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No One Ruins a Holiday Weekend Like the Treasury Department: Understanding the Green Book

President Biden released his Administration's budget proposal for fiscal year 2022 on May 28, 2021. A copy of the Budget can be found at www.whitehouse.gov/omb/budget. To accompany the Administration's Budget, the Treasury Department released its "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals." Known generally as the "Green Book," the document includes detailed descriptions of the tax provisions in President Biden's economic proposals under the American Jobs Plan and American Families Plan, as well as accompanying revenue estimates. Though useful for planning purposes, the proposals have varying likelihoods of passage. As the familiar adage goes, "The President *pro*poses; Congress *dis*poses."

Publication of the Green Book went on hiatus during the Trump presidency, so policy wonks and tax practitioners alike eagerly anticipated its release from the Biden Administration. Like the first Green Book released by other administrations, the FY22 Green Book provided more information on the proposals that Biden first announced on the campaign trail and, for the most part, was light on surprises. We can expect the number and scope of tax proposals to increase in future Green Books.

American Jobs Plan

In the first section of the Green Book, Treasury described tax proposals intended to further three key policy goals identified by the Biden Administration: (1) "reform corporate taxation," (2) "support housing and infrastructure," and (3) "prioritize clean energy."

Corporate Tax Proposals

The corporate tax proposals described in the Green Book are very similar to the proposals described in the American Jobs Plan (Fact Sheet), which was released by the Biden Administration on March 31, 2021.

These proposals include increasing the corporate income tax rate to 28% (from 21%), substantially revising the Global Intangible Low-Taxed Income ("GILTI") regime, repealing the Base Erosion and Anti-Abuse Tax ("BEAT") and replacing it with a new regime, entitled "Stopping Harmful Inversions and Ending Low-Tax Developments" ("SHIELD"), imposing a new 15% minimum tax on corporations

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with worldwide pre-tax book income in excess of $2 billion, and repealing the current deduction available to domestic corporations with respect to 37.5% of any foreign-derived intangible income ("FDII").

The increased corporate income tax rate is estimated to raise $51 billion in fiscal year 2022 ($857 billion over the 2022-31 period). Reforms to the GILTI regime, in conjunction with the disallowance of deductions attributable to exempt income and tightened anti-inversion rules, are estimated to raise $29 billion in fiscal year 2022 ($533 billion over the 2022-31 period). Meanwhile, the repeal of the FDII deduction is estimated to raise $ 8 billion in fiscal year 2022 ($129 billion over the 2022-31 period). However, because the Green Book proposes to use the additional revenue that results from repealing FDII to expand more effective R&D investment incentives, this proposal ultimately is projected to have no revenue impact.

The proposed plan would also revise the current GILTI regime by eliminating the qualified business asset investment ("QBAI") 10% exemption, reducing the Code Section 250 deduction for GILTI income to 25% (from 50% currently), repealing the high-tax exemption (under GILTI and subpart F income), and mandating a "jurisdiction-by-jurisdiction" calculation requiring a separate foreign tax credit limitation for each foreign jurisdiction. These changes would increase the effective GILTI tax rate to 21% (under the proposed 28% corporate tax rate) and prevent cross-crediting of taxes from high-tax jurisdictions to low-tax jurisdictions. Foreign oil and gas extraction income would no longer be exempt from the GILTI rules. Additionally, the amount of a dual-capacity taxpayer's foreign levy that would qualify as creditable foreign tax would be limited to the generally applicable rate of income tax in the foreign jurisdiction.

The proposal further limits the use of foreign tax credits by extending the stock sale treatment for deemed asset sales under section 338 to hybrid entities such that the source and character of any item resulting from the sale of an interest in a hybrid entity would be determined based on the source and character the seller would have taken into account upon the sale or exchange of a stock transaction (rather than a deemed asset sale).

The proposal would replace the "BEAT" with "SHIELD." Under the SHIELD, US group members that make payments to "low-taxed members" of the same financial reporting group would be subject to a disallowance of their deductions. The SHIELD applies when the financial reporting group has more than $500 million in global annual revenues. A member of the group is a "low-taxed" member if the member's income is subject to an effective tax rate that is lower than a designated minimum tax rate. The designated minimum tax rate would be determined by reference to either the OECD's ongoing "Pillar Two" negotiations or, in the absence of any consensus, at the proposed GILTI rate of 21%. Notably, on June 5, 2021, Finance Ministers from the G7 (consisting of Canada, France, Germany, Italy, Japan, the UK, and the US) committed to the principal design elements for the OECD's two pillar approach for international tax reform, including a global minimum tax of at least 15% on a country-by-country basis under Pillar Two.

