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SPECIAL REPORT

2016 Practical Tax Law Changes

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SIGNIFICANT TAX DEVELOPMENTS IN 2016

Although little was accomplished legislatively this year, the courts and the IRS made several important rulings related to various topics, including capital gains, IRAs and mortgage interest limitations.

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Legislatively, little was done in 2016, which is not surprising in a presidential election year. However, the courts and the IRS were busy. Several important issues were clarified by the courts and significant regulatory developments took place including the proposal to markedly restrict valuation discounts for transfer tax purposes.

Legislation

On December 14, 2015, federal surface transportation programs were reauthorized when President Obama signed into law the Fixing America's Surface Transportation (FAST) Act.[1] The Act contained several tax provisions. Effective in 2016, taxpayers who are seriously delinquent in their tax debts may have their passport revoked, denied or limited. A seriously delinquent tax debt is an assessed tax debt that exceeds $50,000 (adjusted annually for inflation) and for which a notice of tax lien has been filed. Several exceptions apply including exceptions for debts for which an agreement is in place for repayment or for which innocent spouse relief is requested. The FAST Act also authorized the IRS to contract with private debt collectors under certain circumstances and reduces, by one month, the automatic extension of time to file returns for certain employee benefit plans to two and one-half months.

Capital expenses — Domain names

Section 263 and the regulations thereunder require taxpayers to capitalize the cost of acquiring an intangible asset.[2] Section 197 entitles a taxpayer to amortize the cost of amortizable Section 197 assets, generally over 15 years. Among the intangible assets subject to Section 197 are trademarks and customer-based intangibles. Although many self-created intangibles are not subject to Section 197, this exception is not applicable to trademarks or customer-based intangibles.[3] A trademark includes any word, name, symbol, device or combination thereof adopted and used to both identify goods or services and distinguish such goods or services from goods or services provided by others.[4] A customer-based intangible is composition of market, market share and any other value resulting from the future provision of goods or services pursuant to contractual or other relationships in the ordinary course of business with customers.[5] The IRS has provided guidance on the application of these rules to the acquisition of web domain names.[6]

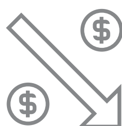
Four fact patterns were analyzed: (1) the acquisition of a generic domain name as part of the acquisition of assets that constituted a trade or business, (2) the acquisition of a nongeneric domain name as part of the acquisition of assets that constituted a trade or business, (3) the acquisition of a generic domain name that was not part of the acquisition of assets that constituted a trade or business and (4) the acquisition of a nongeneric domain name that was not part of the acquisition of assets that constituted a trade or business. A generic name is one that does not identify a particular company or product name but describes a product or service in basic terms that people generally associate with the product or service. A nongeneric name is typically the name of a company or product.

According to the IRS, the cost of a nongeneric domain name that is registered as a trademark or otherwise meets the definition of a trademark must be capitalized and amortized under Section 197.

According to the IRS, the cost of a nongeneric domain name that is registered as a trademark or otherwise meets the definition of a trademark must be capitalized and amortized under Section 197. Whether the acquisition is part of the acquisition of assets that constitute a trade or business is not relevant to whether such costs must be capitalized and amortized. If the nongeneric domain name fails to qualify as a trademark, the costs of acquiring the domain name must be capitalized as a customer-based intangible if the domain name is used to provide goods or services through a website that is already constructed. A generic domain name does not fall under the definition of a trademark. Nonetheless, the costs of acquiring a generic domain name must be capitalized as a customer-based intangible if the domain name is used to provide goods or services through a website that is already constructed. Similar to nongeneric domain names, whether the acquisition of generic domain name is part of the acquisition of assets that constitute a trade or business is not relevant to whether such costs must be capitalized and amortized.

1. P.L. 114-94, 12/4/15.
2. Section 263(a); Reg. 1.263(a)-4(c)(1).
3. Section 197(c)(2).
4. Reg. 1.197-2(b)(10).
5. Section 197(d)(1)(C)(iv).
6. CCA 201543014.

