. The record amply demonstrates that **[*20]** Holdings prized the planned industrial zoning designation for potential future development. After Ramapo's 2004 rezoning, Holdings was required to take action to secure its desired zoning. Holdings chose to obtain its end through the certain means of negotiated settlement rather than expend time and resources to continue along the unpredictable path of litigation. *See Perlmutter v. Commissioner*, 45 T.C. 311, 318 (1965) ("[Taxpayers] received a direct benefit because of the transfer. It appears from the evidence that even if the partnership might have ultimately prevailed in its efforts to get approval of its plans without making the transfers, it certainly avoided considerable and perhaps protracted difficulty in this regard by making the transfers in question.").

Although we are agnostic as to whether Holdings would have been able to prevail in litigation, we are certain that Holdings gained the significant benefit of a change to its then-governing zoning designation as part of the coordinated settlement and land purchase agreement. This benefit was required to be taken into account when analyzing any charitable contribution deduction.[9] Having failed to do so, the Braens are not entitled to the claimed charitable contribution deductions. *See Triumph*, T.C. Memo. 2018-65, at *35, *41-42; *Seventeen Seventy*, T.C. Memo. 2014-124, at *27-28; *Derby v. Commissioner*, 2008 WL 540271, at *19.

B. Contemporaneous Written Acknowledgment

Even if we were to overlook Holdings' failure to value the zoning reversion, the deduction nonetheless would be barred because of a fatal defect in the contemporaneous written acknowledgment. *See* I.R.C. §170(f)(8)(A); *Triumph*, T.C. Memo. 2018-65, at *29.

Section 170(f)(8) requires that the contemporaneous written acknowledgment state (1) the amount of cash and a description (but not value) of any property other than cash contributed, (2) whether the **[*21]** charitable organization provided any goods or services in consideration, in whole or part, for the contributed property, and (3) a description and good-faith estimate of the value of any goods or services the taxpayer received as consideration. *Addis v. Commissioner*, 118 T.C. 528, 533-34 (2002), *aff'd*, 374 F.3d 881 (9th Cir. 2004). "A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment." Treas. Reg. § 1.170A-13(f)(6). "Goods or services means cash, property, services, benefits, and privileges." *Addis*, 118 T.C. at 534 n.8; Treas. Reg. § 1.170A-13(f)(5).

The written acknowledgment and other substantiation requirements are designed to "foster disclosure of 'dual payment' or quid pro quo contributions." *Viralam v. Commissioner*, 136 T.C.

151, 171 (2011). "Where the written acknowledgment of a charitable contribution by a donee organization states that the donor received no consideration and the donor actually received a benefit in exchange for the donation, the deduction is disallowed in its entirety." *Id.*

A taxpayer's failure to supply a satisfactory contemporaneous written acknowledgment bars a charitable contribution deduction. *Izen v. Commissioner*, 148 T.C. 71, 76-77 (2017), *aff'd*, 38 F.4th 459 (5th Cir. 2022); *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557, 562-63 (2016); *Albrecht*, T.C. Memo. 2022-53, at *3-4. The doctrine of substantial compliance does not apply in this context. *Izen*, 148 T.C. at 77; *15 W. 17th St.*, 147 T.C. at 562; *French v. Commissioner*, T.C. Memo. 2016-53, at *8; *see also Addis v. Commissioner*, 374 F.3d at 881, 887 ("The deterrence value of [a] total denial of a deduction [in the case of an improper contemporaneous written acknowledgment] comports with the effective administration of a self-assessment and self-reporting system.").

The 2011 acknowledgment letter provided by the Ramapo town attorney does not satisfy section 170(f)(8). Holdings negotiated for and received the zoning change as part of the settlement and land purchase, and, to satisfy section 170(f)(8), the acknowledgment was required to both identify it as consideration and provide a good-faith valuation of it. The letter plainly did not do so, instead stating that Holdings did not receive "any goods or services, in whole or in part, as consideration" other than the $5,250,000. *See Viralam*, 136 T.C. at 171; *see also Boone*, T.C. Memo. 2013-101, at *17-21.

[*22] The Braens argue that the letter's statement that "[a] lawsuit bearing Rockland County Index No. 1752/05 was settled incident to the sale and was approved by order of Hon. Margaret Garvey, Justice of the Supreme Court, dated April 7, 2010" suffices to meet the statutory requirements. But "[n]othing in the statute or legislative history requires [the Commissioner] to look beyond the written acknowledgment when on its face the acknowledgment fails to provide the information required to substantiate a charitable contribution deduction." *Durden v. Commissioner*, T.C. Memo. 2012-140, 2012 WL 1758655, at *4. Even if we were inclined to see the reference to the settlement as sufficient to identify the rezoning as consideration, neither the letter nor the settlement agreement provides a good-faith valuation as required by section 170(f)(8). *See Boone*, T.C. Memo. 2013-101, at *21-22.

With the doctrine of substantial compliance off limits, the Braens rely on the "reasonable cause" exception of section 170(f)(11)(A)(ii)(II) to excuse the acknowledgment's shortcomings.

This exception, however, does not apply to the contemporaneous written acknowledgment requirement. *See Campbell v. Commissioner*, T.C. Memo. 2020-41, at *28 n.16.

Holdings' failure to comply with requirements of section 170(f)(8) accordingly prohibits the Braens from claiming charitable contribution deductions. *See Addis*, 118 T.C. at 537; *Albrecht*, T.C. Memo. 2022-53, at *5-6; *Boone*, T.C. Memo. 2013-101, at *21-22.[10]

III. Accuracy-Related Penalties

In his answers, the Commissioner determined a 20% accuracy-related penalty against each of the Braens, premised on negligence, a substantial understatement of income tax, and a substantial valuation misstatement. *See* I.R.C. §6662(a), (b)(1)-(3), (c), (d), and (e). He further determined an addition to tax under section 6651(a)(1) against Samuel and Maureen Braen.

Section 7491(c) generally provides that "the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty." This burden requires the **[*23]** Commissioner to come forward with sufficient evidence indicating that the imposition of the penalty is appropriate. *See Higbee v. Commissioner*, 116 T.C. 438, 446 (2001). Once he meets his burden of production, the burden of proof is on the taxpayer to "come forward with evidence sufficient to persuade a Court that the Commissioner's determination is incorrect." *Id.* at 447.

Where penalties are first asserted in an answer, the Commissioner bears the burdens of both production and proof as to the applicability of those penalties. Rule 142(a)(1); *Huzella v. Commissioner*, T.C. Memo. 2017-210, at *9-10. He also "bears the burden of proving the absence of reasonable cause for the Court to impose the penalty if the penalty is either a 'new matter' or an 'increase[ ] in deficiency' within the meaning of Rule 142(a)." *Rogers v. Commissioner*, T.C. Memo. 2018-53, at *123-24, *aff'd*, 9 F.4th 576 (7th Cir. 2021).

A. Supervisory Approval of Penalties

The Commissioner's burden of production under section 7491(c) includes establishing compliance with section 6751(b)(1), which provides that "[n]o penalty . . . 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." *See Graev v.*

Commissioner, 149 T.C. 485, 493 (2017), *supplementing and overruling in part* 147 T.C. 460 (2016); *see also Chai v. Commissioner*, 851 F.3d 190, 217, 221-22 (2d Cir. 2017), *aff'g in part, rev'g in part* T.C. Memo. 2015-42.[11] In *Belair Woods, LLC v. Commissioner*, 154 T.C. 1, 14-15 (2020), we explained that the "initial determination" of a penalty assessment is typically embodied in a letter "by which the IRS formally notifie[s] [the taxpayer] that [it] ha[s] completed its work and . . . ha[s] made a definite decision to assert penalties." Once the Commissioner introduces evidence sufficient to show written supervisory approval, the burden shifts to the taxpayer to show that the approval was untimely, viz, "that there was a formal communication of the penalty [to the taxpayer] before the proffered approval" was secured. *Frost v. Commissioner*, 154 T.C. 23, 35 (2020); *Thompson v. Commissioner*, T.C. Memo. 2022-80, at *6.

[*24] "The word 'determination' has 'an established meaning in the tax context and denotes a communication with a high degree of concreteness and formality." *Oxbow Bend, LLC v. Commissioner*, T.C. Memo. 2022-23, at *5 (quoting *Belair Woods*, 154 T.C. at 15); *Beland v. Commissioner*, 156 T.C. 80, 85 (2021). "[T]he 'initial determination' of a penalty assessment will be embodied in a formal written communication to the taxpayer, notifying him that the Examination Division has completed its work and has made a definite decision to assert penalties." *Belair Woods*, 154 T.C. at 10. A "mere suggestion, proposal, or initial informal mention" of penalties does not, we have held, constitute an initial determination under section 6751(b)(1). *Tribune Media Co. v. Commissioner*, T.C. Memo. 2020-2, at *19.[12]

The Braens advance two arguments regarding supervisory approval. First, they contend that the initial determination of penalties occurred during the 2013 examination of Holdings' 2010 return and lacked written supervisory approval. In the alternative, they claim that if the initial determination came in the answers in these cases, the Commissioner has failed to show supervisory approval. Neither argument convinces.

1. 2013 Examination into Holdings' 2010 Return

We first conclude that the discussion of potential penalties against Holdings' shareholders in the notice of proposed adjustment did not constitute an initial determination.

[*25] A notice of proposed adjustment lacks the "high degree of concreteness and formality" that we have associated with an "initial determination" for section 6751 purposes. *Belair*

Woods, 154 T.C. at 15; *Tribune*, T.C. Memo. 2020-2, at *18. This notice underscores its tentative nature (hinted by the title "proposed adjustment"):

> Based on the information we now have available and our discussions with you, we believe the proposed adjustment listed below should be included in the revenue agent's report. However, if you have additional information that would alter or reverse this proposal, please furnish this information as soon as possible.

"This text makes clear that a [notice of proposed adjustment], standing alone, is not a determination." *Tribune*, T.C. Memo. 2020-2, at *20 (considering similar text in a notice of proposed adjustment). Nor does the notice afford appeal rights, a common hallmark of finality. *Id.*

The attached Form 886-A addressing penalties does not support a different conclusion. Highlighting the unsettled nature of the notice, the Form 886-A stated that the revenue agent had proposed "potential" deficiencies underlying the recommended penalties. Although the Form 886-A includes a section entitled "Government's Position (Argument)" laying out the revenue agent's rationale for imposing penalties on the shareholders, it also includes a section entitled "Taxpayer's Arguments," that was altogether blank. This form did not establish that "penalties *will* be proposed." *See Kestin v. Commissioner*, 153 T.C. 14, 30 (2019) (quoting *Clay v. Commissioner*, 152 T.C. 223, 249 (2019), *aff'd*, 990 F.3d 1296 (11th Cir. 2021)). Instead, it "informed [the Braens] of the exam team's 'proposed adjustments'" and, together with the notice, provided for the possibility of further discussion, undermining any notion of "concreteness." *See Belair Woods*, 154 T.C. at 11, 15.

2. Assertion of Penalties in the Answers

The initial determination of penalties ultimately occurred when the Commissioner filed his answers in these cases. The answers were signed by Ms. Darcy, an attorney with the IRS Office of Chief Counsel, and Ms. Cannarozzi, an associate area counsel with the IRS Office of Chief Counsel. The Braens assert that the Commissioner has not established that Ms. Cannarozzi was Ms. Darcy's "immediate supervisor" as required by section 6751(b)(1).

[*26] As we have explained, the immediate supervisor "is most logically viewed as the person who supervises the . . . substantive work" involving the assertion of penalties. *Sand Inv. Co. v. Commissioner*, 157 T.C. 136, 142 (2021). In the answers, Ms. Cannarozzi identified herself as

Ms. Darcy's immediate supervisor and represented that she "had the discretion to give or withhold her approval" of the penalties. Given these representations, we conclude that Ms. Cannarozzi was Ms. Darcy's immediate supervisor in these cases for purposes of section 6751(b)(1). *Cf. Thompson*, T.C. Memo. 2022-80, at *4, *8; *Koh v. Commissioner*, T.C. Memo. 2020-77, at *4 n.3 ("[T]he Court has found that an IRS Chief Counsel attorney satisfies the supervisory approval requirement . . . where the attorney's immediate supervisor personally approved in writing the assertion of a penalty that was first raised in the answer, as evidenced by the signature of [the Commissioner's] associate area counsel on the pleading."); *Roth v. Commissioner*, T.C. Memo. 2017-248, at *10-11, *aff'd*, 922 F.3d 1126 (10th Cir. 2019).

The Braens have offered no evidence to contradict Ms. Cannarozzi's representations. We therefore conclude that the Commissioner properly satisfied the written supervisory approval requirement of section 6751(b)(1).

B. Substantial Valuation Misstatement

1. Applicability of Penalty

The Code imposes a penalty on taxpayers for any underpayment attributable to a substantial valuation misstatement. I.R.C. §6662(a), (b)(3). A misstatement is "substantial" if the value of the property claimed on a return is 150% or more of the correct amount. I.R.C. §6662(e)(1)(A).[13]

[*27] On its 2010 return Holdings valued the portion of the property sold to Ramapo at $10,472,000. To decide whether there was a substantial valuation misstatement, we must determine the property's fair market value, i.e., the price at which the property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. *See* Treas. Reg. § 1.170A-1(c)(2).

To support their respective positions on the valuation question, the parties retained experts who testified at trial. We evaluate an expert's opinion in light of his qualifications and the evidence in the record. *See Champions Retreat Golf Founders, LLC v. Commissioner*, T.C. Memo. 2022-106, at *10 (citing *Parker v. Commissioner*, 86 T.C. 547, 561 (1986)), *supplementing* T.C. Memo. 2018-146.

"We are not bound by an expert opinion that we find contrary to our judgment." *Plateau Holdings, LLC v. Commissioner*, T.C. Memo. 2020-93, at *32. We may accept an expert's opinion in its entirety, or may accept only those portions we find reliable. *Emanouil*, T.C. Memo. 2020-120, at *50 (citing *Helvering v. Nat'l Grocery Co.*, 304 U.S. 282 (1938)); *Plateau Holdings*, T.C. Memo. 2020-93, at *32. We also may determine fair market value based on our own examination of the record evidence. *Emanouil*, T.C. Memo. 2020-120, at *50-51 (citing *Silverman v. Commissioner*, 538 F.2d 927, 933 (2d Cir. 1976), *aff'g* T.C. Memo. 1974-285).

a. Highest and Best Use

"A 'critical aspect' in calculating fair market value is determining the 'highest and best use' of the property" at issue. *PBBM-Rose Hill, Ltd. v. Commissioner*, 900 F.3d 193, 209 (5th Cir. 2018) (quoting *Whitehouse Hotel Ltd. P'ship v. Commissioner*, 615 F.3d 321, 335 (5th Cir. 2010), *vacating* 131 T.C. 112 (2008)). We look to "[t]he highest and most profitable use for which the property is adaptable and needed or likely to be needed in the reasonably near future." *Palmer Ranch Holdings Ltd. v. Commissioner*, 812 F.3d 982, 996 (11th Cir. 2016) (quoting *Symington v. Commissioner*, 87 T.C. 892, 897 (1986)), *aff'g in part, rev'g in part and remanding* T.C. Memo. 2014-79. We must consider "[a]ny realistically available special use of property due to its adaptability to a particular business," but the fair market value "is not **[*28]** affected by whether the owner actually has put the property to its highest and best use." *Stanley Works & Subs. v. Commissioner*, 87 T.C. 389, 400 (1986).

"The highest and best use inquiry is one of objective probabilities," and the "'realistic, objective potential uses for property control' its valuation." *Esgar Corp. v. Commissioner*, 744 F.3d 648, 657 (10th Cir. 2014) (quoting *Symington*, 87 T.C. at 896), *aff'g* T.C. Memo. 2012-35, 2012 WL 371809, *and aff'g Temple v. Commissioner*, 136 T.C. 341 (2011). Importantly, "[a] suggested higher use other than current use 'requires both "closeness in time" and "reasonable probability."'" *Id.* at 658 (quoting *Hilborn v. Commissioner*, 85 T.C. 677, 689 (1985)); *see also United States v. 269 Acres, More or Less, Located in Beaufort Cnty.*, 995 F.3d 152, 164 (4th Cir. 2021) ("[T]o base [value] on a use other than the current one, the landowner must produce evidence that the proffered use is '"reasonably probable" and that the probability has a real market value.'" (quoting *United States v. 69.1 Acres of Land, More or Less, Situated in Platt Springs Twp., Cnty. of Lexington*, 942 F.2d 290, 296 (4th Cir. 1991)).

"Any proposed use[ ] that 'depend[s] upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable,'" should not be considered a viable use. *See Esgar Corp. v. Commissioner*, 2012 WL 371809, at *7 (quoting *Olson v. United States*, 292 U.S. 246, 257 (1934)). Although the highest and best use can be a use prohibited by zoning laws as of the date of contribution, such a proposed use "cannot be remote, speculative, or conjectural." *Dynamo Holdings Ltd. P'ship v. Commissioner*, T.C. Memo. 2018-61, at *80.

The parties' experts reach vastly different values based primarily on differing conclusions as to the highest and best use of the property sold to Ramapo. The Braens rely on two experts: (1) Mr. Zdunczyk, who determined that the highest and best use of the sale parcel was a quarry and valued the mineral rights at $11,000,000, and (2) Mr. Fader, who provided four different potential valuations, including a value of $12,190,000 if quarrying were the highest and best use. The Commissioner relies on a report by Hilco Real Estate Appraisal (Hilco), which valued the sale parcel at $4,850,000 with a highest and best use of limited residential development.

As an initial matter, the record leaves us with the firm conviction that, as of September 29, 2010, no reasonable probability existed that **[*29]** Holdings would be able to procure within a reasonable time the approvals, zoning changes, and permits required for quarrying. Although we do not doubt Holdings' intentions when it purchased the property or the land's suitability for a quarry, the governmental obstacles proved too much. Any thought otherwise represents a mixture of hope and conjecture.

Specifically, Holdings failed to make significant progress with DEC in obtaining the required state mining permit. From the start, DEC identified significant environmental concerns that needed to be addressed before the issuance of a mining permit. Despite investing time, effort, and expense, Holdings did not obtain authorization of studies relating to two of the major issues, much less assuage DEC's underlying concerns. *Cf. Palmer Ranch Holdings Ltd. v. Commissioner*, 812 F.3d at 997 (finding reasonable probability that development would be approved where the decision-making agency issued an ordinance describing particular requirements for development applications).

Holdings was similarly unsuccessful with Ramapo, and there were no real prospects that the town would change its stance. Ramapo had a longstanding prohibition on quarrying when

Holdings submitted its petition for a zoning amendment in 1997, which was consistent with the negative views of quarrying expressed during and after the 1998 scoping hearing. *Cf. Johnston v. Commissioner*, T.C. Memo. 1997-475, 1997 WL 643299, at *19.

Ramapo's views only hardened over time. Seven years after Holdings initially sought the zoning amendment that would remove quarrying from prohibited uses, Ramapo passed a comprehensive zoning law that changed the zoning of the Ramapo portion of the property to an "R-40" low-density rural residential district. In the Draft Comprehensive Plan, Ramapo stressed that "additional . . . industrial development . . . would have considerable potential to cause significant harm to these critical resources" and recommended the prohibition of "uses that have the greatest potential to cause environmental impact."

We have previously remarked that "we should not consider [a] potential use in valuing the property" "if a hypothetical buyer [at the time of the bargain sale] would not have reasonably considered a potential use of the property." *Boone*, T.C. Memo. 2013-101, at *27 (citing *Boltar, L.L.C. v. Commissioner*, 136 T.C. 326, 336 (2011)); *Glade Creek Partners, LLC v. Commissioner*, T.C. Memo. 2020-148, at *34, *aff'd in part, vacated in part and remanded*, No. 21-11251, 2022 WL **[*30]** 3582113 (11th Cir. Aug. 22, 2022). A hypothetical buyer here would be unlikely to view quarrying as possible in light of the inability of Holdings — an established mining company with a long history of success — to obtain the requisite government approvals despite a decade of effort.

The quarry here is exactly the sort of proposed use that, at best, depended "upon events or combinations of occurrences which, while within the realm of possibility, are not fairly shown to be reasonably probable." *See Esgar Corp. v. Commissioner*, 2012 WL 371809, at *7 (quoting *Olson*, 292 U.S. at 257). We see no reasonable probability that Holdings could obtain DEC's blessing of the mining permit or overcome Ramapo's entrenched opposition after eight years of stasis. Accordingly, quarrying was not the property's highest and best use.[14]

Excluding quarrying leaves residential development as the highest and best use of the property. Our conclusion on this point rests on the common opinion of the parties' experts, each of whom identified residential development as the property's highest and best use in the absence of quarrying.[15]

b. Valuation

i. *Expert Views*

To value the 425.5 acres sold to Ramapo, both parties' experts turn to the sales comparison method, which "values a property by comparing it to similar properties sold in arm's-length transactions in or about the same period." *Champions Retreat*, T.C. Memo. 2022-106, at *21; *see also Wolfsen Land & Cattle Co. v. Commissioner*, 72 T.C. 1, 19 (1979). The reliability of this method "depends to a great extent upon the comparables selected and the reasonableness of the adjustments made thereto." *Wolfsen Land*, 72 T.C. at 19-20. The appraiser considers differences in various aspects of the comparable properties such as time of sale, size, location, or other significant features and then makes **[*31]** appropriate adjustments for each to approximate the qualities of the property. *See, e.g., Champions Retreat*, T.C. Memo. 2022-106, at *21; *see also Johnson v. Commissioner*, T.C. Memo. 2020-79, at *28-29.

Both experts also decided that dividing the 425.5 acres in two and performing separate valuations for each parcel would best capture the fair market value of the property as a whole.[16] After that starting point, never the twain would meet (as an analytic matter, at least).

a) *Mr. Fader's Report*

For his part, Mr. Fader determined that the two parcels should be broken down between the three lots in Ramapo and the two lots in Hillburn. This distribution stemmed from his "belie[f] that for marketing and sales purposes, the real estate industry and a purchaser/developer would analyze and value these two parcels separately" because the property is spread across "two separate tax lots located in [two] separate jurisdictions."

Mr. Fader concluded that the 367-acre Ramapo parcel had a fair market value of $4,861,865, based upon a per-acre value of $13,248. In the course of his valuation, Mr. Fader considered (1) a 2009 sale of 247.9 acres in Ramapo for $11,500,000 (Sterling sale), (2) a 2010 sale of 93.3 acres in Sloatsburg (a village, like Hillburn, within Ramapo) for $1,900,000, and (3) a 2009 sale of 47.5 acres in Warwick, New York (in Orange County, which is adjacent to Ramapo's home county of Rockland County), for $287,500. Mr. Fader made downward adjustments of more than 57% to the Sterling sale to account for, inter alia, (1) the fact that approvals for a subdivision development had been obtained before sale and (2) differences in topography. Although he noted that the Warwick sale involved property zoned "Agricultural Single Family," he did not make any adjustment for that zoning (or for the zoning in Sloatsburg) based on his view that the Ramapo parcel and the comparable "are within similar residential districts."

For the 58.5-acre Hillburn parcel, Mr. Fader reached a fair market value of $1,980,901, based upon a per-acre value of $33,862. Although Mr. Fader's report discussed three sales, he "eliminated" one sale because the property was not comparable. This elimination left only **[*32]** two sales: (1) the 2009 sale of agricultural property in Warwick, which he also had used in valuing the Ramapo parcel, and (2) a 2009 sale of 39.6 acres in Monroe Township, New York (also in Orange County), for $3,022,729. As to the latter, Mr. Fader made a 10% adjustment to its $76,332 per-acre price to account for a portion of the property zoned light industrial.

Stitching the values of his two parcels together, Mr. Fader concluded that the 425.5 acres had a fair market value of $6,840,000.

b) *Hilco Report*

The Hilco appraisal report, on the other hand, fixed its two parcels based on contiguity. Specifically, one of the lots at issue was separated from the other four by the 80-acre lot that Holdings had retained as part of the sale to Ramapo. Hilco concluded that the noncontiguous lot "would be more likely to be sold off separately . . . due to the separation" and thus valued that lot of 115.70 acres and the remaining 309.90 acres as distinct parcels.

With respect to the valuation of the noncontiguous parcel of 115.70 acres, Hilco determined a per-acre value of $18,800, which produced a total value of $2,180,000. Hilco relied on (1) a 2016 sale of 135 acres in Monroe, New York (Orange County), for $3,000,000, (2) a 2010 sale of 99.10 acres in West Milford, New Jersey (located in Passaic County, which borders Rockland and Orange Counties), for $2,250,000, (3) the 2010 Sloatsburg sale considered by Mr. Fader, and (4) a 2010 sale of 139 acres in Highlands, New York (Orange County) for $1,600,000. Hilco took the position that the 2016 sale was relevant because of its view that there had been few changes to prices for vacant residential land in the five years since the valuation date. Hilco found the Sloatsburg property to be the most comparable, with adjustments to account for small differences in size, zoning, site conditions, and frontage.

As to the 309.9-acre parcel composed of the rest of the property, Hilco found a per-acre value of $8,600, which produced a total value of $2,670,000. For this value, Hilco considered (1) a

2016 sale of 240.27 acres in Stony Point, New York (Rockland County), for $1,573,220, (2) a 2016 sale of 340.28 acres in Tuxedo, New York (Orange County), for $3,288,679, (3) a 2010 sale of 174.4 acres in Orange County for $1,940,000, and (4) a 2007 sale in Ramapo of 260.68 acres for $1,900,000. As in connection with the other parcel, Hilco explained that it would **[*33]** consider 2016 sales given the minimal movement in the vacant residential land market. It then applied various adjustments to the sale prices to account for differences in the properties. Hilco did note that it "considered but did not use" the Sterling sale, which had received "final approval for a senior housing subdivision" before sale, because of concerns about the arm's-length nature of the transaction and topographical differences.

Putting the values of the parcel together, Hilco concluded that the 425.5 acres had a fair market value of $4,850,000.

ii. *Analysis*

Although both experts generally support their opinions, we believe that Hilco has the better overall methodology and valuation. As an initial matter, we agree with Hilco's division of lots based on contiguity, viz, that the noncontiguous lot would be more likely to be sold by itself rather than as part of a Ramapo lot package. Mr. Fader fails to persuade us that the separate tax lots or jurisdictions would present an impediment to selling the adjacent lots in Ramapo and Hillburn together (as was done when Holdings purchased the property in 1998 and again when it sold these 425.5 acres in 2010). Although we recognize some differences in the rural residential zoning designations of Ramapo and Hillburn at issue here, Mr. Fader did not see fit to distinguish between the two in his appraisal, and we do not believe that the differences require separating the lots by town for valuation purposes.

Turning to the analysis of Hilco's two-parcel valuation, we first note that Hilco factors in sales from 2016 in its valuation of both parcels. "[E]vidence of lot sales within a reasonable period after the date of valuation . . . tends to make a given estimate of the lot prices more or less likely. . . ." *Trout Ranch, LLC v. Commissioner*, T.C. Memo. 2010-283, 2010 WL 5395108, at *12, *aff'd*, 493 F. App'x 944 (10th Cir. 2012). We wonder whether five years constitutes a reasonable period even granting the relatively stable market for vacant residential land described in Hilco's report, and we will accordingly give less weight to the 2016 sales.

We conclude that the value of the noncontiguous lot is $20,000 per acre, with a total value of $2,314,000 for the 115.7 acres. We place primary reliance on the February 2010 sale of 93.3 acres in Sloatsburg, which was discussed by both the Hilco report and the Fader report (in **[*34]** the context of the 367-acre Ramapo parcel). We agree with both reports that this sale involved land quite similar to the noncontiguous lot, although we conclude that the price-per-acre value for the noncontiguous lot would be closer to the actual price of the Sloatsburg sale than Hilco determined. In particular we believe that Hilco's adjustments for differences in site conditions, size, and road frontage were slightly overstated. We draw further support for this conclusion from the 2010 sale of land in Passaic County for $22,704. Although this sale is somewhat less comparable than the Sloatsburg sale, we believe that after appropriate adjustments it weighs in favor of a higher price-per-acre than determined by Hilco.

For the 309.9-acre parcel, we find a value of $9,400 per acre and a total value of $2,913,060. We find Hilco's valuation of $8,600 to be reasonable by and large. In determining that a slight increase is appropriate, we pay particular heed to the adjusted values of the 2016 sale in Tuxedo, which Hilco deemed to be the strongest comparable, and the 2010 sale in Ramapo. Nor do we second-guess Hilco's decision to exclude the Sterling sale from consideration. The property involved in that sale bears limited topographical similarities to the parcel at issue, and the sale came after approvals had already been procured. We are unconvinced that the Sterling sale is comparable, as evidenced by Mr. Fader's decision to apply a material discount when attempting to use it.

Combining the values we have found produces a fair market value of $5,227,060 for the 425.5 acres sold to Ramapo. Our conclusion as to valuation is broadly consistent with other evidence in the record, including (1) the 1998 purchase price of $3,500,000 for the entirety of the property, (2) the 2008 appraisals obtained by New York valuing the parcel ultimately sold to Ramapo at $3,400,000 and $2,900,000, and

(3) Mr. Fader's 2011 appraisal valuing the 425.5 acres at $5,845,000. The $10,472,000 value stated on Holdings' 2010 tax return thus constitutes a substantial valuation misstatement as it exceeds 150% of the value we have determined.[17] *See* I.R.C. §6662(e)(1)(A).

2. Reasonable Cause

Under section 6664(c)(1), in general "[n]o penalty shall be imposed under section 6662 . . . with respect to any portion of an **[*35]** underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." "Reliance on professional advice may constitute reasonable cause and good faith. . . ." *Evans v. Commissioner*, T.C. Memo. 2010-207, 2010 WL 3735709, at *10. A taxpayer's reliance on professional advice constitutes reasonable cause where (1) the adviser on which the taxpayer relied was a competent professional with sufficient experience to justify the reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment. *Neonatology Assocs.*, 115 T.C. at 99; *Evans v. Commissioner*, 2010 WL 3735709, at *10.

Heightened requirements apply to the reasonable cause exception for valuation overstatements with respect to property for which a deduction has been claimed under section 170: (1) the value of the property must be based on a qualified appraisal made by a qualified appraiser and (2) the taxpayer must have made a good faith investigation into the value of the contributed property. I.R.C. §6664(c)(3); *McGrady v. Commissioner*, T.C. Memo. 2016-233, at *54-55; *Costello*, T.C. Memo. 2015-87, at *35-36; *Esgar Corp. v. Commissioner*, 2012 WL 371809, at *23; Treas. Reg. § 1.6664-4(h)(1). The qualified appraisal required for purposes of section 6664(c)(3)(A) is the same as under section 170(f)(11). I.R.C. §6664(c)(4)(B); *Costello*, T.C. Memo. 2015-87, at *37.

Treasury Regulation § 1.170A-13(c)(3)(ii) sets out the requirements for qualified appraisals. *See* I.R.C. §170(f)(11)(E)(i); *Cave Buttes*, 147 T.C. at 348. Qualified appraisals must include, inter alia, the "terms of any agreement or understanding entered into (or expected to be entered into) by or on behalf of the donor or donee that relates to the use, sale, or other disposition of the property contributed." Treas. Reg. § 1.170A-13(c)(3)(ii)(D). This requirement extends to any agreement that "[r]eserves to, or confers upon anyone (other than a donee organization or an organization participating with a donee organization in cooperative fundraising) any right . . . to the possession of the property." *Id.* subdiv. (ii)(D)(*2*). This information "enables the IRS to determine whether the appraiser took restrictions on the disposition of the contributed property into account when appraising it." *Alli v. Commissioner*, T.C. Memo. 2014-15, at *25.

[*36] Neither appraisal on which Holdings based its valuation satisfied the qualified appraisal requirements.[18] *See* I.R.C. §6664(c)(3); *see also Costello*, T.C. Memo. 2015-87, at *35-36; Treas.

Reg. § 1.170A-13(c)(5)(iii) ("If the donor uses the appraisal of more than one appraiser, . . . each appraiser shall comply with the requirements of [Treasury Regulation § 1.170A-13(c)]. . . ."). The appraisals failed to include the terms of either the settlement agreement or Ramapo's agreement with New York to sell three lots, both of which "relate[ ] to the use, sale, or other disposition of the property contributed." *See* Treas. Reg. § 1.170A-13(c)(3)(ii)(D).[19]

To be more specific, the land purchase agreement provides that "th[e zoning] lawsuit is being settled as part of the conveyance of the [p]roperty from [Holdings] to the Town of Ramapo." In a later section entitled "Subject to Court Approval and Settlement," the agreement specifies that the sale was "contingent on the settlement of" the zoning litigation "and the entry by the Court of an Order which shall include the subdivision of the property in substantial conformity with the proposed order appended hereto." Likewise, the land purchase agreement provided that Ramapo's "obligation hereunder is expressly conditioned upon the execution and all necessary approvals of the contract of sale between" Ramapo and New York and stated that it would be "null and void" if the agreement between Ramapo and New York was not executed.

"Information concerning such agreements is essential to enable the IRS to evaluate . . . whether the donors have received or will receive something in exchange for their gift." *Costello*, T.C. Memo. 2015-87, at *19; *see also Alli*, T.C. Memo. 2014-15, at *26. Although the cover letter to Mr. Fader's appraisal report indicates that he was provided the contract of sale between Holdings and Ramapo, the appraisal neither attached nor described the terms of the land purchase agreement, the settlement agreement, or the Ramapo-New York agreement. Mr. Zdunczyk went a bit further, including the land purchase agreement as **[*37]** an attachment to his appraisal. The Braens argue that this suffices as the land purchase agreement references both the settlement agreement and the agreement between Ramapo and New York, but the land purchase agreement does not set forth the terms of the other agreements and thus cannot cure the omissions in Mr. Zdunczyk's appraisal. *See* Treas. Reg. § 1.170-13A(c)(3)(ii)(D).

Holdings thus did not strictly comply with the qualified appraisal requirements. The Braens contend, however, that any shortcomings are excused by the substantial compliance doctrine. *See Kaufman v. Shulman*, 687 F.3d 21, 29 (1st Cir. 2012) (noting that substantial compliance can be used to "forgive minor discrepancies"), *vacating in part and remanding* 136 T.C. 294 (2011), *and* 134 T.C. 182 (2010).

The "key question" for substantial compliance "is whether the requirements [at issue] relate 'to the substance or essence of the statute.'" *Loube v. Commissioner*, T.C. Memo. 2020-3, at *17 (quoting *Bond v. Commissioner*, 100 T.C. 32, 41 (1993)). If they do, "strict adherence to the statutory and regulatory requirements is mandatory," and substantial compliance does not apply. *Id.* at *17-18. This "doctrine 'should not be liberally applied'" and is no "substitute for missing entire categories of content." *Costello*, T.C. Memo. 2015-87, at *23-24 (first quoting *Alli*, T.C. Memo. 2014-15, at *54; and then quoting *Hendrix v. United States*, No. 2:09-cv-132, 2010 WL 2900391, at *5 (S.D. Ohio July 21, 2010)); *see Chiarelli v. Commissioner*, T.C. Memo. 2021-27, at *17-18; *Brannan Sand & Gravel Co. v. Commissioner*, T.C. Memo. 2020-76, at *17-18. "[R]ather, it is at most a means of accepting a nearly complete effort that has simply fallen short in regard to minor procedural errors or relatively unimportant clerical oversights." *Costello*, T.C. Memo. 2015-87, at *23-24 (quoting *Hendrix*, 2010 WL 2900391, at *5).

The omissions here "were not trivial, formal, or mechanical." *Costello*, T.C. Memo. 2015-87, at *19. The requirement to set forth terms relating "to the use, sale, or other disposition of the property contributed," Treas. Reg. § 1.170A-13(c)(3)(ii)(D), goes to the IRS's evaluation of whether the taxpayer received anything of value as part of a sale, *see Costello*, T.C. Memo. 2015-87, at *19; *Smith v. Commissioner*, T.C. Memo. 2007-368, 2007 WL 4410771, at *20, *aff'd*, 364 F. App'x 317 (9th Cir. 2009); *see also RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1, 16-17 (2017) (framing substantial compliance as focusing on whether the donor provided sufficient information to permit the IRS to evaluate the reported contribution), *aff'd sub nom.* **[*38]** *Blau v. Commissioner*, 924 F.3d 1261 (D.C. Cir. 2019). This issue is at the very heart of the matter. *See Hewitt v. Commissioner*, 109 T.C. 258, 265 (1997), *aff'd*, 166 F.3d 332 (4th Cir. 1998); *Bond*, 100 T.C. at 41. We thus conclude that the doctrine of substantial compliance does not apply. *See* I.R.C. §6664(c)(3)(A).

The Braens finally argue that any failure to comply with the qualified appraisal requirements should be excused for reasonable cause under section 170(f)(11)(A)(ii)(II). But this defense does not apply in the context of section 6664(c)(3). *See Gorra v. Commissioner*, T.C. Memo. 2013-254, at *62. Section 6664(c)(3) provides an *additional* requirement applicable to substantial valuation overstatements, on top of the ordinary reasonable cause requirements. *See Costello*, T.C. Memo. 2015-87, at *35-36; Treas. Reg. § 1.6664-4(h)(1), (3). Applying the reasonable cause defense to the qualified appraisal requirement under section 6664(c)(3)(A) would thus render the additional requirement meaningless.

We therefore conclude that the Braens are liable for the substantial valuation misstatement penalties and are not entitled to the reasonable cause defense under section 6664(c)(3).

C. Section 6651(a)(1) Addition to Tax

Section 6651(a)(1) imposes an addition to tax for the failure to timely file a required return unless the taxpayer establishes that such failure was due to "reasonable cause and not due to willful neglect." *United States v. Boyle*, 469 U.S. 241, 243 (1985); *Williams v. Commissioner*, T.C. Memo. 2022-7, at *4. Although Samuel and Maureen Braen were required to file their 2010 return by October 15, 2011, they did not sign that return until December 7, 2011, and accordingly filed their return late.

The Braens contend that "[t]he facts . . . establish that to the extent" Samuel and Maureen's return was filed late, "there was reasonable cause and any such penalty should be excused." The Braens fail to identify any reasonable cause, and we thus find Samuel and Maureen Braen liable for the determined section 6651(a)(1) addition to tax for their 2010 tax year.

IV. Conclusion

For the reasons explained above, none of the Braens is entitled to any charitable contribution deduction. The Braens are also liable for a **[*39]** substantial valuation misstatement penalties under section 6662(b)(3) and (e), and Samuel and Maureen Braen are additionally liable for the determined section 6651(a)(1) addition to tax.

To reflect the foregoing,

Decisions will be entered under Rule 155.

FOOTNOTES

[1]Cases of the following petitioners are consolidated herewith: Samuel Braen III and Maureen Braen, Docket No. 27002-17; Scott Braen and Cielo Destafano Braen, Docket No. 27003-17; Dirk Braen and Kerry Lynn Braen, Docket No. 27013-17, Darren Magarro and Samantha L. Braen, Docket No. 27017-17; Joshua Braen, Docket No. 169-18; and Eugene Csipkay and Kathleen Csipkay, Docket No. 195-18.

[2]Throughout the pleadings in these cases (including in the stipulation), the parties have referred to the total acreage at issue as approximately 505 acres. Although the parties appear to overstate the size of the property by an acre, we will follow their convention for sake of clarity.

[3]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C. (I.R.C. or Code), in effect at all relevant times, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[4]A subchapter S corporation is a "small business corporation for which an election under section 1362(a)" has been made. I.R.C. §1361(a)(1). S corporations are afforded special treatment under the Code. "One of the benefits of S corporation tax status is that income earned by the entity escapes corporate-level taxation." *Mourad v. Commissioner*, 121 T.C. 1, 3 (2003), *aff'd*, 387 F.3d 27 (1st Cir. 2004). "Thus, an S corporation's income passes through the entity and is, generally, taxed only at the shareholder level on a pro rata basis." *Id.; see* I.R.C. §§1363, 1366.

[5]In addition to Holdings, the Braens acted through other corporate entities, including Stone Industries, Inc., a wholly owned subsidiary of Holdings, and Ramapo Mountain Land Co., which was formed in 1996 to facilitate this deal. The distinctions between these family entities are not meaningful for purposes of these cases, and, for simplicity's sake, we will refer to the actions of all the family's entities as those of Holdings.

[6]A "positive declaration" is a determination of the DEC that an action at issue is likely to have potential impacts on the environment. *See State Environmental Quality Review Act (SEQR)*, N.Y. State Dep't of Env't Conservation, https://www.dec.ny.gov/permits/357.html (last visited Apr. 21, 2023).

[7]The Environmental Protection Agency (EPA) designates "Superfund" sites as those contaminated with hazardous substances, for which the EPA has authority to impose the cost of cleanup on responsible parties or to provide funds for cleanup when there is no viable responsible party. *What is Superfund?*, U.S. Env't Prot. Agency, https://www.epa.gov/superfund/what-superfund (last updated Nov. 1, 2022).

[8]Under New York regulations, "[a] project sponsor may request the regional permit administrator [from DEC] to conduct a conceptual review of the substantive consistency of the project . . . with current State environmental policy and standards." N.Y. Comp. Codes R. & Regs. Tit. 6, §621.15(a) (2006). DEC's postconceptual review decision "is not a permit" but "intended to provide potential applicants with a binding decision from the department as to the general acceptability of a proposed project or any component or issue specified." *Id.* subdiv. (j).

[9]The Braens argue that Ramapo's decision to settle the lawsuit indicates that it knew it would lose the zoning litigation. Any number of reasons might spur a party to settle a lawsuit, and we will not speculate as to motivations. *See Holmes v. Godinez*, 991 F.3d 775, 783 (7th Cir. 2021) ("Settlements are compromises in which the parties . . . sacrifice some goals to achieve others and to resolve a dispute without the expense of future litigation."); *RFF Fam. P'ship, LP v. Ross*, 814 F.3d 520, 530 (1st Cir. 2016) ("[A] settlement is born of compromise."); *Nault v. United States*, 517 F.3d 2, 6 (1st Cir. 2008) ("Parties to a settlement, almost by definition, eschew the possibility of obtaining some portion of what they would like in exchange for certain terms with which they can live.").

[10]Given the Braens' failure to establish the value of the consideration received and to supply a contemporaneous written acknowledgment, we need not address the other issues that might justify disallowance of the deductions. *See Triumph*, T.C. Memo. 2018-65, at *30; *Boone*, T.C. Memo. 2013-101, at *22.

[11]Section 6751(b)(1) does not apply to any addition to tax under section 6651, as was determined against Samuel and Maureen Braen. *See* I.R.C. §6751(b)(2)(A).

[12]We recognize that there is a split among circuits as to whether written supervisory approval must be obtained before the IRS issues a notice of deficiency, *Chai v. Commissioner*, 851 F.3d at 221, or merely before the assessment, *Kroner v. Commissioner*, 48 F.4th 1272, 1278-79 (11th Cir. 2022), *rev'g in part* T.C. Memo. 2020-73; *see also Laidlaw's Harley Davidson Sales, Inc. v. Commissioner*, 29 F.4th 1066, 1074 (9th Cir. 2022) (holding that section 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"), *rev'g and remanding* 154 T.C. 68 (2020).

Appeal of these cases would presumably lie in the U.S. Court of Appeals for the Third Circuit. I.R.C. §7482(b)(1)(A); *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). *Golsen* stands for the proposition that this Court will apply the decision of the court of appeals that is "squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone" and, as a corollary, that this Court's own views will be given effect to the extent the relevant court of appeals has not expressed one. *See Golsen*, 54 T.C. at 757. The Third Circuit does not appear to have taken a clear stance on the section 6751(b)(1) issue.

[13]"Only one accuracy-related penalty may be applied with respect to any given portion of an underpayment, even if that portion is subject to the penalty on more than one of the grounds set forth in section 6662(b)." *Sampson v. Commissioner*, T.C. Memo. 2013-212, at *7-8 (citing *New Phoenix Sunrise Corp. v. Commissioner*, 132 T.C. 161, 187 (2009), *aff'd*, 408 F. App'x 908 (6th Cir. 2010)). Consequently, we will not determine whether the Braens are liable for penalties for negligence or substantial understatements of tax. We note that, were we to do so, our analysis of reasonable cause would be governed by different standards, which might well yield a different conclusion. *See Whitehouse Hotel Ltd. P'ship v. Commissioner*, 755 F.3d 236, 249 (5th Cir. 2014), *aff'g in part, vacating in part and remanding* 139 T.C. 304 (2012); *Rogerson v. Commissioner*, T.C. Memo. 2022-49, at *35; *Clary Hood, Inc. v. Commissioner*, T.C. Memo. 2022-15, at *54-55, *aff'd in part, vacated in part, and remanded*, 69 F.4th 168 (4th Cir. 2023); *Rawls Trading, L.P. v. Commissioner*, T.C. Memo. 2012-340, at *35-37.

[14]Given our conclusion that the highest and best use of the property was not quarrying, we will not further consider Mr. Zdunczyk's mineral appraisal. *See Glade Creek*, T.C. Memo. 2020-148, at *37 (noting that an expert's valuation "is of little relevance" where the expert adopted a different highest and best use from the Court's).

[15]Although Mr. Fader's expert report also provides a valuation based on a highest and best use under the assumption that the Ramapo portion of the property would be zoned industrial, he affirmed both during cross and redirect examination that "it was [his] opinion that the highest and best use was as residential."

[16]Mr. Fader also included a valuation of $5,635,000, treating the 425.5 acres as one parcel of property. Mr. Fader, however, stated his "opinion that a two-parcel valuation will reflect a

more accurate market value of the property address in this report," and we will thus focus on the valuation he deems more accurate.

[17]We note in passing that, even if we were to endorse the highest nonquarry value endorsed by Mr. Fader in his report, i.e., $6,840,000, the value on Holdings' 2010 tax return would constitute a substantial valuation misstatement.

[18]The Braens contend that Holdings reasonably relied upon the advice offered by McGladrey. The Braens fail to offer convincing support for the proposition that interposing an accounting firm to offer a reconciliation of underlying appraisals insulates the appraisals from the requirements of section 6664(c)(3).

[19]We further note that the agreement between Ramapo and New York "confer[red] upon" New York a "right . . . to the possession of the property." *See* Treas. Reg. § 1.170A-13(c)(3)(ii)(D)(2). Holdings does not argue that New York was an "organization participating with a donee organization in cooperative fundraising," so we do not address that possibility. *Id.*

END FOOTNOTES

Monday, July 31, 2023

Lesson From The Tax Court: *An Object Lesson On Adequate Business Records*

By Bryan Camp

*[Author's Note: this past week I joined the 77.5% of Americans who been infected with COVID. So tired .... zzzzz ** what? So this week's lesson may reflect my COVID-fogged brain. If you find more errors than usual, I humbly apologize and promise to do better next week.]*

Some of my Lessons From Tax Court address substantive tax rules. Some are about practice and procedure. Today we have an object lesson: when a taxpayer has a bona fide business but fails to keep adequate records of their business activity, bad things happen.

We all know that taxpayer's need good records to substantiate claimed deductions. *See e.g.* Lesson From The Tax Court: *Receipts Are Not Enough*, TaxProf Blog (Sept. 21, 2020).

This week we also learn that: (1) the failure to keep records allows the IRS to use the bank deposits method to determine income and (2) the same failure also gives the IRS a slam-dunk basis to impose §6662(a) accuracy-related penalties.

The case is *Greg A. Ninke and Jane M. Ninke v. Commissioner*, T.C. Memo. 2023-88 (July 19, 2023) (Judge Halpern). Again, nothing really new here. But it's a useful object lesson. Details below the fold.

Law: Bad Records Leads To IRS Reconstruction of Income

Section 6001 creates the duty to keep decent records. Treas. Reg. 1.6001-1(a) explains further: taxpayers must *"keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown by such person in any return of such tax or information."*

Revenue Agents (RAs) are directed to start their examination of income items by looking at the taxpayer's own records *See* IRM 4.10.4.3.3. Sure, part of these records are bank records, but RA's use them only to reconcile with the taxpayers own business records. IRM 4.10.4.3.7 Put another way, the RA will first attempt to find *direct* evidence of income and expenditures using the taxpayer's records as the basic source of information.

But sometimes the RA finds that a taxpayer either has no records that support asserted income and deduction items, or has really sucky records that practically scream "we're bogus!" In those situations, RA's are authorized to use *indirect* methods to determine unreported income. IRM 4.10.4.6.2.1. The RA can choose from a number of indirect methods, listed in IRM 4.10.6. Perhaps the most common of those indirect methods is the bank deposits method.

The IRM says RAs can use a bank deposits method when, among other things, *"the taxpayer's books and records are unreliable, unavailable, withheld, or incomplete,"* and *"the taxpayer makes periodic deposits of funds into bank account(s) which appear to be generated from an income-producing activity."* IRM 4.10.4.6.4.2. The Tax Court has long held that bank deposits analyses can be a legitimate tool to identify unreported income. *See Hague Estate v. Commissioner*, 132 F.2d 775 (2d Cir. 1943), aff'g 45 B.T.A. 104 (1941); *Estate of Mason v. Commissioner*, 64 T.C. 651, 656 (1975), aff'd 566 F.2d 2 (6th Cir. 1977).

An RA using a bank deposits method will not only look at regular old-fashioned bank accounts, but will also look for other sources of stored value, such as prepaid debit cards or peer to peer payment systems. The RA identifies all deposits, then subtracts from that any identifiable nontaxable sources of deposits, such as transfers from other accounts or Social Security disability payments or documented gifts.

What makes the bank deposit method difficult for taxpayers is the presumption that all deposits are income. It is totally up to the taxpayer to prove the nontaxable nature of any deposit. *Parks v. Commissioner*, 94 T.C. 654, 658 (1990). When you don't keep records, or your records suck, that can be tricky.

What constitutes inadequate records can be squishy. *See e.g. Westby v. Commissioner*, T.C. Memo. 2004-179 (2004) (rejecting "simplistic bank deposits analyses" in light of contemporaneous handwritten ledgers and bank statements taxpayer provided to her return preparer to prepare return). Still, ya gotta have *something* to rebut a bank deposits analysis.

Law: Bad Records Leads to Negligence Penalty

Section 6662(a) imposes an accuracy-related penalty of 20% of any underpayment of tax when that underpayment arises from one of a number of listed causes listed in §6662(b). Section 6662(b) that is caused by a variety of listed actions. The very first listed action is *"Negligence or disregard of rules or regulations."* §6662(b)(1).

For penalty purposes, negligence is broadly defined as *"**any** failure to make a reasonable attempt to comply with the provisions of this title...."* §6662(c) (emphasis supplied). Well, as we have seen, §6001 imposes the duty to keep adequate records! And Treas Reg. 1.6662-3(b) explicitly explains that *"Negligence also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly."*

Let's see how this all works out in the two cases.

Lesson 1: Inadequate Records Lead To Bank Deposit Analysis

The years at issue in *Ninke* were 2015, 2016, and 2017. In those years both Mr. and Ms. Ninke were involved in the porn business. He created websites and *"other forms of adult entertainment."* Op. at 3. For 2015 he also ran a publishing company. In 2016 and 2017 he also drove for Uber and Lyft. During 2017 Ms. Ninke worked as a model for one of Mr. Ninke's websites.

Each year the Ninkes filed returns. For all years they reported modest net profits from Mr. Nike's website business. For 2015 they reported minimal profit from Mr. Nike's publishing business. They did not report income from Ms. Nike's modeling nor does it appear they reported income from Mr. Nike's side hustle driving for Uber and Lyft. The Opinion does not say that explicitly but I infer it because the Opinion recites that they filed Schedule C's only for the porn stuff.

During the years at issue, the Ninkes *"had between 12 and 20 accounts at various banks..."* Op. at 3. They also maintained prepaid debit card accounts with various financial service companies such as Paxum and Netspend. Those accounts permitted peer to peer money transfers, like Paypal or Venmo. Ironically, one of the features touted for prepaid debit cards is that they simplify record-keeping. For example, Netspend's website says its card makes it *"easy to stay on top of your money with simple to use tools like Spending Tracker and Anytime Alerts."* Users of Paxum praise its ability to help them *"have full control over the statistics and income of my payments."* That's from this review website.

So the Ninkes had plenty of records of *account* transactions. And apparently they actively moved money around between various accounts. But when audited they had no records of their *business* activities to support the amount of income they reported. So the RA did a bank deposits analysis. Judge Halpern explains the process, which might be of interest to those readers unfamiliar with how the IRS does it:

"RA Smith conducted a bank deposits analysis, comparing reported Schedule C receipts to bank deposits. He treated the prepaid debit card accounts as if they were checking accounts. He reviewed the account statements that petitioners provided to him. He created spreadsheets, wherein he listed all deposits made in the respective accounts, identified the source of each deposit, and categorized each (i.e., transfer, deposit, loan, refund, adjustment, etc.). He then created a summary sheet for each year, on which he entered the year's deposits, subtracted deposits from identifiable nontaxable sources, e.g., bank-to-bank transfers, counter credits, and items such as Social Security disability payments, and compared the difference with the gross income petitioners reported for the year. For each year, the difference exceeded petitioners' reported gross income, and he treated the difference as unreported gross receipts from petitioners' Schedule C businesses."

The Ninkes did not agree with RA Smith's analysis and petitioned Tax Court. In Court they argued that RA Smith failed to account for transfers from a bunch of *other* accounts...that they had not disclosed until Tax Court! *"Petitioners conceded at trial at least eight bank accounts or prepaid debit card accounts for which they had provided no information to RA Smith."* Op. at 9. *"They spend approximately half of their brief listing individual cash deposits and withdrawals from their bank accounts and prepaid debit card accounts during the years at issue. They show deposits totaling $28,550 and withdrawals totaling $44,639."* Id.

Their overall argument was that their total withdrawals each year exceeded their total deposits. So that meant they could not possibly have had any unreported income.

I confess I don't follow that last argument. Just because you spend more than you deposit does not somehow make the deposits not income. Heck, my son does that on a regular basis!

At any rate, Judge Halpern teaches us the lesson: it's not enough to show a bunch of financial records. To refute a bank deposits analysis, he explained, the Ninkes needed "to tie deposits that respondent had not treated as coming from an excludable source to a transfer or a withdrawal from an account previously identified to respondent. ... Showing that cash withdrawals exceeded cash deposits for the years at issue does not prove that any deposit was of cash withdrawn from the same account or any other account of petitioners. And ... their introduction at trial of...bank accounts and prepaid debit card accounts that they had not disclosed to RA Smith raises the possibility of unreported income." Op. at 12.

Bottom Line: Failure to keep adequate business records may trigger a bank deposits audit, the results of which will always put the taxpayer into a hole of having to prove a negative: that each deposit was *not* income. But that's a hole of the taxpayer's own making.

Lesson 2: Bad Records Lead To Accuracy-Related Penalties

The fact that the Ninkes had no business records also created an additional problem for them. It subjected them to the §6662(a) accuracy-related penalty. Judge Halpern notes that their failure creates *"a prima facie case for the accuracy-related penalties on the grounds that, for each year at issue, petitioners' underpayment of tax resulted from negligence."* Op. at 14.

The Ninkes were now on the hook to show some reasonable cause for their underpayments. They could not. They thew up the argument that they relied on third party information returns to report their income. It did not stick. Judge Halpern writes *"Petitioners ignore that RA Smith found unreported income for each year at issue well in excess of cash deposits that petitioners claim were redeposits of transfers or withdrawals from their various bank accounts and prepaid debit card accounts."* Op. at 15.

Bottom Line: The lack of adequate business records to refute the bank deposits analysis also undermines any attempt to show a reasonable cause for a resulting underpayment.

An object lesson for us and for our clients.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/07/lesson-from-the-tax-court-an-object-lesson-on-adequate-business-records.html

Tax Court Finds Couple Underreported Business Income

JUL. 19, 2023

Greg A. Ninke et al. v. Commissioner

GREG A. NINKE AND JANE M. NINKE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed July 19, 2023

Ps failed to keep appropriate business records, and R employed a bank deposits analysis to determine Ps' unreported business income. R accepted that some cash deposits were from excludable sources because it was clear that deposited cash was transferred from, or had been withdrawn from, another of Ps' accounts. Ps argue that, because PH did not receive cash payments in his business and Ps' cash withdrawals exceeded their cash deposits, all cash deposits should be assumed to be from an excludable source. Ps had at least eight accounts for which they provided no statements to R during his examination of their returns. Ps have not traced any contested cash deposit to an excludable source.

Held: Ps failed to prove error in R's bank deposits analysis.

Held, further, accuracy-related penalties sustained.

Greg A. Ninke and Jane M. Ninke, pro sese.

Zachary B. Friedman, *Rachael J. Zepeda*, and *Ashleigh R. Wise Friedman*, for respondent.

[*2] MEMORANDUM FINDINGS OF FACT AND OPINION

HALPERN, *Judge*: By notice of deficiency dated February 5, 2020, respondent determined deficiencies in, and accuracy-related penalties with respect to, petitioners' federal income tax as follows:

Year	Deficiency	Penalty §6662(a)[1]
2015	$26,260	$5,252
2016	11,500	2,300
2017	14,060	2,812

The parties have filed a Stipulation of Settled Issues. The issues for decision are: (1) whether, and the extent to which, for each of the years at issue, petitioners underreported their gross receipts from business and (2) whether, for each of those years, they are liable for an accuracy-related penalty. Other unsettled issues are computational, and we need not address them here.

FINDINGS OF FACT

Preliminary Statement

Before making our findings of fact, we pause to address petitioners' failure to comply with Rule 151, which addresses briefs. We conducted a trial in this case, and, at its conclusion, we ordered the parties to file briefs, setting a schedule for seriatim briefs. Rule 151(e)(3) requires that an opening brief contain proposed findings of fact in the form of numbered concise statements of essential fact, each statement supported by reference to the pages of the transcript or the exhibits or other sources relied on in support of the proposed finding. The Rule directs that proposed findings precede both the points on which the party relies and the party's argument. Petitioners' Seriatim Opening Brief does contain proposed findings of fact in numbered statements. It violates the Rule, however, in that it does not **[*3]** support those statements with references to transcript pages or Exhibits.

Rule 151(e)(3) also requires that, in an answering or reply brief, a party "set forth any objections, together with the reasons therefor, to any proposed findings of any other party." Respondent filed his Seriatim Answering Brief, making 108 proposed findings of fact, and petitioners asked for, and were granted, leave to file their Seriatim Reply Brief. However, they filed no reply brief. Because petitioners have failed both to provide us with useable findings of fact and to object to respondent's proposed findings, we must conclude that they have conceded respondent's proposed findings of fact as correct except to the extent unsupported by, or inconsistent with, evidence in the record. *See, e.g., Jonson v. Commissioner*, 118 T.C. 106, 108 n.4 (2002), *aff'd*, 353 F.3d 1181 (10th Cir. 2003).

Stipulation

The parties have stipulated certain facts and the authenticity of certain documents. The facts stipulated are so found, and the documents stipulated are accepted as authentic.

Residence

When petitioners filed the Petition, they resided in Tempe, Arizona.

Petitioners' Businesses

During all years at issue, Mr. Ninke operated Tanner Media Productions, which provided pornographic websites and other forms of adult entertainment. During 2015, he operated an electronic book publishing business under the name Tanner Media Publishing. During 2016 and 2017, he had an Uber and Lyft driving business. During 2017, Mrs. Ninke worked as a model for one of her husband's websites.

Petitioners' Bank Accounts and Prepaid Debit Card Accounts

During the years at issue, petitioners had between 12 and 20 accounts at various banks, including Bank of America, E*Trade, Paxum, Salliemae, SunTrust Bank, US Bank, and TCF National Bank. Petitioners also maintained prepaid debit card accounts at financial service providers, including Paxum, FirstChoicePay/Payoneer, and NetSpend. Mr. Ninke received at least some payments for his **[*4]** businesses by way of direct bank deposits and additions to one of his prepaid debit cards.

Petitioners' Returns

For the years at issue, petitioners made joint income tax returns on Forms 1040, U.S. Individual Income Tax Return. For each of those years, they included with Form 1040 one or more Schedules C, Profit or Loss From Business. For each year, they included a Schedule C for Tanner Media Productions (Schedule C-1). For 2015, they included a Schedule C for Tanner Media Publishing (Schedule C-2). During 2017, Ms. Ninke received gross receipts from her modeling business, but petitioners did not report any income from that business on their 2017 return. The parties refer to respondent's adjustment for unreported gross receipts for Ms. Ninke's modeling business as the "Schedule C-3" adjustment (and so shall we).

2015 Return, Schedules C-1 and C-2[2]

On the 2015 Schedule C-1, petitioners reported gross receipts of $191,121, expenses of $175,261, a separately listed expense of $1,939 for business use of their home, and a net profit of $13,921. On the 2015 Schedule C-2, they reported gross receipts of $543, expenses of zero, and a net profit of $543.

2016 Return, Schedule C-1

On the 2016 Schedule C-1, petitioners reported gross receipts of $66,847, expenses of $66,240, and a net profit of $607.

2017 Return, Schedule C-1

On the 2017 Schedule C-1, petitioners reported gross receipts of $20,728, expenses of $16,582, and a net profit of $4,146.

[*5] Respondent's Examination

Respondent examined petitioners' returns for the years at issue. Revenue Agent (RA) Ian Smith conducted the examination. Petitioners did not maintain proper records for their Schedule C businesses. To determine whether petitioners had reported all receipts from those businesses, RA Smith conducted a bank deposits analysis, comparing reported Schedule C receipts to bank deposits. He treated the prepaid debit card accounts as if they were checking accounts. He reviewed the account statements that petitioners provided to him. He created spreadsheets, wherein he listed all deposits made in the respective accounts, identified the source of each deposit, and categorized each (i.e., transfer, deposit, loan, refund, adjustment, etc.). He then created a summary sheet for each year, on which he entered the year's deposits, subtracted deposits from identifiable nontaxable sources, e.g., bank-to-bank transfers, counter credits, and items such as Social Security disability payments, and compared the difference with the gross income petitioners reported for the year. For each year, the difference exceeded petitioners' reported gross income, and he treated the difference as unreported gross receipts from petitioners' Schedule C businesses.

2015 Adjustments

RA Smith determined 2015 Schedule C–1 unreported gross receipts of $20,132, which he computed as follows:

Schedule C–1 bank deposits	$408,830
Plus: FirstChoicePay deposits	4,367
Plus: NetSpend deposits	4,685
Total Schedule C–1 deposits	**$417,882**
Less: Excludable deposits	203,329
Less: Bills.Com and NetSpend adjustments	3,300
Total taxable Schedule C–1 deposits per exam	**$211,253**
Less: Schedule C–1 receipts per return	191,121

Schedule C-1 adjustment	**$20,132**

[*6] RA Smith determined 2015 Schedule C-2 unreported gross receipts of $2,052, which he computed as follows:

Schedule C-2 bank deposits	$2,595
Less: Schedule C-2 receipts per return	543
Schedule C-2 adjustment	**$2,052**

In total, RA Smith made 2015 Schedule C adjustments of $22,184, computed as follows:

Schedule C-1 adjustment	$20,132
Schedule C-2 adjustment	2,052
Schedule C adjustments	**$22,184**

The parties stipulate that an additional $3,190 of deposits is excludable 2015 Schedule C-1 deposits, which they further stipulate reduces RA Smith's 2015 Schedule C-1 adjustment to $16,942. They stipulate the following 2015 Schedule C gross receipts in dispute:

Schedule C-1 adjustment	$16,942
Schedule C-2 adjustment	2,052

Total	**$18,994**

On brief, respondent does not mention the stipulated $3,190 of additional Schedule C–1 excludable deposits. However, he concedes "additional" 2015 Schedule C–1 excludable deposits of $4,540. Respondent proposes that we find a 2015 Schedule C–1 adjustment of $15,592, which equals RA Smith's Schedule C–1 adjustment of $20,132 less $4,540 ($15,592 = $20,132 – $4,540). That would result in the following 2015 Schedule C gross receipts in dispute:

Schedule C–1 adjustment	$15,592
Schedule C–2 adjustment	2,052
Total	**$17,644**

Were we to subtract from RA Smith's Schedule C–1 adjustment of $20,132 both the stipulated $3,190 and the conceded $4,540 of additional excludable deposits, the resulting 2015 Schedule C–1 adjustment would be $12,402 ($12,402 = $20,132 – $3,190 – $4,540).

[*7] That would result in the following 2015 Schedule C gross receipts in dispute:

Schedule C–1 adjustment	$12,402
Schedule C–2 adjustment	2,052
Total	**$14,454**

2016 Adjustment

RA Smith determined 2016 Schedule C–1 unreported gross receipts of $24,595, which he computed as follows:

Schedule C–1 bank deposits	$185,730
Plus: FirstChoicePay deposits	16,370
Plus: NetSpend deposits	69
Total Schedule C–1 deposits	**$202,169**
Less: Excludable deposits	110,728
Total taxable Schedule C–1 deposits per exam	**$91,442**[3]
Less: Schedule C–1 receipts per return	66,847
Schedule C–1 adjustment	**$24,595**[4]

RA Smith did not determine any 2016 Schedule C–2 unreported deposits.

The parties stipulate that an additional $46 of deposits is excludable 2016 Schedule C–1 deposits, which they further stipulate reduces RA Smith's 2016 Schedule C–1 adjustment to $24,549.

On brief, as for 2015, respondent does not mention the stipulated additional $46 of excludable deposits but concedes "additional" 2016 excludable deposits of $46. Respondent proposes that we find a 2016 Schedule C–1 adjustment of $25,548 (apparently correcting the $1 math error in the stipulation).

Were we to subtract from RA Smith's Schedule C–1 adjustment of $24,594 both the stipulated and conceded adjustments of $46, the **[*8]** resulting Schedule C–1 adjustment would be $24,502 ($24,502 = $24,594 – $46 – $46).

2017 Adjustment

RA Smith determined 2017 Schedule C–1 unreported gross receipts of $29,642, which he computed as follows:

Schedule C–1 bank deposits	$109,080
Plus: FirstChoicePay deposits	9,507
Plus: NetSpend deposits	4,759
Total Schedule C–1 deposits	**$123,346**
Less: Excludable deposits	72,976
Total taxable Schedule C–1 deposits per exam	**$50,370**
Less: Schedule C–1 receipts per return	20,728
Schedule C–1 adjustment	**$29,642**

RA Smith did not determine any 2017 Schedule C–2 unreported deposits.

RA Smith determined 2017 Schedule C–3 unreported gross receipts of $3,784.

In total, RA Smith made 2017 Schedule C adjustments of $33,426.

Schedule C–1 adjustment	$29,642
Schedule C–3 adjustment	3,784
Schedule C adjustments	**$33,426**

The parties stipulate that an additional $1,387 of deposits is excludable 2017 Schedule C–1 deposits, which they further stipulate reduces RA Smith's 2017 Schedule C–1 adjustment to $28,255. They stipulate the following 2017 Schedule C gross receipts in dispute:

Schedule C–1 adjustment	$28,255
Schedule C–3 adjustment	3,784
Total	**$32,039**

On brief, as for 2015 and 2016, respondent does not mention the stipulated additional $1,387 of 2017 Schedule C–1 excludable deposits **[*9]** but concedes "additional" 2017 Schedule C–1 excludable deposits of $1,518. Respondent proposes that we find a 2017 Schedule C–1 adjustment of $28,124, which equals RA Smith's Schedule C–1 adjustment of $29,642 less $1,518 ($28,124 = $29,642 − $1,518). That would result in the following 2017 Schedule C gross receipts in dispute:

Schedule C–1 adjustment	$28,124
Schedule C–3 adjustment	3,784

Total	**$31,908**

Were we to subtract from RA Smith's Schedule C–1 adjustment of $29,642 both the stipulated $1,387 and the conceded $1,518 of additional excludable deposits, the resulting 2017 Schedule C–1 adjustment would be $26,737 ($26,737 = $29,642 – $1,387 – $1,518). That would result in the following 2017 Schedule C gross receipts in dispute:

Schedule C–1 adjustment	$26,737
Schedule C–3 adjustment	3,784
Total	**$30,521**

Penalties

RA Smith properly obtained written supervisory approval of an accuracy-related penalty for each year at issue.

Trial Exhibits

At trial, we received into evidence from petitioners lists of deposits that they believe respondent should have accepted as excludable deposits. Many of the deposits on petitioners' lists were among those respondent allowed while others petitioners sourced to bank accounts and prepaid debit card account statements that they had not identified to RA Smith. Petitioners conceded at trial at least eight bank accounts or prepaid debit card accounts for which they had provided no information to RA Smith.

[*10] OPINION

I. Introduction

To reiterate, the issues we must decide are (1) respondent's adjustments increasing petitioners' gross receipts from their Schedule C business activities and (2) the accuracy-related penalties.

II. Burden of Proof

Petitioners bear the burden of proof. *See* Rule 142(a).[5] Nevertheless, because this case involves unreported income, respondent must make a minimal evidentiary showing connecting petitioners with an alleged income-producing activity or demonstrate that they actually received unreported income. *See Walquist v. Commissioner*, 152 T.C. 61, 67 (2019). The requisite evidentiary foundation to connect a taxpayer with an income-producing activity is minimal and need not include direct evidence. *See, e.g., Banister v. Commissioner*, T.C. Memo. 2008-201, 2008 WL 3925877, at *2, *aff'd*, 418 F. App'x 637 (9th Cir. 2011).

Petitioners' Schedule C businesses provided a likely income-producing source for the disagreed cash deposits, and, in any event, for purposes of sustaining an adjustment in a notice of deficiency increasing gross income, a bank deposit is prima facie evidence of income. *Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). Respondent has carried his burden of connecting petitioners with an income-producing activity.

Respondent also bears the burden of production with respect to the penalties, which we discuss *infra*.

III. Unreported Income

A. Bank Deposits Analysis

Gross income includes "income derived from business." §61(a)(2). Taxpayers must maintain books and records sufficient to establish their income and expenses. §6001; Treas. Reg. § 1.6001-1(a). If they fail to **[*11]** do so, the Commissioner may reconstruct income through any reasonable method that clearly reflects income. §446(b); *Petzoldt v. Commissioner*, 92 T.C. 661, 693 (1989). This Court has long accepted the bank deposits method for this purpose. *Clayton v. Commissioner*, 102 T.C. 632, 645 (1994). The bank deposits method assumes all money deposited in a taxpayer's bank account during a given period constitutes either an item of gross income or a gross receipt. *See DiLeo v. Commissioner*, 96 T.C. 858, 868 (1991). If, however, the Commissioner has knowledge that a deposit is from an excludable source (e.g., is a gift) he must exclude it from his tally of taxable deposits. *See id.*

Because respondent believed that petitioners had not reported all income from their Schedule C businesses for the years at issue, and because they had not maintained proper business records, respondent's agent, RA Smith, conducted a bank deposits analysis, which resulted in his determination that petitioners had underreported their Schedule C income for each of the years at issue. Neither at trial nor on brief do petitioners challenge the accuracy of the account statements on which RA Smith relied.

B. Parties' Arguments

1. Petitioners' Argument

Petitioners identify as the only fault with respondent's bank deposits analysis his failure to treat as nontaxable transfers between bank accounts *all* cash deposits that they made during the years at issue. They spend approximately half of their brief listing individual cash deposits and withdrawals from their bank accounts and prepaid debit card accounts during the years at issue. They show deposits totaling $28,550 and withdrawals totaling $44,639. They ask us to find that Mr. Ninke's clients did not pay him in cash. That presumed fact, together with the excess of withdrawals over deposits, they argue, "strongly suggests that the deposits made by the petitioners was [sic] a transfer, made out of cash previously withdrawn by petitioners. There is no reasonable explanation for the cash deposits other than that the funds were being transferred." They concede that "respondent accepted that certain cash deposits were actually transfers, but only when . . . the cash deposit was close in time and/or in [an] amount [equal] to the prior withdrawal." They argue: "[R]espondent should not be allowed to arbitrarily decide whether the petitioner[s] deposited their cash withdrawal fast enough or in an amount close enough to the withdrawal."

[*12] 2. Respondent's Arguments

Respondent rejects petitioners' proposed finding that Mr. Ninke's clients did not pay him in cash as "uncorroborated, self-serving, and not supported by credible evidence." Respondent also rejects petitioners' claim that RA Smith acted arbitrarily in treating only some cash deposits as excludable deposits. He points out that, despite petitioners' lack of records, RA Smith treated as deposits from excludable sources deposits that he could associate with a withdrawal shown on a bank account statement provided to him by petitioners. Respondent adds that, in support of their claim that *all* cash deposits to their bank accounts were no more than nontaxable transfers from other of their accounts, they rely in part on claimed withdrawals from bank accounts and prepaid debit accounts for which they provided no statements to RA Smith (and which did not figure into his tally of bank deposits). With post-examination adjustments to be discussed, respondent claims that RA Smith did not err in his bank deposits analysis.

C. Discussion

Petitioners' burden is to identify additional cash deposits from excludable sources beyond the deposits accepted as such by RA Smith. Their claim is that all cash deposits during the years at issue were transfers from one or another of their bank accounts. It is well settled that we need not accept a taxpayer's self-serving testimony when the taxpayer fails to present credible, corroborative documentary evidence. *See, e.g., Shilgevorkyan v. Commissioner*, T.C. Memo. 2023-12, at *7. At more than one point during the trial, we explained to petitioners that their task on brief would be to tie deposits that respondent had not treated as coming from an excludable source to a transfer or a withdrawal from an account previously identified to respondent. They have made no attempt to do so. Showing that cash withdrawals exceeded cash deposits for the years at issue does not prove that any deposit was of cash withdrawn from the same account or any other account of petitioners. And even were we to accept petitioners' claim that Mr. Ninke's clients did not pay him in cash, their introduction at trial of evidence of withdrawals from bank accounts and prepaid debit card accounts that they had not disclosed to RA Smith raises the possibility of unreported income (whether paid in cash or otherwise) deposited to undisclosed accounts, withdrawn as cash, and redeposited **[*13]** in accounts of which RA Smith did know. Such deposits would not ultimately be from an excludable source.

Petitioners have failed to carry their burden of showing cash deposits from excludable sources more than the cash deposits accepted as such by respondent.

Finally, we have the issue of the parties' stipulating additional Schedule C–1 excludable deposits of $3,190, $46, and $1,387 for 2015, 2016, and 2017, respectively, while, on brief, respondent — not mentioning those stipulations — concedes “additional” Schedule C–1 deposits of $4,540, $46, and $1,518 for those years. We resolve that discrepancy in petitioners' favor and assume that respondent means for each year that the sum of the two amounts be considered additional Schedule C–1 deposits from excludable sources.

We sustain positive adjustments to Schedule C gross receipts of $14,454, $24,502, and $30,521 for 2015, 2016, and 2017, respectively.

IV. Accuracy-Related Penalty

A. Introduction

Section 6662(a) and (b)(1) provides for an accuracy-related penalty of 20% of the portion of an underpayment of tax required to be shown on a return attributable to negligence or disregard of rules and regulations (without distinction, negligence). Section 6662(a) and (b)(2) provides for the same penalty on the portion of an underpayment of tax attributable to any substantial understatement of income tax. In the case of an individual, there is a substantial understatement of income tax for a year if the amount of the understatement exceeds the greater of (1) 10% of the tax required to be shown on the return for the tax year or (2) $5,000. §6662(d)(1)(A). Section 6664(c)(1) provides a reasonable cause exception to imposition of the section 6662(a) accuracy-related penalty on that portion of an underpayment for which it is shown that there was reasonable cause and the taxpayer acted in good faith.

Only one accuracy-related penalty may be applied with respect to any given portion of an underpayment even if that portion is subject to the penalty on more than one of the grounds set out in section 6662(b). Treas. Reg. § 1.6662-2(c).

[*14] B. Burden of Production

1. Introduction

The Commissioner bears a burden of production with respect to the accuracy-related penalty, including making a prima facie case that the section 6751(b)(1) requirement for written supervisory approval has been met. *E.g., DeCrescenzo v. Commissioner*, T.C. Memo. 2023-7, at *18. 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."

2. Penalty Approval

The parties stipulate, and we have found, that RA Smith properly obtained written supervisory approval of an accuracy-related penalty for each year at issue. Respondent has made a prima facie case with respect to the penalty approval required by section 6751(b)(1).

3. Grounds for the Penalty

Respondent has also made a prima facie case for the accuracy-related penalties on the grounds that, for each year at issue, petitioners' underpayment of tax resulted from negligence. Petitioners did not maintain proper records for their Schedule C businesses. Negligence includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. *See Diesel Country Truck Stop, Inc. v. Commissioner*, T.C. Memo. 2000-317, 2000 WL 1478654, at *17; Treas. Reg. § 1.6662-3(b)(1).

Respondent claims as an alternative basis for the accuracy-related penalty that petitioners substantially understated their income tax for the years at issue. We need not reach that question.

C. Burden of Proof

Respondent having met his burden of production with respect to the penalty, the burden of proof (viz, the risk of nonpersuasion) is with petitioners and includes the burden to prove any affirmative defense. *See, e.g., Fabian v. Commissioner*, T.C. Memo. 2022-94, at *38. Petitioners argue that they acted reasonably in reporting any income reported to them on information returns and did not believe that they **[*15]** had any additional cash receipts that were income. Petitioners ignore that RA Smith found unreported income for each year at issue well in excess of cash deposits that petitioners claim were redeposits of transfers or withdrawals from their various bank accounts and prepaid debit card accounts. Petitioners have failed to prove that there was reasonable cause for their underpayments and that they acted in good faith.

We sustain the accuracy-related penalties for the years at issue.

V. Conclusion

To reflect the foregoing,

Decision will be entered under Rule 155.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect for the years in question, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect for those years, and Rule references are to the Tax Court Rules of Practice and Procedure. All dollar amounts have been rounded to the nearest dollar.

[2]Petitioners filed their 2015 return on April 15, 2016. On or around June 7, 2016, petitioners amended their joint 2015 return, attaching an updated 2015 Schedule C–1. The updated 2015 Schedule C–1 reported increased gross receipts and expenses and a greater net profit. On or about October 12, 2017, petitioners amended their 2015 return a second time, attaching a further updated 2015 Schedule C–1, reverting to the information reported on the original 2015 Schedule C–1. Respondent appears not to have relied on the first amended return. We report the information on the identical first and third 2015 Schedules C–1.

[3]Sic: correctly, $91,441.

[4]Sic: correctly, $24,594.

[5]Petitioners have not raised the applicability of section 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that section 7491(a) does not apply here because petitioners have not produced evidence that they have satisfied the preconditions for its application. Indeed, we have found that petitioners failed to maintain proper records for their Schedule C businesses. Proper record keeping is a condition to the application of section 7491(a). *See* §7491(a)(2)(B).

END FOOTNOTES

TaxProf Blog

Monday, August 7, 2023

Lesson From The Tax Court: *Gotta Get Physical For Casualty Loss Deduction*

By Bryan Camp

Individuals generally cannot deduct casualty losses, at least through the end of 2025. §165(h)(5). But Congress continues to permit individual taxpayers to deduct casualty losses if they are attributable to a federally declared disaster. *Id.*

And we are having more and more disasters. Call it climate change, call it a banana, the brutal fact is that *"the number of natural disasters per year has increased significantly in recent years."* That quote is from this June 2023 Forbes Advisor article, which goes in to great detail explaining that conclusion. And there has been a corresponding increase in FEMA disaster declarations over time as well. *See* Congressional Research Services *"Stafford Act Declarations 1953-2016: Trends, Analyses, and Implications for Congress,"* (Aug. 28, 2017).

So today's lesson is still useful even if Congress never restores the general casualty loss deduction. In *Thomas K. Richey and Maureen P. Cleary v. Commissioner*, T.C. Memo. 2023-43 (Mar. 28, 2023) (Judge Holmes), we learn the basic, but vital, lesson that that a taxpayer must prove that some identifiable event caused actual physical damage to their property. Just because there is a storm and you then spend money on your property does not prove the storm caused damage to your property. In today's case the taxpayers reported casualty losses of some $820,000 for damages to their vacation home and boat. But they were unable to prove the claimed losses arose from a casualty event. Details below the fold.

Law: The Basics of Casualty Loss Deductions for Individuals

Section 165(c) permits individual taxpayers a deduction for losses resulting from *"fire, storm, shipwreck, or other casualty, or from theft."* Section 165(h)(5) says that after 2017 and until 2026 the casualty must also qualify as a federally declared disaster, which basically means you need a disaster declaration from FEMA.

To get the deduction, a taxpayer must first show they are entitled to it and then must prove amount. There are different rules for casualty losses to property used in a trade or business, but that's for a different lesson. This is just a short summary of the deduction rules for personal casualty losses incurred by individuals.

(1) Entitlement. The taxpayer must prove there was a casualty event. A casualty event is one that is sudden and unexpected. Storms fit the definition easily. Termite infestations do not; even if your discovery of termites is sudden and unexpected, why *they* have been around a while, munching away. *Dodge v. Commissioner*, 25 T.C. 1022 (1956).

The event must also cause actual physical damage. The classic example is *Pulvers v. Commissioner*, 407 F.2d 838 (9th Cir. 1969). There, a mudslide wiped away three nearby homes but did not physically damage the taxpayer's home. The taxpayers tried to take a casualty loss for the resulting decrease in fair market value. The courts said "no."

(2) Amount. Once a taxpayer establishes entitlement, they must then prove the proper amount of the deduction. I teach students to think of §165 as a capital recovery provision. It protects taxpayers from losing that which they have put into property, but no more. Thus the *upper limit* of the deduction is the taxpayer's basis in the property. Section 165(b) tells us that *"the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property."*

But the amount of loss might be less than basis. Treas. Reg. 1.165-7(b)(1) says the permitted deduction is the *lesser of* basis or loss of fair market value. And that is what confuses a lot of folks because figuring out the loss of fair market value can be tricky. The regulations give some good guidance on how to do that.

First, Treas.Reg. 1.165-7(a)(2)(i) says the taxpayer can prove loss of fair market value by a "competent appraisal" but then warns that such appraisal *"must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property."*

Second, Treas. Reg. 1.165-7(a)(2)(ii) permits taxpayers to use their cost of repairing actual physical damage as the measure of their fair market value loss. Still, the burden is on the taxpayer to show *"that (a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty."* In other words, while taxpayers can certainly use storm damage as an excuse to make improvements to their property, they cannot take a deduction for the costs of improvements, only for the cost of repairs and only because of the presumption that those repair costs represent the loss of fair market value.

Third, even once the taxpayer establishes the correct *amount* of loss (whether basis or change in fair market value), calculating the allowed *deduction* requires reducing that amount by a series of rules: **(a)** it must be reduced by any compensation for the loss either actually received *"by insurance or otherwise"* §165(a). If the taxpayer has insurance and fails to make a claim, then §165(h)(4)(E) denies the deduction completely; **(b)** individuals must reduce the amount by $100. §165(h)(1); and **(c)** while individuals can then offset any casualty gains by their losses, if they end up with net casualty losses, they may only deduct those to the extent the losses exceed 10% of their adjusted gross income. §165(h)(2).

There. I think that's all the relevant basic rules!

What confuses taxpayers is that regardless of how they try to establish a loss of fair market value, they must still link that to *actual physical damages*. As the Tax Court has said many times: *"The Code contemplates only a loss of capital, or, in other words, actual loss of tangible or measurable property. This does not encompass a failure of profits or the loss of potential income." Squirt Company v. Commissioner*, 51 T.C. 543 at 548 (1969), *aff'd*, 423 F.2d 710 (1970). In that case an ice storm damaged the taxpayer's orchard. The IRS allowed a deduction for the $9,000 cost of clearing the land after the storm. The taxpayer sought an addition $45,000 deduction for the loss of fair market value. The Court denied that deduction, explaining:

The additional decrease in value of $45,000 represents a decline not due to actual physical damage to the land but rather because of the decline in demand for citrus land in the area of Texas. The decline in demand that caused the decrease in market value may have been the result, in part, of the freeze. However, this reduction in market value is not a loss of the character deductible under the casualty loss provisions of section 165."

The only glimmer of an exception to this is when the decrease in fair market value caused by the casualty event is "permanent." For example, in *Finkbohner v. United States*, 788 F.2d 723 (11th Cir. 1986), a flood wiped out the taxpayer's neighborhood to the extent that 7 other homes were eventually razed, with the land acquired by the local government to be permanently undeveloped. A split panel of the 11th Circuit held that the resulting loss of fair market value was not merely a temporary fluctuation but was a permanent change in fair market value caused by the flooding. The dissent pointed out that the removal of the other homes was based on the fact that the area had been know as prone to flooding, and the *particular* flood had not permanently altered the character of the land.

I say this is a glimmer. I would not count on courts—and certainly not the Tax Court—to follow *Finkbohner* opinion anytime soon. Last I looked, the case has only been cited eight times since 1986 and, after reading those eight cases, it seems to me that courts give only limited weight to the opinion. Still....it's out there and may be useful to readers to at least make an argument.

It was certainly no help to the taxpayers in today's case. Let's take a look.

Facts

The tax year at issue is 2017. Our taxpayers owned a vacation home in Stone Harbor, N.J., on Cape May, where they also kept a boat. It appears they had bought the home for some $2.25 million. Nice home. It appears they had bought the boat for some $480,000. Nice boat.

In March 2017, Winter Storm Stella hit the upper Northeastern part of the U.S. It was a pretty bad snowstorm with heavy precipitation and high winds. Interestingly FEMA issued a disaster declaration only for certain counties in New York. But nothing for Cape May, or any part of N.J. Fortunately for Mr. Richey and Ms. Cleary, §165 did not require that the casualty loss be attributable to a federally declared disaster. If this had happened in 2018 then we might well have a different lesson. After all, there are intricate politics for how and when FMEA actually *declares* a disaster. For a good discussion see Carolyn Kousky, Karina French, Carlos Martín, Manann Donoghoe, *"The US needs a new system for declaring natural disasters and distributing federal aid,"* Brookings Research Paper (July 14, 2023).

At any rate, Mr. Richey and Ms. Cleary claimed a casualty loss deduction of $640,000 for their home and $180,000 for their boat. That pretty much enabled them to pay no tax on their AGI of some $850,000 for the year. Op. at 6.

On audit, the IRS denied the deductions and issued an NOD. The taxpayers petitioned Tax Court to contest the asserted deficiency. They lost, giving us our lessons.

Lesson: No Casualty Loss Deduction Without Proof of Entitlement

The taxpayers' basic problem was they could not prove that Winter Storm Stella damaged their home or boat. While Mr. Richey testified to that effect, Judge Holmes did not find his testimony credible. For example, Mr. Richey testified that *"no one would buy their home after the storm without considering the cost of a total rebuild of 'the retaining walls* *(from the sea), dock system, and foundation of the home, which suffered significant erosion.'"* Op. at 10, quoting Mr. Richey. But, as Judge Holmes notes, Mr. Richey *"never provided evidence that the damage to the retaining wall or the home's foundation was storm damage rather than damage from erosion and ordinary wear and tear."* Id.

You would think that it should not be hard to show a storm damaged your property, especially with cell phones able to take 1,000's of pictures that are then sent to various cloud storage services. Mr. Richey said he had taken pictures but a later software update to his phone deleted them. Un huh. With all the cloud backup services available that's a pretty lame story.

So all Mr. Richey could do is show the Court some 2018 pictures of the home that showed construction activity on it! As Judge Holmes notes, the *"photographs depict no visible damage other than that which one might see at any construction site, and we could see nothing that showed damage that we could specifically attribute to the storm. They are insufficient to prove that the property was damaged let alone that the damage was attributable to Stella."* Op. at 7.

As for the boat, the taxpayers showed the Court a picture of the boat *before* the storm, but showed the Court no pictures of the boat *after* the storm. *Id.* Nor did they even give the court any receipts for boat repairs. Gosh, that makes it really hard to claim your boat was damaged, let alone damaged by one particular storm.

The failure of proof here is startling, especially since Mr. Richey was represented by counsel. I mean certainly the lawyer would know that that the burden is on the taxpayer to prove their entitlement. Mr. Richey could have brought in witnesses, such as construction workers or the contractors he hired to repair his home, or even neighbors who might testify that "Yep, that storm hit the Richey place pretty hard." But he did none of that. All he had was his sole testimony and some 2018 pictures. Assuming competent counsel, this leads to a strong inference that Mr. Richey and Ms. Cleary simply *had* no proof.

Bottom Line: If you are going to claim a casualty loss, you need to document the entitlement. Don't just assume that batting your baby blues will do the job! Here, I think the song "Jeff Sums It Up" from the current musical version of Tootsie best captures the situation these taxpayers found themselves in.

Coda: Judge Holmes is a careful judge. His holding that the taxpayers here failed to prove their entitlement is a finding of fact and will be reviewed only for clear error. However, Judge Holmes nonetheless goes on to give a lengthy and very useful explanation of how the taxpayers here also failed to substantiate the amount of damages. Remember, §165 is a capital recovery provision so the deduction is limited to the lesser of basis or loss of fair market value. Here, the taxpayers were unable to establish loss of fair market value. They tried a couple of different approaches and Judge Holmes patiently explains why each is an epic fail.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/08/lesson-from-the-tax-court-gotta-get-physical-for-casualty-loss-deduction.html

---

Tax Court & Board of Tax Appeals Memorandum Decisions

Thomas K. Richey, et ux. v. Commissioner, T.C. Memo. 2023-43 , Code Sec(s) 165; 6662; 6751.

THOMAS K. RICHEY AND MAUREEN P. CLEARY, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Case Information:

[pg. 361]

Code Sec(s):	165; 6662; 6751
Docket:	Dkt. No. 14568-20.
Date Issued:	03/28/2023.
Judge:	Opinion by Holmes, *J.*
Tax Year(s):	Year 2017.
Disposition:	Decision for Taxpayers in part and for Commissioner in part.

HEADNOTE

1. Loss deductions—casualty losses—storm damage—accuracy-related penalties—burden of proof and production—written approval of assessment—proof. Former Coast Guard officer/technology corp. executive's and wife's casualty loss claim for alleged decrease in value of their vacation home and boat as result of storm damage was denied. Although taxpayers introduced photographs of their home, such were taken after reconstruction had already begun and showed no damage that was specifically attributable to storm; and they failed to introduce photograph of boat after storm or provide any receipts for boat repairs. Also, taxpayers failed to substantiate home's loss of value due to storm as there was no competent appraisal of before and after values of home, or in any event, fact that appraisal considered market shifts due to fear of future flooding would by itself render it inadequate; and receipts provided didn't show if expenses went to costs of home improvement or repairs. Taxpayers also failed to prove basis in home of anything over purchase price; and while they received some kind of reimbursement for damage to their home, it wasn't from their homeowners ins. Similarly, taxpayers[pg. 362]failed to provide sufficient evidence of boat's actual pre- and post-storm value or that they submitted ins. claim for storm damage to boat. But, accuracy-related penalty wasn't upheld due to IRS's concession it didn't comply with Code Sec. 6751(b)(1)'s written supervisory approval requirement for penalties.

Reference(s): ¶ 1655.3010(20) Code Sec. 165;Code Sec. 6662;Code Sec. 6751

Syllabus

Counsel

Shadi M. Halavi, for petitioners.

Sarah A. Herson and Nathan C. Johnston, for respondent.

HOLMES, *Judge*

MEMORANDUM OPINION AND FINDINGS OF FACT

Thomas Richey and Maureen Cleary claim that their vacation home and boat were damaged by a storm in 2017. They reported a very large casualty-loss deduction of nearly $740,000 which, when lashed to Richey's very large wage income, enabled them to report zero taxable income for the year. The Commissioner says that the couple haven't substantiated the cost of the damage that they suffered and haven't even proved that any of the damage was caused by the storm.

Whom are we to believe?

OPINION

What a casualty loss is, and how to measure it, are unusually well-settled. We begin there, and then apply the law to the particular facts of this case.

Under section 165, a taxpayer can deduct nonbusiness losses that "arise from fire, storm, shipwreck, or other casualty, or from theft." **[*2]** § 165(a), (c)(3).[1] He can claim these losses only for certain kinds of damage, only for damage caused in certain ways, and only for an amount of damage calculated according to certain rules.

I. *The Damage Required*

The first rule of casualty losses is that only physical damage counts. Furer v. Commissioner, 33 F.3d 58, 1994 [74 AFTR 2d 94-6019] WL 417425, at * 1 (9th Cir. 1994) (unpublished table decision), aff'g 65 T.C.M. (CCH) 2420 [1993 RIA TC Memo ¶93,165] (1993); *see also* Citizens Bank of Weston v. Commissioner, 28 T.C. 717, 720 (1957) (same), aff'd, 252 F.2d 425 [1 AFTR 2d 951] (4th Cir. 1958); Dubin v. Commissioner, 35 T.C.M. (CCH) 1120, 1122 [¶76,256 PH Memo TC] (1976).

This means, most importantly, that deductible casualty losses do not include decreases in property value, even decreases in value attributable to the market's perception of the probability of future casualties. Citizens Bank, 28 T.C. at 720; *see also* Kamanski v. Commissioner, 477 F.2d 452, 452–53 [31 AFTR 2d 73-1157] (9th Cir. 1973) (loss in value from predictions of future casualties not casualty loss), aff'g 29 T.C.M. (CCH) 1702 [¶70,352 PH Memo TC] (1970); Pulvers v. Commissioner, 407 F.2d 838, 839 [23 AFTR 2d 69-678] (9th Cir. 1969) (loss in value to properties adjacent to landslide not casualty loss), aff'g 48 T.C. 245 (1967).

In Kendall v. Commissioner, 17 T.C.M. (CCH) 809, 811 [¶58,163 PH Memo TC] (1958), we summarized the caselaw: A loss does not qualify as a casualty loss when the loss is "the result of fear on the part of prospective buyers of damages that might be sustained in future years as a result of storms, contemplated as possible and even probable, but which had not yet occurred and which might never occur." The reason behind disallowing such losses is that the fears of prospective buyers are "not caused by storms which occurred only in [the year at issue], but [rather] by a history of storm damages extending over a period of several, and probably many, years." Id.

II. *The Causation Required*

The second rule of casualty losses is that the loss must be proximately caused by "fire, storm, shipwreck, or other casualty." The IRS and courts look for a close link between event and damage.

[*3] Deductible damage must result from a "sudden, externally-caused" force and not "progressive deterioration of prop-[pg. 363]erty." Khinda v. Commissioner, 48 T.C.M. (CCH) 875, 876 [¶84,432

PH Memo TC] (1984) (quoting Fay v. Helvering, 120 F.2d 253, 253 [27 AFTR 432] (2d Cir. 1941)); *see, e.g.*, Henke v. Commissioner, 32 T.C.M. (CCH) 874, 875 [¶73,186 PH Memo TC] (1973) (damage must be attributable to "a sudden unexpected happening"); Kemper v. Commissioner, 30 T.C. 546, 548 (1958), aff'd, 269 F.2d 184 [4 AFTR 2d 5119] (8th Cir. 1959)).

A loss may, of course, have more than one cause. Think of a decrepit building that's knocked down by a hurricane. When damage is caused in part by wear and tear, failure to maintain, or some other form of progressive deterioration, the taxpayer must prove that the casualty was an independent and sufficient cause of the loss. *See* Edens v. Commissioner, 33 T.C.M. (CCH) 1419, 1421 [¶74,309 PH Memo TC] (1974) (failure to prove damage from casualty and not gradual deterioration) aff'd without, published opinion, 549 F.2d 798 (4th Cir. 1976); *see also* Hayward v. Commissioner, 27 T.C.M. (CCH) 547, 550 [¶68,114 PH Memo TC] (1968) (same).

III. *Calculating the Deduction*

A taxpayer who can show that a storm or other casualty has proximately caused physical damage then needs to calculate the amount of that damage. That means he must find the difference between the fair market value of the property "immediately before the casualty," and the fair market value of the property "immediately after the casualty." , Treas. Reg. § 1.165-7(a)(2)(i), (b)(1). But even that is not enough, for now we come to the third and final rule of casualty losses: A taxpayer can't deduct the whole amount of his loss but must run it through a sharks alley of statutory and regulatory limitations, each of which can take anything from a nibble to a gouge out of the actual amount of his loss and leave him with a deduction much smaller than he wants:

- Casualty losses are deductible only for the tax year in which the losses actually occurred, § 165(a); Treas. Reg. § 1.165-1(d)(1);
- they are deductible only to the extent that they exceed $100, § 165(h);
- they are deductible only to the extent they exceed 10% of a taxpayer's adjusted gross income, § 165(h)(2);
- **[*4]** they are deductible only to the extent they do not exceed a taxpayer's adjusted basis in the damaged property, Treas. Reg. § 1.165-7(b)(1)(ii);
- and they are deductible only if the taxpayer is uninsured or, if insured, filed "a timely insurance claim with respect to such loss," § 165(h)(4)(E).[2]

Taxpayers also have to wade through some difficult problems of proof. The difference between the fair market value immediately before and immediately after the casualty event "shall generally be ascertained by competent appraisal." *See* Treas. Reg. § 1.165-7(a)(2)(i); Lamphere v. Commissioner, 70 T.C. 391, 395 (1978). A taxpayer may appraise his own property when he has sufficient knowledge and expertise of the relevant values before and after the casualty event. Coates v. Commissioner, 112 T.C.M. (CCH) 470, 474 [2016 RIA TC Memo ¶2016-197] (2016).