To further discourage base-erosion, the Green Book resurrects the worldwide interest expense limitations that were originally considered, but ultimately eliminated from, the Tax Cuts and Jobs Act. The Green Book proposes to disallow interest expense deductions by a member of a multinational group to the extent its net interest expenses for US tax purposes exceeds the entity's proportionate share of the group's net interest expense (the "excess financial statement net interest expense"). Any disallowed interest expense could be carried forward indefinitely.

In response to Treasury's concerns that some companies report significant profits to shareholders without paying federal income taxes, the Green Book proposes a 15% minimum tax on worldwide book income for corporations whose book income exceeds $2 billion. While the old alternative minimum tax enacted in 1986 (P.L. 99–514, §§ 701–702 (1986)), was in effect, AMTI for tax years 1987 through 1989 was increased by one half of the excess of adjusted net book income over AMTI before the adjustment and before deduction of any AMT NOL. Former IRC Section 56(f). Adjusted book income was generally the net income or loss on the corporation's applicable financial statement. Former IRC Section 56(f)(3). The book income adjustment was repealed by § 11801(a)(3) of the Revenue Reconciliation Act of 1990. Perhaps these provisions will be dusted off in crafting the new 15% add-on minimum tax.

To limit the ability or incentive for domestic corporations to invert, the Green Book proposes to further tighten the existing section 7874 anti-inversion rule by reducing the continuing ownership threshold above which a non-US acquiring corporation is treated as a US corporation from 80% to 50%, and imposing a "managed and controlled" test by expanding the rule to acquisitions which don't meet the threshold requirement but otherwise evidence continuing US control. Commenters have already expressed concern that these proposals would have a negative impact on US-based companies' ability to compete with foreign-based multinationals in acquisitions.

Finally, to encourage the on-shoring of businesses, taxpayers would be eligible for a new general business credit equal to 10% of certain expenses paid or incurred in connection with moving a trade or business into the US, whereas deductions for expenses paid or incurred to move a business offshore would be correspondingly disallowed.

Effective Dates

The various proposals generally would be effective for taxable years beginning after December 31, 2021, with the exception of the increased corporate income tax rate, limit on foreign tax credits for sales of hybrid entities, and tightened section 7874 anti-inversion rule.

The 28% corporate income tax rate will be effective for taxable years beginning after December 31, 2021. However, for taxable years beginning after January 1, 2021 and before January 1, 2022, the 7-percentage point increase would be multiplied by a fraction, the numerator of which is the number of days of the portion of such taxable year falling within calendar 2022, and the denominator of which is the total number of days in such taxable year. Both the changes to section 338 and the changes to section 7874 will be effective for transactions completed after the date of enactment.

Housing and Infrastructure

To support housing and infrastructure initiatives, the Green Book proposes to expand the low-income housing tax credit, create a new tax credit program (the Neighborhood Homes Investment Credit to support construction and rehabilitation of single family homes), make permanent the New Markets Tax Credit (which provides a tax credit for investments in qualified community development entities and is scheduled to expire in 2025), and provide federally subsidized state and local bonds for infrastructure development (such as educational facilities, public transit, passenger rail and infrastructure for zero emissions vehicles).

Incentivize Clean Energy Investments

The Green Book proposes to repeal several fossil fuel subsidies including: (1) the 15% enhanced oil recovery credit for eligible costs attributable to a qualified enhanced oil recovery project; (2) the credit for oil and gas produced from marginal wells; (3) the expensing of intangible drilling costs paid or incurred in the development of an oil or natural gas property located in the US; (4) the deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; (5) the exception to passive loss limitations provided to working interests in oil and natural gas properties; (6) the use of percentage depletion with respect to oil and gas wells; (7) two-year amortization of independent producers' geological and geophysical expenditures, instead allowing amortization over the seven-year period used by integrated oil and gas producers; (8) expensing of exploration and development costs; (9) the use of percentage depletion for hard mineral fossil fuels; (10) capital gains treatment for royalties received on the disposition of coal or lignite; (11) the exemption from the corporate income tax for publicly traded partnerships with qualifying income and gains from activities relating to fossil fuels; (12) the Oil Spill Liability Trust Fund excise tax exemption for crude oil derived from bitumen and kerogen-rich rock; and (13) accelerated amortization for air pollution control facilities.