Passive losses — Self-charged rent



Section 469 limits the deductibility of net passive losses for certain taxpayers. In general, losses from passive activities, defined as trade or businesses in which the taxpayer does not materially participate, are deductible against income from passive activities. With certain exceptions, rental activities are deemed passive activities. The passive loss limitations imposed by Section 469 apply to individuals, estates, trusts, closely held C corporations and personal service corporations. However, Reg. 1.469-4(a) provides that a taxpayer's activities include those activities conducted through S corporations and partnerships. Reg. 1.469-2(f)(6), the self-charged rental rule, prevents taxpayers from generating passive income from the operation of a nonpassive activity. In effect, rental income received for the use of property in a trade or business in which the taxpayer materially participates is recharacterized as income not from a passive activity. The Fifth Circuit held that the self-charged rental rule applies in situations in which the lessor is an S corporation.[7]

The taxpayers owned 100% of both an S corporation engaged in a rental real estate operation and a C corporation engaged in an operating business in which the taxpayers materially participated. The S corporation earned rental income from the rental of real estate to the C corporation. The taxpayers, on their personal return, classified the rental income passed through to them from the S corporation as passive and, on audit, the IRS reclassified the income as passive pursuant to the self-charged rental rule. The taxpayers asserted that Section 469 did not apply to S corporations and that, even if it did, the self-charged rental rule did not apply because the lessor, the S corporation, did not materially participate in the lessee's business. The Tax Court held for the IRS and the Fifth Circuit affirmed the Tax Court's decision.

According to the Fifth Circuit, there is no need for Section 469 to identify as S corporations taxpayers to whom its provisions apply because an S corporation is not a tax paying entity. Therefore, the regulations' application of the passive loss rules to activities conducted through pass-through entities was a valid interpretation of the statute. Moreover, the court held that the S corporation, as the lessor, did not need to materially participate in the lessee's operation for the self-charged rental rule to apply. Instead, the statute and the regulations apply to the individual taxpayers and, given their participation in the lessee's operation, the self-charged rental rule applied.

COMMENTARY

It is unusual for rental real estate operations to be held in S corporation form. The partnership form offers several tax advantages over the S corporation form. An LLC, generally taxed as a partnership, offers liability protection similar to an S corporation. However, neither form will offer relief from the self-charged rental rule. The taxpayer's interpretation of the statute would, for all practical purposes, eviscerate the self-charged rule because most rental properties are held by a pass-through entity.

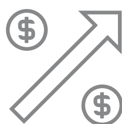
Marital status

The Defense of Marriage Act, a 1996 statute that defined marriage for all federal purposes as the union of one man and one woman, was held unconstitutional by the Supreme Court in 2013.[8] Therefore, the federal tax treatment of same-sex couples depended on whether such couples were married under state law. In 2015, the Court held that same-sex couples have a constitutional right to marry under the Fourteenth Amendment.[9] Consequently, all states must now recognize same-sex marriages. Therefore, same-sex couples will be on the same footing as their heterosexual counterparts nationwide with respect to federal income, gift and estate tax matters.

Final regulations were issued that define the terms spouse, husband and wife in a gender neutral fashion as an individual legally married to another individual.[10] The final rules adopt the rules proposed in 2015 with several important modifications. Under the final regulations, whether a domestic marriage is recognized is determined by the law of the jurisdiction in which the marriage was entered into regardless of the couple's present domicile. Under the proposed rules, it was possible for a couple to be considered married if any jurisdiction would have recognized their union as a marriage regardless of the couple's intent. A couple that is legally married in a foreign jurisdiction is treated as a married couple if any state, possession or territory of the U.S. would recognize the couple as married. A couple that is not legally married in a foreign jurisdiction is not deemed married for federal tax purposes regardless of whether the parties' relationship would be recognized as a marriage under a U.S. jurisdiction. The final regulations also clarify that civil unions, registered domestic partnerships or similar arrangements under state law do not constitute a marriage. This provision allows couples to decide for themselves whether they wish to be treated as married or single for federal tax purposes.

7. Williams, 117 AFTR2d 2016-600 (CA-5, 2016).
8. Windsor, 133 S.Ct. 2675, 111 AFTR2d 2013-2385 (2013).
9. Obergefell v. Hodges, 135 S. Ct. 2584, 115 AFTR2d 2015-2309 (2015).
10. Regs. 1.7701-1; 20.7701-2; 25.7701-2; 26.7701-2; 31.7701-2; 301.7701-18.