But a competent appraisal must take into account the shift in the market due to the casualty event. Treas. Reg. § 1.165-7(a)(2)(i).

The law doesn't always require appraisals, though. Sometimes we can use proof of a property's trade-in value immediately before and after the casualty event. Caras v. Commissioner, 23 T.C.M. (CCH) 1103, 1105 [¶64,187 PH Memo TC] (1964). Trade-in values, however, are not persuasive when they factor in dealer discounts and thus do not reflect actual market prices. And a listed price is not the same as a market price—just advertising property for sale at a specific price is not persuasive evidence of its fair market value. Hale v. Commissioner, 44 T.C.M. (CCH) 1116, 1119 [¶82,527 PH Memo TC] (1982). [pg. 364]

Taxpayers can also win without either an appraisal or proof of actual market prices—sometimes the cost of repairs is good enough when "(a) the repairs are necessary to restore the property to its condition immediately before the casualty, (b) the amount spent for such repairs is not excessive, (c) the repairs do not care for more than the damage suffered, and (d) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty." Treas. Reg. § 1.165-7(a)(2)(ii). Estimates of repair costs are not persuasive. Farber v. Commissioner, **[*5]** 57 T.C. 714, 719 (1972). We consider instead only "actual repairs and expenditures" that a taxpayer incurred. Id.

FINDINGS OF FACT

With the law anchored in place, we can now tie it to the facts of this case.

I. *Background*

Thomas Richey and his wife Maureen Cleary both had had successful careers and retired well before 2017. Though Cleary stayed retired, Richey's career as a Coast Guard officer eventually lured him out of retirement and into the private sector, where he rose to become head of global cybersecurity for Raytheon Technologies. His new berth greatly increased the couple's fortunes and enabled them to buy a second home in Stone Harbor on Cape May in the south of New Jersey. Their home is on the waterfront with docks, bulkheads, and access to the open ocean. Richey and Cleary bought the home in 2007 and became boat owners the next year when they acquired a 40-foot boat they named Celtic Dreams.

They still owned the home and the boat in March 2017, when Winter Storm Stella hit Stone Harbor and flooded the city's streets. Richey and Cleary claim the storm damaged the waterside portion of their property and their boat, then stored at a marina for the winter.

II. *Richey and Cleary's 2017 Return, Audit, Petition, and Trial*

The couple filed their 2017 tax return in August 2018 with the help of a preparer from H&R Block. On it, they claimed total casualty losses of more than $820,000 and a deduction—after taking into account the income limitation we've already described—of nearly $740,000. They attributed about $640,000 of the loss to the vacation home and about $180,000 to the boat.

Looking first to the home, Richey and Cleary reported that before the storm its fair market value was $2,677,650 and that after the storm its fair market value was $1,994,175. They reported receiving a reimbursement, from a source they did not identify, of a bit less than $40,000. They claimed that their basis in the home was $2,450,000. They subtracted this reimbursement from the difference between the home's reported value before and after the storm to reach a casualty loss of **[*6]** about $640,000. Since the loss was less than their home's basis the couple claimed the entire amount.[3]

They performed a similar calculation for their boat. They reported a fair market value immediately before the storm of $364,550, and storm damage of about $180,000. They reported no reimbursement, so their total reported loss came to about $180,000. They reported a basis in the boat of $480,000. This basis was greater than their loss so they claimed the entire amount of the loss as a casualty deduction.

We can summarize:[pg. 365]

	House	Boat
FMV Before Casualty	$2,677,650	$364,550
FMV After Casualty	1,994,175	184,780
Insurance or Other Reimbursement	39,763	–
Loss	643,712	179,770

Such a large loss—one that caused them to reduce their adjusted gross income of more than $850,000 to a taxable income of zero—bobbed into the Commissioner's view, and he selected their return for audit. At the end, he issued a notice of deficiency for 2017 in which he disallowed the casualty-loss deduction in its entirety.[4] Richey and Cleary timely **[*7]** petitioned our Court, and though they resided in Maryland, asked for trial in Los Angeles.[5]

We added the case to one of our trial calendars for Los Angeles, but on the first day of that session neither petitioner showed up. Their lawyer said that the couple did not have enough time to get tickets to travel to the trial, though we'd sent them a pretrial order in mid-December 2021 telling them of the trial date in April. We postponed trial for a day to enable Richey to testify via Zoom. He testified that he learned about the trial only a week before calendar call, and even then, no one told him any specific details about the proceeding. We do not find this credible, and this finding affects our overall evaluation of his testimony. Ms. Cleary did not testify at all.

III. *Storm Damage*

We presume the notice of deficiency is correct. Welch v. Helvering, 290 U.S. 111, 115 [12 AFTR 1456] (1933), and a petitioner bears the burden of proving that he is entitled to a deduction that the Commissioner disallowed, Rule 142(a). No one doubts that storm damage may be deductible— section 165 says so on its face. But that still leaves Richey and Cleary with the need to prove that the storm directly caused physical damage to their vacation home and boat.

The couple's case began taking on water right at the start, when Richey was asked about any proof he had that the storm itself had caused damage to his property. He testified that he had taken pictures of the damage to both home and boat on his phone shortly after the storm. He explained, however, that a later software update to his phone deleted them. That left him to introduce only photographs of the house taken in 2018, nearly a year after the storm hit and after reconstruction had already begun. These photographs depict no visible damage other than that which one might see at any construction site, and we could see nothing that showed damage that we could specifically attribute to the storm. They are insufficient to prove that the property was damaged let alone that the damage was attributable to Stella, and we do not find Richey's testimony, standing alone, credible on this point.

[*8] As for the boat, the couple introduced a photograph of what the boat looked like before the storm, but nothing to show what it looked like afterwards. The couple also gave us no receipts for any boat repairs.

We don't doubt that a severe winter storm could damage property on the coast, but the absence of evidence leads us to find that it is more likely than not the case that it did not damage the property at issue here. *See* House v. Commissioner, 69 T.C.M. (CCH) 2005, 2025 [1995 RIA TC Memo ¶95,092] (1995). [pg. 366]

IV. *Test*

If the absence of proof of damage causes the couple's case to founder, the absence of proof on valuing that damage causes it to sink altogether. Even if we found that the storm damaged the home and boat, they would still have to show us

- the diminution of their property's value caused by the storm, and their basis in that property; and
- proof that they either lacked insurance or had made a claim for compensation and received none.

We'll dive first into the problems of valuing the damage to the home and then to the boat.

A. *The Vacation Home*

Richey and Cleary reported damage of $683,475; a basis of $2,450,000; and reimbursement (though whether from insurance or some other source they didn't say) of $39,763. Each of these is essential to putting a number on a casualty-loss deduction. And each is a problem here.

1. *Loss of Value*

a. *Competent Appraisal*

Richey and Cleary did not get an appraisal of their own home valuing it before and after the storm. Richey instead consulted a real-estate agent who provided them with Multiple Listing Service (MLS) printouts of other people's homes. This is a problem for many different reasons. The first, and on this point we believe Richey's testimony, is that he didn't talk to this agent until after the audit had begun. We conclude from this that the values reported on the return were not a **[*9]** result of an appraisal, but rather of the couple's own estimate. And the MLS printouts are not an appraisal at all, but rather a rationalization of the couple's guess about the before and after values of their home.[6]

It's not impossible for a homeowner to conduct an appraisal himself—but he has to show sufficient knowledge of the property and its value immediately before and after the casualty event. In Coates, 112 T.C.M. (CCH) at 474, we found that a landowner who had worked on his ranch for more than 30 years did have sufficient knowledge to adequately appraise it—especially since he also had substantial experience in buying and selling property in the surrounding county.

We don't find a similarly granular knowledge of a local market here. Richey and Cleary had their primary residence in suburban D.C. and they did not spend most of their time at their vacation home. They also produced no evidence of their awareness of market conditions in Stone Harbor. *See* id. What we got were photographs of MLS printouts. Two were printouts for properties that

Richey claimed were comparable to their home before the storm—the first of which showed a sale price of $2,526,950 from April 2017; and the second of which showed a sale price of $2,125,000 from December 2017. Richey then adjusted those prices himself because he said these comparables were smaller and, he claimed, his home was in a more desirable area. These adjustments let him come up with a "before" value of his own home of $2,677,650.

He also pointed to two other properties that he referred to as "lot value (tear-down)" properties. The purchase prices for these two properties were $1,790,000 and $1,640,000. He argues that these two properties are good comparables for the home's "after" value, and justify a $1,994,175 after-storm value because the "flood events and future threat required the property to essentially be rebuilt or totally renovated." We do not find this to be a persuasive appraisal. We infer from Richey's having to reach out to an agent to give him such comparables an unspoken admission that he is not qualified to conduct an adequate appraisal on his own. We also can't believe the assertion that the storm damage and fear of future flooding rendered their **[*10]** vacation home a teardown. Richey claimed that no one would buy their home after the storm without considering the cost of a total rebuild of "the retaining walls (from the sea), dock system, and foundation of the home, which suffered significant erosion." We likewise[pg. 367]note that he never provided evidence that the damage to the retaining wall or the home's foundation was storm damage rather than damage from erosion and ordinary wear and tear. And if their home's value declined after the storm because of fears of future storm damage, we'd need to exclude that factor from valuing the casualty loss. *See* Treas. Reg. § 1.165-7(a)(2)(i). On this record we have no way of doing so.

In the end, we find there to be no adequate appraisal of the before and after values of the house. The MLS printouts provided no actual valuation of the vacation home. And even if we found there to have been an adequate appraisal, the fact that the appraisal considered market shifts due to the fear of future flooding would by itself render it inadequate.

b. *Cost of Repairs*

Appraisals are not always necessary, however. Richey also introduced evidence of the cost of repairing the home. He contends that the total cost of repairs after the storm was more than $250,000—for just the first phase. He claimed that he would need to spend even more during a second phase of repairs whose additional cost would amount to another $150,000.

[*11] We summarize:[7]

Evidence Provided	Cost Attribution
Channel Marine Construction Invoice	$135,809.85

Dennisville Fence Work Invoice	8,292.00
Stonewood Builders Work Invoice	89,964.76
Oliver Architects Invoice	11,132.83
Waters Edge LLC Invoice	5,675.99
DL Minor Construction Estimate	207,811.88

A problem with these receipts and estimates are that many include items less related to restoration than to improvement. One estimate, for example, included the cost of building a deck and installing a pool, neither of which had been part of their home before the storm. The construction permit that Richey introduced showed not just a new pool, but 25.5 linear feet of vinyl or steel bulkhead 24 inches waterward of the existing bulkhead, and two 10 linear feet of bulkhead returns.[8]

Such estimates of possible future repairs are not persuasive proof of the actual incurred cost of actual repairs. Farber, 57 T.C. at 719. This **[*12]** means that the maximum recovery the couple could substantiate from the receipts is $250,875. And these repairs included work that went beyond restoring the vacation home to its pre-storm condition; a new and improved bulkhead, and a pool are home improvements, not repairs. Richey even admitted in his posttrial brief that $51,600 of his cost of repairs was for these improvements.

But there are problems even with any lower number, because taxpayers still have the burden of proving that the cost of repairs is sufficient evidence of the extent of the casualty loss. Treas. Reg. § 1.165-7(a)(2)(ii). This would first mean showing that the repairs were necessary to restore the property to the condition that it was in immediately before the storm. Id. Richey and Cleary never provided any evidence of the state of their property immediately before or after the storm. Without knowing their home's "before" condition,[pg. 368]we cannot find it more likely than not that any repairs were incurred to restore it.

Second, Richey and Cleary had the burden of proving that the repairs did not remedy more than the storm damage that was suffered from the storm. *See* id. Richey's decision to include more than $50,000 for a new pool and better bulkhead affects our view of his credibility on the question of whether the remainder of his claimed costs were really for repairs rather than improvements.

There is also, and finally, the question of whether the repairs would cause the home's value to exceed its value immediately before the storm. Id. Here again, the absence of any evidence about the home's condition immediately before the storm makes it impossible to determine if the repairs rather exceeded that value.[9]

Richey and Cleary provided receipts that total $250,875 in actual expenditures. They admit that $51,600 of these expenses improved the property rather than repaired it, and did not give us enough evidence about how their home looked before the storm to bear their burden of showing that the remaining expenses were not also the costs of improvement or repair of nonstorm damage or wear and tear. With this we conclude that they have failed to substantiate the amount of their loss.

[*13] 2. *Basis*

The Code also limits the amount of a casualty loss to a taxpayer's adjusted basis in the damaged property. Without proof of this basis, we will not sustain a deduction. Millsap v. Commissioner, 46 T.C. 751, 760 (1966), aff'd on other grounds, 387 F.2d 420 [21 AFTR 2d 376] (8th Cir. 1968). Richey first stated that his home's basis was $2,450,000, but then testified that he and his wife bought the home for $2,400,000; that is, until he was confronted with a purchase contract that showed a price of only $2,250,000. We won't say this is a failure of proof of basis, but it is a failure of proof of basis of anything over $2,250,000.

3. *Insurance*

The Code tells us to reduce the amount of any casualty loss by the amount of insurance that did or could have reimbursed the taxpayer for the damage that he suffered. Richey and Cleary listed on their return a reimbursement of $39,763. They never introduced any information about the source of this reimbursement, and no evidence of an insurance policy or claims that they made. Richey did testify that they had an insurance policy on the home when the storm hit but that he filed no claim because the processing of a claim he made for damage from Superstorm Sandy in 2012 was so unsatisfactory that he didn't want to try again. He also assured us that had he submitted a claim, his policy would have covered only a small portion of the damage.

That's not good enough. The law is clear that taxpayers who have an insurance policy on damaged property must file a timely claim or they don't get a casualty-loss deduction. § 165(h)(4)(E). Though the couple reported receiving some kind of reimbursement for damage to their home, Richey made clear that it was not from their homeowners insurance. That the couple had an insurance policy and failed to file a claim is by itself another reason to deny them any casualty-loss deduction for the home.

B. *The Boat*

Richey and Cleary fare no better on the loss they claim for their boat.

1. *Loss of Value*

Richey's approach to showing the before and after value of the boat was as unpersuasive as his approach to showing his home's loss of **[*14]** value. To substantiate the boat's loss of value, Richey gave us NADA[10] values of boats that he said were similar, both before and after the storm, to his own. He relied on these values as proof that his own boat's value dropped from $364,550 before the storm to $184,780 afterward. What he did was look up NADA values of boats he said were[pg. 369]similar to his own. He looked especially for the values of well maintained boats as helpful for determining the "before" value and the values of damaged boats for the "after" value. But it was all Richey's say so: We got no documentary proof of his NADA research and no evidence of his own boat's condition before or after the storm. Without such proof, we cannot find there is sufficient evidence in the record of the boat's actual pre-and post-storm value.

2. *Basis*

There were also problems with the claimed basis of $480,000. In lieu of an actual receipt or purchase contract to show actual basis in the boat, Richey offered an MSRP price sheet from 2007, one year before he and his wife bought it. Though the value listed on the price sheet was $414,488 MSRP, and the advertised sale price for the boat showed a discount to $344,025, he claimed that he bought it for $480,000 because he had added pricey options. But as proof we have only his own general testimony. He did not specify what the options were or their cost. Without receipts, and with some trouble with his credibility, we find that the couple has failed to prove their claimed basis in the boat.

Richey did introduce a listing agreement that he and his wife entered into with a marina to sell the boat for $189,500. But he testified that the highest offer they received was only $150,000. Listing prices are in general unpersuasive proof of actual market value, and this testimony confirms that this particular listing price is inadequate evidence here. *See* Hale, 44 T.C.M. (CCH) at 1119. It is certainly not sufficient proof of the storm's effect on the boat's value.[11]

[*15] 3. *Insurance*

Richey asserted that the marina where he stored the boat during the storm also had insurance that covered some of the damage. Though he did not report receiving any reimbursement from the marina, he did state that he began the process collecting reimbursement. But we again got no documentation of these efforts. Richey explained that this absence of evidence was due to the "personal" nature of his attempt to collect—an appeal to his relationship with the marina's owner.

But with no corroborating emails, letters, or testimony, we find it more likely than not that there was in fact no such attempt. *See* House, 69 T.C.M. (CCH) at 2025.

There was unusual difficulty even in figuring out whether the couple had their own insurance policy on the boat. They produced an insurance policy in effect from May 2008 to May 2009. Richey testified that at one point the boat had a lien on it to secure a loan. This loan required there to be insurance on the boat for the life of the loan. Richey then claimed that he believed that he'd paid off the loan and that the insurance had expired before the storm, yet the listing agreement that he signed after the storm identified the lien as a current liability. We conclude from this that it was more likely than not that the boat was insured at the time of the storm.

That likely means that there were two insurance policies Richey could have turned to for reimbursement of any storm damage, yet he did not submit a claim. The failure to file a timely claim is yet another reason to deny a casualty-loss deduction. *See* § 165(h)(4)(E).

V. *Conclusion*

Richey and Cleary have thus failed to prove that Stella caused damage to either their vacation home or boat. Even if they had, they did not give us sufficient evidence to substantiate the value of their losses. Even if they had substantiated the value of those losses, they did not give us sufficient evidence of their basis in the boat. And even if they had proved that the basis limitation did not apply, they filed no insurance claims for property that was protected by insurance. All these attacks by the Commissioner have picked completely clean the flesh of their claimed deduction, and

Decision will be entered for respondent as to the deficiency and for petitioners as to the accuracy-related penalty under section 6662(a).

---

1 Unless otherwise indicated, all statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, all regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and all Rule references are to the Tax Court Rules of Practice and Procedure.

2 This section does not limit the deduction for a taxpayer who has no insurance. It limits the deduction in part for a taxpayer who has insurance and files a claim and who does not receive full compensation for his loss. But for a taxpayer who has insurance and doesn't file a claim it eliminates the deduction altogether.

3 The losses that were claimed on both the vacation home and the boat were reduced by $100 as is required by statute.

4 The notice of deficiency included an accuracy-related penalty. Respondent conceded this penalty since he failed to provide evidence of the written authorization that is necessary to impose it. *See* § 6751(b); Graev v. Commissioner, 149 T.C. 485, 493–94 (2017).

5 Appellate venue thus presumptively lies in the Fourth Circuit. § 7482(b)(1)(A).

6 In other words, the MLS printouts are akin to the rational tail of the intuitive dog that is the couple's initial valuation of their home. *See* Jonathan Haidt, *The Emotional Dog and Its Rational Tail: A Social Intuitionist Approach to Moral Judgment*, 108 Psychol. Rev. 814, 822–23 (2001). It was not derived from those MLS printouts (in fact it resembles more of an intuitive evaluation); those printouts serve as a post hoc rationalization of their evaluation.

7 The Commissioner argues that the actual cost of construction amounts to only $173,227 as he argues that this is the amount that the couple has actually paid for repairs. Actual payment is not quite the test here: We instead look to whether the cost of repairs actually made is persuasive evidence of a change in value due to the casualty. *See* Farber, 57 T.C. at 719.

8 A bulkhead is a "hard armor technique usually vertical that maintains soil and abates erosion from waves and currents using rigid materials." And a return wall is a "section of bulkhead that extends towards land, typically from the end of a shore parallel bulkhead, and ties into the bank or backshore." J. Johannessen, et al., Marine Shoreline Design Guidelines xiv, xix (2014), https://wdfw.wa.gov/sites/default/files /publications/01583/wdfw01583pdf.

9 Richey and Cleary also had the burden of proving that the amount spent for the repairs was not excessive. *See* Treas. Reg. § 1.165-7(a)(2)(ii). The Commissioner never contested that the cost of the repairs themselves were excessive, however, and there is no evidence to suggest that it was.

10 NADA stands for National Automobile Dealers Association. It is an organization that collects data and provides estimates of the cost of buying a pre-owned vehicle that reflects factors such as condition, mileage, and type of vehicle. NADA provides similar values for boats. NADAguides Used Car Values vs. Kelly Blue Book, Kelly Blue Book, https://www.kbb.com/nadaguides/ (last visited Jan. 25, 2023).

11 At trial Richey claimed that he and his wife received estimates of the cost of repairs from Sea Ray, but they introduced no documentary evidence that they had.

END OF DOCUMENT -

TaxProf Blog

Monday, August 14, 2023

Lesson From The Tax Court: *Tax Consequence For Discharge Of Non-Recourse Debt*

By Bryan Camp

One of the hard concepts to teach students is the different tax treatments for recourse loans and non-recourse loans. It gets especially confusing when the sale of underwater property includes a Discharge of Indebtedness (DOI) as part of the sale. In *Michael G. Parker and Julie A. Parker v. Commissioner*, T.C. Memo. 2023-104 (Aug. 10, 2023) (Judge Nega), we learn that discharge of non-recourse debt as a result of a property sale cannot generate DOI income (and thus cannot qualify for exclusion under §108) but must instead be used in calculating gain from the sale.

In today's case the taxpayer's S Corporation sold some underwater property and the deal included a discharge of part of the unpaid debt. They argued that they were insolvent at the time of the deal and thus attempted to exclude the DOI from income under the insolvency exclusion allowed by §108(a)(1)(B). But because the cancelled debt was non-recourse, the taxpayers could not use §108. Instead, the amount discharged had to be included in the calculation of gain and thus §108 could not apply. It's a basic, yet complex, lesson. Details below the fold.

Law: Of Loans, DOI Income, and Recourse and Non-Recourse Loans

A loan is not income when made. But a taxpayer will have income to the extent the taxpayer is later relieved of the obligation to repay. Two interchangeable terms—Cancellation of Debt (COD) and Discharge of Indebtedness (DOI)—describe that event. Here I'll use DOI.

No one really knows why DOI is income. There is no single reason. For those who want more on that, see Lesson From The Tax Court: *The Phantom Of The Tax Code—Discharge Of Indebtedness*, TaxProf Blog (Feb. 19, 2018).

Most taxpayers are surprised to learn that DOI is income. They don't usually feel wealthier; they just feel...well...relieved. Less desperate. That very desperation, however, can provide a basis for excluding DOI from gross income because §108(a)(1)(B) allows taxpayers to exclude DOI when they are insolvent. As we learned in a different lesson, the exclusion is limited to the amount of the insolvency at the time of the discharge. For example, if a taxpayer is discharged from $10,000 of debt at a time when the taxpayer is insolvent by $6,000, then the taxpayer can exclude $6,000 of the DOI from income but must report the remaining $4,000 as gross income, assuming no other exclusion applies. §108(a)(3). See Lesson From The Tax Court: *How To Calculate Insolvency For The §108 Exclusion*, TaxProf Blog (June 26, 2023).

Complications arise, however, when the DOI is associated with the sale of underwater property. That happens when the property was purchased with the loan and the loan balance is more than the amount of cash or other consideration the taxpayer receives for the property on the sale. The reason this gets complicated is because loans used to buy property come in two flavors: recourse or nonrecourse. The difference in loan type makes a huge difference in the tax consequences of being discharged from the debt when the property is sold.

Non-recourse loans are those that limit the lender's ability to enforce repayment. They permit the lender to obtain repayment from only those assets the lender uses to secure the loan, generally the property being purchased. In contrast, recourse loans are those that give the lender open season (recourse) to any and all of the debtor's assets to effectuate repayment.

Non-recourse loans cannot generate DOI on the sale of underwater property. That is because the discharge of indebtedness is deemed to be part of the amount realized on sale of the property. Treas. Reg. 1.1001–2(a)(1) (*"the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."*)

Notice the phrase *"as a result of."* Sometimes taxpayers argue that discharge of a non-recourse debt was not closely enough connected to the sale of the underlying property to make it includable in the amount realized. That's a tough sell. See e.g. *Sands v. Commissioner*, T.C. Memo. 1997-146, where the taxpayer transferred ownership of certain property to a lender in one transaction and the lender discharged over $2 million in debt in a separate transaction. Wrote the Court: *"we find incredible the contention that [Lender] forgave over $2 million in debt owed by [Taxpayer], while at the same time letting [Taxpayer] retain some ownership rights in the [property], and then in a "separate and distinct" transaction, [Taxpayer] transferred its ownership rights in the [property] to [Third Party, at direction of Lender]. We find that [Lender's] discharge of the debt and [Taxpayer's] transfer of its ownership rights were part of a single transaction."*

Thus if the sale of encumbered property involves discharge of the non-recourse debt, then the taxpayer is *deemed* to have received the full amount of the outstanding debt as a result of the foreclosure. *Commissioner v. Tufts*, 461 U.S. 300, 317 (1983) (when debtor sells property encumbered by non-recourse debt, the amount realized by the debtor includes the full outstanding balance of the non-recourse debt even if the liabilities exceed the fair market value of the property). Whether that results in income to the taxpayer depends, of course, on basis in the property sold or foreclosed. But what it does mean is that even though there is not an actual full payment of the debt, there is a *deemed* full payment of the debt. There is just a single transaction: the sale transaction. There is no DOI.

However, if the debt is *recourse*, then what the taxpayer uses to pay over to lender is just whatever cash or other consideration the taxpayer *actually* received on sale of the property. There is no deeming. Treas. Reg. 1.1001–2(a)(2) (*"The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness..."*). That means that the unsatisfied part of the loan, if discharged, is DOI income, subject to ordinary rates of taxation and also potentially eligible for exclusion under §108. *See* Treas. Reg. 1.1001–2(c)(2), Example (8).

Let's see how this plays out in today's case.

Facts

The issue here stems from Mr. Parker's business activities, conducted through layers of different disregarded entities. The year at issue is 2012. That year Mr. Parker was the sole shareholder of Exterra Realty Partners, LLC (Exterra). In turn, Exterra was sole member of a bunch of Delaware LLCs that were all involved in the acquisition and commercial development of realty. In 2007 those various LLCs had obtained a series of loans from an unrelated lender (Lender) to buy and develop land in Livermore, California. The loans appear to have totaled about $33 million. Mr. Parker signed a personal guarantee for all the loans.

Apparently things did not go well. Remember, the purchase was in 2007, just before the Great Recession depressed us all. Eventually, Exterra decided to cut its losses. Judge Nega writes that *"on October 4, 2012, Exterra entered into an agreement to sell the Livermore property to a pair of unrelated individual third-party purchasers (Buyers)."* Op. at 3. Because there were a variety of different entities involved, there were a bunch of different agreements that needed to be executed to effectuate the sale. Judge Nega explains it all. But the gist of it was that the Buyers bought the property by assuming responsibility for some of the now ballooned debt (about $40.6 million), relieving Mr. Parker of his personal guarantee, and the Lender agreed to discharge the rest of the outstanding debt (about $12.7 million).

In its initial return, Exterra included all the assumed and discharged debt in its calculation of its business gross receipts for the year. That was the right way to do it. By including the discharged debt in the amount realized, and after accounting for cost of goods sold and appropriate deductions, it reported $2.7 of business income, which flowed into the Parkers' 2012 return.

However, Exterra later amended its return to exclude that $2.7 as being discharged debt excluded under §108 because Exterra was insolvent by that amount as of the date of the discharge. Again, that treatment passed through and the Parkers likewise filed an amended return reflecting that change.

The IRS audited the Parkers and determined a deficiency, most of which was due to the claim of DOI and §108 exclusion. The Parkers petitioned the Tax Court. Judge Urda explains why doing so gave the Tax Court the power to review both the Parkers' return and also the flowed-through items reported on Exterra's return.

The key item here was Exterra's treatment of the discharged debt. Let's learn our lesson.

Lesson: Discharge of Non-Recourse Must Be Accounted For As Part of Sale

In Tax Court the taxpayers first focused their arguments on why they were insolvent.

Secondarily they seemed to argue that while the loans may have been non-recourse as to Exterra, they were recourse as to Mr. Parker because of his guarantees. I'm not sure about that last bit but I infer it from this comment by Judge Nega:*"As best we can tell, much of petitioners' briefing is premised on a misconception that facts relating to Mr. Parker in his personal capacity are relevant to the question of whether there was income to Exterra in 2012 (and only then, flowthrough income to Mr. Parker as its 100% S corporation shareholder)."* Op. at 9.

But these arguments were putting the cart before the horse. The problem for the Parkers, as you see from the above quote, was that ***Exterra*** was the debtor on the loan. Just because S Corps are disregarded for income tax liability purposes does not mean they are otherwise disregarded. To the contrary, Judge Nega reminds us that *"we respect Exterra's separate corporate existence,"* Op. at 9, citing strings of cases for the proposition that income earned by an S corporation through its trade or business is not earned directly by its shareholders; the shareholders are responsible only for the flow-through.

There was no question that, as to Exterra, the debt was non-recourse. The only remaining question was whether the discharged debt was "as a result of" the sale of the Livermore property. As I have mentioned, it is difficult for taxpayers to show that non-recourse debt is not connected to the disposition of the underlying property. Today's case is no exception. There were a bevy of different documents signed and exchanged to effectuate the deal, so it appears that no single document linked the discharge to the sale. But after reviewing the facts and stipulations Judge Nega had no difficulty concluding that *"The COD was part and parcel of the global agreement to convey the Livermore property, with [Lender] accepting new personal guaranties, a partial payment by the Buyers, and the escrowed deed to the Iowa property in consideration of that cancellation."* Op. at 10.

Bottom Line: Discharge of non-recourse debt as a result of a property sale cannot generate DOI income (and thus cannot qualify for exclusion under §108) but must instead be used in calculating gain from the sale.

Coda: I highly recommend reading Justice O'Connor's concurrence in *Tufts* because she explains why, logically, the sale of underwater property that results in discharge of the non-recourse debt should always be treated as two transactions, not one, regardless of whether the discharged debt is recourse or non-recourse. She goes on to explain, however, that because our legal system is path-dependent (e.g. it relies on precedent), the *Tufts* Court was constrained by that precedent.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/08/lesson-from-the-tax-court-tax-consequence-for-discharge-of-non-recourse-debt.html

Canceled Debt Was Gain Includable in S corporation's Income

AUG. 10, 2023

Michael G. Parker et al. v. Commissioner

MICHAEL G. PARKER AND JULIE A. PARKER,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed August 10, 2023

Diana V. Lopez, *Lisa J. Mendes*, and *Christina P. Weed*, for petitioners.

Janice B. Geier, *Gregory Michael Hahn*, *Jamie M. Powers*, and *Amy B. Ulmer*, for respondent.

MEMORANDUM OPINION

NEGA, *Judge*: This deficiency case involves the tax treatment of nonrecourse debt canceled concurrently with the sale of real property by an S corporation wholly owned by petitioner Michael Parker.[1] After concessions,[2] the sole issue for decision is whether income from the cancellation of the nonrecourse debt should be included in the S corporation's amount realized on the sale of the real property or treated as cancellation of debt (COD) income and thus excluded from gross income pursuant to the section 108(a)(1)(B) insolvency exception.

[*2] Background

This case was submitted fully stipulated pursuant to Rule 122. The Stipulation of Facts and the Exhibits attached thereto and the Stipulations of Settled Issues are incorporated herein by this reference. When the Petition was timely filed, petitioners resided in California.

I. The Entities

In 2012 Exterra Realty Partners, LLC (Exterra), was an S corporation for federal income tax purposes. Exterra was a real estate development company operating in California. In 2012 Mr. Parker was the 100% shareholder, president, and chief executive officer of Exterra.

Exterra was the sole member of PLF-XIII, LLC, and PLF-XIV, LLC (together, PLF entities), each of which was a limited liability company (LLC) formed under Delaware state law in February 2007 and treated as a disregarded entity for federal income tax purposes. In turn PLF-XIII was the sole member of Montevina Phase I, LLC, while PLF-XIV was the sole member of Montevina Phase II, LLC; both Montevina Phase I and Montevina Phase II (together, Montevina entities) were LLCs formed under Delaware state law in February 2007 and treated as disregarded entities for federal income tax purposes. Separate from this structure, Mr. Parker was individually the sole member of another entity, PLF-XI, LLC, which, once again, was an LLC formed under Delaware state law and treated as a disregarded entity for federal income tax purposes. PLF-XI was a member of another LLC formed under Delaware law, 4815 Maple Drive Pleasant Hill — IA, LLC, which held real property in Iowa.

II. The Real Estate Dealings

In March 2007, through the Montevina entities, Exterra purchased 23.6 acres of real property in Livermore, California (Livermore property), for the purpose of commercial development. In order to finance the purchase of the Livermore property, the following loans were obtained from NRFC WA Holdings, LLC, an unrelated third-party lender:

[*3] Description	Parties	Amount
Loan N709A — Phase I Senior Mortgage	Montevina Phase I & NRFC WA Holdings	$20,120,000
Loan N709B — Phase II Senior Mortgage	Montevina Phase II & NRFC WA Holdings	4,230,000

[*3] Description	Parties	Amount
Loan N712A — Phase I Mezzanine Loan	PLF-XIII & NRFC WA Holdings	5,030,000
Loan N712B — Phase II Mezzanine Loan	PLF-XIV & NRFC WA Holdings	2,820,000
Loan N713 — Iowa Mezzanine Loan	PLF-XI & NFRC WA Holdings	2,000,000

PLF-XI used Loan N713 to contribute $1,500,000 to Montevina Phase I and $500,000 to Montevina Phase II. Mr. Parker personally signed a guaranty for payment of all five loans. Loans N709A, N709B, N712A, and N712B were each nonrecourse as to Exterra. Loans N712A and N712B were mezzanine loans,[3] which were secured by a pledge of the PLF entities' membership interests in the Montevina entities. Loan N713 was a mezzanine loan, which was secured by a pledge of PLF-XI's membership interest in 4815 Maple Drive Pleasant Hill — IA, LLC. At some point around or after March 2007, a separate entity, NRFC WA Holdings II, LLC, acquired from NRFC WA Holdings all of the loans relating to the purchase and development of the Livermore property by Exterra or its subsidiaries.

On October 4, 2012, Exterra entered into an agreement to sell the Livermore property to a pair of unrelated individual third-party purchasers (Buyers). A number of contractual agreements were executed by the various parties, each dated October 4, 2012. In a membership interest purchase and sale agreement, the PLF entities agreed to sell their sole membership interests in the Montevina entities to the Buyers in exchange for nominal consideration. In a consent and release agreement between the Montevina entities, Mr. Parker, NRFC **[*4]** WA Holdings II, and the Buyers, the Buyers agreed to assume Mr. Parker's personal guaranty obligations on the Phase I Senior Mortgage and the Phase II Senior Mortgage. The consent and release agreement provided that the Buyers would make a partial payment of $7,400,000 on the Phase I mortgage to NRFC WA Holdings II. As part of the consent and release agreement, Mr. Parker also agreed to deliver the deed to the Iowa property in escrow, with release of the deed to NRFC WA Holdings II to be made more than three years later, in January 2015. The consent and release agreement also included the following recital: "[NRFC WA Holdings II] has agreed to consent to the Subject Transactions, the termination of the Existing Mezzanine Loans, and the assumption by [the Buyers] of the obligations of [Mr. Parker] . . . subject to the terms and conditions stated below, including, without limitation, consummation of the Subject Transaction, [NRFC WA Holdings II's] receipt of the [$7,400,000 payment] and the execution of the agreements and documents. . . ."

In a pair of loan termination agreements, NRFC WA Holdings II agreed to cancel the unpaid balance of the mezzanine Loans N712A and N712B owed by the PLF entities, including all accrued interest and related fees and costs. Both loan termination agreements included the following recital: "In connection with the proposed sale by [the PLF entities] of all of [their] interest[s] in [the Montevina entities], [the PLF entities] and [NRFC WA Holdings II] have agreed to terminate the Loan Documents on the terms, and subject to the conditions, set forth herein."

Exterra realized the following amounts from the Buyers' assumption of debt:

Entity	**Description of Debt Assumed**	**Amount**
Montevina Phase I	Loan N709A	$19,527,134.91
Montevina Phase I	Deferred interest on Loan N709A	2,462,746.99
Montevina Phase I	Funds from Mezzanine	6,240,364.69
Montevina Phase I	Other liabilities — lender advances	2,055,475.28
Montevina Phase II	Loan N709B	4,409,594.28

Entity	Description of Debt Assumed	Amount
Montevina Phase II	Deferred interest on Loan N709B	580,449.98
Montevina Phase II	Funds from Mezzanine	5,309,773.81
Total		$40,585,539.94

In addition, Exterra realized the following amounts from the debt canceled by NRFC WA Holdings II:

[*5] Entity	Description of Canceled Debt	Amount
PLF-XIII	Loan N712A	$5,030,000.00
PLF-XIII	Accrued Interest on Loan N712A	2,879,856.79
PLF-XIII	Loan N712A Outstanding Junior Participation Interest	700,000.00
PLF-XIV	Loan N712B	1,920,000.00
PLF-XIV	Accrued Interest on Loan N712B	1,768,972.00
PLF-XIV	Loan N712B Outstanding Junior Participation Interest	400,000.00
Total		$12,698,828.79

III. Tax Reporting

For tax year 2012 Exterra filed an original Form 1120S, U.S. Income Tax Return for an S Corporation. On its original Form 1120S, Exterra reported $53,284,369 in gross receipts, which consisted of (1) the debt assumed by the Buyers in the sale of the Livermore property and (2) the cancellation of the mezzanine loans. After offsetting cost of goods sold and deductions, Exterra reported ordinary business income of $2,741,399. Exterra subsequently filed an amended Form 1120S, in which it reduced its gross receipts by $2,741,399 and attached Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment). On the Form 982 Exterra reported $2,741,399 as a discharge of indebtedness excluded to the extent insolvent and reduced its basis of depreciable property and net operating loss in corresponding amounts. The $2,741,399 related to the cancellation of debt for Loan N712A and/or Loan N712B. As of October 4, 2012, Exterra was insolvent up to $2,741,399. This change resulted in Exterra's reporting zero in ordinary business income on the amended Form 1120S. Exterra issued an amended Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., to Mr. Parker to reflect the reduction in ordinary business income. Exterra did not include in income any amounts relating to Loan N713 on either its original or amended Form 1120S.

For tax year 2012 petitioners filed an original Form 1040, U.S. Individual Income Tax Return, on which they reported $2,741,399 in flowthrough income from Exterra. Subsequently, petitioners filed a Form 1040X, Amended U.S. Individual Income Tax Return, for 2012, **[*6]** reflecting the amended Schedule K-1 and reporting zero in flowthrough income from Exterra.

IV. The Notice of Deficiency and the Petition

On April 15, 2016, respondent issued to petitioners a notice of deficiency for tax year 2012 determining a $3,111,363 deficiency, a $157,224.40 section 6651(a)(1) addition to tax, and a $622,327.20 section 6662(a) accuracy-related penalty. The determined deficiency included an upward adjustment to Exterra's gross receipts of $2,741,399. Petitioners timely filed a Petition disputing respondent's deficiency determinations.

Discussion

I. Jurisdiction and Burden of Proof

Where a notice of deficiency issued to an S corporation shareholder includes adjustments to both S corporation items and other items unrelated to the S corporation, we have jurisdiction to determine the correctness of all adjustments in the shareholder-level deficiency proceeding. *See Johnson v. Commissioner*, No. 19973-18, 160 T.C., slip op. at 11 (Jan. 25, 2023) (citing *Winter v. Commissioner*, 135 T.C. 238, 245-46 (2010)). We thus have jurisdiction to redetermine the correctness of respondent's adjustments to petitioners' flowthrough share of Exterra's income and any other determinations in the notice of deficiency.

In general, the Commissioner's determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving them erroneous.[4] Rule 142(a)(1); *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *Rapp v. Commissioner*, 774 F.2d 932, 935 (9th Cir. 1985). The submission of this case to the Court under Rule 122 does not change or otherwise lessen petitioners' burden of proof. *See* Rule 122(b).

[*7] II. Tax Treatment of Debt Cancellation

Section 61(a) broadly defines gross income as "all income from whatever source derived." Section 61(a)(3) specifies that gross income includes "[g]ains derived from dealings in property," while section 61(a)(12) does the same for "[i]ncome from discharge of indebtedness."[5] *See Gehl v. Commissioner*, 102 T.C. 784, 789 (1994) ("[P]aragraphs (3) and (12) of section 61(a) are separate, independent, and not overlapping provisions in respect of the includability of a particular item in income."), *aff'd*, 50 F.3d 12 (8th Cir. 1995). The distinction between these two subcategories of gross income — gain from property and COD income — can have significant tax consequences.

When a taxpayer sells or disposes of property, the amount realized is equal to the amount of money plus the fair market value of any property received. §1001(b). When a taxpayer sells or otherwise disposes of property encumbered by nonrecourse debt,[6] the amount of the outstanding debt is typically included in the amount realized.[7] *See Commissioner v. Tufts*, 461 U.S. 300, 317 (1983); *Crane v. Commissioner*, 331 U.S. 1, 14 (1947); *Milkovich v. United States*, 28 F.4th 1, 8 (9th Cir. 2022); Treas. Reg. § 1.1001-2(a)(1). To the extent that the amount realized exceeds the taxpayer's basis in the property, the taxpayer has gain. *See* §1001(a).

In contrast, a COD that is not part of a sale or exchange of property generally results in COD income, which may then be subject to certain statutory exclusions. *See* §108(a)(1); *see also*

Estate of Delman v. Commissioner, 73 T.C. 15, 31-32 (1979). Relevantly, section 108(a)(1)(B) allows a taxpayer who is insolvent at the time of a debt cancellation to exclude COD income from gross income. The amount of this exclusion is limited to the amount of the taxpayer's insolvency, i.e., the amount by which the taxpayer's liabilities exceed the fair market **[*8]** value of their assets. §108(a)(3); *see White v. Commissioner*, T.C. Memo. 2023-77, at *3.

In deciding whether debt relief results in gain or COD income, we focus on the facts and circumstances surrounding how the taxpayer-debtor satisfied or extinguished the underlying debt. *See Danenberg v. Commissioner*, 73 T.C. 370, 381 (1979); *Peninsula Props. Co. v. Commissioner*, 47 B.T.A. 84, 91-92 (1942). If nonrecourse debt relief is conditioned upon a sale or exchange of property or is otherwise a part of that underlying sale or exchange, the amount of debt relief is properly included in the amount realized and is not COD income. *See Simonsen*, 150 T.C. at 211 (focusing on fact that lender's willingness to cancel mortgage debt was completely dependent on debtor's willingness to convey proceeds from sale of residence); *Sands v. Commissioner*, T.C. Memo. 1997-146, 73 T.C.M. (CCH) 2398, 2403 (rejecting taxpayer's contention that COD was "separate and distinct" from transfer of ownership in property), *aff'd without published opinion sub nom. Murphy v. Commissioner*, 164 F.3d 618 (2d Cir. 1998); Treas. Reg. § 1.1001-2(a)(1) ("[T]he amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged *as a result* of the sale or disposition." (Emphasis added.)); *see also 2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313, 319 (5th Cir. 1999) (concluding that debt relief "was closely intertwined" with underlying sale of property and thus included in amount realized on sale), *aff'g* T.C. Memo. 1997-298. In such an instance, it is immaterial whether debt relief takes the form of an assumption of debt by a purchaser or a cancellation by a lender. *See 2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d at 319; *Simonsen*, 150 T.C. at 212-13.

Respondent contends that the $2,741,399 relating to the cancellation of Loans N712A and N712B is taxable to Exterra as gain derived from the sale of the Livermore property. *See* §61(a)(3). Respondent emphasizes that Loans N712A and N712B were nonrecourse to Exterra and were canceled as part of the sale of the Livermore property.

Petitioners take a rather different approach. In their briefing petitioners sidestep the threshold inquiry — whether the debt cancellation was part of the sale of the Livermore property and thus gave rise to gain — and focus on their contentions that either Exterra or petitioners themselves were insolvent at the time the debt was discharged. *Cf. Gehl*, 102 T.C. at 789 ("Only after it is determined that [section 61(a)(12)] applies does one reach the question of the impact of **[*9]** insolvency and therefore the applicability of section 108."); *Danenberg*, 73 T.C. at 384 (rejecting taxpayers' argument that their insolvency precluded inclusion of debt relief in amount realized). As best we can tell, much of petitioners' briefing is premised on a misconception that facts relating to Mr. Parker in his personal capacity are relevant to the question of whether there was income to Exterra in 2012 (and only then, flowthrough income to Mr. Parker as its 100% S corporation shareholder). In determining whether to sustain respondent's upward adjustment to Exterra's gross receipts (and thus the corresponding deficiency with respect to petitioners), we respect Exterra's separate corporate existence. *See Durando v. United States*, 70 F.3d 548, 552 (9th Cir. 1995) ("[I]t [is] improper to treat income earned by [an S] corporation through its trade or business as though it were earned directly by its shareholders. . . ."); *Crook v. Commissioner*, 80 T.C. 27, 33 (1983) ("The separate existence of corporations is firmly established under the tax law, and this Court has recognized that the business of a subchapter S corporation is separate and distinct from that of its shareholders." (internal citation omitted)), *aff'd*, 747 F.2d 1463 (5th Cir. 1984). Accordingly, petitioners' observation, for instance, that Loans N712A and N712B were recourse as to Mr. Parker personally, is simply irrelevant to the issue before us.

We agree with respondent that the issue in this case is the threshold question of whether the cancellation of Loans N712A and N712B gave rise to gain or COD income for Exterra. We ultimately resolve that question in respondent's favor.

The parties have stipulated that Loans N712A and N712B were nonrecourse as to the PLF entities and Exterra. While the original loan agreements for Loans N712A and N712B are not part of the stipulated record, the parties further stipulated that Loans N712A and N712B were each mezzanine loans. The record establishes that Loan N712A and N712B were each secured by the PLF entities' pledge of their respective membership interests in the Montevina entities. Because the PLF entities and the Montevina entities were disregarded entities for federal income tax purposes, we treat Exterra as owning the underlying assets (i.e., the Livermore property), subject to the nonrecourse mezzanine Loans N712A and N712B, before the sale.[8] *See* Treas. Reg. **[*10]** § 301.7701-2(a) ("[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."); *see also Pierre v. Commissioner*, 133 T.C. 24, 42 (2009) (Halpern, J., dissenting) ("A sole proprietorship is generally understood to have no legal identity apart from the proprietor."), *supplemented by* T.C. Memo. 2010-106. In turn the sale of the PLF entities' membership interests in the Montevina entities is characterized for federal income tax purposes as a sale of the encumbered Livermore property by Exterra. *See DAF Charters, LLC v. Commissioner*, 152 T.C. 250, 260 (2019) ("[A]ny items of income and loss generated by the [disregarded] entity are directly attributable to and reported by the entity's owner for Federal tax purposes. . . ."); *see also* Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies* §2:83 Westlaw (database updated June 2023) ("The transfer of the interest in a disregarded entity is not treated as a transfer of the interest for federal tax purposes, but rather as a transfer of the assets of the disregarded entity.").

The record is further clear that the cancellation of Loans N712A and N712B was part of the sale by Exterra (through the disregarded entities) of the Livermore property to the Buyers. As the relevant loan termination agreements between the PLF entities and NRFC WA Holdings II represented, the loan cancellation was made "[i]n connection with the proposed sale." Further, the loan termination agreements were executed on October 4, 2012 — the same date that the various other agreements effecting the sale of the Livermore property, including the consent and release agreement to which NRFC WA Holdings II was a party, were executed. The COD was part and parcel of the global agreement to convey the Livermore property, with NRFC WA Holdings II accepting new personal guaranties, a partial payment by the Buyers, and the escrowed deed to the Iowa property in consideration of that cancellation.

We conclude that NRFC WA Holdings II's cancellation of Loans N712A and N712B was dependent on Exterra's sale of the Livermore property to the Buyers and was a part of the same sale transaction. *See Simonsen*, 150 T.C. at 211. Accordingly, given that Loans N712A and N712B were nonrecourse as to Exterra, the amount of debt relief was properly includible in Exterra's amount realized on the sale of the **[*11]** Livermore property and gave rise to gain to the extent in excess of Exterra's basis in the property. *See* Treas. Reg. § 1.1001-2(a)(1). In turn, that gain flowed through to petitioners' personal income tax returns via Mr. Parker's 100% shareholder interest in Exterra.

III. Conclusion

We hold that the $2,741,399 was properly includible in Exterra's amount realized on the sale of the Livermore property. We will sustain respondent's determination of a deficiency with respect to this issue.

To reflect the foregoing,

Decision will be entered under Rule 155.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2]Respondent has conceded several issues underlying the determined deficiency and has conceded that petitioners are not liable for an accuracy-related penalty under section 6662(a) or an addition to tax under section 6651(a)(1).

[3]A mezzanine loan is a type of hybrid financing often used in commercial real estate, where the debtor typically pledges as collateral its equity interest in another entity. *See, e.g., Gaia House Mezz LLC v. State St. Bank & Tr. Co.*, 720 F.3d 84, 87 n.1 (2d Cir. 2013). With respect to a mezzanine loan, the creditor thus sits in an intermediate position to recover from the debtor, junior to any mortgage debt but senior to equity. *See* Andrew R. Berman, *Risks and Realities of Mezzanine Loans*, 72 Mo. L. Rev. 993, 998 (2007) ("Like a theater, mezzanine debt sits in the mezzanine section between senior debt in the more expensive orchestra, and equity sitting in the cheaper section of the balcony.").

[4]The burden of proof may shift from the taxpayer to the Commissioner in certain circumstances under section 7491(a), but petitioners do not allege, nor does the evidence suggest, that the burden of proof should shift to respondent under section 7491(a) as to any issue of fact.

[5]After 2012, the year at issue, section 61(a)(12) was renumbered as section 61(a)(11).

[6]"Indebtedness is generally characterized as 'nonrecourse' if the creditor's remedies are limited to particular collateral for the debt and as 'recourse' if the creditor's remedies extend

to all the debtor's assets." *Simonsen v. Commissioner*, 150 T.C. 201, 205 (2018) (quoting *Great Plains Gasification Assocs. v. Commissioner*, T.C. Memo. 2006-276, 92 T.C.M. (CCH) 534, 550).

[7]If the sold or disposed-of property instead secures recourse debt, the amount realized does not include amounts that would otherwise be COD income (i.e., debt relief in excess of the fair market value of the underlying property). *See Frazier v. Commissioner*, 111 T.C. 243, 245 (1998); Treas. Reg. § 1.1001-2(a)(2).

[8]For federal income tax purposes, we characterize the mezzanine Loans N712A and N712B, which were secured by pledges of equity in the disregarded Montevina entities, as nonrecourse debt encumbering the underlying Livermore property in the hands of Exterra, the regarded entity; we note that the Commissioner as previously adopted a similar view in subregulatory guidance in a related context. See Rev. Proc. 2014-20, 2014-9 I.R.B. 614; I.R.S. Priv. Ltr. Rul. 09-53-005 (Dec. 31, 2009).

END FOOTNOTES

TaxProf Blog

Monday, August 28, 2023

Lesson From The Tax Court: *The DOI Downside To Disregarded LLC*

By Bryan Camp

According to this Wikipedia entry, the *"limited liability company ("LLC") has grown to become one of the most prevalent business forms in the United States."* That is likely because state law gives substantial liability protections to LLCs, similar to traditional corporations, but allows for more flexible ownership and governance structures. That flexibility also creates more difficulties for creditors to pierce the liability shield. For a good review of that idea *see* Dave Rugani, Twenty-First Century Equity: Tailoring The Corporate Veil Piercing Doctrine To Limited Liability Companies In North Carolina, 47 Wake Forest L. Rev. 899 (2012).

LLC popularity is also due in no small part to the 1996 Treasury Regulations that give LLCs the power to choose how to be taxed by the federal government. For example, a single-member LLC can choose to be recognized as a separate taxable entity or can choose to be totally disregarded. Many times a single owner will choose disregarded status. Disregarded status just means that all business activity is the owner's activity and the owner reports all activity on their Schedule C. There is no separate entity taxation, even though there is a separate legal entity under state law.

The upside of disregarded status is generally a reduced tax burden and reduced compliance burden. Today we learn of a potential downside to disregarded status: a lender's discharge of a disregarded LLC's debt results in income to the owner even though neither the owner nor the owner's personal assets were on the hook to repay the loan and the discharge happened long after the LLC went defunct. In *Steven Jacobowitz v. Commissioner*, T.C. Memo. 2023-107 (Aug. 16, 2023) (Judge Ashford), the individual taxpayer was sole owner of an LLC that had taken out a small business loan. Under state law Mr. Jacobowitz had no obligation to repay the loan. It was the LLC's obligation, not his. However, when the lender discharged the LLC from its obligation to repay, some 8 years after the LLC ceased to exist, that Discharge Of Indebtedness (DOI) was income to Mr. Jacobowitz. The bummer details are below the fold.

Background: Quick DOI Review

Remember, no one really knows why Discharge of Indebtedness (DOI) is income. There are two theories: I call them the balance sheet theory and the expectancy theory.

The balance sheet theory says the borrowed funds are not income because the loan creates an immediate offsetting debit on the taxpayer's balance sheet. The taxpayer is no wealthier because the taxpayer's assets are burdened by the obligation to repay. Accordingly, when the taxpayer is discharged from debt, those assets are "free up" and that is the accession to wealth. The classic case is *United States v. Kirby Lumber*, 284 U.S. 1 (1931) where the sainted Justice Holmes used the balance sheet theory to explain why a company had income from buying back its previously issued bonds, effectively cancelling $137k of its debt: *As a result of its dealings, it made available [$137k] assets previously offset by the obligation of bonds now extinct."* 284 U.S. at 2.

The expectancy theory says that the borrowed funds are not income because we just expect they will be repaid over time so what looks like income is just imaginary. However, when the debt is forgiven, that expectation vanishes and the forgiven amount of unpaid debt becomes real, not imaginary income. Burdened assets? We don't care about no burdened assets! The classic case for this is *Commissioner v. Tufts*, 461 U.S. 300 (1984).

To see the two theories at work in the same case, go read *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), where the majority uses the expectancy theory and the dissent relies on the balance sheet theory. For those who want more details on these theories, see Lesson From The Tax Court: *The Phantom Of The Tax Code—Discharge Of Indebtedness*, TaxProf Blog (Feb. 19, 2018).

Background: LLCs and Check the Box Regs

LLCs first appeared on the business organization scene in 1977, a creature of Wyoming state law, according to Wikipedia. At that time tax law had a top-down set of rules for how to classify business entities. It was top-down because the IRS would tell you what the proper classification was. Predicting how the IRS would classify LLCs was tricky because LLCs had some characteristics of corporations and other characteristics of partnerships. They did not fit neatly into either box.

Eventually the IRS interpreted Wyoming LLCs as partnerships in Rev. Rul. 88-76. After that more states began permitting the LLC structure. Eventually, in 1996, the IRS and Treasury issued what are called "Check the Box" regulations, now codified as Treas.Reg. 301.7701-1 through Treas.Reg. 301.7701-3. These regulations flipped the law from a top-down set of rules—where the IRS tells an entity its classification—to a bottom-up set of rules, where the entities themselves get to tell the IRS their classification. LLCs then became all the rage.

Tax law thus now permits the owner or owners of an LLC to elect how their LLC will be treated for federal income tax purposes. Treas.Reg. 301.7701-3(a). When the LLC is owned by multiple shareholders, they can elect for it to be treated like a traditional corporation or instead like a partnership where income or losses from the business are passed through.

When the LLC is owned by a single shareholder, however, their potential election is a bit different. They can elect for the LLC to be taxable as a separate corporation, or they can elect for it to be totally disregarded, so that the business activities of the LLC are treated as the business activities of the single owner, just as if the business was a sole proprietorship. If the single shareholder makes no election, the default tax rule is that the LLC will be disregarded. Treas.Reg. 301.7701-3(b)(2).

For a great article explaining the history and development of these Check-The-Box Treasury regulations, *see* Heather Field, Checking In On Check The Box, 42 Loyola L.A. Law Rev. 451 (2009).

Facts

The tax year at issue is 2016. But the events creating the tax problem that year started many years earlier. According to the Court, Mr. Jacobowitz owned and operated a single member LLC called Sagasolutions that *"he established in November 2003."* Op. at 2. It appears that Sagasolutions was in the business of Customer Relations Management (CRM)

In 2006, the company obtained a $25,000 small business line of credit. Mr. Jacobowitz *"executed on Sagasolutions' behalf a promissory note and a security agreement." Id.*

It is not clear when the company ended. The court said it *"ceased to exist in approximately May 2008."* Op. at 2. But at the same time, the Court also found that Sagasolutions *"took advances from, and made payments to, the line of credit numerous times from January 2006 to September 2010." Id.* Hokay. And then there is an even different story in Mr. Jacobowitz's LinkedIn page, which I'll touch on in the Coda.

Regardless, the Court found that Sagasolutions' last principal payment on the loan was in September 2010. In 2016, the lender wrote off the debt because the state statute of limitations for collecting the debt had run. The lender sent both Sagasolutions and the IRS a Form 1099-C (Cancellation of Debt) for just under $35,000.

On his 2016 Form 1040 Mr. Jacobowitz reported an adjusted gross income of just over $709,000 but none of it was from the DOI. Most of it was compensation from his employer at the time, who also required him to use the services of Ernst & Young to prepare his tax return. Op. at 3. From Mr. J's LinkedIn page it appears his employer was IBM during this year.

The IRS audited the 2016 year and thought Mr. Jacobowitz should have reported the $35k DOI. He disagreed and petitioned the Tax Court.

So let's look at what we learn from Judge Ashford.

Lesson: A Disregarded LLC's DOI is the Owner's DOI Income

Mr. Jacobowitz (pro se) argued that, under state law, neither he nor any of his assets were burdened by the loan made to Sagasolutions. Thus, because the DOI did not free up any of *his personal* assets he personally could not have any DOI! And by the time the DOI occurred, in 2016, Sagasolutions was long dead. So none of *its* assets were freed up either. Truly, that was an argument that would have made Justice Holmes proud!

Judge Ashford, however, is not impressed, calling the argument *"ill conceived."* Op. at 5. She explains that the argument assumes that Sagasolutions was a different taxable entity than Mr. Jacobowitz. It was not. *"Although state law governs the legal relationships that are established when an entity is formed, federal tax governs whether an entity is taxed, or disregarded, as a corporation."* Op. at 6. In other words, the loan to Sagasolutions was, for federal tax law purposes, a loan to Mr. Jacobowitz at the time it was made. Discharge of Sagasolutions from the obligation to repay was thus also a discharge to Mr. Jacobowitz. *"Sagasolutions is treated as a disregarded entity for federal tax purposes, and petitioner, as its sole member, is required to report on his federal income tax return* ***any*** *income (or loss) attributable to Sagasolutions."* Op. at 7 (internal citations omitted, emphasis supplied).

Alert readers will notice the implication of Judge Ashford's reasoning here. It's the expectancy theory at work! When the line of credit was active, Sagasolutions was a disregarded entity and the draws would count as income to Mr. Jacobowitz ... *if* they counted as income. But they *did not* count as income at that time, because of the expectation the loan was going to be repaid. Thus it was the *expectation* of repayment that allowed Mr. Jacobowitz to not have to report the draws on the line of credit as income, not the burdening of his assets (since his assets were not burdened). By 2016, the state statute of limitations had run and that expectation of repayment was gone, converting all the non-taxable draws into taxable income at that later time. Again, it does not matter that there were no assets to free up.

Notice, too, that the insolvency of the LLC does not matter. That's because it's *disregarded*! Sure, if *Mr. Jacobowitz* was insolvent in 2016, then maybe *he* could invoke §108. But gosh, the dude pulled in over $700,000 of income that year, making it unlikely he was insolvent at the time of the DOI.

Bottom Line: State law might well shield a single-member LLC's owner from the LLC's debt obligations. But it cannot shield the *owner* from the DOI tax consequences if that debt is later discharged when the LLC is a disregarded entity.

Coda 1: Other Loser Arguments Mr. Jacobowitz shows himself to be a creative advocate in several respects. First, he tried to argue that the DOI occurred in 2008 when, he claimed, he abandoned Sagasolutions business property. But that's a facts-and-circumstances decision and he was unable to establish facts to prove up the contention. While he testified, Judge Ashford found him to be an unreliable narrator. Op. at 8. *See* Coda 2 below. Judge Ashford instead looked to the regulations governing a lender's obligation to file a 1099-C to find that the lender here properly reported the DOI in the year the debt because legally unenforceable under state law.

Second, Mr. Jacobowitz had the good idea to try and argue that the portion of the DOI representing accrued interest should be excluded from income because payment of that interest would have deductible as an ordinary and necessary business expense. §108(e)(2). Again, he fell on his face on the facts. Judge Ashford points out that he offered no evidence to show how the loan proceeds were used and, more importantly, *"the evidentiary record unminstakeably shows that that Sagasolutions stopped doing business in 2008 and that 2009 was the last year that Sagasolutions' income (or loss) was reported to the IRS, before the interest stated accruing in 2010."* Op. at 10.

Coda 2: The Unreliable Narrator. I think Judge Ashford's concerns about Mr. Jacobowitz's testimony were justified. I found it interesting that the story Mr. Jacobowitz presented to the Tax Court seems quite different than the public story he tells on his LinkenIn site. Mr. Jacobowitz's LinkedIn profile says that he started Sagasolutions in 1993 and then ***sold it*** in 2008. Here's his blurb: *"Grew from 1 to 14 employees before company was sold. Our only focus was CRM Applications, Started with TeleMagic, Moved to GoldMine where we achieved Top 5 Reseller Status for 5 years, and Gold Managed Microsoft Partner for 4 years. Grew revenue from 0 to 5 million per year."*

Well, gosh. The LinkenIn claim that he **sold** Sagasolutions seems to directly contradict the story he apparently gave in Court where he testified that *"when Sagasolutions ceased to exist in 2008, he left a lot of...furniture"* and *"was shocked in 2009 that [the lender] hadn't come after [him] for whatever was left of Saga...."* Op. at 8 (internal quotes omitted). Also, one wonders why, if he indeed grew revenue to $5 million per year at the end, he was unable to pay off the $34,000 line of credit. Or, if he really did sell the company, why didn't he sell the debt as well? Is it possible...just *possible*...that the LinkedIn blurb is wrong? Perish the thought.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/08/lesson-from-the-tax-court-the-doi-downside-to-disregarded-llc.html

Individual Had Canceled Debt Income From Single-Member LLC

AUG. 16, 2023

Steven Jacobowitz v. Commissioner

STEVEN JACOBOWITZ,

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed August 16, 2023

Thomas S. Groth, for petitioner.

William C. Bogardus, for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

ASHFORD, *Judge*: By statutory notice of deficiency dated April 29, 2019, the Internal Revenue Service (IRS or respondent) determined a deficiency in petitioner's federal income tax of $15,266 for the 2016 taxable year. After certain concessions by petitioner,[1] the issue remaining for decision is whether for 2016 petitioner must include in gross income cancellation of indebtedness (COD) income of $34,964.[2] We hold he must.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The Stipulation of Facts and the attached Exhibits are incorporated herein **[*2]** by this reference. Petitioner resided in Connecticut when his Petition was timely filed with the Court.

Petitioner was the sole member of an entity named Sagasolutions.com (Sagasolutions), a single-member limited liability company he established in November 2003. Sagasolutions ceased to exist in approximately May 2008. During its existence it designed and delivered technical solutions to companies having problems in the areas of customer service, sales, and marketing. Additionally, during its existence it was a disregarded entity for federal income tax purposes; it never filed Form 8832, Entity Classification Election, with the IRS to be classified otherwise. The last year for which Sagasolutions' income (or loss) was reported to the IRS was 2009.

On January 17, 2006, Sagasolutions secured a $25,000 small business line of credit with Connecticut-based Newtown Savings Bank (Newtown). In connection with this line of credit petitioner executed on Sagasolutions' behalf a promissory note and a security agreement. The promissory note set forth the terms of the line of credit, including the interest rate, the minimum advance amount, the monthly principal repayment amount and date, the amounts for finance charges and other fees, and that the line of credit would be linked as overdraft protection to petitioner's personal checking account, also at Newtown.[3] The security agreement set forth in pertinent part what property of Sagasolutions was pledged as security for the repayment of the line of credit and under what circumstances Sagasolutions would be in default of its payment or other obligations with respect to the line of credit.

Sagasolutions took advances from, and made payments to, the line of credit numerous times from January 2006 to September 2010. The first advance, of $7,000, was on January 24, 2006, and the last, of $625, was on April 5, 2010. When Sagasolutions' last principal payment of $52 was made on September 27, 2010, the outstanding principal balance for the line of credit was $24,948.

Newtown sent Sagasolutions and the IRS a Form 1099–C, Cancellation of Debt, for 2016. This form indicated that as of December 30, 2016, Newtown had discharged the outstanding principal balance and accrued interest, which totaled $34,964, after the September 27, **[*3]** 2010, payment owed on the line of credit. The form also indicated that the reason for the discharge was "Statute of limitations or expiration of deficiency period."

Petitioner prepared and timely filed (with the assistance of Ernst & Young as required by his employer at the time) his 2016 federal income tax return. As relevant here, on this return petitioner reported adjusted gross income of $709,153, consisting of wages of $707,265, taxable interest of $13, taxable dividends of $1,411, and capital gains of $464. Petitioner did not report on this return the COD income totaling $34,964.

Following an examination of petitioner's 2016 federal income tax return, the IRS determined in pertinent part that the outstanding principal balance and accrued interest owed on the line of credit that Newtown discharged, totaling $34,964, was taxable "other"/COD income to petitioner. The April 29, 2019, notice of deficiency issued to petitioner reflects this determination.

OPINION

I. Burden of Proof

As a preliminary matter we address who has the burden of proof in this case.

In general, the IRS's determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving otherwise. Rule 142(a);[4] *Welch v. Helvering*, 290 U.S. 111, 115 (1933). For this presumption to adhere in cases (such as this one) involving unreported income, the Commissioner must provide some reasonable foundation connecting the taxpayer to the income-producing activity. *El v. Commissioner*, 144 T.C. 140, 142–43 (2015) (citing *Llorente v. Commissioner*, 649 F.2d 152, 156 (2d Cir. 1981), *aff'g in part, rev'g in part and remanding* 74 T.C. 260 (1980)). Once the Commissioner has done this, the burden shifts to the taxpayer to prove by a preponderance of the evidence that the Commisioner's determinations are arbitrary or erroneous. *Id.* at 143. Similarly, under section 6201(d), if a taxpayer in any court proceeding asserts a **[*4]** reasonable dispute with respect to any item of income reported on an information return (such as a Form 1099–C) and has fully cooperated with the Commissioner, then the Commissioner shall have the burden of producing reasonable and probative information concerning the deficiency, in addition to the information return. *See also Kleber v. Commissioner*, T.C. Memo. 2011-233, slip op. at 5.

It is undisputed that Sagasolutions was a single-member limited liability company with petitioner as its sole member and that petitioner, on behalf of Sagasolutions, executed a promissory note and a security agreement for a line of credit with Newtown. It is also undisputed that Sagasolutions had an outstanding line of credit balance of $24,948 and that Newtown forgave that outstanding balance plus accrued interest, which totaled $34,964; with respect to that $34,964, Newtown sent the IRS and Sagasolutions a Form 1099–C, and petitioner's dispute, as discussed below, involves solely whether the $34,964 is taxable COD income to him (and thus not as to the accuracy of the form). On the basis of this undisputed evidence, we are satisfied that respondent has provided a reasonable foundation connecting petitioner with the unreported income. The burden thus shifts to petitioner to show that the IRS's determination with respect to this income was arbitrary or erroneous.[5]

II. COD Income

A taxpayer's gross income includes "all income from whatever source derived," including COD income. §61(a)(12).[6] "The underlying rationale for the inclusion of canceled debt as income is that the release from a debt obligation the taxpayer would otherwise have to pay frees up assets previously offset by the obligation and acts as an accession to wealth — i.e., income." *Weiderman v. Commissioner*, T.C. Memo. 2020-109, at *23 (quoting *Bui v. Commissioner*, T.C. Memo. 2019-54, at *7–8); *see also Landreth v. Commissioner*, 50 T.C. 803, 813 (1968) ("Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction had **[*5]** never occurred. This real increase in wealth may be properly taxable." (citing *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931))). COD income is recognized for the year in which the debt is canceled and is taxed at ordinary rates. *Weiderman*, T.C. Memo. 2020-109, at *23–24 (and cases cited thereat).

As indicated *supra* p. 4, petitioner does not dispute that Sagasolutions owed $24,948 (plus interest) to Newtown and that Newtown canceled that debt, which, as of the December 30, 2016, cancellation date, totaled $34,964. Instead, petitioner contends that (1) this COD income should not be attributed to him but to Sagasolutions; (2) the debt in any event was discharged before 2016; (3) any COD income that may be attributed to him should be characterized as capital gain; and (4) the portion of the COD income that is interest is excludable from his gross income pursuant to section 108(e)(2). Below we address each contention in turn.

A. Tax Consequences to Petitioner of Sagasolutions' Discharged Debt

Petitioner contends that the COD income arising from Newtown's discharge of Sagasolutions' debt should not be attributed to him but rather to Sagasolutions. Petitioner relies on Conn. Gen. Stat. §34-251a(a) (2017), which provides:

> A debt, obligation or other liability of a limited liability company is solely the debt, obligation or other liability of the company. A member or manager is not personally liable, directly or indirectly, by way of contribution or otherwise, for a debt, obligation or other liability of the company solely by reason of being or acting as a member or manager. This subsection applies regardless of the dissolution of the company.

His rationale is that despite his being Sagasolutions' sole member, because he did not personally guarantee Sagasolutions' line of credit with Newtown, his individual assets cannot be reached to satisfy any outstanding line of credit balance; as a result he did not realize any taxable income when Newtown discharged the debt. Under petitioner's rationale, without a personal guaranty, for a disregarded entity there can be no tax consequences for discharged indebtedness. Such a rationale is ill conceived.

[*6] Although state law governs the legal relationships that are established when an entity is formed, federal law governs whether an entity is taxed, or disregarded, as a corporation. *Moye v. Commissioner*, T.C. Memo. 1997-554, slip op. at 15 (and cases cited thereat). Treasury Regulation §§301.7701-1 through 301.7701-3 provide rules for the classification of business entities for federal tax purposes. Known as the "check-the-box" regulations, these regulations generally grant broad discretion to business owners, who can often elect (by "checking the box" for a certain entity type on a form filed with the IRS, hence the name) whether an entity through which they conduct business is treated as an association (i.e., a corporation), a partnership, or a disregarded entity for federal tax purposes. Treas. Reg. §301.7701-3(a); *see also DAF Charters, LLC v. Commissioner*, 152 T.C. 250, 259–60 (2019) (and cases cited thereat).

The check-the-box regulations do not always grant entity owners a choice, though, listing some types of entities that are irrevocably considered corporations. *DAF Charters, LLC*, 152 T.C. at 260 (citing Treas. Reg. §301.7701-2(b)). Entities not in this list may elect their treatment, and the regulations provide default options for entities that fail to choose. *Id.* (citing Treas. Reg. §301.7701-3(b)). In particular, a domestic entity that is not a corporation and has a single owner is disregarded as an entity separate from its owner unless the owner elects otherwise. *Id.* (citing Treas. Reg. §§301.7701-2(c)(2)(i), 301.7701-3(b)(1)(ii)). The effect of being disregarded is that, in general, the entity is treated as a sole proprietorship or branch of its owner. *Id.* (citing Treas. Reg. §301.7701-2(a)). Although the entity may be recognized separately from its owner under state or other federal law, any items of income and loss generated by the entity are directly attributable to and reported by the entity's owner for federal tax purposes (and the entity is not subject to corporate income tax or any partnership or S corporation income allocation rules, all of which are codified under subtitle A of the Code).[7] *Id.*

[*7] Sagasolutions never filed Form 8832 with the IRS electing to be treated as a corporation. As a result, Sagasolutions is treated as a disregarded entity for federal tax purposes, *see* Treas. Reg. §301.7701-2(a); *see also Comensoli v. Commissioner*, T.C. Memo. 2009-242, slip op. at 8, *aff'd*, 422 F. App'x 412 (6th Cir. 2011), and petitioner, as its sole member, is required to report on his federal income tax return any income (or loss) attributable to Sagasolutions. Thus, petitioner should have reported COD income of $34,964, i.e., the amount of Sagasolutions' debt that Newtown discharged.

B. Timing of the Debt Cancellation

Petitioner next contends that Sagasolutions' debt was discharged before 2016. In support of his contention, petitioner claims that (1) the property used to secure the line of credit was abandoned in 2008 and (2) Sagasolutions' last payment to the line of credit was in 2008. Petitioner's contention is without merit.

The question as to the year in which a debtor's obligation is canceled (thus giving rise to COD income) is one of fact to be determined on the basis of the evidence. *Miller Tr. v. Commissioner*, 76 T.C. 191, 195 (1981). A debt is deemed discharged (and COD income is generated) the moment it becomes clear that the debt will never have to be paid. *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987). Determining when that moment occurs requires a practical assessment of the facts and circumstances relating to the likelihood of payment. *Id.* (and cases cited thereat). "Any 'identifiable event' which fixes the loss with certainty may be taken into consideration." *Id.* (citing *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927)).

Treasury Regulation §1.6050P-1(b)(2) provides an exclusive list of seven "identifiable events" which constitute a discharge of debt for canceled debt information reporting purposes under section 6050P. The occurrence of one or more of these events triggers a creditor's obligation to send a Form 1099–C to the IRS and the debtor reporting the COD income. Treas. Reg. §1.6050P-1(a). As relevant here, the third of the seven "identifiable events" giving rise to COD income (and thus the reporting requirement), provided in Treasury Regulation §1.6050P-1(b)(2)(i)(C), is "[a] cancellation or extinguishment of an indebtedness upon the expiration of the statute of limitations for collection of an indebtedness, subject to the limitations described in paragraph (b)(2)(ii) of this section, *or upon the expiration of a statutory period for filing a* **[*8]** *claim or commencing a deficiency judgment proceeding*." (Emphasis added.)

With respect to abandoning the property of Sagasolutions that secured the line of credit, petitioner testified at trial that when Sagasolutions ceased to exist in 2008, he "left a lot of . . . furniture" where it had an office and "was shocked in 2009 that [Newtown] hadn't come after [him] for whatever was left of Saga[solutions]." We need not, and do not, accept petitioner's self-serving testimony when he has failed to present credible, corroborative, documentary evidence. *See Tokarski v. Commissioner*, 87 T.C. 74, 77 (1986). Petitioner offered no evidence of what furniture was left behind or its value, nor of whether Newtown was ever informed of the alleged abandonment.

In his opening brief petitioner on the one hand claims that "[i]t is clear from the evidence . . . that [Sagasolutions] was no longer making any payments [with respect to its line of credit with Newtown] as early as 2008," but then on the other hand just a few sentences later in his brief he contends that "it is clear from the Transaction History that no payments were being made [with respect to the line of credit] subsequent to September 2010." The documentary evidence in this case shows that Sagasolutions defaulted on its line of credit sometime in 2010 (not 2008), and at the latest on October 5, 2010, which was the next due date with respect to the line of credit after a final principal payment of $52 was made in September 2010.

Connecticut law mandated that Newtown bring an action within six years of when the action accrued. *See* Conn. Gen. Stat. §52-576(a) (1971) ("No action for an account, or on any simple or implied contract, or on any contract in writing, shall be brought but within six years after the right of an action accrues. . . ."). With Newtown's right of action accruing sometime in 2010 (and at the latest on October 5, 2010), its opportunity to bring an action with respect to the line of credit expired sometime in 2016 (and no later than October 5, 2016). Newtown did not bring an action (nor did it attempt to seize or foreclose on any of Sagasolutions' property that was pledged as security for the repayment of the line of credit) during the 2010–16 timeframe. When the six-year period for bringing a claim expired, an identifiable event occurred and it triggered Newtown's obligation under section 6050P and the accompanying

Treasury regulations to issue Form 1099–C. Newtown properly did so, indicating that as of December 30, 2016, it had discharged the outstanding principal and accrued interest owed on the line of credit (totaling $34,964) because the time in which to bring a **[*9]** claim had expired. Consequently, 2016 was the correct year of the discharge of Sagasolutions' debt.

C. Characterization of the Discharged Debt

Petitioner further contends that any COD income that may be attributable to him should be characterized as capital gain. In support of his contention, he relies on *L&C Springs Assocs. v. Commissioner*, 188 F.3d 866 (7th Cir. 1999), *aff'g* T.C. Memo. 1997-469, and *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999), *aff'g* T.C. Memo. 1997-298.[8] Petitioner's contention is without merit.

In *L&C Springs Assocs.,* the U.S. Court of Appeals for the Seventh Circuit did not opine on the *nature* of the income, which is the focus of the dispute here; rather, at issue in *L&C Springs Assocs.* was *at what time* the taxpayer abandoned certain property, thereby triggering gain from cancellation of indebtedness for purposes of section 1001. *L&C Springs Assocs.*, 188 F.3d at 868. In *2925 Briarpark, Ltd.*, the issue was whether the taxpayer-partner and the limited partnership realized gain from dealings in property under section 61(a)(3), rather than cancellation of indebtedness income under section 61(a)(12); the U.S. Court of Appeals for the Fifth Circuit did not opine on whether the gain was capital. Sagasolutions and Newtown never agreed that Sagasolutions would surrender or abandon the property that secured the line of credit in exchange for Newtown's canceling the debt, and petitioner has taken no steps to show that the resulting COD income was from the exchange of a capital asset as defined in section 1221. The COD income is ordinary income under section 61(a)(12).

D. Amount of COD Income

Lastly, petitioner contends that because the line of credit was a business loan and the interest paid with respect thereto would have **[*10]** been a deductible business expense, the portion of the COD income that is interest ($10,016) is excludable from his gross income under section 108(e)(2). Petitioner's contention is without merit.

Section 108(e)(2) provides that no income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

As tax deductions are a matter of legislative grace, *Segel v. Commissioner*, 89 T.C. 816, 842 (1987), the taxpayer has the burden of (1) proving that any claimed deduction is allowable pursuant to some statutory provision and (2) substantiating the expense giving rise to the claimed deduction by maintaining adequate records, §6001; *Higbee v. Commissioner*, 116 T.C. 438, 440 (2001); *Hradesky v. Commissioner*, 65 T.C. 87, 89–90 (1975), *aff'd per curiam*, 540 F.2d 821 (5th Cir. 1976). Section 163(h)(1) provides that in the case of a taxpayer other than a corporation no deduction is allowed for personal interest paid or accrued during the taxable year. Interest paid or accrued on indebtedness properly allocable to a trade or business is excluded from the definition of personal interest and so is deductible. §163(h)(2)(A).

Petitioner offered no evidence at trial that the $10,016 of interest, which accrued after the last principal payment was made with respect to the line of credit, would have been an ordinary and necessary business expense. Statements in a party's brief, such as petitioner's assertion regarding the interest, are not part of the evidentiary record. *See* Rule 143(c) ("[S]tatements in briefs . . . do not constitute evidence."); *see also Ashkouri v. Commissioner*, T.C. Memo. 2019-95, at *36. Indeed, the evidentiary record unmistakably shows that Sagasolutions stopped doing business in 2008 and that 2009 was the last year that Sagasolutions' income (or loss) was reported to the IRS, *before* the interest started accruing in 2010. Accordingly, the total amount of the canceled debt, i.e., $34,964, is COD income to petitioner for 2016.

E. Conclusion

In sum, petitioner has not shown that the IRS's determination with respect to the COD income of $34,964 for 2016 was arbitrary or erroneous. Accordingly, we sustain the IRS's determination.

[*11] We have considered all of the arguments made by the parties and, to the extent they are not addressed herein, we find them to be moot, irrelevant, or without merit.

To reflect the foregoing,

Decision will be entered for respondent.

FOOTNOTES

[1]By way of a Stipulation of Settled Issues petitioner conceded that he is liable for unreported education program payments of $1,412, as well as an unreported additional 10% tax of $141 on the education program payments.

[2]Some monetary amounts are rounded to the nearest dollar.

[3]Sagasolutions had its own bank account at Newtown over which petitioner had sole signature authority; alternatively, the line of credit may have been linked as overdraft protection to that bank account.

[4]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C. (Code), in effect at all relevant times, regulation references are to the Code of Federal Regulations, Title 26 (Treas. Reg.), in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[5]Petitioner does not otherwise contend that the burden of proof as to any matter should shift to respondent under section 7491(a), nor has he established that the requirements for shifting the burden of proof under that section have been met. Accordingly, the burden of proof remains on petitioner. *See* §7491(a)(2).

[6]In 2017 section 61 was amended, with section 61(a)(12) becoming section 61(a)(11). *See* Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §11051(b)(1), 131 Stat. 2054, 2089.

[7]We also note that, pursuant to Treasury Regulation §1.108-9(a)(3), the insolvency exclusion of section 108(a)(1)(B) applies to the discharged indebtedness of a disregarded entity at the ownership level, i.e., the insolvency exclusion applies to the discharged indebtedness of a disregarded entity only to the extent the owner of the disregarded entity is insolvent; if the disregarded entity is insolvent, but the owner of the disregarded entity is not, then the section 108(a)(1)(B) exclusion does not apply to the discharge of indebtedness income. This regulation would be superfluous if, as petitioner contends, there is no recognition of income from the discharge of debt for the disregarded entity.

[8]In a footnote in his opening brief petitioner also attempts to draw support from I.R.S. Priv. Ltr. Rul. 202050014 (Dec. 12, 2020) (which he refers to as "PLR-117300-20"). A "written determination" of the IRS may not be used or cited as precedent, §6110(k)(3), and written

determinations are defined to include IRS private letter rulings, §6110(b)(1)(A); *see also Plano Holding LLC v. Commissioner*, T.C. Memo. 2019-140, at *17 n.6 ("Private letter rulings have no precedential value and merely represent the Commissioner's position as to a particular set of facts.") (and cases cited thereat). In any event, I.R.S. Priv. Ltr. Rul. 202050014 is not helpful to petitioner. Like *L&C Springs Assocs.* and *2925 Briarpark, Ltd.*, as discussed above, I.R.S. Priv. Ltr. Rul. 202050014 addresses a situation factually distinct from the instant case.

END FOOTNOTES

TaxProf Blog

Monday, September 11, 2023

Lesson From The Tax Court: *The Boundary Waters Of Equity*

By Bryan Camp

Every birthday gives me the opportunity to appreciate the luck I've had in my life. Last week was my 63rd. I fondly remembered my summers at Camp Chippewa, a wonderful summer camp just outside of Bemidji, MN. One focus of that camp was canoe trips, including trips exploring the Boundary Waters in upper MN and lower Canada. Those 1-2 week trips were amazing adventures. Long before cell phones and GPS, we were cut off from any easy access to population centers. Only if you were careful with your maps would you even know whether you were in the U.S. or in Canada! And yes, I will connect that up with Today's Lesson.

These particular reminiscences were sparked by my reading *William H. Evenhouse and Nelle L. Evenhouse v. Commissioner*, T.C. Memo. 2023-113 (Sept. 7, 2023) (Judge Lauber), because we learn there how the Tax Court interprets §6213 generously to allow certain lucky taxpayers up to 150 days to petition for review of a Notice of Deficiency (NOD). While the particular taxpayers in this case were not able to get the extra time, the case gives us a good lesson in how the Tax Court decides when a taxpayer gets the 150-day period rather than the usual 90-day period to petition for review of an NOD. In my mind, it's a lesson in equity. That could be very useful if and when taxpayers are able to start arguing for equitable tolling of the usual 90 day period.

Details below the fold.

Law: What Triggers the 150-Day Period

Like other federal courts, the Tax Court is very cautious about not overstepping its Congressionally-given bounds. However, the Tax Court also strives to allow taxpayers their day in Court. These two impulses—the caution to stay within the statutory grants of power and the drive to decide cases on the merits—create a tension when the Court is confronted with a timing rule giving taxpayers a certain amount of time to petition the Court. When so confronted, the Tax Court struggles to do the right thing. But what *is* the right thing, anyway, when there is this tension?

The Court sometimes resolves the tension by "cheating." That is, while proclaiming its fidelity to Congressional command, the Court will give a wink to the statutory text if there are facts it believes brings a case within the relevant time period.

Section 6213 is a great example of how the Tax Court does this. Despite the recent misgivings of the Third Circuit in *Culp v. Commissioner*, No. 22-1789 (Mar. 7, 2023), the Tax Court sticks to the traditional view that the limitations periods in §6213 are jurisdictional. They are Congressionally-given bounds on the Court's power. For example, in today's case Judge Lauber makes the usual recitation that *"This Court...may exercise jurisdiction **only** to the extent **expressly authorized** by Congress."* Op. at 2 (emphasis supplied).

Alert readers will notice my use of the plural to describe §6213: limitation **periods**. We normally think that taxpayers only have 90 days to petition the Tax Court for review of an NOD. However, §6213 also gives taxpayers 150 days if the NOD was *"addressed to a person outside the United States."* You can think of this 150-day period as an extension of time—a tolling if you will.

Despite Judge Lauber's claim that the Court will exercise jurisdiction only to the extent "expressly authorized" by Congress, the Tax Court has long adopted a most *un-expressly* authorized facts-and-circumstances test to apply the more generous 150-day period in §6213.

It starts with the 1949 case of *Hamilton v. Commissioner*, 13 T.C. 747 (1949). There, the IRS had mailed the NOD to the taxpayer's undisputed last known address, in New York City. But the taxpayer had been living in Paris for the three years before, even though she had filed returns listing the New York address. She filed her petition 149 days after the day the IRS mailed the NOD.

The government argued for a strict, bright-line, interpretation of §6213(a). Under such a reading, the question would be only whether the NOD was *addressed* to a location outside the U.S. or not. Again, taxpayers would get the 150 days only if the NOD was sent to an *address* outside the U.S. Since Ms. Hamilton's NOD was addressed to a location within the United States and, further, that location was the proper last known address of the taxpayer, the 90 day period applied.

The Tax Court rejected the government's interpretation. It interpreted the statutory text to mean that if the *person* was outside the U.S. at the time the NOD was mailed, then that person got the 150 period. It based this interpretation on the legislative history of the statute, finding that the purpose of the 150-day period was to protect those taxpayers who were outside the United States *"on some settled business and residential basis, and not on a temporary basis." Id.* at 753.

Under the Tax Court's 1949 interpretation, therefore, the facts were important. If the taxpayer was out of the country on some settled business, then the 150 day period would apply. But if the taxpayer was physically outside the U.S. on the relevant date *"because of a recreational or short business trip"* the that taxpayer would have only 90 days. *Id.*

Over time, the Tax Court loosened up what facts would trigger the 150 day period. It ceased to matter where the taxpayer actually was when the NOD was issued. For example, in *Lewy v. Commissioner*, 68 T.C. 779 (1977), the Tax Court allowed the 150 day period even though the taxpayer was in the United States when the NOD was mailed. That was because the taxpayer mostly lived in France and just happened to be at his New York office when the NOD was mailed to his last known address in New York. So the Tax Court labeled the taxpayer's presence in the U.S. as "ephemeral."

The Tax Court has basically settled on a rule that the 150-day period applies when a taxpayer's circumstances results in significant delay in receipt of the notice of deficiency. It now acceptes recreational or short trips as reasons to give taxpayers the extension to 150 days. I personally like this approach but it's a decidedly awkward position for the Tax Court to take when it keeps protesting that the 150-day time period is magically "jurisdictional" and the Court cannot mess around with it.

Currently the Court looks to see whether (1) the taxpayer was outside the United States for some period *around the time* the NOD was mailed and (2) whether such absence resulted in enough of a delay in the taxpayer's ability to meet the 90 day period that the Tax Court feels justifies using the 150 period. The Tax Court has freely admitted that this is not a strict reading of the statute. *"Although a literal reading of the statute suggests that the 150-day rule applies to notices which are addressed to locations outside of the United States, we have interpreted this phrase to mean that the taxpayer to whom the notice is addressed must have been located abroad." Levy, supra,* 76 T.C. at 230.

Notice how the Court's interpretation results in it picking and choosing what facts count in deciding whether a taxpayer has 90 or 150 days to file a petition. It has, in effect, abandoned the statutory language in favor of a court-created "significant delay" test. And reasonable minds might differ on which facts count in any particular case.

For example, compare *Malekzad v. Commissioner*, 76 T.C.963 (1981), with *Levy v. Commissioner*, 76 T.C. 228 (1981). In *Levy*, the taxpayers left the U.S. for a 4-day trip to Jamaica on the same day the IRS mailed the NOD. The Tax Court decided that their 4-day absence earned them the 150 day period. But in *Malekzad*, the Tax Court refused to allow the 150 day period for a taxpayer who was physically outside the United States on the day the NOD was mailed but was back two days later. The Malekzad Court acknowledged the result in Levy but said *"the holding in the Levy case should not be extended to cover the facts of the present case."* And that would be because ...?

... because the Court's exercise in picking and choosing the jurisdictional facts is an exercise in equity. The facts the Court looks for are those that convince the Court it would be unfair to limit the taxpayer to the 90 day period. In various other limitation period contexts, the Court repeatedly emphasizes that *"in determining whether we have jurisdiction over a given matter, this Court and The Courts of Appeals have given our jurisdictional provisions a broad, practical construction rather than a narrow, technical one."* That's from Judge Lauber in *Weiss v. Commissioner*, 147 T.C. 179 (2016). While it's a CDP case, he cites to *Lewy* for that proposition. And it is the approach the Court generally takes with all the limitation periods. For the gritty details, *see* Bryan Camp, Equitable Principles and Jurisdictional Time Periods, Part 2, 159 Tax Notes Fed.l 1581 (June 11, 2018).

In its laudable determination to promote equity, however, the Tax Court's approach to the 90 or 150 day question allows shiny attractive facts to unhook its determination from the statutory language. Again, I am all for that, but let's at least be honest about what the Tax Court is doing: it's applying equitable principles rather than statutory language to choose the relevant time period. So why it continues to cling to the notion that §6213 is jurisdictional is a mystery to me.

We learn from this case just how important the facts and circumstances are to a determination of when the 150-day period applies.

Facts

On May 23, 2022, the IRS mailed an NOD to the Evenhouses. It went to their home in Oakland.

On October 18, 2022, the Tax Court received a letter from the Evenhouses that the Court treated as a Petition for Redetermination. That is 148 days after the NOD date.

In both the letter and in communications with the IRS, the Evenhouses asserted that their petition was timely because on the date the IRS *mailed* the NOD, they were traveling outside the U.S. Therefore, they claimed that they should get the 150 day period, not the 90 day period.

However, the documents they attached appeared to show that they had left Istanbul on May 23, 2022, arriving in San Francisco the same day at 4:35 pm. That is possible because Istanbul is 10 hours ahead of San Francisco, so even a 13.5 hour nonstop flight such as offered by Turkish Airlines would leave and arrive on the same day, but after a very long flight! Their documents also showed their next overseas trip was not until some 10 months later.

Lesson 1: Jet Lag Does not Get You the 150 Days

Given the apparent fact that the Evenhouses got back to the U.S. on the same day the IRS *mailed* the NOD, it is really difficult to see what possible argument they had that their overseas travel resulted in significant delay in them *receiving* the NOD, even under the Tax Court's very generous facts-and-circumstances test. The best I can think of is they might claim ... jet lag!

After pointing out that they were in the U.S. both on the date the NOD was mailed and the date they received it, however, Judge Lauber sensibly finds that *"their absence from the country did not delay their receipt of the notice of deficiency or otherwise adversely affect their ability to file a timely Tax Court petition."* Op. at 4.

Lesson 2: The Boundary Waters of Equity: Significant Delay

The Tax Court applies the 150-day period whenever a taxpayer can show that they were absent from the United States at what the Court considers a relevant time—such as the date on which the NOD was delivered to their last known address in the U.S. or maybe when it was mailed—and that such absence caused a significant delay to their ability to comply with the 90 day period.

Hokay! So, thinking back to my childhood summer camp experience, what if a taxpayer was on a 14-day canoe trip in the boundary waters of Minnesota and Canada? And what if, in the middle of the trip, an NOD was either mailed or delivered to the taxpayer's last known address?

On the one hand, if all of the days were in Canada, then the Court would very likely say that the taxpayer had 150 days to file a Tax Court petition. On the other hand, if all of the days were in the U.S., then under it's current view that the §6213 periods are jurisdictional, the Tax Court would say "too bad, so sad." Finally, if some of the days were in both countries, I would bet that the Tax Court would go with its historical impulse to use equity to get to the merits of the dispute and focus on the days in Canada.

But camping in the wilderness for 14 days has the same effect on the taxpayer's ability to respond to an NOD regardless of the ephemeral boundary in the waters between U.S. and Canada. To me, that is the take-away from all of these §6213 cases about the application of the 150 day period. The Court will look to see what facts show that the out-of-country taxpayer faced significant delay in responding to the NOD in the 90 day period. The key fact is that the taxpayer must show some relevant absence from the U.S. That is because of the wording of §6213. But ...

But if and when the Tax Court shifts its thinking about the jurisdictional nature of §6213 (or is forced to shift), then I think these same cases provide some strong support for taxpayers seeking to equitably toll the 90 day period when their circumstances show some period of time during the 90 days where they were unable to respond to the NOD. Now taxpayers would not be arguing for the 60 extra days given by Congress in §6213. They would be arguing for the equitable number of days, given by Courts under the doctrine of equitable tolling. As with the 150-day cases, however, the strongest facts would be when they can show delay in actual receipt of the NOD, such as being on a 14-day canoe trip in the Boundary Waters, whether on the MN side or the Canada side.

It's a lesson worth putting in one's pocket for potential future application. Keep it dry.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law, which is far far away from the Boundary Waters. He invites readers to return each Monday (or Tuesday if Monday is a federal holiday) to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

Tax Court Rejects International Travel Excuse for Late Petition

SEP. 7, 2023

William H. Evenhouse et al. v. Commissioner

WILLIAM H. EVENHOUSE AND NELLE L. EVENHOUSE,

Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed September 7, 2023

William H. Evenhouse and Nelle L. Evenhouse, pro sese.

Sarah J. Case and *Trent D. Usitalo*, for respondent.

MEMORANDUM OPINION

LAUBER, *Judge*: This deficiency case is before the Court on respondent's Motion to Dismiss for Lack of Jurisdiction on the ground that the Petition was not filed within the time prescribed by section 6213(a).[1] The issue presented is whether petitioners, under section 6213(a), had 90 days or 150 days to file their Petition with this Court.

Background

The following facts are derived from the parties' pleadings and the Exhibits attached to respondent's Motion. Petitioners resided in Oakland, California, when the Petition was filed. Absent stipulation to the contrary, appeal of this case would lie to the U.S. Court of Appeals for the Ninth Circuit. *See* §7482(b)(1)(A).

[*2] On May 23, 2022, the Internal Revenue Service (IRS or respondent) sent petitioners by certified mail a notice of deficiency for tax year 2019. The record includes a U.S. Postal Service Form 3877, Firm Mailing Book For Accountable Mail, showing that this notice was mailed on that date to petitioners' last known address in Oakland. The notice determined a deficiency in income tax of $54,993 and an accuracy-related penalty under section 6662(a) of $10,987. The first page of the notice advised petitioners that they had 90 days from the date of the notice to file a petition with this Court for redetermination of the deficiency. The notice stated that the last day on which petitioners could timely petition this Court was August 22, 2022.

On October 18, 2022, 148 days after the notice of deficiency was mailed, the Court received from petitioners, and filed as the Petition in this case, a letter signed and dated October 8, 2022. In that letter petitioners stated that they were responding to the notice of deficiency and that "this petition cannot be considered late until October 22, 2022, 150 days after the [n]otice date," because they were "traveling outside of the United States" on May 23, 2022, the date the IRS mailed the notice of deficiency.

In support of their position that they were traveling internationally at the relevant time, petitioners provided respondent a copy of their travel documents, which respondent has attached as Exhibit C to his Motion. Those documents show that petitioners departed from Istanbul, Turkey, the afternoon of May 23, 2022, and returned to San Francisco, California, at 4:35 p.m. that same day. These travel documents show that petitioners' next trip outside the United States did not occur until March 24, 2023, ten months later.

On May 22, 2023, respondent filed a Motion to Dismiss for Lack of Jurisdiction. By Order served May 25, 2023, we directed petitioners to file a Response to the Motion on or before June 26, 2023. Petitioners did not respond to our Order by that date or subsequently.

Discussion

This Court is a court of limited jurisdiction and may exercise jurisdiction only to the extent expressly authorized by Congress. *See* §7442; *Hallmark Rsch. Collective v. Commissioner*, 159 T.C. 126, 135 (2022); *Breman v. Commissioner*, 66 T.C. 61, 66 (1976). Jurisdiction must be proven affirmatively, and a taxpayer invoking our jurisdiction bears the burden of proving that we have jurisdiction over the case. *See* **[*3]** *David Dung Le, M.D., Inc. v. Commissioner*, 114

T.C. 268, 270 (2000), *aff'd*, 22 F. App'x 837 (9th Cir. 2001); *Romann v. Commissioner*, 111 T.C. 273, 280 (1998); *Fehrs v. Commissioner*, 65 T.C. 346, 348 (1975).

