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US Supreme Court Eliminates the Physical Presence Standard in Landmark *South Dakota v. Wayfair* Ruling

On June 21, 2018, the US Supreme Court handed down its long-awaited decision in *South Dakota v. Wayfair, Inc.*, upholding the constitutionality of a South Dakota statute that requires certain out-of-state retailers to collect the state's sales and use tax on taxable South Dakota sales even if they do not have a physical presence in the state. *South Dakota v. Wayfair, Inc.*, No. 17-494 (US June 21, 2018), *rev'g Quill Corp. v. North Dakota*, 504 US 298 (1992) and *National Bellas Hess Inc. v. Illinois*, 386 US 753 (1967). In doing so, the Court reversed its own precedent that, for over fifty years, provided an in-state physical presence by a retailer was a prerequisite for the constitutional imposition of a state sales or use tax collection obligation.

The South Dakota law that was at issue in *Wayfair* requires any seller who does not have a South Dakota physical presence to collect and remit the South Dakota sales and use tax if in the previous or current calendar year the seller had gross revenue from South Dakota sales in excess of $100,000 or 200 or more separate South Dakota sales transactions. The majority opinion, delivered by Justice Kennedy and joined by Justices Thomas, Ginsburg, Alito, and Gorsuch, held that the historical bright line physical presence standard established by the Court in *National Bellas Hess Inc. v. Illinois*, 386 US 753 (1967) and later affirmed in *Quill Corp. v. North Dakota*, 504 US 298 (1992) is antiquated in a retail industry dominated by ecommerce. In support of its decision to uphold the South Dakota law, the majority identified three features of the law "that appear designed to prevent discrimination against or undue burdens upon interstate commerce," namely, (1) the $100,000 sales and 200 transaction "safe harbor" that could not be exceeded "unless the seller availed itself of the substantial privilege of carrying on a business in South Dakota," (2) the law's protection against retroactive application, and (3) South Dakota's adoption of the Streamlined Sales and Use Tax Agreement. The dissent, delivered by Chief Justice Roberts and joined by Justices Breyer, Sotomayor, and Kagan, acknowledged that *Quill Corp. v. North Dakota* may have been wrongly decided, but would have left the decision of departing from the physical presence standard up to Congress.

State reaction to the *Wayfair* decision has thus far been swift. Having received the Court's endorsement, it is anticipated that the South Dakota law will serve as a blueprint for those states who have not yet enacted remote sales tax legislation. Indeed, on the same day the *Wayfair* decision was announced, the New Jersey legislature passed remote sales tax legislation that mirrored the South Dakota law and, most recently, the Wisconsin Department of Revenue issued a notice indicating that it would require remote sales tax collection by administrative rule "consistent with the Court's decision in *Wayfair*" (New Jersey and Wisconsin have both adopted the Streamlined Sales and Use Tax Agreement). In addition, the taxing authorities of other states that had enacted

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► September 20-21, 2018

Doing Business Globally

Seattle, Washington
► October 10, 2018

Dallas, Texas
► October 18, 2018

19th Annual International Tax and Trust Training Program

New York, NY
► October 16, 2018

Miami, FL
► October 18, 2018

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remote sales tax legislation in advance of the Court's ruling have issued notices detailing how their laws will be implemented.

The Court's decision makes clear that South Dakota's nexus standards satisfy the Commerce Clause requirement for substantial nexus for sales and use tax purposes, at least as applied to the large, national companies at issue in *Wayfair*. What the decision leaves open for debate, however, is the minimum level of activity sufficient to create substantial nexus for sales and use tax purposes, and whether the South Dakota thresholds apply broadly to state corporate net income and business activity taxes. For a more thorough discussion, please see Baker McKenzie Client Alert, *US Supreme Court Eliminates the Physical Presence Standard in Landmark South Dakota v. Wayfair Ruling*, distributed on June 21, 2018 at bakermckenzie.com or the SALT Savvy blog, distributed on June 22, 2018 at www.saltsavvy.com.

By: *Michael Tedesco*, New York

This Summer is an Unusually Busy Time for Congress, Treasury Regarding Tax Matters

Summer is usually a quiet time in Washington, DC, but the Treasury Department and the Internal Revenue Service are hard at work drafting guidance on numerous topics and Congressional Republicans are planning to vet nominations and introduce legislation for "round two" of tax reform. This year, the usual expectation that Washington empties out in August won't hold true.

Lawmakers, businesses, and tax professionals are still eagerly awaiting guidance from Treasury and the IRS on key provisions of the December 2017 Tax Cuts and Jobs Act (TCJA). Treasury has issued several notices regarding section 965 of the Internal Revenue Code, known as the transition or repatriation tax. Most recently, it issued guidance establishing a number of anti-avoidance rules and per-se transactions. We expect Treasury and the IRS to issue proposed regulations shortly, to address the treatment of accrued foreign income taxes and the application of the constructive ownership and anti-avoidance rules, among other applications. Taxpayers will have the opportunity to comment on the proposed regulations when they are published.