Capital gains



Section 1234A classifies gains and losses from the cancellation, lapse, expiration or other termination of a right or obligation related to an asset that would, if acquired, be a capital asset in the hands of a taxpayer as capital gains and losses. Section 1231 assets — in general depreciable personal property and real property, whether depreciable, used in trade or business and held more than one year — are specifically excluded from the definition of capital assets. However, net gains from the sale or exchange of Section 1231 assets, absent certain recapture provisions, are treated as long-term capital gains, while net losses from such transactions are treated as ordinary losses. In a case of first impression, the Tax Court held that Section 1234A applies to only capital assets and not to section 1231 assets.[11]

The taxpayer received a deposit of almost $10 million related to the sale of real estate used in a trade or business. The buyer was unable to close on the transaction and the deposit was forfeited. The taxpayer reported the forfeited deposited as a capital gain pursuant to Section 1234A. The taxpayer asserted that any gain on the sale of the property would have been classified as a capital gain pursuant to Section 1231. Consequently, the income from the forfeited deposit should be classified as a capital gain under Section 1234A. The Tax Court held that Section 1234A applies to only capital assets and not to Section 1231 assets. The court relied on the plain language of the statute, which clearly limited Section 1234A's application to capital assets. The fact that a passive investor may very well have qualified for Section 1234A treatment with respect to a forfeited deposit for the same type of property does not overcome the clear statutory language that prevents such treatment for property used in a trade or business.

Individual Retirement Accounts

In general, a beneficiary of an IRA for which minimum required distributions are not being made has the choice to receive the IRA proceeds over a five-year period or over his or her life expectancy.[12] Distributions from the IRA are not eligible for rollover treatment, including lump sum distributions. A spouse, however, can elect to treat the IRA of which he or she is a beneficiary as his or her own IRA.[13] Such an election offers several advantages including the ability to defer any distributions until such time as the required minimum distribution rules apply to the spouse — age 70 ½.[14] In addition, a distribution from a spouse's IRA qualifies for 60-day rollover treatment.[15] Reg. 1.408-8, Q&A 5 limits a spouse's ability to treat an inherited IRA as his or her own IRA to inherited IRA's under which the inheriting spouse is the sole beneficiary and has an unlimited right of withdrawal. Consequently, if a trust is named the IRA's beneficiary, the regulations provide that a spouse cannot treat such IRA as his or her own IRA.

Taxpayers should carefully consider the income tax advantages that may be lost by naming trusts as IRA beneficiaries, particularly for relatively large accounts and young spouses.

In a private letter ruling, the IRS relaxed the position set forth in the regulations and ruled that an IRA that named a trust as beneficiary could be treated as a spouse's own IRA if the spouse was the sole trustee of the trust and had unlimited discretion to distribute the IRA proceeds to herself.[16] The ruling dealt with two issues. First, whether the spouse could treat the decedent's IRA as her own and, therefore, take advantage of the 60-day rollover rule. Second, whether her failure to meet the 60-day requirement due to the emotional distress caused by her husband's death justified an IRS waiver of the 60-day rollover time limit. The IRS ruled in her favor on both counts.

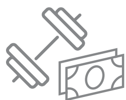
COMMENTARY

The recent change in the law that provides for the portability of estate and gift tax unused unified credit amounts among spouses has reduced the need for spousal trusts designed to assure that the first spouse to die does not waste any unified credit amounts. However, spousal trusts are commonly used for nontax purposes such as asset protection and management. Moreover, they are a commonly used to move assets that have the potential for significant appreciation to younger generations at current values, while still providing for the spouse's needs.

The IRS's ruling, while favorable, is limited. Most trusts for the benefit of a spouse do not name the spouse as sole trustee. It is unclear whether a spouse's general power of appointment over an inherited IRA account without corresponding trustee powers will qualify. Under the regulations, such an arrangement will not qualify and whether the IRS is willing to go any further than its ruling is an open question. Taxpayers should carefully consider the income tax advantages that may be lost by naming trusts as IRA beneficiaries, particularly for relatively large accounts and young spouses.

11. CRI-Leslie, LLC, 147 TC No. 8 (2016).
12. Section 72(s)(1)-(2).
13. Section 72(s)(3).
14. Section 401(a)(9).
15. Section 408(d)(3)(C)(ii).
16. Ltr. Rul. 201606032.

Wellness programs — Cash rewards



The ever increasing cost of health insurance has prompted many employers to take measures to stem the relentless growth. The looming "Cadillac tax" imposed by the Patient Protection and Affordable Care Act provides further impetus for employers to rein in the cost of health care benefits. To that end, many employers have instituted wellness programs for their employees. These programs vary in their details but all share the same objective — improvement in the workforce's overall health. Most programs are voluntary and contain inducements to encourage employee participation. A common inducement is cash rewards. The hurdles to earning such rewards vary among plans. Some plans provide rewards for participation and others provide rewards after the attainment of a predefined performance objective.