To incentivize clean energy, the Green Book proposes to extend and enhance the Renewable Electricity Production Credit (for wind facilities), the Renewable Energy Investment Credit (for solar energy facilities), and the Residential Energy Efficiency Credit; establish a credit for taxpayer investment in electric power transmission property; create an allocated production credit for electricity generation from eligible existing nuclear power facilities that submit a bid; expand the advanced energy manufacturing tax credit in section 48C; establish tax credits for heavy and medium-duty zero emission vehicles; provide tax incentives for renewable aviation fuel; extend and enhance energy efficiency and electrification incentives; provide a disaster mitigation tax credit; expand and enhance the carbon oxide sequestration credit; and extend and enhance the electric vehicle charging station credit.

American Families Plan

The second portion of the Green Book describes proposals applicable to individuals, new reporting requirements, and other mechanisms to improve tax administration. Many of the proposals applicable to individuals were previously announced when the Biden administration unveiled the American Families Plan (Fact Sheet) on April 28, 2021.

As expected, the Green Book proposes several tax increases for wealthier individuals (earned income exceeding $400,000), including an increase in the top ordinary income tax rate from 37% to 39.6%. For taxpayers whose income exceeds $1 million, the Green Book proposes to tax capital gains and qualified dividends at ordinary income tax rates (plus the 3.8% Net Investment Income Tax ("NIIT")). This proposal, which constitutes a fundamental change to the treatment of capital gains, would be effective for gains recognized after "the date of announcement." Although it is not clear whether the "announcement" that the Green Book refers to is the release date of the Fact Sheet for the American Families Plan or the date the Green Book itself was released, a conservative approach is to treat the proposed effective date as the date the Fact Sheet was released: April 28, 2021.

The Green Book also proposes to end the step-up in basis by treating transfers of appreciated property upon death or by gift with unrealized appreciation in excess of $1 million as realization events, with exclusions for spousal transfers, donations, certain tangible personal property, and transfers of certain small business stock and family businesses. The new gain recognition rules would also require a trust, partnership or other non-corporate entity to recognize a capital gain if the entity's appreciated property has not otherwise been the subject of a recognition event within the prior 90 years, with a testing period beginning on January 1, 1940.

Turning to pass-through entities, the Green Book proposes to subject all trade or business income of high-income taxpayers (earned income exceeding $400,000) to the 3.8 percent Medicare tax, either through the NIIT or the SECA tax, and subject limited partners, LLC members and S corporation owners who provide services (and materially participate) to SECA tax on the distributive shares of partnership, LLC income, or business income. The proposal would also tax carried (profits) interest income as ordinary income subject to self-employment tax and repeal Section 1061 for taxpayers whose income (from all sources) exceeds $400,000. Qualified capital interests attributable to invested capital are not subject to this rule and the portion of gain on the sale of an interest attributable to invested capital would be taxed as capital gain.

The current gain deferral on "like-kind exchanges" of real property would be limited to an aggregate amount of $500,000 per year per taxpayer ($1 million for married individuals filing jointly). While many like-kind exchanges would not be impacted by this proposal, it would effectively eliminate Section 1031 for businesses and individuals with more valuable property.

Section 461(l), which limits non-corporate taxpayers' ability to deduct net excess business losses above a certain threshold ($524,000 for married individuals filing jointly and $262,000 for all other taxpayers in 2021), would be made permanent. Under changes made by the TCJA, section 461(l) is currently scheduled to expire at the end of 2026.

The Green Book also proposes to make certain existing credits for lower-income taxpayers permanent or expand such credits, including premium assistance tax credits for those purchasing health insurance through an Affordable Care Act marketplace, the earned income tax credit for workers without children, the child and dependent care tax credit, the child tax credit and the employer-provided childcare tax credit for businesses.

Finally, the Green Book includes additional information reporting proposals that would apply to both traditional and cryptocurrency assets. Effective for tax years beginning after 2022, the Green Book proposes to require financial institutions to file an annual information return reporting, for each account, gross inflows and outflows with a breakdown for physical cash, transactions with a foreign account, and transfers to and from another account with the same owner. The requirement would apply to all business and personal accounts above a $600 de minimis amount. Similar reporting requirements would apply to crypto asset exchanges and custodians. Further, where taxpayers buy crypto assets from one broker and transfer such assets to another broker, transaction reporting obligations will be imposed on businesses receiving crypto assets valued in excess of $10,000.

Is a Bipartisan Infrastructure Bill in the Cards?