Treasury is also expected to issue guidance later this month on the 20 percent deduction for income from pass-throughs. Professional organizations and Congress have been pressing Treasury for guidance on this topic since the TCJA went into effect in January. This guidance is highly anticipated, given the complexity of the deduction and resulting uncertainties facing many small businesses about how best to plan for these changes. Additionally, while Treasury's focus over the coming months will be on implementing the TCJA, Treasury indicated it may also issue further guidance on taxation of cryptocurrency before the end of the year. Earlier in 2018, Treasury issued its only official guidance on the topic, a notice confirming that crypto assets are treated as property for federal tax purposes. In addition, the IRS has also

announced a “campaign” for crypto assets. (See article, LB&I Announces Five Additional International Compliance Campaigns, page 9)

Treasury is also expected to issue proposed regulations on section 163(j), limiting business interest deductibility, sometime this fall. Earlier this year, the IRS issued a notice on section 163(j) promising to address unanswered taxpayer questions, including the treatment of pre-2018 business interest under the base erosion and anti-abuse tax; the treatment of interest paid or accrued on a C-Corporation’s debt; and the treatment of affiliated groups that do not file a consolidated tax return as a single taxpayer.

Republicans hope to pass another round of tax cuts this year, following close on the heels of the TCJA. Just seven months after passage of the TCJA, tax reform remains a Congressional prerogative. Ways and Means Committee Chairman Kevin Brady (R-TX) recently announced plans for Tax Reform 2.0 (TR 2.0), a second phase of the TCJA aimed at securing President Trump’s legacy by making permanent some of the temporary measures in the TCJA and fine-tuning existing provisions. For example, TR 2.0 is expected to extend or make permanent the temporary individual cuts of the TCJA, which are otherwise set to expire at the end of 2025. Additionally, TR 2.0 is expected to give a second look to areas not fully addressed by the TCJA, such as the provisions on retirement. While TR 2.0 could be used as a vehicle for enacting technical corrections to the TCJA, Congress will likely continue to consider other, “must pass” legislation as more likely vehicles for tax technical corrections.

The House Republicans plan to circulate a draft of TR 2.0 after the July 4 recess, spending the month soliciting and incorporating suggestions by GOP leaders before putting the measure to a vote in the House in early August. Critics view TR 2.0 as political posturing ahead of the midterm elections, because—while the reform package has received a fair amount of press—it is unlikely to survive a vote in the Senate. Chairman Brady himself admitted that steering TR 2.0 through both houses of Congress would be a challenge, because unlike the TCJA, TR 2.0 cannot be ushered through Congress along partisan lines as a budget reconciliation measure. Senate Republicans would need the support of nine Democrats to pass the bill, a seemingly herculean feat given that no Democrats voted in favor of the original reform package.

If TR 2.0 passes the House, it could reach the Senate as early as mid-August. Last month, Senate Majority Leader Mitch McConnell (R-KY) announced plans to cancel the Senate’s August recess in order to deal with legislative backlog. Senators will be on break the week of August 6 before returning to Washington the following week. Majority Leader McConnell said he intended to prioritize the passage of a dozen annual spending bills ahead of the September 30 fiscal-year deadline and prioritize confirmations of President Trump’s judicial appointments, especially the new nominee for the Supreme Court. The House has made no similar changes to its schedule. In response to pressure from conservative leaders to cancel the August recess in the House, House Majority Leader Kevin McCarthy (R-CA) said he has no plans to cut the hiatus short. The House is scheduled to adjourn on July 26 and stay in recess until after Labor Day.

The Senate is currently considering nominations to fill three vacancies on the Tax Court, including Trump appointees Elizabeth Copeland, Patrick Urda, Courtney Dunbar Jones, and Emin Toro. In addition, Judge Mark Holmes has been nominated for another 15-year term. In late June, the Senate Finance Committee voted unanimously to advance the nominations of Copeland and Urda. Copeland had previously been nominated to the Court by former President Barack Obama, but her nomination was allowed to lapse without a vote before the full Senate. The June vote sends Copeland's and Urda's nominations to the Senate floor for consideration, where Finance Committee Chairman Orrin Hatch (R-UT) expects they will be swiftly confirmed.

The Senate Finance Committee also has before it President Trump's nominee for Commissioner of the IRS, Charles "Chuck" Rettig. Rettig's nomination hearing in late June was generally non-controversial and he pledged to remain independent if confirmed for the position. However, Democratic committee members expressed a desire to defer confirmation proceedings until there was more clarity on issues related to Rettig's personal assets and tax returns. As of yet, no confirmation hearing before the full Senate has been scheduled.

In sum, taxpayers should continue to engage with Treasury and the IRS, particularly as guidance is released implementing the TCJA. Providing comments to Treasury on proposed regulations and their impact on taxpayers will be a critical part of the regulatory process. In addition, it is increasingly fundamental for taxpayers to engage with key members of Congress, particularly as opportunities for technical corrections to the TCJA emerge and tax reform measures continue to evolve.