The IRS concluded that wellness program cash rewards are taxable compensation to the recipients.[17] In addition, rewards in the form of a benefit that does not qualify as a medical expense, such as gym memberships, are also taxable. In Rev. Rul. 2002-3,[18] the IRS ruled that employer reimbursement of employee pretax salary reductions used to pay health insurance premiums is taxable to the employee. The IRS concluded that any cash rewards used to reimburse employees for the cost of participation in a wellness program is similarly taxable to the employees. Such cash rewards are taxable regardless of whether the employee receives the cash directly or the cash reward is used to reimburse the employee for salary reductions made through a cafeteria plan. Cash rewards received by employees under a plan that has no cost to such employees are taxable. According to the IRS, rewards that do not qualify as the reimbursement of a medical expense are not excludible. Moreover, these rewards do not qualify as a de minimis fringe benefit under Section 132.

COMMENTARY

Presumably, a rewards program structured to reimburse out-of-pocket medical expenses would be tax-free. As a practical matter, most wellness programs encourage some sort of regular exercise program and medical screenings. In most cases, there is little or no out-of-pocket medical cost to employees.

Mortgage interest limitations

The Code is not clear on whether the $1.1 million limitation on mortgage indebtedness (acquisition indebtedness and home equity indebtedness), the interest on which is deductible, applies on a per-taxpayer or per-residence basis. In other words, do unmarried joint owners of a qualified residence each obtain the full limitation or is the limitation applied to the residence and divided among the co-owners?

The IRS informally asserted that the dollar limitations on acquisition and home equity indebtedness are applicable on a per-residence basis and not a per-taxpayer basis.[19] In 2012, the Tax Court held for the IRS and applied the limitations on a per-residence basis.[20] In 2015, the Ninth Circuit reversed the Tax Court and held that the limitations on acquisition and home equity indebtedness are applicable on a per-taxpayer basis because the structure and operation of the statute indicate that the debt limitations were designed to apply to taxpayers and not to residences.[21]

The Supreme Court's holding that same-sex marriage must be recognized in all states heightens the importance of this case because, due to demographic trends and expensive housing costs in certain markets, cohabitation among unmarried persons is much more common than it once was, and the fact that the debt limitations are not indexed for inflation will cause these limitations to apply with greater regularity. The IRS has acquiesced to the Ninth Circuit.[22] Consequently, taxpayers outside of the Ninth Circuit can rest assured that the application of a per-taxpayer limitation will not be challenged.

Deferred compensation

Section 409A was enacted in 2004 to combat perceived abuses in the design and operation of deferred compensation plans by imposing certain requirements on such plans. Failure to meet the statute's requirements will result in an acceleration of income to the recipient and the imposition of penalties and interest to the service provider. Section 409A is effective for amounts deferred after 12/31/04, and the final regulations interpreting and implementing Section 409A were issued in 2007.[23]

17. CCA 201622031.
18. 2002-1 CB 316.
19. CCA 200911007.
20. Sophy, 138 TC 204 (2012).
21. Voss, 796 F.3d 1051, 116 AFTR2d 2015-5529 (CA-9, 2015).
22. AOD 2016-31, 8/1/16.
23. Regs. 1.409A-1 – 3; 1.409A-6.

Single-member LLCs are an effective way to obtain a liability shield for the owner without sacrificing the tax efficiency of operating as a sole proprietor.

It has become apparent in the years since Section 409A went into effect that the final regulations contain several gaps. Proposed regulations were issued that fill in those gaps.[24] Taxpayers may rely on the proposed regulations prior to their finalization. What follows is a brief description of the more salient provisions of the proposed regulations

Section 409A provides an exception for certain short-term deferrals that are paid within an applicable 2½ month period. The proposed regulations clarify that the short-term deferral rule is applicable to payments that are delayed due to a reasonable belief by the service recipient that payment will violate federal securities laws or other applicable laws provided payment is made as soon as reasonably practicable after the service recipient anticipates that such payment will not violate such laws. The proposed regulations also clarify that stock rights may be granted to a service provider as part of negotiations that precede the service provider's employment. The payment of legal fees and other expenses incurred by a service provider to pursue bona-fide legal claims against the service recipient does not constitute deferred compensation. The proposed rules contain anti-abuse provisions, specify Section 409A's application when the service recipient is acquired in a stock acquisition that is treated as a deemed asset sale under Section 338 and clarify that a certain amount of post-employment service as an independent contractor will not jeopardize a determination that a person has terminated service.