This Court's jurisdiction in a deficiency case is predicated on a valid notice of deficiency and a timely filed petition. §§6213, 7442; Rule 13(a), (c); *Hallmark Rsch. Collective*, 159 T.C. at 127, 166–67; *Monge v. Commissioner*, 93 T.C. 22, 27 (1989). Section 6213(a) generally provides that the petition must be filed within 90 days after the notice of deficiency is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day). This 90-day period is extended to 150 days "if the notice is addressed to a person outside the United States." §6213(a). The Court lacks authority to extend the 90-day (or 150-day) period, and we must dismiss a case for lack of jurisdiction if the petition is not filed within the statutorily prescribed time. *Hallmark Rsch. Collective*, 159 T.C. at 166–67; *Joannou v. Commissioner*, 33 T.C. 868, 869 (1960).[2]

The record establishes that the IRS issued and mailed the notice of deficiency to petitioners on May 23, 2022. *See Magazine v. Commissioner*, 89 T.C. 321, 327 n.8 (1987) (holding that U.S. Postal Service Form 3877 constitutes direct evidence of the date of mailing a notice of deficiency). Consequently, the last date for petitioners to file a timely petition with the Court was August 22, 2022, as correctly stated in the notice.[3]

The Court received petitioners' letter and filed it as their Petition on October 18, 2022, 148 days after the notice's mailing date. Under the "timely mailed, timely filed" rule, a petition delivered to the Court after the filing deadline will nevertheless be deemed timely if it bears a timely **[*4]** postmark. *See* §7502. The envelope in which the Petition was mailed to the Court does not bear a postmark. But assuming arguendo that petitioners mailed the envelope on October 8, 2022, the date on which they signed the letter we filed as their Petition, the mailing date would still be 138 days after the notice of deficiency was sent to them.

Petitioners do not dispute that their Petition was untimely under the 90-day period normally prescribed by section 6213(a). Instead, they allege that their absence from the United States during part of the day on May 23, 2022, the day the notice of deficiency was mailed, entitled them to the extended 150-day period. We disagree.

This Court has held that the 150-day period applies, not only to persons outside the United States "on some settled business and residential basis," but also to persons temporarily absent from the country. *See Levy v. Commissioner*, 76 T.C. 228, 231 (1981) (quoting *Mindell v. Commissioner*, 200 F.2d 38, 39 (2d Cir. 1952); *Estate of Krueger v. Commissioner*, 33 T.C. 667, 668 (1960)). But for the 150-day period to apply, the taxpayer's temporary absence from the country must somehow "result in delayed receipt of the deficiency notice." *See Levy*, 76 T.C. at 231 (citing *Lewy v. Commissioner*, 68 T.C. 779, 783 (1977)); *see also Cross v. Commissioner*, 98 T.C. 613, 616 (1992); *Malekzad v. Commissioner*, 76 T.C. 963, 970 (1981); *Degill Corp. v. Commissioner*, 62 T.C. 292, 297 (1974); *Cowan v. Commissioner*, 54 T.C. 647, 652 (1970).

In *Malekzad*, 76 T.C. at 969–70, we explained that, in determining whether the 150-day period applies, we consider both the date on which the IRS mailed the notice of deficiency and the date on which the taxpayer received it. The crucial inquiry is whether a taxpayer falls into the category of persons that Congress intended to benefit from a longer filing period. *See id.* at 970. Congress enacted the 150-day rule to prevent hardship caused by a taxpayer's absence from the United States and the consequent risk of delays in receiving mail. *See Looper v. Commissioner*, 73 T.C. 690, 694 (1980).

On the facts in the instant case, petitioners were not entitled to the 150-day period for filing their Petition. They returned from an international trip on May 23, 2022, landing in San Francisco at 4:35 p.m. that afternoon. That was the same day on which the notice of deficiency was mailed to them. They have supplied no evidence that they took another international trip until March 24, 2023, roughly ten months later.

[*5] Petitioners were thus present in the United States on the date the notice of deficiency was mailed and on the date the notice was received. And they were present in the United States during the ensuing 10-month period. They are ineligible for the 150-day filing period because their absence from the country did not delay their receipt of the notice of deficiency or otherwise adversely affect their ability to file a timely Tax Court petition. *See Malekzad*, 76 T.C. at 971–72 (holding that the 150-day rule did not apply to taxpayers who were in the United States on the notice's mailing date, were outside the country for less than 48 hours, and did not experience delay in receiving the notice); *Lewy*, 68 T.C. at 783; *Cowan*, 54 T.C. at 652 (holding that the 150-day rule did not apply to a taxpayer who went on a day trip to Mexico on the notice's mailing date); *Logan v. Commissioner*, T.C. Memo. 1993-22 (holding that the 150-day rule did not apply to taxpayers who were outside the United States on the notice's mailing date but returned to the country before the notice was received).

Because the Petition was not filed within the applicable 90-day period, we lack jurisdiction under section 6213(a) and must grant respondent's Motion to Dismiss. Although petitioners may not prosecute this case in the Tax Court, we note that they may pursue with the IRS an administrative resolution of their 2019 tax liability. Another remedy potentially available to them is to pay the tax in dispute and file a claim for refund with the IRS. If that claim is denied (or not acted upon after six months), petitioners may file a suit for refund in the appropriate U.S. district court or the U.S. Court of Federal Claims. *See McCormick v. Commissioner*, 55 T.C. 138, 142 n.5 (1970).

To reflect the foregoing,

An appropriate order of dismissal for lack of jurisdiction will be entered.

FOOTNOTES

[1]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C., in effect at all relevant times, and Rule references are to the Tax Court Rules of Practice and Procedure.

[2]Absent stipulation to the contrary this case is appealable to the Ninth Circuit, and we thus follow its precedent. *See Golsen v. Commissioner*, 54 T.C. 742, 756–57 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). The Ninth Circuit has long agreed with this Court's holdings that the statutory period prescribed by section 6213(a) is a jurisdictional requirement. *See Organic Cannabis Found., LLC v. Commissioner*, 962 F.3d 1082, 1093–94 (9th Cir. 2020); *Healy v. Commissioner*, 351 F.2d 602, 603 (9th Cir. 1965) ("The requirement of filing the petition with the Tax Court within 90 days after the certified or registered notice of deficiency is mailed to the correct address of the taxpayer is jurisdictional."). Therefore, we need not address a recent ruling by the U.S. Court of Appeals for the Third Circuit that the statutory filing deadline in deficiency cases is a non-jurisdictional "claims-processing" rule. *See Culp v. Commissioner*, No. 22-1789, 2023 WL 4612024 (3d Cir. July 19, 2023).

[3]The 90-day period expired on Sunday, August 21, 2022, but section 6213(a) provides that Sunday is not counted as the last day of the period.

END FOOTNOTES

TaxProf Blog

- Tax Law
  - News
  - Scholarship
  - Weekly Roundup
- Legal Education
  - News
  - Scholarship
  - Weekly Roundup
- About
  - Join the Network
  - Advertise
- Resources

Monday, October 2, 2023

Lesson From The Tax Court: *Equitable Tolling During Government Shutdown?*

By Bryan Camp

Like winter, a shutdown is coming. And last week, the Tax Court issued a really important reviewed decision about equitable tolling of CDP hearings. The two are connected because the Tax Court lesson may become very useful for taxpayers faced with an inaccessible IRS during periods of government shutdown

For those of us having a hard time keeping track, this Wikipedia entry gives a useful history of federal government shutdowns. Going in reverse chronological order, it appears that top three were: **(1)** during the Trump administration—one at the start of 2018 and then also a long 35-day shutdown from the end of 2018 into 2019; **(2)** during the Obama administration—16 days in 2013; and **(3)** during the Clinton administration—21 days in in 1995–1996. We may well be on the way to another one when the 45-day Continuing Resolution passed yesterday expires.

Last week's opinion in *Organic Cannabis Foundation v. Commissioner*, 161 T.C. No. 4 (Judge Goeke), may help taxpayers who must deal with a closed IRS during the next shutdown. In that case, fourteen of the sitting Tax Court judges interpreted §6320 to permit equitable tolling of the 30-day period that taxpayers have to request a CDP hearing after the IRS files a Notice of Federal Tax Lien (NFTL). Three judges thought that interpretation squarely conflicted with the applicable Treasury Regulation and wanted to hear arguments on the validity of the regulation. The Court's reasoning applies as much to §6330 CDP hearings as well, making it even more consequential.

What makes this a really useful decision is the idea that a government shutdown might indeed qualify taxpayers for equitable tolling. Details below the fold.

Background

A federal government shutdown affects different parts of the government differently.

As to courts, some remain open, others close. I explained in Lesson From The Shutdown: *Court Budgets*, TaxProf Blog (Jan. 22, 2019). At this time, the Tax Court website proudly proclaims that it *"will open for business as usual on Monday, October 2, 2023, and we expect to continue normal operations indefinitely. All scheduled trial sessions will proceed as scheduled. The November 8, 2023, nonattorney exam will proceed as scheduled, including all associated deadlines."* I assume that is because it can pull money from its fees. Well, now it does not have to, thanks to the 45-day Continuing Resolution.

As to the IRS, offices staffed by humans may very well NOT be open for business during the next shutdown. The IRS cannot pull money from fees. If the IRS is closed, then there will be no office open to receive a request for a CDP hearing.

And yet just because the IRS is closed does not mean the IRS computers are turned off! As I never tire of explaining, most of the collection work is done by computers in the Automated Collection System (ACS). *See e.g.* Lesson From The Tax Court: *Using CDP To Stop The Collection Train*, TaxProf Blog (October 15, 2018). Thus, during the first Trump administration shutdown, CDP notices relating to the filing of NFTLs continued, albeit at a slower pace. *See The Effect Of A Government Shutdown On The IRS: Not What You Think*, TaxProf Blog (Jan. 19, 2019).

Today's lesson is about one of those §6320 CDP Notices, the one relating to NFTLs.

Section 6320(a)(2) permits the IRS to file a NFTL without first telling the taxpayer, but then requires it to send the taxpayer a CDP notice within 5 business days after the filing. The taxpayer then has 30 days to request a CDP hearing. The 30 day period starts on the day after the 5-day period. Id.

If the taxpayer timely requests a CDP hearing the Office of Appeals will issue a decision document called a "Notice of Determination." Yup, that's "NOD." Cute! And like the Notice of Deficiency NOD, the CDP NOD is a ticket to the Tax Court. *See* Treas. Reg. 301.6320-1(b)(2), Q&A-B3 (*"Following the hearing, Appeals will issue a Notice of Determination, and the taxpayer is entitled to seek judicial review of that Notice of Determination."*).

If the taxpayer's request for a CDP hearing is untimely, however, they can still get a hearing. It's called an Equivalent Hearing and the Office of Appeals will issue a decision document called "Decision Letter." But that is not a ticket to the Tax Court. The taxpayer may not obtain Tax Court review of that decision. Treas. Reg. 301.6320-1(h).

Facts and Holding

The taxpayer here, Organic Cannabis Foundation, had unpaid taxes for 2010, 2011, and 2018 tax years. The IRS sought to collect, and filed NFTLs.

The IRS sent the taxpayer an NFTL CDP Notice for the 2010 and 2011 years on April 16, 2019 and the taxpayer timely requested as CDP hearing. The IRS also sent the taxpayer an NFTL CDP Notice for the 2018 tax year on March 15, 2021. The taxpayer requested a CDP hearing on the 31st day.

One day late.

The IRS treated the 2018 CDP request as a request for an Equivalent Hearing. It combined that hearing with the CDP hearings for 2010 and 2011, but issued different decision documents: a Notice of Determination (NOD) for the two CDP hearings and a Decision Letter for the Equivalent hearing.

The taxpayer petitioned the Tax Court to review both the CDP determinations and to treat the Decision Letter as a Notice of Determination by applying equitable tolling to its one-day-late CDP hearing request. The government argued that equitable tolling could not apply to the 30-day period.

The Tax Court held that the 30-day period in §6220(a)(2) was subject to equitable tolling. There are some really good reasons supporting that holding and there are also some really good reasons why the deadline should not be subject to equitable tolling. But that's all grist for someone else's mill. Here I just want to consider what this decision means for taxpayer who get caught up in a government shutdown.

Lesson: How Equitable Tolling Might Apply to a Shutdown

The question is this: if a taxpayer's 30-day window to request a CDP hearing ends on a day when the government is shut down, how much additional time do they get to make the request once the government reopens?

One answer would be that taxpayers would have no additional time. That is because the applicable regulations provide that *"the rules and regulations under section 7502 and section 7503 will apply to determine the timeliness of the taxpayer's request for a CDP hearing...."* Section 7502 is the timely-mailing-is-timely-filing rule. Section 7503 is the weekend and holiday rule. Government shutdowns are neither.

The *Williams* opinion makes it unlikely that the Tax Court will adopt this answer, however. That is because the majority goes to great lengths to read the applicable regulations as not prohibiting equitable tolling. So the most likely answer is that the Court will be willing to apply equitable tolling principles. But how would that work? What the heck are equitable tolling principles?

So here are a couple of points you should know about equitable tolling.

First, the idea of "tolling" means that the limitations period is suspended for the tolling period. That is, it stops running and then starts running again when the tolling period ends, picking up where it left off. *Artis v. District of Columbia*, 138 S.Ct. 594 (2018). So this would *not* be like the Tax Court's application of equity in *Guralnik v. Commissioner*, 146 T.C. 230 (2016), where it decided not to count as "last day" a day where the Tax Court Clerk's office was inaccessible. That idea is now found in Tax Court Rule 25(a)(2). To take that approach would mean taxpayers whose 30-day clock ended at some point during a government shutdown would have to check every day to see if the government had reopened and then would need to act within a single day to be timely. As I explain in Equitable Doctrines and Jurisdictional Time Periods, Part 2, the Tax Court uses equity when possible *"to avoid frustrating the statutory provisions designed to afford taxpayers an opportunity to prepayment review of the Commissioner's deficiency determination."* *Lundy v. Commissioner* T.C. Memo 1997-14. You see that same strong move to equity in *Williams*.

Second, it is important to remember that equitable doctrines are not simply free-floating grants of power. Equitable doctrines are linked to, and bounded by, a set of principles. What distinguishes equitable principles from legal rules is that the application of equity is highly contingent on the facts before the court. The great legal historian F. W. Maitland put it this way in his 1910 Lectures On Equity: *"I do not think that any one has expounded or ever will expound equity as a single, consistent system, an articulate body of law. It is a collection of appendixes between which there is no very close connection."* (p. 19) And in this 1913 law review article, Professor Wesley Newcomb Hohfeld discussed the difficulty of teaching equity as a system of rules separate from legal rules. I think it this way: equity fixes problems that legal rules cannot fix.

So when we talk about equitable tolling remember we are not talking about what "feels good" or "seems right." There are actually some basic principles courts will follow.

The most basic principles are these: a person seeking equitable tolling gets it only if they convince the court that (1) they have been pursuing their rights diligently, and (2) that some extraordinary circumstance prevented them from timely filing. *Menominee Indian Tribe of Wis. v. United States*, 577 U.S. 250, 255 (2016). Even then, a court can deny tolling if it would be unfair to the defendant. *See Baldwin County Welcome Center v. Brown*, 466 U. S. 147, 152 (1984).

Courts take those principles seriously and do not grant equitable tolling easily. A good example is *Williams v. Perdue,* 613 F.Supp.3d 437 (D.D.C. 2020). There, Mr. Williams claimed his employer the Department of Agriculture took an illegal personnel action against him. The relevant statute required him to first ask for relief from the Department's Equal Employment Opportunity office. If denied, the statute required him to file suit within 90 days in the federal District Court for the District of Columbia. Well, Mr. Williams, proceeding *pro se,* filed within the 90 days but got understandably confused and filed in the *local* courts for Washington D.C., not the federal court. The government later moved him to the federal court but then got the case dismissed because he had initially filed in the wrong court.

That dismissal came long after the 90 days. Mr. Williams very quickly refiled (in the proper court) and now the government said he was time-barred.

Mr. Williams argued that the court should equitably toll the 90 days for the period that the government first removed, then dismissed, the first case. And part of that delay was due to one of the Trump Administration federal government shut-downs. But that did him no good because all of those delays happened *after* the 90 period had run. Thus the court basically held that all the delays, including the ones outside his control like *"**those caused by the prolonged federal government shutdown** in January 2019...occurred months after Williams needed to file his case in federal court." Id. at 451* (Emphasis added).

Thus, taxpayers seeking equitable tolling must show that despite diligent efforts, some extraordinary circumstance prevented them from protecting their rights by timely filing their CDP request within 30 days. *See e.g. Holland v. Florida,* 560 U.S. 631 (2010).

<u>The Argument For Tolling Based On Government Shutdown</u>

I submit that a government shutdown is just just an extraordinary circumstance. Any limitation period for taxpayers to file something with the IRS—including the 30 days to request a CDP hearing—should be tolled by all the days of a government shutdown.

But the reason is more than that a shutdown is beyond the taxpayer's control. It is simply unconscionable to enforce against taxpayers a statutory time limitation when Congress itself denied taxpayers the ability to protect their rights during all or part of that time period by forcing the closure of the IRS. So while that's more of an equitable estoppel argument, it's based on the same idea: if Congress fails in its most basic duty to fund the government—causing it to close human-staffed offices—then that is precisely the kind of situation that forms one of the principles for equitable tolling. Naturally, to obtain equitable tolling the taxpayer would need to show they attempted to act within the time period and the proof of that may be an actual mailing. But the law does not require a useless act, so proof short of an actual attempt to file—such as proof that a filing package was timely prepared—should also suffice.

The main point here is that a government shutdown is an act of Congress just as much as the statutory limitations periods are acts of Congress. And Congress should not be able to demand that a taxpayer act within a certain time period while at the same time denying the taxpayer the ability to act during all or part of that time period. Equity should and, I believe, will prevent that result.

And today's case allows taxpayers to make the argument.

Bryan Camp is the George H. Mahon Professor of Law at Texas Tech University School of Law. He invites readers to return each Monday, even if the federal government is shut down, to TaxProf Blog for another Lesson From The Tax Court.

[Editor's Note: If you would like to receive a daily email with links to each *Lesson From The Tax Court* and other tax posts on TaxProf Blog, email here.]

https://taxprof.typepad.com/taxprof_blog/2023/10/lesson-from-the-tax-court-equitable-tolling-during-government-shutdown.html

Deadline to Request CDP Hearing Is Subject to Equitable Tolling

SEP. 27, 2023

Organic Cannabis Foundation LLC v. Commissioner

ORGANIC CANNABIS FOUNDATION, LLC,[1]

Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

United States Tax Court

Filed September 27, 2023

P has unpaid tax for 2010, 2011, and 2018. R issued notices of federal tax lien filings to P for all three years. P timely requested a hearing with the Internal Revenue Service Independent Office of Appeals (Appeals) during the 30-day period for requesting a collection due process (CDP) hearing under I.R.C. §6320(a)(3)(B) (30-day period) for 2010 and 2011 but requested a hearing for 2018 after the 30-day period. Appeals provided a CDP hearing for 2010 and 2011. Appeals determined that P's hearing request for 2018 was untimely and provided an equivalent hearing under Treas. Reg. § 301.6320-1(i)(1). Appeals issued a Notice of Determination for 2010 and 2011 that did not contain a determination for 2018. P filed a Petition seeking review for all 3 years. After the Petition was filed, Appeals issued a Decision Letter for 2018.

R moved to dismiss as to 2018 for lack of jurisdiction on the ground that Appeals did not make a determination for us to review under I.R.C. §6330(d)(1). P argues that the 30-day period for requesting a CDP hearing under I.R.C. §6320(a)(3)(B) should be equitably tolled. P further argues that Appeals should have made a determination for 2018 for this Court to review. R argues that the 30-day period is a fixed deadline that is not amenable to equitable tolling.

Held: Appeals has authority under I.R.C. §6320 to hold hearings when the taxpayer files a request after the 30-day period set forth in I.R.C. §6320(a)(3)(B).

Held, further, the Treasury regulations under I.R.C. §6320 do not preclude application of the doctrine of equitable tolling to the 30-day period.

Held, further, the 30-day period is subject to equitable tolling where the circumstances warrant it.

Held, further, *Kennedy v. Commissioner*, 116 T.C. 255 (2001), is overruled to the extent that it holds that Appeals is not authorized to waive the 30-day period under I.R.C. §6320(a)(3)(B) and is not obliged to provide a CDP hearing where the circumstances warrant equitable tolling of the 30-day period.

Christian A. Speck, *Robin Lesley Klomparens*, and *Douglas L. Youmans*, for petitioner in docket No. 381-22L.

Christian A. Speck, for petitioner in docket No. 5442-22L.

Erik W. Nelson, *Daniel G. Kester*, *Adriana E. Vargas*, *Alexander M. Short*, and *Patsy A. Clarke*, for respondent in docket No. 381-22L.

Erik W. Nelson, *Adriana E. Vargas*, *Alexander M. Short*, and *Patsy A. Clarke*, for respondent in docket No. 5442-22L.

OPINION

GOEKE, *Judge*: When the Internal Revenue Service (IRS) files a notice of federal tax lien (NFTL) on a taxpayer's property to collect an unpaid assessment, the Internal Revenue Code gives the taxpayer the right to a collection due process (CDP) hearing with the IRS Independent Office of Appeals (Appeals). §6320(a) and (b).[2] The Code requires that the IRS notify the taxpayer in writing of the NFTL filing within five business days of the NFTL filing (5-day notice period) and inform the taxpayer that it has the right to request a CDP hearing during a 30-day period beginning on the day after the 5-day notice period (30-day period). §6320(a)(1), (3)(B).

In these CDP cases respondent has moved to dismiss as to the taxable year 2018 for lack of jurisdiction on the grounds that Appeals did not make a determination for 2018 because petitioner requested a CDP hearing untimely.[3]

Our precedent has construed the 30-day period for requesting a CDP hearing as a fixed deadline. In *Kennedy v. Commissioner*, 116 T.C. 255, 262 (2001), we held that Appeals is not authorized to waive the 30-day period for requesting a CDP hearing and that Appeals is not required to provide a CDP hearing requested after the 30-day period. In *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, 1501 (2022), the Supreme Court held that a different 30-day period in section 6330(d)(1) for a taxpayer to file a petition with this Court for review of Appeals' determination following a CDP hearing is a nonjurisdictional deadline that is subject to equitable tolling. Thereafter, in *Hallmark Research Collective v. Commissioner*, 159 T.C. 126 (2022), we distinguished *Boechler* in holding that the 90-day deadline for filing a deficiency petition under section 6213(a) is jurisdictional. In the light of the Supreme Court's decision in *Boechler* and our opinion in *Hallmark*, we reexamine our precedent as to the 30-day deadline in section 6320(a)(3)(B) for requesting a CDP hearing. We overrule *Kennedy* to the extent that it holds that the 30-day period for requesting a CDP hearing is a fixed deadline that is not amenable to equitable tolling. We hold that the 30-day period in section 6320(a)(3)(B) is subject to equitable tolling.

Background

The following facts are derived from the pleadings, the parties' Motion papers, and the Declarations and Exhibits attached thereto. Petitioner, Organic Cannabis Foundation, LLC, is a California limited liability company that elected to be taxed as a corporation. Its sole member is Northern California Small Business Assistants, Inc. When the Petition was filed, petitioner's principal place of business was in California.

Petitioner has unpaid income tax for 2010 and 2011 that was assessed as deficiencies following the issuance of a notice of deficiency and an untimely filed petition which this Court dismissed by order for lack of jurisdiction. *See Organic Cannabis Found., LLC v. Commissioner*, 962 F.3d 1082 (9th Cir. 2020). Petitioner has unpaid income tax for 2018 that it reported on its 2018 tax return and unpaid penalties.

On April 16, 2019, respondent issued to petitioner a notice of the filing of an NFTL for 2010 and 2011, and petitioner timely requested a CDP hearing during the 30-day period under section 6320(a)(3)(B). On March 15, 2021, respondent filed an NFTL for unpaid 2018 tax with the Recorder Office of Sonoma County, California. On March 16, 2021, respondent issued to petitioner a notice of the NFTL filing for 2018 (2018 notice). The 2018 notice states that the deadline for requesting a CDP hearing was April 22, 2021, although the computation of the 30-day period under the statute would set the deadline as April 21, 2021, measured from the March 15, 2021, filing date. Respondent states that the April 22, 2021, deadline was incorrect but concedes that he issued a notice which gave petitioner the right to request a CDP hearing by April 22, 2021.

On April 23, 2021, petitioner submitted a CDP hearing request for 2018 by fax and by certified mail. Respondent has conceded that petitioner requested the CDP hearing on April 23, 2021, and has treated the request as filed on that date. *See* §7502. Accordingly, the request was filed one day after the deadline set forth in the 2018 notice. Appeals determined that the hearing request was untimely on the basis of the April 22, 2021, deadline, and provided petitioner with an equivalent hearing under Treasury Regulation § 301.6320-1(i)(1), which petitioner had requested as an alternative to the CDP hearing.[4] The equivalent hearing was combined with the CDP hearing for 2010 and 2011 so that the three years could be considered jointly. The combined hearing was held on September 17, 2021, and included discussion of all three years. Thereafter, petitioner did not provide financial information that the Appeals officer had requested or submit an offer-in-compromise as a collection alternative.

On December 13, 2021, Appeals issued a Notice of Determination sustaining the filing of the 2010 and 2011 NFTLs. The header on the Notice of Determination listed the years at issue as 2010, 2011, and "Due Process — EH Levy — 2018." EH is a commonly used acronym for "equivalent hearing." *See Internal Revenue Manual* Exhibit 8.22.4-3 (May 12, 2022). The header is the only time that 2018 is mentioned in the Notice of Determination. An attachment to the Notice of Determination contains the Appeals officer's summary and recommendations and refers only to 2010 and 2011 and petitioner's unpaid assessments for those years.

On January 11, 2022, petitioner filed a Petition for review of the Notice of Determination for 2010, 2011, and 2018. On February 17, 2022, Appeals issued a Decision Letter on Equivalent

Hearing for 2018 sustaining the NFTL filing. The Decision Letter stated that petitioner did not request a CDP hearing during the 30-day period and advised petitioner that it did not have the right to dispute Appeals' decision in this Court except that it may dispute Appeals' decision that the hearing request was untimely. After receipt of the Decision Letter, petitioner filed a Petition for review of the Decision Letter, docket No. 5442-22L, which has been consolidated with the case at docket No. 381-22. The parties had not filed any motions in that case.

Respondent filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that petitioner's hearing request for 2018 was untimely and Appeals did not make a determination or issue a notice of determination for 2018 for us to review. In opposing respondent's Motion petitioner argued that its CDP hearing request was timely filed during the 30-day period by challenging the date that the NFTL was filed and the date that the 2018 notice was issued. It also argued that the Notice of Determination contained a determination for 2018 on the basis of the reference to 2018 in the header. Alternatively, it argued that we should extend the reasoning of *Boechler* and apply equitable tolling to the 30-day period for requesting a CDP hearing under section 6320(a)(3)(B). It argued that the circumstances of these cases warrant equitable tolling and that Appeals should have treated its late hearing request as timely and should have issued a notice of determination for 2018.

By Order dated November 14, 2022, we held that petitioner's hearing request for 2018 was untimely in the absence of equitable tolling. The NFTL was filed on March 15, 2021, and the 2018 notice was issued on March 16, 2021. The statutory deadline for filing a timely request for a CDP hearing was April 21, 2021, and the 2018 notice incorrectly stated that the deadline was April 22, 2021. *See* §6320(a)(3). Regardless, petitioner submitted its request on April 23, 2021, and the CDP hearing request was untimely in the absence of equitable tolling. We further held that in the absence of equitable tolling the Notice of Determination did not contain a determination for 2018 when it is read together with the Attachment despite the reference in the header to 2018. *See Lunsford* v. *Commissioner*, 117 T.C. 159, 161-64 (2001) (stating that the validity of a notice of determination is assessed on its face, and a notice is valid if it clearly states that Appeals has made a determination).

In the November 14, 2022, Order we stated that under *Craig v. Commissioner*, 119 T.C. 252, 259 (2002), where Appeals erroneously concluded that a CDP hearing request was late, the Court has jurisdiction to determine whether the request was timely and to review Appeals' determination irrespective of the label that Appeals used on the document notifying the taxpayer of its determination. We stated that we must determine whether the 30-day period for submitting a CDP hearing request is subject to equitable tolling and, if it is, whether we would have jurisdiction under *Craig* to correct Appeals' determination that the request was late and review as to 2018. We directed the parties to address whether the doctrine of equitable tolling should apply to CDP hearing requests under the principles set forth in *Boechler*. We further directed the parties to examine the full body of law, including Treasury Regulations, relating to whether the 30-day period is a fixed deadline.

In response to our Order respondent concedes that *Craig* would provide the Court with jurisdiction to review a decision letter issued following an equivalent hearing if the taxpayer's hearing request is timely through the application of equitable tolling. Respondent's brief states: "We believe this Court could apply its precedent in *Craig* to hold that a decision letter is a determination in a situation where a taxpayer's otherwise untimely hearing request is deemed timely through the application of equitable tolling.

Discussion

I. Background

A. Statutory Provisions of CDP Regime

Section 6321 imposes a lien in favor of the United States on all property and rights to property of a person liable for tax when a demand for payment has been made and the person fails to pay the tax. A lien arises when an assessment is made, but the Secretary must file an NFTL for the lien to be valid against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor. §§6322, 6323(a). The filing of an NFTL sets into action a series of mandates for the IRS and rights for the taxpayer. Section 6320(a) requires the IRS to provide written notice of the NFTL filing to the taxpayer during the 5-day notice period. §6320(a)(1) and (2). Section 6320(a)(3) describes the information that must be included in the NFTL. Part of the required information is notice that the taxpayer has "the right . . . to request a hearing during the 30-day period beginning on the day after the 5-day [notice] period." §6320(a)(3)(B).

Section 6320(b) provides taxpayers with a "[r]ight to [a] fair hearing." Section 6320(b)(1) provides the procedural steps that the taxpayer must take to obtain a CDP hearing and also grants authority to Appeals to hold a hearing. It states that "[i]f the person requests a hearing in writing under subsection (a)(3)(B) and states the grounds for the requested hearing, such hearing shall be held by . . . Appeals." By way of cross-reference to subsection (a)(3)(B), the taxpayer has a right to a hearing if it is requested within 30 days beginning on the day after the 5-day notice period for the required NFTL. Taxpayers are limited to one hearing for a taxable year and have a right to a CDP hearing before an impartial Appeals officer. §6320(b)(2) and (3).

Section 6330 provides similar notice and hearing rights regarding the IRS's intent to levy upon taxpayer property. The time periods for the IRS's written notice of intent to levy and for the taxpayer's hearing request for a proposed levy are slightly different from those for an NFTL. The IRS must provide written notice of intent to levy not less than 30 days before the day of the first levy, and the IRS notice must explain that the taxpayer has the right to request a hearing during that 30-day period. §6330(a)(2), (3)(B); Treas. Reg. § 301.6330-1(c)(1) (providing that the 30-day period to request a hearing for a proposed levy commences the day after the date of the IRS notice).

The conduct and scope of CDP hearings are governed by section 6330(c), (d), and (e). *See* §6320(c). Section 6330(c) sets forth the requirements for the conduct and scope "[i]n the case of any hearing conducted under this section." As part of the hearing, the Appeals officer must obtain verification from the Secretary that the requirements of any applicable law or administrative procedure have been met. §6330(c)(1). The taxpayer may raise any relevant issues relating to the unpaid tax and proposed collection action and may propose collection alternatives. §6330(c)(2). After the hearing, the Appeals officer is required to make a determination that takes into consideration the verification process, the issues raised by the taxpayer, and whether the proposed collection action balances the need for the efficient collection of taxes with the taxpayer's legitimate concern that any collection action is no more intrusive than necessary. §6330(c)(3).

Section 6330(d)(1) allows the taxpayer to petition this Court within 30 days of Appeals' determination. The 30-day deadline for filing a petition is a nonjurisdictional deadline that is subject to equitable tolling. *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501. We have jurisdiction to review Appeals' determination. §6330(d)(1). A proposed levy must be suspended until the conclusion of a CDP hearing and any judicial review of Appeals' determination. §6330(e).

B. Legislative History

The CDP regime was enacted as part of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105-206, §3401, 112 Stat. 685, 746, to establish "formal procedures designed to insure due process where the IRS seeks to collect taxes." H.R. Rep. No. 105-599, at 263 (1998) (Conf. Rep.), *as reprinted in* 1998-3 C.B. 747, 1017. The CDP regime is "designed to afford taxpayers due process in collections [with] increase[d] fairness to taxpayers." S. Rep. No. 105 -174, at 67 (1998), *as reprinted in* 1998-3 C.B. 537, 603. The Senate Finance Committee explained that taxpayers should be entitled to the same rights and protections in dealings with the IRS that persons have in dealing with any other creditors and should receive a "meaningful hearing before the IRS deprives them of their property." *Id.*

The conference report indicates that Congress intended that taxpayers that face a levy should have a right to an administrative hearing even if they do not timely request one. It states that "[t]he Secretary must provide a hearing equivalent to the pre-levy hearing if later requested by the taxpayer." H.R. Rep. No. 105-599, at 266, *as reprinted in* 1998-3 C.B. at 1020. The conference report does not specify any differences between a timely requested hearing and an untimely requested, postlevy hearing except with respect to the suspension of the levy. It states:

> [T]he Secretary is not required to suspend the levy process pending the completion of a hearing that is not requested within 30 days of the mailing of the Notice. If the taxpayer did not receive the required notice and requests a hearing after collection activity has begun, then collection shall be suspended and a hearing provided to the taxpayer.

Id.

The conference report separately addresses judicial review of Appeals' determination but says nothing about the taxpayer's right to seek judicial review when a hearing request is untimely. *Contra id.* at 289, *as reprinted in* 1998-3 C.B. at 1043 (stating that for 90-day period of section 6213(a), "[i]f the [deficiency] petition is not filed within that time period, the Tax Court does not have jurisdiction to consider the petition"). It states that the conferees expect Appeals "will prepare a written determination addressing the issues presented by the taxpayer and considered at the hearing. The determination . . . may be appealed to Tax Court." *Id.* at 266, *as reprinted in* 1998-3 C.B. at 1020. The conference report further states that "[n]o further hearings are provided under this provision as a matter of right. . . . However, after the 30 day period had expired, the IRS is not required to provide a hearing or delay any levy. . . ." *Id.*

C. Treasury Regulations

The Treasury regulations reiterate the 30-day period for requesting a CDP hearing and state that a taxpayer is entitled to a CDP hearing "if the taxpayer timely requests such a hearing." Treas. Reg. § 301.6320-1(b)(1); *see also id.* para. (c)(1), (2), Q&A-C3. Where a taxpayer timely requests a CDP hearing but the request is missing information required by the regulations, the regulations allow the taxpayer to perfect the request within a reasonable time.[5] Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(iii). For example, where a timely request fails to state the grounds for the hearing, the taxpayer may correct that error after the 30-day period. *Id.* Q&A-C1(ii)(E), (iii); *see also id.* Q&A-C1(v) (providing that a taxpayer may affirm a timely request that was signed on its behalf by an unauthorized representative within a reasonable time after the 30-day period). A request that is perfected within a reasonable time is considered timely. *Id.* Q&A-C7. A request that is not perfected within a reasonable period is considered untimely. *Id.*

The regulations explain that if a taxpayer does not request a hearing within the 30-day period, it forgoes the right to a CDP hearing with respect to the unpaid tax and tax periods shown on the NFTL. *Id.*; *see also id.* para. (i)(1) ("A taxpayer who fails to make a timely request for a CDP hearing is not entitled to a CDP hearing."); *id.* para. (c)(3) (example 3) (stating that even if the untimeliness of a taxpayer's hearing request is attributable to the taxpayer's being outside the United States, vacationing, or otherwise not receiving the CDP notice until after the 30-day period expires, the taxpayer still is not entitled to a CDP hearing). However, where taxpayers have failed to include the required information in a timely filed hearing request, the regulations allow taxpayers to provide the missing information after the 30-day period. *See* Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(ii) (listing information that taxpayers must include in hearing requests); *id.* (iii) (allowing taxpayers to provide required information after the 30-day period where defective hearing request is timely). The regulations direct Appeals to determine the timeliness of any hearing request and state that Appeals has the authority to determine the validity, sufficiency, and timeliness of both the NFTL and the hearing request. Treas. Reg. § 301.6320-1(e)(1).

The regulations provide an alternative type of administrative hearing, referred to as an equivalent hearing, to taxpayers that request a hearing after the 30-day period. *See id.* para. (i)(1). We have stated that equivalent hearings have "their genesis in the statute's legislative history and the regulations implementing Congressional intent as gleaned from that history." *Craig*, 119 T.C. at 258. When a hearing request is untimely, the taxpayer will be notified of the request's untimeliness and offered an equivalent hearing without needing to submit an additional request. Treas. Reg. § 301.6320-1(c)(2), Q&A-C7. The regulations set a one-year deadline for taxpayers to request an equivalent hearing beginning on the day after the 5-day notice period. *Id.* para. (i)(2), Q&A-I7. An equivalent hearing is held by Appeals and generally follows the same procedures as a CDP hearing. *Id.* subpara. (1). Appeals will consider the same issues that it would have considered at a CDP hearing on the same matter. *Id.* subpara. (2), Q&A-I2. However, after an equivalent hearing Appeals issues a different type of document called a decision letter about its conclusions to sustain or proceed with the collection action. *Id.* subparas. (1), (2), Q&A-I5. A decision letter contains all the information that must be included in a notice of determination except it states that the taxpayer cannot seek judicial review of the decision letter. *Id.* subpara. (2), Q&A-I5 and Q&A-I6.

The regulations state that taxpayers cannot seek judicial review of the outcome of an equivalent hearing. *Id.* Q&A-I6. They provide that "[s]ection 6320 does not authorize a taxpayer to appeal the decision of Appeals with respect to an equivalent hearing." *Id.* We have held that taxpayers are not entitled to seek judicial review of a decision letter issued following an equivalent hearing. *Moorhous v. Commissioner*, 116 T.C. 263, 269-70 (2001); *Kennedy*, 116 T.C. at 262.

According to the regulations, an equivalent hearing has one additional difference from a CDP hearing. Collection actions are suspended during a timely requested CDP hearing and any judicial review. §6330(e)(1). During an equivalent hearing, collection action may be suspended on a case-by-case basis, but collection is not required to be suspended. Treas. Reg. § 301.6320-1(i)(2), Q&A-I4 ("Appeals may request the IRS office with responsibility for collecting the taxes to suspend all or some collection action . . . if it determines that such action is appropriate or necessary under the circumstances.").

D. Review of an Appeals' Determination

Section 6330(d)(1) permits taxpayers to petition this Court to review a determination by Appeals sustaining a collection action. When a taxpayer fails to request a CDP hearing timely, Appeals is not required to make a determination and accordingly there is no determination for this Court to review.[6] *Ramey v. Commissioner*, 156 T.C. 1, 11 (2021); *Offiler v. Commissioner*, 114 T.C. 492, 498 (2000). Accordingly, the absence of a determination is grounds for dismissal for lack of jurisdiction. *LG Kendrick, LLC v. Commissioner*, 146 T.C. 17, 31 (2016), *aff'd*, 684 F. App'x 744 (10th Cir. 2017); *see Laing v. United States*, 423 U.S. 161, 165 n.4 (1976) (issuing a valid notice of deficiency is a jurisdictional prerequisite to filing a deficiency petition in the Tax Court under section 6213(a)).

Taxpayers may not seek review by this Court of a decision letter issued after an equivalent hearing; a decision letter does not constitute a determination. *See Orum v. Commissioner*, 123 T.C. 1, 11 (2004), *aff'd*, 412 F.3d 819 (7th Cir. 2005); *Moorhous*, 116 T.C. at 270; *Kennedy*, 116 T.C. at 263. And as we have said, the issuance of a decision letter rather than a determination turns on the timeliness of a taxpayer's hearing request. Thus, the question of whether the 30-day deadline of section 6320(a)(3)(B) may be equitably tolled affects our power to review the outcome of an Appeals hearing. We could review the outcome of an Appeals hearing where we determine that Appeals erroneously concluded that a CDP hearing request was untimely and erroneously provided an equivalent hearing. In such instance we can correct that error and review the decision of the equivalent hearing as a determination irrespective of the label that Appeals used on the document notifying the taxpayer of the outcome of the Appeals hearing. *See Craig*, 119 T.C. at 259.[7]

In these cases, we must determine whether Appeals should have made a determination with respect to the 2018 notice. To answer that question, we must first decide whether the 30-day period for requesting a CDP hearing is subject to equitable tolling. If it is subject to tolling, a followup question is whether the circumstances of these cases warrant equitable tolling. If Appeals should have equitably tolled the 30-day period for requesting a CDP hearing, then Appeals should have made a determination for 2018, issuance of the Decision Letter for 2018 rather than a notice of determination would have been erroneous, and we could review Appeals' action with respect to 2018 as a determination.

E. Tax Court Precedent

In *Kennedy*, 116 T.C. at 262, we held that the 30-day period for requesting a CDP hearing for a proposed levy under section 6330(a)(3)(B) is a fixed deadline. We stated that "section 6330 does not authorize" the Commissioner to waive the time restrictions imposed therein. *Kennedy*, 116 T.C. at 262. We held that when a taxpayer fails to request a CDP hearing timely, Appeals is "not obliged to conduct the administrative hearing contemplated under section 6330(b)" and "the decision to conduct an equivalent hearing did not result in a waiver by [the Commissioner] of the time restrictions within which [the taxpayer is] required to request an Appeals Office hearing under section 6330." *Id.* We have interpreted *Kennedy* as also applying to the 30-day period for requesting a CDP hearing for an NFTL filing under section 6320(a)(3)(B). *Andre v. Commissioner*, 127 T.C. 68, 70 (2006). We now reconsider these holdings.

II. Statutory 30-Day Administrative Deadline

As a threshold matter, we must decide whether Appeals has authority under the statute to review collection actions where the taxpayer fails to submit a hearing request within the 30-day period.[8] Such an administrative deadline is said to be "jurisdictional" if it defines the agency's authority to hold hearings for untimely requests. *See Sebelius v. Auburn Reg'l Med. Ctr.*, 568 U.S. 145, 154 (2013). An administrative deadline that is "non-jurisdictional" is a claim-processing rule that does not deprive the agency's authority to hold hearings where the deadline was missed. *See id.* at 154-56.

A filing deadline that is "jurisdictional" cannot be equitably tolled. *Id.* at 154; *see also United States v. Kwai Fun Wong*, 575 U.S. 402, 408-09 (2015). Accordingly, before we can consider whether the 30-day period of section 6320(a)(3)(B) is subject to equitable tolling, we must decide whether it is a "jurisdictional" deadline, i.e., whether Appeals has authority to hold hearings for untimely hearing requests. *See Santos-Zacaria v. Garland*, 143 S. Ct. 1103, 1112 (2023). For the sake of simplicity, we will refer to the question of whether the 30-day filing deadline of section 6320(a)(3)(B) is "jurisdictional" or "non-jurisdictional" in terms of whether the 30-day deadline imposes an "administrative bar" to Appeals' authority to hold hearings. If it imposes an administrative bar, it is "jurisdictional" with respect to Appeals' authority and Appeals does not have authority to hold hearings for untimely hearing requests and the deadline cannot be equitably tolled. In such instances the term "jurisdictional" does not refer to this Court's jurisdiction to review Appeals' determinations to sustain collection actions although it would also affect our jurisdiction.

The Supreme Court has applied the same principles to resolve whether an administrative filing deadline is an administrative bar that it applies to determine whether a judicial filing deadline is jurisdictional. *Auburn Reg'l Med. Ctr.*, 568 U.S. at 154-56. It has explained that every filing deadline must state, by definition, a time after which a claim is barred but "most time bars . . . are nonjurisdictional." *Kwai Fun Wong*, 575 U.S. at 403; *see also Wilkins v. United States*, 143 S. Ct. 870, 877 (2023); *Auburn Reg'l Med. Ctr.*, 568 U.S. at 154 ("[W]e have repeatedly held that filing deadlines ordinarily are not jurisdictional. . . ."). It has "described filing deadlines as 'quintessential claim-processing rules,' which 'seek to promote the orderly progress of litigation,' but do not deprive a [tribunal] of authority to hear a case." *Kwai Fun Wong*, 575 U.S. at 410 (quoting *Henderson v. Shinseki*, 562 U.S. 428, 435 (2011)). Jurisdictional deadlines are "rare." *Id.* However, even where an administrative deadline is not an administrative bar, the deadline might not be subject to equitable tolling. *Auburn Reg'l Med. Ctr.*, 568 U.S. at 158-60 (finding an administrative deadline for Medicare providers to request an administrative hearing about reimbursements was not an administrative bar (it was non-jurisdictional) but was not amenable to equitable tolling). A statute and regulations thereunder may categorically preclude equitable tolling of a nonjurisdictional deadline.[9] *Id.*; *see Kwai Fun Wong*, 575 U.S. at 408.

For a filing deadline to be an administrative bar, Congress must clearly state that the deadline has that effect.[10] *Arbaugh v. Y & H Corp.*, 546 U.S. 500, 515 (2006); *see Kwai Fun Wong*, 575 U.S. at 408-09. "[A]bsent such a clear statement . . . 'courts should treat the restriction as nonjurisdictional. . . .'" *Auburn Reg'l Med. Ctr.*, 568 U.S. at 153 (quoting *Arbaugh*, 546 U.S. at 516). The clear statement requirement is a "high bar." *Kwai Fun Wong*, 575 U.S. at 409. A filing deadline is not an administrative bar even when it is important and framed in mandatory and emphatic terms. *Id.* at 410. Under the clear statement rule, it is not sufficient that the interpretation that makes the deadline an administrative bar is more plausible or even better than one that does not. *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1499 ("But in this context, better is not enough."). Where a statutory filing deadline is subject to multiple plausible interpretations, some of which would make the deadline an administrative bar, it is difficult to make the case that such a reading is clear. *Id.* "Congress must do something special, beyond setting an exception-free deadline," to make it an administrative bar and prohibit its tolling.[11] *See Kwai Fun Wong*, 575 U.S. at 410.

We must decide whether section 6320 contains a clear statement that the 30-day period for requesting a CDP hearing is an administrative bar, i.e., that Appeals' authority to review collection actions is conditioned on the taxpayer submitting a CDP hearing request within the 30-day period. Traditional rules of statutory construction must plainly show that Congress imposed a procedural bar that would deprive Appeals of authority to review collection actions. *Id.* We examine the text, context, and relevant historical treatment of the statute to determine whether Congress made the required clear statement. *Reed Elsevier, Inc. v. Muchnick*, 559 U.S. 154, 166 (2010); *see Kwai Fun Wong*, 575 U.S. at 410-12. "Most important" is the text of the statute. *Kwai Fun Wong*, 575 U.S. at 410.

We begin by looking at the text of the statute. The 30-day deadline is in section 6320(a)(3)(B), the part of the statute that is directed at the requirement that the IRS notify the taxpayer of an NFTL filing and that provides the required contents of the IRS's notice. Section 6320(a)(3)(B) establishes when a hearing request will be timely. It does not speak in terms of Appeals' authority to review collection actions or otherwise refer to Appeals' authority to consider untimely hearing requests.

Section 6320(b)(1) provides the grant of authority to Appeals to hold CDP hearings. It does not expressly condition Appeals' authority on a timely filed hearing request, and nothing in the statute prohibits Appeals from providing CDP hearings to taxpayers that file untimely requests. Section 6320(b)(1) also states what the taxpayer must do to obtain a CDP hearing; the taxpayer must "request[] a hearing in writing under subsection (a)(3)(B) and state[] the grounds for the requested hearing." The cross-reference to the 30-day period is in the part of the sentence directed at what the taxpayer must do to obtain a CDP hearing. It is not directed at Appeals' authority to review collection actions. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500 ("[I]ts short, 30-day time limit is directed at the taxpayer, not the court."). Moreover, the fact that the cross-reference to the 30-day period is in the same sentence as the grant of authority to Appeals is not a clear statement of congressional intent that the untimeliness of a CDP hearing request would deprive Appeals of authority to review the collection action. *See id.* at 1499; *Gonzalez v. Thaler*, 565 U.S. 143, 147 (2012) ("Mere proximity will not turn a rule that speaks in nonjurisdictional terms into a jurisdictional hurdle."); *see* ...*so Auburn Reg'l Med. Ctr.*, 568 U.S. at 155 (finding deadline and grant of authority in same ...on).

While a plausible interpretation of section 6320(b)(1) may be that Appeals' authority is limited to timely requested CDP hearings, we learned from *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1499, that even the most plausible reading is not enough. There is no clear statement in the text of section 6320 that requires a taxpayer to comply with the 30-day deadline for Appeals to have authority to review a proposed collection action, and thus, we hold that the 30-day period is not an administrative bar.

III. Equitable Tolling

Having decided that the 30-day deadline for requesting a CDP hearing is not an administrative bar, we must decide whether it is amenable to equitable tolling. Respondent argues it is not; he argues that it is a fixed deadline and equitable tolling is categorically precluded.

The Supreme Court has adopted a rebuttable presumption that "nonjurisdictional" filing deadlines are subject to equitable tolling in suits against the government. *Irwin v. Dep't of Veteran Affairs*, 498 U.S. 89, 95-96 (1990). "Equitable tolling is a traditional feature of American jurisprudence and a background principle against which Congress drafts limitations periods." *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500; *see Young v. United States*, 535 U.S. 43, 49 (2002) ("It is hornbook law that limitations periods are 'customarily subject to "equitable tolling,"' unless tolling would be 'inconsistent with the text of the relevant statute. . . .'" (first quoting *Irwin*, 498 U.S. at 95; and then quoting *United States v. Beggerly*, 534 U.S. 38, 48 (1998))). The Supreme Court adopted the tolling presumption as a rule of statutory interpretation to reflect congressional intent. It reasoned that the presumption is "likely to be a realistic assessment of legislative intent as well as a practically useful principle of interpretation."[12] *Irwin*, 498 U.S. at 95. The presumption replaced the Court's "ad hoc" approach to determining whether filing deadlines are subject to equitable tolling which had produced "unpredictability without the corresponding advantage of greater fidelity to the intent of Congress." *Id.*

To rebut the presumption, there must be an affirmative indication from Congress that it intended to preclude equitable tolling. *Kwai Fun Wong*, 575 U.S. at 420. The presumption is rebutted if there is "good reason to believe that Congress did not want the equitable tolling doctrine to apply," *Brockamp v. Commissioner*, 519 U.S. 347, 350 (1997), or where equitable tolling "is inconsistent with the text of the relevant statute," *Beggerly*, 524 U.S. at 48 (citing *Brockamp*, 519 U.S. 347). Courts examine the statute's text, context, and purpose to determine whether Congress intended to rebut the presumption. *See Arellano v. McDonough*, 143 S. Ct. 543, 548 (2023); *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500; *Holland v. Florida*, 560 U.S. 631, 647 (2010); *Brockamp*, 519 U.S. at 350.

Petitioner relies on the tolling presumption. Respondent does not directly challenge application of the presumption. He states "assuming the presumption applies to agencies," it is rebutted here. The presumption does not apply to all administrative deadlines. In *Auburn Regional Medical Center*, 568 U.S. at 161, the Supreme Court did not apply the presumption to a filing deadline for institutional Medicare providers to appeal reimbursement decisions to an administrative agency, stating that "[w]e have never applied the *Irwin* presumption to an agency's internal appeal deadline," *id.* at 158. In *Brockamp*, 519 U.S. at 350-51, the Supreme Court assumed for the sake of argument that the presumption applied to tax refund claims but held that, even if it did apply, the presumption was rebutted. And in analyzing its own authority to hear a case (rather than the authority of the relevant administrative agency), the Supreme Court has since allowed equitable tolling of an agency filing deadline but did not address the presumption.[13] *Kwai Fun Wong*, 575 U.S. at 407 (finding that equitable tolling of an administrative deadline under the Federal Tort Claims Act was permitted for determining if the statutory prerequisites to bringing a claim in court were satisfied).

Absent the presumption, courts have used traditional tools of statutory construction to determine whether equitable tolling is consistent with the text of the statute and congressional intent for enacting the statute. *Bowen v. City of New York*, 476 U.S. 467, 480 (1986). "[W]hether equitable tolling is available is fundamentally a question of statutory intent." *Lozano v. Montoya Alvarez*, 572 U.S. 1, 10 (2014). Pre-*Irwin* cases consider the text, context, and purpose of the statute to determine whether Congress intended for a deadline to be nonjurisdictional and thus open to equitable tolling. *See Zipes v. Trans World Airlines, Inc.*, 455 U.S. 385, 393-94 (1982) (filing a timely complaint with Equal Employment Opportunity Commission is not a jurisdictional prerequisite to suit in federal court and is subject to waiver, estoppel, and equitable tolling). Post-*Irwin* cases also consider the statute's text, context, and purpose to determine whether there is a congressional intent to rebut the presumption. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500; *Holland*, 560 U.S. at 647; *Brockamp*, 519 U.S. at 350.

Before we proceed, it is worth noting that the cases before us differ from most of the cases cited above in an important respect. With a few exceptions, those cases generally analyze equitable tolling in the context of determining whether and how, under the relevant statutory provisions, a court (as opposed to an administrative agency) may consider a case. In *Kwai Fun Wong*, 575 U.S. 402, for example, the Supreme Court considered the Federal Tort Claims Act (FTCA), which stated, in relevant part, that a tort claim against the United States is "forever barred" unless it is presented to the appropriate federal agency within two years after the claim accrues. The Court decided that, for purposes of a *court's* consideration of a claim under the FTCA, the *court* may equitably toll the two-year deadline. *Id.* at 412. Similarly, in *Zipes*, 455 U.S. at 388-89, the Court considered Title VII of the Civil Rights Act of 1964, which required, in relevant part, that individuals pressing employment discrimination claims file charges with an administrative agency by a certain time before bringing suit in court. The Court concluded that, for purposes of determining a *court's* authority to hear a case under the relevant provisions, the administrative filing deadlines were nonjurisdictional and subject to equitable tolling (also waiver and estoppel) *by the court. Id.* at 393; *see also Brockamp*, 519 U.S. 347 (considering whether, in determining a *court's* authority to entertain a tax refund claim, the *court* may apply equitable tolling to the underlying administrative deadline).

By contrast, in the cases before us we decide whether an *agency* must consider equitable tolling in administering its own deadline — specifically, in determining whether to grant a CDP hearing. Additional considerations may well be relevant in this type of case.[14] Here, however, we conclude that the circumstances are sufficiently analogous to apply the caselaw we describe above, for two principal reasons.

First, while the context of our case is unusual, it is not unique, and in similar cases courts have applied general equitable tolling principles. For example, the U.S. Court of Appeals for the Eleventh Circuit has considered an agency's administration of its own deadlines in the immigration context. *See Avila-Santoyo v. U.S. Att'y Gen.*, 713 F.3d 1357 (11th Cir. 2013). Applying the relevant caselaw, the court held that the Board of Immigration Appeals was required to consider equitable tolling when enforcing certain deadlines for seeking its review. *Id.* at 1364. On similar facts, other courts of appeal have reached the same conclusion. *See, e.g., Harchenko v. INS*, 379 F.3d 405, 409-10 (6th Cir. 2004); *Riley v. INS*, 310 F.3d 1253, 1258 (10th Cir. 2002); *Socop-Gonzalez v. INS*, 272 F.3d 1176 (9th Cir. 2001). And when, in a different context, the Supreme Court considered the same question — whether an agency was required to equitably toll its own deadline — the Court did not hold the caselaw inapplicable; rather, it distinguished the cases according to the particular circumstances before it.[15] *See Auburn Reg'l Med. Ctr.*, 568 U.S. at 158-60.

Second, and significantly, the agency deadline at issue here implicates judicial review in much the same way as the deadlines in *Kwai Fun Wong*, *Zipes*, and other similar cases did, albeit less directly. Equitable tolling cases typically involve a straightforward court filing deadline, *see, e.g.*, *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, or else an agency filing requirement that must be satisfied before a court can hear a case, *see, e.g.*, *Kwai Fun Wong*, 575 U.S. 402. And they typically hold that, in appropriate cases, courts may toll the relevant deadlines, whether they be administrative or judicial, to preserve the court's ability to consider the case.

Here, the mechanics are different, but the effect is the same. Specifically, this Court's review under section 6330(d)(1) is predicated on Appeals' issuing a determination rather than a decision. And under the implementing regulations, the only criteria Appeals considers in determining whether to issue a decision (which we cannot review) and a determination (which we can review) is the timeliness of a taxpayer's CDP hearing request. Thus, the 30-day filing deadline, administered by Appeals, governs the Court's ability to hear a CDP case in much the same way as the deadlines at issue in the other cases. In other words the 30-day deadline in substance operates as a statute of limitations for a taxpayer's right to seek judicial review. *Cf. Lozano*, 572 U.S. at 13-14 (explaining that equitable tolling is most appropriately applied to statutes of limitations, which "establish the period of time within which a claimant must bring an action" (quoting *Heimeshoff v. Hartford Life & Accident Ins. Co.*, 571 U.S. 99, 105 (2013))).

Accordingly, cases that consider equitable tolling in these related contexts are instructive in our examination of congressional intent. *See id.* at 10 ("Because the doctrine effectively extends an otherwise discrete limitations period set by Congress, whether equitable tolling is available is fundamentally a question of statutory intent."). We place significant weight on the Supreme Court's understanding of congressional intent under the CDP regime as stated in *Boechler*. Even without a presumption in favor of equitable tolling, we are convinced that equitable tolling of the 30-day period to request a CDP hearing is consistent with the text of the statute and congressional intent for enacting the CDP regime.

A. Terms of the Statute

Section 6320(b) unambiguously provides taxpayers with the right to a CDP hearing if timely requested. However, it does not expressly address equitable tolling, and its plain text does not preclude equitable tolling. Rather, it prescribes the procedural steps for the taxpayer to obtain administrative review of proposed collection actions: A taxpayer must "request[] a hearing in writing under subsection (a)(3)(B) and state[] the grounds for the requested hearing." §6320(b)(1). Section 6320(b) incorporates the 30-day period by cross-reference. A simple cross-reference is not a clear expression that the failure to request a hearing during the 30-day period is an absolute bar to a CDP hearing or that equitable tolling is categorically precluded.

We find that section 6320 is silent as to equitable tolling and further examine whether equitable tolling is otherwise consistent with the text of the statute. Equitable tolling is not permitted where it is inconsistent with the text of the relevant statute. *Brockamp*, 519 U.S. at 350-51. We consider whether the text manifests a "clear intent" to preclude equitable tolling or "leaves room for . . . flexibility." *Nutraceutical Corp. v. Lambert*, 139 S. Ct. 710, 714 (2019) (equitable tolling of civil procedure rules). There is nothing in the text of section 6320 that suggests that the 30-day period is an absolute or inflexible deadline. Section 6320(a)(3)(B) lacks emphatic terms. The lack of "unusually emphatic" terms suggests equitable tolling is available. *Holland*, 560 U.S. at 647. The Supreme Court has allowed equitable tolling even for a deadline that emphatically states that untimely claims are "forever barred." *Kwai Fun Wong*, 575 U.S. at 420. Section 6320 does not impose, in unequivocal terms, an absolute bar to a CDP hearing when a request is untimely. Equitable tolling is consistent with the terms of the statute.

Other factors also support equitable tolling. The deadline is short. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500; *Beggerly*, 524 U.S. at 48-49 (finding that "unusually generous" 12-year limitations period was "incompatible" with equitable tolling). The 30-day period is contained in the part of the statute directed at the contents of the IRS notice to the taxpayer of the NFTL filing. It is not directed at defining the taxpayer's rights or directed at Appeals' authority to provide CDP hearings. Rather, section 6330(b) defines the taxpayer's hearing rights, the right to one hearing before an impartial Appeals officer. Nothing in section 6320 expressly or impliedly prohibits Appeals from asserting authority to review collection actions from an untimely hearing request when equitable considerations warrant it. The remedial nature of the CDP regime also supports equitable tolling. The CDP regime is unusually protective of taxpayers who are often not represented by lawyers. The Supreme Court found that each of these factors supported equitable tolling of the section 6330(d)(1) 30-day deadline to petition this Court in *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500, and they apply equally to the 30-day period for requesting a CDP hearing.[16] The context and underlying policy of the CDP regime indicate congressional intent to allow equitable tolling of the 30-day period for requesting a hearing.

Section 6320 is easily distinguishable from the section 6511 deadline for filing tax refund claims at issue in *Brockamp*, which is not subject to equitable tolling. Section 6511 is silent as to whether equitable tolling is available but is written in "unusually emphatic form" in a "highly detailed technical manner" with an "explicit listing of exceptions" that contain both procedural and substantive limitations, and it reiterates the filing deadline several times in several different ways.[17] *Brockamp*, 519 U.S. at 350-52; *see Holland*, 560 U.S. at 646 (finding that section 6511 is silent as to whether equitable tolling is available). Equitable tolling is not one of the listed exceptions to the filing deadline. *Brockamp*, 519 U.S. at 351. These features of section 6511 are a strong indication that Congress did not intend for other "unmentioned, open-ended, 'equitable' exceptions" to be read into the statute. *Brockamp*, 519 U.S. at 352. Conversely, section 6320 is not unusually emphatic, highly detailed, or technical. Nor are there explicit exceptions in section 6320 that provide a reason to foreclose the application of the broader doctrine of equitable tolling. The Supreme Court considered these distinguishing characteristics of the CDP regime in *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500-01, when it held that the 30-day deadline to seek judicial review in section 6330(d)(1) is subject to equitable tolling.

The CDP regime's main, and perhaps only, similarity with section 6511 is that both are part of the Code. Respondent relies on this similarity, arguing that tax law is incompatible with equitable tolling. The subject matter of the underlying statute is relevant to determining congressional intent. *See Beggerly*, 524 U.S. at 48-49 (finding that the need for certainty in the underlying subject matter (land ownership) weighed against tolling). However, the Supreme Court has already rejected this argument in *Boechler*. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501-02; *see also Volpicelli v. United States*, 777 F.3d 1042 (9th Cir. 2015) (finding that equitable tolling applies to the deadline for filing a suit for wrongful levy under section 6532(c)).

Respondent argues that the IRS needs a fixed 30-day deadline so that it can determine quickly and definitively whether it may begin to collect. He argues that the CDP regime is the result of a careful balance that Congress struck between affording taxpayers an opportunity for review of collection actions and the IRS's need for efficient and prompt collection which would be subverted if equitable tolling applies and that equitable tolling would complicate and delay the collection efforts. We disagree; the CDP regime does not demand certainty or promptness without equitable considerations. Congress chose to add taxpayer protections with the CDP regime, and we must honor that choice. The purpose of the CDP regime is to bring fairness and due process to the collection process. Congress did not intend to eliminate all delays posed by untimely hearing requests as evidenced by the conference report's suggestion that in some circumstances proposed levies should be suspended even when a hearing request is untimely. H.R. Rep. No. 105-599, at 266, *as reprinted in* 1998-3 C.B. at 1020. The Treasury regulations conform with congressional intent and allow suspension of proposed levies upon an untimely hearing request on a case-by-case basis. Treas. Reg. § 301.6320-1(i)(2), Q&A-I4. This discredits respondent's argument that a "clear line" is necessary to maintain efficient tax collection.

Equitable tolling of the 30-day period under section 6320(a)(3)(B) would not create the administrative burden that respondent anticipates, in contrast to the period discussed in *Brockamp*. In *Brockamp*, 519 U.S. at 352, the Supreme Court cited the administrative burden of processing more than "200 million tax returns" and "more than 90 million refunds" each year as a reason not to apply equitable tolling. Reading an equitable tolling exception into section 6511 for tax refund claims "could create serious administrative problems by forcing the IRS to respond to . . . large numbers of late claims . . . which, upon close inspection, might turn out to lack sufficient equitable justification." *Brockamp*, 519 U.S. at 352. In contrast Appeals closes approximately 4,100 to 7,100 equivalent hearings annually.[18] Concerns about equitable tolling "pale in comparison" to those in *Brockamp*, which dealt with a central provision of tax law. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501. Like the section 6330(d)(1) deadline for filing a petition with this Court, the 30-day period for requesting a CDP hearing "serves a far more limited and ancillary role in the tax collection systems." *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501. Moreover, the short 30-day periods under sections 6320(a)(3)(B) and 6330(d)(1) for the CDP hearing request and the petition to this Court for review of Appeals' determination, respectively, are substantially shorter than the deadline for filing a refund claim under section 6511(a), the later of 3 years from the time the return was filed or 2 years from the time the tax was paid. Such short filing periods support equitable tolling. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500.

A stated purpose of CDP hearings is to balance taxpayers' concerns about the collection action against the government's need for prompt tax collection. *See* §6330(c)(3)(C). The CDP hearing is an opportunity for taxpayers not only to challenge the validity of the collection action but also to propose collection alternatives and discuss those alternatives with the IRS before the IRS proceeds with collection. §6330(c)(2)(A)(iii). These principles are reinforced by the application of equitable tolling.

B. Legislative History

"For those who consider legislative history relevant," *Warger v. Shauers*, 574 U.S. 40, 48 (2014), the legislative history here does not change our conclusion. It does not clearly establish that Congress intended the 30-day period for requesting a CDP hearing to be a fixed deadline that is not amenable to equitable tolling. The conference report states congressional intent that the IRS is required to provide some type of administrative hearing to taxpayers that fail to request one within the 30-day period. It states that a postlevy hearing is to be "equivalent" to a pre-levy hearing but does not otherwise specify what type of protections taxpayers should receive. It does not indicate congressional intent as to the doctrine of equitable tolling. Significantly, it does not suggest that taxpayers should receive any different treatment except that the IRS is not required to suspend the levy. The conference report separately addresses judicial review of collection actions but says nothing about the taxpayer's right to seek judicial review when the hearing request is untimely. It does not expressly or implicitly prohibit taxpayers from having an opportunity for judicial review following an untimely hearing request. *See* H.R. Rep. No. 105-599, at 264, *as reprinted in* 1998-3 C.B. at 1018.

Arguably, the conference report's mention of postlevy hearings supports a finding that Congress intended to allow application of the broader doctrine of equitable tolling within the CDP regime. When Congress has indicated its intent that some tolling should be permitted, the Supreme Court has relied on the provision of some tolling as evidence of congressional intent that the broader doctrine of equitable tolling should apply. The statute at issue in *Bowen*, 476 U.S. at 480, expressly authorized the Secretary to provide some tolling of the filing deadline at issue (the filing period for judicial review of a Social Security benefits decision). The Supreme Court relied on the express provision for some tolling as congressional intent in favor of equitable tolling even though it is broader than the tolling permitted by the statute. The Supreme Court stated that Congress expressed a "clear intention" to allow some tolling and concluded that application of the broader doctrine of equitable tolling was "fully 'consistent with the overall congressional purpose' and is 'nowhere eschewed by Congress.'"[19] *Id.* (quoting *Honda v. Clark*, 386 U.S. 484, 501 (1967)).

We recognize that the conference report contains seemingly unqualified text that "[n]o further hearings are provided . . . as a matter of right" and "after the 30 day period had expired, the IRS is not required to provide a hearing or delay any levy." H.R. Rep. No. 105-599, at 266, *as reprinted in* 1998-3 C.B. at 1020. However, neither of these statements is an absolute bar to equitable tolling. "[T]he simple fact that a deadline is phrased in an unqualified manner does not necessarily establish that tolling is unavailable." *Nutraceutical Corp.*, 139 S. Ct. at 715. Moreover, reading these two statements as congressional intent to preclude equitable tolling would make the conference report internally inconsistent because the conference report clearly indicates that with respect to levy actions taxpayers have a right to a postlevy hearing "after the 30 day period" equivalent to a prelevy hearing. In summary the conference report indicates congressional intent that a hearing is not required but is appropriate when the circumstances warrant it and does not categorically preclude equitable tolling.

Also, the Treasury regulations do not treat the latter of these statements in the conference report as a bar to equitable considerations. The regulations permit the IRS to "delay any levy" on a case-by-case basis. Treas. Reg. § 301.6320-1(i)(2), Q&A-I4. Nor will we treat these statements as manifesting congressional intent for an absolute bar to taxpayers' receiving an administrative hearing with the opportunity for judicial review. Allowing proposed levies to be suspended in some circumstances clearly indicates congressional intent that equitable considerations should be taken into account within the administrative process of the CDP regime. Nothing in the conference report suggests that Congress intended to deny judicial review when hearing requests are untimely. Post-*Boechler*, we do not interpret the conference report to impose a categorical prohibition of equitable tolling of the 30-day period for seeking Appeals' review of the collection action as such a prohibition would deny taxpayers that request a CDP hearing after the 30-day period the right to seek judicial review.

C. Treasury Regulations

Respondent argues that the Treasury regulations implement Congress's choice to provide equivalent hearings to taxpayers that file untimely hearing requests and preclude equitable tolling. The regulations state that a taxpayer that does not timely request a hearing "forgoes the right to a CDP hearing" and will be "offered an equivalent hearing." Treas. Reg. § 301.6320-1(c)(2), Q&A-C7. Respondent argues that the regulations' provision of equivalent hearings is a reasonable interpretation of the statute. We do not need to address that argument because its basic premise, i.e., that the regulations categorically preclude equitable tolling, is wrong. The regulations are silent as to equitable tolling. They allow for equitable considerations with respect to the 30-day deadline and do not interpret the deadline as strict or inflexible.

1. Equivalent Hearings

The regulations establish the procedures for equivalent hearings, and nothing in those procedures categorically precludes equitable tolling. According to the regulations, both CDP and equivalent hearings are conducted by Appeals, follow the same procedures, consider the same issues, and end with the issuance of a document that contains the same information. Treas. Reg. §301.6320 -1(i)(1), (2), Q&A-I2, Q&A-I5; *see Craig*, 119 T.C. at 258-59. None of these provisions is a categorical bar to equitable tolling. The regulations state that "[s]ection 6320 does not authorize a taxpayer to appeal the decision of Appeals with respect to an equivalent hearing." Treas. Reg. § 301.6320-1(i)(2), Q&A-I6. However, under *Craig*, if the 30-day period is tolled, we would review Appeals' conclusion from an equivalent hearing as a determination.

Equivalent hearings can be viewed as an equitable exception to the 30-day period. However, the existence of an express equitable exception to a filing deadline does not foreclose the application of the broader doctrine of equitable tolling. *See Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1501 (finding that a single exception that prohibits taxpayers from filing a petition because of a bankruptcy proceeding does not preclude equitable tolling); *Holland*, 560 U.S. at 647-48 (finding that equitable tolling applied to a statute that "is silent as to equitable tolling while containing one provision that expressly refers to a different kind of tolling"); *Young*, 535 U.S. at 53 (finding that an unrelated, express tolling provision in the same subsection as the limitations period does not indicate a statutory intent to preclude equitable tolling but instead demonstrates that the statute "*incorporates* traditional equitable principles"); *see also Beggerly*, 524 U.S. at 48-49 (finding no equitable tolling for a statute that "already effectively allowed for equitable tolling" by providing that the limitations period did not begin to run until the plaintiff knew or should have known about the claim). We find that the provision of equivalent hearings does not necessarily bar equitable tolling of the 30-day period.

There are instances where the discretion granted to agencies to determine the application of equitable considerations must be respected and may preclude application of equitable tolling. In *Auburn Regional Medical Center*, 568 U.S. at 157, the statute provided for a 180-day administrative deadline, and the agency regulation extended the deadline for a maximum of 3 years "for good cause shown." The plaintiff filed a claim over 10 years late. The Supreme Court thought that the regulation was an adequate substitute for equitable tolling and held against equitable tolling beyond the 3-year regulatory deadline. *Id.* at 157-58. The CDP regime is clearly distinguishable from the Medicare reimbursement process at issue in *Auburn Regional Medical Center*, which is "not designed to be '"unusually protective" of claimants'" who were "sophisticated," "institutional," "repeat players" that were "assisted by legal counsel." *Id.* at 160 (quoting *Bowen*, 476 U.S. at 480); *see also Bowen*, 476 U.S. at 480 (finding equitable tolling allowed for deadline in a statute that provided for some tolling and is "unusually protective" of claimants (quoting *Heckler v. Day*, 467 U.S. 104, 106 (1984))). In the light of the remedial nature of the CDP regime, the regulations' provision of equivalent hearings does not preclude the application of the broader doctrine of equitable tolling.[20]

Nor do the regulations contain other statements precluding the application of equitable tolling. The provisions most supportive of respondent's position include Treasury Regulation § 301.6320-1(c)(2), Q&A-C4 (explaining the criteria Appeals uses to determine the timeliness of a CDP hearing request without mention of equitable tolling), Q&A-C7 (stating that if a taxpayer fails to request a CDP hearing within the 30-day period, "the taxpayer foregoes the right to a CDP hearing"), and paragraph (c)(3) (example 3) (explaining that, even if a taxpayer's untimeliness is attributable to being outside the United States, vacationing, or otherwise not receiving the CDP notice until after the 30-day period, the taxpayer still is not entitled to a CDP hearing). But, unlike the regulation the Supreme Court considered, these provisions are not irreconcilable with equitable tolling. *See Auburn Reg'l Med. Ctr.*, 568 U.S. at 156-57.

To begin with, none of the provisions specifically states that equitable tolling is unavailable, whereas the regulation in *Auburn Regional Medical Center* "[spoke] in no uncertain terms."[21] *Id.* at 156. Additionally, where possible, we interpret regulations consistently with the governing statute. *See, e.g., Long Island Care at Home, Ltd. v. Coke*, 551 U.S. 158, 169-70

(2007); *Emery Mineral Corp. v. Sec'y of Labor*, 744 F.2d 1411, 1414 (10th Cir. 1984); *cf. League of Wilderness Defs./Blue Mountains Diversity Project v. Forsgren*, 309 F.3d 1181, 1190 (9th Cir. 2002) ("An agency simply may not interpret a regulation in a way that contravenes a statute."). As we have already found, equitable tolling is consistent with the text of section 6320. And equitable tolling may be appropriate for reasons not addressed by the regulations. That the regulations provide that exceptions generally are unavailable in certain enumerated circumstances does not mean that exceptions are never available. Accordingly, "we cannot say that . . . allowing for equitable tolling would 'essentially gut' the regulatory scheme." *See Avila-Santoyo*, 713 F.3d at 1364 n.6 (quoting *Auburn Reg'l Med. Ctr.*, 568 U.S. at 157).

2. Equitable Considerations in the Regulations

Other parts of the Treasury regulations allow for equitable considerations and do not interpret the 30-day period as a fixed deadline. The regulations allow taxpayers to perfect defective hearing requests after the 30-day period, a clear example of equitable tolling permitted by the regulations. *See Irwin*, 498 U.S. at 96 (and cases cited thereat) (finding equitable tolling can be used to allow parties to correct defective pleadings). The regulations list information that taxpayers must include in hearing requests and permit taxpayers to provide missing information after the deadline. Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(ii) and (iii). Significantly, the regulations allow late compliance with the express requirements of the statute. Section 6320(b)(1) requires that the taxpayer request a hearing in writing and state the grounds for the hearing. The regulations require that a hearing request state "[t]he reason or reasons why the taxpayer disagrees" with the collection action but allow taxpayers to provide this information after the 30-day deadline. Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(ii)(E), (iii); *see id.* Q&A-C1(ii) (listing information that taxpayers must include in hearing requests). The regulations also seemingly would allow taxpayers to receive CDP hearings even when they request the hearing after the 30-day period so long as they submitted a document contesting the collection action during the 30-day period although not specifically requesting a hearing. Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(ii)(D), (iii). The regulations thus incorporate equitable considerations and allow for exceptions to the 30-day deadline.

3. Suspension of Levy Following Untimely Requests

The Treasury regulations deviate from the prompt collection that respondent says section 6320 demands. Appeals can request that a collection action be suspended following an untimely hearing request on a case-by-case basis. Treas. Reg. § 301.6320-1(i)(2), Q&A-I4. Thus, Appeals is already weighing individualized equities of untimely hearing request cases. The regulations show that a deadline need not be binding when individual equities require otherwise. Notably, the part of the regulations addressing the suspension of levies implements a statutory provision that also cross-references a 30-day period for filing a CDP hearing. Section 6330(e)(1) provides that a levy action is suspended "if a hearing is requested under subsection (a)(3)(B)" of section 6330 during the pendency of "such hearing." The regulations do not interpret the cross-reference as an absolute bar to equitable considerations. Accordingly, they comport with our understanding that the cross-reference in section 6320(b)(1) to the section 6320(a)(3)(B) 30-day period does not categorically preclude equitable tolling of the 30-day period.

IV. Conclusion

Taxpayers must pursue a CDP hearing before they can seek judicial review. A categorical prohibition of equitable tolling of the filing deadline for Appeals' review of collection actions would be contrary to Congressional intent. It would mean that we would protect a taxpayer's ability to seek judicial review through equitable tolling of the section 6330(d) deadline for filing a petition while denying taxpayers the possibility of equitable tolling to obtain Appeals' review and a determination for this Court to review. Although the Supreme Court did not address the 30-day period for requesting a CDP hearing in *Boechler*, we will not apply a stricter standard to the administrative filing deadline. Congress allowed for equitable tolling of the judicial filing deadline in section 6330(d)(1). *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500-01. It would not have intended to place a separate procedural obstacle to access this Court by precluding tolling of the 30-day period for requesting a CDP hearing.

Equitable tolling furthers the basic statutory purposes of the CDP regime of due process, protection, and fairness to taxpayers. We find that congressional intent is effected by applying equitable tolling to the 30-day period. We overrule *Kennedy*, 116 T.C. 255, to the extent that it holds that Appeals is not authorized to waive the 30-day period for requesting a CDP hearing and that the 30 -day period is a fixed deadline that is not amenable to equitable tolling. We hold that the 30-day period for requesting a CDP hearing may be equitably tolled where the circumstances warrant it.

We would have jurisdiction to review an erroneously issued decision letter instead of a determination where a CDP hearing request would be timely on the basis of equitable tolling. Appeals issued the Notice of Determination before the Supreme Court issued its opinion in *Boechler* and did not have reason to consider whether the facts of these cases warrant equitable tolling of the 30-day period under section 6320(a)(3)(B). Accordingly, we will remand the collection action for 2018 to Appeals to determine whether the circumstances surrounding petitioner's late filing warrant equitable tolling before we review that question.

An appropriate order will be issued.

Reviewed by the Court.

KERRIGAN, GALE, PARIS, MORRISON, NEGA, PUGH, ASHFORD, URDA, COPELAND, TORO, GREAVES, MARSHALL, and WEILER, *JJ.*, agree with this opinion of the Court.

FOLEY, BUCH, and JONES, *JJ.*, agree with Parts I, II, and III.A and B of this opinion, but dissent from Part III.C.

JONES, *J.*, concurring in part and dissenting in part: I concur with the opinion of the Court that Appeals has authority under section 6320 to hold CDP hearings when the taxpayer files a request after the 30-day period set forth in section 6320(a)(3)(B), as well as the corollary holding that equitable tolling of the 30-day period is not barred by the statute. *See* op. Ct. pp. 30-31. I also concur that it is appropriate to overrule *Kennedy v. Commissioner*, 116 T.C. 255 (2001), to the extent set forth in the opinion of the Court. *See* op. Ct. p. 31. But I part ways with the majority opinion where it holds that Treasury Regulation § 301.6320-1 does not preclude application of the doctrine of equitable tolling to the 30-day period. *See* op. Ct. pp. 26-30.

Our construction of section 6320 finds the statute silent or ambiguous with respect to equitable tolling.[1] In such situations, the question for the Court is whether the agency's answer is based on a permissible construction of the statute. *Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 843 (1984); *see Cuozzo Speed Techs., LLC v. Lee*, 579 U.S. 261, 277 (2016) (finding that a statute was ambiguous under step one of the *Chevron* doctrine, and analyzing the agency's interpretation under step two); *King v. Burwell*, 576 U.S. 473, 492 (2015) (same); *Wide Voice, LLC v. FCC*, 61 F.4th 1018, 1025-26 (9th Cir. 2023) (same); *Diaz-Rodriguez v.*

Garland, 55 F.4th 697, 727 (9th Cir. 2022) (same); *3M Co. & Subs. v. Commissioner*, No. 5816-13, 160 T.C., slip op. at 253-54 (Feb. 9, 2023) (same); *Oakbrook Land Holdings, LLC v. Commissioner*, 154 T.C. 180, 195-96 (2020) (same), *aff'd*, 28 F. 4th 700 (6th Cir. 2022). Rather than undertake this analysis, the Court errs in holding that "the regulations' provision of equivalent hearings does not preclude the application of the broader doctrine of equitable tolling." *See* op. Ct. p. 28. This holding is based on the incorrect assertion that "[t]he regulation[] [is] silent as to equitable tolling." *See* op. Ct. p. 27.

Therefore, I respectfully dissent with respect to this holding and write separately to explain how the text of the regulation — and the context in which it was promulgated and amended — speaks clearly to close the door to equitable tolling. Because the regulation closes the door that the Court's statutory construction leaves open,[2] I would direct the parties to brief the validity of Treasury Regulation § 301.6320-1 under *Chevron* (step two). I would likewise direct them to brief the severability of regulatory provisions that are permissible constructions from those that are not. *See, e.g., K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 294 (1988).

I. Regulatory Text

The regulation under section 6320 speaks consistently and clearly to establish Treasury's position that a request for a CDP hearing must be filed within the 30-day deadline; any request not made "timely," i.e., within the 30-day deadline, can be treated as a request for an equivalent hearing.[3] *See* Treas. Reg. § 301.6320-1(c)(1), (i)(1). As discussed *infra*, the regulation even goes so far as to emphatically reject equitable tolling of the 30-day deadline for taxpayers residing outside of the United States and clearly states that all taxpayers who want a CDP hearing must request a hearing within the 30-day period. *See id.* para. (2), Q&A-C5.

"Regulations are interpreted according to the same rules as statutes, applying traditional rules of construction." *Minnick v. Commissioner*, 796 F.3d 1156, 1159 (9th Cir. 2015) (citing *Christopher v. SmithKline Beecham Corp.*, 635 F.3d 383, 392 (9th Cir. 2011), *aff'd*, 567 U.S. 142 (2012)), *aff'g* T.C. Memo. 2012-345. We therefore "begin our interpretation of [a] regulation with its text." *Green v. Brennan*, 578 U.S. 547, 553 (2016). When interpreting the meaning of a regulation, the Supreme Court has given us a precise method to use. Our first and sometimes final step is to "'carefully consider[]' the text, structure, history, and purpose of a regulation, in all the ways [a court] would if it had no agency to fall back on." *Kisor v. Wilkie*, 139 S. Ct. 2400, 2415 (2019) (first alteration in original) (quoting *Pauley v. BethEnergy Mines, Inc.*, 501 U.S. 680, 707 (1991) (Scalia, J., dissenting)).

To begin, Treasury Regulation § 301.6320-1(a)(2), Q&A-A10 asks: "What must a CDP Notice given under section 6320 include?" The answer provides a list of required items, which includes, "[a] statement concerning the taxpayer's right to request a CDP hearing *during the 30-day period* that commences the day after the end of the five business day period within which the IRS is required to provide the taxpayer with notice of the filing of the NFTL." *Id.* (emphasis added).

In the same subparagraph, the regulation queries: "What are the consequences if the taxpayer does not receive or accept a CDP Notice that is properly left at the taxpayer's dwelling or usual place of business, or sent by certified or registered mail to the taxpayer's last known address?" *Id.* Q&A-A11. The answer is that a properly sent CDP Notice "is sufficient to start the 30-day period, commencing the day after the end of the five business day notification period, within which the taxpayer may request a CDP hearing." *Id.*

Further, the portion of the regulation that controls a taxpayer's right to a CDP hearing provides the following:

> Entitlement to a CDP hearing — (1) In general. A taxpayer is entitled to one CDP hearing with respect to the first filing of a NFTL (on or after January 19, 1999) for a given tax period or periods with respect to the unpaid tax shown on the NFTL *if the taxpayer timely requests such a hearing. The taxpayer must request such a hearing during the 30-day period that commences the day after the end of the five business day period within which the IRS is required to provide the taxpayer with notice of the filing of the NFTL.*

Id. para. (b)(1) (emphasis added).

We cannot breeze by this provision's use of the words "entitlement," "timely," and "must," as it sets out a taxpayer's right to a CDP hearing and insists that the right depends upon the filing of the request within the 30-day period. "Entitlement" is defined as "[a]n absolute right to a (usu. Monetary) benefit, such as social security, granted immediately upon meeting a legal requirement." *Entitlement, Black's Law Dictionary* (7th ed. 1999).[4] "Timely," which is used as an adverb in Treasury Regulation § 301.6320-1(b)(1),[5] means "[i]n time; opportunely." *Timely, The American Heritage Dictionary of the English Language* (4th ed. 2000). "Must" is defined as "[t]o be obliged or required by morality, law, or custom." *Id., Must.*[6]

In other words, the regulation plainly states that a taxpayer is required to file a request for a CDP hearing within the 30-day period to exercise her right to such a hearing. The implication — which is also made clear in the regulations — is that there is no equitable tolling with respect to the strict and inflexible 30-day deadline.

Consistent with this position, the regulation's guidance on requesting a hearing provides:

> Requesting a CDP hearing — (1) In general. When a taxpayer is entitled to a CDP hearing under section 6320, the CDP hearing must be requested during the 30-day period that commences the day after the end of the five business day period within which the IRS is required to provide the taxpayer with a CDP Notice with respect to the filing of the NFTL.

Treas. Reg. § 301.6320-1(c)(1).

Treasury Regulation § 301.6320-1(c)(2) continues to focus on the importance of timely filing a request. At Q-C3, the paragraph poses the question: "When must a taxpayer request a CDP hearing with respect to a CDP Notice issued under section 6320?" At A-C3, the answer is:

> A taxpayer must submit a written request for a CDP hearing within the 30-day period that commences the day after the end of the five business day period following the filing of the NFTL. Any request filed during the five business day period (before the beginning of the 30-day period) will be deemed to be filed on the first day of the 30-day period. The period for submitting a written request for a CDP hearing with respect to a CDP Notice issued under section 6320 is slightly different from the period for submitting a written request for a CDP hearing with respect to a CDP Notice issued under section 6330. For a CDP Notice issued under section 6330, the taxpayer must submit a written request for a CDP hearing within the 30-day period commencing the day after the date of the CDP Notice.

At Q&A-C4, subparagraph (c)(2) provides that the rules and regulations under sections 7502 and 7503 will be used to determine the timeliness of a taxpayer's request for a CDP hearing.

Furthermore, the regulations soundly reject equitable tolling at subparagraph (c)(2), Q&A-C5. That provision asks: "Is the 30-day period within which a taxpayer must make a request for a CDP hearing extended because the taxpayer resides outside the United States?" At A-C5, the answer is:

> No. Section 6320 does not make provision for such a circumstance. Accordingly, *all taxpayers* who want a CDP hearing under section 6320 must request such a hearing within the 30-day period that commences the day after the end of the five business day notification period.

(Emphasis added.)

Treasury Regulation § 301.6320-1(c) is not shy about the consequence of failing to submit a request for a CDP hearing within the 30-day period: A taxpayer who fails to make a timely request for a CDP hearing is not entitled to a CDP determination. The regulation makes no distinction between taxpayers residing inside or outside of the United States; there is one 30-day period that applies to *all taxpayers* that cannot be extended, for example, on the basis of place of residence. Treas. Reg. § 301.6320-1(c)(2), Q&A-C5.

Further, at Q&A-C7, the question presented is: "What will happen if the taxpayer does not request a CDP hearing in writing within the 30-day period that commences the day after the end of the five business day notification period?" The answer is that the taxpayer has forfeited her right to a CDP hearing:

> If the taxpayer does not request a CDP hearing in writing within the 30-day period that commences on the day after the end of the five-business-day notification period, *the taxpayer foregoes the right to a CDP hearing under section 6320* with respect to the unpaid tax and tax periods shown on the CDP Notice. A written request submitted within the 30-day period that does not satisfy the requirements set forth in A-C1(ii)(A), (B), (C), (D) or (F) of this paragraph (c)(2) is considered timely if the request is perfected within a reasonable period of time pursuant to A-C1(iii) of this paragraph (c)(2). *If the request for CDP hearing is untimely, either because the request was not submitted within the 30-day period or not perfected within the reasonable period provided, the taxpayer will be notified of the untimeliness of the request and offered an equivalent hearing.* In such cases, the taxpayer may obtain

an equivalent hearing without submitting an additional request. See paragraph (i) of this section.

Id. (emphasis added).

To summarize, the text of Treasury Regulation § 301.6230-1 (1) establishes clearly and consistently that a taxpayer's right to a CDP hearing is conditioned on the filing of a request within the 30-day period; (2) provides that the rules and regulations under sections 7502 and 7503 will be used for determining the timeliness of a taxpayer's request; (3) rejects the notion that the 30-day deadline can be extended for taxpayers residing outside of the United States and requires that *all taxpayers* who want a CDP hearing *must* request a hearing within the 30-day period; (4) provides that failure to file a request within the 30-day period means that the taxpayer "foregoes the right to a CDP hearing"; and (5) provides that a taxpayer who fails to file a timely request will be offered an equivalent hearing.[7]

Yet the majority opinion states that the regulations "allow for equitable considerations with respect to the 30-day deadline and do not interpret the deadline as strict or inflexible." *See* op. Ct. p. 27.[8] I believe this conclusion is at odds with the text of the regulation.

As a consequence, the majority's reliance on *Craig v. Commissioner*, 119 T.C. 252 (2002), is misplaced. The Court's opinion states that "[t]he regulations establish the procedures for equivalent hearings, and nothing in those procedures categorically precludes equitable tolling." *See* op. Ct. p. 27. As previously discussed, I disagree. The opinion continues, recognizing that Treasury Regulation § 301.6320-1(i)(2), Q&A-I6, provides that "[s]ection 6320 does not authorize a taxpayer to appeal the decision of Appeals with respect to an equivalent hearing" but concludes that "under *Craig*, if the 30-day period is tolled, we would review Appeals' conclusion from an equivalent hearing as a determination." *See* op. Ct. p. 27.

The opinion of the Court rests on the unspoken assumption that a CDP request is "timely" when equitable tolling is applicable, but as previously discussed, the regulation is at odds with our interpretation of the statute. Under the regulation, a CDP request is timely only if it is received within the 30-day period, and the regulation repeatedly provides this rule in absolute, strict, and inflexible terms. Treas. Reg. § 301.6320-1(b)(1) ("The taxpayer must request [a CDP] hearing during the 30-day period. . . ."); *see also id.* para. (c)(1), (2), Q&A-C3 and Q&A-C4. The regulation provides in no uncertain terms that all taxpayers who want a CDP hearing must request one within the 30-day period. *See* Treas. Reg. § 301.6320-1(c)(2), Q&A-C5, Q&A-C7.

In *Craig*, a taxpayer made a timely request for a CDP hearing, but instead of holding a CDP hearing and issuing a notice of determination, the IRS erroneously held an equivalent hearing and issued a decision letter based on the mistaken belief that the taxpayer's CDP request was untimely. *Craig*, 119 T.C. at 258-59. This Court stated:

> Although the Appeals officer concludes an equivalent hearing by issuing a decision letter, as opposed to a notice of determination, the different names which are assigned to these documents are merely a distinction without a difference when it comes to our jurisdiction over this case, *where a Hearing was timely requested.*

Id. at 258 (emphasis added). The Court continued, stating that "[u]nder the facts herein, where Appeals issued the decision letter to [the taxpayer] *in response to his timely request for a Hearing*, we conclude that the 'decision' reflected in the [equivalent hearing] decision letter issued to [the taxpayer] is a 'determination' for purposes of section 6330(d)(1)." *Id.* at 259 (emphasis added).

Under the Court's holding in *Craig*, the Court has jurisdiction to review the equivalent hearing decision letter only when it is, in substance, a section 6330(d)(1) "determination." In *Craig*, the equivalent hearing decision letter was in substance a section 6330(d)(1) "determination" because the taxpayer timely requested a CDP hearing, and thus was entitled to a determination. *Craig*, 119 T.C. at 259; *see* Treas. Reg. § 301.6320-1(f)(1). And as previously discussed, *see supra* p. 33, the regulation clearly provides that a timely request for a CDP hearing is one made within the 30-day period.

Properly applied, *Craig* does not permit the Court to review a decision letter from an equivalent hearing unless the hearing request was timely filed within the 30-day period prescribed by the regulation. *Craig*, 119 T.C. at 258-59. Viewing equivalent hearings as an equitable exception to the 30-day period, as the opinion of the Court does, *see* op. Ct. p. 27, is only possible if the request for the CDP hearing was not filed within the 30-day period. In such a case *Craig* would be inapplicable. The regulation clearly provides that Appeals can issue a determination that is reviewable by this Court only if the taxpayer requested a CDP hearing within the 30-day period. *See* Treas. Reg. § 301.6320-1(b)(1), (f)(1). *Craig* does not depart from this rule. 119 T.C. at 258-59.

The regulations proceed from the assumption that the 30-day deadline in section 6320 is fixed, i.e., not subject to equitable tolling. *See* op. Ct. p. 16 ("Respondent argues [that the 30-day deadline] is not [amenable to equitable tolling]; he argues that it is a fixed deadline and equitable tolling is categorically precluded."); *see also* op. Ct. pp. 13 n.8, 14 n.9. That premise is borne out in the text and in the dichotomy of process the regulations establish for hearing requests filed within the 30-day period (CDP hearing) as opposed to those not filed within that period (equivalent hearing). *Compare* Treas. Reg. § 301.6320-1(f)(1) ("Appeals is required to issue a Notice of Determination in all cases where a taxpayer has timely requested a CDP hearing. The taxpayer may appeal such determinations made by Appeals within the 30-day period commencing the day after the date of the Notice of Determination to the Tax Court"), *with id.* para. (i)(1) ("A taxpayer who fails to make a timely request for a CDP hearing is not entitled to a CDP hearing. Such a taxpayer may nevertheless request an administrative hearing with Appeals, which is referred to . . . as an 'equivalent hearing.' . . . Appeals will not, however, issue a Notice of Determination."), *and* Treas. Reg. § 301.6320-1(i)(2), Q&A-I6 ("Section 6320 does not authorize a taxpayer to appeal the decision of Appeals with respect to an equivalent hearing."). Of course, as the opinion of the Court points out, the regulations provide that the consequence of a timely requested hearing is a "determination," which this Court reviews while the consequence of an equivalent hearing is a "decision," which we do not review. *See* op. Ct. pp. 10-11; *see also* Treas. Reg. § 301.6320-1(f)(1).

II. Context of Promulgation and Amendment

A careful consideration of the history of Treasury Regulation § 301.6320-1, *see Kisor*, 139 S. Ct. at 2415, demonstrates that it is built on the understanding that the 30-day deadline in section 6320 is fixed.[9] As explained below, such a reading is consistent with the context in which Treasury Regulation § 301.6320-1 was promulgated.

A. The temporary and final regulations published in 1999 and 2002, respectively, explained Treasury's view of the 30-day deadline.

On January 22, 1999, temporary regulations implementing changes made by section 3401 of the IRS Restructuring and Reform Act of 1998 (RRA), Pub L. No. 105-206, 112 Stat. 685, 746, were published. T.D. 8810, 1999-1 C.B. 470. A notice of proposed rulemaking cross-referencing the temporary regulations was published on the same day in the Federal Register. Prop. Treas. Reg. § 301.6320-1, 64 Fed. Reg. 3461 (Jan. 22, 1999).

The relevant portions of the preamble to Treasury Decision 8810 provide the following background:

> The legislative history accompanying RRA also explains that *Congress intended the IRS to grant an equivalent hearing to taxpayers who do not request a hearing under section 6320 within the 30-day period* that commences the day after the five business day notification period. H. Conf. Rep. No. 599, 105th Cong., 2d Sess. 266 (1998).

T.D. 8810, 1999-1 C.B. at 470 (emphasis added). The preamble continues, stating the following in the "[e]xplanation of [p]rovision" section:

> The notification must state the amount of unpaid tax, *inform the taxpayer of the right to request a hearing during the 30-day period* that commences the day after the end of the five business day notification period, inform the taxpayer of the administrative appeals available with respect to such lien and the procedures related to such appeals, and inform the taxpayer of the provisions and procedures relating to the release of liens. Unless the taxpayer withdraws the request that Appeals conduct a hearing when the taxpayer has made a *timely request* for a hearing, Appeals will hold one collection due process hearing (CDP hearing) with respect to the tax and tax period or periods specified in the CDP hearing notice (CDP Notice). . . . If a taxpayer timely requests a CDP hearing, the periods of limitation relating to collection after assessment, relating to criminal prosecutions, and relating to suits are suspended.
>
> . . . .
>
> Lastly, the temporary regulations provide rules and procedures with respect to the administrative hearing (referred to as an "equivalent hearing") the IRS will provide to taxpayers who do not timely request a hearing under section 6320.