By: Josh Odintz, Alexandra Minkovich, and Marisa Bakker (Summer Associate), Washington, DC

A Binding Commitment Can Weather the Years: A Multi-Year Series of Transactions Treated as Related for Purposes of the Anti-Churning Rule

Summary of the Ruling

The IRS in PLR 201820013 adopted the binding commitment test to determine that a multi-step acquisition constituted "a series of related transactions" for purposes of testing relatedness under the anti-churning rule of Code Section 197(f)(9).

The PLR involved a two-step sale of interests in an LLC where the first sale of interests and the second sale of interests were separated by more than a year. The step one sale of LLC interests converted the LLC from a disregarded entity to a partnership, and thus constituted a deemed sale of assets, including goodwill that was not amortizable under section 197 in the hands of the seller. The step two sale of LLC interests reduced the seller's interest in the partnership to under 20%. The IRS ruled that the anti-churning rule did not apply to the goodwill the

buyer of the LLC interests was deemed to have purchased in the step one sale and, further, that the buyer could begin amortizing such purchased goodwill on the first day of the month of the step one sale.

Section 197 provides 15-year straight line amortization for certain intangible assets acquired after August 10, 1993. Prior to the enactment of section 197, certain intangible assets, such as goodwill, were not amortizable. When it enacted section 197, Congress was concerned that taxpayers might attempt to convert such non-amortizable assets into amortizable ones by structuring an acquisition of the assets where the ultimate user of the intangible assets did not change.

To prevent this, Congress included an anti-abuse rule in section 197(f)(9), known as the anti-churning rule. Section 197(f)(9) prohibits the amortization of any section 197 intangible that would not have been amortizable under prior law if it is acquired after August 10, 1993, by the taxpayer, and the taxpayer or a related person held or used the asset after July 25, 1991, and before August 10, 1993. This means a taxpayer cannot amortize goodwill on a section 197 intangible that either it or a related party held or used before the enactment of section 197.

For purposes of the anti-churning rule, a “related person” includes any person related within the meaning of section 707(b), substituting 20% for 50%. That is, a partnership and any person owning a more than a 20% interest, directly or indirectly, are related. In the case of a series of related transactions, Treas. Reg. § 1.197-2(h) provides that relatedness is tested immediately before the earliest transaction and immediately after the last transaction. Thus, where multiple steps have occurred, it is essential to determine whether transactions are treated as separate or constitute a series of related transactions in order to determine whether the anti-churning rule will apply to prohibit amortization under section 197.

The Ruling

PLR 201820013 involves a disregarded, single member LLC (“C”) wholly owned by an S Corporation (“B”). C in turn owns a number of operating entities that are also disregarded for US federal income tax purposes, the oldest of which was incorporated before the enactment of section 197. B also owns significant goodwill attributable to the business of the oldest of these disregarded operating subsidiaries. That goodwill was not amortizable by B under section 197.

In step one of the purchase transaction, B sold part of its interest in C to a buyer (“Buyer”). Under Rev. Rul. 99-5, situation 1, the sale of the interests in C was deemed to be a taxable sale of the an undivided percentage interest each of the assets of C, including the goodwill, to Buyer, followed by a tax-free contribution by B and Buyer of the assets of C to a partnership. Immediately after the deemed asset purchase, B presumably still held a more than 20% interest in C. Thus, if relatedness were tested immediately after step one, the goodwill would still be held by a related party. Accordingly, because of the anti-churning rule, the goodwill would not be amortizable under section 197.

After the step one purchase, B and Buyer entered into a LLC Agreement. The terms of the LLC Agreement establish a binding commitment for step two of the purchase by Buyer. In step two, Buyer is obligated to purchase more of B's interest in C. The LLC agreement laid out all the terms of the step two purchase, including the date of the step two purchase on a certain anniversary of the effective date of the LLC agreement. The taxpayer represented that there were no contingencies related to the step two purchase other than the passage of time. After the step two purchase, B would own less than 20% of C. Thus, if step one and step two were treated as part of “a series of related transactions” and relatedness is tested after step two, then the goodwill would not be held by a related party. As a result, the anti-churning rule would not apply and the goodwill would be amortizable under section 197.

The IRS ruled that step one and step two were a series of related transactions, and that the anti-churning rule of section 197(f)(9) would not prevent Buyer from amortizing its basis in the section 197 intangibles it was deemed to have purchased in step one of the acquisition of C. Further, the IRS ruled that Buyer could commence amortizing such intangibles on the first day of the month of the step one purchase.