The final regulations left some doubt as to the application of Section 409A to teachers and other persons who are regularly paid over a 12 month period for services rendered for less than one year. The proposed regulations make clear that such compensation arrangements do not provide for a deferral of compensation if all compensation earned is paid by the last day of the 13th month following the first day of the service period in question and the total compensation for the service period does not exceed the compensation limit of Section 401(a)(17) — $265,000 in 2016. For example, a college professor who is paid $120,000 in compensation over 12 months for 10 months of service will not be subject to Section 409A.

The acceleration of the payment of deferred compensation is permissible on the service provider's death. The proposed regulations provide plans with greater flexibility with respect to deferred compensation payments due to death. Regardless of the date that the plan specifies the payments on account of death are to be made, a service recipient may make such payment at any time during the period beginning on the date of death and ending on December 31 of the year following the year of death. Moreover, the proposed rules make clear that acceleration of benefits due to death, disability or unforeseen emergency is permissible for beneficiaries who have become entitled to benefits as a result of the death of a service provider. The proposed regulations also clarify that such permissible accelerations are possible regardless of whether payments have already commenced prior to death, disability or unforeseen emergency.

Cancellation of indebtedness

In general, cancellation of indebtedness is includible in income.[25] However, Section 108 provides several exceptions to the general rule, two of which apply if the discharge of indebtedness occurs in bankruptcy or to the extent that the taxpayer is insolvent at the time of the discharge.[26] For federal income tax purposes, several types of entities are disregarded, most prominently, single member LLCs that have not elected to be taxed as corporations and grantor trusts. It is unclear whether the Section 108 exceptions apply to such entities if the owner of entity does not qualify for the exceptions. For example, an LLC may be subject to bankruptcy court jurisdiction or may be insolvent but its owner is neither subject to bankruptcy proceedings nor insolvent.

Final regulations were issued that state that for the bankruptcy or insolvency exceptions to apply, the entity owner must be the debtor in a bankruptcy proceeding or be insolvent.[27] When a partnership is the owner, the aforementioned rules apply to the partners to whom the cancellation of indebtedness income is allocated. The requirement that the owner be a debtor in bankruptcy makes clear that bankruptcy court jurisdiction over the owner does not qualify such owner for the Section 108 exception unless the owner is the debtor in the proceeding. This rule is in contrast to several Tax Court cases in which bankruptcy court jurisdiction over a non-debtor owner in certain matters was enough to cause the exception to apply.

COMMENTARY

This rule can have significant ramifications with respect to LLC owners. Single-member LLCs are an effective way to obtain a liability shield for the owner without sacrificing the tax efficiency of operating as a sole proprietor.

24. Prop. Regs. 409A-1–4; 1.409A-6.
25. Section 61(a)(12).
26. Sections 108(a)(1)(A)-(B).
27. Reg. 1.108-9.

Money market funds — Floating value funds

In 2014, the SEC required certain money market funds to reflect the market value of the funds' underlying portfolio holdings in the funds' share price and, as a consequence, many money market funds will no longer maintain a stable value — i.e. $1 per share. The IRS quickly issued proposed regulations that provide taxpayers with an election to use a simplified method of tax accounting for money market transactions. The proposed rules allow taxpayers to determine their net gain or loss during a tax year based on the aggregate of all transactions. Under the elective method, the net gain or loss for a tax year is the increase or decrease in the fair market value (FMV) of the taxpayers' shares during the period less the net investments (purchases less sales) made by the taxpayer during the period. The resulting net gain or loss is treated as a short-term capital gain, assuming that the shares are capital assets. Any net losses are not subject to the wash sale rules.

Final regulations were issued that expand the availability of the simplified method to investors in stable value funds that recognize gain or loss despite the funds' objective to maintain a stable value. For example, the imposition of a liquidity fee may cause a loss to a stable value fund investor. Moreover, the final regulations remove the consistency requirement that was present in the proposed regulations. Investors may use the simplified method for some investments and not for others. A change to or from the simplified method is an automatic method change and such change is made on a cut-off basis without any Section 481 adjustment.

Partnerships — Self-employment tax

For employment tax purposes, a partner in a partnership is not an employee of the partnership, and any partner who devotes time and energy in conducting the partnership's business or provides services to the partnership as an independent contractor is treated as a self-employed individual with respect to such efforts or services. Single member LLCs, absent an election to the contrary, are disregarded for federal income tax purposes but are treated as corporations for employment tax purposes. Consequently, a single member LLC is considered an employer for employment tax purposes despite the fact that, for income tax purposes, the income or loss of the entity is treated as directly earned or incurred by the entity's owner. However, the regulations make clear that a single member LLC is not treated as an employer with respect to the owner of the entity. Instead, the entity's owner is treated as a sole proprietor for employment tax purposes and, therefore, is subject to self-employment tax.