Id. at 470-71 (emphasis added).

On January 18, 2002, the final regulations were published in the Federal Register. T.D. 8979, 2002-1 C.B. 466. The preamble notes that no comments on the temporary regulations were received during the comment period and only two comments were received after the period.[10] *Id.* at 467. It is noteworthy that neither comment challenged or even mentioned that the temporary regulations required a CDP hearing to be requested within the 30-day period; or that the temporary regulations deemed a taxpayer to have forgone his right to a CDP hearing if the request was not timely; or that the temporary regulations provided taxpayers with an "equivalent hearing," not subject to judicial review, if a request was not timely. Accordingly, these provisions were adopted in the final regulations without further explanation.

B. Treasury maintained its position regarding the 30-day deadline when it amended the regulations in 2006.

On September 16, 2005, Treasury published a notice of proposed rulemaking that proposed to amend Treasury Regulation § 301.6320-1. *See* 70 Fed. Reg. 54,681 (Sept. 16, 2005). The preamble explained that the proposed amendments were designed to improve efficiency in the CDP process following six years of IRS experience. *Id.* at 54,682-83. In relevant part, the proposed amendment maintained Treasury's position that a taxpayer's failure to request a CDP hearing during the 30-day period caused that taxpayer to forfeit such a hearing. The amendment also set forth Treasury's position that the IRS could, but is not required to, treat an untimely request as a request for an equivalent hearing. The preamble provides the following in the "[e]xplanation of [p]rovisions" section:

> The IRS receives a number of tardy requests for CDP hearings. The changes to § 301.6320-1(i)(2) explain how these requests will be treated. The proposed amendments to the regulations add a new Q&A-I1 to § 301.6320-1(i)(2) to explain that a taxpayer must request an equivalent hearing in writing. *A taxpayer may obtain an equivalent hearing if the 30-day period described in section 6320(a)(3) for requesting a CDP hearing has expired. Unlike an Appeals determination in a CDP hearing, the Appeals decision in an equivalent hearing is not reviewable in court.* Under new Q&A-I1, the IRS is not required to treat a late-filed CDP request as a request for an equivalent hearing. Section 301.6320-1(c)(2), A-C7 has been amended to require that the taxpayer be notified of the right to an equivalent

> hearing in all cases in which a tardy request for a CDP hearing is received. It is expected that the IRS will either send the taxpayer a letter or orally inform the taxpayer that the CDP hearing request is untimely and ask if the taxpayer wishes to have an equivalent hearing.

Id. at 54,683 (emphasis added).

On October 17, 2006, final regulations were published in the Federal Register. T.D. 9290, 71 Fed. Reg. 60,835 (Oct. 17, 2006). They adopted the above-referenced provision that was proposed in the temporary regulations. The preamble to the final regulations discusses multiple comments that Treasury received in response to the temporary regulations. *Id.* at 60,835-39. None of the comments queried or challenged Treasury's position that a failure to file a hearing request in the 30-day period caused the taxpayer to forfeit her right to such hearing. Rather, commenters requested that Treasury provide by regulation a specific period within which the IRS would allow a timely filed request to be perfected. *Id.* at 60,836.

C. Supreme Court and Tax Court jurisprudence at the time of promulgation were consistent with Treasury's view.

Treasury's position in the promulgation and amendment of Treasury Regulation § 301.6320-1 (1999-2006) is consistent with the Supreme Court's jurisprudence regarding jurisdiction at that time. Last year, the Supreme Court acknowledged that its efforts to "bring some discipline" to the use of the term "jurisdictional" have been relatively recent. *Boechler, P.C. v. Commissioner*, 142 S. Ct. 1493, 1500-01 (2022) (quoting *Henderson v. Shinseki*, 562 U.S. 428, 435 (2011)); *see also Reed Elsevier, Inc. v. Muchnick*, 559 U.S. 154, 161 (2010) (discussing the Supreme Court's then-recent effort to curtail "drive-by jurisdictional rulings").[11]

Moreover, Treasury's regulatory position was consistent with the Tax Court's jurisprudence at that time. The opinion of the Court correctly states that "[i]n *Kennedy v. Commissioner*, 116 T.C. 255, 262 (2001), we held that Appeals is not authorized to waive the 30-day period for requesting a CDP hearing and that Appeals is not required to provide a CDP hearing requested after the 30-day period." *See* op. Ct. p. 3. Accordingly, Treasury's position that the 30-day deadline was fixed, and its articulation of that position in the promulgation of the original and amended regulations, was consistent with caselaw at that time.

III. Conclusion

The text of Treasury Regulation § 301.6320-1 consistently and clearly treats the 30-day deadline as a fixed deadline (including an unmistakable rejection of equitably tolling the deadline for taxpayers residing outside of the United States), and the context of its promulgation and amendment is consistent with that view. Therefore, I respectfully dissent from that portion of the opinion of the Court that holds that the regulations do not preclude application of the doctrine of equitable tolling to the 30-day period.

FOLEY and BUCH, *JJ.*, agree with this opinion concurring in part and dissenting in part.

FOOTNOTES

[1]Petitioner has sought review for 2018 in both docket numbers. Docket No. 381-22L results from a notice of determination for 2010 and 2011 in which the Appeals officer refers to 2018, and Docket No. 5442-22L concerns a Petition to review a decision letter issued for 2018.

[2]Unless otherwise indicated, statutory references are to the Internal Revenue Code, Title 26 U.S.C. (Code), in effect at all relevant times, and regulation references are to the *Code of Federal Regulations*, Title 26 (Treas. Reg.), in effect at all relevant times.

[3]These cases have been consolidated for trial with the cases at docket Nos. 26889-16, 26890-16, 26891-16, 21033-18, 21034-18, 21035-18, 24708-21L, and 5442-22L. As explained further herein, the collection action for 2018 is also at issue in Docket No. 5442-22L, but the parties have not filed any motions in that case.

[4]We understand, and respondent has not asserted otherwise, that petitioner raised the issue of the timeliness of its 2018 CDP hearing request before Appeals. It is inappropriate for us to decide whether the circumstances of these cases warrant equitable tolling until we address whether *Boechler* requires us to overrule our precedent that has held that the 30-day period is a fixed deadline not subject to waiver.

[5]"[T]he IRS will make a reasonable attempt to contact the taxpayer and request that the taxpayer comply with the unsatisfied requirements. The taxpayer must perfect any timely

written request . . . within a reasonable period of time after a request from the IRS." Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(iii).

[6]Petitioner states that after Appeals has held a hearing, nothing in the statute conditions our review on Appeals' decision on the timeliness of the hearing request. We do not understand petitioner to challenge that a determination is required for our review. Rather, petitioner seems to argue that we may review Appeals' decision with respect to the 2018 notice because Appeals held one joint hearing for 2010, 2011, and 2018 and Appeals made a determination for 2010 and 2011. We rejected this argument in our Order dated November 14, 2022. Appeals is authorized to hold hearings for different tax periods at the same time and may combine an equivalent hearing with a CDP hearing. Treas. Reg. § 301.6320-1(d)(1), (2), Q&A-D2 and Q&A-D3, (i)(1).

[7]We treat a decision as a determination (as opposed to remanding the case to Appeals for further consideration) because, under the regulations, the two resolutions generally are equivalent apart from the timeliness of the taxpayer's hearing request and the availability of judicial review. *See* Treas. Reg. § 301.6320-1(i).

[8]Respondent does not argue that Appeals lacks authority to hold an administrative hearing for taxpayers that submit untimely hearing requests. Rather, he argues that the 30-day period is fixed and not subject to equitable tolling.

[9]Respondent does not argue that the 30-day deadline is an administrative bar but argues that equitable tolling is nevertheless categorically precluded.

[10]The Supreme Court has also held that a judicial filing deadline is jurisdictional on the basis that a long line of Supreme Court precedent left undisturbed by Congress is a clear indication that Congress intended it as such. *See John R. Sand & Gravel Co. v. United States*, 552 U.S. 130 (2008); *Bowles v. Russell*, 551 U.S. 205 (2007). This principle of statutory construction is referred to as the prior-construction canon. *See Hallmark*, 159 T.C. at 153. In *Boechler, P.C. v. Commissioner*, 142 S. Ct. at 1500, the Supreme Court declined to apply this canon to interpret the section 6330(d)(1) filing deadline. No Supreme Court precedent supports a construction of the 30-day period of section 6320(a)(3)(B) as an administrative bar. The prior-construction canon may also be invoked without Supreme Court precedent when, in the lower courts, there has been an "unwavering line of administrative and judicial interpretation," *Bragdon v.*

Abbott, 524 U.S. 624, 645 (1998), as in *Hallmark*, 159 T.C. at 153-63, where we held that the 90-day deadline of section 6213(a) for filing a petition with this Court for review of a notice of deficiency is jurisdictional. But as to the 30-day deadline at issue here, we discern no "unwavering line" of precedent. Consequently, we find the prior-construction canon inapplicable here.

[11]We did not consider these concepts in *Kennedy*, 116 T.C. 255.

[12]In adopting the presumption, the Supreme Court recognized that once Congress has waived sovereign immunity, allowing equitable tolling "amounts to little, if any, broadening of the congressional waiver" and the "same rebuttable presumption of equitable tolling applicable to suits against private defendants should also apply." *Irwin*, 498 U.S. at 95-96.

[13]In *Kwai Fun Wong*, 575 U.S. at 408 n.2, after finding that the agency and judicial deadlines at issue were nonjurisdictional, the Supreme Court held that both were subject to equitable tolling without separately addressing that issue because the government relied on the same indicia of congressional intent for its jurisdictional and tolling arguments and made no independent argument against equitable tolling.

[14]For example, implementing regulations may opine on the availability or nonavailability of equitable tolling, *see Auburn Reg'l Med. Ctr.*, 568 U.S. at 157, and we address this point further below. Additionally, some administrative deadlines may be purely internal, with no implications for a court's authority to review a claim. *See, e.g., PAMC, Ltd. v. Sebelius*, 747 F.3d 1214 (9th Cir. 2014). The presence or absence of such considerations may well affect our analysis in future cases.

[15]Those circumstances included, among other things, the governing regulations, which the Court read as precluding equitable tolling. *Auburn Reg'l Med. Ctr.*, 568 U.S. at 157.

[16]While the Supreme Court relied on the tolling presumption in *Boechler*, these factors are equally relevant to determine congressional intent even if the presumption does not apply to the 30-day period for requesting a CDP hearing.

[17]Tolling would have also affected the amount of the tax refunds. *Brockamp*, 519 U.S. at 352.

[18]*See* Treasury Inspector Gen. for Tax Admin., Review of the Independent Office of Appeals Collection Due Process Program, Report No. 2022-10-043, at 6 (Aug. 18, 2022) (Appeals closed 24,568 CDP cases and 4,099 equivalent hearing cases in fiscal year 2021); *id.* Report No. 2021-10-049, at 7 (Aug. 4, 2021) (Appeals closed 21,438 CDP cases and 4,285 equivalent hearing cases in fiscal year 2020); *id.* Report No. 2017-10-055, at 3 (Sept. 11, 2017) (Appeals closed 34,229 CDP cases and 7,151 equivalent hearing cases in fiscal year 2016). Reports are available at https://www.treasury.gov/ tigta/oa_auditreports.

[19]While the Supreme Court found in *Bowen*, 476 U.S. at 480, that Congress expressed a clear intention to allow equitable tolling, the Supreme Court has not required a clearly expressed intention before it has found a deadline is subject to equitable tolling.

[20]We need not consider whether to grant deference to an agency interpretation of a Treasury regulation under *Kisor v. Wilkie*, 139 S. Ct. 2400 (2019), because respondent does not argue that his interpretation should be granted deference. Furthermore, the regulation is silent on the application of equitable tolling and does not contain a genuine ambiguity, and respondent's argument that equitable tolling is precluded under the statute is not based on authoritative, technical expertise or fair and considered judgment in the light of *Boechler.*

[21]The regulation reads as follows: "A request for a Board hearing filed after [the 180-day time limit] shall be dismissed by the Board, except that for good cause shown, the time limit may be extended. However, no such extension shall be granted by the Board if such request is filed more than 3 years after the date the notice of the intermediary's determination is mailed to the provider." 42 C.F.R. §405.1841(b) (2007).

[1]"There is no clear statement in the text of section 6320 that requires a taxpayer to comply with the 30-day deadline for Appeals to have authority to review a proposed collection action, and thus, we hold that the 30-day period is not an administrative bar." *See* op. Ct. p. 16.

[2]For example, Treasury Regulation § 301.6320-1(b)(1) conditions a taxpayer's entitlement to a CDP hearing on the filing of a request within the 30-day period. This conflicts with our conclusion that "[t]here is no clear statement in the text of section 6320 that requires a taxpayer to comply with the 30-day deadline for Appeals to have authority to review a proposed collection action." *See* op. Ct. p. 16. It is also irreconcilable with our holding that "the 30-day period is not an administrative bar." *See* op. Ct. p. 16.

[3]*See United States v. Gilliam*, 737 F. App'x 660, 666-67 (4th Cir. 2018) ("Section 6330, as incorporated by [section] 6320, is silent as to whether a hearing request must be timely. The regulations raise the issue of timeliness and use timeliness to distinguish between CDP and equivalent hearings without reference to *when* a timeliness determination must be made." (citation omitted)).

[4]*See also Entitlement, The American Heritage Dictionary of the English Language* (4th ed. 2000) ("The state of being entitled."); *Entitlement, Webster's New Universal Unabridged Dictionary* (2003) (same); *Entitled, The American Heritage Dictionary of the English Language* (4th ed. 2000) ("To furnish with a right or claim to something."); *Entitled, Webster's New Universal Unabridged Dictionary* (2003) ("[T]o give (a person or thing) a title, right, or claim to something; furnish with grounds for laying claim.").

[5]*See* Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* 140 (2012) ("Words are to be given the meaning that proper grammar and usage would assign them.").

[6]*See also Must, Webster's New Universal Unabridged Dictionary* (2003) (defining the term "Must," when used as an auxiliary verb, as "to be obliged or bound to by an imperative requirement").

[7]The regulation holds the line on the 30-day period with respect to substitute CDP Notices too. Treas. Reg. § 301.6320-1(c)(2), Q&A-C8.

[8]To the extent the regulations "allow for equitable considerations with respect to the 30-day deadline," *see* op. Ct. p. 27, such leniency is with respect to perfecting and clarifying hearing requests that are filed within the 30-day period, Treas. Reg. § 301.6320-1(c)(2), Q&A-C1(iii). If a request is not so filed, the taxpayer gets an equivalent hearing.

[9]It makes sense that the agency that promulgated regulations that reject equitable tolling would litigate to that end, as respondent has done. On brief, respondent propounds his view that the 30-day deadline in section 6320 is fixed. *See supra* p. 39.

[10]The two comments were generally directed at the temporary regulations under section 6330 that were issued contemporaneously with those under section 6320. *See* T.D. 8809,

1991-1 C.B. 476.

[11]A brief for amicus curiae was filed by *T. Keith Fogg* and *Audrey Patten*, counsel for The Center for Taxpayer Rights, in support of petitioner. Therein, amicus observed that as early as 2004, the Supreme Court acknowledged that the Court itself had "been too careless" in its use of the term "jurisdictional." *See* Brief of The Center for Taxpayer Rights at 4, *Organic Cannabis Found., LLC v. Commissioner*, No. 381-22L (T.C. Jan. 1, 2023) (citing *Kontrick v. Ryan*, 540 U.S. 443, 455 (2004)).

END FOOTNOTES

<u>Guam Society of CPAs</u>
<u>August 21, 2024</u>
<u>Federal Tax Update</u>

1. Moore v. United States, 22-800 U.S. (2024)
2. Secure 2.0 provisions taking effect in 2023 and 2024
3. Overview of the Federal Tax System As In Effect For 2024—Joint Committee on Taxation
4. United Therapeutics v. Commissioner, 133 AFTR 2d 2024 (4th Cir.)—Research Tax Credit
5. In Re: Lee,133 AFTR 2d 2024 (Bankruptcy Court)—Tax Claims
6. In Re: Tampa Hyde Park Café Properties, 133 AFTR 2d 2024-1701 (Bankruptcy Court)—Tax claims-Objection to proof-Alter Ego Theory
7. Friedman v. IRS, 133 AFTR 2d 2024-1663 (Dist. Ct. Wash)—Actions against IRS and IRS Commissioner—proper defendant—damages
8. Cobai v United States, 133 AFTR 2d 2024-1636 (Dist. Ct. Calif)—Refund actions—administrative claims
9. Aguinaldo v. Yee, 133 AFTR 2d 2024-1604 (Dist. Hawaii)—Actions against U.S.—constitutional claims
10. United States v. Eaton Corp., 133 AFTR 2d 2024-1554 (Dist. Ct. Ohio)—Summons enforcement—procedure
11. Cognizant Technology Solutions v. United States, 133 AFTR 2d 2024-1498 (Dist. Ct. New Jersey)—District Court procedure—qui tam suits—False Claims Act—subpoenas—Administrative Procedure Act
12. Foley v. Commissioner, 95 F.4th 740 (2nd Cir. 2024)—Appeals from Tax Court—jurisdiction—small tax case
13. Farhy v. Commissioner, 133 AFTR 2d 2024-1462 (D.C. Cir.)—Information reporting penalties regarding foreign entities—assessment; IRS authority—collection due process
14. Watson v. Commissioner, 133 AFTR 2d 2024-1621 (10th Cir.)—Appeals from Tax Court—jurisdiction
15. United States v. Allahyari, 133 AFTR 2d 2024-1365 (9th Cir.)—Collection actions—lien foreclosure and priority—fraudulent transfers—appeals—jurisdiction
16. Notice 2023-42 Failure to pay corporate estimated tax penalties—corporate alternative minimum tax—waivers
17. Notice 2023-54 Employee benefit plans—required minimum distributions
18. Notice 2023-55 Foreign tax credit—determination of foreign income taxes—temporary relief
19. Notice 2023-59 Energy efficient home improvement credit—home energy audits—requirements and procedure for claiming credit
20. Notice 2023-62 Catch-up contributions—designation of contributions
21. Notice 2023-69 Gross income—leave-based donation programs—Hawaii wildfires

22. Notice 2023-71 Authority to postpone certain deadlines by reason of terroristic or military actions
23. Notice 2024-2 Retirement and pension plans—guidance
24. Notice 2024-7 Failure to pay tax penalties—penalty relief for tax years 2020 and 2021
25. Notice 2024-8 Business use of auto—deductions—optional standard mileage rates for 2024
26. Notice 2024-11 Dividends—reduced capital gains tax rate—qualified foreign corps.—treaties
27. Notice 2024-16 Basis of stock in controlled foreign corps.—adjustments—liquidations and asset reorgs
28. Notice 2024-19 Penalties for failure to furnish correct payee statements—partnerships—sales or exchanges—unrealized receivables and inventory items
29. Notice 2024-31 U.S. taxpayers living abroad—income exclusions—foreign housing costs
30. Notice 2024-44 Tax on nonresident alien individuals—treatment of dividend equivalent payments
31. Notice 2024-54 Partnerships—related-party transactions; basis shifting; tax avoidance—compliance—organization of IRS
32. Notice 2024-55 10% additional tax on early retirement plan distributions—exceptions—emergency personal expenses; domestic abuse
33. Rev. Rul. 2024-10 Exempt orgs.—private foundations—governing instruments—state law
34. Rev. Rul. 2024-14 Partnerships—related-party transactions; basis shifting; tax avoidance—economic substance—accuracy related penalties
35. Rev. Proc. 2023-40 Accuracy-related penalties—adequate disclosure
36. Rev. Proc. 2024-13 Limitations on depreciation for auto owners and lessees
37. Lesson from The Tax Court: Temporary vs. Indefinite Commutes
38. Ledbetter v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-19
39. Lesson from The Tax Court: The IRS's Substantial Justification Defense to Sec. 7430 Fee Awards
40. Castillo v. Commissioner of Internal Revenue, 160 T.C. No. 15 (2023)
41. Lesson from The Tax Court: How to Calculate Insolvency for the Section 108 Exclusion
42. White v. Commissioner of Internal Revenue, T.C. Memo 2023-77
43. Lesson from The Tax Court: Freedom, Taxes, and Hobbies
44. Swanson v. Commissioner of Internal Revenue, T.C. Memo 2023-81
45. Lesson from The Tax Court: Deducting Graduate School Costs
46. Uchinzozo v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-21
47. Lesson from The Tax Court: Creating Your Best Administrative Record
48. Whittaker v. Commissioner of Internal Revenue, T.C. Memo 2023-59
49. Lesson from The Tax Court: Size Does Not Matter
50. Braen v. Commissioner of Internal Revenue, T.C. Memo 2023-85
51. Lesson from The Tax Court: An Object Lesson On Adequate Business Records

52. Ninke v. Commissioner of Internal Revenue, T.C. Memo 2023-88
53. Lesson from The Tax Court: Gotta Get Physical for Casualty Loss Deduction
54. Cleary v. Commissioner of Internal Revenue, T.C. Memo 2023-43
55. Lesson from The Tax Court: Tax Consequence for Discharge of Non-Recourse Debt
56. Parker v. Commissioner of Internal Revenue, T.C. Memo 2023-104
57. Lesson from The Tax Court: The DOI Downside to Disregarded LLC
58. Jacobowitz v. Commissioner of Internal Revenue, T.C. Memo 2023-107
59. Lesson from The Tax Court: The Boundary Waters of Equity
60. Evenhouse v. Commissioner of Internal Revenue, T.C. Memo 2023-113
61. Lesson from the Tax Court: Equitable Tolling During Government Shutdown
62. Organic Cannabis Foundation v. Commissioner of Internal Revenue, 161 T.C. No. 4 (2023)

    General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals ["Green Book"]

63. Reform Business Taxation
64. Reform International Taxation
65. Strengthen Taxation of High-Income Taxpayers
66. Modify Rules Relating to Retirement Plans
67. Support Workers, Families, and Economic Security
68. Modify Estate and Gift Taxation
69. Close Loopholes
70. Improve Tax Administration
71. Improve Tax Compliance
72. Treasury Decision 9980 Identifying numbers—fee for obtaining preparer tax identification number
73. Treasury Decision 9981 Private foundation defined—supporting orgs.
74. Treasury Decision 9984 Penalties for failure to file correct information returns or furnish correct payee statements—de minimis safe harbor—broker returns—final regs.
75. Treasury Decision 9996 Generation-skipping transfer taxes—elections and extensions—final regs.
76. Lesson from The Tax Court: The Designated Payment Rule
77. Edwards v. Commissioner of Internal Revenue, T.C. Summary Opinion 2023-29
78. Lesson from The Tax Court: The Limits of Collection Due Process
79. Olson v. Commissioner of Internal Revenue, T.C. Memo 2023-123
80. Lesson from The Tax Court: The Rules for Penalty Approval Depend on Geography
81. Kraske v. Commissioner of Internal Revenue, 161 T.C. No. 7 (2023)
82. Lesson from The Tax Court: Section 6662 Is Sometimes Multiple Penalties For Supervisory Approval Purposes But Sometimes Not
83. Kelley v. Commissioner of Internal Revenue, T.C. Memo 2023-126
84. Lesson from The Tax Court: Merely Winning Does Not Entitle Taxpayer to Attorney Fees

85. Champions Retreat Golf Founders v. Commissioner of Internal Revenue, T.C. Memo 2023-143

General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals

Department of the Treasury
March 11, 2024

This document is available online at:
https://home.treasury.gov/policy-issues/tax-policy/revenue-proposals

TABLE OF CONTENTS

NOTES

The revenue proposals are estimated relative to a baseline of current law.

The Administration's proposals are not intended to create any inferences regarding current law.

Within the *General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals*, unless otherwise stated:

- "AGI" refers to Adjusted Gross Income.
- "Budget" refers to the *Fiscal Year 2025 Budget of the U.S. Government.*
- "Code" refers to the Internal Revenue Code.
- "C-CPI-U" refers to the Chained Consumer Price Index for Urban Consumers.
- "IRS" refers to the Internal Revenue Service.
- "OECD" refers to the Organisation for Economic Co-operation and Development.
- "Section" refers to the respective section of the Internal Revenue Code.
- "Secretary" refers to the Secretary of the Treasury and/or her delegates.
- "Secretary of the Treasury" refers to the Secretary of the Treasury personally and does not include her delegates.
- "Treasury" refers to the U.S. Department of the Treasury.
- "TIN" refers to Taxpayer Identification Number.

REVENUE PROPOSALS

In the Fiscal Year 2025 Budget, the President proposes a series of reforms that would raise revenues, expand tax credits for workers and families, and improve tax administration and compliance. These reforms cover all areas of tax policy and together they result in a tax system that is both more equitable and more efficient.

For example, reforms to business and international taxation would raise the corporate tax rate and the corporate alternative minimum tax rate, increase the excise tax rate on stock buybacks, end corporate tax deductions for employee compensation over $1 million, and close several business tax loopholes. Additional reforms would strengthen the taxation of foreign earnings and reduce tax incentives that encourage profit shifting and offshoring, consistent with the historic international agreement to implement a global minimum tax and modernize the individual tax system. This agreement will help end the race to the bottom in corporate tax rates and level the playing field for U.S. businesses while protecting U.S. workers. This agreement also updates our international tax rules to provide stability and certainty. Countries around the world are enacting legislation to implement the global minimum tax.

Similarly, reforms to the taxation of high-income taxpayers would raise additional revenue and help ensure more equal treatment of labor and capital income. Income tax rates for those with the highest incomes would increase. Capital gains and dividends would generally be taxed at ordinary rates for those with high incomes, and a loophole that lets some capital gains income escape income taxation forever would be eliminated for certain wealthy taxpayers. A new 25-percent minimum income tax would be imposed on extremely wealthy taxpayers. For high-income taxpayers, gaps in the law that allow some pass-through business owners to avoid Medicare taxes would be eliminated and Medicare tax rates would be increased. Additional loopholes, including the carried interest preference and the like-kind exchange real estate preference, would be eliminated for those with the highest incomes. Together these reforms would sharply curtail tax preferences that allow the wealthy to pay lower tax rates on their investment income and exacerbate income and wealth disparities, including by gender, geography, race, and ethnicity.

Finally, the Budget would expand tax credits for workers and families, reducing child poverty and expanding opportunity. The child tax credit would be expanded through 2025, would permanently be made fully refundable, determined monthly, and paid out in advance. Reforms to the delivery of the credit would facilitate take-up. The earned income tax credit would also be expanded to cover more workers without children. The premium tax credit expansion first enacted in the American Rescue Plan Act of 2021 and extended in the Inflation Reduction Act of 2022 would be made permanent, making health insurance more affordable for millions of families.

Additional reforms would support housing and urban development, eliminate fossil fuel tax preferences, close estate and gift tax loopholes, and improve tax administration and compliance.

REFORM BUSINESS TAXATION

RAISE THE CORPORATE INCOME TAX RATE TO 28 PERCENT

Current Law

Income of a business entity can be subject to Federal income tax in a manner that varies depending upon the classification of the entity for Federal income tax purposes. Most small businesses are owned by individuals and taxed as "pass-through" entities, meaning that their income is passed through to their owners who are taxed under the individual income tax system. Most large businesses, including substantially all publicly traded businesses, are classified as "C corporations" because these corporations are subject to the rules of subchapter C of chapter 1 of the Internal Revenue Code (Code) and accordingly pay an entity-level income tax. Additionally, taxable shareholders of such corporations generally pay Federal income tax on most distributions attributable to their ownership in the corporation. Some mid-sized businesses choose a pass-through form of entity classification (under subchapter K or subchapter S of chapter 1 of the Code) while others choose the C corporation form of entity classification.

C corporations determine their taxable income, credits, and tax liability according to the Code and regulations promulgated thereunder. The Tax Cuts and Jobs Act of 2017 replaced a graduated tax schedule (with most corporate income taxed at a marginal and average rate of 35 percent) with a flat tax of 21 percent applied to all C corporations.

Reasons for Change

Raising the corporate income tax rate is an administratively simple way to raise revenue to pay for the Administration's fiscal priorities. A corporate tax rate increase can also increase the progressivity of the tax system and help reduce income inequality. Additionally, a significant share of the effects of the corporate tax increase would be borne by foreign investors. Therefore, some of the revenue raised by the proposal would result in no additional Federal income tax burden on U.S. persons. Finally, the majority of income from capital investments in domestic C corporations is untaxed by the U.S. government at the shareholder level, so the corporate tax is a primary mechanism for taxing such capital income.

Proposal

The proposal would increase the tax rate for C corporations from 21 percent to 28 percent. The effective global intangible low-taxed income (GILTI) rate would increase to 14 percent under the proposal. The proposal *Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms* described later in this text would further increase the effective GILTI rate to 21 percent.

The proposal would be effective for taxable years beginning after December 31, 2023. For taxable years beginning before January 1, 2024, and ending after December 31, 2023, the corporate income tax rate would be equal to 21 percent plus 7 percent times the portion of the taxable year that occurs in 2024.

INCREASE THE CORPORATE ALTERNATIVE MINIMUM TAX (CAMT) RATE TO 21 PERCENT

Current Law

For taxable years beginning after December 31, 2022, section 55(a) of the Internal Revenue Code imposes an alternative minimum tax on certain corporations based on their adjusted financial statement income (AFSI). This tax is commonly referred to as the Corporate AMT or CAMT.

The CAMT applies to corporations (other than S corporations, regulated investment companies, or real estate investment trusts) that meet an average AFSI test that in general terms is met when average AFSI (with certain modifications) for a 3-taxable-year period exceeds $1 billion, with certain special rules for foreign-parented groups.

The CAMT is equal to the excess (if any) of (a) the tentative minimum tax for the taxable year, over (b) the sum of the regular income tax imposed for the taxable year (reduced by the foreign tax credit, but no other credits) plus the tax imposed under the base erosion and anti-abuse tax (BEAT) for such taxable year.

The tentative minimum tax for the taxable year is equal to the excess of (a) 15 percent of the corporation's AFSI for the taxable year, over (b) a special CAMT foreign tax credit. A corporation's AFSI for a taxable year is equal to the net income or loss set forth on the taxpayer's applicable financial statement with certain adjustments. An applicable financial statement is generally an audited financial statement issued to shareholders and/or creditors.

To the extent an applicable corporation incurs a CAMT liability for a taxable year, the CAMT liability gives rise to a CAMT credit that can be carried forward to offset the corporation's regular tax liability in future years (subject to certain limitations).

Reasons for Change

The CAMT works to reduce the significant disparity between the income reported by large corporations on their Federal income tax returns and the profits reported to shareholders in financial statements by requiring them to pay a minimum amount of tax based on their reported financial statement income. The proposal strengthens the CAMT by increasing the CAMT rate roughly in line with the proposed increase in the regular corporate tax rate and aligns the CAMT rate with the proposed effective GILTI rate. The proposal is a targeted approach to ensure that the most aggressive corporate tax avoiders bear meaningful Federal income tax liabilities.

Proposal

The proposal would increase the rate used to compute the tentative minimum tax from 15 percent to 21 percent.

The proposal would be effective for taxable years beginning after December 31, 2023.

INCREASE THE EXCISE TAX RATE ON REPURCHASE OF CORPORATE STOCK AND CLOSE LOOPHOLES

Current Law

The stock repurchase excise tax applies at a rate of one percent of the fair market value (FMV) of any stock of a covered corporation that is repurchased by the corporation during its taxable year. The statute generally defines a "covered corporation" as a domestic corporation whose stock is publicly traded on an established securities market. An established securities market for this purpose includes U.S. national securities exchanges, certain foreign securities exchanges, regional or local exchanges, and certain interdealer quotation systems. "Repurchases" include a corporation's acquisition of any of its stock from a shareholder for property that qualifies as a redemption of the stock as defined in the Internal Revenue Code (Code). The statute also provides that a repurchase includes any other transaction that the Secretary determines in regulations or other guidance to be "economically similar" to a redemption of stock. A repurchase also may include acquisitions of the corporation's stock by certain specified affiliates.

The stock repurchase excise tax applies to the acquisition of stock of a foreign corporation, the stock of which is traded on an established securities market (an "applicable foreign corporation") by a specified affiliate of such corporation. In this case, the stock repurchase excise tax only applies to the extent the specified affiliate is not a foreign corporation or a foreign partnership (unless such partnership has a domestic entity as a direct or indirect partner). The excise tax also applies to the acquisition of stock of certain foreign corporations subject to the inversion rules.

The annual FMV of a covered corporation's repurchased stock is reduced by certain exceptions and reductions, including the FMV of the covered corporation's stock that is issued or provided to employees during the taxable year.

Reasons for Change

Stock repurchases are tax-favored relative to dividends as a means of distributing corporate profits to shareholders. Increasing the excise tax rate on stock repurchases would reduce this disparity. Moreover, raising the tax rate is an administratively simple and progressive way to raise revenue to pay for the Administration's fiscal priorities. In addition, the tax should apply to specified affiliates of an applicable foreign corporation that are controlled foreign corporations (CFCs), generally corporations whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules), in the same manner that it applies to specified affiliates of an applicable foreign corporation that are U.S. corporations.

Proposal

The proposal would increase the tax rate on corporate stock repurchases to 4 percent. The proposal also would extend the stock repurchase excise tax to the acquisition of stock of an applicable foreign corporation by a specified affiliate of the applicable foreign corporation that is a CFC.

The proposal would apply to repurchases of stock after December 31, 2023.

TAX CORPORATE DISTRIBUTIONS AS DIVIDENDS

Current Law

Section 301 of the Internal Revenue Code (Code) provides rules for characterizing a distribution of property by a corporation to a shareholder. The amount of the distribution is first treated as a dividend under section 301(c)(1) to the extent of the distributing corporation's applicable earnings and profits. Outside of corporate reorganization and spin-off contexts, section 316 provides that all of a corporation's current and accumulated earnings and profits are taken into account in determining the extent to which a distribution of property made by the corporation is taxed as a dividend. The amount of the corporation's earnings and profits at the time the distribution is made is not controlling. Rather, earnings and profits of a corporation are generally computed on a standalone basis as of the close of the corporation's taxable year in which the distribution is made without diminution as a result of distributions made during the taxable year. Special rules apply for consolidated groups, and in the case of a deemed dividend resulting from a sale of stock of a controlled foreign corporation (CFC), as defined in section 957.

The portion of the distribution received by the shareholder that is not a dividend is applied against and reduces the shareholder's adjusted basis of the corporation's stock under section 301(c)(2), and any amount distributed in excess of the shareholder's basis that is not a dividend is treated as gain from the sale or exchange of property under section 301(c)(3). The shareholder takes a basis in the distributed property equal to its fair market value under section 301(d).

Generally, the corporation is required to recognize under section 311(b) any gain realized on the distribution of any appreciated property to a shareholder (and its earnings and profits are increased by such gain under section 312) but does not recognize under section 311(a) any loss realized on a distribution of property with respect to its stock. Although the corporation does not recognize a loss, its earnings and profits are decreased under section 312 by the sum of the amount of money, the principal amount or issue price of any obligations (as the case may be), and the adjusted basis of any other property, so distributed.

If an actual or deemed redemption of stock is treated under section 302 as equivalent to the receipt of a dividend by a shareholder, the shareholder's basis in any remaining stock of the corporation is increased by the shareholder's basis in the redeemed stock. In addition, if a subsidiary corporation acquires in exchange for cash or other property stock of a direct or indirect corporate shareholder issued by that corporation (often referred to as "hook stock"), the issuing corporation does not recognize gain or loss (or any income) under section 1032 upon the receipt of the subsidiary's cash or other property in exchange for issuing the hook stock.

If, as part of a corporate reorganization, a shareholder receives in exchange for stock of the target corporation both stock and property not permitted to be received without the recognition of gain (often referred to as "boot"), the exchanging shareholder is required to recognize under section 356(a)(1) gain equal to the lesser of the gain realized in the exchange or the amount of boot received (commonly referred to as the "boot-within-gain" limitation). If the exchange has the effect of the distribution of a dividend, then section 356(a)(2) provides that all or part of the gain recognized by the exchanging shareholder is treated as a dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits. The remainder of the gain (if any) is treated as gain from the exchange of property.

Reasons for Change

Corporations have devised many ways to avoid dividend treatment under current law. For example, corporations can enter into preparatory transactions to eliminate a corporation's earnings and profits or shift the corporation's earnings and profits to a prior or subsequent tax year. Corporations also enter into transactions (so-called "leveraged distributions") to avoid dividend treatment upon a distribution by having a corporation with earnings and profits provide funds (for example, through a loan) to a related corporation with no or little earnings and profits, but in which the distributee shareholder has high stock basis. In addition, because current law permits a corporation to receive cash without recognizing any income in exchange for issuing its stock, subsidiaries may distribute property tax-free to corporate shareholders in exchange for hook stock issued by such shareholder.

Under current law, these types of transactions reduce earnings and profits for the year in which a distribution is made without a commensurate reduction in a corporation's dividend paying capacity. Such transactions are inconsistent with a corporate tax regime in which earnings and profits are viewed as measuring a corporation's dividend-paying capacity, and these transactions inappropriately result in the avoidance of dividend treatment for the corporation's shareholders. Finally, there is not a significant policy reason to vary the tax treatment of a distribution received in a reorganization (and currently subject to the boot-within-gain limitation of section 356) with the treatment afforded ordinary distributions under section 301.

Proposal

The proposal would amend the Code to ensure that a transfer of property by a corporation to its shareholder(s) better reflects the corporation's dividend-paying capacity in the following ways:

Prevent elimination of earnings and profits through distributions of certain stock with basis attributable to dividend equivalent redemptions

The proposal would amend section 312(a)(3) to provide that earnings and profits are reduced by the basis in any distributed high-basis stock determined without regard to basis adjustments resulting from actual or deemed dividend equivalent redemptions or any series of distributions or transactions undertaken with a view to create and distribute high-basis stock of any corporation.

The proposal would be effective as of the date of enactment.

Prevent use of leveraged distributions from related corporations to avoid dividend treatment

The proposal would treat a leveraged distribution from a corporation (distributing corporation) to its shareholder(s) that is treated as a recovery of basis as the receipt of a dividend directly from a related corporation (funding corporation) to the extent the funding corporation funded the distribution with a principal purpose of not treating the distribution as a dividend from the funding corporation.

The proposal would be effective for transactions occurring after December 31, 2024.

Treat purchases of hook stock by a subsidiary as giving rise to deemed distributions

The proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entities) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary. The proposal would grant the Secretary authority to prescribe regulations to treat purchases of interests in shareholder entities other than corporations in a similar manner and provide rules related to hook stock within a consolidated group.

The proposal would be effective for transactions occurring after December 31, 2024.

Repeal gain limitation for dividends received in reorganization exchanges

The proposal would repeal the boot-within-gain limitation in reorganization transactions in which the shareholder's exchange is treated under section 356(a)(2) as having the effect of the distribution of a dividend. For this purpose, the Administration also proposes to align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions.

The proposal would be effective for transactions occurring after December 31, 2024.

LIMIT TAX AVOIDANCE THROUGH INAPPROPRIATE LEVERAGING OF PARTIES TO DIVISIVE REORGANIZATIONS

Current Law

In general, when a corporation distributes appreciated property to its shareholders, the corporation must recognize gain on the built-in appreciation (that is, the value of that property less the corporation's adjusted basis in that property). Sections 355 and 368(a)(1)(D) of the Internal Revenue Code (Code) provide an exception to this general gain recognition rule in the case of divisive reorganizations, commonly referred to as "spin-offs", "split-offs", or "split-ups".

In a divisive reorganization, a parent corporation (Distributing) transfers property (for example, the appreciated assets underlying a line of business) to a corporation it controls (Controlled), in exchange for consideration. In the simplest version of a divisive reorganization, the consideration Distributing receives consists solely of Controlled stock, which Distributing then must distribute to its shareholders. In this case, none of Distributing, Controlled, or their shareholders will recognize any gain, despite Distributing effectively transferring the built-in gain underlying the Controlled stock (related to the appreciated assets transferred to Controlled by Distributing) to Distributing's shareholders.

Commonly, divisive reorganizations are structured such that Distributing receives more than Controlled stock. This consideration may include (a) securities or other debt obligations of which Controlled is the obligor (Controlled debt), (b) money and other property other than Controlled debt (Controlled boot), and (c) the assumption by Controlled of Distributing's liabilities (Controlled liability assumption). Distributing can transfer Controlled boot and debt to its creditors without recognition of gain. This is known as "monetization".

This monetization may require Distributing to recognize gain. For instance, Distributing recognizes gain on any boot or Controlled debt that it retains. However, current law provides for two safe harbors that allow some monetization to occur without Distributing recognizing gain. The first safe harbor provides that Distributing does not recognize gain if the amount of the assumed Controlled liabilities and any Controlled boot transferred to Distributing's creditors does not exceed the aggregate adjusted basis of the assets that Distributing transfers to Controlled (adjusted basis limitation). The second safe harbor provides that an unlimited amount of Controlled debt securities may be transferred to Distributing's creditors without gain recognition.

In addition, certain other liabilities assumed by Controlled under current law are not subject to the adjusted basis limitation due to their contingent or speculative nature (contingent Distributing liabilities). Once fixed and determinable at a later date, these liabilities often are very large, and typically far exceed their estimated amounts. As a result, Distributing can cause Controlled to make payments to satisfy contingent Distributing liabilities arising from assets and businesses contributed to Controlled for an unlimited future period and in an unlimited aggregate amount.

For the transaction to qualify for non-recognition treatment, the Code requires that Distributing and Controlled be engaged immediately after the distribution in the active conduct of a trade or business. However, currently there are no adequate safeguards to ensure Controlled's adequate capitalization or continued economic viability following its separation from Distributing through a divisive reorganization.

Reasons for Change

The Distributing monetization techniques carried out in divisive reorganizations are all economically similar, and therefore should be subject to the same adjusted basis limitation. In the absence of a comprehensive limitation, divisive reorganizations can provide opportunities for tax-planners to structure transactions that economically resemble tax-free cash sales.[1]

Moreover, as described above, Distributing can effectively circumvent the adjusted basis limit by transferring contingent liabilities to Controlled, which similarly allows Distributing to accomplish transactions that resemble tax-free cash sales. Additionally, this practice can burden Controlled with crippling liabilities and excessive leverage, jeopardizing its ability to continue as a viable going concern. Such practice is inconsistent with the intent and purposes of the divisive reorganization provisions of the Code,[2] and has resulted in numerous Controlled bankruptcies.

Taken together, the proposal's elimination of these monetization loopholes will increase the integrity of the Code.

Proposal

Eliminate excessive tax-free monetization of divisive reorganizations

The proposal would modify the two safe harbors for the tax-free transfer of Controlled boot and securities to Distributing creditors. In particular, the proposal would define a new quantity, the "excess monetization amount," equal to the aggregate of the following amounts less the total adjusted bases of the assets transferred by Distributing to Controlled: (a) the total amount of the liabilities assumed by Controlled, (b) the total amount of Controlled boot transferred to Distributing's creditors, (c) the fair market value of nonqualified preferred stock transferred to Distributing's creditors, and (d) the total principal amount of Controlled debt transferred to Distributing's creditors.

The proposal would not limit the amount of stock (or right to acquire stock) in Distributing or Controlled received as part of the transaction, which the statute treats as property qualifying for nonrecognition treatment. This exception reflects the fact that such qualifying property does not give rise to the same tax-free monetization concerns that are posed by Controlled debt, which more closely resembles cash than an equity interest.

[1] This proposal would eliminate those opportunities by extending Congress' prior amendments to section 361 that eliminated unlimited nonrecognition treatment for Controlled boot transferred to Distributing's creditors. H.R. Conf. Rep. 108-755 (Oct. 7, 2004), at 770 (observing that the amount of property that may be distributed to creditors without gain recognition is unlimited under then-present law).

[2] Gregory v. Helvering, 293 U.S. 465, 469 (1935) ("But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."); S. Rep. No. 82-781, at 58 (1951) (emphasizing that "all of the new corporations as well as the parent [must] carry on a business").

Under the proposal, an excess monetization amount would cause Distributing to recognize gain in two ways. First, Distributing would recognize gain dollar-for-dollar equal to the smaller of Distributing's excess monetization amount or the amount of Controlled boot that Distributing transfers to its creditors. Therefore, if Distributing's excess monetization amount equaled $3 billion and Distributing transferred $4 billion of Controlled boot to its creditors, Distributing would recognize $3 billion of gain.

Second, Distributing would recognize gain if Distributing's excess monetization amount exceeds the amount of Controlled boot that Distributing transfers to Distributing's creditors. Specifically, this remaining excess monetization amount would cause an equal principal amount of Controlled debt to be treated as if sold in a taxable sale. Therefore, if Distributing's excess monetization amount equaled $5 billion, and Distributing transferred $4 billion of Controlled boot and $1 billion of Controlled debt to Distributing's creditors, Distributing would recognize gain to the extent that $1 billion exceeds the adjusted basis of that Controlled debt. This would be in addition to the $4 billion in dollar-for-dollar gain on the Controlled boot transferred to Distributing's creditors.

Prevent tax avoidance through the transfer of contingent liabilities to Controlled

The proposal would impose two additional requirements under section 355 that, if not satisfied, would result in gain recognition by Distributing (but not Distributing's shareholders). First, under the proposal, Controlled must be adequately capitalized as a result of the divisive reorganization. Second, Controlled must continue to be an economically viable entity after the completion of the divisive reorganization. The satisfaction of both of these requirements would be based on all relevant facts and circumstances,[3] including (a) the projected, as well as actual, amount of contingent Distributing liabilities assumed by Controlled, and (b) whether Controlled declares bankruptcy within the five-year period following the divisive reorganization. In addition, the proposal would authorize the Secretary to promulgate such regulations as may be necessary to carry out the purposes of the proposal or to prevent the avoidance of tax.

Both parts of the proposal would be effective for transactions occurring after enactment. However, the new rules would not apply to any distribution pursuant to a divisive reorganization described in a ruling request initially submitted to the Internal Revenue Service on or before the date of enactment (if the request has not been withdrawn and for which a ruling has not been issued or denied in its entirety as of such date).

[3] For purposes of this analysis, the fact that one or more creditors would lend to Controlled would not be relevant.

LIMIT LOSSES RECOGNIZED IN LIQUIDATION TRANSACTIONS

Current Law

In general, if a corporation distributes its property in complete liquidation, the shareholders of the corporation recognize gain or loss on their stock under section 331 of the Internal Revenue Code, and the corporation recognizes gain or loss on the property distributed to the shareholders under section 336. Under section 332, however, if the same corporate shareholder owns 80 percent or more (by vote and value) of the distributing corporation's stock, then the 80 percent corporate shareholder does not recognize gain or loss on the liquidation and, under section 337, the liquidating corporation does not recognize gain or loss on property distributed to the 80 percent shareholder. Related party stock ownership is not taken into account for purposes of determining whether the 80 percent threshold is satisfied, unless the shareholders are members of a single U.S. consolidated group.

Section 267(a) disallows losses recognized on sales or exchanges of property between related parties. However, losses recognized on the sale or exchange of property between members of a controlled group of corporations, are generally deferred under section 267(f)(2) until the property is transferred outside the controlled group. For this purpose, a controlled group of corporations is defined using a 50 percent ownership threshold under sections 267(f)(1) and 1563(a). Section 267 does not apply to losses incurred on the complete liquidation of a corporation.

Reasons for Change

Taxpayers with a built-in loss in the stock of a subsidiary may be able to recognize the loss on a taxable liquidation within a controlled group of corporations under section 331, without exiting their investment. For example, a corporate taxpayer may transfer more than 20 percent of the stock of the subsidiary to a related entity, reducing ownership below the 80 percent threshold, and then cause the subsidiary to liquidate.[4] The liquidation is often accomplished through a "check-the-box" election to be classified as a partnership rather than a corporation, an election which applies only for U.S. income tax purposes. Structuring into such taxable liquidations can also be used to recognize a loss on property held by the liquidating corporation under section 336, such as in cases involving a foreign-owned domestic corporation.

Proposal

Section 267 would be modified to apply to complete liquidations within a controlled group where the assets of the liquidating corporation remain in the controlled group after the liquidation. Where applicable, this would cause losses – both on the stock of the liquidating corporation and the property it holds – to be denied. The proposal would also grant the Secretary the authority to allow for the deferral, rather than the denial, of such losses under the principles of section 267(f), as well to address the use of controlled partnerships to avoid these rules.

The proposal would apply to distributions after the date of enactment.

[4] Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956).

PREVENT BASIS SHIFTING BY RELATED PARTIES THROUGH PARTNERSHIPS

Current Law

A partnership is permitted to make a section 754 election to adjust the basis of its property when it makes certain distributions of money or property to a partner. For example, if a partnership distributes property to a partner and the partnership has a section 754 election in effect, the partnership may increase ("step-up") the basis of its non-distributed property. If there is no gain recognized by the distributee-partner as a result of the distribution, the partnership step-up is generally equal to the excess of the partnership's basis in the distributed property over the distributee-partner's basis in its interest. If applicable, the distributee-partner's basis in its interest is first reduced (but not below zero) by the amount of cash distributed to the partner.

Reasons for Change

Under current law, related-party partners may use a section 754 election to shift basis between partners and achieve an immediate tax savings for the partners as a group without any meaningful change in the partners' economic arrangement.

More specifically, in partnerships with related-person partners, a partnership basis step-up could be designed to shift basis from non-depreciable, non-amortizable partnership property to depreciable or amortizable partnership property, resulting in immediate increases in depreciation or amortization deductions for remaining partners related to the distributee-partner. For example, when a partnership distributes property to a partner, the distributee-partner may take a basis in the distributed property that is less than that of the distributing partnership, resulting in a decrease ("step-down") in the basis of the distributed property in the hands of the distributee-partner. In such a situation, the distributing partnership is allowed to step-up the basis of its non-distributed property by an amount equal to the distributee-partner's step-down in the basis of its distributed property. If the distributed property is held by the distributee-partner indefinitely, the basis step-down does not create taxable income for the distributee-partner, while the basis step-up to the distributing partnership's depreciable or amortizable property could result in remaining partners related to the distributee-partner immediately benefiting from increased amounts of allocable deductions for depreciation or amortization.

Proposal

The proposal would reduce the ability of related parties to use a partnership to shift partnership basis among themselves for the purpose of creating advantageous tax results with no meaningful economic consequences. In the case of a distribution of partnership property that results in a step-up of the basis of the partnership's non-distributed property, the proposal would apply a matching rule that would prohibit any partner in the distributing partnership that is related to the distributee-partner from benefitting from the partnership's basis step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

The Secretary would have the authority to prescribe regulations necessary to implement the matching rule with respect to related parties.

The proposal would be effective for partnership taxable years beginning after December 31, 2024.

CONFORM DEFINITION OF "CONTROL" WITH CORPORATE AFFILIATION TEST

Current Law

Most large businesses in the United States are comprised of corporate affiliates connected to the parent company through direct and indirect links of stock ownership. In order to administer the income tax to these corporate groups in a manner that reflects economic substance and prevents abuse, the Internal Revenue Code (Code) must define what it means for one corporation to "control" another.

For purposes of most corporate tax provisions, "control," as defined by section 368(c) of the Code, requires ownership of stock possessing at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent ownership of the total number of shares of each class of outstanding nonvoting stock of the corporation. For the purpose of determining whether a corporation is a member of an "affiliated group" of corporations under section 1504(a)(1) of the Code, the "affiliation" test is significantly different. Specifically, the test under section 1504(a)(2) requires ownership of stock possessing at least 80 percent of the total voting power of the stock of the corporation and that has a value of at least 80 percent of the total value of the stock of the corporation.

Reasons for Change

The control test under section 368(c) creates potential for taxpayers to improperly achieve desired tax outcomes through structured transactions. By carefully allocating voting power among the shares of a corporation, taxpayers can manipulate the section 368(c) control test in order to qualify or not qualify, as desired, a transaction as tax-free. For example, a taxpayer may structure a transaction in this manner to avoid tax-free treatment in order to recognize a loss. In addition, the absence of a value component under this standard allows corporations to retain control of a corporation but to "sell" a significant amount of the value of the corporation tax-free. A uniform ownership test for corporate transactions would reduce the complexity currently caused by these inconsistent tests.

Proposal

The proposal would conform the control test under section 368(c) with the affiliation test under section 1504(a)(2). Therefore, "control" would be defined as the ownership of at least 80 percent of the total voting power and at least 80 percent of the total value of stock of a corporation. The term "stock" would not include certain preferred stock that meets the requirements of section 1504(a)(4).

The proposal would be effective for transactions occurring after December 31, 2024.

STRENGTHEN LIMITATION ON LOSSES FOR NONCORPORATE TAXPAYERS

Current Law

Section 461(l) of the Internal Revenue Code (Code) provides that, for taxable years 2021 through 2028 (inclusive of the extensions under the American Rescue Plan Act of 2021 and the Inflation Reduction Act of 2022), any excess business losses are disallowed for noncorporate taxpayers. Excess business losses are the excess of current-year net business losses over a specified amount. In 2024, these specified amounts are $610,000 for married couples filing jointly, and $305,000 for all other taxpayers. These specified amounts are adjusted for inflation each year.

In determining the amount of an excess business loss, business losses for the taxable year exclude net operating loss (NOL) deductions and the 20 percent deduction for qualified business income under section 199A of the Code. Additionally, income, deductions, and gains attributable to a taxpayer's performance of services as an employee (e.g., wage income) are disregarded. Lastly, business income or gains include capital gain net income only when attributable to a trade or business.

Excess business losses may be carried forward and deducted as NOLs in subsequent years.

Reasons for Change

In general, for individual taxpayers, non-passive losses from a business activity may offset income or gains from unrelated activities. There are several reasons why this is undesirable. First, evidence from randomized audits suggests that business losses are especially likely to be misreported on a taxpayer's Federal income tax return. The benefit of allowing business losses to offset other types of income or gain without limitation provides an additional incentive for such misreporting on the return.

Second, the ability to use business losses to offset unrelated income or gain creates a distortion in entity organization choice. The business losses may generate a reduction in tax liability much earlier if the business is organized as a pass-through entity rather than a C corporation because C corporation losses do not flow through to individual owners. As a result, C corporations' business losses cannot be deducted by individual owners of C corporations, and a C corporations' ability to deduct business losses (including those carried from prior years) is limited only to the extent they have business income or gain. By constraining individuals' abilities to offset income sources such as wages with nonpassive pass-through business losses, section 461(l) creates a more similar tax regime for business losses across different forms of business organization and types of business activity.

Section 461(l) is designed to reduce the ability of individual taxpayers to use business losses to offset unrelated income by capping net business losses at $305,000 (or $610,000 for married filing jointly taxpayers), indexed for inflation. However, under current law, section 461(l) contains a significant deficiency: the losses denied by section 461(l) in a current year become an NOL carryforward in the subsequent year, subject only to the general limitations in section 172 (e.g., NOLs may not reduce taxable income by more than 80 percent). For example, consider a taxpayer who each year has a large amount of business losses, an even larger amount of non-business gains, and no other income. Section 461(l) effectively delays the benefit of the excess business loss for only one year. In contrast, under the proposal this taxpayer would never be able to benefit from the excess business loss.

Proposal

The proposal would make permanent the excess business loss limitation. It would also treat excess business losses carried forward from the prior year as current-year business losses instead of as NOL deductions.

The proposal would be effective for taxable years beginning after December 31, 2024.

EXPAND LIMITATION ON DEDUCTIBILITY OF EMPLOYEE REMUNERATION IN EXCESS OF $1 MILLION

Current Law

Section 162(m) of the Internal Revenue Code (Code) generally disallows a deduction by a publicly held corporation for compensation in excess of $1 million paid to certain employees and former employees ("covered employees") in a taxable year. Covered employees include the chief executive officer (CEO); chief financial officer (CFO); the three highest-paid non-CEO, non-CFO officers; or anyone who met these criteria for any previous taxable year (but not in taxable years beginning before December 31, 2016).

For taxable years beginning after December 31, 2026, the definition of covered employee is expanded to include the next five highest-paid employees.

The section 162(m) deduction disallowance rules apply to "applicable employee remuneration" in excess of $1 million paid to a covered employee in the taxable year. In general, applicable employee remuneration means all otherwise-deductible compensation paid to an employee (or an employee's beneficiary) for services performed, including cash and non-cash compensation, performance-based compensation, and commissions, regardless of when the services were performed. Certain types of compensation are not subject to the deduction disallowance and are not taken into account in determining whether other compensation exceeds $1 million, including (a) certain grandfathered compensation payments, (b) payments made to a tax-favored retirement plan (including salary-reduction contributions), and (c) amounts that are excludable from the employee's gross income, such as employer-provided health benefits and miscellaneous fringe benefits.

Reasons for Change

The section 162(m) deduction disallowance rules generally increase the taxes owed by certain employers when they pay compensation above $1 million. Increasing the tax liability associated with high compensation payments reduces the deficit, makes the Federal income tax system more progressive, and distributes the cost of government more fairly among taxpayers of various income levels.

However, under current law, the section 162(m) deduction disallowance rules apply only to publicly held corporations and only with respect to compensation in excess of $1 million paid to a small number of covered employees. The limited application of the section 162(m) rules means that all compensation in excess of $1 million paid by privately held corporations and compensation in excess of $1 million paid by publicly held corporations to employees other than covered employees is fully deductible.

These scope-limiting rules introduce distortions and horizontal inequity. The current rules limiting a publicly held corporation's compensation deduction, but not limiting the compensation deduction for a privately held corporation, may distort a business's decision to remain private or to go public. Moreover, businesses with a smaller number of employees receiving compensation in excess of $1 million are relatively more affected by the current section 162(m), which unfairly favors the largest businesses.

In addition, under current law, section 162(m) does not include an entity aggregation rule, and the aggregation rule in the regulations is not as broad as the rules that generally apply in other similar contexts, in particular to employer-sponsored retirement plans and to other employee benefits. Some taxpayers have used the lack of a comprehensive aggregation rule to avoid the application of the deduction disallowance rules.

Moreover, some taxpayers have tried to avoid the application of the section 162(m) deduction disallowance rules by paying a covered employee's compensation from an affiliated partnership, rather than directly from the publicly held corporation.

Proposal

The proposal would strengthen the deduction disallowance by amending section 162(m) to apply to all C corporations – publicly held and privately held – and to all compensation paid by the corporation in excess of $1 million to any employee.

In addition, the proposal would further strengthen section 162(m) by closing some mechanisms taxpayers have used in an attempt to avoid the deduction limitation.

The proposal would add an aggregation rule that would treat all members of a controlled group within the meaning of section 414(b), (c), (m), and (o) of the Code as a single employer for purposes of determining the covered employees and applying the deduction disallowance for compensation paid to these employees in excess of $1 million. The section 414 controlled group rules are the rules used to treat related entities as a single employer for other employee benefits purposes.

The proposal would amend section 162(m) to ensure that otherwise deductible compensation paid to an employee is considered "applicable employee remuneration", subject to the deduction disallowance, whether or not paid directly by the corporation.

Finally, the proposal would expand the regulatory authority of the Secretary to issue regulations and other guidance as necessary to carry out the purposes of section 162(m) and to prevent the avoidance of the rule, including through the performance of services other than as an employee or by payment of compensation through a partnership or other pass-through entity.

The proposal would be effective for taxable years beginning after December 31, 2024.

PREVENT PRISON FACILITY RENT PAYMENTS FROM CONTRIBUTING TO QUALIFICATION AS A REIT

Current Law

If a C corporation qualifies as a Real Estate Investment Trust (REIT), it can deduct the dividends that it pays to its shareholders in order to avoid an entity-level tax on its income. To qualify as a REIT for a taxable year, the corporation must satisfy various criteria, including two income tests: (a) in general, at least 95 percent of its gross income for the year must be derived from sources on one list, and (b) at least 75 percent of its gross income for the year must be derived from sources on a second list. (Both lists include "rents from real property.")

Even if, for some year, a corporation would not satisfy the 95 percent and/or the 75 percent test, the Secretary may treat some non-qualifying income as qualifying or may treat some non-qualifying income as not being gross income. These actions to cause the corporation to qualify as a REIT may be taken to the extent necessary to carry out the purposes of the REIT provisions of the Internal Revenue Code (Code) and apply only for purposes of those provisions.

REITs may own real estate assets of private for-profit prisons. Often the REIT owns the prison real estate assets and receives rents from the (possibly related) business that is operating the prison.

Reasons for Change

A January 26, 2021, Executive Order forbade the Federal Department of Justice from entering any new or renewed contracts with privately operated criminal detention facilities.[5] The Executive Order described investigations that had uncovered situations in which "privately operated criminal detention facilities do not maintain the same levels of safety and security" as do governmentally operated facilities. In addition, it is important to "reduce profit-based incentives to incarcerate."

Although the Executive Order has phased out private operation of Federal prisons, it does not affect REITs' involvement with non-Federal facilities. The reasons underlying the Executive Order, however, make it inappropriate to provide the tax benefits of REIT status for the private operation of any detention facility.

Proposal

The proposal would exclude from both the 95 percent and the 75 percent income lists any rent received from a prison or other detention facility. The exclusion would apply to rent from any rented property a substantial use of which is in connection with punishment, detention, or correction. Moreover, the Secretary would not have the ability under section 856(c)(5)(J) of the

[5] Executive Order 14006: *Reforming Our Incarceration System To Eliminate the Use of Privately Operated Criminal Detention Facilities*, 2021. https://www.govinfo.gov/content/pkg/DCPD-202100088/pdf/DCPD-202100088.pdf

Code either to treat that rent as qualifying income, or to exclude it from gross income, for purposes of the REIT provisions of the Code.

The proposal would be effective for taxable years beginning after December 31, 2024.

REFORM INTERNATIONAL TAXATION

REVISE THE GLOBAL MINIMUM TAX REGIME, LIMIT INVERSIONS, AND MAKE RELATED REFORMS

Current Law

Global minimum tax regime with respect to controlled foreign corporation earnings

Any U.S. shareholder of a controlled foreign corporation (CFC) is taxed annually in the United States under the global minimum tax in Internal Revenue Code (Code) section 951A with respect to its CFCs (generally referred to as global intangible low-taxed income, or GILTI). A U.S. shareholder's global minimum tax inclusion is determined by combining its pro rata share of the tested income (or tested loss) of its CFCs. A CFC's tested income is the excess of certain gross income of the CFC over the deductions of the CFC that are properly allocable to the CFC gross tested income. A CFC's tested loss is the excess of the CFC's properly allocable deductions over the CFC's gross tested income. A U.S. shareholder's pro rata share of a CFC's tested loss may be used to offset the shareholder's pro rata share of the tested income of another CFC owned by the shareholder; however, if there is a net tested loss, the U.S. shareholder has no global minimum tax inclusion. Any unused loss may not be carried back or carried forward for use in another year.

The U.S. shareholder's actual global minimum tax inclusion reflects a reduction for a 10 percent return on qualified business asset investment (QBAI), which is generally foreign tangible property eligible for depreciation, such as buildings or machinery. QBAI does not include assets that are not depreciable (such as land) or intangible assets (such as patents, copyrights, and trademarks).

Under section 250, subject to a taxable income limitation, a corporate U.S. shareholder is generally allowed a 50 percent deduction against its global minimum tax inclusion. The section 250 deduction generally results in a 10.5 percent U.S. effective tax rate on a corporate U.S. shareholder's global minimum tax inclusion under the current U.S. corporate tax rate of 21 percent. The 50 percent deduction is scheduled to be reduced to 37.5 percent starting in 2026.

Certain foreign income taxes paid by a CFC are creditable against a corporate U.S. shareholder's U.S. tax liability attributable to its global minimum tax inclusion, including Pillar Two qualified domestic minimum top up tax (QDMTT) paid in a jurisdiction if they satisfy the requirements in section 901 or 903. The allowable credit is limited to 80 percent of the amount of the foreign income taxes properly allocable to a CFC's tested income taken into account as part of the global minimum tax inclusion. Unlike foreign income taxes allocated to other types of foreign source income, if a taxpayer cannot claim a credit for foreign income taxes associated with its global minimum tax inclusion in a given year because of the operation of the foreign tax credit (FTC) limitation, those foreign income taxes are not eligible to be carried back or carried forward for use in another taxable year.

Under Treasury regulations, if the foreign effective tax rate on the gross income of a CFC that would otherwise be part of a global minimum tax inclusion exceeds 90 percent of the U.S. corporate income tax rate, the U.S. shareholder of the CFC is generally permitted to exclude that gross income (and the associated deductions and foreign income taxes) from its global minimum tax inclusion. A similar statutory rule applies for purposes of certain Subpart F income, i.e., certain foreign income earned indirectly by U.S. persons at full U.S. tax rates.

A single FTC limitation generally applies to a corporate U.S. shareholder's global minimum tax inclusion. This means foreign income taxes paid to a high-tax foreign jurisdiction can be used to reduce the U.S. tax liability with respect to global minimum tax income earned in lower-tax jurisdictions. Thus, generally, a U.S. shareholder's aggregate U.S. tax (after accounting for the allocation of U.S. shareholder deductions) on its global minimum tax inclusion is reduced by reference to the average foreign effective tax rate on its aggregate global minimum tax income rather than the effective tax rates in each individual foreign jurisdiction where income is earned.

Deduction for dividends received from non-controlled foreign corporations

The Code provides different dividends received deductions for domestic corporate shareholders, depending on the nature of the dividend distributed, the shareholder's ownership level in the distributing corporation, and whether the distributing corporation is a domestic or foreign corporation. First, section 243 provides a dividends received deduction (section 243 DRD) for domestic corporate shareholders on distributions received from other domestic corporations. The amount of the section 243 DRD depends on the level of ownership in the domestic corporation. In general, if the domestic corporate shareholder is part of the same affiliated group as the distributing corporation, the section 243 DRD is 100 percent. If the domestic corporate shareholder owns at least 20 percent of the distributing corporation but is not affiliated with the distributing corporation, then the section 243 DRD is 65 percent; in all other cases, the section 243 DRD is 50 percent.

Under section 245, a domestic corporate shareholder generally is entitled to a dividends received deduction (section 245 DRD) for the U.S.-source portion of dividends received from certain foreign corporations. A foreign corporation qualifies for the section 245 DRD only if it is not a passive foreign investment company and at least 10 percent of the stock is owned by the domestic corporate shareholder. The amount of the section 245 DRD is based on the amount provided in section 243.

However, if a domestic corporation is a U.S. shareholder of a foreign corporation, in general, the domestic corporation is allowed a 100 percent dividends received deduction under Code section 245A (section 245A DRD) equal to the foreign-source portion of any dividend ("foreign-sourced dividend") received from that foreign corporation. For example, if the undistributed earnings of the foreign corporation are entirely foreign sourced, then this section 245A DRD allows the domestic corporation to receive a dividend from the foreign corporation without any increase in its U.S. tax burden. Under section 951(b), a U.S. shareholder is a U.S. person who owns at least 10 percent of the stock (by vote or value) of a foreign corporation.

A foreign corporation whose stock is majority owned directly or indirectly by U.S. shareholders is a CFC. When a CFC earns Subpart F income or tested income, U.S. shareholders are subject to current U.S. taxation (but eligible for FTCs) on their pro rata shares of that income under sections 951(a) and 951A(a) of the Code, respectively. When these previously taxed earnings and profits are remitted to U.S. shareholders, under section 959, those earnings are not subject to U.S. tax again.

Treatment of deductions properly allocable to exempt income

Certain dividends received by a domestic corporation from foreign corporations are effectively exempt from U.S. tax by reason of the section 245A DRD. Specifically, section 245A provides to a domestic corporation a deduction equal to the foreign-source portion of a dividend received from a specified 10 percent owned foreign corporation, but only if the domestic corporation is a U.S. shareholder of the foreign corporation.

Section 265(a)(1) generally disallows a deduction for any amount that is allocable to certain classes of income that are wholly exempt from U.S. tax. For purposes of determining a taxpayer's FTC limitation, tax exempt assets and their associated income are disregarded under section 864(e)(3). Section 904(b)(4) applies to disregard (solely for purposes of the FTC limitation) deductions allocable to income attributable to foreign stock other than global intangible low-taxed income (GILTI) or Subpart F income inclusions.

Limitations on the ability of domestic corporations to expatriate

Section 7874 applies to certain transactions (known as "inversion transactions") in which a U.S. corporation is acquired by a foreign corporation ("foreign acquiring corporation") in a transaction where (a) substantially all of the assets held directly or indirectly by the domestic corporation are acquired directly or indirectly by the foreign acquiring corporation; (b) the former shareholders of the domestic corporation hold at least a 60 percent ownership interest in the foreign acquiring corporation by reason of the acquisition; and (c) the foreign acquiring corporation, together with its expanded affiliated group, does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. Similar provisions apply to acquisitions of domestic partnerships. The tax consequences of an inversion transaction depend on the level of continuing former shareholder ownership. If the continuing former shareholder ownership of the foreign acquiring corporation is at least 80 percent (by vote or value), the foreign acquiring corporation is treated as a domestic corporation for all U.S. tax purposes (the "80 percent test"). If the continuing former shareholder ownership is at least 60 percent but less than 80 percent (by vote or value), the foreign acquiring corporation is respected as foreign but full U.S. tax must generally be paid with respect to certain income or gain recognized by the expatriated U.S. entity and its affiliates in connection with the inversion or within the ten-year period ending after the completion of the inversion (the "60 percent test"). Furthermore, the Tax Cuts and Jobs Act of 2017 adopted several anti-abuse provisions that apply to inversion transactions that satisfy the 60 percent test.

Stock losses attributable to foreign income that was taxed at a reduced rate

Section 250 generally provides a 50 percent deduction (37.5 percent for taxable years beginning after December 31, 2025) for a global minimum tax inclusion, resulting in a 10.5 percent effective tax rate (13.125 percent for taxable years beginning after December 31, 2025) on this income (before taking FTCs into account). (This *General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals* proposes to increase the corporate rate to 28 percent and reduce the section 250 deduction rate to 25 percent, resulting in a 21 percent effective tax rate on this income.) A global minimum tax inclusion increases a U.S. shareholder's basis in the stock of a CFC dollar-for-dollar (that is, without regard to the 50 percent deduction). Thus, if stock of a CFC is sold at a loss, the U.S. shareholder can take a deduction at the full value of the U.S. corporate tax rate. A similar result occurs if a U.S. shareholder had income inclusions with respect to a specified foreign corporation under the section 965 transition tax. This is because a section 965(c) deduction was allowed for a section 965 inclusion, resulting in a lower effective tax rate (prior to FTCs) on this income, but basis in the stock of the specified foreign corporation was increased dollar-for-dollar.

Information reporting requirements for foreign business entities

Section 6038 generally requires a U.S. person who controls a foreign business entity (whether a corporation or partnership) to report certain information regarding such entity. The statute provides for penalties for a failure to report.

Reasons for Change

Global minimum tax regime with respect to CFC earnings

The reduction to global minimum tax inclusions for a percentage of certain foreign tangible assets incentivizes U.S. multinational companies to invest in tangible assets abroad rather than domestically. The elimination of QBAI would eliminate this perverse investment incentive while simplifying the taxation of CFCs.

The difference between the effective U.S. tax rate on global minimum tax inclusions and the effective U.S. tax rate on income earned directly by U.S. companies that results from the section 250 deduction incentivizes U.S. companies to locate profits and operations offshore. Reducing the section 250 deduction for these foreign earnings would reduce this perverse incentive.

The determination of a U.S. company's global minimum tax inclusion and residual U.S. tax liability on such inclusions on a global blended basis incentivizes U.S. companies with operations in high-tax jurisdictions to invest in lower-tax jurisdictions, to take advantage of the automatic global averaging under the existing global minimum tax regime. In some cases, U.S. companies may have an incentive to locate operations in jurisdictions with corporate income tax rates higher than the United States, to average these high taxes against low-taxed income earned elsewhere. This automatic blending feature exacerbates the race to the bottom on corporate income tax rates and encourages U.S. companies to report profits (as well as the activities that give rise to those profits) in offshore jurisdictions rather than in the United States, creating a perverse "America last" tax policy. Similar global blending concerns arise with respect to high and low-taxed income earned through foreign branches.

In contrast, determining a taxpayer's global minimum tax inclusion and residual U.S. tax liability on such inclusions on a jurisdiction-by-jurisdiction basis would be a stronger deterrent to profit shifting and offshoring because residual U.S. tax would be due on every dollar earned in a low-tax jurisdiction at the minimum rate, with no ability to reduce that residual U.S. tax for excess foreign taxes paid to higher-tax jurisdictions.

In a jurisdiction-by-jurisdiction system, high-tax income cannot be used to offset low-tax income from other jurisdictions. In contrast, as discussed above, current law allows more favorable global blending of income and tax. This favorable treatment is partially offset by restrictive rules for foreign tax credits and losses. Thus, in conjunction with the adoption of a jurisdiction-by-jurisdiction system, elimination of the QBAI exemption, and a higher effective GILTI rate, the proposal would also allow increased use of foreign tax credits and both foreign tax credit and loss carryforwards.

In December 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime that would help end the race to the bottom on corporate tax rates in a manner that puts the United States and other countries on a more level playing field.[6] Since that time, multiple jurisdictions have enacted legislation implementing some portion of Pillar Two. The Pillar Two "income inclusion rule" (IIR) applies on a "top down" basis. That is, it is applied only by the ultimate parent entity of a multinational group, and generally is not applied by lower tier holding companies. Therefore, in the case of foreign-controlled domestic corporations that own CFCs, the IIR is expected to be applied by the foreign parent with respect to low-taxed CFC income.

Deduction for dividends received from non-controlled foreign corporations

The section 245A DRD effectively exempts from U.S. taxation the foreign-sourced dividend of a CFC. With limited exceptions, for the earnings to be eligible for the section 245A DRD, the earnings must first be potentially subject to tax under the global minimum tax or Subpart F regimes (or be subject to a sufficiently high level of foreign tax). However, current law also effectively exempts the foreign-sourced dividend from a foreign corporation that is not a CFC, even though such earnings are not subject to tax under the global minimum tax or Subpart F regimes and may be subject to low or no tax in the foreign jurisdiction. Moreover, the section 245A DRD for the foreign-source earnings of non-CFCs (100 percent) is larger than the section

[6] In December 2021, the OECD/G20 Inclusive Framework on BEPS reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime. OECD, *Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, 2021. https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf; OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, 2021. https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf.

243 DRD available on dividends from domestic corporations or the section 245 DRD available on dividends from foreign corporations on U.S.-source income, where the shareholder owns 50 percent or less of the distributing corporation (50 to 65 percent).

Deductions attributable to income exempt from U.S. tax and taxed at preferential rates

To the extent deductions are claimed for expenses allocable to income eligible for a deduction under section 245A or section 250, on the basis that section 265 does not apply because that income is not "wholly exempt" from U.S. tax, the United States is providing a tax subsidy for foreign investment.

Limitations on the ability of domestic corporations to expatriate

To reduce their U.S. tax liabilities, certain domestic entities have been combining with smaller foreign entities in transactions that avoid the 80 percent test but that may satisfy the 60 percent test under section 7874. These combination transactions are typically structured so that the domestic entity and the foreign entity become subsidiaries of a newly formed foreign parent company. The domestic entities can often substantially reduce their U.S. income tax liability following these combination transactions with only a minimal change to their operations.

Inversion transactions raise significant policy concerns because they facilitate the erosion of the U.S. tax base through deductible payments by the U.S. members of the multinational group to the non-U.S. members and through aggressive transfer pricing for transactions between such U.S. and non-U.S. members. The inverted group also may reduce its U.S. taxes by reducing or eliminating altogether its direct and indirect U.S. ownership in foreign subsidiaries or assets. The adverse tax consequences under current law of 60 percent inversion transactions have not deterred taxpayers from pursuing these transactions. There is no policy reason to respect an inverted structure when the owners of a domestic entity retain a controlling interest in the group, only minimal operational changes are expected, and there is potential for substantial erosion of the U.S. tax base. Furthermore, an inverted structure should not be respected when the structure results from the combination of a larger U.S. group with a smaller entity or group and, after the transaction, the expanded affiliated group is primarily managed and controlled in the United States and does not have substantial business activities in the relevant foreign country, even if the shareholders of the domestic entity do not maintain control of the resulting multinational group.

Stock losses attributable to foreign income that was taxed at a reduced rate

Under current law, if an increase in stock basis from an inclusion under section 951A or section 965 results in a loss on the sale or other disposition of the stock, the loss may inappropriately be available to offset income or gain that would be subject to the full corporate tax rate even though the income inclusion that gave rise to the basis was subject to tax at a reduced rate.

Definition of foreign business entity

Because of the shift in emphasis to apply the global minimum tax, Subpart F, and the FTC rules using a jurisdiction-by-jurisdiction taxable unit standard, there is a need to collect information at the same level, with respect to each taxable unit in a foreign jurisdiction. By obtaining accurate information on each taxable unit, compliance and enforcement efforts would be improved. To further improve compliance, penalties for failure to provide information should also apply for reporting failures at the taxable unit level.

Proposal

Revise global minimum tax regime with respect to controlled foreign corporation earnings

The proposal would make several changes to the existing global minimum tax system. First, the QBAI exemption would be eliminated, so that the U.S. shareholder's entire net CFC tested income is subject to U.S. tax. Second, the section 250 deduction for a global minimum tax inclusion would be reduced to 25 percent, generally increasing the U.S. effective tax rate under the global minimum tax (to 21 percent under the proposed U.S. corporate income tax rate of 28 percent). Third, the "global averaging" method for calculating a U.S. shareholder's global minimum tax would be replaced with a "jurisdiction-by-jurisdiction" calculation. Under the new standard, a U.S. shareholder's global minimum tax inclusion and, by extension, residual U.S. tax on such inclusion, would be determined separately for each foreign jurisdiction in which its CFCs have operations. This means a separate FTC limitation would apply for each foreign jurisdiction. A similar jurisdiction-by-jurisdiction approach would also apply with respect to a U.S. taxpayer's foreign branch income. These changes mean that foreign taxes paid to higher-taxed jurisdictions will no longer reduce the residual U.S. tax paid on income earned in lower-taxed foreign jurisdictions. As under current law, Pillar Two QDMTTs paid in a jurisdiction may be creditable against GILTI liability in that jurisdiction if they satisfy the requirements in section 901 or 903.

With respect to the global minimum tax, the proposal would decrease the 20 percent disallowance of FTCs incurred to five percent, would allow net operating losses (NOLs) to be carried forward (within a single jurisdiction), and would allow FTCs to be carried forward ten years (within a single jurisdiction). In each case, the carryover would be at the U.S. shareholder level.

The proposal would also repeal the high-tax exemption to Subpart F income and the cross-reference to that provision in the global minimum tax regulations issued under section 951A.

A domestic corporation that is a member of a foreign-parented controlled group generally owes residual U.S. tax when it has a global minimum tax inclusion. The proposal would account for any foreign taxes paid by the foreign parent, under an IIR that is consistent with the OECD/Inclusive Framework Pillar Two Model Rules on global minimum taxation, with respect to the CFC income that would otherwise be part of the domestic corporation's global minimum tax inclusion. The proposal's jurisdiction-by-jurisdiction approach would also apply for this purpose.

The reduction in the section 250 deduction to 25 percent would be effective for taxable years beginning after December 31, 2023. The other elements of the proposal in this section would be effective for taxable years beginning after December 31, 2024.

Limit the deduction for dividends received from non-controlled foreign corporations

The proposal would limit the section 245A DRD to only those dividends remitted either by CFCs or by qualified foreign corporations, which includes corporations incorporated in a territorial possession of the United States and certain corporations eligible for the benefits of a comprehensive income tax treaty. A U.S. shareholder would receive a section 245A DRD equal to 65 percent of the foreign-sourced dividends received from a qualified foreign corporation that is not a CFC if the U.S. shareholder owns at least 20 percent of the stock (by vote and value) of the qualified foreign corporation. Otherwise, if a U.S. shareholder owns less than 20 percent (by vote or value) of the stock of a qualified foreign corporation that is not a CFC, the U.S. shareholder would receive a section 245A DRD equal to 50 percent of the foreign-sourced dividends received.

The DRD would remain unchanged for dividends received from CFCs.

The proposal would be effective for distributions after the date of enactment.

Reform the treatment of deductions properly allocable to exempt income

The proposal would expand the application of section 265 to disallow deductions allocable to a class of foreign gross income that is exempt from tax or taxed at a preferential rate through a deduction (e.g., a global minimum tax inclusion with respect to which a section 250 deduction is allowed or dividends eligible for a section 245A deduction).[7] The proposal would provide rules for determining the amount of disallowed deductions when only a partial deduction is allowed under section 245A with respect to a dividend or a partial section 250 deduction with respect to a global minimum tax inclusion. The proposal would also repeal section 904(b)(4).

The proposal would be effective for taxable years beginning after December 31, 2024.

Limit the ability of domestic corporations to expatriate

The proposal would broaden the definition of an inversion transaction by replacing the 80 percent test with a greater than 50 percent test and eliminating the 60 percent test. The proposal would also provide that, regardless of the level of shareholder continuity, an inversion transaction occurs if (a) immediately prior to the acquisition, the fair market value of the domestic entity is greater than the fair market value of the foreign acquiring corporation, (b) after the acquisition the expanded affiliated group is primarily managed and controlled in the United States, and (c) the expanded affiliated group does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized. The proposal would also expand the scope of an acquisition for purposes of section 7874 to include a direct or indirect acquisition of substantially all of the assets constituting a trade or business of a domestic corporation, substantially all of the assets of a domestic partnership, or substantially all of the U.S. trade or business assets of a foreign partnership. Furthermore, a distribution of stock of a foreign corporation by a domestic corporation or a partnership that represents either substantially

[7] As is true for all proposals described this volume, this proposal is not intended to create any inferences regarding current law, including whether section 265 currently applies to this income.

all of the assets or substantially all of the assets constituting a trade or business of the distributing corporation or partnership would be treated as a direct or indirect acquisition of substantially all of the assets or trade or business assets, respectively, of the distributing corporation or partnership. The Secretary would be granted regulatory authority to exempt certain internal restructurings involving partnerships from the application of section 7874 and to define a trade or business for purposes of section 7874.

The proposal would be effective for transactions that are completed after the date of enactment.

Disallow stock losses attributable to foreign income that was taxed at a reduced rate

The rules for basis in the stock of a foreign corporation would be amended to provide that, for purposes of determining loss on a U.S. shareholder's disposition of stock of a foreign corporation, the basis in stock of the foreign corporation is reduced (but not below zero) by the sum of (a) the section 245A DRDs allowed to the U.S. shareholder with respect to the stock, (b) the deductions for GILTI inclusions that are attributable to the stock, and (c) the deductions for income inclusions under the section 965 transition tax that are attributable to the stock. In addition, the principles of the proposal would apply to reduce the basis in other property by reason of which a domestic corporate U.S. shareholder owns stock of a foreign corporation under section 961(a). Finally, the proposal would apply to successors of the basis in stock or other property subject to the proposal and to exchanged basis property or similar property.

The proposal would apply to dispositions occurring on or after the date of enactment (regardless of whether the deductions under section 250 or 965(c) were claimed in taxable years prior to such date).

Expand the definition of foreign business entity to include taxable units

The proposal would expand the definition of foreign business entity to treat any taxable unit in a foreign jurisdiction as a "foreign business entity" for purposes of applying section 6038. Thus, information would be required to be reported separately with respect to each taxable unit, and penalties would apply separately for failures to report with respect to each taxable unit. To harmonize the reporting with the annual accounting period for which taxable income of a branch or disregarded entity is determined, the proposal would also provide that, except as otherwise provided by the Secretary, the annual accounting period for a taxable unit that is a branch or disregarded entity is the annual accounting period of its owner. For example, if a domestic corporation or a CFC conducts activities in a foreign branch or owns a foreign disregarded entity, the annual accounting period of the foreign branch or foreign disregarded entity generally would be the annual accounting period of the domestic corporation or CFC, respectively. Finally, for a taxpayer who is a U.S. person (as defined in section 7701(a)(30) of the Code) but who is a resident of a foreign jurisdiction, the proposal would provide the Secretary with the authority to treat the taxpayer as a resident of the United States for the purpose of identifying a taxable unit subject to reporting under section 6038.

The proposal would apply to taxable years of a controlling U.S. person that begin after December 31, 2024, and to annual accounting periods of foreign business entities that end with or are within such taxable years of the controlling U.S. person.

ADOPT THE UNDERTAXED PROFITS RULE

Current Law

Section 59A of the Internal Revenue Code (Code) imposes a Base Erosion Anti-Abuse Tax (BEAT) liability on certain corporate taxpayers in addition to their regular tax liability. Liability for BEAT is generally limited to corporate taxpayers with substantial gross receipts that make deductible payments to foreign related parties above a specified threshold (referred to as a "base erosion payment"). Taxpayers potentially liable for this additional tax have three-year average gross receipts in excess of $500 million and a "base erosion percentage" exceeding a specified threshold. The base erosion percentage is generally determined by dividing the taxpayer's "base erosion tax benefits" by the amount of all deductions allowed to the taxpayer for the taxable year.[8]

A taxpayer's BEAT liability is computed by referencing the taxpayer's "modified taxable income" and comparing the resulting amount to the taxpayer's regular tax liability. For purposes of this calculation, regular tax liability is reduced by some but not all credits. When calculating BEAT liability for taxable years beginning after December 31, 2025, regular tax liability is reduced by all credits. A taxpayer's modified taxable income is equal to its regular taxable income increased by base erosion tax benefits with respect to base erosion payments and an adjustment for the taxpayer's net operating loss (NOL) deduction, if any. The taxpayer's BEAT liability generally equals the difference, if any, between 10 percent of the taxpayer's modified taxable income and the taxpayer's regular tax liability (as reduced by certain credits against such tax). For taxable years beginning after December 31, 2025, the relevant BEAT rate increases to 12.5 percent.[9]

Reasons for Change

On October 8, 2021, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) reached a comprehensive agreement on minimum taxation under Pillar Two, and on December 20, 2021, it published Model Rules describing two interlocking Pillar Two rules: (a) an income inclusion rule (IIR), which imposes top-up tax on a parent entity with respect to the low-taxed income of a member of its financial reporting group; and (b) an undertaxed profits rule (UTPR), which denies deductions or requires an equivalent adjustment to tax liability to the extent that the low-taxed income of a member of the group is not subject to an IIR.[10] Since that time, multiple jurisdictions have enacted legislation implementing some portion of Pillar Two.

---

[8] Under current Treasury regulations, taxpayers can avoid a BEAT liability by electing to "waive" enough deductions for payments made to related foreign persons sufficient to remain below the base erosion percentage threshold.

[9] For all periods, the relevant BEAT rate is one percentage point higher for certain banks and registered securities dealers.

[10] In December 2021, the OECD/G20 Inclusive Framework on BEPS reached agreement on Model Rules under Pillar Two for a comprehensive jurisdiction-by-jurisdiction global minimum taxation regime: OECD *Base Erosion and Profit Shifting Project: Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, October 2021. https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf; and OECD, *Tax*

In conjunction with the global intangible low-taxed income (GILTI) regime, adopting the UTPR ensures that income earned by a multinational company, whether parented in the United States or elsewhere, is subject to a minimum rate of taxation regardless of where the income is earned. Just as the GILTI proposal (see <u>*Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms*</u>) ensures that a minimum per-jurisdiction rate of tax is paid by U.S.-based multinationals on income earned through controlled foreign corporations (CFCs), the UTPR ensures that a minimum per-jurisdiction rate of tax is paid on income earned in each jurisdiction in which foreign-parented multinationals operate. This ensures that companies cannot avoid a minimum rate of taxation by, for example, relocating their headquarters to a foreign jurisdiction that has not implemented an IIR. The UTPR is designed to encourage countries to adopt the global minimum tax agreed to as part of the international negotiations by ensuring that profits in low-tax jurisdictions are taxed at the same minimum rate.

The proposal would increase alignment between the U.S. international tax rules and the international system emerging from Pillar Two. In addition, the UTPR has the potential to address the concern of erosion of the U.S. corporate tax base more fully and evenly. For example, the BEAT does not apply comprehensively to cost of goods sold, or COGS, of manufacturing companies in the same manner that it applies to deductions incurred by services firms. Further, firms with lower profit margins are more likely to have a BEAT liability than similarly situated firms with higher profit margins because the BEAT is a form of alternative minimum tax that effectively claws back a percentage of deductions above a threshold level.

<u>Proposal</u>

The proposal would repeal the BEAT and replace it with a UTPR that is consistent with the UTPR described in the Pillar Two Model Rules. When a UTPR in another jurisdiction comes into effect, the proposal also includes a domestic minimum top-up tax that would protect U.S. revenues from the imposition of UTPR by other countries. Separately, the proposal would ensure U.S. taxpayers would continue to benefit from U.S. tax credits and other tax incentives that promote U.S. jobs and investment, including clean energy tax provisions enacted in the IRA.

The UTPR would disallow domestic corporations' and domestic branches' of foreign corporations U.S. tax deductions in an amount determined by reference to low-taxed income of foreign entities and foreign branches that are members of the same financial reporting group (including the common parent of the financial reporting group).[11] However, the UTPR would not apply with respect to income subject to an IIR that is consistent with the Pillar Two Model Rules,

---

Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS, 2021. https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.pdf.

[11] A financial reporting group is any group of business entities that prepares consolidated financial statements and that includes at least one domestic entity or domestic branch and at least one foreign entity or foreign branch. Consolidated financial statements means those determined in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other methods authorized by the Secretary under regulations. Under the proposal, the Secretary would be delegated authority to treat a group of business entities as a financial reporting group if a financial reporting group would exist had those business entities been required to prepare consolidated financial statements.

which would include income that is subject to GILTI, reformed as proposed. Thus, the UTPR would generally not apply to U.S.-parented multinationals.

The UTPR would primarily apply to foreign-parented multinationals with operations in low-tax jurisdictions. In addition, the UTPR would only apply to financial reporting groups that have global annual revenue of the dollar equivalent to €750 million or more in at least two of the prior four years.

Under the proposal, when UTPR applies, domestic group members would be disallowed U.S. tax deductions to the extent necessary to collect the hypothetical amount of top-up tax required for the financial reporting group to pay an effective tax rate of at least 15 percent in each foreign jurisdiction in which the group has profits.[12] The amount of this top-up tax would be determined based on a jurisdiction-by-jurisdiction computation of the group's profit and effective tax rate consistent with the Pillar Two Model Rules, which would take into account all income taxes, including the corporate alternative minimum tax. As discussed below, the top-up amount would be allocated among all of the jurisdictions where the financial reporting group operates that have adopted a UTPR consistent with the Pillar Two Model Rules (a Qualified UTPR).

The computation of profit and the effective tax rate for a jurisdiction is based on the group's consolidated financial statements, with certain specified adjustments such as rules to address temporary and permanent differences between the financial accounting and tax bases. In addition, the computation of a group's profit for a jurisdiction is reduced by an amount equal to 5 percent of the book value of tangible assets and payroll with respect to the jurisdiction.[13]

In addition to the general limitation of the UTPR to financial reporting groups that have global annual revenue of at least the dollar equivalent of €750 million, the proposal includes several de minimis exclusions. The UTPR would not apply to a group's profit in a jurisdiction if the three-year average of the group's revenue in the jurisdiction is less than $10.9 million and the three-year average of the group's profit in the jurisdiction is less than $1.09 million.[14] Under an exception for groups in the initial phase of their international activity, the UTPR would not apply to a group with operations in no more than five jurisdictions outside of the group's primary jurisdiction and the book value of the group's tangible assets in those jurisdictions is less than $55 million. This exception would expire five years after the first day of the first year in which the UTPR otherwise would apply to the group.

---

[12] For example, a group with $1,000x of profits in a foreign jurisdiction with no corporate income tax would have a top-up tax amount of $150x with respect to that jurisdiction. If the top-up tax were not collected under GILTI or an IIR implemented by a foreign jurisdiction, a domestic corporation or domestic branch that is a member of the group would be subject to a deduction disallowance of $536x, equal to the top-up tax amount of $150x divided by the U.S. corporate income tax rate of 28 percent. For simplicity, this example assumes that there are no tangible assets or payroll in the foreign jurisdiction with no corporate income tax, and that there are no other jurisdictions with a UTPR such that all of the top-up tax is allocated to the domestic corporation or domestic branch.

[13] During a transition period of nine years, the exclusion equals 7.8 percent of the book value of tangible assets and 9.8 percent of payroll, declining annually by 0.2 percentage points for the first four years, by 0.4 percentage points for tangible assets and by 0.8 percentage points for payroll for the last five years.

[14] Under the proposal, the Secretary would be delegated authority to adjust dollar-based thresholds to address currency fluctuations for international standards reflected in Euros.

The deduction disallowance applies pro rata with respect to all otherwise allowable deductions,[15] and applies after all other deduction disallowance provisions in the Code. To the extent that the UTPR disallowance for a taxable year exceeds the aggregate deductions otherwise allowable to the taxpayer for that year, such excess amount of the UTPR disallowance would be carried forward indefinitely until an equivalent amount of deductions are disallowed in future years.

A coordination rule would reduce the UTPR disallowance imposed by the United States to reflect any top-up tax collected by members of the group under a Qualified UTPR (QUTPR in the formula below) in one or more other jurisdictions. With respect to each financial reporting group, the percentage of top-up tax allocated to the United States would be determined by the following formula where a QUTPR jurisdiction is a jurisdiction applying a Qualified UTPR.

$$\textit{U.S. allocation} = 50\% \times \frac{\textit{Number of employees in the U.S.}}{\textit{Number of employees in all QUTPR jurisdictions}} + 50\% \times \frac{\textit{Total book value of tangible assets in the U.S.}}{\textit{Total book value of tangible assets in all QUTPR jurisdictions}}$$

The portion of the top-up tax allocated to the United States would be allocated among domestic group members (domestic corporations and domestic branches) under regulations prescribed by the Secretary.

If any prior year's UTPR disallowance has not yet resulted in cash tax liability equal to the full amount of the prior year's allocated top-up tax (for instance, due to net operating losses) then, in general, no additional top-up tax for the current year would be allocated to the United States until the UTPR disallowance has resulted in a cash tax liability equal to the full amount of the allocated top-up tax. Any low-taxed profits of the group for the given year may instead be subject to a Qualified UTPR applied in other jurisdictions.

Whether a foreign jurisdiction has in effect a Qualified UTPR or an IIR that is consistent with the Pillar Two Model Rules would be determined by the Secretary under the standard specified in the Pillar Two Model Rules.

The proposal includes a domestic minimum top-up tax that would apply to U.S. profits when a UTPR in another jurisdiction comes into effect. This top-up tax equals the excess of (a) 15 percent of the financial reporting group's U.S. profit determined using the same rules as under the UTPR to determine the group's profit for a jurisdiction, over (b) all the group's income tax paid or accrued with respect to U.S. profits (including Federal and State incomes taxes, corporate alternative minimum tax, and creditable foreign income taxes incurred with respect to U.S. profits). When a UTPR in another jurisdiction comes into effect, the proposal would also ensure that taxpayers continue to benefit from tax credits and other tax incentives that promote U.S. jobs and investment, including clean energy tax provisions enacted in the IRA.

[15] For example, if a taxpayer incurs $50x of interest expense that would otherwise be deductible and would otherwise be allowed a $50x depreciation deduction, a UTPR disallowance of $20x would disallow a deduction for $10x of the interest expense and $10x of the depreciation.

The proposal to repeal the BEAT and replace it with the UTPR would be effective for taxable years beginning after December 31, 2024.

REPEAL THE DEDUCTION FOR FOREIGN-DERIVED INTANGIBLE INCOME

Current Law

Current law provides a deduction to domestic corporations on their foreign-derived intangible income (FDII). The deduction allowed is 37.5 percent of a domestic corporation's FDII for any taxable year beginning after December 31, 2017, and 21.875 percent for any taxable year beginning after December 31, 2025. A domestic corporation's FDII is the portion of its intangible income, determined on a formulaic basis, that is derived from exports. The formulaic calculation of income eligible for the FDII deduction is generally determined by taking a domestic corporation's overall income, minus certain exceptions, and reducing it by a deemed tangible income return which is 10 percent of a domestic corporation's qualified business asset investment to arrive at a domestic corporation's deemed intangible income. A portion of this amount is treated as FDII based on the percentage of the taxpayer's income that is derived from serving foreign markets.

Reasons for Change

FDII is not an effective way to encourage research and development (R&D) in the United States. It provides large tax breaks to companies with excess profits – who are already reaping the rewards of prior innovation – rather than incentivizing new domestic investment. Further, FDII disadvantages domestic producers, offering tax incentives only to those companies with high export sales, rather than those with significant domestic sales.