On June 24, the Biden administration announced the Administration's support for the Bipartisan Infrastructure Framework that a group of Democratic and Republican senators, spearheaded by Sen. Kyrsten Sinema (D-AZ) and Sen. Rob Portman (R-OH), negotiated throughout the month of June. Although no legislative language is available yet, the broad contours of the framework are described in a Fact Sheet published on the White House website.

The Framework, which is anticipated to cost $1.2 trillion, includes investments in transportation (transit, rail, roads, bridges, and electric vehicle infrastructure), clean water, universal broadband, energy grid and power; remediation for legacy pollution; and to prepare for the impact of climate change, cyber attacks, and severe weather events. There are several proposed funding sources under consideration but the only tax-specific funding source is a proposal to "reduce the IRS tax gap." Although no details are provided in the Fact Sheet, reducing the tax gap generally refers to increased funding for IRS enforcement and collection of taxes due but unpaid.

Conclusion

Now that Treasury has released the Green Book and taxpayers have the benefit of proposed effective dates and additional information beyond what was provided in the Fact Sheets, taxpayers can model the impact of the proposals on their particular facts with more certainty. In addition, Congress has additional insight into the Biden Administration's preferred policy changes, which will be important as the Ways & Means Committee prepares draft tax legislation. We expect Congress and the White House to focus their efforts on drafting and passing the bipartisan infrastructure bill first, and for the tax changes described in this article to be included in a separate bill. At the time this article was written, there were outstanding procedural and political questions about whether the bipartisan infrastructure bill and the (presumably) Democratic-only tax bill would be "linked" together by Congressional leadership. Regardless of how those questions are resolved, we expect Congress to focus on introducing and passing tax legislation later this summer and in the early fall.

By: Alexandra Minkovich and Varuni Balasubramaniam, Washington, DC

The Road to Venice

On June 5, 2021, the G7 finance ministers released a communique that included a commitment on a path forward for international tax reform. Of the tax items included in the communique, the most notable is a commitment to a global minimum tax rate of "at least 15%" imposed on a country-by-country basis.

Achieving a global minimum tax is a key part of the Biden administration's Stopping Harmful Inversions and Ending Low-tax Development ("SHIELD") proposal. If enacted, SHIELD would deny deductions to corporations for payments made by US companies to foreign related parties that are subject to an effective tax rate that is less than the minimum tax rate agreed to under Pillar Two of the OECD's Inclusive Framework. Absent an agreement at the OECD, the proposal sets the minimum effective tax rate at 21%. Biden's proposal and the Pillar Two Blueprint leave many technical questions unanswered, including how the effective tax rate would be calculated.

The G7's commitment on the minimum tax rate is an important step for the Biden administration, but the minimum tax proposal would still need the approval of the substantially broader set of countries participating in the OECD's Inclusive Framework, let alone Congress. The Biden administration will be managing overlapping domestic and international timelines over the course of this summer and fall. Progress at the international level may affect the success of domestic reforms, and vice versa.

To read more about the specifics of the G7 communique, please see our client alert here.

By: Katie Rimpfel, Washington, DC

A *Jolly* Good Outcome: *Flora*'s Full-Payment Rule Is No Jurisdictional Barrier Where Deficiency Is Improperly Assessed in *Jolly v. United States*

Sometimes bad facts make good law. In a recent order and opinion in *Jolly v. United States*, No. 20-412 (Ct. Cl. May 20, 2021) ("order"), Judge Ryan T. Holte of the US Court of Federal Claims ("the Court") denied the Government's motion to dismiss for lack of jurisdiction, holding that Maketa Jolly "could possibly have fully paid her tax liability" for a year that the IRS had not proven it properly assessed the deficiency. The order addresses a largely unexplored intersection of the jurisdictional full payment rule articulated in *Flora v. United States*, 357 U.S. 63, 75 (1958), and the deficiency assessment procedures in Code Sections 6012 and 6013.

Facts and Procedural Background

Ms. Jolly sought refunds of income taxes for four years: 2016, 2017, 2018, and 2019.

2016–2019 Tax Years

Ms. Jolly timely filed her 2016 income tax return, and received a refund of $2,392. The IRS audited her 2016 tax year, and issued her a notice of deficiency that "result[ed] in a $1,965.00 increase to Ms. Jolly's 2016 tax liability." The notice stated that the last date for her to petition the US Tax Court to redetermine her 2016 deficiency was July 8, 2019. Ms. Jolly did not pay the deficiency stated on the notice.