Temporary regulations were issued that clarify the application of the aforementioned rules to individuals who are employed by an LLC that is owned by a partnership in which the individual is a partner. In such situations, the regulations state that, with respect to such an individual, the disregarded LLC is not treated as that individual's employer. The individual is subject to self-employment tax similarly to an individual who is employed by an LLC that is owned directly by such individual. Taxpayers were previously structuring their affairs in a tiered structure to achieve employee status to qualify for certain qualified employee benefits. In order to allow time to make necessary adjustments, the regulations are effective on the later of 8/1/16 or the first day of the latest starting plan year of an affected plan following 5/4/19. An affected plan includes qualified pension and profit sharing plans, health plans and cafeteria plans. Thus, for individuals who are affected by the regulations but whose employment status does not implicate participation in certain qualified employee benefit plans, the regulations are effective 8/1/16.

COMMENTARY

The IRS has requested comments on the application of the general rules applicable to partners and partnerships set forth in Rev. Rul. 69-184 to tiered partnership arrangements. The comments indicate that the IRS believes that, in certain circumstances, it may be appropriate for a partner to be treated as a partnership's employee and is seeking comments regarding the effect of employment treatment on qualified plans and employment taxes. Neither Rev. Rul. 69-184 nor the temporary regulations address partners and employment status in tiered partnership arrangements.

Transfer tax valuation

Proposed regulations were issued under Section 2704 that would significantly hinder a taxpayer's ability to discount the value of certain intra-family transfers. Section 2704 was enacted in 1990 to limit valuation discounts for gift and estate tax purposes applicable to intra-family transfers of interests in closely held corporations and partnerships. Section 2704(a) provides that the lapse of a voting or liquidation right shall be taxed as a transfer subject to tax if an individual and the individual's family hold voting or liquidation control over the entity. Section 2704(b) provides that a restriction that limits the ability of the corporation or partnership to liquidate that can be removed by the family is disregarded for valuation purposes when an interest is transferred within the family. Moreover, the IRS has broad regulatory authority to disregard other restrictions in valuing intra-family transfers if such restrictions have the effect of reducing the value of the transferred interest for tax purposes but not its economic value.

As noted above, Section 2704(a) treats the lapse of a voting or liquidation right as a transfer by the individual holding the right immediately before its lapse. However, current regulations provide an exception if the rights with respect to the transferred interest are not restricted or eliminated. For example, under this exception a controlling family member could gift minority voting interests to several family members and these interests would not be subject to Section 2704(a) despite the fact that the transferor's right to liquidate the entity lapsed as a result of the transfers. The proposed regulations would make this exception inapplicable to transfers occurring within three years before the transferor's death if the entity is controlled by the transferor and members of his or her family immediately before and after the lapse. Such a transfer within three years of death is treated as a lapse of rights occurring at death resulting in an increase in the transferor's gross estate. Consequently, minority discounts would be eliminated for these so-called deathbed transfers.

Section 2704(b) disregards certain restrictions on redemption or liquidation in valuing such a transferred interest for gift or estate tax purposes when that interest is transferred to a family member and the restrictions will lapse or can be removed by the transferor or any of his or her family members. Taxpayers avoided the application of this rule by transferring a small interest to a nonfamily member, thus giving a nonfamily member the power to prevent the removal of a restriction. The proposed regulations, for this purpose, disregard interests held by nonfamily members unless such interests meet several requirements, including a threshold ownership level.

Section 2704 exempts restrictions on the owners' ability to liquidate the entity that are "imposed or required to be imposed, by any Federal or State law." The current regulations look at whether the restrictions in the entity's governing documents are more restrictive than the default limitations — those that would apply under state law generally applicable to the entity in the absence of the limitations. Developments in state laws have provided cover for various restrictions to meet this exception. The proposed regulations provide that a state law restriction that may be superseded by the entity's governing documents is not a restriction required to be imposed by federal or state law. Most states allow for such supersession. Consequently, fewer restrictions will reduce the value of an interest in an entity for transfer tax purposes.

Section 2704 refers to interests in corporations and partnerships. The proposed regulations clarify that the rules apply to LLCs and other entity arrangements. The new rules will become effective for transfers that occur after the date the regulations are published as final rules, expected to be sometime in 2017, or, in certain cases, not until 30 days after that date.