In addition, FDII creates undesirable incentives to locate certain economic activity abroad. Because the preferential FDII rate applies to income in excess of a domestic corporation's tangible assets, firms can lower the hurdle necessary to obtain preferential tax treatment by reducing tangible investments in the United States. Coupled with the current global intangible low-taxed income (GILTI) regime, there is a strong incentive for companies to offshore plants and equipment, since moving equipment offshore both increases the tax-free return under GILTI and increases the tax deduction under FDII.

Finally, eliminating FDII will raise significant revenue that can be deployed to incentivize R&D in the United States directly and more effectively.

Proposal

The proposal would repeal the deduction allowed for FDII. The resulting revenue will be used to encourage R&D.

The proposal would be effective for taxable years beginning after December 31, 2024.

REVISE THE RULES THAT ALLOCATE SUBPART F INCOME AND GILTI BETWEEN TAXPAYERS TO ENSURE THAT SUBPART F INCOME AND GILTI ARE FULLY TAXED

Current Law

A controlled foreign corporation (CFC) is a foreign corporation whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules). Section 951(a) of the Internal Revenue Code (Code) generally requires a U.S. shareholder of a CFC to include in gross income its pro rata share of the CFC's Subpart F income. A U.S. shareholder is required to include this amount only if the U.S. shareholder directly or indirectly owns stock in the foreign corporation on the last day of the foreign corporation's taxable year on which it is a CFC (the "last relevant day").

In general, a U.S. shareholder's pro rata share of Subpart F income is based on the amount of current year earnings and profits that the U.S. shareholder would receive if the CFC were to distribute all its current year earnings and profits on the last relevant day. However, a U.S. shareholder's pro rata share is reduced by the portion of the year during which the foreign corporation was not a CFC and by any dividends paid by the CFC during the year to another person with respect to stock of the CFC that the U.S. shareholder owns on the last relevant day. The reduction for dividends paid is limited to the CFC's Subpart F income allocable to the period that the U.S. shareholder did not own the stock of the CFC.

Thus, a dividend paid to a corporate U.S. shareholder with respect to the stock of a CFC that the U.S. shareholder sells may reduce the tax burden on the U.S. shareholder who subsequently purchases the stock in the same year. This is the case even though the selling U.S. shareholder may not pay any tax on the dividend because it is eligible for a dividends received deduction under section 245A of the Code (section 245A DRD).

A U.S. shareholder's pro rata share of a CFC's tested income, which is used to determine its global intangible low-taxed income (GILTI) inclusion under section 951A(a) of the Code, is determined based on the pro rata share rules for Subpart F income.

Reasons for Change

Current law allows Subpart F income (or tested income) of a CFC to escape U.S. taxation in certain cases in which stock of the CFC is transferred and the CFC distributes a dividend (including a deemed dividend) to any person other than the U.S. shareholder on the last relevant day.

To illustrate the potential tax avoidance, suppose a corporate U.S. shareholder (the "seller") owns 50 percent of the single class of outstanding stock of a CFC at the beginning of the CFC's tax year. The CFC pays a dividend of $80 to the seller, and then three-quarters of the way into the tax year, the seller sells all of its stock of the CFC to another U.S. shareholder (the "buyer"). The CFC earns $200 of Subpart F income for its tax year. Without taking into account the dividend, the buyer's pro rata share of the CFC's Subpart F income would be $100 (50 percent of

$200). Because the $80 dividend received by the seller is greater than $75 (the portion of the Subpart F income allocable to the period the stock of the CFC is owned by the seller and not the buyer), the buyer's pro rata share of the CFC's Subpart F income is reduced by $75 to $25. Furthermore, the seller is generally allowed a 100 percent section 245A DRD. As a result, the dividend does not increase the seller's taxable income. Thus, in effect, $75 of the CFC's Subpart F income has escaped U.S. taxation by reason of the sale.

Regulations issued under section 245A of the Code limit this type of tax avoidance in certain cases when a U.S. shareholder owns, directly or indirectly, more than 50 percent of the stock of a CFC, but do not address all cases, such as the previous example, where the seller owns 50 percent or less of the CFC.

Proposal

The proposal would modify the existing pro rata share rules to require a U.S. shareholder of a CFC that owns, directly or indirectly, a share of stock of the CFC for part of the CFC's taxable year, but not on the last relevant day, to include in gross income a portion of the foreign corporation's Subpart F income allocable to the portion of the year during which it was a CFC. That portion of Subpart F income would equal the portion of the CFC's current year earnings and profits paid as non-taxed current dividends on the share while it was a CFC. A non-taxed current dividend is the portion of a dividend paid out of current year earnings and profits that, without regard to the proposal, either (a) is paid to a U.S. shareholder and would qualify for a dividends received deduction, or (b) to the extent prescribed by the Secretary, is paid to an upper-tier CFC.

The remaining portion of a CFC's Subpart F income that is allocable to the portion of the year during which it was a CFC – that is, the amount that is not allocated under the non-taxed current dividend rule – would be allocated to a U.S. shareholder that owns a share of stock of the CFC on the last relevant day. Similar to current law, a U.S. shareholder's pro rata share of Subpart F income with respect to the share of stock would be reduced for taxable dividends paid by the foreign corporation, provided the taxable dividends are paid while it was a CFC, out of current year earnings and profits, and are paid either (a) to another United States person, or (b), to the extent prescribed by the Secretary, to another CFC. However, the U.S. shareholder's pro rata share would not be reduced below the portion attributable to the portion of the year during which the U.S. shareholder owned the share.

Because the proposal applies on a share-by-share basis, a U.S. shareholder may be allocated Subpart F income under both the non-taxed current dividend rule and the last relevant day rule.

The proposal would similarly revise the pro rata share rules for determining a U.S. shareholder's GILTI inclusion with respect to a CFC.

The Secretary would be authorized to issue regulations or other guidance necessary or appropriate to carry out the purposes of the proposal, including (a) to treat distributions and other amounts as dividends or not dividends for purposes of this section, (b) to treat a partnership as an aggregate of its partners, (c) to provide rules allowing or requiring a foreign corporation to close its taxable year upon a change in ownership for purposes of determining U.S. shareholders' pro rata share, and (d) to treat a distribution and related issuance of stock to a shareholder not subject to tax under this chapter in the same manner as an acquisition of stock.

The proposal would apply to taxable years of foreign corporations beginning after the date of enactment and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

REQUIRE A CONTROLLED FOREIGN CORPORATION'S TAXABLE YEAR TO MATCH THAT OF ITS MAJORITY U.S. SHAREHOLDER

Current Law

A controlled foreign corporation (CFC) is a foreign corporation whose stock is majority owned by U.S. shareholders (taking into account stock attribution rules). Section 898(c) of the Internal Revenue Code requires a CFC to use the same taxable year as its majority U.S. shareholder but provides an election to use a taxable year that ends one month earlier than the majority U.S. shareholder's taxable year. This provision, which was enacted in 1989, was intended to alleviate potential difficulties in obtaining and translating tax information from a foreign entity. The ability of a CFC to use a different taxable year than its majority U.S. shareholder permits the U.S. shareholder to defer income inclusions related to the income of the CFC.

Reasons for Change

Technological advances have reduced or eliminated the difficulties in obtaining and translating tax information from a foreign entity. In addition, the ability to choose a different taxable year from that of the majority U.S. shareholder has resulted in aggressive tax planning opportunities for taxpayers, unnecessary complexity, and significant compliance and administrative burdens.

Proposal

The proposal would eliminate the election for a CFC to use a taxable year different from the taxable year of the CFC's majority U.S. shareholder.

The proposal would be effective as of the date of enactment. CFCs with existing one-month deferral elections would have a short taxable year as of the first taxable year end of its majority U.S. shareholder that is at least 60 days after the date of enactment of the proposal.

LIMIT FOREIGN TAX CREDITS FROM SALES OF HYBRID ENTITIES

Current Law

A corporation that makes a qualified stock purchase of a target corporation is permitted to elect, under section 338 of the Internal Revenue Code (known as a "section 338 election") to treat the stock acquisition as an asset acquisition for U.S. tax purposes, thereby generally adjusting the post-acquisition tax basis of the target corporation's assets to fair market value. For this purpose, a qualified stock purchase is any transaction or series of transactions in which the purchasing corporation acquires at least 80 percent of the stock of the target corporation. Section 338(h)(16) provides that (subject to certain exceptions) the deemed asset sale resulting from a section 338 election is generally ignored in determining the source or character of any item for purposes of applying the foreign tax credit rules to the seller. Instead, for these purposes, any gain recognized by the seller is treated as gain from the sale of the stock of the target corporation. Thus, in the case of a foreign target corporation, section 338(h)(16) prevents the earnings and profits generated from the deemed asset sale from changing the character of the gain from capital to ordinary, thereby permitting the use of foreign tax credits (FTCs) to reduce or eliminate residual U.S. tax on the stock gain.

Similar to a section 338 election, Treasury regulations under section 336(e) allow a corporation to elect to treat certain dispositions of stock of a domestic corporation (but not a foreign corporation) as a disposition of the assets of the domestic corporation instead. These regulations apply section 338(h)(16) to a deemed sale of foreign assets of the domestic corporation.

Reasons for Change

Section 338(h)(16) applies to a qualified stock purchase for which a section 338 election is made, but it does not apply to transactions that produce similar results – sales of an interest in an entity that is treated as a corporation for foreign tax purposes but as a partnership or a disregarded entity for U.S. tax purposes (specified hybrid entity), or taxable changes in the classification of an entity for U.S. tax purposes that are not recognized for foreign tax purposes. These transactions present the same FTC concerns as in the case of a qualified stock purchase for which a section 338 election is made, and so should be subject to similar limitations.

Proposal

The proposal would apply the principles of section 338(h)(16) to determine the source and character of any item recognized in connection with a direct or indirect disposition of an interest in a specified hybrid entity and to a change in the classification of an entity that is not recognized for foreign tax purposes (for example, due to an election under the entity classification regulations). Thus, for purposes of applying the foreign tax credit rules, the source and character of any item resulting from the disposition of the interest in the specified hybrid entity, or change in entity classification, would be determined based on the source and character of an item of gain or loss that the seller would have accounted for upon the sale or exchange of stock (determined without regard to section 1248). In addition, because the proposal is limited to determining the source and character of such an item of gain or loss for purposes of applying the foreign tax credit rules, the proposal does not affect the amount of gain or loss recognized as a result of the disposition or the change in entity classification. The Secretary would be granted authority to issue any regulations necessary or appropriate to carry out the purposes of the proposal, including those applying the proposal to other transactions that have a similar effect and exempting certain transactions among related parties from application of the proposal.

The proposal would be effective for transactions occurring after the date of enactment.

RESTRICT DEDUCTIONS OF EXCESSIVE INTEREST OF MEMBERS OF FINANCIAL REPORTING GROUPS

Current Law

Business interest expense generally is deductible from regular taxable income. An exception to this general rule is section 163(j) of the Internal Revenue Code (Code), which generally limits U.S. tax deductions for business interest expense to the sum of (a) business interest income, (b) 30 percent of adjusted taxable income (not less than zero), and (c) floor plan financing interest. Business interest expense for which a deduction is disallowed under section 163(j) may be carried forward indefinitely for deduction in a subsequent year.

Certain interest paid to a foreign related party is treated as a base erosion payment for purposes of the base erosion and anti-abuse tax (BEAT), in which case the deduction is added back to the BEAT modified taxable income base. See *Adopt the Undertaxed Profits Rule* earlier in this volume for a description of the relevant law.

In addition, certain interest paid to a foreign related party may not be deductible by reason of the anti-hybrid rules of section 267A, which limit deductibility of an interest payment when the amount is not included in the income of the recipient under foreign tax laws or when the recipient receives a deduction with respect to the payment. Furthermore, certain rules under the Code affect the timing of a deduction for interest. For example, certain interest owed to a related party may not be deductible to the payor by reason of section 267(a) until the interest is included in the gross income of the related-party payee.

In addition, both case law and regulations issued under section 385 can determine whether an instrument issued by an entity is treated as indebtedness that gives rise to interest expense for Federal income tax purposes, or as stock. Specifically, regulations under section 385 treat as stock certain debt instruments issued by a corporation to a controlling shareholder in a distribution or in certain other related-party transactions that achieve an economically similar result.

Reasons for Change

The fungibility of money makes it easy for multinational groups to substitute debt for equity in a controlled entity in order to shift profits to lower-tax jurisdictions. Under current law, multinational groups are able to reduce their U.S. tax on income earned from U.S. operations by over-leveraging their U.S. operations relative to those located in lower-tax jurisdictions. Although section 163(j) limits the amount of interest expense a corporation can deduct relative to its U.S. earnings, section 163(j) does not consider the leverage of a multinational group's U.S. operations relative to the leverage of the group's worldwide operations. In addition, while certain interest paid to a foreign related party is added to the modified taxable income base for determining a taxpayer's BEAT liability, many taxpayers are able to avoid a BEAT liability because of the various exceptions for certain deductible payments. Moreover, the BEAT rate is less than half of the regular corporate income tax rate. (See *Adopt the Undertaxed Profits Rule* in this volume.) The proposal would limit the ability of multinational groups to lower U.S. taxable income through high interest-to-income ratios for U.S. operations relative to the worldwide group.

Proposal

Under the proposal, a financial reporting group (defined below) member's deduction for interest expense generally would be limited if the member has net interest expense for U.S. tax purposes and the member's net interest expense for financial reporting purposes (computed on a separate company basis) exceeds the member's proportionate share of the financial reporting group's net interest expense reported on the group's consolidated financial statements (excess financial statement net interest expense). A member's proportionate share of the financial reporting group's net interest expense would be determined based on the member's proportionate share of the group's earnings (computed by adding back net interest expense, tax expense, depreciation, depletion, and amortization) reflected in the financial reporting group's consolidated financial statements. The proposal generally would apply to an entity that is a member of a multinational group that prepares consolidated financial statements ("financial reporting group") in accordance with U.S. Generally Accepted Accounting Principles (GAAP), International Financial Reporting Standards (IFRS), or other method identified by the Secretary under regulations.

When a financial reporting group member has excess financial statement net interest expense, a deduction will be disallowed for the member's excess net interest expense for U.S. tax purposes. For this purpose, the member's excess net interest expense equals the member's net interest expense for U.S. tax purposes multiplied by the ratio of the member's excess financial statement net interest expense to the member's net interest expense for financial reporting purposes. Conversely, if a member's net interest expense for financial reporting purposes is less than the member's proportionate share of the net interest expense reported on the group's consolidated financial statements, such excess limitation would be converted into a proportionate amount of excess limitation for U.S. tax purposes and carried forward three years.

Alternatively, if a financial reporting group member fails to substantiate its proportionate share of the group's net interest expense for financial reporting purposes, or a member so elects, the member's interest deduction would be limited to the member's interest income plus ten percent of the member's adjusted taxable income (as defined under section 163(j)). Regardless of whether a taxpayer computes the interest limitation under the proportionate share approach or using the ten percent alternative, any disallowed interest expense could be carried forward indefinitely. A member of a financial reporting group that is subject to the proposal would continue to be subject to the application of section 163(j). Thus, the amount of interest expense disallowed for a taxable year of a taxpayer that is subject to both interest expense disallowance provisions would be determined based on whichever of the two provisions imposes the lower limitation. A member of a financial reporting group may also be subject to the new undertaxed profits rule. (See *Adopt the Undertaxed Profits Rule* in this volume for a description)

Each U.S. subgroup of a financial reporting group would be treated as a single member of the financial reporting group for purposes of applying the proposal (except for purposes of applying the ten percent alternative). For this purpose, a U.S. subgroup is comprised of any U.S. entity that is not owned directly or indirectly by another U.S. entity, and all members (domestic or foreign) that are owned directly or indirectly by such entity. If a member of a U.S. subgroup owns stock in one or more foreign corporations, the proposal would apply before the application of section 265, which generally disallows a deduction for amounts allocable to tax-exempt income. Under the Administration's proposals, tax-exempt income would include dividends from a foreign corporation eligible for a section 245A deduction and a global intangible low-taxed income (GILTI) inclusion eligible for a section 250 deduction. (See *Revise the Global Minimum Tax Regime, Limit Inversions, and Make Related Reforms* in this volume.)

The proposal would not apply to financial services entities, and such entities would be excluded from the financial reporting group for purposes of applying the proposal to other members of the financial reporting group. The proposal also would not apply to financial reporting groups that would otherwise report less than $5 million of net interest expense, in the aggregate, on one or more U.S. income tax returns for a taxable year.

The Secretary would be granted authority to promulgate any regulations necessary to carry out the purposes of the proposal, including (a) coordinating the application of the proposal with other interest deductibility rules, (b) defining interest and financial services entities, (c) permitting financial reporting groups to apply the proportionate share approach using the group's net interest expense for U.S. tax purposes rather than net interest expense reported in the group's financial statements, (d) providing for the treatment of pass-through entities, (e) providing adjustments to the application of the proposal to address differences in functional currency of members, (f) if a U.S. subgroup has multiple U.S. entities that are not all members of a single U.S. consolidated group for U.S. tax purposes, providing for the allocation of the U.S. subgroup's excess net interest expense for U.S. tax purposes among the members of the U.S. subgroup; (g) allowing or requiring the adjustment of amounts reported on applicable financial Statements, including by increasing a member's reported net business interest expense under rules similar to those that apply for disallowed interest expense; and (h) providing rules to address structures with a principal purpose to limit application of the proposal. In addition, if a financial reporting group does not prepare financial statements under U.S. GAAP or IFRS, it is expected that regulations generally would allow the use of financial statements prepared under other jurisdictions' generally accepted accounting principles in appropriate circumstances.

The proposal would be effective for taxable years beginning after December 31, 2024.

CONFORM SCOPE OF PORTFOLIO INTEREST EXCLUSION FOR 10-PERCENT SHAREHOLDERS TO OTHER TAX RULES

Current Law

No tax is generally imposed on portfolio interest received by a foreign person. Portfolio interest is any U.S.-source, non-effectively connected interest paid on an obligation that is in registered form and that would otherwise be taxable to a foreign owner of the obligation.

Interest does not qualify as portfolio interest if an exclusion applies. One particular exclusion applies if the holder of the obligation is a "10-percent shareholder" of the issuer at the time the interest is received. For an obligation issued by a corporation, a 10-percent shareholder is any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote. In the case of an obligation issued by a partnership, a 10-percent shareholder is any person who owns 10 percent or more of the capital or profits interest in such partnership.

The Tax Cuts and Jobs Act of 2017 modified the definition of "United States shareholder" for income tax purposes to mean a U.S. person who owns or is considered to own 10 percent or more of the total combined voting power of all classes of stock of a foreign corporation or 10 percent or more of the total value of shares of all classes of stock of such corporation. Prior to the enactment of the Tax Cuts and Jobs Act of 2017, the definition of "United States shareholder" looked only to the voting power of the shareholder.

Reasons for Change

Taxpayers are often able to avoid (or attempt to avoid) being classified as a 10-percent shareholder by limiting their technical voting power in the corporation to under 10 percent, while retaining a substantial interest in the total value of shares of all classes of stock in the corporation. Modifying the definition of 10-percent shareholder to take into account the value of stock owned would prevent gaming of this definition. Moreover, it would promote uniformity by aligning the 10-percent shareholder definition for portfolio interest purposes with the definition of United States shareholder.

Proposal

The proposal would modify the definition of a 10-percent shareholder, in the case of interest paid on an obligation issued by a corporation, to mean any person who owns 10 percent or more of the total combined voting power of all classes of stock of such corporation entitled to vote or 10 percent of the total value of shares of all classes of stock of such corporation.

The proposal would apply to payments of U.S.-source interest made on debt instruments issued (including a deemed issuance) on or after the date that is 60 days after enactment.

TREAT PAYMENTS SUBSTITUTING FOR PARTNERSHIP EFFECTIVELY CONNECTED INCOME AS U.S. SOURCE DIVIDENDS

Current Law

A foreign taxpayer that invests in a U.S. partnership with income effectively connected to the conduct of a trade or business (ECI) is required to file a U.S. tax return to report that income and pay tax on it. Some or all of the gain on the sale of an interest in a partnership that is engaged in the conduct of a U.S. trade or business may be treated as ECI by reference to a deemed sale of the partnership's assets, and tax is required to be withheld on that gain.

For certain purposes, including the U.S. withholding tax rules applicable to foreign persons, a dividend equivalent is treated as a dividend from U.S. sources. A dividend equivalent is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that (directly or indirectly) is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States. Any payment made under a specified notional principal contract, or made under an equity-linked instrument that meets certain criteria, that directly or indirectly is contingent upon, or determined by reference to, the payment of a dividend from sources within the United States also is treated as a dividend equivalent.

In the case of a dividend equivalent payment made by a foreign person to a foreign person, the jurisdiction of the foreign person making the payment may not treat the payment as a U.S. source dividend subject to U.S. taxation. As a result, the foreign person making the payment may be subject to different and potentially conflicting obligations under U.S. law and foreign law.

Reasons for Change

Foreign taxpayers may take the position that the rules requiring reporting and payment of tax on investments in U.S. partnerships do not apply if the foreign taxpayer acquires an economic interest in a publicly traded partnership with ECI through a derivative financial instrument, such as a total return swap, and that the payments on the financial instrument that are received by the foreign taxpayer are foreign source payments. Foreign taxpayers may also take the position that the rules requiring withholding on dividend equivalent payments do not apply to payments on the financial instrument or apply only to a small portion of those payments. As a result, taxpayers can readily avoid the imposition of U.S. tax on ECI from an investment in a partnership with a U.S. trade or business.

Proposal

The proposal would treat the portion of a payment on a derivative financial instrument (including a securities loan or sale-and-repurchase agreement) that is contingent on income or gain from a publicly traded partnership or other partnership specified by the Secretary as a dividend equivalent, to the extent that the related income or gain would have been treated as ECI if the taxpayer held the underlying partnership interest.

The Secretary would have authority to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, this section, including with respect to payments made between foreign persons.

No inference is intended as to the application of current law to derivative transactions on interests in partnerships with ECI.

The proposal would be effective for taxable years starting December 31, 2024.

EXPAND ACCESS TO RETROACTIVE QUALIFIED ELECTING FUND ELECTIONS

Current Law

The passive foreign investment company (PFIC) rules are intended to prevent taxpayers from deferring the taxation of income from passive investments and from transforming the character of income from those investments from ordinary income into capital gain by holding the investments through a foreign investment company. Absent a qualified electing fund (QEF) or another permitted election, excess distributions received from a PFIC are subject to additional tax in an amount determined by reference to the taxpayer's holding period during which the company has been a PFIC, the highest marginal tax rates applicable during that period, and the rate of interest that applies to underpayments of tax. Gain recognized on disposition of PFIC stock is treated as an excess distribution.

If an investor in a PFIC makes a QEF election, the taxpayer is not subject to the tax on excess distributions after the effective date of the election. Instead, the taxpayer generally is required to take into account the taxpayer's pro rata share of the ordinary income and long-term capital gain of the PFIC on an annual basis and pay tax on this income. Section 1295(b)(2) of the Internal Revenue Code (Code) generally allows the owner of a PFIC to make a QEF election for any taxable year at any time on or before the due date for filing the return of the tax. Section 1295(b)(2) permits an election to be made after that date if the taxpayer reasonably believed that the company was not a PFIC, to the extent provided by regulations.

Under regulations, a taxpayer also is permitted to make a retroactive QEF election if the Commissioner of the Internal Revenue Service (IRS) consents to the election under a special consent procedure. To qualify for the special consent procedure, three conditions must be met: the taxpayer must have relied on a qualified tax professional, granting consent must not prejudice the interests of the U.S. Government, and the request for the special consent must be made before the issue is raised on audit.

Reasons for Change

A taxpayer who makes a QEF election does not obtain the timing and character benefits that the PFIC rules are intended to prevent. QEF elections reduce tax costs to investors and increase tax compliance. The availability of a QEF election also incentivizes taxpayers to voluntarily report investments in a PFIC.

Under current law, individuals who inadvertently did not make a QEF election with respect to a PFIC investment may not be eligible for relief under the special consent procedure. For example, a student with low or no income may inherit stock and discover only years later that the stock is that of a PFIC when the individual hires a qualified tax professional. In other cases, an individual may have hired a qualified tax professional who fails to advise the taxpayer of the availability of a QEF election but refuses to provide an affidavit acknowledging that failure.

Additionally, there are large individual and administrative costs under current law for the existing special consent procedure. The existing procedure requires a taxpayer to file a ruling request with the IRS and pay a user fee that is currently several thousand dollars. The IRS receives many requests for consent, which result in the use of IRS time and resources to determine whether consent should be granted and, if so, to issue the private letter ruling. In many cases, allowing the taxpayer to make a retroactive QEF election would be consistent with the proper administration of the law and would promote tax compliance, but the IRS must deny the request because the taxpayer does not qualify for relief under the special consent procedure.

To encourage more taxpayers to make QEF elections, improve taxpayer disclosure, and relieve the costs and burdens that current law imposes on both taxpayers and the IRS, retroactive QEF elections should be permitted for a broader range of circumstances through changes to the statute that expand regulatory authority. For example, the IRS should have authority to allow a retroactive QEF election after the first year of ownership of a PFIC in appropriate cases that promote these goals even if the taxpayer cannot demonstrate a reasonable belief that the company was not a PFIC and cannot satisfy the special consent requirements.

Proposal

The proposal would modify section 1295(b)(2) of the Code to permit a QEF election by the taxpayer at such time and in such manner as the Secretary shall prescribe by regulations.

Taxpayers would be eligible to make a retroactive QEF election without requesting consent only in cases that do not prejudice the U.S. Government. For example, if the taxpayer owned the PFIC in taxable years that are closed to assessment, the taxpayer would need to obtain consent and to pay an appropriate amount to compensate the government for the taxes not paid in the closed years on amounts that would have been includable in the taxpayer's income if the taxpayer had made a timely QEF election.

While it is less common for partnerships and other non-individual taxpayers to inadvertently fail to make a QEF election, the Secretary would have authority to allow such taxpayers to make retroactive QEF elections in appropriate circumstances.

The proposal would be effective on the date of enactment. It is intended that regulations or other guidance would permit taxpayers to amend previously filed returns for open years.

REFORM TAXATION OF FOREIGN FOSSIL FUEL INCOME

Current Law

Under the global intangible low-taxed income (GILTI) rules, foreign oil and gas extraction income (FOGEI) of a controlled foreign corporation (CFC) is excluded from tested income, whereas foreign oil related income (FORI) is included. In addition, FOGEI and FORI earned by a CFC are not part of the CFC's Subpart F income. Therefore, FOGEI earned through CFCs may be eligible for a deduction under section 245A when repatriated and thus is generally exempt from U.S. taxation. In contrast, both FOGEI and FORI earned directly through a foreign branch (including a disregarded entity) are subject to full U.S. taxation, subject to allowable foreign tax credits (FTCs).

Subject to certain limitations, a taxpayer may claim a credit against its U.S. income tax liability for income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States. Under Treasury regulations, a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign government to levy taxes. A foreign levy is not a tax to the extent a person subject to the levy receives a specific economic benefit from the foreign country in exchange for the payment (e.g., a concession to extract government-owned petroleum).

A taxpayer that is subject to a foreign levy and who also receives a specific economic benefit from the foreign country (a dual capacity taxpayer) must establish the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. The dual capacity taxpayer cannot claim FTCs with respect to amounts paid in exchange for the specific economic benefit. Treasury regulations provide a safe harbor for determining the qualifying portion of the levy based on the generally applicable rate of tax under the jurisdiction's income tax. However, taxpayers may use the facts and circumstances method for determining the qualifying portion of the levy rather than the safe harbor.

Reasons for Change

FTCs are intended to mitigate double taxation of income by the United States and a foreign government. When a payment is made to a foreign government in exchange for a specific economic benefit, there is no double taxation. Current law recognizes the distinction between a payment of creditable taxes and a payment in exchange for a specific economic benefit but may fail to achieve the appropriate split between the two (e.g., when a foreign jurisdiction does not charge royalties but imposes a levy only on oil and gas income, or imposes a higher levy on oil and gas income as compared to other income). The safe harbor method reflects the view that the higher effective rate of the nominal foreign tax is appropriately characterized as compensating the foreign government in its capacity as the owner of the minerals in place, rather than in its role as tax collector. However, many dual capacity taxpayers subject to alternative tax regimes use the facts and circumstances method for determining the qualifying portion of the levy and claim FTCs for a much larger amount than would be creditable under the safe harbor method. Consequently, many oil and gas producers are able to claim a credit against their U.S. income tax liability for high levies imposed by foreign governments that effectively constitute royalty equivalents (instead of income taxes), while other U.S. businesses (not in the oil/gas sector) in those same countries pay a much lower income tax rate (and therefore are only eligible for the correspondingly lower FTCs in the United States).

Foreign hydrocarbon income should not be eligible for preferential tax treatment relative to other industries because of the negative externalities associated with such industry and the Administration's overall goal of promoting clean energy.

Proposal

The proposal would repeal the exemption from GILTI for FOGEI. The definition of FOGEI and FORI would also be amended to include income derived from shale oil and tar sands activity.

In the case of a dual capacity taxpayer, the proposal would limit the amount of a levy that would qualify as a creditable foreign tax to the amount of tax that the dual capacity taxpayer would have paid to the foreign government if it were a non-dual capacity taxpayer. Thus, the proposal would codify the safe harbor included in the current Treasury regulations for determining the portion of the levy that is paid in exchange for a specific economic benefit, and would make the safe harbor the sole method for determining the creditable portion of the levy. The aspect of the proposal that would determine the amount of a foreign levy paid by a dual-capacity taxpayer that qualifies as a creditable tax would yield to U.S. treaty obligations that explicitly allow a credit for taxes paid or accrued on certain oil or gas income.

The proposal would be effective for taxable years beginning after December 31, 2024.

PROVIDE TAX INCENTIVES FOR LOCATING JOBS AND BUSINESS ACTIVITY IN THE UNITED STATES AND REMOVE TAX DEDUCTIONS FOR SHIPPING JOBS OVERSEAS

Current Law

Under current law, there are limited tax incentives for U.S. employers to bring offshore jobs and investments into the United States. In addition, costs incurred to offshore U.S. jobs generally are deductible for U.S. income tax purposes.

Reasons for Change

The proposal creates a tax incentive to bring offshore jobs and investment back to the U.S. Reducing the tax benefits from moving U.S. jobs offshore will increase incentives to keep those jobs at home.

Proposal

The proposal would create a new general business credit equal to 10 percent of the eligible expenses paid or incurred in connection with onshoring a U.S. trade or business. For this purpose, onshoring a U.S. trade or business means reducing or eliminating a trade, business, or line of business currently conducted outside the United States and starting up, expanding, or otherwise moving the same trade or business within the United States, to the extent that this action results in an increase in U.S. jobs. While the eligible expenses may be incurred by a foreign affiliate of the U.S. taxpayer, the tax credit would be claimed by the U.S. taxpayer. If a non-mirror code U.S. territory (the Commonwealth of Puerto Rico and American Samoa) implements a substantially similar proposal, the Department of the Treasury (Treasury) will reimburse the U.S. territory for the new general business credits provided to their taxpayers pursuant to a plan. Furthermore, the Treasury will reimburse a mirror code U.S. territory (Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands) for the new general business credits provided to their taxpayers by reason of the enactment of the proposal.

In addition, to reduce tax benefits associated with U.S. companies moving jobs outside of the United States, the proposal would disallow deductions for expenses paid or incurred in connection with offshoring a U.S. trade or business. For this purpose, offshoring a U.S. trade or business means reducing or eliminating a trade, business, or line of business currently conducted inside the United States and starting up, expanding, or otherwise moving the same trade or business outside the United States, to the extent that this action results in a loss of U.S. jobs. In addition, no deduction would be allowed against a U.S. shareholder's global intangible low-taxed income or Subpart F income inclusions for any expenses paid or incurred in connection with moving a U.S. trade or business outside the United States.

For purposes of the proposal, expenses paid or incurred in connection with onshoring or offshoring a U.S. trade or business are limited solely to expenses associated with the relocation of the trade or business and do not include capital expenditures or costs for severance pay and other assistance to displaced workers. The Secretary would be given authority to prescribe rules to implement the provision, including rules to determine covered expenses and treatment of independent contractors.

The proposal would be effective for expenses paid or incurred after the date of enactment.

STRENGTHEN TAXATION OF HIGH-INCOME TAXPAYERS

APPLY THE NET INVESTMENT INCOME TAX TO PASS-THROUGH BUSINESS INCOME OF HIGH-INCOME TAXPAYERS

Current Law

Individuals with modified adjusted gross incomes over a threshold amount are subject to a 3.8 percent tax on net investment income. The threshold is $200,000 for single and head of household returns and $250,000 for joint returns. Net investment income generally includes: (a) interest, dividends, rents, annuities, and royalties, other than such income derived in the ordinary course of a trade or business; (b) income derived from a trade or business in which the taxpayer does not materially participate; (c) income from a business of trading in financial instruments or commodities; and (d) net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The net investment income tax (NIIT) does not apply to self-employment earnings.

Self-employment earnings and wages are subject to employment taxes under the Self-Employment Contributions Act (SECA) and the Federal Insurance Contributions Act (FICA), respectively. Both SECA and FICA taxes apply at a rate of 12.4 percent for social security tax on employment earnings (capped at $168,600 in 2024) and at a rate of 2.9 percent for Medicare tax on all employment earnings (not subject to an earnings cap). An additional 0.9 percent Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of $200,000 for single and head of household filers and $250,000 for joint filers, thus bringing the combined rate of Medicare tax to 3.8 percent for these taxpayers.

General partners and sole proprietors pay SECA tax on the full amount of their net trade or business income, subject to certain exceptions. Section 1402(a)(13) of the Internal Revenue Code provides that the distributive share of partnership income or loss of a limited partner is excluded from SECA tax, although limited partners are subject to SECA tax on their section 707(c) guaranteed payments from the partnership that are for services they provide to, or on behalf of, the partnership. Because the statutory exclusion only refers to limited partners, questions have arisen as to the meaning of this term and whether the limited partner exclusion might be applicable to limited liability company (LLC) members. Some partners who claim to be limited partner members may more accurately be described as general partners who would be subject to SECA.

S corporation shareholders are not subject to SECA tax. However, tax law requires that those shareholders who are owner-employees pay themselves "reasonable compensation" for services provided, on which they pay FICA tax like any other employee. Nonwage distributions to shareholders of S corporations are not subject to either FICA or SECA taxes.

Reasons for Change

Active owners of pass-through businesses, including S corporations and partnerships, are treated differently for purposes of the NIIT, SECA tax, and FICA tax according to the legal form of their ownership and the legal form of the payment that they receive. While general partners and sole proprietors pay SECA tax on earnings from their businesses, S-corporation owner-employees pay employment taxes on only a portion of their earnings, and limited partners often pay little or no SECA tax. Although the NIIT reflects an intention to impose the 3.8 percent tax on both earned and unearned income of high-income taxpayers, certain income, specifically distributions to S corporation shareholder-employees and distributions to limited partners who claim the statutory exclusion for limited partners, escape the combined 3.8 percent tax from FICA or SECA and the NIIT.

These inconsistencies in the treatment of pass-through business income are unfair and inefficient. They distort choice of organizational form and provide tax planning opportunities for business owners, particularly those with high incomes, to avoid paying their fair share of taxes.

The current system is also a challenge for the Internal Revenue Service (IRS) to administer. The determination of "reasonable compensation" of S corporation owner-employees generally depends on facts and circumstances and requires a valuation analysis that can be contested by the taxpayer and increases the IRS's cost of administration and enforcement. Uncertainty surrounding the treatment of limited partners and LLC members who materially participate in their businesses undermines the IRS's ability to ensure payment of SECA tax and the NIIT.

Proposal

The proposal would expand the NIIT base to ensure that all pass-through business income of high-income taxpayers is subject to either the NIIT or SECA tax.

In order to determine the amount of trade or business income that would be subject to the NIIT under the proposal, the taxpayer would sum (a) ordinary business income derived from S corporations for which the owner materially participates in the trade or business, (b) ordinary business income derived from either limited partnership interests or interests in LLCs that are classified as partnerships to the extent a limited partner or LLC member materially participates in its partnership's or LLC's trade or business,[17] and (c) any other trade or business income to the extent that such income is not subject to NIIT or SECA under current law (this sum referred to as the "potential NIIT income"). The additional income that would be subject to the NIIT would be a specified percentage of potential NIIT income. The specified percentage would start at zero and would increase linearly to 100 as adjusted gross income rises from $400,000 to $500,000 ($200,000 to $250,000 for married taxpayers filing separately). The threshold amounts given in this paragraph would not be indexed for inflation.

Material participation standards would apply to individuals who participate in a business in which they have a direct or indirect ownership interest. Taxpayers are usually considered to materially participate in a business if they are involved in it in a regular, continuous, and substantial way. Often this means they work for the business for at least 500 hours per year. The

[17] For purposes of clause (b), limited partners and LLC members claiming to be limited partners who provide services and materially participate in their partnerships and LLCs would be subject to the NIIT on their distributive shares of partnership or LLC ordinary income to the extent that this income exceeds certain threshold amounts and is not treated as self-employment income subject to SECA.

statutory exception to SECA tax for limited partners would not exempt a limited partner from the NIIT if the limited partner otherwise materially participated.

The proposal would be effective for taxable years beginning after December 31, 2023.

INCREASE THE NET INVESTMENT INCOME TAX RATE AND ADDITIONAL MEDICARE TAX RATE FOR HIGH-INCOME TAXPAYERS

Current Law

Individuals with modified adjusted gross incomes over a threshold amount are subject to a 3.8 percent tax on net investment income. The threshold is $200,000 for single and head of household returns, $250,000 for joint returns, and $15,200 (for 2024) for estates and trusts. Net investment income generally includes: (a) interest, dividends, rents, annuities, and royalties, other than such income derived in the ordinary course of a trade or business; (b) income derived from a trade or business in which the taxpayer does not materially participate; (c) income from a business of trading in financial instruments or commodities; and (d) net gain from the disposition of property other than property held in a trade or business in which the taxpayer materially participates. The net investment income tax (NIIT) does not apply to self-employment earnings. Proceeds from the NIIT flow into the General Fund of the Treasury.

Self-employment earnings and wages are subject to employment taxes under either the Self-Employment Contributions Act (SECA) or the Federal Insurance Contributions Act (FICA), respectively. Both SECA and FICA taxes apply at a rate of 12.4 percent for social security tax on employment earnings (capped at $168,600 in 2024) and at a rate of 2.9 percent for Medicare tax on all employment earnings (not subject to a cap). An additional 0.9 percent Medicare tax is imposed on self-employment earnings and wages of high-income taxpayers, above the same NIIT thresholds of $200,000 for single and head of household filers and $250,000 for joint filers, thus bringing the combined rate of Medicare tax to 3.8 percent for these taxpayers. The FICA and SECA Medicare taxes flow into the Hospital Insurance Trust Fund (HITF), which finances Medicare Part A.

Reasons for Change

According to current projections from the Medicare trustees, the Hospital Insurance Trust Fund (HITF) will be exhausted in 2031. Increasing the NIIT and additional Medicare tax for high-income taxpayers and devoting NIIT proceeds to the HITF will extend the life of the trust fund.

In addition, the differential treatment of NIIT revenues and the Medicare portion of FICA and SECA taxes, with the former paid into the General Fund of the Treasury and the latter paid into the HITF, is inconsistent with the fact that the taxes are intended for the same purpose.

A previous proposal in this volume, *Apply the Net Investment Income Tax to Pass-Through Business Income of High-Income Taxpayers*, would expand the base of the NIIT to ensure all pass-through trade or business income is taxed either through the NIIT or SECA taxes.

Proposal

The proposal would increase the additional Medicare tax rate by 1.2 percentage points for taxpayers with more than $400,000 of earnings. When combined with current-law tax rates, this would bring the marginal Medicare tax rate up to 5 percent for earnings above the threshold. The threshold would be indexed for inflation.

The proposal would also increase the NIIT rate by 1.2 percentage points for taxpayers with more than $400,000 of income, similarly bringing the marginal NIIT rate to 5 percent for investment income above the threshold. Specifically, for taxpayers with positive net investment income, the NIIT would increase by 1.2 percentage points on the lesser of (a) net investment income or (b) the excess, if any, of modified adjusted gross income over $400,000. The threshold would be indexed for inflation.

Under the proposal, the revenue from the NIIT (that raised under current law and that which would be raised under any proposed expansion) would be directed to the HITF in the same manner as the revenue from the current 3.8 percent tax on earnings and the proposed additional 1.2 percent tax on earnings.

The proposal would be effective for taxable years beginning after December 31, 2023.

INCREASE THE TOP MARGINAL INCOME TAX RATE FOR HIGH-INCOME EARNERS

Current Law

For taxable years beginning after December 31, 2017, and before January 1, 2026, the top marginal individual income tax rate is 37 percent. For taxable years beginning after December 31, 2025, the top marginal tax rate is 39.6 percent.

For taxable years beginning after December 31, 2023, and before January 1, 2025, the top marginal tax rate applies to taxable income over $731,200 for married individuals filing a joint return and surviving spouses, $609,350 for unmarried individuals (other than surviving spouses and head of household filers), $609,350 for head of household filers, and $365,600 for married individuals filing a separate return. The tax bracket thresholds are indexed for inflation.

Reasons for Change

Raising the top tax rate for the highest-income taxpayers would raise revenue and increase the progressivity of the tax system.

Proposal

The proposal would increase the top marginal tax rate to 39.6 percent. The top marginal tax rate would apply to taxable income over $450,000 for married individuals filing a joint return and surviving spouses, $400,000 for unmarried individuals (other than surviving spouses and head of household filers), $425,000 for head of household filers, and $225,000 for married individuals filing a separate return. After 2024, the thresholds would be indexed for inflation using the C-CPI-U, which is used for all current thresholds in the tax rate tables.

The proposal would be effective for taxable years beginning after December 31, 2023.

REFORM THE TAXATION OF CAPITAL INCOME

Current Law

Most realized long-term capital gains and qualified dividends are taxed at graduated rates based on the taxpayer's taxable income, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax, if applicable based on the taxpayer's modified adjusted gross income). Moreover, capital gains are taxable only upon the sale or other disposition of an appreciated asset. When a donor gives an appreciated asset to a donee during the donor's life, the donee's basis in the asset is the basis of the donor; the basis is "carried over" from the donor to the donee. There is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain by the donee until the donee later disposes of that asset. When an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. As a result, the appreciation accruing during the decedent's life on assets that are still held by the decedent at death avoids Federal income tax.

Reasons for Change

Preferential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers. Preferential tax rates also disproportionately benefit White taxpayers, who receive the overwhelming majority of the benefits of the reduced rates. The rate disparity between taxes on capital gains and qualified dividends on the one hand, and taxes on labor income on the other, also encourages economically wasteful efforts to convert labor income into capital income as a tax avoidance strategy.

Under current law, because a person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value at the time of the decedent's death, appreciation that had accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement pay income tax on their realized capital gains. This dynamic increases the inequity of the tax treatment of capital gains. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Moreover, the distribution of wealth among Americans has grown increasingly unequal, concentrating economic resources in a steadily shrinking percentage of individuals. Coinciding with this period of growing inequality, the long-term fiscal shortfall of the United States has significantly increased. Reforms to the taxation of capital gains and qualified dividends will reduce economic disparities among Americans and raise needed revenue.

Proposal

The proposal would make the following changes to current law:

Tax capital income for high-income earners at ordinary rates

Long-term capital gains and qualified dividends of taxpayers with taxable income of more than $1 million would be taxed at ordinary rates, with 37 percent generally being the highest rate (40.8 percent including the net investment income tax).[18] The proposal would only apply to the extent that the taxpayer's taxable income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2024.[19]

The proposal would be effective for gains required to be recognized and for dividends received on or after the date of enactment.

Treat transfers of appreciated property by gift or on death as realization events

Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer. The amount of the gain realized would be the excess of the asset's fair market value on the date of the gift or the decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the donor or to the decedent's estate on the Federal gift or estate tax return or on a separate capital gains return. The use of capital losses and carry-forwards from transfers at death would be allowed against capital gains and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any).

Gain on unrealized appreciation also would be recognized by a trust, partnership, or other non-corporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years. For this purpose, a tacking[20] rule would apply to property received in a nonrecognition event from another such entity. This provision would apply to property held on or after January 1, 1944, that is not subject to a recognition event after December 31, 1943, so that the first recognition event would be deemed to occur on December 31, 2033.

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply. First, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent that its assets are actively

[18] A separate proposal would first raise the top ordinary rate to 39.6 percent (43.4 percent including the net investment income tax). An additional proposal would increase the net investment income tax rate by 1.2 percentage points above $400,000, bringing the marginal net investment income tax rate to 5 percent for investment income above the $400,000 threshold. Together, the proposals would increase the top marginal rate on long-term capital gains and qualified dividends to 44.6 percent. (See *Increase the Top Marginal Income Tax Rate for High-Income Earners* and *Increase the Net Investment Income Tax Rate and Additional Medicare Tax Rate for High-Income Taxpayers* in this volume.)

[19] For example, a taxpayer with $1,100,000 in taxable income of which $200,000 is preferential capital income would have $100,000 of capital income taxed at the preferential rate and $100,000 taxed at ordinary rates.

[20] A tacking rule would give the transferee a holding period that includes the holding period of the transferor.

used in the conduct of that trade or business. Second, transfers of property into, and distributions in kind from a trust, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee. The deemed owner of such a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, not including distributions made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

Certain exclusions would apply. Transfers to a U.S. spouse or to charity would carry over the basis of the donor or decedent. Capital gain would not be realized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would be exempt from capital gains tax. The transfer of appreciated assets to a split-interest trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

The proposal would exclude from recognition any gain on all tangible personal property such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple. Finally, the exclusion under current law for capital gain on certain small business stock would also apply.

In addition to the above exclusions, the proposal would allow a $5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift. In addition, the proposal would allow any remaining portion of the $5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (resulting in a married couple having an aggregate $10 million exclusion) and would be indexed for inflation after 2024. The recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death.

The proposal also includes several deferral elections. Taxpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and -operated. Furthermore, the proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made. The Internal Revenue Service (IRS) would be authorized to require security at any time when the IRS perceives a reasonable need for security to continue this deferral. That security could be provided from any person, and in any form, deemed acceptable by the IRS.

Additionally, the proposal would include other legislative changes designed to facilitate and implement the proposal, including without limitation: the allowance of a deduction for the full cost of appraisals of appreciated assets; the imposition of liens; the waiver of penalty for underpayment of estimated tax to the extent that underpayment is attributable to unrealized gains at death; the grant of a right of recovery of the tax on unrealized gains; rules to determine who has the right to select the return filed; the achievement of consistency in valuation for transfer and income tax purposes; coordinating changes to reflect that the recipient would have a basis in the property equal to the value on which the capital gains tax is computed; and a broad grant of regulatory authority to provide implementing rules.

To facilitate the transition to taxing gains at gift, death and other events under the proposal, the Secretary would be granted authority to issue any regulations or other guidance necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable, reporting requirements for all transfers of appreciated property including value and basis information, and rules where reporting could be permitted on the decedent's final income tax return instead.

The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2024, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2025.

IMPOSE A MINIMUM INCOME TAX ON THE WEALTHIEST TAXPAYERS

Current Law

Most realized long-term capital gains and qualified dividends are taxed at graduated rates under the individual income tax, with 20 percent generally being the highest rate (23.8 percent including the net investment income tax, if applicable, based on the taxpayer's modified adjusted gross income). Moreover, capital gains are taxable only upon a realization event, such as the sale or other disposition of an appreciated asset. As a result, the Federal income taxation of the appreciation of an asset that accrues during the asset's holding period is deferred. In the case of unrealized appreciation at death, the basis adjustment (usually, a step-up) for a decedent's assets may cause Federal income taxation of that gain to be eliminated entirely.

Reasons for Change

Preferential treatment for unrealized gains disproportionately benefits high-wealth taxpayers and provides many high-wealth taxpayers with a lower effective tax rate than many low- and middle-income taxpayers. Preferential treatment for unrealized gains also exacerbates income and wealth disparities, including by gender, geography, race, and ethnicity.

Under current law, the preferential treatment for unrealized gains produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Reforms to the taxation of capital gains will reduce economic disparities among Americans and raise needed revenue.

Proposal

The proposal would impose a minimum tax of 25 percent on total income, generally inclusive of unrealized capital gains, for all taxpayers with wealth (that is, the difference obtained by subtracting liabilities from assets) greater than $100 million.

Under the proposal, taxpayers could choose to pay the first year of minimum tax liability in nine equal, annual installments. For subsequent years, taxpayers could choose to pay the minimum tax imposed for those years (not including installment payments due in that year) in five equal, annual installments.

A taxpayer's minimum tax liability would equal the minimum tax rate (that is, 25 percent) times the sum of taxable income and unrealized gains (including on ordinary assets) of the taxpayer, less the sum of the taxpayer's unrefunded, uncredited prepayments and regular tax. Payments of the minimum tax would be treated as a prepayment available to be credited against subsequent taxes on realized capital gains to avoid taxing the same amount of gain more than once. The amount of a taxpayer's "uncredited prepayments" would equal the cumulative minimum tax liability assessed (including installment payments not yet due) for prior years, less any amount credited against realized capital gains in prior years.

Uncredited prepayments would be available to be credited against capital gains taxes due upon realization of gains, to the extent that the amount of uncredited prepayments, reduced by the cumulative amount of unpaid installments of the minimum tax (net uncredited prepayments), exceeds 25 percent of unrealized gains. Refunds would be provided to the extent that net uncredited prepayments exceed the long-term capital gains rate (inclusive of applicable surtaxes) times the taxpayer's unrealized gains – such as after unrealized loss or charitable gift. However, refunds would first offset any remaining installment payments of minimum tax before being refundable in cash.

Minimum tax liability would be reduced to the extent that the sum of minimum tax liability and uncredited prepayments exceeds two times the minimum tax rate times the amount by which the taxpayer's wealth exceeds $100 million. As a result, the minimum tax would be fully phased in for all taxpayers with wealth greater than $200 million.

For single decedents, net uncredited prepayments in excess of tax liability from gains at death would be refunded to the decedent's estate and would be included in the decedent's gross estate for Federal estate tax purposes. For married decedents, net uncredited prepayments that are unused would be transferred to the spouse or as otherwise provided by the Secretary through regulations or other guidance.

Taxpayers with wealth greater than the threshold would be required to report to the Internal Revenue Service (IRS) on an annual basis, separately by asset class, the total basis and total estimated value (as of December 31 of the taxable year) of their assets in each specified asset class, and the total amount of their liabilities. Tradable assets (for example, publicly traded stock) would be valued using end-of-year market prices. Taxpayers would not have to obtain annual, market valuations of non-tradable assets. Instead, non-tradable assets would be valued using the greater of the original or adjusted cost basis, the last valuation event from investment, borrowing, or financial statements, or other methods approved by the Secretary. Valuations of non-tradable assets would not be required annually and would instead increase by a conservative floating annual return (the five-year Treasury rate plus two percentage points) in between valuations. The IRS may offer avenues for taxpayers to appeal valuations, such as through appraisal.

This reporting also would be used to determine if the taxpayer is eligible to be treated as "illiquid." Taxpayers would be treated as illiquid if tradeable assets held directly or indirectly by the taxpayer make up less than 20 percent of the taxpayer's wealth. Taxpayers who are treated as illiquid may elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. However, taxpayers making this election would be subject to a deferral charge upon, and to the extent of, the realization of gains on any non-tradeable assets. The deferral charge would not exceed ten percent of unrealized gains.

Estimated tax payments would not be required for minimum tax liability. The minimum tax payment amount would be excluded from the prior year's tax liability for purposes of computing estimated tax required to be paid to avoid the penalty for the underpayment of estimated taxes.

The proposal would provide the Secretary with the authority to prescribe such regulations or other guidance determined to be necessary or appropriate to carry out the purposes of the proposal, including rules to prevent taxpayers from inappropriately converting tradeable assets to non-tradeable assets.

The proposal would be effective for taxable years beginning after December 31, 2024.

MODIFY RULES RELATING TO RETIREMENT PLANS

PREVENT EXCESSIVE ACCUMULATIONS BY HIGH-INCOME TAXPAYERS IN TAX-FAVORED RETIREMENT ACCOUNTS AND MAKE OTHER REFORMS

Current Law

Individuals may save for retirement through a tax-favored retirement arrangement. The tax-favored retirement arrangement could be an employer-sponsored plan, such as a qualified plan under section 401(a), a section 403(b) plan, a simplified employer pension (SEP), a SIMPLE-IRA plan, or an eligible deferred compensation plan described in section 457(b), or it could be an individual retirement account or annuity (IRA) described in section 408(a) and 408(b).

Employer-sponsored plans and IRAs have distinct characteristics. The following briefly summarizes these rules for employer-sponsored plans and IRAs:

1. Contributions to an employer-sponsored plan

An employee who saves through an employer-sponsored plan is subject to a limit on elective contributions. For 2024, the annual limit on these elective contributions is generally $23,000, except that an employee who is at least 50 years old generally can contribute an additional $7,500. The $23,000 contribution limit and the $7,500 "catch-up contribution" limit are adjusted for inflation. An employer can also provide matching contributions or non-elective contributions under its plan (and may also permit the employee to make after-tax contributions), but there is a limit on the total of the employer and employee contributions (other than rollover contributions) for a year. For 2024, that limit is $69,000 in the case of a qualified plan, a section 403(b) plan, or SEP (with lower limits for a SIMPLE-IRA plan and an eligible deferred compensation plan), except that a taxpayer who is at least 50 years old can make the additional catch-up contribution (generally $7,500, with a lower amount in the case of certain plans). The $69,000 contribution limit is adjusted for inflation.

Employer contributions and an employee's elective contributions to an employer-sponsored plan are generally excluded from an employee's income for the year of the contribution (but the contributions and earnings on those contributions are included in the distributee's income when distributed). However, an employer may design the plan to provide its employees the option of designating some or all of an employee's elective contributions (or a vested employer's contributions) as Roth contributions. Designated Roth contributions are included in the employee's income when they are made, but the contributions, and earnings on the contributions, are excluded from income when distributed, if the distribution satisfies the requirements to be a qualified distribution.

2. Contributions to an IRA

A taxpayer who saves using an IRA is subject to a limit on their contributions (other than rollover contributions). The annual limit on contributions is $7,000 for 2024, except that a taxpayer who is at least 50 years old can contribute an additional $1,000. The $7,000 contribution limit and the $1,000 "catch-up contribution" limit are adjusted for inflation.

If a taxpayer's contribution to an IRA for a year exceeds the allowable contribution for that taxpayer and the taxpayer does not withdraw that excess contribution and net income attributable to the excess prior to the tax filing deadline (with extensions) for the year, then the taxpayer is subject to an annual 6 percent excise tax on the amount of the excess contribution.

The tax treatment of a contribution to an IRA depends on whether the IRA is a traditional IRA or a Roth IRA. A taxpayer may deduct a contribution to a traditional IRA; however, if the taxpayer or the taxpayer's spouse is an active participant in an employer-sponsored plan, then the deduction is available only if the taxpayer's income is below a specified limit. A taxpayer for whom the deduction is limited or unavailable because of the income limit for an active participant can make an after-tax contribution to a traditional IRA (and a taxpayer who is not so limited can also choose to make an after-tax contribution rather than deduct that contribution).

Contributions to a Roth IRA are not deductible when they are made, but the contributions, and earnings on the contributions, are excluded from income when distributed, if the distribution satisfies the requirements to be a qualified distribution. A taxpayer may not contribute to a Roth IRA if the taxpayer's income for the year exceeds certain thresholds.

The following five features of the rules applicable to tax-favored retirement arrangements under current law are addressed by the proposal:

1. Distribution rules, including rules for required minimum distributions

Under current law, taxpayers are not required to receive a distribution from tax-favored retirement arrangements due to the vested account balance exceeding a specified amount. Instead, under current law, taxpayers are required to commence to receive distributions from their tax-favored retirement arrangement when they attain a specified age, except in the case of a Roth IRA or designated Roth account.

A retired employee who participates in an employer-sponsored plan generally is required to begin distributions from that plan (other than from a designated Roth account under the plan) by the required beginning date (April 1 following the calendar year in which the employee attains age 73) and to take the required minimum distributions (RMDs) over the employee's life expectancy or lifetime (or over the life expectancy or the lifetime of the employee and a designated beneficiary). If the employee is not a 5 percent owner of the employer then the required beginning date is April 1 following the later of the calendar year in which the employee attains age 73 or the calendar year in which the employee retires.

A taxpayer who has an IRA is also subject to the RMD rules. However, there is no RMD requirement for a Roth IRA during the lifetime of the IRA owner (although the beneficiary of the IRA is subject to the RMD rules after the IRA owner dies). If an IRA owner has more than one IRA (or a taxpayer is the beneficiary of more than one IRA from the same decedent) then the total of the RMD requirements for a year calculated for all of those IRAs may be satisfied by a distribution from any of those IRAs. However, the RMD requirements for IRAs that are not Roth IRAs cannot be satisfied by distributions from a Roth IRA and the RMD requirements for Roth IRAs cannot be satisfied by distributions from an IRA that is not a Roth IRA.

If a taxpayer is subject to the requirement to take an RMD for a year and does not take the full amount required, then the taxpayer is subject to a 25 percent excise tax on the portion of the distribution not taken (reduced to 10 percent if the failure is corrected within a specified period).

A distribution of an eligible rollover distribution from an employer-sponsored tax-favored retirement plan is subject to mandatory income tax withholding at a 20 percent tax rate. A nonperiodic distribution from an IRA (other than from a Roth IRA) is subject to income tax withholding at a 10 percent tax rate. However, an individual can elect to have no withholding apply to a nonperiodic distribution from an IRA.

2. Rollovers and conversions to designated Roth retirement accounts or to Roth IRAs

Under current law, an employer may design its plan to permit employees who participate in the plan to elect to rollover a distribution from the plan that is not from the designated Roth account (or to transfer a portion of the balance of the employee's account that is not held as a designated Roth account) into a designated Roth account. Any amount so rolled over or transferred (sometimes referred to as a conversion) is included in the employee's income to the same extent as if the amount rolled over or transferred were distributed (except that the additional income tax for early distributions does not apply).

An employer may also design the plan to provide the employee with the option to make after-tax contributions that are not designated Roth contributions. These after-tax contributions are excluded from income when distributed (but earnings on those contributions are included in income when distributed). If an employee has made after-tax contributions to the plan, then generally a portion of each distribution is treated as coming from the employee's after-tax contributions and the remainder of the distribution is a taxable distribution of employer contributions and earnings (with the proportions of those amounts for the distribution based on the total of those amounts for the employee as a whole).

Individuals are permitted to roll over a distribution from an employer-sponsored tax-favored retirement plan or from an IRA to a Roth IRA. If the distribution was from an account other than a designated Roth account (or was from an IRA other than a Roth IRA) any amount rolled over is included in the employee's income to the same extent as if the amount rolled over was distributed (except that the additional income tax for early distributions does not apply). These rollovers are sometimes called conversions.

3. IRA prohibited transactions

If the individual for whom an IRA is established engages in a prohibited transaction, the account loses its tax-favored retirement account status as of the first day of the taxable year in which the transaction occurs and the account is treated as if all the assets in the account were distributed on that day. A prohibited transaction is any direct or indirect: (a) sale or exchange, or leasing, of any property between the IRA and a "disqualified person"; (b) lending of money or other extension of credit between the IRA and a disqualified person; (c) furnishing of goods, services, or facilities between the IRA and a disqualified person; (d) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the IRA; (e) act by a disqualified person who is a fiduciary whereby they deal with the income or assets of the IRA in their own interest or for their own account; or (f) receipt of any consideration for their own personal account by any disqualified person who is a fiduciary from any party dealing with the IRA in connection with a transaction involving the income or assets of the IRA.

A disqualified person includes a fiduciary, certain members of a fiduciary's family, and certain entities controlled by a fiduciary. A fiduciary is any person who: (a) exercises any discretionary authority or discretionary control respecting management of the IRA or exercises any authority or control respecting management or disposition of its assets; (b) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so; or (c) has any discretionary authority or discretionary responsibility in the administration of such plan.

Section 4975 imposes an excise tax on a disqualified person who participates in a prohibited transaction (other than an IRA owner who engages in that transaction) in an amount equal to 15 percent of the amount involved, up to 100 percent of the amount involved if the prohibited transaction is not corrected.

4. DISC and FSC ownership interests

A domestic international sales corporation (DISC) that earns qualified export receipts may exempt a portion of that income, subject to an interest charge imposed on the shareholders of the DISC with respect to those tax-deferred amounts. Shareholders of the DISC are taxed with respect to qualified export receipts of the DISC either upon actual distribution or deemed distribution from the DISC. The effect of these rules is to defer tax liability except to the extent that the interest charge reduces that deferral benefit.

A foreign sales corporation (FSC) that earns foreign trading gross receipts may exempt a portion of that income. Shareholders of the FSC are generally not subject to tax when those amounts are distributed to them. The FSC provisions were generally repealed by the FSC Repeal and Extraterritorial Income Exclusion Act of 2000, subject to transition rules.

5. Statute of Limitations

The Internal Revenue Code includes a general rule under which the assessment of tax must occur within 3 years of the date that a return is filed. For purposes of the excise tax on excess contributions under section 4973, the return that starts this 3-year period is generally the Form 5329, Additional Taxes on Qualified Plans (including IRAs) and Other Tax-Favored Accounts. As an alternative, a taxpayer can file an income tax return without attaching the Form 5329 (in which case the period for assessment extends to 6 years after the date the return is filed). For purposes of the excise tax on prohibited transactions, the return that starts the 3-year period is the Form 5330, Return of Excise Taxes Related to Employee Benefit Plans.

Reasons for Change

The purpose of tax-favored retirement arrangements is to help people save for retirement. In recent years, it has become clear that some taxpayers have been able to accumulate amounts in tax-favored retirement arrangements that are far in excess of the amount needed for retirement security. In addition, the exemption from required minimum distribution rules for Roth IRAs means that a taxpayer who has other sources of retirement income could choose to continue accumulating investment returns on a tax-favored basis until the taxpayer dies, which means that the tax-favored retirement arrangement could be passed on in its entirety to the taxpayer's heirs. By requiring a high-income taxpayer with an excessive accumulation in tax-favored retirement arrangements to distribute a portion of that excess (and to cease contributions to an IRA), the arrangements would be used for the intended retirement savings purpose. This is especially important if the taxpayer has an excessive accumulation in a Roth IRA or in a designated Roth account in an employer-sponsored tax-favored plan (because of the lifetime exemption from the RMD rules). Prohibiting a high-income taxpayer from converting an amount into a Roth IRA will minimize the extent to which the taxpayer can take advantage of the exemption from the RMD rules for Roth IRAs.

Some taxpayers have avoided the income-based limitations on making Roth IRA contributions by (a) making a non-deductible contribution to a traditional IRA or an after-tax contribution to an employer-sponsored plan, (b) taking a distribution from that IRA or plan, and (c) rolling that distribution into a Roth IRA. This practice inappropriately sidesteps the income restrictions on contributions to Roth IRAs.

Some IRA owners or beneficiaries have taken the position that they are not fiduciaries. As a result, they take the position that they, their family members, and entities that they control are not disqualified persons (so that they may participate in transactions with the IRA that would otherwise be prohibited).

Some taxpayers have directed their Roth IRA to purchase a DISC or FSC ownership interest in order to use the special tax characteristics of those corporations to funnel excessive amounts into the IRA. These transactions, the subsequent payment of commissions to the DISC or FSC, and the distributions from the DISC or FSC to the Roth IRA have, in substance, violated the annual limitation on contributions to a Roth IRA.[21]

It is difficult for the Internal Revenue Service to enforce the IRA rules, particularly in the case of IRAs that are invested in hard-to-value assets. For example, it may be difficult for the IRS to identify if a transaction with the IRA has inappropriately transferred value into the IRA or to identify whether a prohibited transaction has occurred.

[21] Summa Holdings. Inc. v. Commissioner, 848 F.3d 779 (6th Cir. 2017), reversing T.C. Memo. 2015-119; Mazzei v. Commissioner, 998 F.3d 1041 (9th Cir. 2021), reversing T.C. Memo. 2014-55 (in both cases, the application of the substance-over-form judicial doctrine by the United States Tax Court to determine that the arrangements were, in substance, excess contributions, was overturned on appeal).

Proposal

The proposal would make the following changes to current law:

1. Impose special distribution rules on high-income taxpayers with large retirement account balances

The proposal would require a high-income taxpayer with an aggregate vested account balance under tax-favored retirement arrangements that exceeded $10 million as of the last day of the preceding calendar year to distribute a minimum of 50 percent of that excess. The tax-favored retirement arrangements included in this calculation are: (a) defined contribution plans to which section 401(a) or 403(a) applies; (b) annuity contracts under section 403(b); (c) eligible deferred compensation plans described in section 457(b) maintained by a State, a political subdivision of a State, or an agency or instrumentality of a State or political subdivision of the State; and (d) IRAs. In addition, if the high-income taxpayer's aggregate vested account balance under these tax-favored retirement arrangements exceeds $20 million, then the required distribution is subject to a floor. The floor is the lesser of (a) that excess and (b) the portion of the taxpayer's aggregate vested account balance that is held in a Roth IRA or designated Roth account.

A taxpayer is considered a high-income taxpayer if for the taxable year the taxpayer's modified adjusted gross income is: (a) over $450,000, if the taxpayer is married and filing jointly (or is filing as a surviving spouse); (b) over $425,000, if the taxpayer is a head-of-household; or (c) over $400,000, in other cases.[22]

The taxpayer would generally be permitted to choose from which of the tax-favored retirement arrangements the required distribution is paid. However, if the floor applies, then the distribution must come first from Roth IRAs and then from designated Roth accounts. In addition, the taxpayer may not specify that any of the required distribution come from an employee stock ownership plan (ESOP) to the extent the account under the ESOP holds employer securities that are not readily tradable on an established securities market (other than any portion of that account attributable to a rollover contribution made after the date of enactment).

The distribution required under the proposal is structured as an increase to the RMD for purposes of the excise tax on failure to take RMDs. As a result, a taxpayer who fails to satisfy the requirement is subject to a 25 percent excise tax on the portion of the distribution not taken (reduced to 10 percent if the failure is corrected within a specified period). The requirement to take this minimum distribution applies without regard to whether an RMD otherwise must be taken by the taxpayer in the year.

The amount distributed would be exempt from the additional income tax on early distributions under section 72(t) and would not be eligible for rollover. If the distribution is from a Roth IRA or from a designated Roth account, then it is treated as a qualified distribution (and therefore is

---

[22] The dollar thresholds for the definition of a high-income taxpayer are adjusted for inflation. For this purpose, modified adjusted gross income means adjusted gross income determined without regard to sections 911, 931, and 933, without regard to any deduction for contributions to an individual retirement plan, and without regard to any increase in RMDs under the proposal.

not includible in the taxpayer's income). If the distribution is from a tax-favored retirement arrangement other than an IRA, then it would be subject to mandatory withholding at a 35 percent rate (unless it is from a designated Roth account).

If an individual has an increase in the RMD for a year as a result of the excessive accumulation, any contribution the individual makes to an IRA for the year (other than a rollover) is treated as an excess contribution to an IRA, subject to the 6 percent excise tax under section 4973.[23]

A plan administrator of a tax-favored retirement arrangement that is included in the calculation of whether a high-income taxpayer has an excessive accumulation in tax-favored retirement arrangements would be required to report the vested account balance of any participant or beneficiary for whom the vested account balance exceeds $2.5 million (as adjusted for inflation) to the Secretary. This requirement would apply without regard to whether the plan administrator is required to file a registration statement for a participant who separated from service under the plan (i.e., it would apply to plans that are not subject to the vesting standards of Title I of ERISA), but it would not apply to an IRA. The report would separately report the portion of the vested account balance that is held in a designated Roth account and the portion of that balance that is held in other accounts.

This provision would be effective for tax years beginning after December 31, 2024, except that the requirement that a plan administrator report vested account balances above $2.5 million would be effective for plan years beginning after December 31, 2025.

2. <u>Limit rollovers and conversions to designated Roth retirement accounts or to Roth IRAs</u>

The provision would prohibit a rollover to a Roth IRA of an amount distributed from an account in an employer-sponsored eligible retirement plan that is not a designated Roth account (or of an amount distributed from an IRA other than a Roth IRA) for a high-income taxpayer. The provision would also prohibit rollovers or transfers of amounts that are not held within a designated Roth account into a designated Roth account for a high-income taxpayer. High-income taxpayers would be defined in the same manner as above. This provision would be effective for taxable years beginning after December 31, 2024.

The proposal also would prohibit a rollover of a distribution from a tax-favored retirement arrangement into a Roth IRA unless the distribution was from a designated Roth account within an employer-sponsored retirement plan or was from another Roth IRA if any part of the distribution includes a distribution of after-tax contributions. Similarly, the proposal would prohibit a rollover of a distribution from a tax-favored retirement arrangement into a designated Roth account if any part of the distribution includes a distribution of after-tax contributions, unless the distribution was from a designated Roth account.

---

[23] If a high-income taxpayer does not have such an increase because the individual's aggregate vested account balance in tax-favored retirement arrangements is less than the $10 million threshold, then any contribution to an IRA (other than a contribution made by an employer under a SIMPLE plan or SEP arrangement) that when added to the aggregate vested account balance in tax-favored retirement arrangements as of the last day of the preceding calendar year would result in a total in excess of $10 million is also treated as an excess contribution.

This provision would be effective for distributions made after December 31, 2024.

3. Clarify disqualified persons for purposes of IRA prohibited transactions

The proposal would clarify that the individual for whom an IRA is maintained is always a disqualified person for purposes of prohibited transaction rules.

This provision would be effective for transactions after December 31, 2024.

4. Prohibit IRA purchase of a DISC or FSC ownership interest

The proposal would prohibit an IRA from holding an interest in a DISC or FSC that receives a payment from an entity owned by the IRA owner. Whether an entity is owned by the IRA owner would be determined by substituting 10 percent for 50 percent in the constructive ownership rules in section 318 of the Internal Revenue Code. The sanction for a violation of this prohibition would be the same as the sanction for an IRA owner engaging in a prohibited transaction (i.e., the IRA would be deemed to have distributed all of its assets as of the first day of the taxable year).

This provision would be effective for interests in DISCs and FSCs acquired or held after December 31, 2024.

5. Extend statute of limitations

The proposal would extend the statute of limitations in the case of a substantial error relating to valuation of assets with respect to an IRA from three years to six years. The proposal would also extend the statute of limitations for the excise tax on prohibited transactions from three years to six years.

This provision would be effective for taxes for which the three-year window would end after December 31, 2024.

SUPPORT WORKERS, FAMILIES, AND ECONOMIC SECURITY

EXPAND THE CHILD CREDIT, AND MAKE PERMANENT FULL REFUNDABILITY AND ADVANCEABILITY

Current Law

A taxpayer may claim a child tax credit (CTC) for each qualifying child. A qualifying child for the CTC must meet the following five requirements:

1. Relationship – The child generally must be the taxpayer's son, daughter, grandchild, sibling, niece, nephew, or foster child.

2. Residence – The child must live with the taxpayer in the same principal place of abode for over half the year.

3. Support – The child must not have provided more than half of their own support.

4. Age – The child must be under the age of 17 (or under 18 in taxable year 2021) at the end of the year.

5. Identification – The child must have a taxpayer identification number (TIN) at the time the return is filed. (In taxable years 2021 through 2025 this TIN must be a social security number valid for work.)

The value of the credit, the portion of the credit that may be received as a refund, the presence of a related credit for children and dependents who do not meet the requirements for the CTC, and the income thresholds differ across taxable years. Taxpayers receive the credit in two parts: the portion that offsets tax liability which is generally called the CTC, and the remainder which is potentially received as an additional child tax credit (ACTC).

The American Rescue Plan Act of 2021 (ARP) expanded the CTC for taxable year 2021. Earlier expansions under the Tax Cuts and Jobs Act of 2017 (TCJA) applied in taxable years 2022 and 2023 and still apply for taxable years 2024 and 2025. In later taxable years, most elements of the child credit reflect pre-TCJA law. Specific rules for each period are described below:

CTC for taxable year 2021 (ARP was in effect)

Taxpayers could claim a CTC for up to $3,600 for each qualifying child under age 6 and up to $3,000 for all other qualifying children under age 18. The full amount of the credit was refundable, regardless of the taxpayer's Federal income tax liability or the presence of earned income.

A taxpayer could also claim a $500 nonrefundable credit for all qualifying children and other dependents for whom a CTC could not be claimed. This second credit is called the credit for other dependents (ODTC).

The first $1,600 of the CTC per qualifying child under age 6 and the first $1,000 per qualifying child age 6 through 17 phased out sequentially with modified adjusted gross income (modified AGI) in excess of $150,000 for married joint filers or surviving spouses, $112,500 for head of household filers, and $75,000 for all other filers, at a rate of $50 per $1,000 (or part thereof) of modified AGI in excess of the relevant threshold.

The remainder of the CTC, plus any amount of ODTC, was further reduced by $50 for each $1,000 (or part thereof) that exceeded $200,000 ($400,000 for married taxpayers filing a joint return) of modified AGI. Larger families followed a modified phaseout rule that extended the AGI range of the phaseout.

Taxpayers could have received up to 50 percent of their estimated total CTC (including ACTC) in advance, in a series of periodic payments. These payments were issued from July to December of 2021 and were based on information reported by taxpayers on their 2020 individual income tax return (or the 2019 return if the 2020 return was not available).

Taxpayers were allowed to opt out of advance payments of the credit. A taxpayer's Federal income tax was increased, dollar for-dollar, if their total CTC advance payments during 2021 exceeded the amount of the CTC to which they were eventually entitled. However, safe harbor rules reduced the additional income tax owed by many low- and moderate-income families, as determined solely by the taxpayer's 2021 modified AGI.

<u>CTC for taxable years 2022-2025 (TCJA in effect)</u>

For taxable years 2022 through 2025, a taxpayer may claim a CTC of up to $2,000 per qualifying child, only part of which is refundable. A taxpayer without sufficient Federal income tax liability to claim the full CTC can claim the ACTC. In 2024 the ACTC will be the lesser of (a) $1,700 per qualifying child, and (b) 15 percent of earnings in excess of $2,500, up to the amount of any unclaimed CTC.

A taxpayer may also claim a $500 ODTC for all children and other dependents for whom a CTC may not be claimed. The sum of the CTC (including any ACTC) and the ODTC is reduced by $50 for each $1,000 (or part thereof) that exceeds $200,000 of modified AGI or $400,000 of modified AGI for married taxpayers filing a joint return.

The $1,700 maximum refundable amount per qualifying child in 2024 is indexed for inflation but cannot exceed $2,000. The maximum credit amount per qualifying child, the income at which the phaseout begins, and the $2,500 earned income threshold for refundability are not indexed.

<u>CTC in taxable years after 2025 (TCJA has expired)</u>

For taxable years beginning after December 31, 2025, a taxpayer may claim a CTC of up to $1,000 per qualifying child. A taxpayer without sufficient Federal income tax liability to claim the full $1,000 credit can claim the ACTC. The ACTC will be the lesser of (a) $1,000 per qualifying child, and (b) 15 percent of earnings in excess of $3,000, up to the amount of any unclaimed CTC.

The credit will be reduced for single taxpayers with over $75,000 of modified AGI, $110,000 for married taxpayers filing a joint return, and $55,000 for married taxpayers filing separately. No parameters are indexed for inflation.

U.S. territories (permanent changes included in the ARP):

The Code provides for permanent reimbursement of mirror code Territories for the costs of this credit. Puerto Rico's child tax credit is administered by the Internal Revenue Service (IRS) directly. American Samoa has the choice of reimbursement from the IRS for its CTC or administration of the credit by the IRS, and American Samoa has chosen to be reimbursed.

Reasons for Change

Expanding the CTC and making it fully refundable will substantially reduce child poverty. The ARP achieved historic reductions in child poverty through the 2021 CTC and advance CTC payment program. Moreover, full refundability would help ensure that families that have been historically excluded from economic opportunities or experienced persistent poverty are fully included in the nation's future growth.

Offering the credit in advance would also make it more useful for families. Periodic payments with a consistent pay date allow families to rely on the income when making their plans to buy groceries, pay bills, or set money aside for a rainy day.

Determining the credit on a monthly basis and basing the rules for determining who can claim a child on who provides care for a child better accommodates the dynamics of modern families and better supports children and their caregivers. Adopting a system of presumptive eligibility will also reduce taxpayer errors and help the IRS administer the law.

Finally, setting up automatic procedures to establish eligibility at birth using information provided via the Social Security Administration's enumeration at birth program will increase take-up and help ensure all eligible families benefit from the credits for which they are eligible.

Proposal

For taxable years beginning after December 31, 2023, and ending before January 1, 2026, the proposal would:

1. Increase the maximum credit per child to $3,600 for qualifying children under age 6 and to $3,000 for all other qualifying children.

2. Phase out the portion of the credit in excess of $2,000 with income in excess of $150,000 of modified AGI for married joint filers or surviving spouses, $112,500 for head of household filers, and $75,000 for all other filers, with a modified rule for large families.

3. Increase the maximum age to qualify for the CTC from 16 to 17.

For taxable years beginning after December 31, 2023, the proposal would make the CTC fully refundable, regardless of earned income.

For taxable years beginning after December 31, 2024, the proposal would make additional changes to the CTC to implement an advance payment program so that taxpayers who wish to could receive their credit in a series of advance monthly payments during the year instead of receiving their credit as a lump sum when they file their income tax return in the following year. The Secretary will develop and implement a mechanism for advancing 100 percent of the credit in monthly installments that accommodates changes in family structure and resources over the year. These changes are described in greater detail below.

Eligibility and credit amount determined monthly, rather than annually

The proposal would reform the CTC to divide the annual tax credit described above into 12 monthly tax credits, referred to as "monthly specified child allowances." In general, a taxpayer's eligibility for, and amount of, a monthly specified child allowance would be determined on a monthly basis, rather than a taxable year basis. The total amount of CTC for a given child would equal the sum of the taxpayer's allowed monthly specified child allowances for the taxable year.

The monthly specified child allowance would be reduced by 1/12 of 5 percent of the excess of the taxpayer's modified AGI over the phase-out threshold or thresholds in effect for the taxable year. For taxable years 2024 through 2025, the first phaseout would not reduce a taxpayer's monthly specified child allowance below $166.67 per child (that is, $2,000 per child for the year). For purposes of applying the phase out, the proposal would require the use of the taxpayer's lowest modified AGI for the three taxable years ending with the taxable year that includes the month for which the monthly specified child allowance would be determined.[24]

Replacement of "qualifying child" with "specified child" standard

The proposal would replace the historical "qualifying child" eligibility standard with a new "specified child" standard solely for purposes of the child credit that would focus primarily on the source of care received by the child. A child would qualify as a "specified child" of a taxpayer only if the child (a) shared the taxpayer's principal place of abode for more than one-half of the month and (b) received uncompensated care from the taxpayer, disregarding compensation received from Federal, State, local, or Tribal governments. A taxpayer would be determined to have provided the required "care" to a child based on all facts and circumstances, including (a) supervision of the child's daily activities, (b) maintenance of a secure environment

[24] For example, for purposes of claiming any remaining credit on a tax year 2024 return (filed in 2025), the taxpayer would use the lowest modified AGI from their tax year 2022, 2023, or 2024 Federal income tax return. For purposes of determining the monthly advance child payment amount in January 2025, at which time the taxpayer has not yet filed their 2024 return, the IRS would use the modified AGI from the taxpayer's tax year 2023 Federal income tax return. Suppose the taxpayer files a 2024 return in February 2025. Then, for purposes of calculating the taxpayer's monthly advance child payment amount in March 2025, the IRS would use the lowest modified AGI from the taxpayer's tax year 2023 and 2024 returns. However, if the taxpayer subsequently reported to the IRS their expected modified AGI for 2025 – for example, through the portal described in this text – then the IRS would use the lowest of their expected modified AGI for 2025 and the modified AGI amounts from the taxpayer's tax year 2023 and 2024 Federal income tax returns to calculate the monthly payment amount for the remaining months of 2025.

for the child, (c) arrangement of medical care for the child, and (d) the involvement in, and other financial support for, the education of the child.

Under the proposal, the taxpayer first allowed to claim a child as a specified child following the child's birth would be allowed to claim the child in all months during the same calendar year prior to the child's birth. In addition, the taxpayer last allowed to claim a child as a specified child prior to the child's death would be allowed to claim the child in all months during the same calendar year after the child's death.

The proposal also would revise the historical tie-breaker rules that have addressed situations when a child is a qualifying child of multiple taxpayers, only one of whom can claim the CTC under current law, as well as other rules.

Establishment of presumptive eligibility

The proposal would establish a "presumptive eligibility" concept to determine when a taxpayer would be eligible to claim a monthly specified child allowance or receive a monthly advance child payment.

Once a taxpayer establishes presumptive eligibility with respect to a child, that child would be treated as a specified child of the taxpayer for each month during the period of the taxpayer's presumptive eligibility. Therefore, the taxpayer would be eligible to claim a monthly specified child allowance or receive a monthly advance child payment with regard to that child until the date on which the taxpayer's presumptive eligibility terminates. In addition, the proposal would prohibit that child from being treated as a specified child of any other taxpayer with respect to whom a period of presumptive eligibility has not been established.

Under the proposal, taxpayers would establish presumptive eligibility solely by filing a Federal income tax return, using an online information portal, or pursuant to any other procedures established by the Secretary. Among other requirements, the taxpayer must express a reasonable expectation and intent that the taxpayer will continue to be eligible to claim the child for the credit. The proposal also would authorize the Secretary to provide any additional requirements for taxpayers to establish presumptive eligibility.

A taxpayer's period of presumptive eligibility would begin with the month for which presumptive eligibility is established and end with the earliest of three dates. First, a taxpayer's period of presumptively eligibility would be treated as never existing if the Secretary determines that the taxpayer committed fraud or intentionally disregarded rules or regulations in establishing or maintaining presumptive eligibility. Second, a taxpayer's presumptive eligibility period would terminate in the month specified by the Secretary in a written notice provided to the taxpayer that terminated or suspended presumptive eligibility due to a question regarding eligibility. Finally, a taxpayer's presumptive eligibility period would terminate on the first month following any failure of the taxpayer to make the required annual renewal of presumptive eligibility. In such case, the Secretary would be required to provide to the taxpayer written notification of the termination as well as information on how to reestablish their presumptive eligibility.

Automatic presumptive eligibility based on information-sharing with trusted partners

The proposal would require the Secretary to issue regulations or other guidance to establish procedures by which a parent of a child born during a month would be treated as automatically establishing presumptive eligibility with respect to that child, including through information provided to the Secretary via the Social Security Administration's enumeration at birth program. The proposal also would require the Secretary to issue regulations or other guidance to establish procedures under which a taxpayer would be treated as automatically establishing presumptive eligibility with respect to a child based on information provided to the Secretary by one or more government entities, including, for example, the Social Security Administration, State Medicaid agencies, or State agencies administering the Supplemental Nutrition Assistance Program.

Automatic grace period to address certain failures to timely establish presumptive eligibility

The proposal would provide two types of automatic grace periods under which a taxpayer who failed to establish presumptive eligibility in a timely way could receive monthly specified child allowances or retroactive monthly advance child payment for prior months in which the taxpayer otherwise would have been presumptively eligible. First, in the absence of fraud or reckless disregard for any rules or regulations, a taxpayer could automatically receive a three-month grace period in the case of any failure or delay to establish presumptive eligibility with respect to a child. Such taxpayer would not be able to receive this automatic relief more frequently than once every 36-month period. Second, the proposal would authorize the Secretary to provide an extended six-month grace period in cases of domestic violence, serious illness, natural disaster, and any other hardships. No limitation in frequency would be imposed with regard to this second form of relief.

Monthly advance child payment program

The proposal would require the Secretary to establish a program for making monthly advance child payments. A "monthly advance child payment" of a taxpayer would equal 100 percent of the amount of the taxpayer's monthly specified child allowance estimated by the Secretary for the calendar month based on the taxpayer's relevant "reference month" and "reference taxable year." In determining the estimated amount of a taxpayer's monthly advance child payment, the proposal would authorize the Secretary to consider all available information with regard to the taxpayer.

The proposal also would provide safeguards to ensure that the Secretary has adequate information, as well as time to verify such information, before disbursing any monthly advance child payment. Specifically, no month or year would be treated as a "reference month" or "reference taxable year" upon which a monthly advance child payment could be made unless (a) all relevant information with respect to that month or year is available to the Secretary, and (b) the Secretary has adequate time to make estimates on the basis of such information before the beginning of such calendar month. In the case in which the Secretary has insufficient information to make a monthly advance child payment, the Secretary would not disburse a payment until after the Secretary receives and verifies sufficient information.

Form and manner of monthly advance child payments

The proposal generally would require that the Secretary disburse monthly advance child payments through electronic funds transfer to the same extent and in the same manner as if those payments were Federal payments not made under the Code. In addition, any monthly advance child payment would not be subject to reduction or offset of (a) past-due support against overpayments, (b) collection of debts owed to Federal agencies, (c) collection of past-due, legally enforceable State income tax obligation, (d) collection of unemployment compensation debts, and (e) any similar authority permitting offset. In addition, the proposal would mandate that such payments could not be reduced or offset by other assessed Federal taxes that would otherwise be subject to levy or collection.

The proposal also would provide rules for the U.S. territories to facilitate the ability of those territories to provide monthly advance child payment programs.

Establishment of online information portal

To facilitate the sharing of information between taxpayers and the IRS, the proposal would require the Secretary to establish an online information portal similar to the online portal required by the ARP. This online portal would allow a taxpayer to (a) elect to begin or cease receiving monthly advance child payments, and (b) provide information to the Secretary for determining the taxpayer's eligibility for, and amount of, monthly advance child payments. The proposal would authorize the Secretary to expand the information that could be provided through the portal and also establish "specified alternative mechanisms" to help facilitate sharing of information between the IRS and taxpayers for those who lack reasonable access to the internet and in other circumstances where the portal does not suffice.

Streamlined adjudication process to address competing claims for a specified child

The proposal would provide rules and procedures to address claims by multiple taxpayers of the same specified child. As a general rule, the proposal would require the Secretary to resolve any competing claim among multiple taxpayers in favor of the taxpayer with the most recent reference month. To address instances in which each competing taxpayer relies on the same reference month, the proposal would require the Secretary to establish streamlined procedures under which the Secretary would adjudicate those competing claims of presumptive eligibility. The streamlined adjudication procedures required by the proposal would include an expedited process for taxpayers meeting criteria specified by the Secretary and procedures for adjudicating appeals of an adverse decision. Under the proposal, the Secretary would be authorized to enter into agreements to receive information from, and otherwise coordinate with, Federal agencies; State, local, or Tribal governments; and any other individual or entity the Secretary determines to be appropriate for purposes of adjudicating such claims. The proposal also will authorize the Secretary to make retroactive payments if the Secretary determines that a child is a specified child of a taxpayer and the Secretary did not make payments to that taxpayer during any portion of the period during which the determination was made. Likewise, the Secretary would be authorized to recapture payments from taxpayers based upon a facts-and-circumstances analysis pursuant to procedures established by the Secretary.

Reconciliation and potential recapture of monthly advance child payments

The proposal would require taxpayers to compare on their Federal income tax return (a) the total amount of the monthly advance child payments received during the taxable year, with (b) the total amount of monthly specified child allowances that the taxpayer could properly claim on that return. If the aggregate amount of allowances exceeds the aggregate amount of payments received during the taxable year, the taxpayer could claim the remaining amount of CTC on their Federal income tax return. If the aggregate amount of allowances is less than the aggregate amount of payments received during the taxable year, the taxpayer may be required to repay the difference, based on the recapture rules described below.

Statutory repayment protection based on presumptive eligibility

A taxpayer who receives a monthly advance child payment for a child generally would not be required to repay that amount to the IRS if the taxpayer received that payment during a period in which the taxpayer established presumptive eligibility with respect to that child. However, a taxpayer would be required to repay any monthly advance child payment received for a child for whom the taxpayer had not established presumptive eligibility. Similarly, the proposal would require a taxpayer to repay any monthly advance child payments identified for recapture by the Secretary through written notification to the taxpayer.

The proposal also would require taxpayers to repay any excess monthly advance child payments due to understatements or changes of income and changes in filing status by the taxpayer. Specifically, recapture in these circumstances would be required even if the taxpayer had established presumptive eligibility with regard to the child to whom such excess monthly advance child payments were attributable.

In addition, if the taxpayer received monthly payments because of fraud or reckless or intentional disregard of CTC rules and regulations, the proposal would require taxpayers to repay those excess monthly advance child payments. To prevent potential abuse, the proposal also would authorize the Secretary to issue special rules to address taxpayers who have moved to another jurisdiction, as well as any other circumstances that the Secretary determines could give rise to abuse.

The changes described in the above pages to implement an advance monthly payment program would be effective for all taxable years beginning after December 31, 2024. The changes to the maximum credit amounts, phase-out thresholds, age requirements, and refundability would be effective for taxable years beginning after December 31, 2023, and, except for refundability, would expire for taxable years beginning after December 31, 2025.

RESTORE AND MAKE PERMANENT THE AMERICAN RESCUE PLAN EXPANSION OF THE EARNED INCOME TAX CREDIT FOR WORKERS WITHOUT QUALIFYING CHILDREN

Current Law

Low- and moderate-income workers may be eligible for a refundable earned income tax credit (EITC). Eligibility for the EITC is based on the presence and number of qualifying children in the worker's household, the worker's earned income, adjusted gross income (AGI), investment income, filing status, age, and immigration and work status in the United States.

The EITC has a phase-in range (where each additional dollar of earned income results in a larger credit), a plateau (where additional dollars of earned income or AGI have no effect on the size of the credit), and a phase-out range (where each additional dollar of the larger of earned income or AGI results in a smaller total credit). The phaseout begins at a higher earned income or AGI for joint filers than for other filers. The dollar thresholds and the amount by which the phaseout for joint filers exceeds that for other filers are adjusted annually for inflation. The phase-in rate and the phaseout rate vary with the number of children.

The American Rescue Plan Act of 2021 (ARP) expanded the credit for workers without children in taxable year 2021 by increasing the phase-in and phase-out rates, and increasing the income range over which the credit phases in. These changes increased the maximum credit from $542 to $1,502.

Under current law and prior to ARP, the taxpayer must be at least 25 years old and less than 65. In the case of married taxpayers filing jointly, at least one spouse must have been within the age range. The ARP decreased the minimum age at which a taxpayer could claim the credit and eliminated the maximum age at which a taxpayer could claim the credit for 2021.

The following chart shows the 2024 current law parameters for workers without children and what those parameters would have been in 2024 had ARP been extended.

EITC PARAMETERS FOR WORKERS WITHOUT CHILDREN IN 2024

EITC Parameter	2024 Current Law	2024 ARP Extended
Credit phase-in rate	7.65%	15.30%
Credit phase-out rate	7.65%	15.30%
End of phase-in range	$8,260	$11,430
End of plateau	$10,330	$13,510
(married joint filers)	$17,250	$20,430
End of phase-out range	$18,590	$24,940
(married joint filers)	$25,510	$31,860
Maximum credit	$632	$1,749
Investment income max	$11,600	$11,600

Reasons for Change

The permanent EITC for workers without children is relatively small and phases out at very low incomes. As such, it provides little or no assistance to individuals at or near the poverty line. For example, in 2024 a single worker without children who earned $15,000 (a wage close to the poverty line), would be in the phase-out range and eligible for a credit of about $275. This credit would generate a net refund of about $235 after subtracting their Federal income tax. (The taxpayer would pay over $1,100 in Federal payroll taxes.) A larger EITC for workers without children would promote employment and reduce poverty for this group of workers. It also would increase the progressivity of the Federal tax system.

The current age restrictions prevent young workers and older workers from claiming the EITC. As a result, young workers living independently from their families are unable to benefit from the anti-poverty and work-related effects of the EITC just when they are establishing the patterns of behavior that may persist throughout their working lives. The EITC, by increasing the effective after-tax wage, encourages additional work.

Proposal

The proposal would restore for taxable year 2024 and make permanent the increase in the EITC parameters for workers without children enacted in the ARP. The end of the phase-in and the end of the plateau would be indexed for inflation in the same manner as other EITC parameters (by the Chained Consumer Price Index for All Urban Consumers, or C-CPI-U). The EITC parameters that would be in place for 2024 are those presented in "2024-ARP Extended Parameters" of the table above.

The proposal would also restore for taxable year 2024 and make permanent the ARP expansion of age-eligibility. As under ARP law, taxpayers who could be claimed as a qualifying child or a dependent would not be eligible for the EITC for childless workers. Thus, full-time students who are dependents of their parents would not be allowed to claim the EITC for workers without qualifying children, despite meeting the new age requirements, even if their parents did not claim them as a dependent or qualifying child for other tax benefits.

More concretely, under the proposal, the taxpayer must be at least 19 years old or at least 24 if a full-time student. In the case of married taxpayers filing jointly, the credit may be claimed if at least one spouse is over age 19 (or at least 24 if a full-time student). Former foster children and qualified homeless individuals are eligible at 18, regardless of student status. The proposal would eliminate the maximum age at which a taxpayer may claim the credit.

The proposal would be effective for taxable years beginning after December 31, 2023.

MAKE PERMANENT THE INFLATION REDUCTION ACT EXPANSION OF HEALTH INSURANCE PREMIUM TAX CREDITS

Current Law

A premium assistance tax credit (premium tax credit or PTC) is provided to certain individuals who purchase health insurance through an exchange in the individual health insurance market established under the Affordable Care Act of 2010 (ACA). The PTC is refundable and payable in advance (as advance payments of the premium tax credit, or APTC) directly to the insurer. Eligibility for the APTC is based on an individual's expected household income and family size. APTC may be updated to reflect mid-year changes in income, marital or other household circumstances, and employment status.

Through 2025, the PTC is generally available to individuals with household income above 100 percent of the Federal poverty line (FPL) for the relevant family size. After 2025, the PTC is generally available to individuals with household income between 100 and 400 percent of the FPL. Individuals are eligible for the PTC only if they are not eligible for health care under programs such as Medicare, Medicaid, the Children's Health Insurance Program, Basic Health Program, TRICARE, or for certain types of health insurance provided through an employer.

A taxpayer's PTC is equal to the lesser of: (a) the premium for the plan chosen by the taxpayer, or (b) the amount by which the cost of the benchmark plan exceeds a required contribution by the taxpayer. The taxpayer's required contribution is a percentage of household income (the applicable contribution percentage) calculated with reference to the taxpayer's FPL.

The American Rescue Plan Act of 2021 (ARP) decreased the applicable contribution percentages and extended PTC eligibility to taxpayers with household income above 400 percent of FPL for taxable years 2021 and 2022. The Inflation Reduction Act of 2022 (IRA) extended these changes through taxable year 2025. Thus, under current law, the more generous PTC would not be available to consumers enrolling in coverage during the open enrollment period that begins on November 1, 2025. Unlike prior law, which had a sharp household income limitation on eligibility for the credit, the PTC under ARP and IRA phases out with income as the required contribution eventually exceeds the benchmark premium. By fixing the parameters for five years, the ARP and IRA paused the pre-ARP indexation of the applicable contribution percentage.

Applicable contribution percentages for the PTC under ARP/IRA and under prior law are shown in the following table.

APPLICABLE CONTRIBUTION PERCENTAGES FOR PREMIUM TAX CREDIT[1]

Percent of FPL	ARP/IRA	Pre-ARP[2]
Up to 133%	0%	2%
133% up to 150%	0%	3%-4%
150% up to 200%	0%-2%	4%-6.3%
200% up to 250%	2%-4%	6.3%-8.05%
250% up to 300%	4%-6%	8.05%-9.5%
300% up to 400%	6%-8.5%	9.5%
400%+	8.5%	not eligible

[1] Required contributions increase incrementally between income breaks.
[2] Pre-ARP applicable contribution percentages are indexed beginning in 2015.

Reasons for Change

Even with the ACA's changes to the individual market, health coverage can still be expensive for some families and out of reach for others. Making permanent the ARP and IRA's expansion of the PTC will reduce individuals' cost of individual market coverage by increasing the amount and availability of premium tax credits for a wide range of income levels.

Proposal

The proposal would make permanent the ARP and IRA decrease in the applicable contribution percentages of household income used for determining the PTC. The proposal would also make permanent the ARP and IRA expansion of PTC eligibility to taxpayers with household income above 400 percent of FPL.

In addition, the proposal would permanently repeal the indexation of the applicable contribution percentages.

The proposal would be effective for taxable years beginning after December 31, 2025.

MAKE THE ADOPTION TAX CREDIT REFUNDABLE AND ALLOW CERTAIN GUARDIANSHIP ARRANGEMENTS TO QUALIFY

Current Law

Two tax benefits are provided to taxpayers who adopt children: (a) a nonrefundable 100 percent tax credit for a limited amount of qualified expenses incurred in the adoption of a child; and (b) an exclusion from gross income of a limited amount of qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. For taxable year 2024 the separate limits on qualified adoption expenses for the credit and the exclusion are $16,810. Taxpayers may use both adoption tax benefits, but the same expenses cannot be used for both benefits. Taxpayers may claim the credit for domestic and foreign adoptions, although the rules differ.