Conclusion and Takeaways

In PLR 201820013, the IRS permitted the purchaser of goodwill to treat transactions that spanned more than a year as related transactions for purposes of testing relatedness to determine the applicability of the anti-churning rule. The taxpayer's representation that the LLC Agreement established a binding commitment for the buyer to execute the step two purchase was a material representation. This is a reasonable approach to demonstrating that transactions constitute a series of related transactions for purposes of determining relatedness under the anti-churning rule. Thus, the binding commitment test can provide a method for taxpayers to find comfort when planning multi-step acquisitions of goodwill.

Additionally, the IRS permitted the purchaser of the goodwill to begin amortizing its basis in that goodwill immediately after such goodwill was acquired, rather than requiring the purchaser to wait until the end of the series of transactions. This is a helpful ruling for taxpayers undertaking multi-step acquisitions to provide certainty that they can begin amortizing their section 197 intangibles immediately after they are purchased rather than waiting until after the time for testing relatedness for purposes of the anti-churning rule.

By: Amanda Swartz, Houston

Section 355 Distribution Untouched by Share Offering

In a recent, taxpayer-friendly private letter ruling, the IRS ruled that a share offering immediately followed by a section 355 distribution would be respected as separate transactions. This ruling addressed a north-south transaction in the context of section 355, an area in which the IRS would not issue rulings from 2013 until 2017, and provided the taxpayer with comfort that the step-transaction doctrine would not be applied to integrate its share offering with its distribution, potentially causing its distribution to fail to qualify for tax-free treatment under section 355.

Summary of Facts

In PLR 201820016 (May 18, 2018), Distributing was a publicly traded corporation that owned foreign and domestic entities, including Controlled. Prior to the transactions, both Distributing and Controlled were engaged in multiple businesses. Distributing had two classes of common stock: (i) Class A shares entitled to "a" vote(s) per share; and (ii) Class B shares entitled to "b" vote(s) per share.

Distributing's board of directors authorized the issuance of additional shares as part of a share offering (the "Share Offering") made to all holders of Class A shares and Class B shares (the "Shareholders") on the record date. Each Shareholder was entitled to pay cash to subscribe for an additional share of Distributing of the same class already held. Only a certain percentage of the Shareholders chose to exercise their subscription rights, and the remaining authorized shares were sold to those Shareholders who applied to further participate in the Share Offering. Distributing used the cash from the Share Offering to reduce its external debt.

Distributing then distributed, on a pro rata basis, shares of Controlled to the Shareholders (the "Distribution"). Distributing's Class A shareholders received Class A shares of Controlled and Distributing's Class B shareholders received Class B shares of Controlled. The terms of each class of share in Controlled mirrored the terms of the same class of shares in Distributing.

IRS Ruling

The IRS ruled that the Share Offering would not prevent the Distribution from otherwise qualifying under section 355. That is, the Share Offering could be disregarded in determining whether the Distribution qualified under section 355.

Background on North-South Transactions in the 355 Context

The taxpayer in PLR 201820016 made a Share Offering to its existing shareholders, i.e., it solicited contributions of cash from its current shareholders, in order to pay down its external debt prior to its spin off of Controlled. An issue can arise, however, when a pre-spin-off transaction involves a contribution of property in exchange for Distributing stock. For example, in Rev. Rul. 80-221, a

third party contributed cash to a corporation in exchange for its preferred stock. Later, the corporation distributed property desired by the new preferred shareholder to the new shareholder in redemption of the preferred stock. The IRS disregarded the transitory existence of the preferred stock and treated the overall transaction as a cash sale of the distributed property to the third party for cash.

Similarly, in PLR 201820016, the IRS could treat the Distributing shareholders who acquired additional Class A or Class B shares in the Share Offering as paying cash in exchange for the shares of Controlled stock, as well as the additional Class A or Class B shares (a “north-south transaction”). If more than 20% of the Controlled stock were received in respect of the additional Class A or Class B shares issued in the Share Offering and, hence, treated as acquired for cash under step-transaction principles similar to those applied in Rev. Rul. 80-221, then the distribution of the Controlled stock would have failed to qualify under section 355(a)(1)(D).

There is, however, a significant difference between the relevant facts of PLR 201820018 and those of Rev. Rul. 80-221; primarily, the Distributing stock acquired in the Share Offering remained outstanding following the spin-off and was not transitory as was the preferred stock in Rev. Rul. 80-221. Despite significant grounds to distinguish the relevant facts of PLR 201820016 and those of Rev. Rul. 80-221, some taxpayers may desire certainty that the IRS would not view their pre-spin off transactions as integrated with the distribution of Controlled.

North-South Once a No-Rule Area

From January 1, 2013 until May 3, 2017, the taxpayer would have been unable to get a ruling that the Share Offering and Distribution would be respected as separate transactions. In Rev. Proc. 2013-2, the IRS announced that north-south transactions were “under study” and no rulings would be issued on whether the contribution and distribution in a north-south transaction would be respected as separate.