Ms. Jolly timely filed her 2017 income tax return, and received a refund of $6,863. The court wrote, "according to the government, on 9 July 2018, the IRS assessed a total of $6,371.16 in Ms. Jolly's tax liability." Critically, the court found that the Government could not locate a notice of deficiency issued to Ms. Jolly in advance of the assessment of her 2017 tax liability.

Ms. Jolly timely filed her 2018 and 2019 income tax returns, on which she claimed refunds (*i.e.*, she claimed she had overpaid her tax due for both years). For both years, the IRS applied Ms. Jolly's claimed 2018 and 2019 refunds (of $1,947 and $1,255, respectively) to her 2017 balance. After the application of the 2018 and 2019 refund amounts, Ms. Jolly's 2017 "additional taxes due . . . . [were] assessed to be $2,069.20 as of 5 October 2020 . . . ." Ms. Jolly did not pay that $2,069.20 amount.

Proceedings at the Tax Court

On September 17, 2019, Ms. Jolly filed a petition with the Tax Court seeking a redetermination of the tax due for her 2016, 2017, and 2018 tax years. The Tax Court dismissed Ms. Jolly's petition with respect to her 2016 tax year as untimely. It dismissed her petition with respect to her 2017 and 2018 tax years for lack of jurisdiction because no valid notice of deficiency had been issued for those years.

Proceedings at the Court of Federal Claims

On April 6, 2020, Ms. Jolly filed her complaint with the Court of Federal Claims seeking a refund for her 2016, 2017, 2018, and 2019 tax years. The Government moved to dismiss her refund claims for 2016 and 2017 for lack of subject-matter jurisdiction, and for 2018 and 2019 for failure to state a claim.

The Government argued that the Court lacked jurisdiction as to Ms. Jolly's 2016 and 2017 tax years because she had not paid "her alleged tax liabilities" before filing a refund suit, thereby violating *Flora*'s full payment rule. Ms. Jolly contended that she had satisfied the *Flora* full payment rule because she had paid the tax she determined was due for 2016 and 2017. In the alternative, Ms. Jolly argued that the "IRS violated 'the Internal Revenue Code' . . . . by failing to provide 'tax liability deficiency notices' 'prior to the assessment of a deficiency.'"

With respect to Ms. Jolly's 2018 and 2019 tax years, the Government argued that Ms. Jolly had failed to state a claim upon which relief may be granted because she had already received her 2018 and 2019 refund payments as applied to "her alleged 2017 tax debt." The parties did not dispute that given Ms. Jolly's 2018 and 2019 refunds had been applied to her 2017 tax liability, any controversy over her 2018 and 2019 tax years would be resolved by a determination of her 2017 liability.

Law and Analysis

Law

In order to maintain a suit for refund in a district court or the Court of Federal Claims, the taxpayer must make "full payment of the assessment" of the tax that is seeks to be refunded. *See Flora*, 357 U.S. at 75 (resolving whether 28 U.S.C. section 1346(a) demands full payment). This is known as the "full payment" rule, and it is jurisdictional. *See Abruzzo v. United States*, 24 Cl. Ct. 668, 670 (1991). In general, the party availing itself of the Court's jurisdiction has the burden of proving jurisdiction. *Acevedo v. United States*, 824 F.3d 1365, 1368 (Fed. Cir. 2016).

In construing motions to dismiss, the court must accept as true all undisputed facts and draw reasonable inferences in favor of the non-moving party. *Id.* Though ordinarily the court is confined to the allegations in the pleadings, where a party seeks to dismiss a case for lack of jurisdiction, and a fact underlying jurisdiction is in dispute, the court may "weigh evidence" and "find facts," all of which must be construed in favor of the non-movant. *Knight v. United States*, 65 F. App'x 286, 289 (Fed. Cir. 2003). A court will not dismiss a complaint for failure to state a claim where the complaint is plausible—it contains "sufficient factual content that allows the court to draw reasonable inferences that the defendant is liable for the misconduct alleged." *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). Though a pro se litigant must establish jurisdiction in her pleadings, a court will construe the pleadings with “less stringent standards than the formal pleadings drafted by lawyers.” *Hughes v. Rowe*, 449 U.S. 5, 9 (1980).