For domestic adoptions, qualifying expenses paid prior to the year in which the adoption is finalized are allowable as a credit in the year following the year of payment (even if the adoption is never finalized); however, qualifying expenses paid in the year in which the adoption is finalized (or later) are allowable as a credit in the year of payment. For foreign adoptions, the credit may be claimed only in the year the adoption becomes final (or, if later, in the year the qualified expense is paid).

Taxpayers who adopt children with special needs may claim the full $16,810 credit even if total adoption expenses are less than that amount, although credits in excess of actual expenses may only be claimed for the year the adoption is finalized.

In 2024, if modified adjusted gross income (AGI) exceeds $252,150, both the credit amount and the amount excluded from gross income are reduced pro rata over the next $40,000 of modified AGI. The maximum credit, the maximum exclusion, and the income at which the phaseout range begins are indexed annually for inflation. The credit and exclusion amounts are per adoption; benefits for a given adoption may be claimed over several years.

Taxpayers may carry forward credit amounts they are unable to use because they have insufficient tax liability for up to five years.

Reasons for Change

Tax benefits for adoption lower the cost of adoptions. Because adoption credits are currently non-refundable, low- and moderate-income families are unlikely to have sufficient tax liability to benefit from the full amount of the credit to which they are otherwise entitled. Refundability would help low- and moderate-income families afford adoption expenses, potentially making adoption more attainable for these families and ensure that this credit is available to all taxpayers, regardless of tax liability. Because the adoption process, and therefore the expenses, may extend over several years, it is important that the change to make the adoption credit refundable be made permanent.

There are circumstances where a family might choose to claim legal and financial responsibility for a child via guardianship instead of adoption. Expanding the credit to include families bonded by legal guardianship rather than adoption promotes the goal of creating stability for vulnerable children and provides assistance to the families caring for them.

Proposal

The proposal would make the adoption credit fully refundable. Thus, taxpayers could claim the full amount of any eligible credit in the year that the expense was first eligible regardless of tax liability.

In addition, taxpayers with unused carryforward amounts from eligible expenses from earlier adoptions would be able to claim the full amount of any unused carryforward on their 2025 tax return. However, unused carryforward amounts that expired before 2025 (pursuant to the 5-year limit under current law) would not be eligible to be claimed.

The proposal would also allow families who enter into a guardianship arrangement with a child that meets the requirements below to claim a refundable credit for the expenses related to establishing the guardianship relationship in the year such requirements are satisfied. Unless otherwise specified, eligible expenses and the timing of claims for guardianships would follow existing rules for domestic adoptions.[25] The extra benefit for special needs adoptions would not be extended to include cases of guardianships.

A guardianship arrangement would be eligible for the credit if four requirements were met: (a) the relationship must be established by court order, (b) the relationship must not be with one's own child or stepchild (as is the case with the adoption credit), (c) the guardian and the child must meet a residency requirement, and (d) the child must be under 18 at the time the relationship was established.

In cases where the child was later adopted by the same individual (or individuals on a joint return), allowable expenses for the adoption credit by this individual (or individuals) would be decreased by the amount already claimed.

The Secretary would be granted regulatory authority to develop rules and reporting requirements to ensure that eligibility, relationships, and expenses are well defined and verifiable and to establish cooperation procedures with relevant State and local agencies and courts.

The proposal would be effective for taxable years beginning after December 31, 2024.

---

[25] As with adoption, qualified expenses would include court and attorney fees, travel, and other expenses directly related to and for the principal purpose of establishing guardianship of the child. Taxpayers generally claim a credit for domestic adoption expenses in the taxable year after the expense was paid or incurred, except in the year the adoption is finalized (expenses paid or incurred in the year the adoption is finalized can be claimed as a credit in such year).

MAKE PERMANENT THE INCOME EXCLUSION FOR FORGIVEN STUDENT DEBT

Current Law

Loan amounts that are forgiven or otherwise discharged are considered gross income to the borrower and subject to individual income tax in the year of discharge, unless otherwise provided. Exceptions are provided in the Internal Revenue Code for some, but not all, education debt. The American Rescue Plan Act of 2021 (ARP) provides an exception to the treatment of forgiven loan amounts as gross income for certain qualifying student debt that is discharged after December 31, 2020, and before January 1, 2026.

During the period of the exception, forgiven student loans will be excluded from gross income and thus not subject to taxation. A qualified student loan is a loan that was taken out for the express purpose of funding post-secondary education expenses, subject to specific rules that vary with the characteristics of the originator or insurer of the loan. The tax exclusion is extended to apply to forgiven amounts for both private and public student loans and includes loan amounts borrowed for the education of one's children (e.g., Parent PLUS loans).

Reasons for Change

Permanently extending the ARP's tax treatment of student loan debt forgiven by the lender will encourage lower income borrowers to enroll in income-driven repayment (IDR) plans, remove barriers for colleges and universities seeking to provide relief on debts owed to them by students, and provide relief to Federal borrowers resulting from legal causes of action. This provision of the ARP conforms the tax treatment of most student loan forgiven debt, including balances under IDR plans, which were taxable in absence of this provision, non-Federal loans (including private education loans), which were taxable in most cases, and the tax treatment of Federal student loans cancelled due to (a) meeting certain work requirements, (b) death or permanent and total disability, or (c) receipt of certain student loan repayment assistance. Conformity eliminates the need for future legislative changes to accommodate specific loan programs that support future policy goals.

Proposal

The proposal would make permanent the ARP exclusion of certain student loan amounts forgiven by the lender from gross income.

The proposal would be effective for taxable years beginning after December 31, 2025.

EXTEND TAX-PREFERRED TREATMENT TO CERTAIN FEDERAL AND TRIBAL SCHOLARSHIP AND EDUCATION LOAN PROGRAMS

Current Law

Treatment of scholarship income

Gross income generally does not include certain scholarship amounts that are used to pay tuition, required fees, and related expenses (e.g., books, certain computing equipment, fees, and supplies). Scholarship amounts for other expenses, including childcare and travel not incidental to the scholarship, are included in ordinary income. If the scholarship represents payment for teaching, research, or other services required as a condition for receiving the scholarship, including a future work obligation, the scholarship is considered ordinary income (i.e., wage income) and is thus taxable for Federal income tax purposes. These scholarships are generally considered wages taxable for Federal payroll tax purposes as well. However, a separate provision that exempts from payroll taxation the student's earnings from their educational institution may limit payroll tax liability for many, but not all, students whose scholarships have teaching, research, or work requirements.

An exception to the work rule described in the first paragraph exists for recipients of National Health Service Corp (NHSC) scholarships, who provide care to underserved populations, and recipients of awards from certain other scholarship programs. The NHSC is a Health Resources and Service Administration (HRSA) program.

Treatment of education loans repaid on another's behalf

Loan amounts repaid on another's behalf are considered ordinary income and are taxable unless excepted through a provision of the Code. Excepted amounts are excluded from income for income and payroll tax purposes. Exceptions include debt repaid under the NHSC Loan Repayment Program, certain State programs intended to increase the availability of health care services in underserved areas, certain work-related loan forgiveness programs, and (through 2025) loan payments made by an employer through a cafeteria plan up to $5,250 per year.

Support for underserved communities

HRSA programs described in the Public Health Services Act (PHSA) provide scholarships and loan repayment assistance in exchange for a commitment to work with underserved populations upon graduation or to train medical personnel in shortage areas related to underserved populations. Their programs include the following: the NHSC Scholarship Program, the Nurse Corps Scholarship Program, the Native Hawaiian Health Scholarship Program, the Nurse Corps Loan Repayment Program, the Substance Use Disorder Treatment and Recovery Loan Repayment Program, the Faculty Loan Repayment Program, and the new Child and Adolescent

Mental Health Pediatric Subspecialty Loan Repayment Program.[26] Only the NHSC Scholarship Program and the NHSC Loan Repayment Program receive preferred Federal tax treatment.

The Indian Health Service (IHS) Scholarship Program and the IHS Loan Repayment Program described in sections 108 and 104 of the Indian Health Care Improvement Act (Public Law 94-437) provide scholarships and loan repayment assistance in exchange for a commitment to work in IHS facilities. These IHS programs do not receive preferred tax treatment.

Segal AmeriCorps Education Awards (Segal Awards) described in subsection D of the National and Community Service Act of 1990 provide assistance with education expenses or student loan repayment upon completion of a term of service with AmeriCorps or other participating service-oriented programs (e.g., Teach For America alumni are eligible for Segal Awards). Segal Awards do not receive preferred tax treatment. In certain limited cases, the grants are transferable.

Reasons for Change

The proposal would provide HRSA loan repayment and scholarship programs and the parallel programs at the IHS with the Federal tax treatment enjoyed by participants in the NHSC programs. These programs serve similar purposes and should be treated similarly for tax purposes. In fact, participants from the different programs may work alongside each other.

The IHS Health Professions Scholarship and IHS Loan Repayment Program are similar to the programs receiving exceptions under current Federal tax law and/or the proposal and should be treated similarly for tax purposes. This change would provide the same treatment to Tribal governments that is provided to State governments offering similar programs.

Segal Awards can be used strictly for education purposes – either for current expenses or loan repayment. As such, they are similar to other scholarship and loan repayment programs receiving exceptions under current Federal tax law and should be treated similarly for tax purposes.

Proposal

The proposal would extend tax preferred treatment for scholarship and loan repayment programs to certain Federal programs dedicated to improving access to medical care for underserved populations. It would do so by adding these programs to the exceptions listed in sections 117(c)(2) (scholarships) and 108(f)(4) (loans), which are provided preferential tax treatment even though they involve a (future) work obligation. The programs that would be added are:

1. Loan Repayment Programs administered by the HRSA as described in the PHSA: the Nurse Corps Loan Repayment Program, the Substance Use Disorder Treatment and Recovery Loan Repayment Program, the Faculty Loan Repayment Program, and the new Child and Adolescent Mental Health Pediatric Subspecialty Loan Repayment Program.

[26] Scholarship and loan forgiveness programs administered by the HRSA that provide care to underserved communities are described here: https://bhw.hrsa.gov/funding. The Child and Adolescent Mental Health Pediatric Subspecialty Loan Repayment program is new.

2. Scholarship Programs administered by the HRSA as described in the PHSA: the Nurse Corps Scholarship Program and the Native Hawaiian Health Scholarship Program.

3. The Indian Health Service (IHS) Scholarship Program and the IHS Loan Repayment Program described in sections 108 and 104 of the Indian Health Care Improvement Act.

In addition, Segal AmeriCorps Education Awards used for current education expenses would be treated like scholarships even though the awards represent payment for services. Awards used to repay student loans would be excluded from income. Transferred awards would also be excluded.

The proposal would be effective for taxable years beginning after December 31, 2024.

INCREASE THE EMPLOYER-PROVIDED CHILDCARE TAX CREDIT FOR BUSINESSES

Current Law

Employers who provide childcare facilities or contract with an outside facility for the provision of care may claim a nonrefundable credit equal to the sum of 25 percent of qualified care expenses and 10 percent of referral expenses, up to a maximum total credit of $150,000 per year. A qualified facility may include an in-home facility that serves as the principal residence of the operator of the facility. Qualified expenses include the acquisition, construction, rehabilitation or expansion of qualifying properties, operating costs, or contracting with a qualified childcare facility to provide services for the taxpayer's employees.[27]

Reasons for Change

Increased tax credits available to businesses would subsidize the cost and encourage the provision of childcare for employees. On-site childcare is valued by parents, and may generate important benefits such as lower absenteeism, higher employee performance, higher employee retention, and higher employee satisfaction. Clarifying that joint ventures are eligible for the credit would further increase available childcare options.

Proposal

The proposal would retain the structure of the credit under current law. The total credit amount would be the sum of the portion related to qualified care expenses and the portion related to referral expenses subject to an overall cap on the two portions combined.

The proposal would increase the portion of the credit related to qualified care expenses to be 50 percent of the first $1 million of qualified care expenses. For small businesses with gross receipts less than or equal to $25 million (inflation adjusted) for the 5-year period preceding the taxable year, this portion of the credit would be 60 percent of the first $1 million of qualified care expenses. The portion of the credit related to referral expenses would be 10 percent of the first $1.5 million of referral expenses. The credit would be limited to $600,000 for employers meeting the receipts threshold above and $500,000 for all other employers.

In addition, under the proposal, a taxpayer may contract with another party or form a joint venture to incur qualified childcare expenditures or qualified childcare resource and referral expenditures. The taxpayer – and not the contractor, joint venture, or other parties to the joint venture – would be treated as the employer for purposes of the requirements of the credit.

---

[27] Qualified childcare expenditures do not include the amounts paid or incurred to acquire, construct, rehabilitate, or expand property that constitutes the principal residence of the taxpayer or an employee of the taxpayer.

Under the proposal, a taxpayer would be required to provide the taxpayer identification number for any qualified childcare facility with which they contract to provide childcare services and any provider of childcare resource and referral services (for which they claim the credit).

The proposal would be effective for taxable years beginning after December 31, 2024.

IMPROVE THE DESIGN OF THE WORK OPPORTUNITY TAX CREDIT TO PROMOTE LONGER-TERM EMPLOYMENT

Current Law

The work opportunity tax credit (WOTC) is available for employers hiring individuals from one or more of 10 targeted groups and is generally equal to 40 percent of qualified wages paid during the first year of employment (i.e., first-year wages). The WOTC does not apply to wages paid to individuals who work fewer than 120 hours in the first year of service. The WOTC rate is reduced to 25 percent if the individual works at least 120 hours, but less than 400 hours.

Individuals must be certified by a designated local agency as a member of a targeted group. Current WOTC targeted groups include the following: (a) recipients of Temporary Assistance for Needy Families; (b) veterans; (c) people recently convicted of, or released from incarceration for, a felony, (d) residents of an empowerment zone or a rural renewal community who are at least 18 but not yet 40 years old; (e) referrals from State-sponsored vocational rehabilitation programs for the mentally and physically disabled; (f) summer youth employees who are 16 or 17 years old residing in an empowerment zone; (g) Supplemental Nutrition Assistance Program benefits recipients at least 18 years old but not yet 40 years old; (h) Supplemental Security Income recipients; and (i) long-term family assistance recipients, and (j) long-term unemployment recipients.

Qualified first-year wages are capped at the first $3,000 for summer youth employees, $10,000 for long-term family assistance recipients, $12,000 for disabled veterans hired within one year of being discharged or released from active duty, $14,000 for long-term unemployed veterans, $24,000 for long-term unemployed veterans who are also disabled, and $6,000 for all other categories of targeted individuals. In addition, the first $10,000 of qualified second-year wages paid to long-term family assistance recipients is eligible for a 50 percent credit. A disabled veteran is a veteran entitled to compensation for a service-connected disability.

The WOTC does not apply to an individual who begins work after December 31, 2025.

Reasons for Change

The allowance of the 25 percent credit for employees who work between 120 and 400 hours may encourage the hiring of temporary employees, contrary to the goal of WOTC of providing long-term employment opportunities to members of targeted groups.

Proposal

The proposal would increase the minimum number of hours worked by an individual in the first year of service to become eligible for the WOTC from 120 to 400.

The proposal would be effective for individuals hired after December 31, 2024.

PROVIDE TAX CREDITS FOR CERTAIN FIRST-TIME HOMEBUYERS AND HOME SELLERS

Current Law

Federal law supports homeownership in many direct and indirect ways. For example:

1. For those who itemize, mortgage interest on owner-occupied homes can reduce taxable income.

2. For those who itemize, up to $10,000 of State and local tax, including property tax, can reduce taxable income.

3. The first $250,000 of capital gains from the sale of the taxpayer's principal residence is excluded from income. (The exclusion is $500,000 for married couples filing jointly.)

4. There is generally a penalty for early distributions from qualified retirement accounts, but there is no penalty for early distributions if they are used by a first-time homebuyer to make a down payment on a home.

5. As private companies established by the Federal Government, the Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") buy mortgage loans and package them into mortgage-backed securities, which gives front-line mortgage lenders access to vast supplies of capital for originating additional loans.

There is currently no tax credit to support home purchases by first-time homebuyers, though such credits have existed in the past.

In general, real estate transactions must be reported to the Internal Revenue Service (IRS). Sales of principal residences are generally exempt from this reporting requirement if the sales price is $250,000 or less ($500,000 or less for joint filers) and the full amount of the gain on such sale is excludable from gross income under section 121 of the Internal Revenue Code (Code).

Reasons for Change

Increased interest rates following the pandemic have made it more difficult to become a homeowner for the first time, partially because current homeowners are more reluctant to sell a home on which they have a low-interest mortgage.

Proposal

The proposal would provide two refundable tax credits: a refundable credit for qualified first-time homebuyers and a refundable credit for qualified home sellers.

Homebuyer credit

The first-time homebuyer credit would be equal to ten percent of the purchase price of a home, up to a maximum credit of $10,000. For multiple individuals who purchase a home together, the maximum credit would be allocated proportionally to ownership interest in the purchased home or in a manner determined by the Secretary in published guidance. The credit allocated to a married individual filing a separate return would not exceed $5,000. The home must be in the United States.

Under the proposal, a first-time homebuyer would be a natural person[28] who:

1. Purchases a home as a principal residence from an unrelated party; and

2. Had no ownership interest in any other principal residence during the tax year in which the purchase was made or during the prior three tax years.

The credit would phase out with income, beginning at a modified adjusted gross income (AGI) of $100,000 and ending at a modified AGI of $200,000. In the case of a married individual filing a separate return, the credit would phase out between $50,000 and $100,000. For the purpose of this credit, modified AGI would be equal to adjusted gross income, minus distributions from qualified retirement accounts that were penalty free because they were taken to make a down payment, plus any amount excluded from gross income under Section 911, 931, or 933 of the Code. If there are multiple purchasers and the credit allocated to one or more of them is subject to this phase out, then the phased-out amount would not be reallocated to any of the other purchasers.

Half of a purchaser's credit would be applied to the return for the tax year in which the home was purchased, and the other half of the credit would be applied to the return for the following tax year.

Under the proposal, a taxpayer must meet the following conditions to qualify for the credit. If multiple individuals purchase a home together, then all the taxpayers must meet the following conditions for any of the taxpayers to qualify for the credit:

1. The taxpayer is a first-time homebuyer.

2. The taxpayer attained age 18 on or before the date of purchase, or the taxpayer purchased the home jointly with a spouse who attained age 18 on or before the date of purchase.

3. The taxpayer was a U.S. citizen or legal permanent resident (green card holder) on the date of purchase, or in the case of a joint return, the couple has elected to treat a nonresident spouse as a permanent resident for tax purposes under section 6013(g) of the Code.

[28] The natural person (and not a disregarded entity whose transactions and assets are attributed to the person for Federal income tax purposes) must be the purchaser of the home under local real estate law.

4. The taxpayer cannot be claimed as a dependent by another taxpayer.

To claim the credit, a taxpayer must (a) begin using the home as a principal residence no later than 120 days following the purchase, (b) own the home and be using the home as a principal residence on the date on which they file that year's Federal income tax return, and (c) to facilitate the IRS's administration and enforcement of the credit, provide to the IRS on a tax return information from the settlement statement used to complete the home purchase and retain a copy of the settlement statement (and be required to produce the settlement statement upon request).

In general, the taxpayer must continue to use the credited home as a principal residence during the three years following the date of purchase. If, during those three years, the taxpayer disposes of the home or ceases to use it as a principal residence (recapture events), then there is a recapture of the entire previously claimed credit (the recapture amount). That is, for the taxable year of disposition or cessation of residence, the taxpayer's tax liability is increased by the full amount of this credit in all prior taxable years, regardless of when during the three years the disposition or cessation occurs. During those three years, transfer of the credited home is subject to information reporting, regardless of any exception that might otherwise have applied.

The taxpayer's tax liability, however, is not increased (that is, there is no recapture) in certain cases where the taxpayer purchases some other home and starts using it as a principal residence. To avoid recapture, the following conditions must be met: (a) the taxpayer purchases some other home within 120 days of the recapture event, (b) the taxpayer begins using that other home as the taxpayer's principal residence on a date that is both no later than 120 days after it is purchased and no later than 180 days after the recapture event, and (c) the taxpayer includes on a timely filed tax return (including extensions) information from the settlement statement for the purchase of the other home. (The settlement statement must be retained with the taxpayer's books and records for the year of the recapture event.) If there is no recapture because some other home is purchased and all of the above conditions are satisfied, then that other home is subsequently treated like the credited home for purposes of information reporting and for determining whether a recapture event has occurred and whether tax liability must be increased by the recapture amount. A recapture event with respect to the other home does not result in recapture if it occurs three years or more after the purchase of the credited home.

The tax credit would be available for home purchases after December 31, 2023, and before January 1, 2026.

Home seller credit

The home seller credit would be equal to ten percent of the sales price of a home, up to a maximum credit of $10,000. For multiple individuals who sell a home together, the maximum credit would be allocated proportionally to ownership interest in the sold home or in a manner determined by the Secretary in published guidance. The credit allocated to a married individual filing a separate return would not exceed $5,000. The home must be in the United States.

A home seller is a natural person who:

1. Sells a home to an unrelated party; and

2. Had an ownership interest in the home during the tax year in which the sale was made and during the prior tax year.

The credit would phase out with income, beginning at a modified AGI of $100,000 and ending at a modified AGI of $200,000. In the case of a married individual filing a separate return, the credit would phase out between $50,000 and $100,000. For the purpose of this credit, modified AGI would be equal to adjusted gross income, minus capital gains that were realized as a result of the sale of the home to the extent they are included in AGI, plus any amount excluded from gross income under Section 911, 931, or 933. If there are multiple sellers and the credit allocated to one or more of them is subject to this phase out, then the phased-out amount would not be reallocated to any of the other sellers.

The credit would also phase out with the sales price of the sold home, beginning at a sales price of 80 percent of the area median price and ending at a sales price of 100 percent of the area median price. The area median price would be defined as the median home value within the county of the sold home as reported by the Census Bureau in the 1-year estimates from the American Community Survey. The area median price would be determined annually based on data available as of October 1 of the previous calendar year.

The seller credit would apply to the return for the taxable year in which the home was sold.

Under the proposal, a taxpayer must meet all of the following conditions to qualify for the credit. If multiple individuals sell a home together, then all of the taxpayers must meet the following conditions for any of the taxpayers to qualify for the credit:

1. The taxpayer is a home seller.

2. The taxpayer attained age 18 on or before the date of sale, or the taxpayer sold the home jointly with a spouse who attained age 18 on or before the date of sale.

3. The taxpayer was a U.S. citizen or legal permanent resident (green card holder) on the date of sale, or in the case of a joint return, the couple has elected to treat a nonresident spouse as a permanent resident for tax purposes under section 6013(g).

4. The taxpayer cannot be claimed as a dependent by another taxpayer.

In addition, for a sale to qualify for the credit, the buyer(s) must be a natural person or person(s) and must attest that they intend to own the home and use it as a primary residence for at least one year.

To claim the credit, a taxpayer must (a) provide to the IRS on a tax return information from the settlement statement used to complete the home sale for the purpose of facilitating administration and enforcement and retain a copy of the settlement statement, (b) attest that they did not invoke the exception to information reporting for certain home sales, and (c) attest that they obtained an attestation from the buyer that they intend to own the home and use it as a primary residence for at least one year and retain a copy of the attestation. The exemption for information reporting on certain home sales would not apply to sales for which the seller intends to claim the credit.

The tax credit would be available for homes sold after December 31, 2023, and before January 1, 2025.

MODIFY ESTATE AND GIFT TAXATION

IMPROVE TAX ADMINISTRATION FOR TRUSTS AND DECEDENTS' ESTATES

Current Law

Definition of executor

Section 2203 of the Internal Revenue Code (Code) defines "executor" for purposes of the estate tax as the person appointed, qualified, and acting within the United States as executor or administrator of the decedent's estate or, if none, then "any person in actual or constructive possession of any property of the decedent" who is considered a "statutory" executor. A "statutory" executor is a person who is not appointed by a court but has an obligation to file an estate tax return because they possess assets of the decedent. A statutory executor could include, for example, the trustee of the decedent's revocable trust, a beneficiary of an individual retirement account (IRA) or life insurance policy, or a surviving joint tenant of jointly owned property.

Limit on the reduction in value of special use property

Generally, the fair market value of real property for estate tax purposes is based on the property's value at its "highest and best use." For example, an undeveloped parcel of land might be valued as property that could be developed for residential or commercial purposes. However, the estates of owners of certain real property used in a family-owned trade or business may reduce the value of that property for Federal estate tax purposes below its highest and best use value to help preserve its current use. The maximum reduction in value is limited to $750,000, as adjusted for inflation since 1997; in 2024, the reduction in value is capped at $1.39 million.

Duration of certain estate and gift tax liens

Current law provides an automatic lien on all gifts made by a donor and generally on all property in a decedent's estate to enforce the collection of gift and estate tax liabilities from the donor or the decedent's estate, as applicable. The lien remains in effect for 10 years from the date of the gift for gift tax, or the date of the decedent's death for estate tax, unless the tax is paid in full sooner.

Reporting of estimated total value of trust assets and other information about the trust

Although most domestic trusts are required to file an annual income tax return, there is no requirement to report the nature or value of their assets. As a result, the IRS has no statistical data on the nature or magnitude of wealth held in domestic trusts. Other agencies collect data on the amount of wealth held in some types of domestic trusts, but this data is not comprehensive. In contrast, private foundations are required to report both the basis and fair market value of their assets on their annual tax return. While some of that asset information is required to compute the foundation's tax liability and distribution requirements, that information also provides statistical data useful to the IRS for various tax administration purposes and policy development.

Use of defined value formula clauses to determine bequests or gifts

Taxpayers often want to make gifts, bequests, or disclaimers in an amount that achieves a particular tax result. For example, a taxpayer may wish to avoid triggering gift tax liability by limiting the gift to that amount of property equal to the donor's remaining gift tax exclusion amount.[29] The mechanism used for such transfers is sometimes referred to a "defined value formula clause." That clause purports to define the gift by a value determined by a formula. Often, the formula determines the value by reference to the results of IRS enforcement activities.[30]

Exclusion from the gift tax for annual gifts

The first $18,000 of gifts made to each donee in 2024 are excluded from the donor's taxable gifts (and therefore do not use up any of the donor's lifetime exclusion from gift and estate taxes). This annual gift tax exclusion is indexed for inflation and there is no limit on the number of donees to whom such gifts may be made by a donor in any one year. To qualify for this exclusion, each gift must be of a present interest rather than a future interest in the donated property. A present interest is an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (including life estates and term interests). Generally, a contribution to a trust for the donee is a future interest.

Reasons for Change

Definition of executor

Because the statutory definition of executor applies only for estate tax purposes, a statutory executor (including a surviving spouse who filed a joint income tax return) has no authority to represent the decedent or the estate with regard to the decedent's final income tax liabilities, failures to report foreign assets, or other tax liabilities and obligations that arose before the decedent's death. Similarly, no one has the authority to extend a limitations statute, claim a refund, agree to a compromise or assessment, or pursue judicial relief with regard to a tax liability of the decedent. Because reporting obligations (particularly regarding interests in foreign assets or accounts) have increased, problems associated with this absence of any representative authority are arising more frequently. Additionally, in the absence of an appointed executor, multiple persons may meet the definition of executor and, on occasion, multiple persons have filed separate estate tax returns for the decedent's estate or have made conflicting tax elections.

---

[29] Another common example is defining the bequest that will qualify for the marital deduction as the minimum amount needed to reduce the decedent's estate tax liability to zero.

[30] An example of such a formula is the following: "I give my interest in [entity] as follows: to my children, that number of units having a fair market value as of [date of gift], as finally determined for Federal transfer tax purposes, of [specified amount] dollars; and to [another person, such as a charity], my remaining number of units after satisfying the gifts to my children." Generally, the units remaining after the defined gift are retained by the owner or are given to another person or entity (often a charity or marital trust) whose receipt would not give rise to a gift tax liability.

Limit on the reduction in value of special use property

The inflation adjustments since 1997 have not kept up with the increases in the value of real property over that same period, causing this special use valuation provision to be of diminishing benefit to decedents' estates.

Duration of certain estate and gift tax liens

Currently, this 10-year lien cannot be extended, including in cases where the taxpayer enters into an agreement with the IRS to defer tax payments or to pay taxes in installments that extend beyond 10 years. Thus, for unpaid amounts due to be paid after the 10-year period, this special lien has no effect.

Reporting of estimated total value of trust assets and other information about the trust

Because of the lack of statistical data on the nature and value of assets held in trusts in the United States, it is difficult to develop the administrative and legal structures capable of effectively implementing appropriate tax policies and evaluating compliance with applicable statutes and regulations. This lack of this data further hampers efforts to design tax policies intended to increase the equity and progressivity of the tax system.

Use of defined value formula clauses to determine bequests or gifts

The increasing popularity and use of defined value formula clauses poses a significant challenge to the administration of the gift and income taxes by potentially (a) allowing a donor to escape the gift tax consequences of undervaluing transferred property, (b) making examination of the gift tax return and litigation by the IRS cost-ineffective, and (c) requiring the reallocation of transferred property among donees long after the date of the gift. Further, defined value formula clauses that depend on the value of an asset as finally determined for Federal transfer tax purposes create a situation where the respective property rights of the various donees are being determined in a tax valuation process in which those donees have no ability to participate or intervene.

Exclusion from the gift tax for annual gifts

Because the annual per-donee gift tax exclusion is available only for gifts of a present interest, taxpayers making a gift in trust usually give the trust beneficiary a limited right to withdraw the trust contribution (a "*Crummey* power").[31] Generally, a *Crummey* power makes the gift in trust a present interest gift if timely notice of the existence of the power is given to the donee. However, the cost to taxpayers of complying with the notice and record maintenance requirements associated with *Crummey* powers is significant, as is the cost to the IRS of administering these rules. Further, because *Crummey* powers can be granted to an unlimited number of beneficiaries, these powers can be given to multiple discretionary beneficiaries, most of whom are never

[31] *Crummey* powers are widely used, particularly in life insurance trusts and in irrevocable trusts to hold property for the benefit of minor children.

intended to receive a distribution from the trust, for the primary (if not exclusive) purpose of shielding a larger trust contribution from gift tax.

Proposal

Expand definition of executor

The proposal would move the existing definition of executor from section 2203 to section 7701 of the Code, expressly making it applicable for all tax purposes, and would authorize such an executor to do anything on behalf of the decedent in connection with the decedent's pre-death tax liabilities or other tax obligations that the decedent could have done if still living. Because this definition frequently results in multiple parties being an executor, the proposal also would grant regulatory authority to the Secretary to adopt rules to resolve conflicts among multiple executors authorized by that provision.

The proposal would apply upon enactment, regardless of a decedent's date of death.

Increase the limit on the reduction in value of special use property

The proposal would increase the cap on the maximum valuation decrease for "qualified real property" elected to be treated as special use property to $14 million. Such property generally would include the real estate used in family farms, ranches, timberland, and similar enterprises.

The proposal would apply to the estates of decedents dying on or after the date of enactment.

Extend 10-year duration for certain estate and gift tax liens

The proposal would extend the duration of the automatic lien beyond the current 10-year period to continue during any deferral or installment period for unpaid estate and gift taxes.

The proposal would apply to 10-year liens already in effect on the date of enactment, as well as to the automatic lien on gifts made and the estates of decedents dying on or after the date of enactment.

Require reporting of estimated total value of trust assets and other information about the trust

The proposal would require certain trusts administered in the United States, whether domestic or foreign (other than a trust subject to the reporting requirements of section 6048(b) of the Code), to report certain information to the IRS on an annual basis to facilitate the appropriate analysis of tax data, the development of appropriate tax policies, and the administration of the tax system. That reporting could be done on the annual income tax return or otherwise, as determined by the Secretary, and would include the name, address, and TIN of each trustee and grantor of the trust, and general information with regard to the nature and estimated total value of the trust's assets as the Secretary may prescribe. Such reporting on asset information might be satisfied by identifying an applicable range of estimated total value on the trust's income tax return. This reporting requirement for a taxable year would apply to each trust whose estimated total value on the last day of the taxable year exceeds $300,000 (indexed for inflation after 2025) or whose gross income for the taxable year exceeds $10,000 (indexed for inflation after 2025).

In addition, each trust (regardless of value or income) would be required to report on its annual income tax return the inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year. This additional information will provide the IRS and taxpayers with current information necessary to verify the GST effect of any trust contribution or distribution without requiring either party to go back through multiple prior years' records to determine that information.

The proposal would apply for taxable years ending after the date of enactment.

Require that a defined value formula clause be based on a variable that does not require IRS involvement

The proposal would provide that, if a gift or bequest uses a defined value formula clause that determines value based on the result of involvement of the IRS, then the value of such gift or bequest will be deemed to be the value as reported on the corresponding gift or estate tax return. However, a defined value formula clause would be effective if (a) the unknown value is determinable by something identifiable other than activity of the IRS, such as an appraisal that occurs within a reasonably short period of time after the date of the transfer (even if after the due date of the return) or (b) the defined value formula clause is used for the purpose of defining a marital or exemption equivalent bequest at death based on the decedent's remaining transfer tax exclusion amount.

The proposal would apply to transfers by gift or on death occurring after December 31, 2024.

Simplify the exclusion from the gift tax for annual gifts

The proposal would eliminate the present interest requirement for gifts that qualify for the gift tax annual exclusion. Instead, the proposal would define a new category of transfers (without regard to the existence of any withdrawal or put rights) and would impose an annual limit of $50,000 per donor, indexed for inflation after 2025, on the donor's transfers of property within this new category that would qualify for the gift tax annual exclusion. This new $50,000 limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. Thus, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $18,000. The new category would include transfers in trust (other than to a trust described in section 2642(c)(2)), transfers of interests in pass-through entities, transfers of interests subject to a prohibition on sale, partial interests in property, and other transfers of property that, without regard to withdrawal, put, or other such rights in the donee, cannot immediately be liquidated by the donee.

The proposal would be effective for gifts made after December 31, 2024.

LIMIT DURATION OF GENERATION-SKIPPING TRANSFER TAX EXEMPTION

Current Law

The generation-skipping transfer (GST) tax is imposed on gifts and bequests by an individual transferor to transferees who are two or more generations younger than the transferor. Each individual has a lifetime GST tax exemption ($13.61 million in 2024) that can be allocated to transfers made by that individual to a grandchild or other "skip person," whether directly or in trust. Allocating GST exemption does not directly exempt any assets or portion of a trust from tax. Rather, allocating GST exemption to a trust or transfer reduces the applicable rate of tax (from as high as 40 percent to as low as 0 percent) on generation-skipping transfers.[32] An allocation of GST exemption to a trust excludes from GST tax not only the value to which GST exemption was allocated, but also all subsequent appreciation and accrued income on that value during the existence of the trust.

Reasons for Change

In most cases, as long as property remains in a trust, the death of a trust beneficiary will not trigger the imposition of estate tax on trust assets. This is because beneficiaries typically have no rights to the trust property that would cause the property to be includable in that beneficiary's gross estate at death. At the termination of the trust, however, the trust assets are required to vest in one or more persons, at which point the assets become the property of those persons and reenter the gift and estate tax base.

At the time of the enactment of the GST provisions, the laws of most States included a common-law Rule Against Perpetuities (RAP) or some statutory version of it requiring that every trust terminate no later than 21 years after the death of a person who was alive at the time the trust was created. Today, many States either have limited the application of their RAP statutes (permitting trusts to continue for several hundred or up to 1,000 years), or entirely repealed their RAP statute. In those States, trusts are permitted to continue in perpetuity and the property in those trusts has been permanently removed from the estate and gift tax base.

Proposal

The proposal would make the GST exemption applicable only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations

[32] The GST tax is imposed as a flat tax rate equal to the highest estate tax rate (currently 40 percent) multiplied by the trust's "inclusion ratio." Generally, the inclusion ratio is determined by subtracting the "applicable fraction" from one. The numerator of the applicable fraction is the total amount of GST exemption allocated to the trust or transfer, and the denominator is the fair market value of the trust or property transferred. For example, if the amount of GST exemption allocated to the trust is equal to the value of property transferred to the trust, the inclusion ratio will be zero and the applicable tax rate will be 0 percent (40 percent multiplied by the inclusion ratio). Such a trust is described as being fully exempt from the GST tax.

occurring while any person described in (a) is a beneficiary of the trust.[33] Under current law, section 2653 resets the generation assignment of trust beneficiaries once GST tax has been imposed, treating younger generations of skip persons as being in the first generation below that of the transferor (and thus as non-skip persons). Under the proposal, section 2653 would not apply in determining the generation assignment of a beneficiary for purposes of testing whether the GST exemption has terminated. In addition, solely for purposes of determining the duration of the exemption, a pre-enactment trust would be deemed to have been created on the date of enactment and, in this case, the proposal would provide that the grantor is deemed to be the transferor and in the generation immediately above the oldest generation of trust beneficiaries in existence on the date of enactment. The result of these proposals is that the benefit of the GST exemption, which shields property from the GST tax, would not last for a trust's duration. Instead, the GST exemption would only shield from GST tax distributions to trust beneficiaries who either are in a generation no younger than that of the transferor's grandchild or are members of a younger generation who were alive at the creation of the trust. Similarly, the exemption would shield a taxable termination from GST tax only as long as a person described in the prior sentence is a trust beneficiary.

Specifically, upon the expiration of this limit on the duration of the GST exemption, the trust's inclusion ratio would be increased to one, thereby rendering no part of the trust exempt from GST tax. Because contributions to a trust from different grantors are deemed to be held in separate trusts under section 2654(b) of the Code, each such separate trust would be subject to the same rule for the duration of the exemption, measured from the date of the first contribution by the grantor of that separate trust. The special rule for pour-over trusts under section 2653(b)(2) would continue to apply to pour-over trusts and to trusts created under a decanting authority, and for purposes of this rule, such trusts would be deemed to have the same date of creation as the initial trust.[34] The other rules of section 2653 would continue to apply and would be relevant in determining when a taxable distribution or taxable termination occurs. An express grant of regulatory authority to the Secretary and her delegates would be included to facilitate the implementation and administration of this provision.

The proposal would apply on and after the date of enactment to all trusts subject to the generation-skipping transfer tax, regardless of the trust's inclusion ratio on the date of enactment.

[33] The three types of GST transfers are direct skips, taxable distributions, and taxable terminations. Section 2612 defines a direct skip as a transfer to a skip person that is subject to Federal estate or gift tax; a skip person generally is one assigned to a generation more than one generation below that of the transferor. Section 2612 also defines a taxable distribution and taxable termination.

[34] A pour-over trust is a trust to receive assets passing under the will of the grantor at death. In general, decanting involves distributing assets from one trust to a new trust created by the trustee of the first trust, thereby changing the terms of the trust.

MODIFY INCOME, ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX RULES FOR CERTAIN TRUSTS

Current Law

Tax rules for grantor trusts

Generally, a trust is a grantor trust, and the grantor is its deemed owner, if the grantor (a) creates a revocable trust, or (b) creates an irrevocable trust but retains certain powers over the trust or its assets (such as the power to control or direct the trust's income or assets).[35] A deemed owner of a grantor trust is treated as owning the assets of the trust solely for income tax purposes. As a result, sales and other transactions between a grantor trust and its deemed owner are disregarded for income tax purposes so no income tax on gains is incurred. Further, the income tax liability generated by a trust's assets is the obligation of the deemed owner, rather than the obligation of the trust or its beneficiaries. No amount paid by the deemed owner of a grantor trust to satisfy the trust's income tax liability is treated as a gift by the deemed owner to the trust or its beneficiaries for Federal gift tax purposes.

A grantor retained annuity trust (GRAT) is an irrevocable grantor trust in which the grantor retains an annuity interest for a term of years. At the end of that term, the assets then remaining in the trust are transferred to (or held in further trust for) the beneficiaries. The gift of this remainder interest is subject to gift tax at the creation of the trust and is valued by deducting the present value of the grantor's retained annuity interest from the fair market value of the property contributed to the GRAT. The present value of the grantor's retained annuity interest is the value of the expected payments to the grantor during the GRAT term, determined using a discount rate or rate of return based in part on the applicable Federal (statutory) interest rate in effect for the month in which the GRAT is funded.

Generation-Skipping Transfer (GST) inclusion ratio on transactions with other trusts

The GST tax is imposed by multiplying the value of a trust by the product of a flat tax rate (equal to the highest estate tax rate, currently 40 percent), and the trust's "inclusion ratio." A trust's inclusion ratio is determined by subtracting the "applicable fraction" from one. Generally, the numerator of the applicable fraction is equal to the amount of GST exemption allocated to the trust and the denominator is equal to the value of the trust. The applicable fraction is redetermined on each allocation of GST exemption to the trust and on certain changes to the trust principal, such as additional contributions to the trust or the consolidation of multiple trusts.

GST tax characterization of certain tax-exempt organizations

A taxable termination is one of three types of transfers that triggers the imposition of GST tax. In defining a taxable termination of a trust, the statute provides that there is no taxable termination

[35] A grantor also can create a trust that gives a beneficiary certain powers over the trust (such as the right to withdraw all of the trust's income). Those powers could make the beneficiary the trust's deemed owner.

as long as a non-skip person has an interest in the trust.[36] Although for this purpose, the current GST statute ignores trust interests held by most charities, there are other types of non-charitable tax-exempt organizations that are treated as non-skip persons. As a result of this characterization, a discretionary interest held by such an organization will prevent a taxable termination and thereby avoid the imposition of GST tax.

Definition of a guaranteed annuity from a charitable lead annuity trust (CLAT)

A CLAT requires the payment of an annuity at least annually to one or more charitable beneficiaries for a term of years or for the life of the donor. At the end of that term, the trust distributes any remaining trust property to noncharitable remainder beneficiaries. The CLAT's grantor makes a gift of the remainder interest to the remainder beneficiaries on the creation of the CLAT, and the present value of that deferred remainder interest is based, in part, on an assumed rate of growth for the trust's assets during the annuity term. However, the actual rate of appreciation of the trust's assets can exceed the assumed rate of growth on which the gift tax calculation is based. As a result, the value of the remainder interest subjected to gift tax on the CLAT's creation can be significantly less than the value of the remainder interest received by the noncharitable beneficiaries at the end of the CLAT term.

Tax treatment of loans from a trust

The Internal Revenue Code (Code) has complex and comprehensive rules governing the income, GST, and sometimes gift tax consequences of distributions from trusts to trust beneficiaries. Generally, these rules are intended, at least in part, to ensure that those who enjoy the benefits from a trust share an appropriate level of tax liability related to the receipt of those benefits. However, except for certain loans from a foreign trust to a U.S. person, a loan from a trust does not carry with it any tax consequences to the borrower.

Reasons for Change

Modify tax rules for grantor trusts

GRATs and grantor trusts allow taxpayers to substantially reduce their combined Federal income, gift, and estate tax obligations through tax planning. The proposal addresses the three most common and significant planning techniques that allow the grantor of a trust to remove significant value from the grantor's gross estate for Federal estate tax purposes without Federal income or gift tax consequences. Reform is needed to close the existing loopholes and ensure the effective operation of the Federal income, gift, and estate taxes. To be effective, any change in the law should address all of these techniques; otherwise, taxpayers will simply shift their planning from one technique to the other.

[36] A non-skip person is a person other than a skip person. A skip person is either (a) a natural person assigned to a generation which is 2 or more generations below the generation assignment of a transferor to the trust or (b) certain trusts. A trust is a skip person if, at the time of a contribution to the trust, (a) all interests in the trust are held by skip persons, or if (b) there is no person holding an interest in the trust, and at no time after such a contribution may a distribution (including distributions on termination) be made from such trust to a non-skip person.

The first technique is the funding of a GRAT with assets that are expected to appreciate. If the value of a GRAT's assets appreciate at a rate that exceeds the relatively low statutory interest rate used to value the grantor's retained annuity interest, that excess appreciation will have been transferred to the remainder beneficiaries with little or no gift tax. Because almost the entire value of the GRAT assets generally is includible in the grantor's gross estate for Federal estate tax purposes if the grantor dies during the GRAT term, the grantor usually selects a GRAT term that the grantor expects to survive. To minimize the gift tax cost, the GRAT is structured to have a remainder interest with only a very small value and thus incurring very little gift tax. As a result, even if the GRAT assets do not significantly appreciate by the end of the GRAT term, the GRAT involved little to no cost or downside risk for the grantor.

The second technique is the sale of an appreciating asset to a grantor trust by its deemed owner. Generally, when a taxpayer sells an appreciating asset to a grantor trust of which the taxpayer is the deemed owner for income tax purposes,[37] the sale is disregarded for income tax purposes. Such a sale allows the taxpayer to remove the future appreciation from the taxpayer's gross estate without the payment of gift or estate tax and without the recognition of any capital gain on the sale.

The third technique is the deemed owner's repurchase of an appreciated asset from the grantor trust for the asset's then-fair market value, usually shortly before the deemed owner's death. Generally, as with the grantor's sale of an appreciating asset to the trust, when a grantor trust sells an appreciated asset back to the trust's deemed owner, the purchase is disregarded for income tax purposes, so no capital gains tax is incurred. When the deemed owner dies, the appreciated asset is part of the grantor's gross estate, so its basis is adjusted (usually increased) to its fair market value on the date of death. In this way, no gain is ever taxed, and the trust has the same value as immediately before the repurchase by the deemed owner but without the future capital gains tax liability on the appreciation that accrued before the deemed owner's death.

Finally, because the deemed owner's payment of the income tax on the trust's taxable income and gains each year is considered the owner's payment of the owner's own tax liability and therefore is not a taxable gift, the property in the grantor trust can grow free of income tax, without any gift tax cost.

Adjustment of a trust's GST inclusion ratio on transactions with other trusts

A popular technique for leveraging the benefit of the GST exemption is for a GST exempt trust[38] to purchase either assets from a GRAT or other trust, or a remainder interest in the GRAT or other trust. Presumably, a taxpayer engaging in such a sale would treat the transaction as any other reinvestment of trust assets, which would not change the purchasing trust's applicable fraction or inclusion ratio. Because the grantor of the GRAT cannot allocate GST exemption to the GRAT until the end of the GRAT term, the GRAT is not exempt from GST tax at the time of

[37] In most cases, the taxpayer receives the sales price for the appreciating asset in the form of a note issued by the trust to be paid from the future income or return from the asset sold to the trust.

[38] A trust can be exempt from GST tax either because it is a trust treated as having an inclusion ratio of zero under the grandfather rules or it is a trust with an inclusion ratio of zero due to the allocation of the donor's GST exemption.

such a purchase, but the purchase by the GST exempt trust, in effect, cleanses the purchased interest of its GST potential.[39] Therefore, a purchase of the remainder interest shortly after the creation of the GRAT could significantly leverage the taxpayer's GST exemption by avoiding the need to allocate GST exemption at the end of the GRAT term to shield the purchased property from GST tax. While it appears that the categories of the changes to trust principal that trigger a redetermination of a trust's inclusion ratio could be expanded by regulations, it is not clear that regulations could adequately address the effect of sales between trusts.

Change the GST tax characterization of certain tax-exempt organizations

Because many types of tax-exempt organizations are included in the definition of a non-skip person with an interest in the trust for purposes of determining taxable terminations, simply naming one of these organizations (other than most charities) as a potential recipient of trust distributions is enough to avoid the imposition of GST tax on the trust, even though that organization may be unlikely to ever receive a distribution from the trust. In this way, the statute has created a loophole being used by taxpayers to avoid GST tax.

Modify the definition of a guaranteed annuity from a charitable lead annuity trust (CLAT)

The term of a CLAT and the size of the annual annuity generally are structured to cause the deferred value of the remainder interest for transfer tax purposes to be minimal or zero even though the actual value of that remainder interest is expected to be substantial. The longer that annuity payments to the charity can be delayed, the longer the trust assets can remain in the trust where the expectation is that they will continue to appreciate in value. Although annuity payments must be made at least annually, the amount of each payment may vary within certain limits. A higher annuity amount payable from the beginning of the trust term can reduce the appreciation that otherwise would accrue for the ultimate benefit of the remaindermen. As a result, taxpayers often design the CLAT to have an annuity that increases over the trust term, thereby largely deferring the charitable benefit until the end of the trust term. This technique can increase very significantly the value of the remainder without gift tax consequences.

Modify the tax treatment of loans from a trust

Loans to trust beneficiaries are being used to avoid the income and GST tax consequences of trust distributions. The current widespread practice of making loans rather than distributions from dynastic trusts subject to the GST tax supports the conclusion that loans are an alternative method of obtaining beneficial enjoyment from a trust. Although a loan differs from a distribution because of the obligation to repay, the borrower nevertheless is receiving property from the trust – a benefit that the borrower is unlikely to have been able to otherwise obtain. In addition, these loans often are forgiven or otherwise remain unpaid, and it is difficult for the Internal Revenue Service (IRS) to identify those occurrences and thus to collect the taxes that should be paid in such circumstances. Thus, the use of loans allows taxpayers to divorce their

[39] In addition, if the GRAT's assets appreciate during the GRAT term at a higher rate than the rate assumed at its creation, the value of the remainder interest at the creation of the GRAT (the value subject to gift tax) is substantially lower than the value of the remainder at the end of the GRAT term.

ability to benefit from trust assets from the receipt of income for tax purposes, which allows them to inappropriately avoid income and GST taxes.

Treating loans as distributions also would facilitate tax administration and compliance by providing the IRS with greater visibility into transactions with trusts and information about who is benefiting from a trust.

Proposal

Modify tax rules for grantor trusts

The proposal would require that the remainder interest in a GRAT, at the time the interest is created, have a minimum value for gift tax purposes equal to the greater of 25 percent of the value of the assets transferred to the GRAT or $500,000 (but not more than the value of the assets transferred). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the trust without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These provisions would impose some downside risk on the use of GRATs so they are less likely to be used purely for tax avoidance purposes.

For trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person as one that is regarded for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset and the basis of the transferred asset in the hands of the buyer being the amount the buyer paid to the seller. Such regarded transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. However, securitization transactions would not be subject to this new provision. (A corresponding addition to disallowed losses would be made to section 267(b) of the Code).

The proposal also would provide that the payment of the income tax on the income of a grantor trust (other than a trust that is fully revocable by the grantor) is a gift. That gift would occur on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid. The amount of the gift cannot be reduced by a marital or charitable deduction or by the exclusion for present interest gifts or gifts made for the donee's tuition or medical care. The gift, however, is an adjusted taxable gift.

The GRAT portion of the proposal would apply to all trusts created on or after the date of enactment. The portion of the proposal characterizing the grantor's payment of income taxes as a gift also would apply to all trusts created on or after the date of enactment. The gain recognition portion of the proposal would apply to all transactions between a grantor trust and its deemed owner or any other person occurring on or after the date of enactment. It is expected that the legislative language providing for such an immediate effective date would appropriately detail the particular types of transactions to which the new rule does not apply.

Adjust a trust's GST inclusion ratio on transactions with other trusts

The proposal would treat a trust's purchase of assets from, or interests in, a trust that is subject to GST tax (regardless of the selling trust's inclusion ratio), as well as a purchase of any other property that is subject to GST tax, as a change in trust principal that would require the redetermination of the purchasing trust's inclusion ratio when those assets (or trust interest) are purchased. Specifically, the inclusion ratio would be redetermined in the same way as in the case of a consolidation of trusts: the purchased assets would be included in the total value of the trust in the denominator of the applicable fraction, and only the portion of those assets excluded from GST tax immediately before the purchase would be added into the numerator of the fraction. The proposal similarly would apply to a trust's receipt of assets pursuant to a decanting of another trust (generally, the distribution of trust property to another trust pursuant to the trustee's discretionary authority to make distributions to, or for the benefit of, one or more beneficiaries of the decanted trust).

The proposal would apply to all such transactions occurring after the date of enactment.

Change the GST tax characterization of certain tax-exempt organizations

The proposal would ignore trust interests held by additional tax-exempt organizations for purposes of the GST tax.[40] As a result, the inclusion of such an organization as a permissible distributee of a trust would not prevent the occurrence of a taxable termination subject to GST tax.

The proposal would apply in all taxable years beginning after the date of enactment.

Modify the definition of a guaranteed annuity from a charitable lead annuity trust (CLAT)

The proposal would require that the annuity payments made to charitable beneficiaries of a CLAT at least annually must be a level, fixed amount over the term of the CLAT, and that the value of the remainder interest at the creation of the CLAT must be at least 10 percent of the value of the property used to fund the CLAT, thereby ensuring a taxable gift on creation of the CLAT.

The proposal would apply to all CLATs created after the date of enactment.

Modify the tax treatment of loans from a trust

The proposal would treat loans made by a trust to a trust beneficiary as a distribution for income tax purposes, carrying out each loan's appropriate portion of distributable net income to the borrowing beneficiary. In addition, a loan to a trust beneficiary would be treated as a distribution

[40] Specifically, the proposal would treat an organization described in section 501(c)(4) through (29) other than (c)(10) for GST tax purposes in the same way as an organization described in section 2055(a).

for GST tax purposes, thus constituting either a direct skip or taxable distribution, depending upon the generation assignment of the borrowing beneficiary. Within one year after the final payment made on the loan to the trust (whether or not that constitutes full satisfaction of the loan), a refund of the appropriate amount of GST tax (with interest only from the date of the claim for refund) could be requested to be refunded to the payor of the GST tax that was incurred when the loan was made.

To discourage borrowing from a trust by a person who is not a trust beneficiary but who is a deemed owner of the trust under the grantor trust rules, the proposal would create a special rule for GST tax purposes. Specifically, the repayment (regardless of the identity of the payor) of any loan made by a trust to a deemed owner or the spouse of a deemed owner would be treated as a new contribution to the trust by the borrowing deemed owner(s). Depending on the generation assignments of the trust's beneficiaries at the time of the repayment, this new contribution (like any other contribution) would utilize GST exemption of the borrower(s), generate a GST tax liability in the case of a direct skip on such borrower(s) or their respective estates, or increase the trust's inclusion ratio. Any GST tax payable on such a deemed direct skip that could not be collected from a deemed owner or a deceased deemed owner's estate (such as, if the time for collecting such a debt from a decedent has expired), would be payable by the trust itself.

The proposal includes a grant of regulatory authority to identify certain types of loans that would be excepted from the application of the proposal. This authority could be used to exempt short-term loans, which do not raise the same concerns. Similarly, other exceptions might be the use of real or tangible property for a minimal number of days.

The proposal would apply to loans made, as well as to existing loans renegotiated or renewed, by trusts after the year of enactment.

REVISE RULES FOR VALUATION OF CERTAIN PROPERTY

Current Law

Valuation of promissory notes

Generally, an individual who lends money at a below-market rate of interest to another individual is treated as making a gift for gift tax purposes and the lender is imputed a commensurate amount of income for Federal income tax purposes. The Internal Revenue Code (Code) requires minimum rates of interest based on the duration of a note or other loan (its term); the Internal Revenue Service (IRS) issues monthly rates for each term. These rates effectively create a safe harbor: if the interest rate on a loan is at least equal to the minimum rate of interest specified by the IRS for a loan of the same term, the loan avoids being a "below-market loan" (the forgone interest on which is subject to income tax) and the loan is not treated as a gift for gift tax purposes.

Valuation of partial/fractional interests in certain assets transferred intrafamily

The standard for determining the value of transferred property for transfer tax purposes is fair market value (FMV), which is defined as the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of all relevant facts. In determining the FMV of various forms of partial interests, appraisers generally consider several factors, such as the form of ownership, restrictions on transferability, and prevailing market conditions. These factors can increase the value of a transferred interest (in the form of a premium) or decrease the interest's value by applying valuation discounts for things like lack of marketability and lack of control. The Code disregards the effects on FMV of liquidation restrictions on controlled partnerships and corporations in limited circumstances but does not modify the FMV of partial interests in assets.

Reasons for Change

Valuation of promissory notes

The rules for below-market loans allow taxpayers to take inconsistent positions regarding the valuation of loans to achieve tax savings. Typically, a taxpayer sells a valuable asset within their family for a promissory note carrying the minimum interest rate required to ensure that the loan is not taxed as a below-market loan for Federal income tax purposes. The taxpayer claims that the minimum interest rate is sufficient to avoid both the treatment of any foregone interest on the loan as imputed income to the lender and the treatment of any part of the transaction as a gift. However, in subsequently valuing that unpaid note for Federal estate tax purposes after the death of the taxpayer, the estate takes the position that the fair market value of the note should be discounted because the interest rate is well below the market rate at the time of the taxpayer's death. In other words, the taxpayer relies on the statutory rules to assert that the loan is not below market for gift tax purposes at the time of the transaction but relies on the underlying economic characteristics later to assert the loan is below market for estate tax purposes.

Alternatively, the term of a promissory note may be very lengthy, and at death, the holder's estate may claim a significant discount on the value of the unpaid note based on the amount of time before the note will be paid in full.

Valuation of partial/fractional interests in certain assets transferred intrafamily

The valuation of partial interests in closely held entities, real estate and other personal property offers opportunities for tax avoidance when those interests are transferred intrafamily. Taxpayers regularly transfer portfolios of marketable securities and other liquid assets into partnerships or other entities, make intrafamily transfers of interests in those entities (instead of transferring the liquid assets themselves), and then claim entity-level discounts in valuing the gift. Similarly, taxpayers often make intrafamily transfers of partial interests in other hard-to-value assets such as real estate, art, or intangibles, allowing all family co-owners to claim fractional interest discounts.

While valuation discounts for lack of marketability and lack of control are factors properly considered in determining the FMV of such interests in general, they are not appropriate when families are acting in concert to maximize their economic benefits. In these cases, because the family often ignores the restrictions that justified the discounts, the claimed FMV of the transferred interest is below its real economic value, artificially reducing the amount of transfer tax due.

Proposal

Require consistent valuation of promissory notes

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to no more than the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. The Secretary would be granted regulatory authority to establish exceptions to account for any difference between the applicable minimum interest rate at the issuance of the note and actual interest rate of the note. In addition, the term of any note (regardless of its rate of interest) would be shortened for purposes of valuing that note if there is a reasonable likelihood that the note will be satisfied sooner than the specified payment date and in other situations as determined by the Secretary.[41]

The proposal would apply to valuations as of a valuation date on or after the date of enactment.

[41] Permissible approaches could include without limitation treating the note as being short term regardless of the due date, valuing term loans as demand loans in which the lender can require immediate payment in full, or reducing the stated term to the earliest possible date on which the related property (such as an investment in a life insurance policy or arrangement) could be monetized by cashing in or selling the policy.

Revise the valuation of partial/fractional interests in certain assets transferred intrafamily

The proposal would replace section 2704(b) of the Code, which disregards the effect of liquidation restrictions on FMV, and instead provide that the value of a partial interest in non-publicly traded property (real or personal, tangible or intangible) transferred to or for the benefit of a family member of the transferor would be the interest's pro-rata share of the collective FMV of all interests in that property held by the transferor and the transferor's family members, with that collective FMV being determined as if held by a sole individual. Family members for this purpose would include the transferor, the transferor's ancestors and descendants, and the spouse of each described individual.

In applying this rule to an interest in a trade or business, passive assets would be segregated and valued as separate from the trade or business. Thus, the FMV of the family's collective interest would be the sum of the FMV of the interest allocable to a trade or business (not including its passive assets), and the FMV of the passive assets allocable to the family's collective interest determined as if the passive assets were held directly by a sole individual. Passive assets are assets not actively used in the conduct of the trade or business, and thus would not be discounted as part of the interest in the trade or business.

This valuation rule would apply only to intrafamily transfers of partial interests in property in which the family collectively has an interest of at least 25 percent of the whole.[42]

The proposal would apply to valuations as of a valuation date on or after the date of enactment.

[42] An attribution rule, that would be relevant only for purposes of determining whether the family's collective interest meets that threshold, would attribute to a person the maximum interest held through an entity or trust that could be allocated to that person. However, for purposes of determining the FMV of the family's collective interest, only interests held directly by a member of the family, interests held through a general partnership or wholly owned entity, and interests held in trusts either for the sole benefit of the family member or that are withdrawable or fully revocable by the family member, would be taken into consideration.

CLOSE LOOPHOLES

TAX CARRIED (PROFITS) INTERESTS AS ORDINARY INCOME

Current Law

A partnership is not subject to Federal income tax. Instead, an item of income or loss of the partnership retains its character and flows through to the partners who must include such item on their tax returns. Generally, certain partners receive partnership interests in exchange for contributions of cash and/or property, while certain partners (not necessarily other partners) receive partnership interests, typically interests in future partnership profits referred to as "profits interests" or "carried interests," in exchange for services. Accordingly, if and to the extent a partnership recognizes long-term capital gain, the partners, including partners who provide services, will reflect their shares of such gain on their tax returns as long-term capital gain. If the partner is an individual, such gain would be taxed at the reduced rates for long-term capital gains. Gain recognized on the sale of a partnership interest, whether it was received in exchange for property, cash, or services, is generally capital gain. Section 1061 of the Internal Revenue Code (Code) generally extends the long-term holding period requirement for certain capital gains resulting from partnership property dispositions and from partnership interest sales, from one year to three years.

Under current law, income attributable to a profits interest is generally subject to self-employment tax, except to the extent that the partnership generates types of income that are excluded from self-employment taxes, including capital gains, certain interest, and dividends. A limited partner's distributive share is generally excluded from self-employment tax under section 1402(a)(13) of the Code.

Reasons for Change

Although profits interests are structured as partnership interests, the income allocable to such interests is received in connection with the performance of services. A service provider's share of the income of a partnership attributable to a carried interest should be taxed as ordinary income and subject to self-employment tax because such income is derived from the performance of services. By allowing service partners to receive capital gains treatment on labor income without limit, even with the holding period extension provided by section 1061, the current system creates an unfair and inefficient tax preference. Activity among large private equity firms and hedge funds has increased the breadth and cost of this tax preference, with some of the highest-income Americans benefiting from this preferential treatment.

Proposal

The proposal would generally tax as ordinary income a partner's share of income on an "investment services partnership interest" (ISPI) in an investment partnership, regardless of the character of the income at the partnership level, if the partner's taxable income (from all sources) exceeds $400,000. Accordingly, such income would not be eligible for the reduced rates that apply to long-term capital gains. In addition, the proposal would require partners in such investment partnerships to pay self-employment taxes on ISPI income if the partner's taxable income (from all sources) exceeds $400,000. In order to prevent income derived from labor services from avoiding taxation at ordinary income rates, the proposal assumes that the gain recognized on the sale of an ISPI would generally be taxed as ordinary income, not as capital gain, if the partner is above the income threshold. To ensure more consistent treatment with the sales of other types of businesses, the Administration remains committed to working with Congress to develop mechanisms to assure the proper amount of income recharacterization where the business has goodwill or other assets unrelated to the services of the ISPI holder.

An ISPI is a profits interest in an investment partnership that is held by a person who provides services to the partnership. A partnership is an investment partnership if substantially all of its assets are investment-type assets (certain securities, real estate, interests in partnerships, commodities, cash or cash equivalents, or derivative contracts with respect to those assets), but only if over half of the partnership's contributed capital is from partners in whose hands the interests constitute property not held in connection with a trade or business. To the extent (a) the partner who holds an ISPI contributes "invested capital" (which is generally money or other property) to the partnership, and (b) such partner's invested capital is a qualified capital interest, income attributable to the invested capital would not be recharacterized and would continue to be eligible for capital gain treatment. A qualified capital interest is generally one where (a) the partnership allocations to the invested capital are made in the same manner as allocations to other capital interests held by partners who do not hold an ISPI and (b) the allocations to these non-ISPI holders are significant. Similarly, the portion of any gain recognized on the sale of an ISPI that is attributable to a qualified capital interest would be treated as capital gain. However, "invested capital" would not include contributed capital that is attributable to the proceeds of any loan or advance made or guaranteed by any partner or the partnership (or any person related to such persons) to a person who holds an ISPI.

Also, any person who performs services for any entity and holds a "disqualified interest" in the entity would be subject to tax at rates applicable to ordinary income on any income or gain received with respect to the interest, if the person's taxable income (from all sources) exceeds $400,000. A "disqualified interest" is defined as convertible or contingent debt, an option, or any derivative instrument with respect to the entity (but does not include a partnership interest, stock in certain taxable corporations, or stock in an S corporation). This would act as an anti-abuse rule and prevent avoidance of the proposal's application through the use of compensatory arrangements other than partnership interests. Additional anti-abuse rules could be necessary.

The proposal is not intended to adversely affect qualification of a real estate investment trust owning a profits interest in a real estate partnership.

The proposal would repeal section 1061 for taxpayers with taxable income (from all sources) in excess of $400,000.

The proposal would be effective for taxable years beginning after December 31, 2024.

REPEAL DEFERRAL OF GAIN FROM LIKE-KIND EXCHANGES

Current Law

Currently, owners of appreciated real property used in a trade or business or held for investment can defer gain on the exchange of the property for real property of a "like-kind." As a result, the tax on the gain is deferred until a later recognition event, provided that certain requirements are met.

Reasons for Change

The proposal would treat the exchanges of real property used in a trade or business (or held for investment) similarly to sales of real property, resulting in fewer distortions. The change would raise revenue while increasing the progressivity of the tax system. It would also align the treatment of real property with other types of property.

Proposal

The proposal would allow the deferral of gain up to an aggregate amount of $500,000 for each taxpayer ($1 million in the case of married individuals filing a joint return) each year for real property exchanges that are like-kind. Any gains from like-kind exchanges in excess of $500,000 (or $1 million in the case of married individuals filing a joint return) in a year would be recognized by the taxpayer in the year the taxpayer transfers the real property subject to the exchange.

The proposal would be effective for exchanges completed in taxable years beginning after December 31, 2024.

REQUIRE 100 PERCENT RECAPTURE OF DEPRECIATION DEDUCTIONS AS ORDINARY INCOME FOR CERTAIN DEPRECIABLE REAL PROPERTY

Current Law

In general, a taxpayer recognizes gain or loss upon the disposition of an asset used in a trade or business. Such gain or loss can have the character of a capital gain or loss or an ordinary gain or loss according to various provisions of the Internal Revenue Code (Code). Generally, ordinary losses are deductible against a taxpayer's gross income, but capital losses may only offset capital gains.[43] Gains and losses from the sale or exchange of capital assets that have been held for more than one year generally are long-term capital gains and losses. A net capital gain (the excess of a net long-term capital gain over a net short-term capital loss) recognized by a noncorporate taxpayer is generally taxed at lower tax rates than those imposed on ordinary income. Corporations are taxed at the same rate for net capital gains and ordinary income.

A portion of the gain recognized upon the disposition of property used in a trade or business or held for investment may be treated as ordinary income to the extent that such gain reflects some or all of the depreciation allowances previously deducted against the taxpayer's gross ordinary income (depreciation recapture). In general, any recognized gain on "section 1245 property" is recaptured as ordinary income up to 100 percent of the cumulative depreciation deductions taken with respect to the property. Section 1245 property primarily consists of depreciable personal property, any real property that is subject to special expensing or amortization rules (such as under section 179 of the Code), and certain depreciable real property (other than buildings and structural components) used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, and utility services. Buildings and certain other real property are section 1250 property. For section 1250 property, the amount of recognized gain subject to depreciation recapture generally equals the amount by which cumulative depreciation deductions exceed the sum of depreciation allowances determined by using the straight-line depreciation method and the property's applicable depreciation cost recovery period.

The section 1250 property depreciation recapture rules have little or no effect on recharacterizing gain as ordinary income upon the disposition of section 1250 property because most section 1250 property is ineligible for the additional first-year bonus depreciation allowance and uses the straight-line depreciation method and applicable recovery period.[44]

Property used in a trade or business is not a capital asset, and gains and losses recognized from the sale, exchange, or involuntary conversion of such property are generally treated as ordinary income and ordinary loss. However, when held for more than one year, most depreciable property and other real property (for example, land) used in a trade or business are defined as "section 1231 property" and subjected to additional rules that determine whether a gain or loss from the sale, exchange, or involuntary conversion of such property is classified as capital or

[43] Noncorporate taxpayers can deduct up to $3,000 of the excess capital losses over capital gains.

[44] Section 1250 property that is "qualified improvement property" is eligible for the additional first year bonus depreciation allowance and accelerated regular depreciation allowances if placed in service after December 31, 2017. In general, qualified improvement property is an improvement made to the interior portion of a non-residential building that is placed in service after the building is first placed in service.

ordinary.[45] The sum of the gains on a taxpayer's section 1231 property (other than gains treated as ordinary income under the depreciation recapture rules) is compared to the sum of the losses on section 1231 property. If the taxpayer's section 1231 losses exceed its section 1231 gains for a taxable year, then such section 1231 losses and section 1231 gains are treated as ordinary losses and ordinary income, respectively. However, if the section 1231 gains exceed the section 1231 losses for a taxable year, then such gains and losses are generally treated as capital gains and capital losses, respectively. A taxpayer's aggregate net section 1231 gain for any taxable year is nevertheless treated as ordinary income to the extent that it does not exceed the amount of net section 1231 losses incurred in the five preceding taxable years (to the extent that such losses have not already been "recaptured" in this manner).

For noncorporate taxpayers, any gain on section 1250 property that represents unrecaptured depreciation (and is treated as capital gain after application of the above rules) is taxed using a maximum tax rate of 25 percent.

Reasons for Change

For noncorporate taxpayers, most gains on buildings or other real property used in the taxpayer's trade or business are taxed at reduced rates because of the rules of sections 1250 and 1231 of the Code. When taxpayers claim depreciation deductions against ordinary income in excess of the actual decline in value of real property while paying tax on any gains at reduced rates, they are able to convert ordinary income into preferentially taxed capital income. This provides a tax subsidy for certain noncorporate businesses, especially real estate businesses.[46] Applying 100 percent depreciation recapture to the cumulative depreciation deductions on section 1250 property would eliminate this tax subsidy and opportunity for conversion of income. It would raise revenue while increasing the progressivity of the tax system.

The 100 percent recapture of the cumulative depreciation deductions on section 1250 property would promote efficiency and simplification as it would gradually remove the existing disparate tax treatment of section 1250 and section 1245 properties. However, sales of real estate would continue to require an allocation of sales price between land (non-depreciable property) and depreciable property and separate calculations of gain.

While 100 percent section 1250 depreciation recapture would also apply to C corporations, it would have minimal impact on them because there is no tax rate differential between ordinary net gains and capital net gains of such taxpayers. However, an increase in section 1250 depreciation recapture amounts would result in lower section 1231 gains, and this could possibly create an overall net capital loss or lead to a higher net capital loss for certain corporations. Such increased net capital losses would not be deductible in the current taxable year and would have to be carried forward to future taxable years.

---

[45] Inventory, certain intangibles, and assets held for investment purposes are not considered property used in a trade or business and are not section 1231 property. However, gains and losses from the involuntary conversion of capital assets are also included as section 1231 gains and losses.

[46] Approximately 75 percent of section 1231 gains distributed to individual partners or shareholders by pass-through businesses are in the real estate sector.

Proposal

Upon disposition, any measured gain on an item of section 1250 property held for more than one year would be treated as ordinary income to the extent of the cumulative depreciation deductions taken after the effective date of the provision. Depreciation deductions taken on section 1250 property prior to the effective date would continue to be subject to current rules and recaptured as ordinary income only to the extent that such depreciation exceeds the cumulative allowances determined under the straight-line method. Any gain recognized on the disposition of section 1250 property in excess of recaptured depreciation would be treated as section 1231 gain. Any unrecaptured gain on section 1250 property would continue to be taxed to noncorporate taxpayers at a maximum 25 percent rate.

The proposal would not apply to noncorporate taxpayers with adjusted gross income (AGI) below $400,000 ($200,000 for married individuals filing separate returns).[47] Partnerships and S corporations would be required to compute the character of gains and losses on business-use property (including section 1250 property, section 1245 property, and land) at the entity level and to report to entity owners the relevant amounts for ordinary income (loss), capital gain (loss), and unrecaptured section 1250 gain under both "new law" and "old law". Those taxpayers with income of at least the threshold amount would use the "new law" amounts in completing their tax returns.

The proposal would be effective for depreciation deductions taken on section 1250 property in taxable years beginning after December 31, 2024, and sales, exchanges, involuntary conversions, or other dispositions of section 1250 property completed in taxable years beginning after December 31, 2024.

[47] The taxpayer's AGI is determined before applying the proposed change to 100-percent depreciation recapture of section 1250 property for purposes of calculating the $400,000 ($200,000 for married filing separate returns) threshold.

MODIFY DEPRECIATION RULES FOR PURCHASES OF GENERAL AVIATION PASSENGER AIRCRAFT

Current Law

Under the depreciation rules, the recovery period for airplanes not used in commercial or contract carrying of passengers or freight (including corporate jets) generally is five years and the recovery period for airplanes and other assets (including ground property but excluding helicopters) used in commercial or contract carrying of passengers or freight generally is seven years.

Reasons for Change

The shorter recovery period for depreciating airplanes not used in commercial or contract carrying of passengers, but nevertheless used to carry passengers (such as corporate jets), provides a tax preference for these airplanes over airplanes used in a similar manner. To eliminate this preference, their recovery periods should be harmonized.

Proposal

The proposal would define "general aviation passenger aircraft" to mean any airplane (including airframes and engines) not used in commercial or contract carrying of passengers or freight, but which primarily engages in the carrying of passengers (other than an airplane used primarily in emergency or emergency relief operations).

The proposal would increase the recovery period for depreciating general aviation passenger aircraft from five years to seven years. Correspondingly, for taxpayers using the alternative depreciation system, the recovery period for general aviation passenger aircraft would be extended to 12 years.

Any airplane not used in commercial or contract carrying of passengers or freight, but which is primarily engaged in non-passenger activities (e.g., crop dusting, firefighting, aerial surveying, etc.) and any helicopter would continue to be depreciated using a recovery period of five years (six years under the alternative depreciation system).

The proposal would be effective for property placed in service after December 31, 2024.

LIMIT USE OF DONOR ADVISED FUNDS TO AVOID A PRIVATE FOUNDATION PAYOUT REQUIREMENT

Current Law

Private nonoperating foundations are generally required to annually distribute at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year. A foundation that fails to meet this minimum distribution requirement is subject to a 30 percent excise tax on the undistributed amount.

Qualifying distributions (those that satisfy the distribution requirement) include amounts paid to accomplish religious, charitable, scientific, or educational purposes, as well as reasonable and necessary administrative expenses paid by the foundation to further its charitable purposes.

Qualifying distributions do not include the private foundation's contributions to either an organization controlled directly or indirectly by the private foundation's disqualified person(s),[48] or to another private nonoperating foundation, unless (a) not later than one year after the end of the taxable year in which the donee organization received the contribution, the receiving organization makes a distribution equal to the full amount of the contribution and the distribution is a qualifying distribution that is treated as being made out of corpus (or would be so treated if the donee organization were a private nonoperating foundation) and (b) the foundation making the contribution obtains adequate records or enough other evidence from the donee showing that the donee has made a qualifying distribution.

Qualifying distributions also do not include the private foundation's contributions to a Type I, Type II, or functionally integrated Type III supporting organization[49] if any of the private foundation's disqualified persons directly or indirectly control the organization or a supported organization of such organization.

Finally, qualifying distributions do not include the private foundation's contributions to non-functionally integrated Type III supporting organizations, even though those organizations are subject to an annual 3.5 percent payout requirement.

Private foundations can set up donor advised funds (DAFs). A DAF is defined as a fund or account which is (a) separately identified by reference to contributions of a donor or donors, (b) owned and controlled by a sponsoring organization, and (c) with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund by reason of the donor's status as a donor. There is currently no requirement that amounts held in a DAF be

[48] Disqualified persons are defined generally as substantial contributors to the foundation, foundation managers, owners of more than 20 percent of certain entities that are substantial contributors to the foundation, family members of the foregoing, and certain entities in which the foregoing, alone or together, own more than 35 percent.
[49] A supporting organization is classified as a Type I, Type II or Type III supporting organization based on the type of relationship it has with its supported organization(s). Type III supporting organizations are further classified as functionally integrated and non-functionally integrated. For more information, see section 509(a)(3) and the regulations thereunder.

distributed within any set period of time. Under current law, a distribution by a private foundation to a DAF is generally considered a qualifying distribution.

Reasons for Change

Because a private foundation has advisory privileges with respect to a DAF to which it contributes, and because there is no requirement for a DAF to make a further distribution of funds for a charitable purpose within any set period of time, it is not appropriate for a private foundation to satisfy its distribution requirement by making a distribution to a DAF. This use of DAFs can subvert the goal behind requiring minimum distributions, by reducing the current charitable use of the associated funds.

Proposal

The proposal would clarify that a distribution by a private foundation to a DAF is not a qualifying distribution unless (a) the DAF funds are expended as a qualifying distribution, which does not include a distribution to another DAF, by the end of the following taxable year and (b) the private foundation maintains adequate records or other evidence showing that the DAF has made a qualifying distribution within the required time frame.

The proposal would be effective after the date of enactment.

EXCLUDE PAYMENTS TO DISQUALIFIED PERSONS FROM COUNTING TOWARD PRIVATE FOUNDATION PAYOUT REQUIREMENT

Current Law

Private nonoperating foundations are generally required to annually distribute at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year ("payout requirement"). A foundation that fails to meet this payout requirement is subject to a 30 percent excise tax on the undistributed amount.

Qualifying distributions (those that satisfy the payout requirement) include amounts paid to accomplish religious, charitable, scientific, or educational purposes, as well as reasonable and necessary administrative expenses paid by the foundation to further its charitable purposes.

Paying compensation or reimbursing expenses by a private foundation to a disqualified person is generally an act of self-dealing. The general rule does not apply, however, to the extent that the payments, which cannot be excessive, are for personal services that are reasonable and necessary to carry out the foundation's exempt purposes.

Reasons for Change

Some private foundations meet their entire payout requirement by hiring family members. The intent of the payout requirement is to ensure private foundations use at least 5 percent of the total fair market value of their non-charitable use assets from the preceding taxable year for charitable purposes, such as grants to needy persons or to operating charities. Allowing payments to disqualified persons to count towards a private foundation's payout requirement does not meet this intent to directly further charitable purposes.

Proposal

Under the proposal, paying compensation or reimbursing expenses by a private foundation to a disqualified person (other than a foundation manager of such private foundation who is not a member of the family of any substantial contributor) is not a qualifying distribution that satisfies the payout requirement. The self-dealing rule would not change, so a private foundation could still pay reasonable compensation to a disqualified person for personal services that are reasonable and necessary to carry out the foundation's exempt purposes; these payments would just not count toward the payout requirement.

The proposal would be effective for payments made and expenses reimbursed after the date of enactment.

EXTEND THE PERIOD FOR ASSESSMENT OF TAX FOR CERTAIN QUALIFIED OPPORTUNITY FUND INVESTORS

Current Law

Section 6501 of the Internal Revenue Code (Code) generally requires that the Internal Revenue Service (IRS) assess a tax within three years after the filing of a tax return, subject to several exceptions.

If a taxpayer invests an amount of eligible gain in a Qualified Opportunity Fund (QOF) and elects deferral, that amount of eligible gain is excluded from the taxpayer's income for the year that the gain is realized. Pursuant to statute, recognition of that gain is deferred until December 31, 2026, or an earlier date on which there occurs any of various inclusion events.[50]

Reasons for Change

Although deferral for all taxpayers must end no later than December 31, 2026, inclusion events may require some taxpayers to recognize the deferred gain before that date. In many cases, the only manifestation of the inclusion event on the taxpayer's return is the inclusion of the deferred gain in gross income. Thus, inclusion events that occur prior to December 31, 2026, may not be readily identifiable on the taxpayer's return and there is an increased risk that the IRS may be barred from assessing a deficiency arising from the inclusion event by the expiration of the typical three-year statute of limitations.

Proposal

The proposal would provide that if an inclusion event requires deferred gain of a taxpayer to be included in gross income, but the taxpayer fails to properly include that deferred gain or the taxpayer in any other way fails to properly reflect on one or more tax returns this required inclusion, then there would be an extension of the time during which the IRS may assess any deficiency in any tax where the deficiency results directly or indirectly from these failures. The time during which these deficiencies may be assessed would not expire before the date that is three years after the date on which the IRS is furnished with all of the information that it needs to assess these deficiencies.

The proposal generally would be effective for inclusions of deferred gains with respect to which deferral elections had been based on investments in QOFs that are made after December 22, 2017 (the date of enactment of the Tax Cuts and Jobs Act of 2017). The proposal, however, would not apply in situations where the statute of limitations for assessment has expired before the date of enactment.

[50] Examples of inclusion events include certain events (a) that reduce a taxpayer's direct equity interest in a QOF, (b) in which a taxpayer receives property with respect to its interest in a QOF and the event is treated as a distribution for Federal income tax purposes, (c) in which a taxpayer claims a loss for worthless stock or otherwise claims a worthlessness deduction with respect to its interest in a QOF, and (d) in which an entity certified as a QOF loses its status as a QOF.

IMPOSE OWNERSHIP DIVERSIFICATION REQUIREMENT FOR SMALL INSURANCE COMPANY ELECTION

Current Law

The taxable income of a non-life insurance company generally includes the company's underwriting income (consisting of earned premiums, less incurred losses and expenses), investment income, gains on the disposition of property, and other income items, reduced by allowable deductions. However, certain small non-life insurance companies may elect to be taxed under an alternative tax regime. Electing companies are taxed only on their taxable investment income, which consists of interest, dividends, rents, royalties, capital gains, certain non-insurance trade or business income, and similar items, less deductions related to such income, including deductions for tax-exempt interest, capital losses, and dividends received. An election under this provision is irrevocable without the consent of the Secretary.

The election is available to non-life insurance companies that receive during the taxable year net written premiums (or, if greater, direct written premiums) that do not exceed the threshold amount for that year. The threshold amount for taxable years beginning in 2024 is $2.80 million, an amount that is indexed annually for inflation. For this test, the electing company is treated as receiving the (net or direct) written premiums received by all other companies that are members of the same controlled group as the company for which the determination is being made. For this purpose, and for that of meeting the first diversification requirement (described below), a parent-subsidiary controlled group is defined by using a more-than-50 percent ownership threshold.

An insurance company must meet at least one of two ownership diversification requirements to qualify for an election. A company meets the first diversification requirement if no more than 20 percent of its net written premiums (or, if greater, direct written premiums) is attributable to any one policyholder. For this purpose, all policyholders that are related (within the meaning of section 267(b) or 707(b) of the Internal Revenue Code (Code)) or that are members of the same controlled group of corporations are treated as a single policyholder. The cited relatedness standard generally includes close family relationships (siblings, spouses, ancestors, and lineal descendants), certain trust fiduciary relationships, and certain corporate and partnership relationships (using a more-than-50 percent ownership threshold as an indicator of relatedness). In addition, any policyholder of an underlying direct written insurance contract that is reinsured by the potential electing company is treated as a policyholder of that company for the purpose of this test.

If the first diversification requirement is not met, the second requires that no person holding, directly or indirectly, an interest in the electing insurance company and who is a spouse or lineal descendent of an individual holding an interest in a business or in other assets being insured by the insurance company has a greater percentage ownership interest in the insurance company than he or she has in the business or assets being insured.

Reasons for Change

The alternative tax regime is intended to allow electing insurance companies to provide more affordable insurance coverage to policyholders. However, some taxpayers have worked with promoters to abuse the alternative regime by benefitting themselves or related parties without providing insurance or by providing minimal insurance at very high premium rates unrelated to the expected losses associated with the insured risks. In these cases, taxpayers, or related parties, usually own both an electing entity characterized as an insurance company and one or more businesses paying amounts characterized as insurance premiums to the electing entity. Each business purchasing a policy from the electing entity claims tax deductions for the amounts paid and characterized as premiums. The electing entity, however, does not include these amounts in gross income and does not deduct any underwriting costs (insurance claims and associated expenses) in computing its taxable income.

In many cases identified in audit by the Internal Revenue Service (IRS), the arrangements characterized as insurance do not satisfy the requirements for insurance contracts under Federal income tax law. The amounts characterized as insurance premiums in these cases are unreasonably high, resulting in large amounts of untaxed underwriting income that are not needed to pay policyholder claims and related expenses. The electing entity often uses these funds for purposes unrelated to the business of insurance, such as making loans to, or purchases for, the personal or business use of related persons, including policyholders.

In several recent decisions, the U.S. Tax Court determined that certain fact patterns with these attributes do not represent insurance transactions and denied the claimed deductions. In some cases, the Court imposed penalties or required the electing entity to include the alleged premiums in income.[51] Nevertheless, auditing and litigating such arrangements consumes significant scarce tax administration resources, and a statutory remedy would be more effective in addressing the pervasiveness of abuse.

Because the abusive fact patterns described above are most likely to occur if related parties own both the electing entity and the entities paying the amounts characterized as premiums, an effective ownership diversification requirement would appropriately address this abuse. The current diversification requirements (described above) are ineffective because the industry has been able to develop ownership and payment structures that may avoid those requirements.

Proposal

The proposal would curtail abuse by certain companies while preserving the alternative tax election for those companies that use this tax benefit to reduce the cost of insurance. Under the

[51] Avrahami v. Commissioner, 149 T.C. 144 (2017); Swift v. Commissioner, T.C. Memo. 2024-13 (2024) accuracy related penalty sustained and company would be required to recognize the premiums it received as income); Keating v. Commissioner, T.C. Memo 2024-2 (2024) (accuracy related penalty also sustained); Caylor Land & Development, Inc. v. Commissioner, T.C. Memo. 2021-30 (2021) (accuracy related penalty also sustained); Syzygy Ins. Co., Inc. v. Commissioner, T.C. Memo 2019-34 (2019) (company also required to recognize the premiums it received as income).

proposal, to qualify for the alternative tax regime, an insurance company would be required to meet the following conditions:

1. Qualify as a non-life insurance company;

2. Have net written premiums (or, if greater, direct written premiums) for the taxable year that do not exceed a statutorily determined amount ($2.80 million in 2024); and

3. Have no more than 20 percent of the assets or the voting power or value of the stock of such company owned, attributed, or constructively owned by: (a) a policyholder of such company or an owner of such policyholder, or (b) collectively by a policyholder or owner of a policy holder and one or more persons related to that policyholder or owner.

Under requirement (2), the proposal would continue the current law requirement to attribute premiums received by members of a controlled group including the potential electing company to that company, with the controlled group determined using a more-than-50 percent ownership threshold.

For requirement (3), a policyholder would include any person that conducts a trade or business and treats amounts paid under the relevant insurance contract as insurance premiums for Federal income tax purposes. An owner of a policyholder would be any person with an ownership interest in the policyholder, determined based on constructive ownership and attribution rules found elsewhere in the Code. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust would be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. Grantor trusts would be treated as owned by the grantors, and "stock" would include any certificate entitling the holder to voting power in a mutual insurance company. An individual would be considered as owning stock owned, directly or indirectly, by or for his or her family, which would include any sibling, ancestor, or lineal descendent of the individual's parents, and the spouses of such family members.

The proposal would continue to maintain the current law relatedness standards under sections 267(a) and 707(b), including the more-than-50 percent ownership threshold for corporations and partnerships, but would use the broader definition of family members described in the previous paragraph for this purpose. The proposal would also maintain the current law rule that identifies as a "policyholder" of the company any policyholder of an underlying direct written insurance contract that has been reinsured by the company.

Finally, the proposal would add an anti-abuse rule, stating that a company would fail to meet requirement (3) for the taxable year in the case of a transaction or arrangement that directly or indirectly shifts payments (including premiums) between policyholders of companies that would otherwise be electing companies. The Secretary would be authorized to issue regulations or other guidance with respect to such transactions or arrangements (including the use of a fronting company, an intermediary, cross insurance, reinsurance, or a pooling arrangement designed to facilitate the shifting of payments in order to allow companies to meet requirement (3)).

The Secretary would also be authorized to issue guidance regarding possible requirements for new elections, revocation of prior elections, and related tax consequences for companies that previously qualified for the election but do not qualify under the new standard.

The two ownership diversification requirements under current law would be repealed.

The proposal would be effective for taxable years beginning after December 31, 2024.

EXPAND PRO RATA INTEREST EXPENSE DISALLOWANCE FOR BUSINESS-OWNED LIFE INSURANCE

__Current Law__

In general, no Federal income tax is imposed concurrently on a policyholder with respect to the earnings credited under a life insurance or endowment contract. Furthermore, amounts received under a life insurance contract by reason of the death of the insured generally are excluded from the gross income of the recipient. Federal income tax generally is deferred until income is distributed with respect to earnings under an annuity contract unless the annuity contract is owned by a person other than a natural person.

Interest paid or accrued on policy loans or other indebtedness with respect to life insurance, endowment, or annuity contracts owned by a business generally is not deductible unless the contract insures the life of a current key person of the business and the amount of the indebtedness does not exceed $50,000 per key person insured. The amount of such deductible interest is limited to an amount determined using an average corporate bond yield. A key person is an officer or 20 percent owner of the business, but the number of key persons is capped at between five and 20 individuals, depending on the size of the business. All members of a controlled group (defined as a single employer under section 52(a) or (b) or section 414(m) or (o)) are treated as a single taxpayer. This interest-disallowance rule applies only to the extent that the relevant indebtedness can be traced to a life insurance, endowment, or annuity contract.

The interest deductions of a business other than an insurance company are reduced to the extent the general interest expense of the business is allocable to unborrowed policy cash values of life insurance, endowment, or annuity contracts. This allocation is based on the ratio of the company's average unborrowed policy cash values to average total assets. The provision does not apply to a policy or contract held by a natural person unless the business (other than a sole proprietorship) is directly or indirectly a beneficiary under the policy, nor does it apply to annuity contracts not held by natural persons, the income of which is subject to current taxation. For partnerships and S corporations, the provision applies at the entity level. All members of a controlled group of corporations (as defined above) are treated as a single taxpayer. The provision generally applies before interest expense is capitalized into the cost of produced property under the uniform capitalization rules of the Internal Revenue Code (Code) but generally after other limitations on interest deductions are imposed. Interest expense which has been disallowed as a deduction due to section 265 (i.e., interest on indebtedness incurred or continued to purchase or carry tax-exempt securities) is not taken into account under this provision, and the taxpayer's average total assets taken into account under this provision is reduced by the amount of such indebtedness.

An exception to the pro rata interest-disallowance rule applies with respect to contracts that cover individuals who were officers, directors, employees, or 20 percent owners of the trade or business at the time the individual was first covered by the contract. There is no limit to the number of such excepted individuals. The unborrowed cash values of excepted contracts are not taken into account in either the numerator or the denominator of the interest allocation formula.

Insurance companies are excepted from the interest allocation rule. Instead, they are subjected to special proration rules that require taxable income adjustments to prevent or limit the funding of tax-deductible reserve increases with tax-preferred income, including earnings credited under life insurance, endowment, and annuity contracts.

Reasons for Change

Certain interest disallowance provisions of the Code are intended to deny a deduction for the cost of earning gross income when that income is not taxed. However, in the current instance, the Code allows certain exceptions to this principle that are overly broad and should be narrowed. In particular, if debt is directly traceable to an insurance contract covering the life of a current officer or 20 percent owner of the business, then interest expense may be deductible, although, in this case, the number of such excepted contracts is limited, and the amount of deductible interest may be limited. Broader exceptions are allowed in the case where an entity's interest expense is generally allocated to insurance contracts under a pro rata rule. Here, excepted contracts are those covering the lives of both past and current employees and directors, in addition to past and current officers and 20 percent owners, with no limit on the numbers of insured lives. The proposal would narrow this loophole and better ensure that interest deductions are limited when generating non-taxed income.

Proposal

The proposal would repeal the exception from the pro rata interest expense disallowance rule for contracts covering employees, officers, or directors. The exception for a policy covering a 20 percent owner of a business would remain.

The proposal would apply to contracts issued after December 31, 2024. For this purpose, a material increase in the death benefit or other material change in an existing contract would be treated as the issuance of a new contract, except that in the case of a master contract, the addition of covered lives would be treated as the issuance of a new contract only with respect to the additional covered lives.

MODIFY RULES FOR INSURANCE PRODUCTS THAT FAIL THE STATUTORY DEFINITION OF A LIFE INSURANCE CONTRACT

Current Law

A life insurance contract under the applicable law (typically the insurance law of the domestic or foreign jurisdiction controlling the issuance and interpretation of the contract) is generally treated as an insurance contract under the Internal Revenue Code (Code). However, to qualify for most tax benefits of life insurance policies, the contract must meet the Code's definition of a life insurance contract by satisfying one of two tests that serve to limit a contract's cash value relative to its death benefit.

In general, investment earnings credited to the cash value of a qualifying life insurance policy are taxable only if the income is deemed distributed to the policyholder. Cash distributions from a life insurance contract (other than policy loans, which are generally not regarded as distributions) are generally treated as coming first from the investment in the contract (equal to aggregate premiums paid, less aggregate untaxed distributions); that is, distributions are treated first as an untaxed return of basis. However, if a life insurance contract is determined to be a modified endowment contract (because it is funded too quickly), distributions are deemed to come first from the excess of a contract's cash value over investment in the contract, and to that extent included in gross income. Policy loans made to any person from a modified endowment contract are taxed in the same way as policy distributions, but investment in the contract is increased to the extent such loans are treated as taxable. Nevertheless, accumulated investment earnings of a qualified life insurance contract (including a modified endowment contract) are usually exempt from tax if they are paid as a component of death benefits upon the insured's death.

In contrast, a policyholder of a life insurance contract under the applicable law that has failed both statutory tests (hereafter, a "failed contract") is subject to tax on the "income on the contract" that has accrued during the policyholder's taxable year, regardless of whether any policyholder distributions have occurred. If a life insurance contract under applicable law satisfies the definition of life insurance under the Code, but becomes a failed contract during a taxable year, the income on the contract for all prior taxable years is treated as received or accrued during that taxable year.

The statute defines "income on the contract" as the excess of (a) the sum of the increase in the contract's net surrender value during the taxable year and the cost of insurance protection provided under the contract during the taxable year over (b) any policy premiums paid during the taxable year. A contract's net surrender value is the amount currently payable under the contract, determined without regard to any policy loan, but net of any surrender charges. In the absence of relevant regulations, the cost of insurance protection equals the mortality charge (if any) stated in the contract, which generally depends on the contract's amount at risk (the difference between the contract death benefit and its gross investment or asset value). Premiums paid are measured net of any untaxed distributions of cash received by the policyholder. For a failed contract, the excess of any amount paid by reason of death of the insured over the policy's net surrender value is exempt from tax. A failed policy's net surrender value typically represents net premiums paid and previously taxed, but undistributed, investment earnings (the contract's adjusted basis); therefore, these amounts also bear no tax if paid out as a death benefit.

Reasons for Change

U.S. State insurance non-forfeiture laws generally require that policyholders have access to income credited to their cash value life insurance policies, and policyholders, in many cases, want to maximize their ability to access their policies' values via withdrawals of cash values, loans, or policy surrenders. In recent decades, however, some foreign insurance companies have designed contracts, typically known as "frozen cash value" (FCV) contracts, that do not allow access to amounts credited to the contract that are in excess of the sum of gross premiums paid, less amounts withdrawn or loaned. Thus, the net surrender value for these contracts never exceeds net premiums paid. An FCV contract is usually a flexible premium life insurance contract, whose supporting assets reflect premiums paid, accumulated earnings, and any realized and unrealized appreciation or depreciation of those assets. An FCV contract is unlikely to have surrender charges, and its death benefit will generally equal the value of the supporting assets plus a small amount at risk, which reportedly equals between 2.5 percent and 10 percent of the policy's assets, although certain contracts may have a smaller (or even zero) amount at risk.

FCV contracts are designed to be life insurance contracts under the applicable foreign law and failed contracts under the Code. A U.S. policyholder of such an FCV contract is subject to tax on the policy's "income on the contract" (which will typically be zero or very low), and the contract's death benefit in excess of the net surrender value is tax-free to a U.S. beneficiary. Because the increase in the net surrender value of an FCV contract is attributable only to premium payments, "income on the contract" is limited, at most, to the cost of insurance protection. But this cost of insurance protection is determined by multiplying the FCV contract's amount at risk by a mortality rate, so the amount of tax due is relatively small. Increases in a contract's asset value are not included in taxable income because they are either offset by a payment of premiums during the taxable year or are not part of a contract's net surrender value. Furthermore, proponents of FCV contracts argue that both partial withdrawals and policy loans received during the life of the insured are nontaxable to the extent they are limited to premiums paid and therefore should be deemed to be a return of the contract's basis.

By taxing the excess of a contract's net surrender value over the premiums paid, the rules governing the taxation of failed life insurance contracts were intended to fully tax to the policyholder the earnings and gains accruing on a failed contract's underlying investments, as well as the mortality charges (which are generally designed to be paid out as otherwise tax-excluded contract death benefits). These outcomes are negated by FCV contracts, since these contracts manage to avoid virtually all income tax expected to be levied on earnings by excluding them from the contract's net surrender value.