Luckily for taxpayers, in 2017, the IRS issued Rev. Rul. 2017-09, which not only removed north-south transactions from the no-rule list, but also provided helpful guidance how the step-transaction doctrine should be applied to north-south transactions. In that ruling, the IRS stated:

> The tax treatment of a transaction generally follows the taxpayer's chosen form unless: (1) there is a compelling alternative policy; (2) the effect of all or part of the steps of the transaction is to avoid a particular result intended by otherwise-applicable Code provisions; or (3) the effect of all or part of the steps of the transaction is inconsistent with the underlying intent of the applicable Code provisions.

This articulation of the step-transaction doctrine, applicable to north-south transactions in the context of section 355, seems to provide some deference to the taxpayer’s chosen form in the absence of a contrary policy reason for disregarding the taxpayer’s form. As a subjective standard, it also gives

taxpayers a reason to request a ruling to gain certainty that their transactions will be respected as separate transactions.

Conclusion

In PLR 201820016, the IRS provided the taxpayer with certainty that its transactions, the Share Offering and the Distribution, would be respected as separate transactions. This PLR should be welcome news to taxpayers because it shows where a taxpayer undertook reasonable pre-spin-off transactions that involved contributions to Distributing, the IRS was willing to issue a favorable private letter ruling on the north-south issue.

By: Amanda Swartz, Houston and Jacque Titus (Summer Associate), Dallas

LB&I Announces Five Additional International Compliance Campaigns

On July 2, 2018 the IRS Large Business and International ("LB&I") division announced its approval and introduction of five additional compliance campaigns. The announced campaigns are: (1) restoration of sequestered alternative minimum tax ("AMT") credit carryforward; (2) S corporation dividends; (3) virtual currency; (4) repatriation via foreign triangular reorganizations; and (5) section 956 transition tax.

LB&I Compliance Campaign Program

In 2016, LB&I unveiled a revised division structure–shifting away from a domestic/international divide, moving towards IRS employee specialization, and focusing compliance efforts on specified high-risk audit issues through an approach known as "campaigns." The goal of the compliance campaign approach was to publicly identify specific areas of non-compliance, set preferred compliance outcomes, provide tailored resources, and suggest "treatment streams" for compliance personnel to achieve the stated outcomes.

The move towards compliance campaigns also reflected the reality of a shifting audit landscape for large business and international taxpayers. The expansion of multinational corporations increased the need for LB&I examination teams to utilize specialists (industry experts, economists, engineers, etc.) during a period of a shrinking IRS compliance budget. Moreover, the average LB&I audit increasingly presented a combination of domestic, international, and transfer pricing issues, raising the risk of conflicts among IRS employees over issues such as audit control, resolution authority, the issue escalation process, and responsibility for timing delays. The compliance campaign structure presented an opportunity to focus training, audit issue ownership, and a risk-based approach.

On January 31, 2017, LB&I announced the initial set of thirteen campaigns. Since that announcement, LB&I has issued a total of 22 supplemental campaign topics. As the list of compliance campaigns grows, LB&I asserts that it continues to review legislation, including the 2017 Tax Cuts and Jobs Act (P.L. 115-97), to

determine if any existing campaigns have been impacted, but that analysis has yet to be completed.

New LB&I Compliance Campaigns

The July 2, 2018 announcement included campaigns topics ranging from repatriation issues before and after U.S. federal tax reform (triangular reorganizations and section 965 transition tax issues) to the more headline-grabbing new frontiers of tax compliance (virtual currency). As with previous campaigns, LB&I stated that the five additional campaigns were selected through analysis of internal data and suggestions from IRS employees.

The first campaign addresses situations where a taxpayer improperly (in LB&I's view) restores a sequestered AMT credit in a subsequent tax year though section 168(k)(4). While section 168(k)(4) was repealed under the 2017 Tax Cuts and Jobs Act, LB&I will be issuing letters to taxpayers that it has identified as having improperly restored sequestered credits. LB&I will also focus educating taxpayers on the proper treatment of sequestered AMT credits in an effort to have taxpayers self-correct the issue.

The second campaign addresses multiple compliance issues LB&I identified related to S corporation distributions. The announcement highlights three issues in particular: failure to report gain upon distributions of appreciated property, failure to appropriately characterize S corporation distributions as taxable dividends, and failure by S corporation shareholders to report distributions in excess of basis as subject to taxation. The campaign announcement states that LB&I will address these issues through issue-based examinations, suggesting revisions to relevant tax forms, and taxpayer outreach.

The third campaign addresses the new frontier of virtual currency. On March 25, 2014, Treasury issued Notice 2014-21 to clarify the status and characterization of virtual currency for federal income tax purposes and certain implications of convertible virtual currency transactions. Notice 2014-21 provided guidance through a series of frequently asked questions covering issues including, but not limited to, determination of currency fair market value upon acquisition, income characterization upon sale or exchange, and employment tax considerations. The virtual currency compliance campaign will address non-compliance with the principles outlined in Notice 2014-21 and provide additional educational opportunities for taxpayers.