A deficiency is the correct tax minus the tax reported and amounts previously assessed, with certain exceptions not relevant here. *See* section 6211(a). In general, the IRS may not assess a deficiency until the IRS first mails a notice of deficiency to the taxpayer. *Bush v. United States*, 655 F.3d 1323, 1328 (Fed. Cir. 2011) (en banc). Judge Holte wrote: “Applying *Bush*, the Court of Federal Claims has previously ruled, aside from computational adjustments, the IRS is ‘statutorily obligated to serve taxpayers with a notice of deficiency.’ *Mandich v. United States*, 124 Fed. Cl. 209, 215 (2015).” Judge Holte further wrote: “In *Welch v. United States*, the Federal Circuit reversed the Court of Federal Claims’ summary judgment decision regarding a 1995 tax assessment and entered judgment in favor of the plaintiff ‘with respect to the refund they seek for the deficiency paid relating to the 1995 tax year,’ because the government failed to meet the burden of proof of mailing a notice of deficiency for that tax year. *Welch v. United States*, 678 F.3d 1371, 1382–83 (Fed. Cir. 2012).”

Analysis

In determining the jurisdictional question of whether Ms. Jolly fully paid her tax liabilities for 2016 or 2017, Judge Holte framed the disputed fact as “whether the IRS issued a notice of deficiency before assessing Ms. Jolly’s personal tax for 2016 and 2017 . . . .” Though he did not spell it out in so many words, Judge Holte was looking to whether the 2017 notice of deficiency was ever issued because if it was never issued, then the assessment of the 2017 deficiency was invalid, and therefore was no 2017 deficiency. Without a deficiency for 2017, Ms. Jolly had already satisfied *Flora*’s full payment rule.

To determine whether the notice of deficiency was issued for 2016 and 2017, the court looked to the Tax Court’s order dismissing Ms. Jolly’s deficiency petition and to the Government’s filings. For 2016, the Tax Court held that a notice of deficiency had been issued, but Ms. Jolly had filed her petition too late. Judge Holte held that the Government had met its burden of showing a 2016 notice of deficiency had been issued. For 2017, the Tax Court found that a notice of deficiency had never been issued. And in its motion to dismiss at the Tax Court, the Government alleged that “no notice of deficiency was issued to petitioner for tax years 2017 or 2018 . . . .” *Jolly v. Comm’r*, No. 17172-19 (T.C. Mar. 11, 2020). In its reply, the Government alleged that it was “unable to obtain the IRS administrative file for the 2017 tax year. Presumably, however, a similar notice of deficiency was issued with respect to that year.” Judge Holte held that for the purpose of the Government’s motion to dismiss, the IRS may not have issued Ms. Jolly a notice of deficiency for 2017, and therefore also held that “Ms. Jolly may not owe the IRS the levied deficiency for 2017, allegedly $6,371.76.”

On June 17, 2021, the Government filed a motion for reconsideration. That motion remains pending.

Taxpayer Takeaways

Jolly's key takeaways derive from the necessity of a valid deficiency assessment.

***Flora*'s full payment rule can be met where the deficiency assessment was invalid.** This application of *Flora* is novel due to the unique facts of the case, but it follows from the Code. There is no deficiency unless there has been a valid assessment of one. Absent a deficiency, there was nothing more for Ms. Jolly to fully pay for 2017; therefore, she had satisfied *Flora*'s full payment rule.

Courts may effectively estop the Government from taking conflicting positions in different litigation over the same issue. Judge Holte noted that Ms. Jolly was foreclosed from litigating her 2017 dispute in the Tax Court because there, the IRS successfully argued that the Tax Court lacked jurisdiction over the claim as the IRS had never issued a notice of deficiency for her 2017 tax year. Yet in the Court of Federal Claims, the Government argued that it had issued Ms. Jolly a 2017 notice of deficiency. Such a drastic change in position not only would deprive Ms. Jolly of a venue to litigate her tax controversy but is also unfair to litigants and the judicial system. Judge Holte may have considered the Government's change in position but was unwilling to sua sponte raise such a powerful defense as collateral estoppel (*i.e.*, issue preclusion) or judicial estoppel.

By: Daniel Rosen and Sonya Bishop, New York

Settlement Payments Deductible for Liquidating Subsidiary, Service Says

In a heavily redacted technical advice memorandum released on April 23, 2021, the IRS considered whether an insolvent liquidating subsidiary could deduct certain liabilities. In TAM 202116012, multiple entities within a consolidated group, including the company at issue and its direct parent (which was a second-tier subsidiary of the US parent of the consolidated group) were subject to a number of products liability claims in a multidistrict litigation proceeding. The entities resolved the claims by entering into several master settlement agreements ("MSAs") with the claimants. The company at issue, which was then insolvent, converted from a C corporation into a limited liability company and checked the box to be treated as a disregarded entity, causing its parent to acquire all of its assets and assume all of its liabilities for tax purposes. The company at issue included the fixed and determinable portion of the settled liabilities arising from the MSAs in its amount realized on the deemed liquidation and sought to deduct those liabilities on its consolidated group's return for the year that included the conversion and deemed liquidation.