Proposal

Rules governing failed life insurance contracts would be modified in several respects to ensure that taxation occurs as intended with respect to FCV contracts. First, the current law definition of income on the contract for a failed contract would be modified by substituting "net investment value" for net surrender value. A failed contract's net investment value would be defined for a given date as the amount representing the contract's death benefit, less the contract's amount at risk and any specific charges that might be imposed upon a contract's surrender, at that date. Any policy loan would be disregarded in the determination of a contract's net investment value. This change would mean that the policyholder of any failed contract (including FCV contracts) would be subjected to current taxation on the earnings credited to that contract.

Second, amounts distributed and policy loans from a failed contract would be deemed to be amounts distributed or loaned under a modified endowment contract. For this purpose, the definition of investment in the contract would be amended to include amounts of income on the contract that have been taxed prior to the distribution or loan date, other than amounts equal to the cost of life insurance protection. (These last amounts, while taxed, do not accrue to the value of a contract's net investment value.) A failed contract's adjusted basis for other Code purposes would be defined as equal to its investment in the contract.

Third, the excess of the amount paid by the reason of the death of the insured over the net investment value of the contract would be deemed to be paid under a life insurance contract for purposes of determining the exclusion amount of death benefit proceeds and for purposes of estate and gift taxes.

The proposal would be effective for taxable years beginning after December 31, 2024 for life insurance contracts issued under applicable law on or after the day following the date of publication of this *General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals*. Thus, all earnings and gains credited to failed contracts owned by U.S. persons that were issued after this publication date would be included in the U.S. policyholder's "income on the contract" for taxable years beginning after December 31, 2024. For any qualifying life insurance contracts issued after the publication date that become failed contracts in later years, any prior amounts of untaxed investment value would become taxable in the year of contract failure. Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose. Future withdrawals of cash value from a newly failed contract and any associated policy loan would be deemed funded from the policy's investment in the contract and would not be treated as a taxable distribution.

LIMIT TAX BENEFITS FOR PRIVATE PLACEMENT LIFE INSURANCE AND SIMILAR CONTRACTS

Current Law

The Internal Revenue Code (Code) provides significant tax benefits to policyholders and beneficiaries of life insurance and annuity contracts. In general, investment earnings credited to the cash value of a life insurance or annuity contract are taxable only if the income on the contract is deemed distributed to the policyholder. Thus, such earnings enjoy a deferral of tax liability not available if the invested assets supporting the insurance or annuity contract were held outside of the contract.

Cash distributions from a life insurance contract (other than policy loans, which are generally not regarded as policy distributions) are generally treated as coming first from the "investment in the contract" (generally equal to aggregate premiums paid, less aggregate untaxed distributions received by the policyholder); that is, distributions are treated first as an untaxed return of premiums. However, if a life insurance contract is determined to be a "modified endowment contract" (MEC) because it is funded too quickly, distributions are deemed to come first from the excess of a contract's cash value over its investment in the contract, and, to that extent, are included in taxable income. With some exceptions, an additional 10 percent tax is levied on taxable amounts received from a MEC.[52] Policy loans and assignments or pledges of any portion of the policy value made to any person from a MEC are taxed in the same way as cash distributions, but investment in the contract is increased to the extent such loans are taxable.

For annuity contracts held by a natural person (or trust/agent for the benefit of a natural person), amounts received prior to the annuity starting date (the first day of the first period for which an amount is received as an annuity) are taxed in the same manner as distributions from a MEC, except that loans and pledges of cash value to or by individuals (rather than any person) are treated as distributions. Amounts received after the annuity starting date, but not paid as an annuity, are included in taxable income, while periodic payments received as an annuity after the annuity starting date generally are allocated between income on the contract and investment in the contract, and the portion allocated to income is taxable. With some exceptions, an additional 10 percent tax is levied on taxable amounts received from an annuity.[53]

An annuity contract not held by a natural person generally is not treated as an annuity contract under the Code's income tax provisions (other than for purposes of the taxation of insurance companies). Consequently, all income earned on such a contract (other than amounts reflecting contract surrender charges) is taxed as ordinary income to the policyholder in the year it is credited to the contract's cash value. There are exceptions to this treatment, including for immediate annuities. Furthermore, the 10 percent additional tax on taxable annuity amounts is not levied on annuity contracts subject to annual taxation of credited earnings.

---

[52] Distributions to taxpayers aged 59½ or older, those attributable to the taxpayer becoming disabled, and those made in the form of an annuity for the life or life expectancy of the taxpayer are excepted from the MEC penalty tax.
[53] The annuity penalty tax exceptions include those distributions excepted under the MEC penalty tax, those made on or after the death of the contract holder or the primary annuitant, distributions from qualified retirement plans or contracts, and those made under a qualified funding asset or under an immediate annuity contract.

Accumulated investment earnings of a life insurance contract (including those of a MEC) are generally exempt from tax if they are paid by reason of the death of the insured. Life insurance held through a properly structured irrevocable life insurance trust (or otherwise deemed not to be owned by the insured) is not included in the insured's gross estate and thus death benefits for such policies are not subject to estate and generation-skipping transfer taxes.

Certain life insurance and annuity contracts offer a policyholder the opportunity to invest a contract's supportive assets in one or more managed investment portfolios. Such investment options are made available exclusively to policyholders by the insurance company. These portfolios may produce variable investment returns that determine adjustments to a policy's cash value and, in the case of life insurance, to its death benefit. For such variable contracts, the investment assets usually are held in one or more separate accounts that are legally segregated from an insurance company's general asset account. Although the insurance company is the owner of the separate account assets for legal and tax purposes, these assets cannot be accessed by the company other than to pay the variable contracts' premiums, fees, and benefits.

The investment portfolios of certain variable contracts must meet diversification requirements specified in the Code, or the policy will cease to be treated as a life insurance or annuity contract under the Code. In that case, income earned on the separate account assets is treated as taxable income received by the contract owner. Also, under the "investor control doctrine," policyholders must not have direct or indirect control of the managed portfolio investments underlying their contract, or they (rather than the insurance company) will be treated as the owner of those investments for tax purposes.

Variable contracts under which policyholders bear the risk of investment loss are subject to Securities and Exchange Commission (SEC) regulation as securities if they are sold or marketed in the United States. However, because registering products and maintaining the related compliance obligations are time consuming, expensive, and may limit the ability to offer certain investment options, life insurance companies only register with the SEC standardized products that offer a relatively narrow set of investment options and are marketed widely to the general public in the United States. Unregistered products may only be sold on the condition that their purchasers certify that they meet certain SEC-specified "accredited investor" or "qualified purchaser" definitions. These definitions are intended to ensure that the targeted policyholders are financially able and sophisticated enough to bear the investment risks of unregistered products.

Reasons for Change

As described above, investments made through a life insurance or annuity contract benefit from significant deferral or exclusion tax benefits relative to investments held directly without an insurance or annuity "wrapper." For life insurance, the presumed public policy justification for these tax advantages is to encourage the purchase of insurance for the support of individuals who lose their source of income due to a death. Annuities are intended to provide a stream of income and, in the case of life annuities, insurance protection against outliving income available from one's invested assets.

The tax advantages of life insurance are not intended to provide opportunities for the wealthiest taxpayers to earn substantial tax-free or tax-deferred investment income. Nevertheless, some insurance companies offer customized "private placement" life insurance (PPLI) and annuity (PPA) contracts that do exactly that. Companies selling PPLI contracts generally require annual premiums on such policies of at least $1 million for several years, and often substantially more. Consequently, these policies are offered to only very high net worth individuals or as business-owned life insurance. Most individual PPLI policyholders reportedly have a net worth of $20 million or more, with $10 million or more in liquid assets.

PPLI and PPA contracts allow very affluent purchasers to select from an array of investment options that are not accessible generally to purchasers of registered policies. For example, PPLI and PPA separate accounts may be invested in unregistered hedge funds and private equity funds or in more exclusive portfolios closely tailored to the investment preferences of private placement policyholders (possibly including real estate and other assets deemed attractive to the specific investor).

PPLI contracts are highly investment-oriented policies, provide legally minimal life insurance protection relative to the amounts invested, and are available only to the wealthiest taxpayers to whom income tax and/or estate tax benefits are far more important than the provision of insurance for their heirs. PPLI is also distinguishable from other life insurance products because more than half of the value of such policies is held by institutions, such as large corporations, and not individuals. This type of policyholder uses PPLI death benefits and other distributions to fund executive compensation, employee benefits, and other corporate purposes unrelated to the impact on the business from the death of the insured.

Some U.S. individuals purchase investment-oriented contracts outside of the United States. These variable contracts are regulated as life insurance under foreign law and may permit even greater product customization than is available generally in the United States. For example, foreign law may permit the payment of in-kind premiums, rather than only payment in cash or cash-equivalents, whereby the contributed assets are held as part of the contract's separate account investment. Indeed, an investment manager might purchase assets directly or indirectly from the policyholder or from related persons or businesses, thus allowing policyholders to fund their variable contracts with desired idiosyncratic investments. U.S. State insurance regulation generally does not permit in-kind premium payments. Variable contracts funded by policyholder assets may violate the investor control doctrine, and an enhanced ability to identify such contracts would be helpful to tax administration.

Given the relatively minimal life insurance justification for PPLI contracts and the predominant investment orientation of PPLI, PPA, and similar contracts, such contracts should not give rise to the same tax benefits traditionally provided to life insurance and annuities under the Code. Accordingly, the proposal described below ensures that all earnings on PPLI, PPA, and similar contracts are ultimately taxable, and that tax deferral is limited and discouraged through a penalty tax, while preserving a tax exemption for the pure life insurance benefits (amounts paid in excess of a contract's cash value) received under PPLI contracts.

Proposal

The proposal would limit the tax benefits for private placement life insurance and annuity contracts. It would do so by defining a class of contracts ("Covered Contracts") that are predominantly investment oriented and denying these contracts most of the tax benefits that are generally granted to life insurance and annuity contracts. Covered Contracts would also be subject to additional reporting requirements.

Tax treatment of Covered Contracts

Covered Contracts would be subject to the following tax consequences:

1. Any funds distributed to a policyholder or contract beneficiary from a Covered Contract prior to the contract's annuity starting date (if applicable) would be taxed as ordinary income to the extent the contract's investment value exceeds its investment in the contract (income-first rule). In addition to partial or full surrenders of cash value, distributions would include amounts payable as death benefits, amounts received as policy loans, and amounts of policy cash value assigned or pledged to any person. A life insurance contract's investment value would be defined on a given date as the greater of (a) the contract's cash value and (b) an amount equal to the contract's death benefit, less the contract's amount at risk (i.e., the amount of pure insurance protection). An annuity contract's investment value would equal its cash value.

   The Secretary would be authorized to issue regulations regarding the definition of the Covered Contract's investment value to prevent avoidance of the purposes of these rules, including regulations which ensure that such value, as of any time, properly reflects the value of any underlying investments with respect to such Covered Contract as of such time.

2. Amounts paid after the annuity starting date (if applicable) would be treated as under current law.

3. Amounts paid from a life insurance contract by reason of the insured's death would be taxable as ordinary income, but only to the extent the beneficiary's share of the contract's investment value exceeds the beneficiary's share of the contract's investment in the contract. A contract's investment value and investment in the contract would be allocated to multiple beneficiaries in proportion to the allocation of the death benefit itself to those beneficiaries.

4. An additional tax equal to 10 percent of any taxable distribution from a Covered Contract would be assessed to account for the tax deferral benefits accorded Covered Contracts. The current Code exceptions to the 10 percent penalty tax that apply to taxable amounts received from a MEC or an annuity would not apply to Covered Contracts.

5. A Covered Contract's investment in the contract, as well as its basis for determining taxable gain or loss, would be determined as under current law but would be reduced by

the amount of any mortality charges that have been assessed against the contract's investment value.

Definition of Covered Contracts

The following categories of variable contracts (defined below) would be Covered Contracts subject to the tax treatment described above and the reporting requirements described below:

1. Any PPLI or PPA contract, defined as a variable contract subject to SEC regulation as a security that is not a registered product with the SEC, with respect to which the purchaser, as a condition of purchase, must have sufficient income and wealth to qualify (or can otherwise qualify) as an accredited investor or qualified purchaser under SEC regulations at the time of purchase.

2. Any variable life insurance contract any of whose premiums are paid, directly or indirectly, in kind rather than in cash.

3. Any variable life insurance contract whose underlying assets include assets purchased, directly or indirectly, from the policyholder, persons related to the policyholder, or a business or other entity in which the policyholder or a related person has more than a de minimis ownership interest.

4. Any variable life insurance contract that, in combination with contracts owned by persons related (directly or indirectly) to the contract's policyholder, owns an interest in a separate account of an insurance company, and the cash value of the related contracts, in the aggregate, represents at least 5 percent of the value of any distinct investment option whose assets are accounted for in that separate account.[54]

5. A variable life insurance contract issued outside of the United States, if any of the investment assets supporting the contract, if supporting a contract sold or marketed in the United States, would cause that contract to be salable only to an accredited investor or qualified purchaser and subject to SEC regulation as a security.

For purposes of the proposal, a "variable contract" would be defined as any life insurance or annuity contract for which the amount of the covered insurance company's obligations to the contract holder depends in whole or in part (by law, regulation, or the terms of the contract) on the value of assets that are designated to support the contract.

The following annuity contracts would not be Covered Contracts:

1. A contract held by a nonnatural person that is subject to annual taxation of earnings under current law.

[54] A life insurance separate account or subaccount with this level of ownership concentration is an exclusive portfolio likely closely tailored to the investment preferences of a small group of policyholders, and the participating contracts are therefore similar in nature to the most investment-oriented PPLI contracts.

2. A contract issued under a qualified retirement plan or contract (including a tax-exempt pension trust, individual retirement account, or individual retirement annuity).

For defining a Covered Contract, the relatedness standard would generally include close family relationships (siblings, ancestors, and lineal descendants of the parents of the tested individual or the individual's spouse, and spouse of the individual or of any of the described relatives), certain trust fiduciary relationships, and certain corporate and partnership relationships (using a more-than-50 percent ownership threshold as an indicator of relatedness).

The Secretary would be authorized to issue regulations to prevent avoidance of variable contract status, and to prevent avoidance of Covered Contract status by conduit arrangements or otherwise. The Secretary also would be authorized to issue regulations or other guidance identifying other categories of investment-oriented variable life insurance contracts issued outside of the United States and not subject to SEC registration requirements that are similar in nature to PPLI and should thus be subject to the same tax treatment for U.S. tax purposes.

New reporting requirements for Covered Contracts

The Secretary would be authorized to require reporting by insurance companies and policyholders as necessary to ensure that payments from Covered Contracts are identified and taxed appropriately, including information on policy distributions and premiums. Insurance companies and policyholders would be subject to appropriate penalties for noncompliance with these reporting requirements. In addition, if a payment recipient omits a taxable amount attributable to a distribution from a Covered Contract from the recipient's reported gross income on an income tax return, the associated income and penalty taxes would be assessable at any time within six years after the return was filed.

The proposal would be effective for taxable years beginning after December 31, 2024, for Covered Contracts issued under applicable law on or after the day following the date of publication of this *General Explanation of the Administration's Fiscal Year 2025 Revenue Proposals*. Any substantial modification of an existing life insurance or annuity contract, or exchange of one such contract for another, would be treated as the issuance of a new contract for this purpose.

CORRECT DRAFTING ERRORS IN THE TAXATION OF INSURANCE COMPANIES UNDER THE TAX CUTS AND JOBS ACT OF 2017

Current Law

The Tax Cuts and Jobs Act of 2017 (TCJA) contains two drafting errors related to the taxation of insurance companies.

Policy acquisition expenses

Insurance companies must capitalize, as policy acquisition expenses, a portion of their general deductions otherwise allowed. These capitalized amounts are generally amortized over 180 months, although up to $5 million of such expenses may be amortized over 60 months. This $5 million amount is reduced to the extent an insurer has annual policy acquisition expenses in excess of $10 million. Capitalized policy acquisition expenses generally equal a percentage of an insurer's net premiums on specified contracts. Net premiums are gross premiums reduced by return premiums and by amounts paid for reinsurance. Prior to TCJA, the policy acquisition expense percentages equaled 1.75 percent of net premiums received on annuity contracts, 2.05 percent of net premiums received on group life insurance contracts, and 7.70 percent of net premiums received on other life insurance or noncancellable accident and health insurance contracts. In the TCJA, Congress not only extended the general amortization period for future capitalized amounts from 120 months to 180 months, but also attempted to increase the capitalization percentages to 2.09 percent for annuity contracts, 2.45 percent for group life insurance contracts, and 9.20 percent for other specified contracts, effective for taxable years beginning in 2018. These changes represent approximately a 19.5 percent increase in capitalized amounts for each of the three contract categories. A statutory drafting error, however, misidentified the appropriate language in the Internal Revenue Code (Code), so that only the percentage for annuity contracts could be implemented logically. Consequently, a reasonable reading of the law could claim that only the percentage for annuity contracts was changed by TCJA, despite the intent of Congress identified in the statute's legislative history.

Discounting of unpaid losses

Insurance companies must discount their unpaid loss reserves on property and liability insurance contracts to reflect the fact that unpaid claims and other incurred losses may not be paid for several years into the future. Certain "short-tail" lines of business have relatively short payout profiles. These lines of business include, for example, auto physical damage, warranty insurance, financial guarantee insurance, and certain special property lines of business. Under the tax law, these lines are treated as paying out virtually all their claims by the end of the third year after the accident year (i.e., the year in which losses are incurred). Other lines of business, such as workers' compensation and liability insurance lines, are assumed to pay out claims over much longer periods – currently, up to 17 years after the accident year in the case of workers' compensation claims. Consequently, the average discounting of the unpaid losses under these "long-tail" lines of business is much deeper than the discounts applied to the unpaid losses of "short-tail" lines. Nonproportional reinsurance and international lines of business are deemed to be long-tail lines under the accounting rules promulgated by the National Association of

Insurance Commissioners and, prior to enactment of the TCJA, were treated as long-tail lines for purposes of the unpaid loss discounting tax rules. The TCJA significantly modified the discounting rules, mainly by establishing a different method for determining the applicable interest rates and by lengthening the expected claim payment patterns for long-tail lines of business. However, in modifying the Code to enact these changes, the drafters deleted statutory provisions that had addressed the treatment of the nonproportional reinsurance and international lines of business. Under the revised statute, these lines of business must be treated as short-tail lines of business, and Department of the Treasury regulations now consider them as such – even though there is no legislative history to indicate that this change was intended by Congress.

The payment patterns used to compute discount factors are redetermined every five years. Those patterns used for the most recent "determination year" were developed using insurance company annual statement data for the year 2019 and used first to discount unpaid losses incurred in 2022.

Reasons for Change

The TCJA intended to align the capitalization and amortization requirements of the Code to the economic realities of the market. This required greater capitalization percentages and a longer amortization period. The drafting errors of the TCJA, however, cast doubt on whether actual law represented the intended changes. While preliminary analysis of post-TCJA tax data shows most companies have been capitalizing amounts consistent with the described intent of the TCJA, this does not appear to reflect the opinion of all taxpayers. Correcting this error would restore certainty in the application of the tax law and result in a more even tax treatment of similar taxpayers.

Proper identification of the international and nonproportional reinsurance lines of business as long-tail lines of business would result in payment patterns for those lines of business that are as long as 10 to 14 years after the accident year. While the TCJA discounting drafting error has had relatively minor consequences for aggregate revenue, it nonetheless inappropriately favors these lines of business by reducing the degree of discount for their unpaid losses and provides an unwarranted and unintended deferral of income recognition.

Proposal

The proposal would make two required technical corrections to these statutory drafting errors in the TCJA:

The first correction would change the capitalization rate of net premiums for group life insurance contracts from 2.05 percent to 2.45 percent and the capitalization rate for other non-annuity specified life and health contracts from 7.70 percent to 9.20 percent.

The proposal would be effective as if it had been a part of the original TCJA and would be treated as a change of accounting method initiated by the taxpayer with the consent of the Internal Revenue Service for the taxable year beginning in 2025.

The second technical correction would include the international and nonproportional reinsurance lines of business in the list of long-tail lines of business that are explicitly identified in the statute. This list currently includes various liability lines of business, medical malpractice insurance, workers' compensation insurance, and multiple peril lines.

The proposal would be effective for taxable years beginning after December 31, 2024, for losses incurred and salvage recoverable in accident years beginning after 2024. New loss payment patterns for the international and nonproportional reinsurance lines of business would be determined as if they had been promulgated for the 2022 determination year under the rules proposed here.

DEFINE THE TERM "ULTIMATE PURCHASER" FOR PURPOSES OF DIESEL FUEL EXPORTATION

Current Law

If any diesel fuel or kerosene is exported, the Internal Revenue Service (IRS) is required to pay to the "ultimate purchaser" of the diesel fuel or kerosene a rebate of any Federal excise taxes previously collected on that diesel fuel or kerosene. The term "ultimate purchaser" is not defined in the Internal Revenue Code. Under current law, it is possible in some circumstances for both the foreign national end user of the diesel fuel or kerosene and the last purchaser within the United States that exports the diesel fuel or kerosene to qualify as the ultimate purchaser for this purpose.

Reasons for Change

The ability of more than one person to qualify as the ultimate purchaser results in cases where the IRS is required to pay as a rebate of twice the amount of Federal excise taxes collected on exported diesel fuel or kerosene.

Proposal

The proposal would define the person entitled to a rebate of Federal excise taxes as the last purchaser in the United States for the purposes of diesel fuel and kerosene exportation.

The proposal would be effective for diesel fuel and kerosene exported after December 31, 2024.

LIMIT THE DEDUCTION FOR THE TRANSFER OF PROPERTY TO THE VALUE OF PROPERTY ACTUALLY INCLUDED IN INCOME

Current Law

Current law limits an employer's deductions for the transfer of property, such as employer stock, in connection with the performance of services to the "amount included" in the person's gross income. Internal Revenue Service (IRS) regulations clarify that the deduction is limited to the amount *actually* included in the service provider's income, but the regulations provide a safe harbor that deems the amount that is reported by the employer on the applicable annual information return (e.g., Form W-2, Wage and Tax Statement, for an employee) to be included in the service provider's income for this purpose.

Reasons for Change

Uncertainty exists whether an employer that compensates a service provider (either an employee or an independent contractor) with stock or other property is entitled to deduct the amount that is legally required to be included in the service provider's income, or only the amount that the service provider actually includes in income. These amounts can differ, for example, if the service provider values the property incorrectly or includes it in the wrong year on their Form 1040, U.S Individual Income Tax Return.

In *Robinson v. United States,* 335 F.3d. 1365 (Fed. Cir.), *cert. denied,* 540 U.S. 1105 (2003), the Court of Appeals for the Federal Circuit held that an employer is entitled to deduct the amount "legally required to be included" in a service provider's gross income as a result of a compensatory transfer of stock, without regard to whether the employer ever reported such income on the applicable annual information return or whether the service provider ever reported the income on Form 1040. The court reasoned that the section 83(h) statutory language that allows a deduction for the amount "included" in gross income means the amount allowed as a deduction is the amount "included as a matter of law" in gross income. The *Robinson* decision considered the IRS's regulatory guidance contrary to the statute and declined to follow it.

Requiring consistency in the deduction for property transferred by a service recipient and the income inclusion for the same property by the service provider will improve compliance and ensure fair application of the tax law.

Proposal

The proposal would amend section 83(h) to limit the service recipient's deduction for income attributable to property transferred in connection with the performance of services to the amount actually included in income by the service provider, and to deem the amount reported on the appropriate annual information return to be included in income for this purpose.

The proposal would be effective after December 31, 2024.

REFORM EXCISE TAXES ON BUSINESS AVIATION

Current Law

Under current law, the tax rate on kerosene jet fuel used by private and corporate jets (a segment known as noncommercial business aviation) is 21.8 cents per gallon. The tax is collected on behalf of and transferred to the Airport and Airway Trust Fund (AATF) to support Federal Aviation Administration (FAA) activity.

Certain noncommercial aviation operations are exempt from Federal excise tax on jet fuel. Examples of exempted operations include activity related to foreign trade, farming, nonprofit educational organization, and State and military activity.

Reasons for Change

Each sector of the aviation industry should contribute revenues proportional to its use. This ensures the FAA can sustainably and equitably support existing users, ensure high-demand air space is safely allocated, and meet the growing demand for air traffic control and related services. Currently, business aviation activity does not contribute sufficient revenues to cover their costs.

Business aviation accounts for approximately three percent of the FAA's costs while contributing less than one percent to AATF revenue. As a result, private jet users are not paying taxes commensurate to the costs they impose on the FAA. Increasing existing taxes on kerosene jet fuel would align the contribution of business aviation to the costs they impose on the FAA.

Proposal

The proposal would raise taxes on kerosene used for private jet travel, including corporate jets, from the current 21.8 cents per gallon to $1.06 per gallon. The increase would be phased in over a 5-year period. In the first year, the jet fuel tax would increase from 21.8 cents per gallon to 38.64 cents with a 16.84 cent per gallon increase in each subsequent year until 2029.

This proposed excise tax increase would not affect the existing exemptions for certain noncommercial aviation operations, including foreign trade uses, farming uses, nonprofit educational uses, exclusive use by State or local government and military use. Such uses would remain exempt.

The proposal would be effective for taxable years beginning after December 31, 2024.

IMPROVE TAX ADMINISTRATION

ENHANCE ACCURACY OF TAX INFORMATION

Current Law

Electronic filing of forms and returns

Generally, the Secretary may issue regulations that require electronic filing of returns (as opposed to paper filing of returns) if the taxpayer files a minimum number of returns during a year. For example, corporations that have assets of $10 million or more and file at least 250 returns of any type during a calendar year are required to file electronically their Form 1120/1120S, U.S. Corporation Income Tax Return. Partnerships with more than 100 partners are required to file electronically, regardless of how many returns they file.

Before requiring electronic filing, the Internal Revenue Service (IRS) and the Department of the Treasury are generally required to take into account the ability of taxpayers to comply at a reasonable cost. Taxpayers may request waivers of the electronic filing requirement if they cannot meet that requirement due to technological constraints, or if compliance with the requirement would result in undue financial burden on the taxpayer. In general, the Secretary may not require individuals, estates, and trusts to file their income tax returns electronically.

Reportable payments subject to backup withholding

Backup withholding applies to a reportable payment if a payee fails to furnish the payee's taxpayer identification number (TIN) to the payor in the manner required. Currently, the IRS may only require that the payee furnish the TIN under penalties of perjury with respect to interest, dividends, patronage dividends, and amounts subject to broker reporting. Accordingly, payees of these reportable payments are generally required to provide payors with a certified TIN using a Form W-9, Request for Taxpayer Identification Number and Certification, under penalties of perjury. Payees of other reportable payments subject to backup withholding may furnish their TINs in other ways, including orally, unless the IRS has notified a payor that the TIN furnished is incorrect. This applies to payments under sections 6041, 6041A, 6050A, 6050N, and 6050W of the Internal Revenue Code.

Reasons for Change

Facilitating more accurate tax information supports the broader goals of improving IRS service to taxpayers, enhancing compliance, and modernizing tax administration.

Expanding electronic filing will help provide tax return information to the IRS in a more uniform electronic form, which will enhance the ability of the IRS to better target its audit activities. This in turn can reduce burdens on compliant taxpayers by decreasing the probability that they will be among those selected for audit. Consequently, increased electronic filing of returns may improve satisfaction and confidence in the filing process. The proposal would provide the Secretary broader authority to require electronic filing that would facilitate the IRS's compliance risk assessment process and allow for more efficient tax administration, particularly with respect to large or complex business entities and certain types of transactions that may warrant greater scrutiny.

The intent of backup withholding is to serve as an enforcement tool in ensuring payors and payees are compliant with their reporting obligations. Requiring payees to certify their TINs to payors on a Form W-9 or equivalent form reduces the level of enforcement necessary to ensure information is accurate. Information reporting increases compliance by providing taxpayers with the information that they need to accurately complete their tax returns and by providing the IRS with information that can be used to verify taxpayer compliance. Without accurate taxpayer identifying information, information reporting requirements impose avoidable burdens on businesses and the IRS, and they cannot reach their potential to improve compliance.

Proposal

Expand the Secretary's authority to require electronic filing for forms and returns

Electronic filing would be required for returns filed by taxpayers reporting larger amounts or that are complex business entities, including: (a) income tax returns of individuals with gross income of $400,000 or more; (b) income, estate, or gift tax returns of all related individuals, estates, and trusts with assets or gross income of $400,000 or more in any of the three preceding years; (c) partnership returns for partnerships with assets or any item of income of more than $10 million in any of the three preceding years; (d) partnership returns for partnerships with more than 10 partners; (e) returns of real estate investment trusts (REITs), real estate mortgage investment conduits (REMICs), regulated investment companies (RICs), and all insurance companies; and (f) corporate returns for corporations with $10 million or more in assets or more than 10 shareholders. Further, electronic filing would be required for the following forms: (a) Form 8918, Material Advisor Disclosure Statement; (b) Form 8886, Reportable Transaction Disclosure Statement; (c) Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons; (d) Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds; and (e) Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business.

Return preparers who expect to prepare more than 10 corporation income tax returns or partnership returns would be required to file such returns electronically.

The Secretary would also be authorized to determine which additional returns, statements, and other documents must be filed in electronic form in order to ensure the efficient administration of the internal revenue laws without regard to the number of returns that a person files during a year.

The proposal would be effective for forms and returns required to be filed after December 31, 2024.

Improve information reporting for reportable payments subject to backup withholding

The proposal would also treat all information returns subject to backup withholding similarly. Specifically, the IRS would be permitted to require payees of any reportable payments to furnish their TINs to payors under penalty of perjury.

The proposal would be effective for payments made after December 31, 2024.

AMEND THE CENTRALIZED PARTNERSHIP AUDIT REGIME TO PERMIT THE CARRYOVER OF A REDUCTION IN TAX THAT EXCEEDS A PARTNER'S TAX LIABILITY

Current Law

Section 6226 of the Internal Revenue Code (Code) requires reviewed year partners to include in their reporting year taxes an amount equal to the change in tax that would have occurred for the reviewed year (the taxable year under audit) and all years between the reviewed year and the reporting year if the partnership adjustments were taken into account by the partners in those taxable years. The statutory formula provides, however, that for each of those years, the partners take into account the changes in tax liability that would have occurred in those years by increasing or decreasing their tax liability on their reporting year return by the sum of those changes in tax. If the calculation results in a net decrease, current law treats that net decrease as an amount that can be used by the partners to reduce their reporting year income tax liabilities to zero. Any excess of that amount not offset with an income tax due in the reporting year at the partner level does not result in an overpayment under section 6401 of the Code that can be refunded. The excess amount cannot be carried forward and is permanently lost.

Reasons for Change

The inability for reviewed year partners to receive the full benefit of any reductions in tax as a result of partnership adjustments can lead to situations where a partner may be viewed as being taxed more for an adjustment made under the centralized partnership audit regime than the partner would have outside of the centralized partnership audit regime.

Proposal

The proposal would amend sections 6226 and 6401 to provide that the amount of the net negative change in tax that exceeds the income tax liability of a partner in the reporting year is considered an overpayment under section 6401 and may be refunded.

The proposal would be effective on the date of enactment.

INCORPORATE CHAPTERS 2/2A IN CENTRALIZED PARTNERSHIP AUDIT REGIME PROCEEDINGS

Current Law

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), currently separates the treatment of Chapters 1 (income tax) and 2/2A (self-employment income tax/net investment income tax) adjustments for reporting, tax calculation, and assessment purposes. This disparate treatment requires taxpayers to file multiple tax returns to meet their filing obligations and/or requires the Internal Revenue Service (IRS) to apply dual proceedings to meet its enforcement obligations.

Partnerships report their income on Form 1065, U.S. Return of Partnership Income, in an overall manner and allocate that income to their partners on Schedules K-1 (Form 1065), Partner's Share of Current Year Income, Deductions, Credits, and Other Items, separately stating income amounts subject to Chapters 1 and 2/2A. The calculations of tax liability under these three chapters are intrinsically linked, and individual partners, including partners in partnerships that are subject to the BBA, calculate and pay their taxes under these three chapters in one filing: Form 1040, U.S. Individual Income Tax Return. A BBA proceeding requires the IRS to address adjustments impacting the Chapter 1 liability of any person at the partnership level, meaning the IRS must follow centralized BBA rules and generally assess and collect from the partnership an imputed underpayment amount with respect to such adjustments that would increase the taxable income of its partners. In contrast, with respect to Chapters 2/2A taxes that result from a BBA proceeding, the IRS must assess and collect these taxes from individual partners, rather than the partnership.

Reasons for Change

Cumbersome procedures that link impacted partners' returns to a BBA return under examination in addition to administering the BBA proceeding are contrary to the intent that BBA streamline tax administration of partnership examinations. Essentially, the partners' returns are also required to be examined. For partnerships that file Administrative Adjustment Requests, make Amended Return Modification elections, or make Push-Out elections, partners must separately amend their reviewed-year Forms 1040 to pay any Chapter 2/2A taxes attributable to the adjustments made in the partnership proceeding.

Proposal

The proposal would amend the definition of a BBA Partnership-Related-Item to include items that affect a person's Chapter 2/2A taxes and would apply the sum of the highest rates of tax in section 1401(b)(1) and (b)(2) of the Internal Revenue Code in effect for the reviewed year to these items.

The proposal would be effective after the date of enactment for all open taxable years.

ALLOW PARTNERSHIPS TO RESOLVE AUDITS EARLIER

Current Law

The centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), currently requires the issuance of a Notice of Proposed Partnership Adjustments (NOPPA) and a Notice of Final Partnership Adjustments (FPA) before a partnership may make an election to push out the adjustments to its reviewed year partners. By default, a partnership is liable to pay an Imputed Underpayment (IU) on partnership adjustments. A push out election transfers responsibility to pay taxes on the adjustments to its partners and relieves the partnership of its obligation to pay the IU. The partnership may pay the IU or elect to push out the adjustments at the conclusion of an audit. Partnerships have 45 days from the issuance of the FPA to elect to push out the adjustments.

Reasons for Change

Partnerships may not make a push out election until the issuance of an FPA even if the partnership does not plan to dispute the adjustment proposed in a NOPPA. Both partnerships and the IRS would save time and resources if partnerships had the option, but not the requirement, to resolve an audit by pushing out the adjustments at an earlier point in cases where there is no dispute regarding the adjustments.

Proposal

The proposal would allow a partnership to make an election to push out the adjustments after the issuance of the NOPPA until 45 days after the issuance of the FPA.

The proposal would be effective upon enactment.

MODIFY REQUISITE SUPERVISORY APPROVAL OF PENALTY INCLUDED IN NOTICE

Current Law

Section 6751(b)(1) of the Internal Revenue Code (Code) provides that no penalty under Title 26 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 or her delegate may designate. This section applies to all civil penalties imposed by the Code, except for penalties under section 6651 for failure to file tax returns or to pay tax; section 6654 for failure by individuals to pay estimated income tax; section 6655 for failure by corporations to pay estimated income tax; section 6662 with respect to an overstatement of certain qualified charitable contributions; and penalties that are automatically calculated through electronic means. With respect to individuals, the Internal Revenue Service (IRS) has the burden of production in a U.S. Tax Court proceeding challenging penalties to show the penalties are appropriate.

Reasons for Change

Recent court decisions have led to uncertainty concerning, among other things, the requisite timing of the approval and qualified approvers. Judicial opinions have required supervisory approval of a penalty before the penalty is communicated to a taxpayer when a taxpayer still has the opportunity to raise defenses to the penalty. As a result, a supervisor may not have all the information relevant to deciding whether a penalty is appropriate by the deadline certain opinions have imposed. Many judicial opinions have barred penalties that a supervisor approved before assessment and before any opportunity for judicial review. When supervisory approval did not meet judicially-created deadlines, courts have barred penalties without considering whether the penalties were appropriate under the facts of the particular case. These barred penalties have included accuracy-related penalties where the taxpayers did not show they acted with reasonable case for underpayments on their returns. Barred penalties have also included those arising from understatements attributable to reportable transactions that the IRS identified as tax avoidance transactions or that taxpayers entered into with a significant purpose of income tax avoidance or evasion. In some cases, barred penalties have even included civil fraud penalties where the IRS has met its burden of showing by clear and convincing evidence that an underpayment of tax was attributable to fraud. These cases undercut the purpose of penalties to deter taxpayer non-compliance with tax laws, based on unclear, hard to apply rules that often apply retroactively.

Proposal

The proposal would clarify that a penalty can be approved at any time prior to the issuance of a notice from which the Tax Court can review the proposed penalty and, if the taxpayer petitions the court, the IRS may raise a penalty in the court if there is supervisory approval before doing so. For any penalty not subject to Tax Court review prior to assessment, under the proposal supervisory approval could occur at any time before assessment. In addition, the proposal would expand approval authority from an "immediate supervisor" to any supervisory official, including those that are at higher levels in the management chain or others responsible for review of a potential penalty. Finally, the proposal would eliminate the written approval requirement under section 6662 for underpayments of tax; section 6662A for understatements with respect to reportable transactions; and section 6663 for fraud penalties.

The proposal would be effective upon enactment.

MODIFY THE REQUIREMENT THAT GENERAL COUNSEL REVIEW CERTAIN OFFERS IN COMPROMISE

Current Law

Section 7122 of the Internal Revenue Code authorizes the Secretary to enter into an agreement with a taxpayer that settles the taxpayer's tax liabilities for less than the full amount owed if the taxpayer's case has not been referred to the Department of Justice. Such an agreement is known as an offer in compromise. The Internal Revenue Service (IRS) is authorized to compromise a liability on grounds of doubt as to liability, doubt as to collectability, or the promotion of effective tax administration.

Section 7122(b) requires the General Counsel of the Department of the Treasury, or their delegate, to review and provide an opinion in support of offers in compromise where the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, and assessable penalty) is $50,000 or more. The General Counsel has delegated legal review of offers in compromise to the Chief Counsel of the IRS, who has delegated that authority to the Small Business/Self-Employed Division (Counsel).

Reasons for Change

The IRS receives thousands of offers in compromise applications every year and must verify that the requirements for compromise are met prior to proposing acceptance. Counsel reviews offers in compromise to determine whether the offers meet the legal standards of doubts of liability, doubts as to collectability, or the promotion of effective tax administration, and to ensure offers conform to the IRS's policies and procedures. The time Counsel spend on reviewing offers already reviewed by other IRS employees may delay acceptance, which may result in financial uncertainty or harm to taxpayers, while providing no additional protection of taxpayer rights.

Proposal

The proposal would amend section 7122(b) to repeal the requirement that General Counsel review all offers in compromise where the unpaid amount of tax assessed (including any interest, additional amount, addition to tax, or assessable penalty) is $50,000 or more and instead authorize the Secretary to require Counsel review of offers in compromise only in cases that she determines present significant legal issues.

The proposal would be effective for offer in compromise applications submitted after the date of enactment.

SIMPLIFY FOREIGN EXCHANGE GAIN OR LOSS RULES AND EXCHANGE RATE RULES FOR INDIVIDUALS

Current Law

Section 988 of the Internal Revenue Code provides rules for determining the timing, amount, character and source of foreign exchange gain or loss from foreign currency, foreign currency debt, certain foreign currency expenses or foreign currency derivatives (when the foreign currency is a nonfunctional currency for the taxpayer). These rules apply to individuals as well as to businesses.

These rules do not apply to any transaction that is a personal transaction. A personal transaction generally means any transaction entered into by an individual. Such transactions do not include those where expenses properly allocable to the transaction are deductible as trade or business expenses or are expenses for the production of income (subject to some exceptions).

In addition, no gain is recognized for Federal income tax purposes for personal transactions involving the disposition of foreign currency where the gain is $200 or less. This exemption for gains of no more than $200 was enacted in 1986.

When a U.S. individual earns income denominated in a foreign currency, the individual must translate such income into U.S. dollars at the spot rate when earned. This includes U.S. individuals living and working abroad that regularly earn income in foreign currency.

Reasons for Change

Under current law, U.S. individuals living and working abroad must apply complicated rules relating to foreign currency transactions. Simplifying certain rules relating to these transactions for U.S. individuals living and working abroad or with other foreign ties would improve compliance and better reflect the economic environment in which these individuals live and work.

For example, a U.S. citizen working abroad who receives a salary denominated in euros every two weeks must translate each deposit into U.S. dollars at the spot rate on the date each payment is received. Consequently, the U.S. citizen must use 26 different spot rates to calculate annual compensation income to file the citizen's U.S. tax return.

Another example involves a mortgage on a personal residence. An individual that purchased a residence abroad with a mortgage on the property may have gain attributable to currency fluctuations when the individual sells the residence that are offset economically by currency losses on the individual's mortgage. The gain, including the amount attributable to foreign currency fluctuations, from the sale of the residence may be taxable to the individual, while foreign currency losses on a mortgage of a personal residence are generally non-deductible personal losses. This could lead to individuals recognizing taxable gain in situations in which no economic gain was realized.

Proposal

The proposal would allow individuals living and working abroad to use an average rate for the year to calculate qualified compensation received in foreign currency, as well as for other items of income or expense of such individuals (including retired individuals) as specified in regulations. It is anticipated that the average rate generally would be available for ordinary course payments expected to recur regularly during the course of a year.

The proposal would increase the personal exemption amount for foreign currency gain from \$200 to \$600, to reflect inflation since 1986, and would index this threshold to inflation on an annual basis.

The proposal would also allow individuals to deduct foreign currency losses realized with respect to mortgage debt secured by a personal residence to the extent of any gain taken into income on the sale of the residence as a result of foreign currency fluctuations. Since an individual may own a personal residence outside the United States that is secured by a foreign currency-denominated mortgage whether or not the individual lives abroad, the proposal would not be limited to individuals who live and work abroad.

The proposal would be effective for taxable years beginning after December 31, 2024.

MODERNIZE REPORTING WITH RESPECT TO FOREIGN TAX CREDITS TO REDUCE BURDEN AND INCREASE COMPLIANCE

Current Law

Taxpayers are required to substantiate their foreign tax credits (FTC) and to notify the Secretary if certain events occur after the payment or accrual of a foreign income tax that affects the amount of such foreign income tax (a foreign tax redetermination or FTR).

While a failure to substantiate the FTC may cause the entire credit to be disallowed, there is no specific penalty or extension to the statute of limitations (SOL) for failing to provide or substantiate the information required on the FTC reporting forms (i.e., Form 1116, Foreign Tax Credit, and Form 1118, Foreign Tax Credit – Corporations). In the event of an FTR, the foreign income tax originally reported must be adjusted (along with related tax items) to redetermine the amount of U.S. tax due. If the FTR results in additional tax, the taxpayer must file an amended return and pay the additional tax due. If the taxpayer does not file an amended return, the Secretary will assess the additional tax, which is due upon notice and demand. The penalty for failure to timely report an FTR is five percent of any deficiency arising from the failure to report, increasing by five percent for each month during which the failure continues, up to 25 percent.

Current law provides an exception to certain FTC rules and reporting requirements for U.S. individuals who incur $300 ($600 if married and filing a joint return) or less of creditable foreign income taxes on passive investment income.

Reasons for Change

Modernizing reporting requirements with respect to foreign tax credits will reduce taxpayer burden, reduce administrative costs for the IRS, and improve compliance.

Since the 1918 Revenue Act, when the FTC and FTR provisions were first enacted, the frequency, scope, and complexity of cross-border activities have substantially increased. While other tax statutes governing cross-border activities have changed substantially in response to these developments, there has been little change to the law related to FTRs and information reporting and substantiation of FTCs.

In recent years, FTRs have become burdensome for the government and taxpayers. A U.S. multinational may have hundreds of FTRs each year. The required amended returns for each affected year impose costs on taxpayers and are administratively difficult for the government. Similarly, while the requirement that additional tax be collected on notice and demand promoted compliance and efficient enforcement when FTRs were uncommon, in recent years, the audit and the assessment of tax outside of the ordinary audit work stream have proven inefficient.

The rules governing information reporting and substantiation of FTCs have likewise fallen behind international information reporting norms. While the relevant information reporting has been expanded in recent years, the lack of comprehensive rules requiring taxpayers to timely provide complete and accurate information for purposes of computing FTCs has led to difficulties in audit and enforcement. Additionally, the penalty for failure to report an FTR is narrow and has generally been ineffective at improving compliance or promoting audit efficiency.

Finally, increasing the $300 ($600 in the case of a joint return) threshold for U.S. individuals would simplify return preparation for a greater number of individual taxpayers.

Proposal

The proposal would expand the regulatory authority under which the Secretary may require taxpayers to furnish information relating to the verification and computation of the FTC.

The proposal would clarify that FTRs include changes in the liability for foreign income taxes as well as certain other changes that may affect a taxpayer's U.S. tax liability (e.g., a change to foreign taxes that affects the subpart F or GILTI inclusion amounts). The proposal would clarify that the Secretary will provide the form and manner of notification and would have the authority for alternative adjustments to account for FTRs, including special rules for FTRs involving taxpayers that do not claim a FTC but report foreign income taxes to their owners, such as partnerships, trusts, or certain regulated investment companies. The proposal would provide that the Secretary may provide for the assessment and collection of any U.S. tax liability resulting from an FTR in the year of the FTR and under deficiency procedures.[55] The Secretary may also provide alternative adjustments including appropriate netting or offsetting of adjustments, overpayments, underpayments, and interest in different years with respect to FTRs reportable in the same taxable year.

The proposal would extend the statute of limitations in the event taxpayers fail to report the required information relating to FTCs and FTRs to three years after the date on which the Secretary receives the required information. Failure to report an FTR would be subject to a penalty equal to the greater of five percent or $10,000 for each failure, with an increase from five percent to 20 percent for willful failures. Additionally, failure to respond to any IRS information requests relating to substantiation of an FTC or FTR would be subject to a penalty equal to the greater of five percent or $10,000 after 90 days of failing to respond, increased by the greater of five percent or $10,000 for each subsequent 30-day period up to a maximum of the greater of 25 percent (40 percent in the case of willful failures) or $50,000.

Finally, the proposal would increase the threshold for the exception to certain FTC rules and reporting requirements for U.S. individuals to $600 ($1,200 in the case of a joint return) and would index this threshold to inflation.

The increase in the threshold for the exception to certain FTC rules and reporting requirements would be effective for foreign income taxes paid or accrued in taxable years beginning after

[55] This would reduce the need for taxpayers to file amended returns, allowing the adjustment to be reported on their tax return for the year of the FTR. The Secretary could provide that these amounts are assessed and collected under deficiency procedures if doing so is more efficient than issuing separate notice and demand. However, the calculation of the tax would still be calculated by reference to the relation-back year.

December 31, 2024. All other changes provided in the proposal would apply to taxable years beginning after the date of enactment, including with respect to FTRs occurring in such years that relate to prior years.

AUTHORIZE LIMITED SHARING OF BUSINESS TAX RETURN INFORMATION TO MEASURE THE ECONOMY MORE ACCURATELY

Current Law

Current law authorizes the Internal Revenue Service (IRS) to disclose certain Federal Tax Information (FTI) for governmental statistical use. Business FTI may be disclosed to officers and employees of the Census Bureau for all businesses. Similarly, business FTI may be disclosed to officers and employees of the Bureau of Economic Analysis (BEA), but only for corporate businesses. Specific items permitted to be disclosed are detailed in the associated Treasury Regulations. The Bureau of Labor Statistics (BLS) is currently not authorized to receive FTI.

Reasons for Change

BEA's limited access to business FTI and BLS's lack of access to business FTI prevents BEA, BLS, and Census Bureau from synchronizing their business lists. Synchronization of business lists would significantly improve the consistency and quality of sensitive economic statistics including productivity, payroll, employment, and average hourly earnings.

In addition, given the growth of non-corporate businesses, especially in the service sector, the current limitation on BEA's access to corporate FTI impedes the measurement of income and international transactions in the National Accounts. The accuracy and consistency of income data are important to the formulation of fiscal policies.

Further, the Census Bureau's Business Register is constructed using both FTI and non-tax business data derived from the Economic Census and current economic surveys. Because this non-tax business data is inextricably comingled with FTI, it is not possible for the Census Bureau to share data with BEA and BLS in any meaningful way.

Proposal

The proposal would give officers and employees of BEA access to FTI of those sole proprietorships with receipts greater than $250,000 and of all partnerships. No BEA contractor would have access to FTI.

The proposal would also give BLS officers and employees access to certain business (and tax-exempt entities) FTI including: Taxpayer Identification Number (TIN); name(s) of the business; business address (mailing address and physical location); principal industrial activity code (including the business description); form number and name of business tax forms filed; number of employees and total wages (including wages, tips, and other compensation), quarterly from Form 941, Employer's Quarterly Federal Tax Return, and annually from Form 943, Employer's Annual Federal Return for Agricultural Employees, and Form 944, Employer's Annual Federal Tax Return); employment code from the Business Master File; type of entity code from Form SS-4; gross receipts or sales less returns and allowances for for-profit businesses; and total revenues for non-profit organizations. The proposal would permit BLS, BEA, and the Census Bureau to share such FTI amongst themselves (subject to the restrictions described below). BLS would not have access to individual employee FTI. No BLS contractor would have access to FTI.

The proposal would require any FTI to which BEA and BLS would have access, either directly from IRS, from the Census Bureau, or from each other, to be used for statistical purposes consistently with the Confidential Information Protection and Statistical Efficiency Act of 2002 (CIPSEA). The three statistical agencies would be subject to taxpayer privacy law, safeguards, and penalties. They would also be subject to CIPSEA confidentiality safeguard procedures, requirements, and penalties. Conforming amendments to applicable statutes would be made as necessary to apply the taxpayer privacy law, including safeguards and penalties to BLS as well as the Census Bureau and BEA.

The proposal would be effective on the date of enactment.

EXPAND TIN MATCHING AND IMPROVE CHILD SUPPORT ENFORCEMENT

Current Law

Section 6103(a) of the Internal Revenue Code (Code) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several provisions authorizing the disclosure of specific return information in specific circumstances. Recipients of returns or return information may not further disclose this information unless specifically authorized by law and must maintain returns and return information according to strict procedures to safeguard such data. Information security requirements for Federal, state, and local agencies receiving taxpayer information are described in *IRS Publication 1075, Tax Information Security Guidelines*.[56]

The Internal Revenue Service (IRS) has established a Taxpayer Identification Number (TIN) Matching Program for payors of certain reportable payments subject to the backup withholding provisions of section 3406 of the Code. The TIN Matching Program allows taxpayers required to file certain information returns to confirm that the TIN-name pairs for which the taxpayer intends to file a return match IRS records. No information other than a numerical indicator for the validity of the match is disclosed.

Separately, section 6103 authorizes the IRS to disclose certain return information to Federal, State, and local child support enforcement agencies (CSEs). Section 6103 further authorizes CSEs to disclose some, but not all, of that information to their contractors. Such redisclosures are authorized solely for the purposes of establishing or collecting child support obligations and locating individuals owing child support obligations. There is no explicit authority in section 6103 for the IRS to disclose to Tribal CSEs or their contractors return information for purposes of child support enforcement.

The Federal tax refund offset program collects past-due child support payments from the tax refunds of parents who owe support, but the program only covers past-due child support from a court order or an administrative process established under State law.

Reasons for Change

Because the TIN Matching Program only applies to reportable payments under section 3406, the Program does not apply to a number of widely-used information returns, including Form 1098, Mortgage Interest Statement; Form 1098-T, Tuition Statement; Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.; Form 5498, IRA Contribution Information; Form 1099-G, Certain Government Payments; Form 1099-S, Proceeds from Real Estate Transactions; and Form 1042-S, Foreign Person's U.S. Source Income Subject to Withholding. Expanding IRS authority to apply the TIN Matching Program to all information return filers would save the government and taxpayers significant resources and would result in fewer reporting errors, IRS notices, and penalties.

[56] IRS Publication 1075, *Tax Information Security Guidelines for Federal, State and Local Agencies: Safeguards for Protecting Federal Tax Return and Return Information*, revised November, 2021. https://www.irs.gov/pub/irs-pdf/p1075.pdf

State and local CSEs rely on their contractors for efficient child support operations. Expanding the ability of CSEs to share information with their contractors will facilitate the establishment and collection of child support obligations, the locating of individuals owing child support obligations, and the administration of the Federal tax refund offset program.

Because Tribal CSEs are not explicitly identified in section 6103, they are not able to use return information to establish or collect child support or locate individuals with child support obligations in the same way that State and local CSEs are even though they perform similar functions. In addition, because they are not listed in section 6402 of the Code Tribal CSEs are not able to use the Federal tax refund offset program to collect past-due support.

Proposal

The proposal would amend section 6103 to permit TIN matching for filers of all information returns requiring the reporting of names and TINs.

The proposal would also amend section 6103(l) to allow CSEs to share all of the information they receive with their contractors, subject to the same confidentiality and safeguard provisions applicable to recipients of return information under current law. It would also provide Tribal CSEs with the same access to the same return information as Federal, State, and local CSEs, and would amend section 6402(c) to provide Tribal CSEs with access to the Federal tax refund offset program.

These proposals would be effective upon enactment.

CLARIFY THAT INFORMATION PREVIOUSLY DISCLOSED IN A JUDICIAL OR ADMINISTRATIVE PROCEEDING IS NOT RETURN INFORMATION

Current Law

Section 6103(a) of the Internal Revenue Code (Code) prohibits the disclosure of returns and return information unless a provision of Title 26 provides otherwise. Section 6103 contains several provisions authorizing the disclosure of specific return information in specific circumstances.

While section 6103(h) permits certain disclosures of returns and return information in judicial and administrative tax proceedings, neither this exception nor any other section 6103 exception explicitly creates a general authorization to redisclose return information that has previously been disclosed during a judicial or administrative proceeding and become public information as a result.

Reasons for Change

In abusive tax transaction cases where the Internal Revenue Service refers the case to the Department of Justice (DOJ), it is common for DOJ to issue a press release as a key tool to encourage taxpayer compliance. For example, by announcing the filing of a complaint in abusive tax transactions cases, the government alerts taxpayers that certain transactions and conduct will draw the attention of the government and that the government will seek to enjoin those transactions and conduct. Taxpayers not monitoring court filings may become aware of abusive tax schemes to watch out for through the government's press releases designed to reach broader audiences. Disclosures for purposes of judicial and administrative proceedings are explicitly authorized under section 6103 but press releases or other communications relating to this previously disclosed information that has been made part of the public record are not explicitly referenced in section 6103.

Proposal

The proposal would amend section 6103(b)(2) to clarify that information previously disclosed pursuant to section 6103 in the course of any judicial or administrative tax proceeding and made a part of the public record thereof, including information disclosed in any Notice of Federal Tax Lien filed in accordance with section 6323 of the Code or related filings, is not return information protected from disclosure by section 6103.

The proposal would be effective upon enactment.

REQUIRE EARLIER ELECTRONIC FILING DEADLINES FOR CERTAIN INFORMATION RETURNS

Current Law

Most electronically filed information returns, including those reporting gambling winnings, unemployment compensation, social security benefits, interest income, dividend income, distributions from retirement plans, cancellation of indebtedness, and mortgage interest are required by statute to be filed with the Internal Revenue Service (IRS) by March 31 of the year following the year for which the information is being reported. Electronically filed returns and statements relating to employee wage information and nonemployee compensation are subject to an earlier filing deadline of January 31 of the year following the calendar year to which such returns relate.

Third parties filing information returns with the IRS must also furnish a copy to payees. The deadline for furnishing this information to payees is earlier than the deadline to file the return with the IRS in most cases. A copy of the information filed with the IRS for most information returns is required to be furnished to payees by January 31 of the year following the year for which the information is being reported. In the case of payments reported on the Form 1099-B, statements to payees are required to be furnished by February 15.

Individuals are generally required to file their income tax returns by April 15 of the year following the close of the calendar year, but many file earlier, before the IRS has received the relevant information returns.

Reasons for Change

An earlier filing deadline for certain information returns can improve tax administration for both the government and taxpayers.

The IRS uses third-party information reporting to determine a taxpayer's compliance with Federal tax obligations. The information is also used to detect fraud and identity theft. The current March 31 deadline for most electronically filed information returns is well after the start of the filing season, limiting the IRS's real-time matching of information reporting to tax returns. Accelerating the IRS's receipt of third-party information will facilitate detection of non-compliance earlier in the filing season and will reduce identity theft and fraud.

In addition, providing the IRS with access to this information at the time when taxpayers receive the same information (for most returns January 31 or February 15) can facilitate the electronic use of data during the tax return filing season, which can simplify the tax preparation process for individuals and reduce errors, such as the inadvertent omission of income or expense information already furnished to the individual. Accelerating the IRS's receipt of third-party information will also support the implementation of the *IRS Inflation Reduction Act Strategic Operating Plan* [57]

[57] IRS Publication 3744: *Internal Revenue Service Inflation Reduction Act Strategic Operating Plan FY2023-FY2031*, April 2023. https://www.irs.gov/pub/irs-pdf/p3744.pdf

including the delivery of proactive alerts and helping taxpayers start their returns with data that can go directly into return preparation software.

Proposal

The proposal would amend Section 6071(b) to require information returns made under sections 6041 through 6050Z of the Code (other than returns and statements required to be filed with respect to nonemployee compensation) to be filed on or before the date returns are required to be furnished to payees and other recipients.

The proposal would be effective for information returns required to be filed after December 31, 2024.

ALLOW THE TAX COURT TO REVIEW ALL EVIDENCE IN INNOCENT SPOUSE RELIEF CASES

Current Law

A married taxpayer who files a joint return is jointly and severally liable for any tax liability stemming from that return. However, a taxpayer may be eligible for innocent spouse relief and relieved from all or a portion of any tax liability that evolved from the actions of their spouse. For example, if their spouse understated the tax due on their joint return without the taxpayer's knowledge, innocent spouse relief can reduce or completely remove the tax liability from the "innocent" spouse. When determining whether to grant relief, the Internal Revenue Service (IRS) considers several factors, such as knowledge, financial hardship, and whether the spouse requesting relief separated or got divorced from the taxpayer who misreported the taxpayer's income or underpaid taxes. To initiate a request for relief, a taxpayer is required to complete a form and submit documentation that ultimately becomes part of the IRS's administrative record.

Taxpayers may petition the Tax Court to review adverse determinations by the IRS involving innocent spouse relief. As part of the Taxpayer First Act of 2019, Congress amended section 6015 of the Internal Revenue Code to provide a *de novo* standard of review for innocent spouse relief determinations. A *de novo* standard allows the Tax Court to engage in a new analysis without deference to the IRS's decision. However, this legislation limited the scope of review to a) the administrative record at the time of the IRS's determination and b) any newly discovered or previously unavailable evidence. Therefore, the Court may not consider information that was previously available but is not in the administrative record.

Reasons for Change

The statutory limitation on the scope of review in innocent spouse relief cases prevents the Tax Court from fully reviewing cases for taxpayers who did not present a complete administrative record or submit critical documentation to the IRS prior to the time of the final determination.

Some taxpayers may overlook or not submit evidence that would have helped their case, or they may be reluctant to share certain information with the IRS that they may be more comfortable sharing with a judge. Additionally, some administrative records, which include the facts and circumstances of each case, may not be fully developed, and the taxpayer may have little control over the maintenance and completeness of the agency's administrative case file. Consequently, the outcome of the taxpayer's case before the Tax Court may significantly depend on the IRS's factual development and analysis of the case, and whether it was accurate and complete.

Expanding the scope of Tax Court review will reduce the risk that taxpayers bear tax liability due to the lack of a complete and accurate administrative record. Eliminating the existing limitations on the scope of Tax Court review will enhance due process in innocent spouse cases and lead to more equitable outcomes for taxpayers petitioning the Tax Court for review.

Proposal

The proposal would eliminate statutory limitations on the scope of information that the Tax Court may review in innocent spouse relief cases.

The proposal would be effective on the date of enactment.

PERMIT ELECTRONICALLY PROVIDED NOTICES

Current Law

The Internal Revenue Service (IRS) sends notices by mail to taxpayers for a variety of reasons. A notice may inform taxpayers about a change to their accounts, an issue on their tax returns, a request for information or a payment, or other information. It may also provide taxpayers with the information about important deadlines and their statutory rights. Various provisions in the Internal Revenue Code (Code) specify that a notice must be sent by certified or registered mail to the taxpayer's last known address. Some of these notices grant taxpayers the right to contest the IRS's proposed administrative actions, including those that would take place in the Independent Office of Appeals or in a Federal court of law.

Reasons for Change

The notice requirements protect taxpayers because if the IRS does not adhere to the requirements provided by statute, it may be limited in its ability to pursue administrative actions. For example, pursuant to section 6303 of the Code, if the IRS fails to mail to a taxpayer's last known address a notice and demand for payment of tax within 60 days of assessment, then the IRS may be prohibited from using administrative means for collection. In this case, the IRS may lose priority over other creditors for repayment in certain situations (for example, in bankruptcy proceedings) and be required to bring suit to collect.

A taxpayer may also be disadvantaged by the requirement that the IRS notify taxpayers of their rights by certified or registered mail to the taxpayers' last known address. For example, pursuant to section 6212 of the Code, the IRS must send its notice of a proposed increase in tax liability to the taxpayer by "certified or registered mail" to the taxpayer's "last known address." This notice advises the taxpayer of the right to petition the U.S. Tax Court for a review of that determination. So long as the IRS complies with this requirement, the notice is legally effective when sent and the time limit begins to run on that day, regardless of whether or when the taxpayer receives the correspondence.

To modernize the agency and create a seamless taxpayer experience, the IRS is digitizing forms, creating online accounts, and allowing taxpayers to elect to correspond electronically with the IRS. Taxpayers may elect to digitally receive and submit certain correspondence with the IRS. However, even when a taxpayer elects to receive notices electronically, such notices do not satisfy the statutory requirement that certain notices must be sent by certified or registered mail to a taxpayer's last known address. Allowing taxpayers to elect to receive IRS notices by means of secure, trackable, electronic transmission in lieu of, or in addition to, paper notices can reduce administrative burdens on the IRS and taxpayers by ensuring these notices are delivered and retained through a second medium.

Proposal

The proposal would amend all Code provisions which require notice by mail (including notice by certified or registered mail sent to the taxpayer's last known address) such that electronic notice pursuant to the taxpayer's election or preference will have the same legal effect as a mailed notice. The IRS would still be obligated to send these notices by mail unless the taxpayer elected to receive such notices only electronically.

The proposal would be effective as of December 31, 2024.

REFORM FEDERAL GRANTS TO LOW-INCOME TAXPAYER CLINICS

Current Law

The Low-Income Taxpayer Clinic (LITC) grant program provides financial support for the development and existence of LITCs throughout the country. LITCs provide free or nominal-cost representation to low-income taxpayers involved in tax disputes with the IRS and to educate individuals who speak English as a second language (ESL) about their tax rights and responsibilities.

Section 7526 authorizes the Secretary, subject to the availability of appropriated funds, to provide grants of no more than $100,000 per clinic per year. The Secretary may award multi-year grants, not to exceed three years. The grant limitation in section 7526 is not indexed for inflation and has remained at $100,000 since the program's creation in 1998. However, the Consolidated Appropriations Act, 2023 provided for grants to individual clinics of up to $200,000. Further, section 7526 requires LITCs to match the grant funds on a dollar-for-dollar basis (a 100 percent matching funds requirement).

Reasons for Change

The LITC program plays a valuable role in strengthening tax administration by ensuring low-income and ESL taxpayers have access to representation in tax disputes, by providing outreach, and through systemic advocacy. In 2022, LITCs represented almost 20,000 taxpayers and educated almost 57,000 taxpayers and service providers.[58]

The statutory cap of $100,000 per clinic on grant funding limits the expansion of the LITC program and its overall impact on low-income and ESL taxpayers. At this level, well-functioning clinics struggle to expand and maximize their impact in their communities. Additionally, the 100% matching requirement presents challenges to the expansion of existing clinics and the launch of new clinics in underserved areas where it is difficult to raise funds from other sources. For example, potential clinics are sometimes unable to open due to an inability to match funds and to receive a grant award that is sufficient to cover operating expenses.

The LITC Program Office could ensure more taxpayers receive LITC services if it had authority to provide larger grants to clinics that use the grant funds especially effectively, consistent with the objective of providing maximum geographic coverage to taxpayers across the United States. Additionally, the LITC Program Office could use discretion to reduce the matching requirement to provide more support to clinics in underserved areas.

Proposal

The proposal would increase the annual limitation on grants to a single clinic to $200,000, indexed for inflation. In addition, while the applicable percentage of matching funds generally

[58] IRS Publication 5066, *Low Income Taxpayer Clinics 2023 Program Report*, https://www.irs.gov/pub/irs-pdf/p5066.pdf, December 2023. Forms 13424-A and 13424-K, Low Income Taxpayer Clinic (LITC) General Information Report; data compiled by GrantSolutions.

would remain at 100%, the Secretary would be granted authority to reduce the matching requirement to as low as 25%, where doing so would serve the mission of the LITC program. For example, the Secretary could reduce the match to 25% for clinics in areas that are underserved or that require additional monetary support to launch or operate the clinic.

The proposal would be effective upon enactment.

IMPROVE TAX COMPLIANCE

ADDRESS TAXPAYER NONCOMPLIANCE WITH LISTED TRANSACTIONS

Current Law

Generally, the Internal Revenue Service (IRS) must assess a tax within three years after the date the return is filed, subject to several exceptions. A special rule applies if a taxpayer fails to include, on any return or statement, information that is required with respect to a listed transaction. A listed transaction means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary or her delegate (Secretary) as a tax avoidance transaction. The period for assessment of tax with respect to a listed transaction does not expire before one year after the earlier of the date the required information is furnished to the Secretary or the date that a material advisor makes the required disclosure.

The Department of the Treasury and the IRS have identified intermediary transaction tax shelters as listed transactions that require disclosure on a tax return to avoid certain penalties. These transactions typically involve a sale of a controlling interest in the stock of a C corporation to another entity (an intermediary entity) that is undertaken as part of a plan to cause the C corporation to recognize income or gain from the sale of its assets shortly before or shortly after the sale of the C corporation's stock.

In a typical case, an intermediary entity borrows funds to purchase the stock of the C corporation from the C corporation's shareholders, and the consideration received by the C corporation from the sale of its assets is effectively used to repay that loan. These transactions are structured so that when a C corporation's assets are sold, the C corporation is ultimately left with insufficient assets from which to pay the tax owed from the asset sale. In many cases, the intermediary does not pay the corporate income tax liability and is judgment-proof, frustrating the IRS's ability to collect taxes that are legally owed.

The transaction may yield the selling shareholders a higher sales price for their C corporation stock than could be supported if the corporate income tax liability were to be paid. However, outside of the consolidated return context, former shareholders of a C corporation generally are not liable for any unpaid income taxes, interest, additions to tax, or penalties owed by the C corporation.

Reasons for Change

Despite such transactions being identified by the IRS as listed transactions since 2001, shareholders, corporate officers, directors, and their advisors have continued to engage in Intermediary Transaction Tax Shelters or substantially similar transactions. Because the unpaid Federal tax evaded through these transactions is reflected in the price paid for the corporation's stock, either the buyer or the seller could be liable for such unpaid amounts. Although the Federal Government generally has adequate tools under current law to collect amounts from the buyer or its lenders, these parties typically do not have assets in the United States against which the IRS can proceed to collect the unpaid taxes. The selling shareholders are typically the only parties with sufficient assets in the United States against which the IRS could proceed for collection; however, it has proven difficult for the IRS to effectively collect the unpaid Federal taxes from these selling shareholders under current law. Even though the IRS has pursued litigation to enforce collection from the selling shareholders of several corporations, these actions have yielded mixed results in factually similar cases. Thus, existing law does not adequately protect the Federal Government's interest in collecting the amounts due from selling shareholders as a result of these transactions.

In addition, additional time is needed for the IRS to conduct examinations and assess taxes in connection with listed transactions, which may be complex in nature and require a thorough examination of the relevant facts.

Proposal

Extend statute of limitations for listed transactions

The proposal would increase the limitations period under section 6501(a) of the Internal Revenue Code (Code) for returns reporting benefits from listed transactions from three years to six years. The proposal also would increase the limitations period for listed transactions under section 6501(c)(10) from one year to three years.

This proposed change would be effective on the date of enactment.

Impose liability on shareholders to collect unpaid income taxes of applicable corporations

The proposal would also add a new section to the Code that would impose on shareholders who sell the stock of an "applicable C corporation" secondary liability (without resort to any State law) for payment of the applicable C corporation's Federal income taxes, interest, additions to tax, and penalties to the extent of the sales proceeds received by the shareholders. The proposal applies to shareholders who, directly or indirectly, dispose of a controlling interest (at least 50 percent) in the stock of an applicable C corporation within a 12-month period in exchange for consideration other than stock issued by the acquirer of the applicable C corporation stock. The secondary liability would arise only after the applicable C corporation was assessed income taxes, interest, additions to tax, and penalties with respect to any taxable year within the 12-month period before or after the date that its stock was disposed of, and the applicable C corporation did not pay such amounts within 180 days after assessment.

For purposes of the proposal, an applicable C corporation is any C corporation (or successor) two thirds or more of whose assets consist of cash, passive investment assets, or assets that are the subject of a contract of sale or whose sale has been substantially negotiated on the date that a controlling interest in its stock is sold. The proposal would grant the Secretary authority to prescribe regulations necessary or appropriate to carry out the proposal.

The proposal would not apply with respect to dispositions of a controlling interest (a) in the stock of a C corporation or real estate investment trust with shares traded on an established securities market in the United States, (b) in the shares of a regulated investment company that offers shares to the public, or (c) to an acquirer whose stock or securities are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such a public issuer of stock or securities.

The proposal would close the taxable year of an applicable C corporation as of the later of a disposition of a controlling interest in its stock or a disposition of all of its assets. The proposal would also amend the Code to provide that the amount that the selling shareholder was secondarily liable for under the proposal would constitute a deficiency that was governed by the general notice and demand rules of the Code but with an additional year added to the statute of limitations for assessment. The proposal would not limit the government's ability to pursue any cause of action available under current law against any person.

The proposed changes in this section would be effective for sales of controlling interests in the stock of applicable C corporations occurring on or after April 10, 2014.

IMPOSE AN AFFIRMATIVE REQUIREMENT TO DISCLOSE A POSITION CONTRARY TO A REGULATION

Current Law

Section 6662(b)(1) of the Internal Revenue Code imposes a 20 percent accuracy-related penalty on underpayments attributable to disregard of a rule or regulation. In general, this portion of the accuracy-related penalty does not apply if the taxpayer adequately discloses, via Form 8275-R, Regulation Disclosure Statement, a tax position contrary to a regulation when it files its return. To avoid the application of this penalty, a position contrary to a regulation must represent a good faith challenge to the validity of the regulation, have a reasonable basis, and be properly substantiated. If the position contrary to a regulation relates to a reportable transaction, the taxpayer must also report the transaction in accordance with the reportable transaction rules.

The accuracy-related penalty is subject to a reasonable cause and good faith exception. This exception applies on a case-by-case basis and requires consideration of all relevant facts and circumstances, including whether the taxpayer reasonably relied in good faith on the opinion or advice of a professional tax advisor. However, a taxpayer cannot rely on a tax advisor's opinion that a regulation is invalid to establish reasonable cause and good faith if the taxpayer did not adequately disclose the position.

Reasons for Change

Current law treats the disclosure of a position contrary to a regulation as a means to avoid imposition of the accuracy-related penalty. There is, however, no affirmative obligation for taxpayers to inform the Internal Revenue Service (IRS) that they are taking such a position.

In recent years, a growing number of taxpayers – especially large multinational entities – have taken tax positions on their returns that are contrary to a regulation. Such positions are difficult for the IRS to identify if the taxpayer chooses not to disclose them for penalty protection purposes. Some taxpayers have eschewed penalty protection by forgoing the disclosure of positions that are contrary to a regulation in the hopes of avoiding scrutiny.

Proposal

The proposal would impose an affirmative requirement on taxpayers to disclose a position on a return that is contrary to a regulation. Except to the extent provided in regulations for failures due to reasonable cause and not willful neglect, a taxpayer who fails to make the required disclosure would be subject to an assessable penalty that is 75 percent of the decrease in tax shown on the return as a result of the position. Such penalty shall not be less than $10,000 or more than $200,000, adjusted for inflation. The penalty would not apply if a taxpayer reasonably and in good faith believed that its position is consistent with the regulation. The penalty would apply regardless of whether the taxpayer's interpretation of the regulation is ultimately upheld.

The proposal would be effective for returns filed after the date of enactment.

REQUIRE EMPLOYERS TO WITHHOLD TAX ON FAILED NONQUALIFIED DEFERRED COMPENSATION PLANS

Current Law

A nonqualified deferred compensation (NQDC) arrangement is a plan or agreement between an employer and an employee (or a service recipient and service provider) to pay the employee compensation at retirement or another specified future date. An employee generally does not recognize NQDC income and owe tax on that income until the compensation is received, provided the NQDC arrangement satisfies specific tax requirements.

Under the tax rules, a NQDC arrangement must comply with election and distribution timing requirements that are designed to prevent taxpayers from manipulating the timing of the recognition of income. If a NQDC arrangement fails to comply with these requirements, then the employee must include vested NQDC in income currently and is subject to a 20 percent additional tax and, in some circumstances, an additional interest tax.

Employers are required to withhold Federal income tax from an employee's compensation based on the regular income tax rates. However, employers are not required to withhold the 20 percent additional tax or additional interest tax in the case of a NQDC arrangement that fails to comply with the tax requirements.

Reasons for Change

Internal Revenue Service (IRS) employment tax examiners can assess the regular Federal income tax withholding on an employer through an employment tax examination of the employer. However, IRS examiners are unable to collect from employers the 20 percent additional tax or additional interest tax on NQDC that fails to comply with the section 409A tax requirements. Instead, in the case of NQDC that fails to satisfy the tax requirements, the IRS examiner must assess the employee for the 20 percent additional tax and the additional interest tax. Initiating exams of each employee for these additional taxes is time-consuming, administratively impractical, burdensome, and an inefficient use of IRS resources.

Proposal

The proposal would require employers to withhold the 20 percent additional tax and additional interest tax on the NQDC included in an employee's income due to the NQDC arrangement failing to comply with the tax requirements. Section 3402(a) of the Internal Revenue Code (Code) would be amended to include the 20 percent additional tax and the additional tax imposed by section 409A(a)(1)(B) of the Code.

The proposal would be effective after December 31, 2024.

EXTEND TO SIX YEARS THE STATUTE OF LIMITATIONS FOR CERTAIN TAX ASSESSMENTS

Current Law

Section 6501 of the Internal Revenue Code generally requires the Internal Revenue Service (IRS) to assess a tax within three years after the filing of a return, subject to several exceptions. For example, section 6501(c)(1) provides that there are no time limitations on the assessment of tax arising from a false or fraudulent return; section 6501(e)(1)(A) provides a six-year limitations period where there is a substantial omission of gross income on a taxpayer's return; and section 6501(e)(1)(C) applies a six-year limitations period if a taxpayer omits amounts that must be included in income under the subpart F rules.

Reasons for Change

Complex audits in the largest cases require extensive factual development by multidisciplinary teams of revenue agents, tax law specialists, economists, engineers, and other IRS personnel. Critical issues may not be identified until late in the process of an examination, and in many cases further development often cannot be pursued due to time and resource constraints, including the three-year statute of limitations. Although taxpayers will typically consent to extend their statutes of limitations, those consents may be subject to negotiations between the IRS and taxpayers and the resulting consents may be limited to particular issues and for insufficient lengths of time. Extending the statute of limitations for complex cases would provide the IRS with enhanced agility and flexibility in evaluating and staffing its case inventory and appropriately allocating its limited enforcement resources. These considerations are especially acute for cases requiring the assistance of transfer pricing economists, as well as for cases involving the application of recently enacted statutory provisions to complex cross-border transactions.

Proposal

The proposal would amend section 6501 to provide a six-year statute of limitations if a taxpayer omits from gross income more than $100 million on a return.

The proposal would be effective for returns required to be filed after the date of enactment.

INCREASE THE STATUTE OF LIMITATIONS ON ASSESSMENT OF THE COVID-RELATED PAID LEAVE AND EMPLOYEE RETENTION TAX CREDITS

Current Law

The Families First Coronavirus Response Act of 2020 (FFCRA) enacted the paid sick and family leave tax credit (the paid leave tax credit) entitling certain employers to a refundable tax credit for the payment of qualified leave wages. The Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act) enacted the employee retention tax credit (ERC) entitling certain employers to a refundable tax credit for the payment of qualified wages. The paid leave tax credit under the FFCRA and the ERC under the CARES Act applied to wages paid during the second, third, or fourth quarters of 2020. Subsequent legislation – the COVID-Related Tax Relief Act of 2020 (Relief Act) and American Rescue Plan Act of 2021 (ARP) – extended the paid leave tax credit for qualified leave wages paid during the first, second or third quarters of 2021 and extended the ERC for qualified wages paid during the first, second, third or fourth quarters of 2021. ARP also codified the paid leave credit and ERC provisions in the Internal Revenue Code (Code). (The Infrastructure Investment and Jobs Act of 2021 amended the ERC to apply only to wages paid prior to October 1, 2021, except for employers in limited circumstances.)

These credits were claimed on employment tax returns, which generally are filed quarterly on Form 941, Employer's Quarterly Federal Tax Return (with a small number of employers, including household employers, filing annually on other forms). The due date for a quarterly Form 941 filing generally is the last day of the month following the quarter to which it applies – e.g., the due date for Form 941 in the first quarter of 2021 was April 30, 2021. The Relief Act expanded ERC eligibility and applied retroactively to quarters with filing due dates that already had passed. To claim the ERC for a prior quarter, an employer is required to file an amended employment tax return, generally on Form 941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund, for each earlier quarter.

In general, taxpayers must file a claim for credit or refund within the later of three years from the time the tax return was filed or two years from the time the tax was paid. For this purpose, if an employment tax return for a period ending with or within a given calendar year is filed on or before April 15 of the succeeding calendar year, the return is considered filed on April 15 of that succeeding calendar year. For example, all timely filed Forms 941 for any quarter of 2020 are considered filed on April 15, 2021. Thus, an employer that timely filed and paid employment tax may file a claim for ERC with respect to any quarter of 2020 by filing an amended employment tax return, generally Form 941-X, until April 15, 2024. For all timely-filed Forms 941 for any quarter of 2021, the same deadlines apply as in the previous sentence, but one year later.

Taxpayers that claim either the paid leave tax credit or the ERC must reduce their income tax deduction for wages paid by the amount of those credits. Accordingly, when taxpayers claim the ERC or paid leave tax credit on an amended employment tax return, they must also amend their income tax return for the year in which the wages were paid no later than three years from the time the income tax return was filed or two years from the time the income tax was paid.

Generally, the Internal Revenue Service (IRS) must assess any additional tax within three years after a return's original filing date (whether or not the return was filed on any extension). The timing for when a return is considered "filed" for this purpose is similar to the rule as it pertains to the time for filing a claim for credit or refund on an amended return: if an employment tax return for a period ending with or within a calendar year is filed before April 15 of the succeeding calendar year, the return is considered filed, for purposes of the statute of limitations on assessment, on April 15 of that succeeding calendar year. The period of limitations on assessment generally does not restart upon the filing of an amended return.

As a result of these timing rules, it is often the case that the statutes of limitations on assessment and refund expire at the same time. For example, if an employer timely filed its employment tax returns and timely paid its employment tax, for the calendar year 2020, the employment tax returns and employment tax would be deemed filed and paid on April 15, 2021. The statute of limitations for the IRS to assess additional tax, and for the employer to claim a refund, would end on the same day: April 15, 2024, which is three years after April 15, 2021.

ARP extended the limitation on the time period for the assessment of any amount attributable to the paid leave tax credit and the ERC under the Code that was improperly claimed from three to five years. Thus, the limitation period for assessment of erroneous ARP paid leave credits and ERC will not expire before the date that is five years after the later of (a) the date on which the original return that includes the calendar quarter with respect to which the paid leave credit or ERC is determined is filed, or (b) the April 15 date on which the return is treated as filed. However, the ARP extension of the limitations period applies only for the second and third quarters of 2021 for the paid leave tax credit and the third and fourth quarters of 2021 for the ERC. The FFCRA and the CARES Act did not include extensions of the limitations period. Hence, the ARP's extended limitations period applies only for two of the six quarters in which an employer may claim the paid leave tax credit and only for two of the eight quarters in which an employer may claim the ERC.

Reasons for Change

Providing a consistent rule for the limitations period to assess erroneous FFCRA paid leave credits and the CARES Act ERC, as amended prior to the ARP, would assist with IRS compliance and enforcement efforts. Additionally, a significant number of ERC claims were made on amended tax returns, often with a substantial delay relative to the quarter of the underlying activity that generated the credit, and amended returns with new ERC claims continue to be filed. The current-law three-year limitations period applicable to the FFCRA paid leave credits and the ERC does not restart when an amended return is filed, making it difficult for the IRS to ensure compliance with respect to such amended returns, many of which the IRS believes have been filed incorrectly.

Proposal

The proposal would extend the limitations on the time period for the assessment of erroneous paid leave tax credits under the FFCRA and the ERC under the CARES Act, as amended prior to the ARP, to conform with the same five-year period provided under ARP. Additionally, the proposal would extend the limitations period for the IRS to assess additional income tax from the taxpayer if the taxpayer that claimed the ERC or paid leave tax credit did not make a corresponding downward adjustment to its wage deduction on Forms 1120, 1065, or 1040.[59]

The proposal would be effective on the date of enactment.

[59] These three forms are the Federal income tax returns for corporate income, partnership income, and individual income respectively. The full titles are Form 1120, U.S. Corporation Income Tax Return; Form 1065, U.S. Return of Partnership Income; and Form 1040, U.S. Individual Income Tax Return.

IMPOSE PENALTIES FOR INACCURATE OR FRAUDULENT EMPLOYMENT TAX RETURNS

Current Law

Section 6676 of the Internal Revenue Code (Code) imposes a civil penalty on claims for refund or credit, equal to 20 percent of the excessive amount claimed, when a taxpayer submits an erroneous refund or credit claim for income tax. The penalty may be rebutted by a showing of reasonable cause, unless any part of the excessive amount is attributable to a transaction lacking economic substance. The excessive amount is the portion of a claim for refund or credit for any tax year that exceeds the amount of such claim allowable for the tax year. The penalty does not apply to any portion of the excessive amount that is subject to the imposition of any component of the accuracy-related penalty or the fraud penalty.

Congress enacted several refundable credits against employment tax during the COVID-19 pandemic. For example, the employee retention credit (ERC) provides a refundable credit against employment taxes for the payment of qualified wages. Eligible employers can claim the credit on an original or amended employment tax return. Similarly, the paid leave credits for small and midsize businesses generally allow employers with fewer than 500 employees who paid COVID-related sick leave or family leave wages to claim refundable tax credits against employment taxes for qualified leave wages. Currently, there is no civil penalty applied to an erroneous claim for refund or credit of employment taxes.

Reasons for Change

Currently, claims for refund or credit with respect to employment taxes are not subject to the penalty for erroneous refund claims under section 6676. Expanding the authority of the Internal Revenue Service (IRS) to assert a penalty against those taxpayers who have improperly filed for employment tax refunds will support sound tax administration and provide parity with existing penalty provisions regarding excessive refund or credit claims for income taxes.

The IRS is actively auditing and conducting criminal investigations related to false ERC claims. However, the Administration has serious concerns about improper ERC claims, including claims made by entities that did not exist or did not have employees during the period of eligibility. Extending penalties to improper claims for refunds or credits with respect to employment taxes in cases where the reasonable cause exception is not substantiated would discourage these sorts of fraudulent claims.

Proposal

The proposal would extend the penalty under section 6676 to erroneous claims for refund or credit with respect to employment taxes. The proposal would be effective for claims for which the statute of limitations has not expired as of the date of enactment.

EXPAND AND INCREASE PENALTIES FOR NONCOMPLIANT RETURN PREPARATION AND E-FILING AND AUTHORIZE IRS OVERSIGHT OF PAID PREPARERS

Current Law

Penalties for return preparation and e-filing

Many taxpayers rely on paid tax return preparers to prepare their tax returns and refund claims each year. Paid tax return preparers are subject to statutory return preparation standards. Such obligations include making certain disclosures and taking certain actions with respect to returns they prepare. For example, by law, anyone who is paid to prepare, or assists in preparing, Federal tax returns must identify themselves on those returns by using the prescribed identifying number. Under the applicable regulations, that number is a valid Preparer Tax Identification Number (PTIN). Paid tax return preparers must sign and include their PTIN on the return.

While the Internal Revenue Code authorizes the Internal Revenue Service (IRS) to issue PTINs, it provides no authority to revoke or rescind issued PTINs. As a result, unless a paid tax return preparer is enjoined by a court from preparing returns, there is no authority to preclude a paid tax return preparer who misuses or abuses taxpayers and/or the tax system from continuing to prepare returns. Additionally, there is no authority to address paid tax return preparers who are deemed to be unsuitable to prepare returns based upon a continual failure to comply with their own tax obligations.

Civil penalties and injunctive relief may be used to address preparer noncompliance. For example, civil penalties apply to paid tax return preparers who fail to report all of the taxpayer's income on the return that results in understatement of the taxpayer's liability as well as paid tax return preparers who fail to follow rules and regulations when preparing a tax return. These penalties generally must be assessed within three years after the return is filed. The penalties and their amounts under current law are listed below in a table following the description of the proposal.

In addition, many taxpayers rely on e-file providers to electronically originate and transmit their returns to the IRS. E-file providers must apply with the IRS and pass a suitability check before becoming an authorized e-file provider and receiving an Electronic Filing Identification Number (EFIN), which is required to electronically file tax returns. There is no civil penalty on e-file provider misconduct.

IRS oversight of paid preparers

Under U.S. Code Title 31 (Money and Finance), Section 330 – Practice before the Department, the Secretary has the authority to regulate practice before the IRS. Regulations under that section, referred to as "Circular 230," regulate the practice of licensed attorneys, certified public accountants, and enrolled agents and actuaries. In 2009, in response to concerns about the lack of regulation of unlicensed and unenrolled paid tax return preparers, the IRS conducted a formal review of its regulation of paid tax return preparers. After significant consideration and input from taxpayers, tax professionals, and other stakeholders, Treasury and the IRS amended Circular 230 to regulate practice of all paid tax return preparers, including individuals who are unlicensed and unenrolled. Paid tax return preparers challenged these regulations in *Loving v. Commissioner*. The Court of Appeals for the District of Columbia Circuit determined that these regulations exceeded the IRS's authority in 2014.[60]

Reasons for Change

Expand and increase penalties for return preparation and e-filing

Inappropriate behavior by paid tax return preparers harms taxpayers through the filing of inaccurate returns, erroneous refunds and credits, and personal tax return noncompliance. It may also diminish public confidence in the tax system, which relies on the public's cooperation. In addition, the inability to immediately address issues of suitability, noncompliance, or taxpayer abuses by paid tax return preparers with valid identification numbers reflects poorly on tax administration and taxpayer confidence. Despite the penalties that may apply to paid tax return preparers, tax-return-preparer misconduct has continued, in part, because the amounts of the penalties under current law do not adequately promote voluntary compliance.

Furthermore, it is time-consuming for the IRS to identify and investigate paid tax return preparers who fail to include a valid identification number on returns they prepare, generally referred to as "ghost preparers." These preparers may be: (a) attempting to avoid IRS scrutiny of positions taken on the return; (b) already subject to a compliance action or under a Federal court order barring them from further return preparation; or (c) underreporting their own income from tax preparation, thereby increasing the tax gap. Allowing additional time for the IRS's investigation will increase the effectiveness of the applicable preparer penalty. A new penalty for failure by a taxpayer to disclose the use of a paid tax return preparer will discourage reliance on incompetent and dishonest paid tax return preparers and promote compliance. With this disclosure, the IRS will be better positioned to identify preparers perpetuating fraud that harms taxpayers.

Although e-file providers must pass an initial suitability check to receive an EFIN, there have been instances of e-file providers improperly allowing unauthorized persons to use their EFIN to engage in electronic filing. Additional authority, including new penalties, is needed to regulate the conduct and suitability of e-file providers to prevent such abuse.

Grant authority to IRS for oversight of paid preparers

Paid tax return preparers have an important role in tax administration because they assist taxpayers in complying with their obligations under the tax laws. Incompetent and dishonest paid tax return preparers increase collection costs, reduce revenues, disadvantage taxpayers, and undermine confidence in the tax system.

The current lack of authority to provide oversight on paid tax return preparers results in greater non-compliance when taxpayers who use incompetent preparers or preparers who engage in unscrupulous conduct become subject to penalties, interest, or avoidable costs of litigation due to

[60] Loving v. Commissioner, 742 F.3d 1013 (D.C. Cir. 2014).

the poor-quality advice they receive. The lack of authority affects revenues to the IRS when the resulting noncompliance is not mitigated during return processing. Regulation of paid tax return preparers, in conjunction with diligent enforcement, will help promote high quality services from paid tax return preparers, will improve voluntary compliance, and will foster taxpayer confidence in the fairness of the tax system.

Proposal

The proposal would make the following changes to current law:

Expand and increase penalties for return preparation and e-filing

The proposal would increase the amount of the tax penalties that apply to paid tax return preparers for willful, reckless, or unreasonable understatements, as well as for forms of noncompliance that do not involve an understatement of tax.

The proposal would also establish new penalties for the appropriation of PTINs and EFINs and for failing to disclose the use of a paid tax return preparer. A $1,000 penalty would apply for each appropriation of a PTIN, with a maximum penalty of $75,000 for a calendar year. A $250 penalty would apply for each appropriation of an EFIN. Except for failures due to reasonable cause, a $500 penalty would apply for each failure by a taxpayer to disclose the use of a paid tax return preparer and the fees paid to such a preparer.

For all of the new or increased penalties in the proposal, the specified dollar amounts and any applicable annual limitations would be adjusted for inflation. The dollar penalties under current law and under the proposal are summarized in the table following the description of the proposal.

In addition, the proposal would expand the authority to determine the suitability of paid tax return preparers applying for identification numbers and the authority to revoke identification numbers for paid tax return preparers subsequently determined to be unsuitable.

The proposal would increase the limitations period during which the penalty for a failure to furnish the paid tax return preparer's identifying number may be assessed from three years to six years.

The proposal would also clarify the Secretary's authority to regulate the conduct and suitability of persons who participate in the authorized e-file program, including setting standards and imposing sanctions to protect the integrity of the e-file program.

The proposal would be effective for returns filed after December 31, 2024.

Grant authority to the IRS for oversight of all paid preparers

The proposal would amend Title 31, U.S. Code (Money and Finance) to provide the Secretary with explicit authority to regulate all paid preparers of Federal tax returns, including by establishing mandatory minimum competency standards.

The proposal would be effective on the date of enactment.

The following table shows selected penalties faced by paid preparers under current law for taxable year 2024, and under the proposal for paid preparers, e-file providers, and taxpayers for taxable year 2025.

SUMMARY OF SELECTED PENALTIES UNDER CURRENT LAW (CALENDAR YEAR 2024) AND THE PROPOSAL (CALENDAR YEAR 2025)

	Calculation of Penalties			
NONCOMPLIANT BEHAVIOR	**CURRENT LAW**		**PROPOSAL**	
1. UPDATED PENALTIES FOR UNDERSTATEMENT OF LIABILITY				
Understatement due to ...	Greater of $X or X% of income derived by preparer with respect to return or claim			
unreasonable conduct	$1,000 or 50%		$5,000 or 50%	
willful or reckless conduct	$5,000 or 75%		$10,000 or 100%	
2. UPDATED PENALTIES FOR REASONS OTHER THAN UNDERSTATEMENT OF LIABILITY				
Failure to ...	Per Offense	Maximum	Per Offense	Maximum
furnish a copy of a return or a claim for refund to taxpayer	$60	$30,000	$250	$50,000
sign a copy of a return or a claim for refund	$60	$30,000	$1,000	$75,000
furnish preparer's identifying number	$60	$30,000	$1,000	$75,000
retain completed copy of prepared return or list of taxpayers for whom returns were prepared	$60	$30,000	$250	$50,000
file correct information returns identifying the return preparers employed by a person	$60	$30,000	$250	$50,000
refrain from endorsing or negotiating a check in respect of taxes	$600	None	$1,000	None
comply with certain due diligence requirements[2]	$600	None	$1,500	None
3. NEW PENALTIES ON PREPARERS, E-FILE PROVIDERS, AND TAXPAYERS:				
NONCOMPLIANT BEHAVIOR	Per Offense	Maximum[2]	Per Offense	Maximum[2]
Appropriation of ...				
a PTIN			$1,000	$75,000
an EFIN			$250	None
Failure to disclose use of preparer and fees paid to preparer by taxpayer.			$500	None

[1]Taxpayers and the preparers they use must comply with the requirement of IRS Form 8867, Paid Preparers' Due Diligence Checklist for the Earned Income Credit, American Opportunity Tax Credit, Child Credit (including the Additional Child Tax Credit and the Credit for Other Dependents) and/or Head of Household Filing Status.
[2]Maximum is annual maximum per calendar year.

MAKE REPEATED WILLFUL FAILURE TO FILE A TAX RETURN A FELONY FOR THOSE WITH SIGNIFICANT TAX LIABILITY

Current Law

A person with Federal tax liability who willfully fails to file a tax return is guilty of a misdemeanor, punishable by a term of imprisonment of not more than one year, a fine of not more than $250,000 ($200,000 in the case of a corporation), or both. A person with Federal tax liability who willfully fails to file tax returns for multiple years commits a separate misdemeanor offense for each year a tax return is not filed.

Reasons for Change

Voluntary tax compliance is the foundation of our tax system. Non-compliance by high-income taxpayers has a significant corrosive effect on tax administration and collection. A significant portion of the non-filer tax gap – the difference between tax liability and the taxes paid – is attributable to high-income non-filers. Closing the tax gap is critical to a fair tax system and best serving the public good, as those who do not pay their taxes shift the tax burden to those who meet their tax obligations. Increasing criminal penalties for high-income people who willfully and repeatedly do not file a tax return would provide a more effective deterrent to such blatant tax evasion, encourage voluntary compliance and help close the tax gap.

Proposal

The proposal would amend section 7203 of the Internal Revenue Code to increase criminal penalties for high-income people with significant Federal tax liability who willfully fail to file a tax return for multiple years. The proposal would provide that any person who willfully fails to file timely required tax returns in any three years within a consecutive five-year period, where the aggregate tax underpayment for such five-year period is more than $250,000, would be subject to a new aggravated failure-to-file criminal penalty. The offense would be classified as a felony, punishable by a term of imprisonment of no more than five years, a fine of up to $250,000 ($500,000 in the case of a corporation), or both.

The proposal would be effective for tax returns required to be filed after December 31, 2024.

EXPAND IRS SUMMONS AUTHORITY FOR LARGE PARTNERSHIPS

Current Law

The statute of limitations on assessment limits the ability of the Internal Revenue Service (IRS) to assess additional tax against a taxpayer after a certain period of time has passed, generally three years. However, for corporate taxpayers being examined under the IRS's Large Corporate Compliance program, the statute of limitations on assessment can be suspended via the issuance of a designated summons. A designated summons can only be issued under certain limited circumstances and is subject to written approval by the Chief Counsel of the IRS and select others. Designated summonses must be served at least 60 days before the statute of limitations expires. The IRS must establish in a judicial enforcement proceeding that prior reasonable requests were made to obtain the information sought from the taxpayer. The taxpayer's statute of limitations is suspended for 120 days following a court's enforcement of the summons. If a court does not enforce the summons, the statute of limitations remains suspended for 60 days following the court proceeding (including a period for appeal of the decision).

The designated summons provisions, however, do not apply to large partnerships, such as complex investment funds and hedge funds.

Partnerships examined under the IRS's large partnership compliance program (LPC) are subject to the centralized partnership audit regime, as enacted by the Bipartisan Budget Act of 2015 (BBA), where any understatement is determined at the partnership, rather than the partner, level.

Reasons for Change

Large partnerships are often embedded in complex business structures that require painstaking and time-intensive examination. These structures can involve many tiers of indirect partners, some of which may not be known to the IRS when the examination begins. Providing for designated summonses in examinations of large partnerships will enable the IRS to better enforce the tax law with respect to these large and complex business entities.

Proposal

The proposal would extend the designated summons provisions to examinations of large partnerships under the LPC or any successor program. In the case of a partnership designated summons, the relevant statutes of limitations under BBA could be extended subject to judicial enforcement.

The administrative procedures for partnership designated summonses would parallel the current procedures applicable to designated summonses issued to corporations, whereby approvals would be required by the IRS Chief Counsel and the IRS Large Business and International Division Commissioner.

The proposal would be effective after the date of enactment.