COMMENTARY

That the IRS was looking to clamp down on valuation discounts was well-known and, therefore, these proposals should not come as a surprise. The lack of any retroactive application offers taxpayers the opportunity to consummate transactions under existing rules. However, transfers already made or made in advance of the final regulations may still be subject to the new rules, if and when finalized, if the transferor dies within three years of the transfer. It is likely that final regulations in a form similar to the proposed rules will be challenged in court.

Fines and penalties

Section 162(f) prohibits the deduction of any fine or similar penalty paid to a government for the violation of any law. The regulations define the term government to include a corporation or other entity serving as an agency or instrumentality of the U.S. government. Recently, the Tax Court held that an entity should be regarded as an agency or instrumentality of the government for Section 162(f) purposes if it has been delegated the right to exercise part of the sovereign power of a government, performs an important government function and has the authority to act with the sanction of government. The court further held that the meaning of agency or instrumentality is ambiguous and that an entity can be an agency or instrumentality of the government for some purposes but not for other purposes.

The Financial Industry Regulatory Authority (FINRA) is a nonprofit Delaware corporation formed in 2007. FINRA consolidated the regulatory functions of the National Association of Securities Dealers, Inc. and the New York Stock Exchange. It is a registered self-regulatory authority under the Securities Exchange Act of 1934 and has the authority to adopt, administer and enforce rules to prevent fraud and to promote practices for the protection of investors. As a self-regulatory organization, FINRA is the entity that self-regulates the securities industry under SEC oversight.

The IRS concluded that fines levied by FINRA to enforce statutory or administrative rules or to enforce its own rules pursuant to statutory or administrative authority are subject to Section 162(f) and, therefore, not deductible. According to the IRS, FINRA is an agency or instrumentality of the government when it is performing its federally mandated duties under the securities laws. FINRA has been delegated part of the government's sovereign power, performs an important government function and has the authority to act with government sanction. Moreover, FINRA has absolute immunity with respect to actions it takes in furtherance of its regulatory duties.

The IRS concluded that fines levied by FINRA to enforce statutory or administrative rules or to enforce its own rules pursuant to statutory or administrative authority are subject to Section 162(f) and, therefore, not deductible.

COMMENTARY

The IRS did concede that sanctions imposed by FINRA in its capacity as a professional association for violations of rules that form part of the private contracts between FINRA and its members are not subject to Section 162(f). There has been conflicting case law regarding the status of fines imposed by private organizations, both in tax cases and nontax cases. It is likely that this issue will be subject to litigation in the future.

The regulations under Section 162(f) provide that settlement payments to resolve actual or potential liability, whether criminal or civil, are not deductible. Legal fees to defend a taxpayer from such liability are deductible, however. IRS Field Attorneys have taken the position that settlement payments to a foreign government to resolve that government's charges of illegal bribery were not deductible. The taxpayer was indicted in a foreign jurisdiction on charges of bribing government officials to obtain contracts. The parties entered into a settlement and non-prosecution agreement under which the taxpayer paid a fixed sum to the government and the government agreed, among other things, to terminate all criminal and civil proceedings against the taxpayer and not file additional charges against the taxpayer. The taxpayer asserted that the settlement payment was not subject to Section 162(f) because there was no evidence of guilt against the taxpayer and that the taxpayer's motivation in entering into the settlement agreement was to preserve its business reputation and avoid business disruptions.

The IRS believes that such motivations are not relevant to the issue of whether settlement payments are subject to Section 162(f). The settlement agreement resolved potential criminal liability and the settlement payment was punitive, not compensatory, in nature. Whether the taxpayer was actually guilty has no bearing on the payment's deductibility. Moreover, as long as a settlement avoids criminal liability, the fact that a taxpayer has business motivations to settle and not litigate a matter does not convert a nondeductible fine or penalty into a deductible payment.

COMMENTARY

Although the issue involved here was under foreign law, the federal government has been active in enforcing the Foreign Corrupt Practices Act. Presumably, similar types of settlements with the federal government will obtain similar tax treatment. Deferred prosecution agreements with no admissions of guilt have come under scrutiny recently, particularly with respect to the securities law violations. That said, such agreements are commonly entered into and the denial of wrongdoing and the existence of valid business reasons to settle charges do not appear to sanction the deduction of payments made under such agreements.