Section 162 generally allows taxpayers to take a deduction for all ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. Settlement payments related to a taxpayer's business generally are deductible under section 162. *See* Rev. Rul. 80-211, 1980-2 C.B. 57 ("the courts and the Service have recognized that payments made in settlement of lawsuits are deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business"). Determining *when* a deduction is allowed, however, can be just as important as (and potentially more complicated than) determining *if* a deduction is allowed. Section 461 provides that any deductions allowed must be taken in the proper taxable year according to the method of accounting used by the taxpayer in computing taxable income. For taxpayers using the accrual method of accounting, like the company at issue in TAM 202116012, Treas. Reg. § 1.461-1(a)(2)(i) provides that the proper taxable year to account for a liability is the taxable year in which (1) all events have occurred establishing the fact of the liability, (2) the amount of the liability can be reasonably ascertained, and (3) economic performance has occurred with respect to the liability. The rules for determining when economic performance occurs largely depend on the type of liability at issue. For liabilities arising from torts, breaches of contract, and violations of law, economic performance generally is treated as occurring only when the liability is paid. Treas. Reg. § 1.461-4(g)(2). If, in connection with the sale or exchange of a trade or business, the transferee expressly assumes an accrued liability arising out of that trade or business that the transferor would have been entitled to deduct (or otherwise take into account for tax purposes) at the time of the sale or exchange *but for* the economic performance requirement, economic performance with respect to the liability coincides with the liability being included in the transferor's amount realized on the transaction. Treas. Reg. § 1.461-4(d)(5)(i).

The only issue publicly addressed in TAM 202116012 is whether the parent company assumed the subsidiary's MSA liabilities such that the economic performance requirement was met. Citing Rev. Rul. 2003-125, 2003-2 C.B. 1243, the IRS explained that because the subsidiary company was insolvent at the time of its conversion to a disregarded entity, the parent company could not be treated as acquiring the subsidiary's assets and liabilities in exchange for the parent's stock in the subsidiary. Instead, the parent had to be treated as purchasing the subsidiary's assets in exchange for the parent's assumption of the subsidiary's MSA liabilities (either by direct assumption of those liabilities or by taking the subsidiary's assets subject to those liabilities). Thus, the IRS concluded that the economic performance requirement was satisfied under Treas. Reg. § 1.461-4(d)(5)(i), and the subsidiary was consequently allowed a deduction under section 162 for its MSA liabilities.

By: Linnie Benezech, Miami and Neil Donetti, Chicago

The Application of the Claw-back Adjustment under the Section 163(j) Regulations Capped by the IRS Clarification

Marie Milnes-Vasquez of the IRS Office of Associate Chief Counsel (Corporate) recently provided clarification on the scope of the final claw-back adjustment under the section 163(j) regulations, specifically noting that not all gain on the disposition of subsidiary stock would be subject to claw-back adjustment. The clarification came after the IRS had received numerous comments on the application of the claw-back adjustment to the consolidated return rules under the section 163(j) regulations.

On January 5, 2021, Treasury and the IRS released 2021 Final Regulations (T.D. 9943) with guidance on the business interest expense limitation under Code Section 163(j), only about four months after releasing the 2020 Final Regulations (T.D. 9905). The 2017 Tax Cuts and Jobs Act ("TCJA") and the 2020 Coronavirus Aid, Relief and Economic Security Act ("CARES Act") amended section 163(j) to limit the business interest expense deduction. Under the amended section 163(j)(1), a taxpayer's business interest expense deductions are limited to the sum of business interest income, 30% (or 50%, as temporarily raised by the CARES Act) of adjusted taxable income ("ATI"), and the taxpayer's floor plan financing interest for the tax year. The 2021 final regulations provide important guidance and changes to the rules set forth in the 2020 final regulations and, in particular, clarify the claw-back adjustment for computing ATI.