ADDRESS COMPLIANCE IN CONNECTION WITH TAX RESPONSIBILITIES OF EXPATRIATES

Current Law

An individual may become a U.S. citizen at birth either by being born in the United States (or in certain U.S. territories) or by having a parent who is a U.S. citizen. All U.S. citizens generally are subject to U.S. income taxation on their worldwide income, even if they reside abroad.

U.S. citizens that reside abroad also may be subject to tax in their country of residence. Potential double taxation is generally relieved in two ways. First, U.S. citizens can credit foreign taxes paid against their U.S. taxes due, with certain limitations. Second, U.S. individuals may exclude from their U.S. taxable income a certain amount of income earned from working outside the United States. U.S. citizens living abroad are also eligible for the same exclusions from gross income and deductions as other U.S. taxpayers, and therefore may have taxable income that is low enough that no income tax is due.

The Internal Revenue Code (Code) imposes special rules on certain individuals who relinquish their U.S. citizenship or cease to be lawful permanent residents of the United States (expatriates). Expatriates who are "covered expatriates" generally are required to pay a mark-to-market exit tax on a deemed disposition of their worldwide assets as of the day before their expatriation date.

An expatriate is a covered expatriate if they meet at least one of the following three tests: (a) has an average annual net income tax liability for the five taxable years preceding the year of expatriation that exceeds a specified amount that is adjusted for inflation (the tax liability test); (b) has a net worth of $2 million or more as of the expatriation date (the net worth test); or (c) fails to certify, under penalty of perjury, compliance with all U.S. Federal tax obligations for the five taxable years preceding the taxable year that includes the expatriation date (the certification test).

The definition of covered expatriate includes a special rule for an expatriate who became at birth a citizen of both the United States and another country and, as of the expatriation date, continues to be a citizen of, and taxed as a resident of, such other country. Such an expatriate will be treated as not meeting the tax liability or net worth tests if the individual has been a resident of the United States for not more than 10 taxable years during the 15-taxable year period ending with the taxable year during which the expatriation occurs. However, such an expatriate remains subject to the certification test.

If a taxpayer renounces U.S. citizenship or abandons lawful permanent resident status, that taxpayer must file Form 8854, Initial and Annual Expatriation Statement, with the taxpayer's U.S. tax return to make the certification described in the preceding paragraph and provide information to determine whether the individual is subject to the exit tax (and to compute such tax, if applicable).

Generally, the Internal Revenue Service (IRS) has three years from the date a return is filed to assess the tax. However, existing law extends the assessment statute of limitations in certain cases, such as when a taxpayer fails to furnish required information returns relating to various international transactions or assets. In these cases, the statute of limitations does not expire until three years after the information required to be reported is provided. Existing law does not include Form 8854 as one of the information returns that would trigger an extended statute of limitations.

Under the Foreign Account Tax Compliance Act (FATCA) provisions of the Code, a foreign financial institution is required to collect certain information about U.S. persons who hold an account with the institution, including the person's U.S. taxpayer identification number (TIN). A foreign financial institution that fails to comply with these rules may be subject to U.S. withholding tax on certain U.S. source payments. Foreign financial institutions consequently routinely require an account holder who is a U.S. citizen to provide a TIN.

With some exceptions, an individual who is not a U.S. citizen is required to obtain a certificate from the IRS (generally referred to as a "sailing permit") that the individual has complied with all of the individual's income tax obligations before departing from the United States.

Reasons for Change

Form 8854 is critical to the IRS's ability to identify expatriating taxpayers. If a person expatriates but fails to include the form with a tax return, it is difficult for the IRS to identify such a failure, and consequently the IRS may not be aware that the person has expatriated. Although the IRS receives information on expatriating individuals from the Department of State or from the United States Citizenship and Immigration Service, the information is received after the expatriating act and does not include TINs, which means that it is more difficult and time-consuming for the IRS to match this information with taxpayer records. In the case of long-term permanent residents, many are not aware of the requirement to file Form 8854 when they surrender their green cards, and the IRS has no established methodology of identifying such cases. Because of these difficulties, the IRS may not discover that an individual has expatriated and failed to file Form 8854 until more than three years after the individual files the tax return for the year of expatriation. In these circumstances, unless the IRS proves fraud, the IRS may be barred from making any expatriation related tax assessments because the assessment statute of limitation on the taxpayer's tax return may have already expired. These cases can involve substantial amounts of foregone exit tax and related taxes, and high net wealth taxpayers can exploit the tax system by simply failing to file Form 8854 with their tax return.

Lower-income individuals who have spent most of their lives abroad may find complying with these rules difficult when attempting to expatriate. A dual citizen who has spent most of his or her life outside the United States will be considered a covered expatriate despite having relatively low income and assets if the individual does not certify to the IRS compliance with all U.S. Federal tax obligations for the five preceding taxable years. Some dual citizens who have spent most of their lives outside the United States may not have previously filed a U.S. tax return or obtained a TIN. Foreign financial institutions in some countries have threatened to close bank accounts of U.S. citizens who do not provide a TIN. U.S. citizens who are citizens and residents of foreign countries and have limited contacts with the United States may wish to expatriate, but in order to avoid being considered covered expatriates such individuals need to be able to certify that they are compliant with all U.S. Federal tax obligations for the five preceding taxable years. For taxpayers with modest incomes who have not been filing U.S. tax returns but have been filing tax returns and paying tax in their countries of residence, the cost and practical difficulties of certifying compliance with their U.S. Federal tax obligations may impede their ability to satisfy the requirements for expatriation. For example, it may be difficult to find a U.S. tax advisor to prepare a U.S. tax return in the taxpayer's country of residence, and the cost of doing so may be significant for a lower-income taxpayer. If the taxpayer would not owe any U.S. tax, the benefit to the IRS of the filing of such tax returns is limited.

The requirement for an alien to obtain a sailing permit is no longer necessary as the IRS has other tools to help ensure tax compliance, including withholding tax requirements applicable to payments to nonresident aliens that have been implemented since the sailing permit requirement was originally enacted.

Proposal

First, the proposal would provide that, in the case where a taxpayer is required to provide Form 8854 to the IRS with their tax return, the time for assessment of tax will not expire until three years after the date on which Form 8854 is filed with the IRS. This would create parity with the current statute of limitation rules for tax returns when other information returns relating to various international transactions or assets are required to be filed with the return. The proposal would reduce abuse and noncompliance with respect to high net wealth expatriates.

Second, the proposal would grant the Secretary authority to provide relief from the rules for covered expatriates for a narrow class of lower-income dual citizens with limited U.S. ties. This relief would apply only to taxpayers that have a tax home outside the United States and satisfy other conditions that ensure that their contacts with the United States are limited, and whose income and assets are below a specified threshold. Evidence of limited contacts with the United States may include a demonstration that the taxpayer's primary residence has been outside the United States for an extended period. Evidence of the taxpayer's income and assets may include a foreign tax return, information about the value of property owned by the taxpayer and the taxpayer's sources of income, or information demonstrating that a certain amount of income earned from working outside the United States is excludable from U.S. tax. No inference would be intended that the evidence acceptable to the Secretary under this provision constitutes the filing of a U.S. tax return.

The requirement for an alien to obtain a sailing permit would be repealed.

The proposal would be effective for taxable years beginning after December 31, 2024.

DEFINE CONTROL OF THE PAYMENT OF WAGE

Current Law

Employers are required to pay employment taxes and withhold income tax from wages paid to the employees. Section 3401(d) of the Internal Revenue Code defines an "employer" generally as the person for whom an individual performs services as the employee. Section 3401(d)(1) provides an exception if the person for whom the individual performs services does not have control of the payment of the wages, in which case the employer is the person having "control of the payment of such wages". The Internal Revenue Service's longstanding position is that when the section 3401(d)(1) exception applies, the liability for employment taxes and income tax withholding shifts from the common law employer to the person in control of the payment of wages.

In a recent decision involving a professional employer organization (PEO), the Eleventh Circuit created a new test for determining who has control of the payment of wages. The Circuit Court concluded that a contract between the PEO and its clients (the common law employers) could affect who controls the wage payments. The Circuit Court looked to both the language in the PEO's contracts with its clients and how the relationship between the parties functioned, including whether the PEO generally issued wage payments before receiving payment from its clients.

Reasons for Change

If the Eleventh Circuit's interpretation of section 3401(d)(1) were universally adopted, it would provide common law employers a means to avoid liability for employment taxes and income tax withholding merely by entering into a contractual agreement that included certain minimal terms with a PEO or other intermediary to issue wage payments. The Circuit Court's interpretation of section 3401(d)(1) undermines the purpose and objectives of the certified professional employer organization (CPEO) program, enacted at the end of 2014, that requires applicants to satisfy rigorous tax compliance and criminal background checks before becoming CPEOs. Furthermore, the Circuit Court's interpretation could be (and has been) used by PEOs to claim income tax credits that would otherwise belong to common law employers. In some instances, both the PEO and the common law employer have claimed the same tax credit.

Proposal

The proposal would amend section 3401(d)(1) to clarify the phrase "control of the payment of wages" in a manner that assures that a common law employer cannot avoid liability for employment taxes and income tax withholding except in limited circumstances consistent with the original legislative history and congressional intent. The proposal would be effective after December 31, 2024.

Checkpoint Contents
Federal Library
Federal Source Materials
Code, Regulations, Committee Reports & Tax Treaties
Final, Temporary, Proposed Regulations & Preambles
Preambles to Final and Temporary Regulations (Treasury Decisions)
Preambles to Final Regulations (TD corr_88FR17725 - TD 9927)
TD 9980, Identifying numbers—fee for obtaining preparer tax identification number., IRC Sec(s). 6109, 10/02/2023

Treasury Decision

Treasury Decision 9980, 10/02/2023, IRC Sec(s). 6109

Identifying numbers—fee for obtaining preparer tax identification number.

Headnote:

IRS has issued interim final regs to reduce amount of user fees to apply for or renew preparer tax identification number (PTIN), effective for PTIN application or renewal filed on or after 10/19/2023. IRS reviews these fees biennially, and PTIN user fee is authorized because IRS provides specific benefit to identifiable recipients.

Reference(s): ¶ 61,095.01(5); Code Sec. 6109;

Full Text:

RIN 1545-BQ78

Preparer Tax Identification Number (PTIN) User Fee Update

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Interim final rule.

SUMMARY: This document contains interim final regulations relating to the imposition of certain user fees on tax return preparers. These regulations reduce the amount of the user fee to apply for or renew a preparer tax identification number (PTIN) and affect individuals who apply for or renew a PTIN. The Independent Offices Appropriation Act of 1952 authorizes the charging of user fees. The text of the interim final regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in this issue in the Proposed Rules section of this edition of the *Federal Register*.

DATES: *Effective date*: These regulations are effective on October 19, 2023.

Applicability date: For date of applicability, see paragraph (d) of these interim final regulations.

FOR FURTHER INFORMATION CONTACT: Concerning the interim final regulations, Jamie Song at (202) 317-6845; concerning cost methodology, Michael A. Weber at (202) 803-9738 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains interim final amendments to 26 CFR part 300 regarding user fees.

A. *User Fee Authority*

The Independent Offices Appropriation Act of 1952 (IOAA), which is codified at , authorizes agencies to prescribe regulations that establish user fees for services provided by the agency. The IOAA provides that regulations implementing user fees are subject to policies prescribed by the President; these policies are set forth in the Office of Management and Budget Circular A-25, 58 FR 38142 (July 15, 1993) (OMB Circular A-25).

Under OMB Circular A-25, Federal agencies that provide services that confer benefits on identifiable recipients are to establish user fees that recover the full cost of providing the service. An agency that seeks to impose a user fee for government-provided services must calculate the full cost of providing those services. In general, a user fee should be set at an amount that allows the agency to recover the direct and indirect costs of providing the service, unless the Office of Management and Budget (OMB) grants an exception. OMB Circular A-25 provides that agencies are to review user fees biennially and update them as necessary.

B. *PTIN Requirement*

Section 6109(a)(4) of the Internal Revenue Code (Code) authorizes the Secretary of the Treasury or her delegate to prescribe regulations for the inclusion of a tax return preparer's identifying number on a return, statement, or other document required to be filed with the IRS. On September 30, 2010, the Treasury Department and the IRS published final regulations (TD 9501) under section 6109 in the *Federal Register* (75 FR 60309) to provide that, for returns or claims for refund filed after December 31, 2010, the identifying number of a tax return preparer is the individual's PTIN or such other number prescribed by the IRS in forms, instructions, or other appropriate guidance. Those regulations require a tax return preparer who prepares or who assists in preparing all or substantially all of a tax return or claim for refund after December 31, 2010, to have a PTIN.

C. *PTIN User Fee*

Final regulations (TD 9503) published in the Federal Register (75 FR 60316) on September 30, 2010, established a $50 user fee to apply for or renew a PTIN, based on a 2010 Cost Model. In addition, a $14.25 fee for a new application and a $13 fee for an application for renewal was payable directly to a third-party contractor.

In 2013, the IRS conducted a biennial review of the PTIN user fee and issued a new Cost Model that estimated an increase of the PTIN user fee, to $54. However, the IRS determined to keep the fee at $50 for the next two years.

In 2015, the IRS conducted a biennial review of the PTIN user fee and issued a new Cost Model, which determined that the full cost of administering the PTIN program going forward was reduced from $50 to $33 per application or application for renewal, plus a $17 fee per application or application for renewal payable directly to a third-party contractor. Final regulations (TD 9781) published in the *Federal Register* (81 FR 52766) on August 10, 2016, superseded and adopted temporary regulations (TD 9742) published in the *Federal Register* (80 FR 66792) on October 30, 2015, and established the $33 annual user fee to apply for or renew a PTIN, plus $17 per application or application for renewal payable directly to a third-party contractor.

In 2017, the IRS again conducted a biennial review of the PTIN user fee and issued a new Cost Model, which determined that the amount of the fee going forward should be reduced to $31 per application or application for renewal, plus an amount payable directly to a third-party contractor. However, on June 1, 2017, before a notice of proposed rulemaking proposing to reduce the amount of the PTIN user fee was issued, the IRS was enjoined from charging a PTIN user fee. In *Steele v. United States*, 260 F. Supp. 3d 52 [119 AFTR 2d 2017-2065] (D.D.C. 2017), the United States District Court for the District of Columbia concluded that the Treasury Department and the IRS lacked the statutory authority to charge a PTIN user fee and enjoined the IRS from charging a PTIN user fee. *See Steele*, 2017 WL 3621747 [120 AFTR 2d

2017-5145] (D.D.C. July 10, 2017) (final judgment and permanent injunction). The government filed an appeal and on March 1, 2019, the United States Court of Appeals for the District of Columbia Circuit reversed the district court's decision and lifted the injunction against charging the PTIN user fee. *See Montrois v. United States*, 916 F.3d 1056 [123 AFTR 2d 2019-920] (D.C. Cir. 2019) (holding that a PTIN provides tax return preparers a specific benefit by allowing them to provide an identifying number that is not a social security number on returns they prepare and stating that the permissible amount of the fee would be the same regardless of whether the specific benefit was instead the ability to prepare tax returns for compensation). The case was remanded to the United States District Court for the District of Columbia to determine whether the fee amounts were excessive. *Id.* at 1068.

In 2019, the IRS again conducted a biennial review of the PTIN user fee and issued a new Cost Model, which determined that the amount of the fee going forward should be reduced to $21 per application or application for renewal, plus a $14.95 fee per application or application for renewal payable directly to a third-party contractor. Final regulations (TD 9903) published in the *Federal Register* (85 FR 43433) on July 17, 2020, adopted the proposed regulations (REG-117138-17) published in the *Federal Register* (85 FR 21126) on April 16, 2020, and established the $21 annual user fee to apply for or renew a PTIN, plus $14.95 per application or application for renewal payable directly to a third-party contractor.

In *Steele v. United States*, No. 1:14-cv-1523-RCL, — F. Supp. 3d —, 2023 WL 2139722 [131 AFTR 2d 2023-718] (Feb. 21, 2023), the United States District Court for the District of Columbia on remand considered whether the fee amounts were excessive under the IOAA.

Explaining that while an agency may charge only the reasonable cost incurred to provide a service, or the value of the service to the recipient, whichever is less, the district court allowed that the activities charged for need only be "reasonably related" to the cost to the agency and the value to the recipient, and the amount may include both "direct and indirect costs" associated with the service provided. 2023 WL 2139722 [131 AFTR 2d 2023-718], at * 7. The court further noted that where an activity produces an independent public benefit, the fee that would otherwise be charged must be reduced by that portion of the costs attributable to the public benefit. *Id.*

The district court concluded that the PTIN fees for fiscal years (FYs) 2011 through 2017 were excessive to the extent they were based on: (1) the activities already conceded by the government in the case;[1] (2) any compliance activities other than direct and indirect costs of investigating ghost preparers who do not list their PTINs on returns they prepared for compensation as required by law, handling complaints regarding improper use of a PTIN, use of a compromised PTIN, or use of a PTIN obtained through identity theft, and composing the data to refer to those specific types of complaints to other IRS business units; (3) any suitability activities; (4) any support activities, other than those for the provision of PTINs and maintenance of the PTIN database, that facilitated provision of an independent benefit to the agency and the public; and (5) any activities of the third-party contractor, other than those related to the issuance, renewal, and maintenance of PTINs, that facilitated provision of an independent benefit to the agency and the public. *Id.* at * 19.

In accordance with the biennial review requirement in OMB Circular A-25 and taking into account the district court's February 2023 memorandum opinion in *Steele*, the IRS has issued a new Cost Model that re-determines costs that the government continues to incur for providing PTINs and administering the PTIN program, and re-calculates the amount of the user fee as $11 per application or application for renewal, plus a $8.75 fee per application or application for renewal payable directly to a third-party contractor. The amount payable directly to the third-party contractor also takes into account certain costs that were addressed by the district court's February 2023 memorandum opinion in *Steele*. Subsequently, the IRS entered into a modified contract that allows the government to pay those costs rather than the individuals who apply for or renew a PTIN.

The government is authorized to charge a PTIN user fee under the IOAA because, in exchange for the fee, it provides a service by issuing and maintaining PTINs, which provide tax return preparers a specific benefit by allowing them to provide an identifying number that is not a social security number on returns and claims for refund and to prepare returns and claims for refund for compensation. OMB Circular A-25 states that user fees should be collected in advance of or simultaneously with the provision of a service. The PTIN user fee is collected when tax return preparers apply for or renew their PTINs during the application season, which begins annually in October.

Explanation of Provisions

The IRS follows generally accepted accounting principles (GAAP) in calculating the full cost of administering PTIN applications and renewals. The Federal Accounting Standards Advisory Board (FASAB) is the body that establishes GAAP that apply for Federal reporting entities, such as the IRS. FASAB publishes the FASAB Handbook of Federal Accounting Standards and Other Pronouncements, as Amended (Current Handbook), available at *https://files.fasab.gov/pdffiles/2022_%20FASAB_%20Handbook.pdf*. The Current Handbook includes the *Statement of Federal Financial Accounting Standards (SFFAS) No. 4: Managerial Cost Accounting Standards and Concepts. SFFAS No. 4* establishes internal costing standards to accurately measure and manage the full cost of Federal programs, and the methodology below is in accordance with *SFFAS No. 4*.

1. *Cost Estimation of Direct Labor*

The IRS uses various cost-measurement techniques to estimate the cost attributable to the program. These techniques include using various timekeeping systems to measure the time required to accomplish activities, or using information provided by subject-matter experts on the time devoted to a program. To determine the labor and benefits cost incurred to provide the service of providing a PTIN, the IRS estimated the number of full-time employees required to conduct activities related to the costs of issuing and renewing PTINs. The number of full-time employees is based on both current employment numbers and future hiring estimates. When the indirect cost of a service or activity is not specifically identified from the cost accounting system, an overhead rate is added to the identifiable direct cost to arrive at full cost.

2. *Overhead*

Overhead is an indirect cost of operating an organization that is not specifically identifiable with an activity. Overhead includes costs of resources that are jointly or commonly consumed by one or more organizational unit's activities but are not specifically identifiable to a single activity. These costs can include:

- Financial, human resources, information technology, and general management and administrative.
- Rent and building.
- Procurement, other services, and consulting.
- Property, plant, and equipment.
- Publication services.
- Research, analytical, statistical, library and legal services.

To calculate the overhead allocable to a service, the IRS applies an overhead rate to the identified direct labor and benefits and other direct costs. The overhead rate is the ratio of the IRS's indirect labor, benefits, and non-labor costs of business divisions that do not interact with taxpayers to the labor and benefits costs of business divisions that interact with taxpayers. The IRS calculates an overhead rate annually. For the FY 2023 user fee review, an overhead rate of 62.5 percent was used.

3. *Calculation of PTIN User Fee*

The IRS used projections for FYs 2024 through 2026 to determine the direct and indirect costs associated with the PTIN program that are includible in the PTIN user fee calculation taking into account the district court's February 2023 memorandum opinion in *Steele*. Direct costs are incurred by the Return Preparer Office and include staffing and contract-related costs for activities, processes, and procedures related to administering the PTIN program. Staffing costs included in the PTIN user fee calculation relate to the compliance activities of investigating ghost preparers; handling complaints regarding the improper use of a PTIN, use of a compromised PTIN, or use of a PTIN obtained through identity theft; and composing the data to refer those specific types of complaints to other IRS business units. The PTIN user fee also takes into account indirect costs for support activities related to the provision of PTINs and maintenance of the PTIN database. In accordance with *Steele*, the PTIN user fee calculation does not take into account compliance costs other than those described in this paragraph, costs incurred by the Suitability Department, support costs other than those described in this paragraph, and costs previously conceded by the government in *Steele*, as detailed earlier in this preamble.

The labor and benefits for the work performed related to the PTIN program is projected to be $16,536,827 in total over FYs 2024 through 2026. In addition to labor and benefits and overhead expenses, the IRS projects incurring travel, training, and supplies costs of $115,000 in each of FYs 2024 through 2026. The total labor and benefits, travel, training, and supplies, and overhead expenses projected are shown below:

Expense	FY 2024	FY 2025	FY 2026	Total
Labor and benefits	$5,364,566	$5,510,939	$5,661,322	$16,536,827
Travel, training, and supplies	$115,000	$115,000	$115,000	$345,000
Overhead (62.5 percent)	$3,424,729	$3,516,212	$3,610,201	$10,551,142

The total cost for FYs 2024 through 2026 are therefore projected to be $27,432,969. The number of users is based on FY 2022 numbers adjusted by a projected increase in applications over the next three FYs. Dividing this total cost by the projected population of users for FYs 2024 through 2026 results in a cost per application of $11 as shown below:

Total Costs		$27,432,969
Number of Applications	÷	2,542,665
Cost Per Application		$ 10.79

Taking into account the full amount of these costs, the amount of the PTIN user fee per application or application for renewal is $11.

Costs related to a third-party contractor's activities for the issuance, renewal, and maintenance of PTINs, such as processing applications and operating a call center, are included in the PTIN user fee calculation, in accordance with *Steele*, which will be set at $8.75 per application or application for renewal, in addition to the amount charged by the government. The third-party contractor was chosen through a competitive bidding process.

The amount of the third-party contractor portion may change in 2026 when the contract expires and will be re-computed.

Special Analyses

I. *Regulatory Planning and Review*

The OMB's Office of Information and Regulatory Analysis has determined that these regulations are not significant and are not subject to review under section 6(b) of Executive Order 12866.

II. *Regulatory Flexibility Act*

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these interim final regulations will not have a significant economic impact on a substantial number of small entities. These regulations affect all individuals who prepare or assist in preparing all or substantially all of a tax return or claim for refund for compensation. Only individuals, not businesses, can have a PTIN. Thus, the economic impact of these regulations on any small entity generally will be a result of an individual tax return preparer who is required to have a PTIN owning a small business or a small business otherwise employing an individual tax return preparer who is required to have a PTIN. The Treasury Department and the IRS estimate that approximately 847,555 individuals will apply annually for an initial or renewal PTIN. Although these regulations will likely affect a substantial number of small entities, the economic impact on those entities is not significant. These regulations will establish an $11 fee per application or application for renewal (plus $8.75 payable directly to the third-party contractor), which is a reduction from the previously established fee and will not have a significant economic impact on a small entity. Accordingly, the rule is not expected to have a significant economic impact on a substantial number of small entities, and a regulatory flexibility analysis is not required.

III. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

IV. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. These interim final regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

V. *Good Cause*

The annual PTIN application and renewal period for the 2024 filing season will begin shortly. It would be unnecessary and contrary to the public interest for the IRS to continue to charge the current, higher user fee pending public comment after the IRS has determined pursuant to the biennial review conducted under OMB Circular A-25 that the PTIN user fee should be reduced going forward. To enable the reduced fee amount to be in effect for PTINs issued or renewed by tax return preparers preparing returns or claims for refund in 2024, the Treasury Department and the IRS find that there is good cause to dispense with (1) notice and public comment pursuant to and (c) and (2) a delayed effective date pursuant to . The Treasury Department and the IRS will consider public comments submitted in response to the cross-referenced notice of proposed rulemaking published in the Proposed Rules section of this issue of the *Federal Register* and will promulgate a final rule after considering those comments.

VI. *Submission to Small Business Administration*

Pursuant to section 7805(f) of the Code, this Treasury decision has been submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

VII. *Congressional Review Act*

Pursuant to the Congressional Review Act (et seq.), the Office of Information and Regulatory Affairs designated this rule as not a major rule, as defined by .

Drafting Information

The principal author of these regulations is Jamie Song, Office of the Associate Chief Counsel (Procedure and Administration). Other personnel from the Treasury Department and the IRS participated in the development of the regulations.

List of Subjects in 26 CFR Part 300

Estate taxes, Excise taxes, Fees, Gift taxes, Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 300 is amended as follows:

PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read in part as follows:

Authority: .

Par. 2. Section 300.11 is amended by revising paragraphs (b) and (d) to read as follows:

§300.11 Fee for obtaining a preparer tax identification number.

*****

(b) *Fee*. The fee to apply for or renew a preparer tax identification number is $11 per year and is in addition to the fee charged by the contractor.

*****

(d) *Applicability date*. This section applies to applications for or renewal of a preparer tax identification number filed on or after October 19, 2023.

Douglas W. O'Donnell,

Deputy Commissioner for Services and Enforcement.

Approved: September 25, 2023.

Lily Batchelder,

Assistant Secretary of the Treasury (Tax Policy).

---

1 The government previously conceded $26,576,661, $26,623,420, and $25,685,247 for amounts collected in FY 2011, FY 2012, and FY 2013, respectively, which related to certain communications, compliance, Office of Professional Responsibility (OPR), and operations support activities; $8,737,123 and $9,010,458 for amounts collected in FY 2014 and FY 2015, respectively, which related to certain communications, Office of the Director, Strategy and Finance, suitability, compliance and complaint referrals, competency and standards, continuing education, OPR, enrolled agent and enrolled retirement plan agent department, and contractor processing activities; and $6,904,345 and $6,784,762 for amounts collected in FY 2016 and FY 2017, respectively, which related to certain communications, Office of the Director, Strategy and Finance, suitability, compliance and complaint referrals, OPR, enrolled agent and enrolled retirement plan agent department, and contractor processing activities.

END OF DOCUMENT -

Treasury Decision

Treasury Decision 9981, 10/13/2023, IRC Sec(s). 509

Private foundation defined—supporting orgs.

Headnote:

To reflect changes made to requirements org. must satisfy to qualify as Type III supporting org. made by Pension Protection Act '06 (P.L. 109-280; 8/17/2006), IRS issued final regs to better define "control" for purposes of Code Sec. 509(f)(2); which prohibits Type I or Type III supporting org. from accepting any gift or contribution from any person who controls governing body of supported org./orgs. Various additional requirements for Type III supporting orgs. are set forth. Proposed regs issued in 2006 are adopted as revised.

Reference(s): ¶ 5095.02(5); Code Sec. 509;

Full Text:

RIN 1545-BJ53

Requirements for Type I and Type III Supporting Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance on the prohibition on certain gifts or contributions to Type I and Type III supporting organizations from persons who control a supported organization and on certain other requirements for Type III supporting organizations. The regulations reflect changes to the law made by the Pension Protection Act of 2006. The regulations affect certain Type I and Type III supporting organizations and their supported organizations.

DATES: Effective date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].**

Applicability date: For dates of applicability, see §1.509(a)-4(l).

FOR FURTHER INFORMATION CONTACT: Michael Gruccio at (202) 317-4541 or Don Spellmann at (202) 317-4086.

SUPPLEMENTARY INFORMATION:

Background

I. Overview

This document amends the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 509(a) of the Internal Revenue Code (Code). These final regulations amend §1.509(a)-4 to provide guidance on amendments to the Code enacted by section 1241 of the Pension Protection Act of 2006 (PPA), Public Law 109-280 , 120 Stat. 780 (August 17, 2006).

An organization described in section 501(c)(3) of the Code is classified as either a private foundation or a public charity. To be classified as a public charity, an organization must be described in section 509(a)(1), (2), or (3). Organizations described in section 509(a)(3) are known as "supporting organizations." Supporting organizations achieve their public charity status by providing support to one or more organizations described in section 509(a)(1) or (2), which, in this context, are referred to as "supported organizations."

To be described in section 509(a)(3), an organization must satisfy (1) an organizational test, (2) an operational test, (3) a relationship test, and (4) a disqualified person control test. The organizational and operational tests require that a supporting organization be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more supported organizations. The relationship test requires a supporting organization to establish one of three types of relationships with one or more supported organizations. A supporting organization that is operated, supervised, or controlled by one or more supported organizations is known as a “Type I” supporting organization. The relationship of a Type I supporting organization with its supported organization(s) is comparable to that of a corporate parent-subsidiary relationship. A supporting organization that is supervised or controlled in connection with one or more supported organizations is known as a “Type II” supporting organization. The relationship of a Type II supporting organization with its supported organization(s) involves common supervision or control by the persons supervising or controlling both the supporting organization and the supported organization(s). A supporting organization that is operated in connection with one or more supported organizations is known as a “Type III” supporting organization and is discussed further in the remainder of this preamble. Finally, the disqualified person control test requires that a supporting organization not be controlled directly or indirectly by certain disqualified persons.

Sections 1241 through 1243 of the PPA revised the requirements for supporting organizations. These final regulations under §1.509(a)-4 address section 1241's five changes to the requirements an organization must satisfy to qualify as a Type III supporting organization.

II. PPA Changes to Type III supporting organizations.

The PPA made the following five changes to the requirements an organization must satisfy to qualify as a Type III supporting organization:

(1) Section 1241(c) of the PPA removed the ability of a charitable trust to rely on the special rule under §1.509(a)-4(i)(2)(iii) as then in effect, which allowed a trust to satisfy the attentiveness requirement of the integral part test for non-functionally integrated Type III supporting organizations if the supported organization was a beneficiary of the trust and state law allowed the beneficiary to enforce the trust and compel an accounting of the trust;

(2) Section 1241(d) of the PPA directed the Secretary of the Treasury or her delegate (Secretary) to promulgate regulations under section 509 that establish a new distribution requirement for Type III supporting organizations that are not “functionally integrated” (a non-functionally integrated (NFI) Type III supporting organization) to ensure that a “significant amount” is paid to supported organizations; for this purpose, the term “functionally integrated” means a Type III supporting organization that is not required under regulations to make payments to supported organizations, because the supporting organization engages in activities that relate to performing the functions of, or carrying out the purposes of, its supported organization(s);

(3) Section 1241(b) of the PPA required a Type III supporting organization to provide annually to each of its supported organizations the information required by the Department of the Treasury (Treasury Department) and the IRS (referred to in

§1.509(a)-4(i)(2) as the notification requirement) to ensure that the supporting organization is responsive to the needs or demands of its supported organization(s);

(4) Section 1241(b) of the PPA also prohibited a Type III supporting organization from supporting any supported organization not organized in the United States; and

(5) Section 1241(b) of the PPA additionally prohibited a Type I or Type III supporting organization from accepting any gift or contribution from a person who, alone or together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III supporting organization.

III. <u>Prior Rulemaking</u>

On August 2, 2007, the Treasury Department and the IRS published in the *Federal Register* (72 FR 42335) an advanced notice of proposed rulemaking (ANPRM) (REG-155929-06) in response to the PPA. The ANPRM described proposed rules to implement the changes made by the PPA to the Type III supporting organization requirements and solicited comments regarding those proposed rules.

On September 24, 2009, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-155929-06) in the *Federal Register* (74 FR 48672) proposing regulations regarding certain requirements to qualify as a Type III supporting organization under the PPA (2009 proposed regulations). The 2009 proposed regulations set forth those proposed requirements in §1.509(a)-4(i).

On December 28, 2012, the Treasury Department and the IRS published a Treasury Decision (TD 9605) in the *Federal Register* (77 FR 76382) containing final and temporary regulations under §1.509(a)-4 regarding the requirements to qualify as a Type III supporting organization (2012 TD). Also on December 28, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-155929-06) in the *Federal Register* (77 FR 76426) containing proposed regulations that incorporated the text of the temporary regulations in the 2012 TD by cross-reference. The temporary regulations in the 2012 TD made significant changes to the distribution requirement for NFI Type III supporting organizations. The 2012 TD adopted other aspects of the 2009 proposed regulations with some changes in response to comments and provided transition relief for Type III supporting organizations in existence on December 28, 2012, that met and continued to meet the test under former §1.509(a)-4(i)(3)(ii), known as the "but for" test, as in effect prior to December 28, 2012, treating them as functionally integrated until the first day of their second taxable year beginning after December 28, 2012. Upon expiration of this relief period, the 2012 TD requires these organizations to meet the same rules as all other supporting organizations to be considered functionally integrated. The preamble to the 2012 TD also identified issues for possible future rulemaking and requested comments.

On January 6, 2014, the Treasury Department and the IRS published Notice 2014-4, 2014-2 I.R.B. 274, to provide additional transition relief for any Type III supporting organization (1) supporting at least one supported organization that is a governmental entity to which the supporting organization is responsive (within the meaning of §1.509(a)-4(i)(3)) and (2) engaging in activities for or on behalf of the governmental supported organization that perform the functions of, or carry out the purposes of, the governmental supported organization and that, but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself. Notice 2014-4 stated that such an organization will be treated as a functionally integrated Type III supporting organization until the earlier of the date final regulations under §1.509(a)-4(i)(4)(iv) are published in the *Federal Register* or the first day of the organization's third taxable year beginning after December 31, 2013.

On December 23, 2015, the Treasury Department and the IRS published a Treasury Decision (TD 9746) in the *Federal Register* (80 FR 79684) containing final regulations under §1.509(a)-4(i) regarding the distribution requirement for NFI Type III supporting organizations, finalizing the rule in the 2012 proposed and temporary regulations with very minor changes (2015 final regulations). The preamble to the 2015 final regulations indicated that additional proposed regulations would be forthcoming to provide additional guidance for Type III supporting organizations, including specific rules under §1.509(a)-4(i)(4)(iv) for Type III supporting organizations that support governmental supported organizations; the 2012 TD had reserved §1.509(a)-4(i)(4)(iv). In addition, the preamble to the 2015 final regulations indicated that supporting organizations that support a governmental supported organization could continue to rely on Notice 2014-4 until the date of publication of the new proposed regulations.

On February 19, 2016, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-118867-10) in the *Federal Register* (81 FR 8446) containing proposed regulations under §1.509(a)-4(f) and (i) regarding the prohibition on certain contributions to Type I and Type III supporting organizations and the requirements for Type III supporting organizations (2016 proposed regulations). The 2016 proposed regulations addressed issues identified in the preamble to the 2012 TD as well as the comments (six in total) on the 2012 TD and Notice 2014-4.

The Treasury Department and the IRS received six comments in response to the 2016 proposed regulations. The comments are available for public inspection at *https://www.regulations.gov* or upon request. No public hearing was requested. After considering the comments received, the Treasury Department and the IRS adopt the 2016 proposed regulations in these final regulations with certain revisions described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

I. Overview

This Summary of Comments and Explanation of Revisions addresses the comments that the Treasury Department and the IRS received in response to the 2016 proposed regulations and describes the revisions adopted in these final regulations. As described in this Summary of Comments and Explanation of Revisions, these final regulations define the term "control" for purposes of section 509(f)(2), which prohibits a Type I or Type III supporting organization from accepting any gift or contribution from any person who controls the governing body of the supported organization(s). These final regulations also set forth additional rules and requirements for Type III supporting organizations, including additional requirements to meet the responsiveness test for all Type III supporting organizations; (2) additional rules regarding the qualification of an organization as a functionally integrated Type III supporting organization under §1.509(a)-4(i)(4), including specific rules for supporting organizations that support governmental supported organizations; and (3) additional rules regarding the required annual distributions under §1.509(a)-4(i)(5) by an NFI Type III supporting organization.

II. Contributions from Controlling Donors - Meaning of Control

Section 509(f)(2) and §1.509(a)-4(f)(5) prohibit Type I and Type III supporting organizations from accepting any gift or contribution from any person (other than an organization described in section 509(a)(1), (2), or (4)) who, alone or together with certain related persons (as described in §1.509(a)-4(f)(5)(i)(B) or (C)), directly or indirectly controls the governing body of a supported organization of the Type I or Type III supporting organization, or from persons related to a person possessing such control. Section 509(f)(2) does not define "directly or indirectly controls." The 2012 TD reserved §1.509(a)-4(f)(5)(ii), titled "Meaning of control," for future proposed regulations.

The 2016 proposed regulations proposed defining "control" consistently with the definition of control in §1.509(a)-4(j), which relates to control by disqualified persons for purposes of the disqualified person control test in section 509(a)(3)(C) and §1.509(a)-4(a)(4). In general, under the 2016 proposed regulations, the governing body of a supported organization is considered "controlled" by a person if that person, alone or by aggregating his or her votes or positions of authority with certain related persons described in §1.509(a)-4(f)(5)(i)(B) or (C), may require the governing body of the supported organization to perform any act that significantly affects its operations or may prevent the governing body of the supported organization from performing any such act.

These final regulations adopt the definition of "control" proposed in the 2016 proposed regulations with minor changes to add clarity. These final regulations make clear that control exists if one or more persons described in §1.509(a)-4(f)(5)(i)(A), (B), or (C) hold 50 percent or more of the total voting power of the governing body or have the right to exercise veto power over the actions of the governing body. These final regulations also incorporate language from §1.509(a)-4(j)(1) to make clear that even if persons do not have control by virtue of having 50 percent or more of the voting power or a veto power, all pertinent facts and circumstances will be taken into consideration in determining whether such persons do in fact directly or indirectly control the governing body of a supported organization.

One commenter stated that if a parent supporting organization controls a supported organization, section 509(f)(2) would prohibit Type I and Type III supporting organizations of that controlled supported organization from accepting any gift or contribution from the parent supporting organization. To allow these contributions, the commenter recommended excluding from the definition of control the control a parent supporting organization exercises over its supported organizations.

Section 509(f)(2) only excepts gifts or contributions from organizations described in section 509(a)(1), (2), and (4). Congress did not provide an exception for section 509(a)(3) organizations. For this reason, the commenter's recommendation is not consistent with section 509(f)(2), and these final regulations do not adopt it.

III. Type III Supporting Organization Relationship Test

Section 1.509(a)-4(i)(1) provides that, for each taxable year, a Type III supporting organization must satisfy (i) a notification requirement, (ii) a responsiveness test, and (iii) an integral part test provided in the regulations. The 2016 proposed regulations proposed additional rules regarding each of these requirements. These final regulations adopt the 2016 proposed rules with the modifications described in this part III.

A. Notification Requirement

Section 509(f)(1)(A) provides that an organization will not be considered a Type III supporting organization unless the organization provides to each supported organization, for each taxable year, such information as the Secretary may require to ensure that the organization is responsive to the needs or demands of the supported organizations. To satisfy this notification requirement, §1.509(a)-4(i)(2) requires a Type III supporting organization to provide to each of its supported organizations for each taxable year: (1) A written notice addressed to a principal officer of the supported organization describing the type and amount of all of the support it provided to the supported organization during the supporting organization's preceding taxable year; (2) a copy of the supporting organization's most recently filed Form 990, *Return of Organization Exempt from Income Tax*, or other annual information return required to be filed under section 6033; and (3) a copy of the supporting organization's governing documents, including any amendments (unless previously provided and not subsequently amended). The 2016 proposed regulations proposed clarifying that for NFI Type III supporting organizations the description of support in the written notice must include all of the distributions described in §1.509(a)-4(i)(6) to the supported organization. These final regulations adopt this clarification.

Section 1.509(a)-4(i)(2)(iii) requires that the notification be transmitted by the last day of the fifth calendar month following the close of "that taxable year." Due to the lack of clarity regarding the reference to "that taxable year," the 2016 proposed regulations proposed amending §1.509(a)-4(i)(2) to clarify that a supporting organization must deliver the required documents to each of its supported organizations by the last day of the fifth month of the supporting organization's taxable year after the taxable year in which it provided the support it is reporting. The preamble to the 2016 proposed regulations stated that the proposed change is intended to reduce confusion but does not substantively change the due date or the content of the required notification. The preamble also stated that the date of delivery is determined by applying the general principles of section 7502. The final regulations adopt this proposed amendment without change.

One commenter requested clarification that the annual written notice may summarize all the programs and services a supporting organization performs for its supported organization. The Treasury Department and the IRS agree that a supporting organization may summarize its activities directly furthering the exempt purpose of the supported organization as long as that summary provides sufficient notice to the supported organization on the character of the activity and its related costs. The report must include a brief narrative description of the support provided and sufficient financial detail for the recipient to identify the types and amounts of support being reported.

B. Responsiveness Test

Section 1.509(a)-4(i)(3)(i) provides that a supporting organization meets the responsiveness test if it is "responsive to the needs or demands of a supported organization." To meet this responsiveness test, an organization must satisfy two elements—the "relationship requirement" and the "significant voice requirement." Under the relationship requirement, described in §1.509(a)-4(i)(3)(ii), the officers, directors, or trustees of the organization must have one of three specified relationships with the officers, directors, or trustees (and in some cases the members) of the supported organization. Under the significant voice requirement, described in §1.509(a)-4(i)(3)(iii), the officers, directors, or trustees of the supported organization, by reason of their relationships described in §1.509(a)-4(i)(3)(ii), must have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, and the selection of grant recipients by the supporting organization, and in otherwise directing the use of the income or assets of the supporting organization.

The preamble to the 2012 TD stated that, in determining the appropriate distribution amount for NFI Type III supporting organizations, the Treasury Department and the IRS considered the required relationship between a supporting organization and its supported organizations, and that the Treasury Department and the IRS intended to issue proposed regulations in the future that would amend the responsiveness test by requiring a Type III supporting organization to be responsive to all of its supported organizations.

In response to this proposal in the preamble to the 2012 TD, one commenter stated that a supporting organization should not be required to be responsive to all of its supported organizations because the resulting administrative burden would effectively limit the total number of organizations a supporting organization could support. The commenter suggested alternatives under which a supporting organization would be responsive to only a subset of its supported organizations that would vary from year to year.

As stated in the preamble to the 2016 proposed regulations, the distinguishing characteristic of Type III supporting organizations, and the basis for their public charity classification, is that they are responsive to and significantly involved in the operations of their publicly supported organizations. See §1.509(a)-4(f)(4). Unless a Type III supporting organization is responsive to each of its supported organizations, the supported organizations cannot exercise the requisite level of oversight of and engagement with the supporting organization. Limiting the responsiveness requirement to fewer than all of the supported organizations may result in the necessary oversight and accountability being present for less than all of a supporting organization's operations. Consistent with this view, the 2016 proposed regulations proposed revising §1.509(a)-4(i)(3)(i) to require a supporting organization to be responsive to the needs and demands of each of its supported organizations to meet the responsiveness test.

In addition, to illustrate how concerns about potential administrative burdens may be addressed consistent with the revised responsiveness test, the 2016 proposed regulations proposed a new Example 3 in §1.509(a)-4(i)(3)(iv) to demonstrate one way in which a Type III supporting organization that supports multiple organizations may satisfy the responsiveness test in a manner that can be cost-effective. The Example shows that a supporting organization can meet the relationship requirement in §1.509(a)-4(i)(3)(ii) in different ways with respect to each of its supported organizations. The Example also shows how a supporting organization can organize and hold regular meetings, provide information, and encourage communication to help ensure that its supported organizations have a significant voice in the operations of the supporting organization.

As noted in the preamble to the 2016 proposed regulations, another commenter in response to the preamble of the 2012 TD requested additional guidance regarding the ability of trusts to satisfy the significant voice requirement of the responsiveness test. The new Example 3 in the 2016 proposed regulations provides further illustration of how Type III supporting organizations, including charitable trusts, might satisfy the significant voice requirement of the responsiveness test. The Treasury Department and the IRS note that although the examples in the regulations relating to the responsiveness test may involve a Type III supporting organization that is organized as either a corporation or a trust, the applicable law and relevant regulatory provisions, as modified by the final regulations, are applicable to all Type III supporting organizations in the same manner, whether they are organized as corporations or trusts.

As the preamble to the 2016 proposed regulations stated, the Treasury Department and the IRS anticipate that Type III supporting organizations may be able to demonstrate that they satisfy the responsiveness test in a variety of ways, and that the determination will be based on all the facts and circumstances.

As a result of the proposed changes to the responsiveness test, the 2016 proposed regulations also include conforming changes to examples and other regulatory provisions, specifically, removing references to "supported organizations to which the supporting organization is responsive" since the supporting organization is to be responsive to each supported organization.

Two commenters to the 2016 proposed regulations address the responsiveness test, agreeing with the proposed amendments to §1.509(a)-4(i)(3)(i) and the new example in §1.509(a)-4(i)(3)(iv). Thus, these final regulations adopt these proposed amendments without change.

C. Integral Part Test - Functionally Integrated Type III Supporting Organizations

Section 1.509(a)-4(i)(1)(iii) provides that, for each taxable year, a Type III supporting organization must satisfy the integral part test. The integral part test under §1.509(a)-4(i)(1)(iii) is satisfied by maintaining significant involvement in the operations of one or more supported organizations and providing support on which the supported organizations are dependent. To satisfy this test, a Type III supporting organization must meet the requirements either for a functionally integrated Type III supporting organization or for an NFI Type III supporting organization, as set forth in §1.509(a)-4(i)(4) or (5), respectively.

One commenter to the 2016 proposed regulations stated that the cross reference in §1.509(a)-4(d)(4)(i)(C) to the integral part test should be corrected to conform to the amendments made by the 2012 TD. The final regulations adopt this recommendation and revise §1.509(a)-4(d)(4)(i)(C) to reference the requirements of the integral part test set forth in §1.509(a)-4(i)(1)(iii).

A Type III supporting organization is functionally integrated under §1.509(a)-4(i)(4) if it (1) engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations and otherwise meets the requirements described in paragraph (i)(4)(ii) of that section, (2) is the parent of each of its supported organizations as described in paragraph (i)(4)(iii) of that section, or (3) supports a governmental supported organization and otherwise meets the requirements of paragraph (i)(4)(iv) of that section.

1. “Substantially All” Test

Section 1.509(a)-4(i)(4)(ii)(B) provides that all pertinent facts and circumstances will be taken into consideration in determining whether substantially all of a supporting organization's activities directly further the exempt purposes of its supported organization(s). One commenter to the 2016 proposed regulations requested that supporting organizations be given the option of meeting the "substantially all" test on average over a three- or five-year period. The commenter also recommended that transition relief be provided if an organization does not meet the test over the most recent three or five years before the promulgation of final regulations.

The 2012 TD adopted the substantially all test in §1.509(a)-4(i)(4)(ii). The 2012 TD also provided transition relief in §1.509(a)-4(i)(11)(ii) for existing organizations to adjust to the new rules. The 2016 proposed regulations did not include any substantive changes to §1.509(a)-4(i)(4)(ii). Furthermore, the substantially all test in §1.509(a)-4(i)(4)(ii)(B) takes into consideration all pertinent facts and circumstances, which allows for some consideration of year-to-year changes in activities. Finally, the Treasury Department and the IRS note that the commenter's proposed multi-year averaging test would be complex, create uncertainty about a supporting organization's functionally integrated status at the close of each taxable year, and would be difficult to administer. For these reasons, the final regulations do not adopt this recommendation.

2. Parent of Each Supported Organization

Under §1.509(a)-4(i)(4)(iii), a supporting organization is the parent of a supported organization, and thus is deemed to be functionally integrated, if the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacities) of the supporting organization.

As the 2009 proposed regulations noted, the classification of a parent organization as functionally integrated was intended to "apply to supporting organizations that oversee or facilitate the operation of an integrated system, such as hospital systems." To more fully accomplish this objective, the 2016 proposed regulations proposed a revision to §1.509(a)-4(i)(4)(iii) clarifying that for a supporting organization to qualify as the parent of each of its supported organizations, the supporting organization and its supported organizations must be part of an integrated system (such as a hospital system), and the supporting organization must engage in activities typical of the parent of an integrated system. The 2016 proposed regulations stated that examples of these activities include (but are not limited to) coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting, and resource allocation for the supported organizations.

One commenter requested that the final regulations provide additional examples of integrated systems, such as private schools and universities, continuing care retirement communities, and residential rehabilitation facilities. The parenthetical in the 2016 proposed regulations--such as a hospital system-- is stated as only one example and is not exclusive. This section of the regulations applies to any type of integrated system of which the parent organization and its supported organizations are a part. The test is whether the structure is that of an integrated system and whether the requirements of §1.509(a)-4(i)(4)(iii) are satisfied, not whether the system is in a particular industry. The Treasury Department and the IRS conclude that it is unnecessary to add other examples of industries that may have integrated systems; doing so at this time may indicate that any industries not specifically mentioned in the final regulations are excluded. Accordingly, the final regulations do not adopt the commenter's request to provide additional examples. Nevertheless, in response to the comment and to make clear that a hospital system is just one example of an integrated system, the final regulations revise the parenthetical in the 2016 proposed regulations to read as follows: (such as, for example, a hospital system).

The commenter also recommended including additional examples of activities that are typical of a parent of an integrated system and suggested that the examples might include financial planning and forecasting, legal services, human resources, information management, billing and collection services, marketing, and community outreach and education. The Treasury Department and the IRS note that the list of activities in the 2016 proposed regulations was only illustrative of how a parent directs the overall policies, programs, and activities of the supported organizations within the integrated system and was not exclusive. Thus, the absence of any particular activity, such as financial planning, from this list is not determinative. The final regulations clarify that a parent of an integrated system of supported organizations must direct the overall policies, programs, and activities of the supported organizations (such as, for example, coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting, and resource allocation). The Treasury Department and the IRS note that a parent of an integrated system may also perform system-wide administrative services, such as the examples provided by the commenter, in conjunction with directing the overall policies, programs, and activities of the supported organizations. For clarity, these final regulations omit the defined term "activities typical of a parent" in proposed §1.509(a)-4(i)(4)(iii). The 2016 proposed regulations proposed to retain the requirement in §1.509(a)-4(i)(4)(iii) that the governing body, members of the governing body, or officers of a parent supporting organization must appoint or elect a majority of the officers, directors, or trustees of the supported organization. The preamble to the 2016 proposed regulations stated that the use of the phrase "appointed or elected, directly or indirectly" means the supporting organization could qualify as a parent of a second-tier (or lower) subsidiary. Thus, for example, if the directors of supporting organization A appoint a majority of the directors of supported organization B, which in turn appoints a majority of the directors of supported organization C, the directors of supporting organization A will be treated as appointing the majority of the directors of both supported organization B and supported organization C. One commenter agreed with this interpretation and requested that it be addressed in the final regulations. These final regulations adopt this recommendation.

As stated in the preamble to the 2016 proposed regulations, the Treasury Department and the IRS interpret the existing requirement under §1.509(a)-4(i)(4)(iii) that the parent organization have the power to appoint or elect a majority of the officers, directors, or trustees of each supported organization to include the requirement that the parent organization also have the power to remove and replace such officers, directors, or trustees, or otherwise have an ongoing power to appoint or elect with reasonable frequency. One commenter requested that language reflecting this interpretation be specifically added to §1.509(a)-4(i)(4)(iii). The final regulations adopt this commenter's recommendation.

3. Supporting a Governmental Supported Organization

The 2012 TD reserved §1.509(a)-4(i)(4)(iv) for future guidance on how a Type III supporting organization can qualify as functionally integrated by supporting a governmental entity. As interim guidance, Notice 2014-4 provided that a Type III supporting organization will be treated as functionally integrated if it (i) supports a supported organization that is a governmental entity to which the supporting organization is responsive; and (ii) engages in activities for or on behalf of that governmental supported organization that perform the functions of, or carry out the purposes of, that governmental supported organization and that, but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself. This interim guidance was subsequently extended by the 2015 final regulations. The 2016 proposed regulations proposed new rules under which a Type III supporting organization would qualify as functionally integrated by supporting governmental supported organizations. These final regulations adopt the proposed §1.509(a)-4(i)(4)(iv), with the modifications discussed in the following paragraphs.

The 2016 proposed regulations proposed that a supporting organization that only supports governmental supported organizations would be considered functionally integrated if a substantial part of its total activities directly further the exempt purposes of its governmental supported organizations and, if the supporting organization supports more than one governmental supported organization, all of its governmental supported organizations either: (1) Operate within the same geographic region (defined as a city, county, or metropolitan area); or (2) work in close coordination or collaboration with each other to conduct a service, program, or activity that the supporting organization supports. The 2016 proposed regulations proposed defining a governmental supported organization as a governmental unit described in section 170(c)(1), or an organization described in section 170(c)(2) and (b)(1)(A) (other than in clauses (vii) and (viii)) that is an instrumentality of one or more governmental units described in section 170(c)(1). To satisfy the close coordination or collaboration requirement, the proposed regulations proposed requiring a supporting organization to maintain on file a letter from each of the governmental supported organizations (or a joint letter from all of them) describing their coordination or collaboration efforts with respect to the particular service, program, or activity. The 2016 proposed regulations proposed an exception to this rule for certain pre-existing organizations that support no more than one non-governmental supported organization along with one or more governmental supported organizations, as well as a transition rule for pre-existing organizations that continue to meet the requirements of Notice 2014-4.

Two commenters recommended that Type III functionally integrated supporting organizations should not be limited to only supporting governmental supported organizations. One commenter proposed that a supporting organization which supports both governmental and non-governmental supported organizations should qualify as functionally integrated if the supporting organization (i) conducts activities that perform the functions of or carry out the purposes of its governmental supported organization(s), (ii) its non-governmental supported organizations operate in the same geographic region or work in close coordination or collaboration with the governmental supported organization(s), and (iii) substantially all of the supporting organization's activities directly further the exempt purposes of its governmental supported organization(s).

The other commenter recommended replacing the requirement that all supported organizations be governmental supported organizations with a new requirement that substantially all the activities of the supporting organization either (i) directly further the purposes of the governmental supported organizations, or (ii) consist of grantmaking, fundraising, or investing for governmental supported organizations that meet either the same geographic region or close coordination and collaboration requirements in the 2016 proposed regulations.

A third commenter requested that, when a supporting organization supports more than one governmental supported organization, the governmental supported organizations should only be required to work in close coordination or collaboration. The commenter requested deleting the requirement that the governmental supported organizations conduct a service, program, or activity that the supporting organization supports.

The 2016 proposed regulations proposed allowing certain Type III supporting organizations that support governmental supported organizations to be classified as functionally integrated on the basis that the involvement of the governmental supported organizations in the supporting organization's activities would minimize the potential for abuse. As stated in the preamble to the 2016 proposed regulations, requiring close cooperation and collaboration on a common service, program, or activity that the supporting organization supports helps ensure that the governmental supported organizations will provide sufficient input to and oversight of the supporting organization. Moreover, the coordination and collaboration between the governmental supported organizations would be greatly diminished if they engaged in different services, programs, or activities. Furthermore, governmental input and oversight would be diluted if the definition of functionally integrated were expanded to permit these supporting organizations to support and be responsive to non-governmental supported organizations as well. Additionally, for the reasons discussed later in this preamble, the Treasury Department and the IRS utilize the substantial part test for supporting governmental supported organizations (instead of the substantially all test) but specifically exclude grant making and other financial activities from the definition of activities that directly further the exempt purposes of the governmental supported organizations. Accordingly, these final regulations do not adopt these recommendations. For clarity, these final regulations omit the defined term "geographic region" contained in proposed §1.509(a)-4(i)(4)(iv)(C).

As noted previously in this preamble, the 2016 proposed regulations proposed that, for simplicity and administrability, the term "governmental supported organization" be defined using an existing Code definition of governmental unit. Three commenters stated their support for this definition. Thus, the final regulations adopt the definition in the 2016 proposed regulations with the clarification described in the following paragraph.

The preamble to the 2016 proposed regulations noted that, because a governmental unit described in section 170(c)(1) includes all of the agencies, departments, and divisions of that governmental unit, all such agencies, departments, and divisions will be treated as one governmental supported organization for purposes of §1.509(a)-4(i)(4)(iv). One commenter stated its support for this position and requested that it be specifically written into the regulations. These final regulations adopt this commenter's recommendation. The final regulations specifically state that a governmental unit includes all of its agencies, departments, and divisions, and that they will be treated as one governmental supported organization for these purposes.

One commenter on the 2016 proposed regulations requested that an instrumentality of a governmental supported organization and the governmental supported organization with respect to which it is an instrumentality should be treated as one governmental supported organization. The final regulations do not adopt this recommendation because, unlike an agency, department, or division of a governmental unit, an instrumentality described in §1.509(a)-4(i)(4)(iv)(B)(2) is a separate legal entity.

The 2016 proposed regulations also proposed that supporting organizations that support only governmental supported organizations may qualify as functionally integrated only if a "substantial part" of their activities directly furthers the exempt purposes of their governmental supported organization(s). The 2016 proposed regulations proposed using the same definition of "directly further" contained in §1.509(a)-4(i)(4)(ii)(C), the integral part test for functionally integrated Type III supporting organizations, as promulgated in the 2012 TD. This definition provides that fundraising, making grants, and investing and managing non-exempt-use assets are not activities that directly further the exempt purposes of the supported organization.

One commenter recommended that fundraising, making grants, and investing and managing non-exempt-use assets should be considered activities that directly further the exempt purposes of a governmental supported organization. The Treasury Department and the IRS determined that a Type III supporting organization should qualify as functionally integrated only if the supporting organization itself conducts activities that perform the functions of or carry out the purposes of its supported organization (as distinguished from providing financial support for the activities carried out by the supported organization). As the 2012 TD stated, fundraising, making grants, and investing and managing non-exempt-use assets relate to producing and distributing income to finance the charitable activities directly carried out by the supported organization. The 2016 proposed regulations did not adopt comments seeking to apply a different definition of "directly further" to supporting organizations that support governmental supported organizations. These final regulations do not adopt the commenter's proposal because using a different definition of "directly further" for governmental supported organizations would undermine a fundamental distinction that §1.509(a)-4(i)(4) makes between functionally integrated and NFI Type III supporting organizations, i.e., directly conducting charitable activities versus financing charitable activities. The Treasury Department and the IRS also note the complexity and administrative difficulty of applying different definitions of "directly further" under the integral part test.

These final regulations adopt the requirement in the 2016 proposed regulations that a substantial part of the supporting organization's total activities must directly further the exempt purposes of its governmental supported organizations. These final regulations also add a new example to clarify that a supporting organization can meet this requirement and still make grants to one of its governmental supported organizations as a substantial part of its activities. As the preamble to the 2016 proposed regulations stated, the "substantial part" test in §1.509(a)-4(i)(4)(iv) allows these supporting organizations to conduct more fundraising and other financial activities, if certain requirements are met, than is permitted under the "substantially all" test of §1.509(a)-4(i)(4)(ii) that applies generally to be a functionally integrated Type III supporting organization. One commenter requested confirmation concerning the identity of these certain requirements that must be met. Under §1.509(a)-4(i)(4) as promulgated by the 2012 TD and amplified by these final regulations in providing the rules for supporting governmental supported organizations, the organization must meet the annual notification requirement in §1.509(a)-4(i)(2) and the responsiveness test in §1.509(a)-4(i)(3), in addition to the specific requirements in §1.509(a)-4(i)(4)(iv), in order to be a functionally integrated Type III supporting organization by virtue of supporting governmental supported organizations.

One commenter recommended providing a clear definition of what constitutes a substantial part of a supporting organization's total activities for purposes of meeting §1.509(a)-4(i)(4)(iv). Another commenter recommended not adopting a bright line rule to measure the quantity of activities that equal a substantial part, but requested a statement in the final regulations that all pertinent facts and circumstances will be taken into account. This commenter also requested more examples of activities that directly further the exempt purpose of the governmental supported organization and clarification in the regulations to require that a substantial part of a supporting organization's activities directly further the exempt purposes of “at least one” (as opposed to all) of its governmental supported organizations when the governmental supported organizations share a common geographic region.

In response to these comments, the final regulations revise proposed §1.509(a)-4(i)(4)(iv) to provide that, in determining whether a substantial part of a supporting organization's total activities directly further the exempt purposes of its governmental supported organization(s), all pertinent facts and circumstances will be taken into consideration. This approach is consistent with the approach in §1.509(a)-4(i)(4)(ii)(B), which determines “substantially all” for the general test of being functionally integrated by considering all pertinent facts and circumstances. The final regulations also revise proposed §1.509(a)-4(i)(4)(iv)(A) and add a new example in §1.509(a)-4(i)(4)(v) to make clear that a supporting organization that supports more than one governmental supported organization as described in §1.509(a)-4(i)(4)(iv)(A) satisfies the substantial part test if a substantial part of its activities directly furthers the exempt purpose of at least one of its governmental supported organizations.

One commenter stated that proposed §1.509(a)-4(i)(4)(iv)(A)(1)(ii), which uses the phrase “close coordination or collaboration,” should be made consistent with proposed §1.509(a)-4(i)(4)(iv)(D), which uses the phrase “close cooperation or coordination.” The final regulations adopt this recommendation and make the provisions consistent by changing the phrasing in §1.509(a)-4(i)(4)(iv)(C) of the final regulations to "close coordination or collaboration." No substantive change is intended by this revision.

The 2016 proposed regulations proposed an exception to the general rule for supporting organizations that support governmental supported organizations. The exception would treat a Type III supporting organization in existence on or before February 19, 2016 (the date of the issuance of the 2016 proposed regulations), as functionally integrated if: (1) It supports one or more governmental supported organizations and no more than one supported organization that is not a governmental supported organization; (2) it designated each of its supported organizations as provided in §1.509(a)-4(d)(4) on or before February 19, 2016; and (3) a substantial part of its total activities directly furthers the exempt purposes of its governmental supported organization(s). One commenter stated that the proposed exception would allow it and similar organizations currently to qualify as functionally integrated. The final regulations adopt the proposed exception without change.

The 2016 proposed regulations also proposed further extending the transition relief provided in Notice 2014-4 and extended in the preamble to the 2015 final regulations. Under the 2016 proposed regulations, a Type III supporting organization in existence on or before February 19, 2016, that met and continues to meet the requirements of Notice 2014-4 would be treated as functionally integrated until the earlier of the first day of the organization's first taxable year beginning after the date final regulations are published under §1.509(a)-4(i)(4)(iv) or the first day of the organization's second taxable year beginning after February 19, 2016. The Treasury Department and the IRS did not receive any comments about the transition rule or any requests to extend the transition period in the 2016 proposed regulations, which now has expired. The Treasury Department and the IRS therefore conclude supporting organizations have had sufficient time to adjust to the new rules and further transition relief is not necessary. Accordingly, these final regulations do not provide a further extension of the transition relief proposed in the 2016 proposed regulations.

D. Integral Part Test - Non-Functionally Integrated Type III Supporting Organizations

Section 1.509(a)-4(i)(5) provides that a supporting organization meets the integral part test to be an NFI Type III supporting organization if it satisfies the distribution requirement of §1.509(a)-4(i)(5)(ii) and the attentiveness requirement of §1.509(a)-4(i)(5)(iii), or the pre-November 2, 1970, trust requirements of §1.509(a)-4(i)(9). Section 1.509(a)-4(i)(5)(ii) provides that, with respect to each taxable year, a supporting organization must distribute to or for the use of one or more supported organizations an amount equaling or exceeding its "distributable amount." Section 1.509(a)-4(i)(6) provides the amount of a distribution made to a supported organization is the amount of cash or the fair market value of the property distributed.

The 2016 proposed regulations proposed revising §1.509(a)-4(i)(5)(ii) to state that a supporting organization must make distributions as described in §1.509(a)-4(i)(6) in a total amount equaling or exceeding the supporting organization's distributable amount to satisfy the distribution requirement, and proposed revising §1.509(a)-4(i)(6) to describe in detail what distributions count toward satisfying the distribution requirement. These final regulations adopt these proposed revisions, explained as follows, without change.

1. No Reduction of Distributable Amount for Taxes Subtitle A Imposes Section 1.509(a)-4(i)(5)(ii)(B) provides that the distributable amount is equal to the greater of 85 percent of an organization's adjusted net income for the immediately preceding taxable year (as determined by applying the principles of section 4942(f) of the Code and §53.4942(a)-2(d)) or its minimum asset amount for the immediately preceding taxable year, reduced by the amount of taxes imposed on the supporting organization under subtitle A of the Code (subtitle A) during the immediately preceding taxable year.

Because the taxes under subtitle A are imposed on a supporting organization's unrelated business taxable income (pursuant to section 511 of the Code) and the activity that produces the unrelated business taxable income does not further the supported organization's exempt purposes, the preamble to the 2016 proposed regulations stated that these taxes should not be treated as the functional equivalent of an amount distributed to a supported organization. The 2016 proposed regulations, therefore, proposed removing the provision in §1.509(a)-4(i)(5)(ii)(B) that reduces the distributable amount by the amount of taxes subtitle A imposed on a supporting organization during the immediately preceding taxable year.

One commenter stated that the distributable amount should be reduced by the amount of taxes imposed on the supporting organization's unrelated business income, as section 4942(d) provides for private foundations. In advocating to retain the reduction in the distributable amount, the commenter suggested that only the supporting organization's after-tax income from unrelated business activities should be considered available for distribution to its supported organizations.

A supporting organization's adjusted net income under §1.509(a)-4(i)(5)(ii)(B) includes gross income from all sources, including investment income that is not subject to tax under section 511. The 2012 TD and the 2015 final regulations, therefore, stated it was necessary to revise the distribution requirement to ensure that NFI Type III supporting organizations distribute significant amounts to their supported organizations, as Congress directed in the PPA. As stated in the 2015 final regulations, the 85 percent of adjusted net income test makes it more likely that supported organizations will timely benefit from higher returns received by their supported organizations. Reducing the distributable amount by any taxes on the income would be counter to this objective.

The Treasury Department and the IRS further note that section 4942(d) only applies to private non-operating foundations. As the preamble to the 2012 TD recounted, a number of commenters to the 2009 proposed regulations stated that NFI Type III supporting organizations should not be subject to the higher payout for private non-operating foundations because they are distinguishable from them. These commenters stated that NFI Type III supporting organizations are more similar to private operating foundations and medical research organizations and therefore should be subject to their lower payout requirements. The 2012 TD and the 2015 final regulations adopted this recommendation, providing lower payout requirements for NFI Type III supporting organizations than for private non-operating foundations. Private operating foundations and medical research organizations are not able to reduce their payout requirements by the taxes imposed by subtitle A. See §1.170A-9(d)(2)(v)(B); §53.4942(b)-1(a)(1)(ii). The Treasury Department and the IRS conclude for the foregoing reasons that it would be inconsistent to apply a different rule to NFI Type III supporting organizations. Therefore, these final regulations adopt the 2016 proposed revision to §1.509(a)-4(i)(5)(ii)(B) without change.

2. Distributions that Count toward Distribution Requirement

Section 1.509(a)-4(i)(6) provides details on the distributions by a supporting organization that count toward satisfying the distribution requirement imposed in §1.509(a)-4(i)(5)(ii). The regulations provide that distributions include but are not limited to: (1) Any amount paid to a supported organization to accomplish the supported organization's exempt purposes; (2) any amount paid by the supporting organization to perform an activity that directly furthers the exempt purposes of the supported organization within the meaning of §1.509(a)-4(i)(4)(ii), but only to the extent such amount exceeds any income derived by the supporting organization from the activity; (3) any reasonable and necessary administrative expenses paid to accomplish the exempt purposes of the supported organization(s), which do not include expenses incurred in the production of investment income; (4) any amount paid to acquire an exempt-use asset described in §1.509(a)-4(i)(8)(ii); and (5) any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive.

The list in §1.509(a)-4(i)(6) is not exhaustive and other distributions may count towards the distribution requirement. As stated in the preamble to the 2016 proposed regulations, the use of a non-exclusive list creates uncertainty for supporting organizations and the IRS about what counts toward the distribution requirement. Therefore, the 2016 proposed regulations proposed revising and clarifying the list in §1.509(a)-4(i)(6) of what counts toward the distribution requirement and making it an exclusive list.

a. Reasonable and necessary administrative expenses

Under §1.509(a)-4(i)(6), reasonable and necessary administrative expenses paid to accomplish the exempt purposes of supported organizations, but not expenses incurred in the production of investment income, count toward the distribution requirement. For example, if a supporting organization conducts exempt activities that are for the benefit of, perform the functions of, or carry out the purposes of its supported organization(s) and also conducts nonexempt activities (such as investment activities or unrelated business activities), then the supporting organization's administrative expenses (such as salaries, rent, utilities and other overhead expenses) must be allocated between the exempt and nonexempt activities on a reasonable and consistently-applied basis. The supporting organization's administrative expenses attributable to the exempt activities are treated as distributions to its supported organization(s) if such expenses are reasonable and necessary. Conversely, the administrative expenses and operating costs attributable to the nonexempt activities are not treated as distributions to the supported organization(s). The 2016 proposed regulations proposed retaining this provision, with additional guidance regarding fundraising expenses.

b. Fundraising expenses

Section 1.509(a)-4(i)(6) does not specifically address whether fundraising expenses count toward the distribution requirement. The 2016 proposed regulations addressed the issue, specifying that reasonable and necessary administrative expenses paid to accomplish the exempt purposes of a supported organization generally do not include fundraising expenses the supporting organization incurs. For example, when a supporting organization conducts a fundraising event for its supported organization(s) and distributes the proceeds of the event, net of its fundraising expenses, to its supported organization(s), only the amount that the supporting organization actually distributes to its supported organization(s) counts towards the distribution requirement. Thus, under the 2016 proposed regulations, the supporting organization's fundraising expenses do not count towards the distribution requirement.

If a supporting organization conducts a fundraising event at which the supporting organization instructs donors to make contributions directly to the supported organization, the 2016 proposed regulations proposed that those contributions would not count as a distribution from the supporting organization to its supported organization. However, in this situation the supporting organization could count towards the distribution requirement the reasonable and necessary expenses it incurs to solicit the contributions the donors pay directly to its supported organization: (1) to the extent that the amount of these solicitation expenses does not exceed the amount of contributions the supported organization actually receives; and (2) if the supporting organization can substantiate (as discussed later in this preamble) that those contributions were received as a result of the supporting organization's solicitation activities. The 2016 proposed regulations proposed this rule to provide consistency with the treatment of contributions that supporting organizations receive directly and then distribute to their supported organizations (net of the supporting organization's solicitation expenses).

While commenters were generally supportive of the proposal to count as distributions the fundraising expenses incurred to solicit contributions directly to the supported organization, one commenter recommended deleting the requirement that contributions be received directly by the supported organization for the fundraising expenses to count. Alternatively, the commenter requested this special rule for fundraising expenses also apply if the contributions were received directly by an agent of the supported organization.

Another commenter proposed that contributions the supporting organization received directly from the fundraising solicitation as a matter of convenience should be treated as contributions the supported organization received directly if the supporting organization is contractually obligated to remit the contributions to the supported organization and the supporting organization actually distributes the contributions to the supported organization within a reasonable time period. The commenter also proposed that the supporting organization be allowed to count its fundraising solicitation expenses in the year it incurred them so long as the supported organization received the corresponding contributions within a reasonable time period following the end of that year.

In response to these comments, these final regulations adopt the proposed rules with certain modifications and clarifications. These final regulations provide that expenses the supporting organization incurs to solicit contributions count towards the distribution requirement when the resulting contributions are received directly by a supported organization, but only to the extent that the supporting organization's expenses for each solicitation do not exceed the amount of contributions a supported organization actually receives, and only if the supporting organization substantiates that those contributions were received as a result of the supporting organization's solicitation activities. This limitation is applied on a solicitation-by-solicitation basis; the supporting organization may not aggregate its expenses, or the contributions a supported organization receives, from more than one solicitation to determine the amount of solicitation expenses that count towards its distribution requirement. The Treasury Department and the IRS intend that contributions are received directly by the supported organization when donors make their checks, credit card or other payments payable to the supported organization. The Treasury Department and the IRS also intend that when a supporting organization receives checks or processes credit card or other transactions that are payable to its supported organization, the supporting organization may count as distributions the expenses it incurs for soliciting those checks or credit card or other payments, but only up to the amount of contributions received directly by or paid directly to the supported organization and substantiated by the supported organization. Thus, for purposes of meeting its distribution requirement, the supporting organization may not count as distributions from the supporting organization to the supported organization the amount of the check and credit card or other contributions the donors make payable to the supported organization. Contributions made payable to the supporting organization that are transferred to the supported organization, however, may be counted as distributions from the supporting organization to the supported organization at the time that the funds are given by the supporting organization to the supported organization. These final regulations do not adopt a rule permitting payments that are first deposited with the supporting organization to count as contributions received directly by the supported organization (for purposes of permitting additional solicitation expenses related to those contributions to count as distributions). Preventing the supporting organization from counting those amounts twice toward satisfying the supporting organization's annual distribution requirements and accounting for those funds in the supporting organization's account would be administratively difficult.

c. Joint fundraising expenses

One commenter also requested guidance on how to allocate contributions when the supporting organization and the supported organization share the costs of a solicitation event. The Treasury Department and the IRS do not intend for the rule for fundraising expenses to apply with respect to a solicitation event if the supported organization incurs more than de minimis costs related to the same solicitation event. Section 1.509(a)-4(i)(6)(i) permits supporting organizations to count any amount they pay to their supported organization as a distribution for purposes of satisfying the annual distribution requirement described in §1.509(a)-4(i)(5)(ii). A supporting organization can, therefore, share the costs of a fundraiser by distributing to the supported organization an amount equal to the supporting organization's share of the joint fundraising expenses. Section 1.509(a)-4(i)(6)(i) would permit the supporting organization to count this payment as a distribution for purposes of §1.509(a)-4(i)(5)(ii), negating the need for a special rule in proposed §1.509(a)-4(i)(6)(iii)(B). The Treasury Department and the IRS note that it would be very difficult to determine and substantiate what portion of the contributions a supported organization receives are attributable to the supporting organization's expenditures. Thus, expanding the rule to cover joint solicitation efforts as the commenter suggests would increase the compliance burden on supporting organizations and supported organizations and would be difficult for the IRS to administer. These final regulations, therefore, do not adopt this recommendation.

d. Taxable year to which fundraising expenses are attributable

One commenter requested a clarification that contributions made to a supported organization in response to a supporting organization's end-of-the-year fundraiser that the supported organization does not receive until the following year may be used to determine the portion of reasonable and necessary fundraising expenses the supporting organization may treat as a distribution for the year in which the fundraiser occurred. This commenter recommended a 90-day window in the second year for counting such contributions. These final regulations clarify that, for purposes of applying the limitation on the supporting organization's solicitation expenses for each taxable year that count toward its distribution requirement, any contributions the supported organization receives directly from donors that are attributable to a solicitation the supporting organization conducted in a particular taxable year includes any contributions the supported organization receives and substantiates in writing on or before the due date (without regard to extensions) of the supporting organization's Form 990 for the year in which it conducted the solicitation.

For example, assume a supporting organization makes a solicitation on December 15, 2024. The supported organization receives contributions from donors of $1x on December 26, 2024, and $2x on March 15, 2025, that are attributable to the solicitation made on December 15, 2024. The supported organization substantiates the total contributions of $3x in writing prior to May 15, 2025 (the due date without extensions of the supporting organization's Form 990 for 2024). The written substantiation indicates that these contributions were attributable to the December 15, 2024 solicitation. Under §1.509(a)-4(i)(6)(iii)(B), the supporting organization may treat up to $3x of any reasonable and necessary expenses it incurred for the December 15, 2024 solicitation toward its distribution requirement.

A supporting organization may not take into account the same contributions in computing the fundraising expense limitation in more than one year or with respect to more than one solicitation. Thus, in the preceding example, the $2x contribution the supported organization received on March 15, 2025, may only be used by the supporting organization to determine its fundraising expense limitation for the December 15, 2024, solicitation. The supporting organization may not use the $2x again to determine its 2025 fundraising expense limitation.

e. Written substantiation from supported organization

The 2016 proposed regulations proposed requiring a supporting organization to obtain written substantiation from the supported organization of the amount of contributions the supported organization actually receives as a result of each of the supporting organization's solicitations. One commenter requested that the permitted written substantiation include an email from the supported organization that the supporting organization maintains in its electronic records. These final regulations adopt this recommendation, stating that the written substantiation may be provided by electronic media.

Another commenter requested that a supported organization be allowed to aggregate into a single annual written report the substantiation of all the contributions it received from the supporting organization's fundraising activities. The commenter also requested that the supported organization should only be responsible for reporting the amount of the contributions it received and not be responsible for calculating the supporting organization's fundraising activities.

These final regulations clarify that the supporting organization may substantiate the contributions provided to the supported organization by a single annual statement in writing from the supported organization, provided that the amount of contributions, if any, received by the supported organization as a result of each solicitation is separately identified. To satisfy §1.509(a)-4(i)(6)(iii)(B), the written substantiation must be postmarked or electronically transmitted to the supporting organization no later than the due date (without regard to extensions) of the supporting organization's Form 990 for the year of the solicitation. In addition, written substantiation relied on by the supporting organization (whether provided in one or multiple reports) must separately state the amount of contributions, if any, received directly by the supported organization allocable to each solicitation made by the supporting organization that is covered in the report. The supporting organization is responsible for determining its solicitation expenses. The written substantiation the supporting organization is required to receive from the supported organization need only provide information relevant to the amount of contributions the supported organization received; it does not need to address the supporting organization's expenses.

f. Program-related investments not taken into account

Finally, one commenter requested that program-related investments (PRIs) count toward the distribution requirement. The preamble to the 2016 proposed regulations stated that, for purposes of meeting the integral part test, PRIs are not treated as distributions to the supported organizations. As the preamble to the 2016 proposed regulations stated, the Treasury Department and the IRS recognize that private foundations may use PRIs in a variety of ways to accomplish their exempt purposes and that PRIs thus are treated as qualifying distributions under section 4942. However, because supporting organizations must be operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of their supported organizations, they differ from private foundations. Furthermore, other provisions relating to the distribution requirement, such as the availability of set-asides and the potential for carry-forwards of excess distributions, provide significant flexibility for supporting organizations to meet the current and future needs of their supported organizations. For these reasons, these final regulations do not adopt this recommendation.

IV. Technical Corrections

This Treasury Decision conforms the paragraphs throughout §1.509(a)-4 to the Code of Federal Regulations by making non-substantive changes, including capitalizing letters of fourth level paragraphs. This Treasury Decision also modifies §53.4947-1 to correct certain cross-references to §1.509(a)-4.

V. Applicability Date

These final regulations are applicable to taxable years beginning on or after **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. Taxpayers may choose to apply these final regulations to taxable years beginning on or after February 19, 2016, and before **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**, so long as the taxpayer applies the provisions of these final regulations in their entirety and in a consistent manner.

Special Analyses

I. Regulatory Planning and Review

Pursuant to the Memorandum of Agreement, *Review of Treasury Regulations under Executive Order 12866* (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6(b) of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 () under control number 1545-2271.

The collection of information in these regulations is in §1.509(a)-4(i)(4)(iv)(C) (written record of close coordination or collaboration by certain governmental supported organizations) and §1.509(a)-4(i)(6)(iii)(B) (written record of contributions received by certain supported organizations). Requiring a supporting organization to collect (1) written records of its governmental supported organizations' close coordination or collaboration with each other and (2) written records of the contributions its supported organizations directly received from donors in response to solicitations by the supporting organization helps the IRS determine whether the supporting organization is a functionally integrated or non-functionally integrated Type III supporting organization. The record keepers are certain Type III supporting organizations.

Estimated number of recordkeepers: 6,089.

Estimated average annual burden hours per recordkeeper: 2 hours.

Estimated total annual recordkeeping burden: 12,178 hours.

Estimated frequency of collection of such information: Annual.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by .

III. Regulatory Flexibility Act

In connection with the requirements of the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these final regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these final regulations will not impact a substantial number of small entities.

Based on IRS Statistics of Income data for 2019, there are 1,365,744 active nonprofit charitable organizations recognized by the IRS under section 501(c)(3), of which only 6,089 organizations self-identified as Type III supporting organizations. The universe of organizations that would be affected by §1.509(a)-4(i)(4)(iv)(C) and §1.509(a)-4(i)(6)(iii)(B) is a subset of all Type III supporting organizations, because those provisions apply either to organizations seeking to qualify as functionally integrated based on support of two or more governmental supported organizations or to non-functionally integrated organizations that solicit contributions that are received directly by a supported organization (rather than by the supporting organization). Thus, the number of organizations that will be affected by the collection of information under §1.509(a)-4(i)(4)(iv)(C) and (i)(6)(iii)(B) will not be substantial. Moreover, the time to complete the recordkeeping requirements is expected to be no more than 2 hours for each organization, thus the regulations will not have a significant economic impact. The requirements under §1.509(a)-4(i)(4)(iv)(C) and (i)(6)(iii)(B), therefore, will not have a significant economic impact.

Pursuant to section 7805(f) of the Code, this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business and no comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The regulations do not include any Federal mandate that may result in expenditures by State, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The regulations do not have federalism implications, impose substantial direct compliance costs on State and local governments, or preempt State law within the meaning of the Executive order.

VI. Congressional Review Act

Pursuant to the Congressional Review Act (*et seq.*), the Office of Management and Budget's Office of Information and Regulatory Affairs designated this rule as not a "major rule," as defined by .

Statement of Availability of IRS Documents

Notice 2014-4 is published in the Internal Revenue Bulletin and is available from the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402, or by visiting the IRS website at: https://www.irs.gov/irb/2014-02_IRB#NOT-2014-4.

Drafting Information

The principal authors of these regulations are Jonathan Carter and Don Spellmann, Office of Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 53

Excise taxes, Foundations, Investments, Lobbying, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR parts 1 and 53 as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority:

***

Par. 2. Section 1.509(a)-4 is amended by:

1. In paragraph (d)(2)(i) introductory text, removing "subdivision (iv) of this subparagraph" and "subparagraph (1) of this paragraph" and adding "paragraph (d)(2)(iv) of this section" and "paragraph (d)(1) of this section" in their places, respectively.

2. Redesignating paragraphs (d)(2)(i)(a) and (b) as paragraphs (d)(2)(i)(A) and (B), respectively.

3. In newly redesignated paragraph (d)(2)(i)(B)(1), removing "(a) of this subdivision" and adding "paragraph (d)(2)(i)(A) of this section" in its place.

4. In newly redesignated paragraph (d)(2)(i)(B)(2), removing "subdivision (i)(a) or this subparagraph" and adding "paragraph (d)(2)(i)(A) of this section or this paragraph (d)(2)(i)(B)(2)" in its place.

5. In paragraph (d)(2)(ii), removing "subdivision (i)(a) or this subparagraph", "subparagraph (1) of this paragraph" and "subparagraphs (3) (i), (ii), and (iii) and (4)(i) (*a*) and (*b*) of this paragraph" and adding "paragraph (d)(2)(i)(A) of this section", "paragraph (d)(1) of this section", and "paragraphs (d)(3)(i) through (iii) and (d)(4)(i)(A) and (B) of this section" in their places, respectively.

6. In paragraph (d)(2)(iii) introductory text, removing "subparagraph" and adding "paragraph (d)(2)" in its place.

7. Designating *Examples 1* and *2* of paragraph (d)(2)(iii) as paragraphs (d)(2)(iii)(A) and (B), respectively.

8. In paragraph (d)(2)(iv) introductory text, removing "subparagraph (1) of this paragraph" and adding "paragraph (d)(1) of this section" in its place.

9. Redesignating paragraphs (d)(2)(iv)(a) and (b) as paragraphs (d)(2)(iv)(A) and (B), respectively.

10. In newly redesignated paragraph (d)(2)(iv)(A), removing ", and" and adding "; and" in its place.

11. In paragraph (d)(3) introductory text, removing "subparagraph (2)(i) (*a*) of this paragraph" and adding "paragraph (d)(2)(i)(A) of this section" in its place.

12. In paragraph (d)(4)(i) introductory text, removing "subparagraph (2)(iv) of this paragraph" and "this subparagraph" and adding "paragraph (d)(2)(iv) of this section" and "this paragraph (d)(4)" in their places, respectively.

13. Redesignating paragraphs (d)(4)(i)(a) through (c) as paragraphs (d)(4)(i)(A) through (C), respectively.

14. Revising newly redesignated paragraph (d)(4)(i)(C).

15. In paragraph (d)(4)(ii), removing "subdivision (i)(*b*) of this subparagraph" and "subdivision (i)(*b*)" and adding "paragraph (d)(4)(i)(B) of this section" and "paragraph (d)(4)(i)(B)" in their places, respectively.

16. In paragraph (d)(4)(iii) introductory text, removing "subparagraph" and adding "paragraph (d)(4)" in its place.

17. Designating the *Example* in paragraph (d)(4)(iii) as paragraph (d)(4)(iii)(A) and adding reserved paragraph (d)(4)(iii)(B).

18. In paragraph (e)(3) introductory text, removing "paragraph" and adding "paragraph (e)" in its place.

19. Designating *Examples 1* through *5* of paragraph (e)(3) as paragraphs (e)(3)(i) through (v), respectively.

20. Revising paragraph (f)(5)(ii).

21. In paragraph (g)(2) introductory text, removing "paragraph" and adding "paragraph (g)" in its place.

22. Designating *Examples 1* through *3* of paragraph (g)(2) as paragraphs (g)(2)(i) through (iii), respectively.

23. In newly redesignated paragraph (g)(2)(iii), removing "subparagraph (1)(ii) of this paragraph" and adding "paragraph (g)(1)(ii) of this section" in its place.

24. In paragraph (h)(3) introductory text, removing "paragraph" and adding "paragraph (h)" in its place.

25. Designating *Examples 1* through *3* of paragraph (h)(3) as paragraphs (h)(3)(i) through (iii), respectively.

26. Revising paragraphs (i)(2)(i) introductory text, (i)(2)(i)(A), (i)(2)(iii), and (i)(3)(i).

27. Designating *Examples 1* and *2* of paragraph (i)(3)(iv) as paragraphs (i)(3)(iv)(A) and (B), respectively.

28. Adding paragraph (i)(3)(iv)(C).

29. Revising paragraphs (i)(4)(ii)(A)(1), (i)(4)(ii)(B), and (i)(4)(iii) and (iv).

30. Designating *Examples 1* through *5* of paragraph (i)(4)(v) as paragraphs (i)(4)(v)(A) through (E), respectively.

31. Adding paragraph (i)(4)(v)(F).

32. Revising paragraphs (i)(5)(ii)(A) and (B) and (i)(5)(iii)(A).

33. Designating *Examples 1* through *4* of paragraph (i)(5)(iii)(D) as paragraphs (i)(5)(iii)(D)(1) through (4), respectively.

34. Revising newly designated paragraph (i)(5)(iii)(D)(4), the third sentence of paragraph (i)(6) introductory text, and paragraphs (i)(6)(iii) and (v) introductory text.

35. In paragraph (k)(2) introductory text, removing “paragraph” and adding “paragraph (k)” in its place.

36. Designating the *Example* in paragraph (k)(2) as paragraph (k)(2)(i) and adding reserved paragraph (k)(2)(ii).

37. Revising paragraph (l).

The revisions and additions read as follows:

§1.509(a)-4 Supporting organizations.

*****

(d)

***

(4)

***

(i)

***

(C) Permit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test set forth in paragraph (i)(1)(iii) of this section with respect to at least one beneficiary organization.

*****

(f)

***

(5)

***

(ii) *Meaning of control.* For purposes of paragraph (f)(5)(i) of this section, the governing body of a supported organization will be considered *controlled* by a person described in paragraph (f)(5)(i)(A) of this section if that person, alone or by aggregating the person's votes or positions of authority with persons described in paragraph (f)(5)(i)(B) or (C) of this section, may require the governing body of the supported organization to perform any act that significantly affects its operations or may prevent the governing body of the supported organization from performing any such act. The governing body of a supported organization will be considered to be controlled directly or indirectly by one or more persons described in paragraph (f)(5)(i)(A), (B), or (C) of this section if the voting power of such persons is 50 percent or more of the total voting power of such governing body or if one or more of such persons have the right to exercise veto power over the actions of the governing body of the supported organization. Thus, if the governing body of a supported organization is composed of five members, none of whom has a veto power over the actions of the supported organization, and no more than two members are at any time described in paragraph (f)(5)(i)(A), (B), or (C) of this section, such supported organization will not be considered to be controlled directly or indirectly by such persons by reason of this fact alone. However, all pertinent facts and circumstances will be taken into consideration in determining whether one or more persons do in fact directly or indirectly control the governing body of a supported organization.

*****

(i)

***

(2)

***

(i) *Annual notification*. For each taxable year (Reporting Year), a Type III supporting organization must provide the following documents to each of its supported organizations:

(A) A written notice addressed to a principal officer of the supported organization describing the type and amount of all of the support (including all of the distributions described in paragraph (i)(6) of this section, if applicable) the supporting organization provided to the supported organization during the supporting organization's taxable year immediately preceding the Reporting Year (and during any other taxable year of the supporting organization ending after December 28, 2012, for which such support information has not previously been provided), including a brief narrative description of the support provided and sufficient financial detail for the recipient to identify the types and amounts of support being reported;

*****

(iii) *Due date*. The notification documents required by this paragraph (i)(2) must be delivered or electronically transmitted by the last day of the fifth calendar month of the Reporting Year.

*****

(3)

***

(i) *General rule.* A supporting organization meets the responsiveness test only if it is responsive to the needs or demands of each of its supported organizations. Except as provided in paragraph (i)(3)(v) of this section, in order to meet this test, a supporting organization must satisfy the requirements of paragraphs (i)(3)(ii) and (iii) of this section with respect to each of its supported organizations.

*****

(iv)

***

(C) *Example 3.* Z is described in section 501(c)(3). Z's organizational documents provide that it supports ten different organizations, each of which is described in section 509(a)(1). One of the directors of S (one of the supported organizations) is a voting member of Z's board of directors and participates in Z's regular board meetings. Officers of Z hold regularly scheduled face-to-face or telephonic meetings during the year, to which officers of all the supported organizations are invited. Z's meetings with the supported organizations may be held jointly or separately. Prior to the meetings, Z makes available to the supported organizations (including by email) up-to-date information about its activities, including its assets and liabilities, receipts and distributions, and investment policies and returns. In the meetings, officers of each of the supported organizations have an opportunity to ask questions and discuss with officers of Z the projected needs of their organizations, as well as Z's investment and grant making policies and practices. In addition to holding these meetings with the supported organizations, Z provides the contact information of one of its officers to each of the supported organizations and encourages them to contact that officer if they have questions, or if they wish to schedule additional meetings to discuss the projected needs of their organization and how Z should distribute its income and invest its assets. Z provides the information required under paragraph (i)(2) of this section and a copy of its annual audited financial statements to the principal officers of the supported organizations. Z meets the relationship requirement of paragraph (i)(3)(ii)(B) or (C) of this section with respect to each of its supported organizations. Based on these facts, Z also satisfies the significant voice requirement of paragraph (i)(3)(iii) of this section, and therefore meets the responsiveness test of this paragraph (i)(3) with respect to each of its ten supported organizations.

*****

(4)

***

(ii)

***

(A)

***

(1) Directly further the exempt purposes of one or more supported organizations by performing the functions of, or carrying out the purposes of, such supported organization(s); and

*****

(B) *Meaning of substantially all.* For purposes of paragraph (i)(4)(ii)(A) of this section, in determining whether substantially all of a supporting organization's activities directly further the exempt purposes of one or more supported organization(s), all pertinent facts and circumstances will be taken into consideration.

*****

(iii) *Parent of supported organization(s)—*

(A) *In general.* For purposes of paragraph (i)(4)(i)(B) of this section, in order for a supporting organization to qualify as the parent of each of its supported organizations—

(1) The supporting organization and its supported organizations must be part of an integrated system (such as, for example, a hospital system);

(2) The supporting organization must direct the overall policies, programs, and activities of the supported organizations (such as, for example, coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting, and resource allocation); and

(3) The supporting organization's governing body, members of the governing body, or officers (acting in their official capacities) must appoint or elect, directly or indirectly, a majority of the officers, directors, or trustees of each supported organization and have the power to remove and replace such directors, officers, or trustees, or otherwise have an ongoing power to appoint or elect such directors, officers or trustees with reasonable frequency.

(B) *Subsidiary organizations.* A supporting organization may meet the requirements of paragraph (i)(4)(iii)(A)(3) of this section with respect to a second-tier (or lower) subsidiary provided that the supporting organization, by control of its first-tier subsidiary, has the power to appoint or elect (as described in paragraph (i)(4)(iii)(A)(3) of this section) a majority of the officers, directors, or trustees of the lower-tier subsidiary. For example, if the board of directors of supporting organization A elects a majority of the directors of supported organization B, and the board of directors of B, in turn elect, by a simple majority vote, a majority of the directors of supported organization C, the directors of supporting organization A will be treated as electing a majority of the directors of both supported organization B and supported organization C.

(iv) *Supporting a governmental supported organization*—

(A) *In general.* A supporting organization satisfies the requirements of this paragraph (i)(4)(iv) if—

(1) The supporting organization only supports one or more governmental supported organizations;

(2) In any case in which the supporting organization supports more than one governmental supported organization, all of the governmental supported organizations either—

(i) Operate within the same city, county, or metropolitan area; or

(ii) Work in close coordination or collaboration with one another to conduct a service, program, or activity that the supporting organization supports; and

(3) A substantial part of the supporting organization's total activities are activities that directly further, as defined by paragraph (i)(4)(ii)(C) of this section, the exempt purposes of at least one governmental supported organization.

(B) *Governmental supported organization defined.* For purposes of paragraph (i)(4)(iv)(A) of this section, the term *governmental supported organization* means a supported organization that is:

(1) A governmental unit described in section 170(c)(1), including all of its agencies, departments, and divisions (all of which will be treated as one governmental supported organization for purposes of this paragraph (i)(4)(iv)); or

(2) An organization described in section 170(c)(2) and (b)(1)(A) (other than in clauses (vii) and (viii)) that is an instrumentality of one or more governmental units described in section 170(c)(1).

(C) *Close coordination or collaboration.* To satisfy the close coordination or collaboration requirement of paragraph (i)(4)(iv)(A)(2) of this section, the supporting organization must maintain on file a letter from each of the governmental supported organizations (or a joint letter from all of them) describing their coordination or collaboration efforts with respect to the particular service, program, or activity.

(D) *Substantial part*. For purposes of paragraph (i)(4)(iv)(A)(3) of this section, in determining whether a substantial part of a supporting organization's activities directly further the exempt purposes of one or more governmental supported organization(s), all pertinent facts and circumstances will be taken into consideration.

(E) *Exception for organizations supporting a governmental supported organization on or before February 19, 2016*. A Type III supporting organization in existence on or before February 19, 2016, will be treated as meeting the requirements of this paragraph (i)(4)(iv) if it met and continues to meet the following requirements:

(1) It supports one or more governmental supported organizations described in paragraph (i)(4)(iv)(B) of this section and does not support more than one supported organization that is not a governmental supported organization;

(2) Each of the supported organizations is designated by the supporting organization as provided in paragraph (d)(4) of this section on or before February 19, 2016; and

(3) A substantial part (as defined in paragraph (i)(4)(iv)(D) of this section) of the supporting organization's total activities are activities that directly further (as defined by paragraph (i)(4)(ii)(C) of this section) the exempt purposes of its governmental supported organization(s).

(F) *Transition rule for supporting organizations in existence on or before February 19, 2016*. Until the first day of the organization's second taxable year beginning after February 19, 2016, a Type III supporting organization in existence on or before February 19, 2016, will be treated as meeting the requirements of this paragraph (i)(4)(iv) if it continuously met the following requirements prior to the first day of the organization's second taxable year beginning after February 19, 2016—

(1) It supported at least one supported organization that was a governmental entity to which the supporting organization was responsive within the meaning of paragraph (i)(3) of this section; and

(2) It engaged in activities for or on behalf of the governmental supported organization described in paragraph (i)(4)(iv)(E)(1) of this section that performed the functions of, or carried out the purposes of, that governmental supported organization and that, but for the involvement of the supporting organization, would normally have been engaged in by the governmental supported organization itself.

*****

(v)

***