Property acquired from decedent — Basis consistency rules

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 imposed a basis consistency requirement for property acquired by reason of death. In general, the basis of property received by reason of death, whose inclusion in the decedent's gross estate increased the estate's transfer tax liability, is the property's final value as shown on the estate tax return; or if no final value has been determined, the value of property as specified by the estate's executor in a statement required to be furnished to the IRS and the beneficiary. This rule is effective for estate tax returns filed after 7/31/15. Underpayments of tax due to the failure to comply with the consistent basis rules are subject to a new 20% accuracy related penalty. The IRS has thrice delayed the reporting requirements, first to 2/29/16, then to 3/31/16 and then to 6/30/16. Temporary and proposed regulations were issued that retain the 3/31/16 effective date and provide guidance with respect to the consistency and reporting requirement.

Under the regulations, final value is the value of property reported on an estate tax return once the statute of limitations for purposes of contesting that value has expired or, if such value was determined to be a different value, once that value can no longer be contested by the estate. If the property's value is contested, final value is either the value agreed on by the IRS and the estate in a binding agreement or the value established by a final court determination. The regulations also provide that the basis consistency rules do not apply if an estate tax return is filed by an executor solely for purposes of making certain elections, such as generation-skipping tax exemption allocations or a unified credit portability election. Moreover, the reporting requirement does not apply to cash, income in respect of a decedent, certain household and personal effects and property that has been disposed of by the estate in a taxable transaction. The regulations also require supplemental information returns to be provided when originally reported information is incorrect or incomplete, such as when there is a change in the property's value as a result of an audit or litigation or a change in the identity of beneficiaries.

Anti-Injunction Act

Section 7421, the Anti-Injunction Act, prohibits any "suit for the purpose of restraining the assessment or collection of any tax . . . in any court by any person, whether or not such person is the person against whom such tax was assessed." In effect, Section 7421 requires that taxpayers resolve their tax disputes in a suit for refund and is a significant burden for taxpayers desiring to challenge regulations that have a negative impact on pending transactions. There are several narrow statutory exceptions in the statute, but the Supreme Court has recognized two common law exceptions to the Anti-Injunction Act. First, a pre-enforcement challenge will be countenanced if the government could not prevail under any circumstances and the taxpayer would suffer irreparable harm from enforcement action. Second, a pre-enforcement action is permitted if, under the circumstances, no other legal remedy is available. The Court, in its landmark decision upholding the constitutionality of the Patient Protection and Affordable Care Act, held that the individual mandate was a penalty and not a tax subject to the Anti-Injunction Act.

In Mayo, the Supreme Court categorically stated that tax regulations are subject to the same standards of review that are applicable to regulations issued by federal agencies in general.

The regulations require banks to report the interest they pay to certain nonresident aliens. Two banking associations, representing over 800 banks, brought a pre-enforcement challenge to the regulations arguing that the regulations violated the Administrative Procedure Act and the Regulatory Flexibility Act. The district court upheld the regulations but the D.C. Circuit vacated the decision and held that the bankers associations' challenge was barred by the Anti-Injunction Act. Despite the fact that the reporting requirements were enforced by means of a penalty, the court held that the penalty, in this case, was a tax for purposes of the Anti-Injunction Act. The Supreme Court denied certiorari.

The application of the Anti-Injunction Act by the D.C. Circuit precluded the court from dealing with the application of the Administrative Procedure Act to the regulations. In 2011, the Supreme Court decided Mayo Foundation for Medical Education and Research and held that the Chevron standard, a very deferential standard of review, applied to all tax regulations issued after notice and comment. This case is considered a major victory for the IRS. However, in recent years other administrative law doctrines have surfaced in tax cases, most notably, the State Farm doctrine. This doctrine requires that the IRS explain the reasoning for its decisions and that its reasons be supported by the facts. The Federal Circuit applied the doctrine to invalidate certain uniform capitalization rules, and the Tax Court applied it to invalidate regulations that required equity compensation costs to be shared by controlled corporations operating under research and development cost sharing arrangements. The bankers associations raised issues similar to the ones present in those cases, and the D.C. Circuit could have shed more light on the application of the State Farm doctrine to tax regulations.

COMMENTARY

In Mayo, the Supreme Court categorically stated that tax regulations are subject to the same standards of review that are applicable to regulations issued by federal agencies in general. In the Court's view, tax regulations are no different, from an administrative law perspective, than other regulations. The State Farm case was decided in 1983 and rarely surfaced in tax cases. Mayo may very well have opened the door for taxpayer challenges to tax regulations that are explained in a conclusory manner or that do not address public comments in opposition to the regulations. As noted above, State Farm has been used to invalidate two sets of tax regulations since 2012.

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