In the July 2, 2018 campaign announcement, the IRS encouraged taxpayers with unreported virtual currency transactions to amend their returns as soon as possible. Notably, the announcement explicitly states that the IRS is not contemplating a virtual currency-specific voluntary disclosure program to address taxpayers currently in non-compliance. Put differently, the IRS is putting taxpayers on notice that they should not expect a better deal by delaying their compliance efforts.

The fourth and fifth campaigns highlight LB&I's focus on repatriation issues. The fourth campaign, repatriation via foreign triangular reorganizations, focuses on taxpayer's attempts to repatriate untaxed CFC earnings through the use of

triangular reorganization transactions, following up on Notice 2016-73 issued in December 2016. Notice 2016-73 addressed certain triangular reorganizations involving foreign corporations where a subsidiary acquires stock in its parent and uses that stock to acquire a target corporation. LB&I's stated goal of this campaign is "to identify and challenge these transactions." It is not clear whether this statement was intended to leave LB&I room to expand its audit focus to triangular repatriations beyond those described in Notice 2016-73.

The fifth campaign focuses on issues arising in connection with the section 965 deemed repatriation and transition tax. Section 965, overhauled under the 2017 Tax Cuts and Jobs Act, requires United States shareholders to pay a transition tax on the untaxed foreign earnings of foreign corporations as if those earnings had been repatriated to the United States. Under section 965, taxpayers may affirmatively elect to pay the tax in installments over an eight-year period. The IRS has previously provided guidance on the mechanics of revised section 965 in Notices 2018-07, 2018-13, 2018-26 and an online FAQ. LB&I announced this compliance campaign early relative to other issues from an audit perspective, as the transition tax would be imposed, in whole or in part, in connection with a calendar-year taxpayer's 2017 return at the earliest (i.e., for a taxable year that closed on Dec. 31, 2017).

Implications of New Campaigns

The announcement of the five additional compliance campaigns is not surprising. Nor is it surprising that the announcement does not provide significant detail on the campaigns, beyond a short summary, the relevant practice area, and the IRS employee assigned to lead each campaign. Practically, taxpayers should expect these issues to receive increased scrutiny in upcoming audits cycles, especially as LB&I further develops issue-focused training materials to assist exam teams with identifying and evaluating these issues. Additionally, the compliance campaign expansion increases the risk of audit delay by incentivizing LB&I examination teams to request assistance from centralized issue experts, often unfamiliar with the taxpayer-specific facts obtained over the course of the audit.

By: Robert Hammill, Palo Alto

It's All Graevy

Code Section 6751(b)(1) requires personal, written approval "by the immediate supervisor" of the "initial determination" of a penalty assessment. A string of recent cases have put into question what an "initial determination" means, at what point in time the approval is needed, and who is the appropriate "immediate supervisor" to approve the determination. The most recent in this line of cases is *Graev v. Commissioner*, 149 T.C. 23 (2017) ("*Graev III*"). *Dynamo Holdings v. Commissioner*, 150 T.C. 10 (2018), considered the impact of *Graev III* in the context of partnership proceedings. The IRS has published litigating guidelines in light of these and other cases.

Graev III

In *Graev III*, the Tax Court partially adopted the holding of the Second Circuit in *Chai v. Commissioner*, 851 F.3d 190 (2d Cir. 2017). In a prior split opinion in *Graev II*, the Tax Court sustained a penalty against individual taxpayers. The majority opinion held that approval under section 6751(b)(1) could be obtained *at any time* before the penalty was assessed and that the taxpayers' challenge of the penalty in a deficiency case was premature. The dissenting opinion, joined by four other judges, would have held that approval must be obtained prior to initiating Tax Court proceedings. See *Graev v. Commissioner*, 147 T.C. 16 (2016), and *Tax News and Developments* article, *The IRS Skips Statutory Procedures—The Tax Court Rules in its Favor* (Vol. XVII, Issue 2, March 2017).

Subsequently, the Second Circuit in *Chai* reversed a Tax Court order that had upheld a penalty assessed against an individual taxpayer. The Second Circuit declined to follow the majority opinion in *Graev II*. Instead, the court concluded that approval must be obtained no later than the date that the IRS issued the notice of deficiency (or filed an answer or amended answer) asserting the penalty. Reading sections 7491(c) and 6751(b)(1) together, *Chai* further held that compliance with section 6751(b) was part of the IRS's burden of production and proof in deficiency cases. Under section 7491(c), "the Secretary shall have the burden of production in any court proceeding with respect to the liability of any individual for any penalty …." *See Tax News and Developments* article, *The Second Circuit Agrees with Dissenting Tax Court Judges to Hold the Commissioner Accountable* (Vol. XVII, Issue 4, May 2017).

Because *Graev II* was appealable to the Second Circuit—the same Court of Appeals as *Chai*—the Tax Court vacated *Graev II*. Subsequently, in *Graev III,* the Tax Court overruled in part *Graev II* which rejected taxpayers' argument as premature. *Graev III* held that the written supervisory approval must occur no later than the date the IRS mailed the notice of deficiency (or filed an answer or amended answer) asserting the penalties. *Graev III* also held that part of the IRS's burden of production for penalties under section 7491(c) included producing evidence of compliance with section 6751(b). The Tax Court ruled that the IRS had shown compliance with section 6751(b) and that the taxpayers were liable for the penalty. The dissent—joined by five other judges—partially dissented because the penalties in the *Graev* cases were not approved by a supervisor who had authority to do so. *See* prior analysis on *Graev II* for factual background.

Dynamo Holdings

In *Dynamo Holdings*, the Tax Court held that, section 7491(c), which applied to "any court proceeding" with respect to the "liability of any individual," was inapplicable to partnership-level proceedings or corporate-level proceedings. The IRS did not bear the burden of production in these proceedings, but that lack of compliance with section 6751(b) may be raised as a defense by the taxpayer. The court focused its analysis on partnership-level proceedings.

First, under a plain reading of the statutes governing partnership-level proceedings, such proceedings were not with respect to the liabilities of individuals. The tax treatment of partnership items and the applicability of any

penalty, addition to tax, or additional amount relating to an adjustment to a partnership item, were determined at the partnership level. Once a partnership-level proceeding was final, the liability of the partners may be determined in a partner-level proceeding, where partners may raise defenses to penalties.

Moreover, the very nature of partnership-level proceedings was inconsistent with section 7491(c), which focused on liability. A partnership-level proceeding did not determine the liability of any partner for either tax or penalties. In addition, partnership-level proceedings were not proceedings with respect to "individuals"—partnerships were not individuals. Lastly, other Code sections and other subsections of section 7491 showed that Congress did not intend section 7491(c) to apply to partnership-level proceedings. The Tax Court noted "practical concerns" in partnership-level proceedings that made the Tax Court's approach the "only reasonable approach."

Chief Counsel Notice CC 2018-006

In light of *Graev III*, the IRS has released guidance to Chief Counsel attorneys on how to address compliance with section 6751(b) in litigation. IRS, Office of Chief Counsel, Notice CC-2018-006, "Section 6751(b) Compliance Issues for Penalties in Litigation" (Jun. 6, 2018) ("CC-2018-006"). CC-2018-006 provides litigating guidelines on, among others, the following: (1) burden of production and burden of proof; (2) compliance with section 6751(b)(1) in deficiency cases and Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") cases; (3) how to show evidence of compliance; and (4) what to do when there is no such evidence.

CC-2018-006 largely echoes the holdings of the recent decisions and recommends that Chief Counsel attorneys be vigilant on documenting compliance with section 6751(b)(1). For instance, CC-2018-006 instructs attorneys to submit evidence of compliance during litigation, regardless of whether the petitioners have raised the issue, "at the earliest opportunity, and no later than filing the pretrial memorandum." When Chief Counsel attorneys review a notice of deficiency and recommend a penalty, they should obtain approval from their immediate supervisor and prepare a memorandum to memorialize the recommendation and approval. When Chief Counsel attorneys raise penalties in litigation, they should obtain their supervisor's signatures. These instructions are in direct response to the fact pattern in the *Graev* cases. Chief Counsel attorneys also must concede the penalty if they cannot find evidence to establish compliance with section 6751(b)(1). Chief Counsel attorneys must concede "at the earliest opportunity, which will typically be in the answer, and in all events at the very latest in the pretrial memorandum."

CC-2018-006 also hammers home IRS-friendly takeaways. For instance, CC-2018-006 states repeatedly that compliance with section 6751(b)(1) is not necessarily a part of the IRS's burden of proof. CC-2018-006 points out that both the majority and concurring opinions in *Graev III* questioned *Chai's* holding that producing evidence of compliance with section 6751(b)(1) was part of the IRS's burden of proof in deficiency cases. CC-2018-006 also reminds the Chief Counsel attorneys that the IRS can assert penalties later on in answers or amended answers, even if they were not included in the notice of deficiency.

By: Angela Chang, Palo Alto

Treatment of Certain PTI Arising from Section 965 Transition Tax Remains Uncertain

The mandatory deemed repatriation of foreign earnings pursuant to Code Section 965 resulted in large amounts of previously taxed income ("PTI") for U.S. multinational corporations. Not all PTI that originated under the transition tax, however, was created equal. The allocation of deficits in certain foreign subsidiaries to shield the positive earnings in other foreign subsidiaries from inclusion gave rise to a particular type of PTI under section 965(b)(4). Per the literal statutory language, this "shielded PTI" does not obviously benefit from the basis increase that accompanies the PTI arising from "normal" subpart F inclusions. The presence or absence of accompanying basis can mean the critical difference between PTI that is freely distributable without triggering gain, and PTI—*i.e.*, cash—that is essentially trapped. The questions around what Congress really intended with respect to shielded PTI are explored in *The Surprisingly Dubious Fate of Code Sec. 965 PTI*, by Julia Skubis Weber, Stewart Lipeles, and Ethan Kroll, published by *CCH Tax - Taxes The Tax Magazine*, July 2018 (available at www.bakermckenzie.com).

By: Julia Skubis Weber, Chicago

IRS Puts SALT Deduction Workarounds on Notice

Under the Tax Cuts and Jobs Act, Congress amended Code Section 164 was amended to add a $10,000 limit on individual itemized deductions for state and local taxes ("SALT") for tax years 2018 to 2025. This limitation appears to disproportionately affect high-income residents of states with high income taxes and property taxes. It has motivated lawmakers in states such as California, Connecticut, Illinois, New York, New Jersey, and Oregon to propose and, in some cases, pass legislation that would create workarounds to the limitation found in Section 164(b)(6). In general, these workarounds would allow taxpayers to receive a full or partial state or local tax credit in exchange for certain qualifying charitable contributions approved by the relevant state. Additionally, some states such as New York and Connecticut have taken measures to shift the incidence of tax from the individual to a business entity (as the $10,000 SALT deduction limitation applies to individuals, not business entities such as corporations and partnerships) in an effort to reduce the federal tax increases otherwise resulting from the SALT deduction limitation. The IRS has taken notice of the charitable contribution workarounds and, in response, issued Notice 2018-54 (the "Notice") on May 23, 2018.

The Notice informs taxpayers of the Treasury Department's and the IRS's intent to propose regulations that address the federal income tax treatment of certain payments to state-approved funds for which taxpayers receive a credit against their state and local taxes. The Notice cautions taxpayers that "[d]espite these state efforts to circumvent the new statutory limitation on state and local tax limitation, taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes." While the Notice does not indicate the exact nature of the proposed regulations, it states that the proposed regulations "will make clear that the requirements of the Internal

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Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers." The proposed regulations are expected to be released relatively soon.

But the Notice is significant in and of itself. The Notice is the harbinger of a proposed regulation that purportedly would delineate the circumstances for diverging from the result in Chief Counsel Advice 201105010 (Oct. 27, 2010), a non-precedential memorandum which addressed the issue of whether a cash payment to either a state agency or a charitable organization in exchange for a transferable state tax charitable credit could qualify for a charitable contribution for federal income tax purposes. In that memorandum, the IRS Office of Chief Counsel concluded that the fact that the taxpayer received state tax credits in return for its donation did not disqualify the donation from being characterized as a deductible charitable contribution for federal income tax purposes. Notwithstanding this conclusion, the Advice memorandum explicitly provides that "[t]here may be unusual circumstances in which it would be appropriate to recharacterize a payment of cash or property that was, in form, a charitable contribution as, in substance, a satisfaction of tax liability." The proposed regulation is expected to set forth and identify those unusual circumstances in greater detail.

In hopes of improving its chances for withstanding scrutiny under the forthcoming proposed regulation, California legislators have amended proposed legislation that would provide a state tax credit for charitable contributions. Prior to the Notice, California SB 227 provided an 85% state tax credit for charitable contributions to the California Excellence Fund. Under the current version that was amended subsequent to the issuance of the Notice, California SB 227 provides a 85% state tax credit for amounts contributed to the Local Schools and Colleges Voluntary Contribution Fund. This Fund would have two subaccounts, the Baseline Schools and Colleges Subaccount and the Supplemental Schools and Colleges Subaccount. Generally, the funds from the Baseline Schools and Colleges Subaccount would be used to reimburse the state's General Fund for its constitutional minimum funding requirements for local educational agencies and community college districts. The funds from the Supplemental Schools and Colleges Subaccount would be allocated to local educational agencies and community college districts based on average daily attendance.

This change in California's proposed legislation appears to be designed to conform with the state tax credit programs adopted by other states prior to the enactment of the Tax Cuts and Jobs Act, which presumably resulted in deductible charitable contributions for federal income tax purposes. Several of these legacy states probably would not be categorized as being disproportionately affected by the SALT deduction limitation. Thus, if the Treasury Department and the IRS issue a regulation that broadly disallows a charitable contribution deduction under circumstances similar to the one proposed under current California SB 227, such a regulation could result in residents of other states losing their charitable contribution deduction for such similar donations.

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States that conform their tax credit programs to similar programs that qualified for the charitable contribution deduction prior to the Tax Cuts and Jobs Act could put the IRS and the Treasury Department in an interesting spot. Will the forthcoming proposed regulation attempt to take away the charitable contribution deduction for all taxpayers that receive state tax credits in exchange for their donations? Or will it try to formulate a method that distinguishes between programs adopted by states subsequent to the Tax Cuts and Jobs Act and programs adopted in legacy states? An affirmative response to the former could provide some residents of disproportionately affected states with a small measure of schadenfreude (i.e., pleasure or satisfaction derived from the misfortune of another), and an affirmative response to the latter may result in administrative challenges and litigation. We will find out when the proposed regulation is published.

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