In general, pursuant to section 163(j)(8)(A), ATI is calculated in a manner similar to earnings before interest, taxes, depreciation and amortization (EBITDA) for tax years beginning prior to Jan 1, 2022 (the "EBITDA period"), but is scheduled to be calculated similar to earnings before interest and taxes (EBIT) for tax years beginning after Dec. 31, 2021. Furthermore, section 163(j)(8)(B) grants Treasury the authority to mandate other adjustments beyond those enumerated in section 163(j)(8)(A). Pursuant to the authority given under section 163(j)(8)(B), Treasury and the IRS provided rules to prevent taxpayers from getting a potential double benefit during the EBITDA period. For instance, the availability of immediate full depreciation of property under section 168(k) increases the 30% of ATI cap, which allows taxpayers to take a larger interest expense deduction. It also allows taxpayers to get another benefit on the recognized gain when such fully depreciated property is sold.

As an example, assume taxpayer B acquires asset M in 2019 for $100, which it fully depreciates under section 168(k). B's 2019 ATI would be increased by the $100 of depreciation. In 2021, B sells asset M for $50, resulting in a $50 gain as the tax basis in fully depreciated asset M is $0. B's 2021 ATI would increase by this $50 gain on the sale of asset M. In both years, increased ATI would allow the taxpayer to take larger business interest expense deductions.

Claw-back Adjustment

To prevent taxpayers from getting a potential double benefit during the EBITDA period, the 2020 final regulations impose an ATI claw-back adjustment with respect to a sale or other disposition of certain property to reverse prior EBITDA period ATI adjustments. For instance, upon a sale of property that has a basis affected by amortization, depreciation or depletion for the EBITDA period, ATI must be reduced by the full amount of the basis adjustments in the property with respect to such amortization, depreciation or depletion. The 2020 final regulations further provide that with respect to the sale or other disposition of stock of a member of a consolidated group by another member, ATI must be reduced by "the investment adjustments under § 1.1502–32 with respect to such stock that are attributable" to any amortization, depreciation or depletion deductions taken during the EBITDA period. For instance, in the same example as above, B's 2021 ATI includes the $50 gain but is also reduced by $100 (i.e., the full depreciation amount of the EBITDA period) under the 2020 final regulations.

The 2021 final regulations instead permit a taxpayer to compute its adjustment to ATI upon the disposition of property, member stock or a partnership interest by determining "the lesser of" (i) the amount of gain on the sale of such property, member stock or partnership interest, and (ii) the amount of amortization, depreciation or depletion deductions with respect to such property, member stock or partnership interest for the EBITDA period that would otherwise decrease ATI.

Therefore, in the same example as above, if B elects to apply the "lesser of" rule under the 2021 final regulations with respect to the sale of asset M, B's 2021 ATI would only be reduced by $50, as the $50 gain recognized on the sale is less than the $100 of depreciation taken during the EBITDA period.

Consolidated Return Rules

For dispositions of a consolidated group member's stock, complexities arise in determining the claw-back adjustment for computing ATI. Some taxpayers noted that the scope of the final claw-back adjustment was expanded to include "any transaction, even where it doesn't involve a double benefit."

As an example, assume P, the parent of a consolidated group, owns the stock of subsidiary 1 ("B"), and B owns the stock of subsidiary 2 ("M"). M acquired depreciable property in 2019 and fully depreciated it in that year. B owns other non-depreciated assets, and in 2021 P sells its B stock to an unrelated buyer, thereby recognizing a gain.

Under the new Treas. Reg. § 1.163(j)-1(b)(1)(iv), such transaction is considered a deemed disposition of the stock of B and M because both subsidiaries are leaving the consolidated group. A plain reading of the regulation indicates that the claw-back adjustment would apply to both B and M even though B does not directly own the depreciated property. This is because the parent's (P's) basis in the stock of subsidiary 1 (B) includes investment adjustments potentially attributable to the depreciation deduction (of M's property).

Regarding this confusion, Milnes-Vasquez clarified that "not all gain on the disposition of subsidiary stock would be subject to claw-back." She further explained (referring to the above example) that there would only be a claw-back on the gain on the disposition of the M stock and not on the B stock. Yet this would change "if a depreciable property had been held in B when the deduction was claimed and was later transferred to M, then the subsequent sale of B stock by the parent would require assessing the gain on both the B and M stock," Milnes-Vasquez said.

Milnes-Vasquez acknowledged that the IRS should “go back and clarify” the application of the claw-back adjustment to the consolidated return rules under the section 163(j) regulations. For now, until further guidance is released, such application is limited to the clarification given by the IRS official.

By: Eric Min, New York

U.S. Tax Court Tells IRS to Beat It in *Estate of Jackson v. Commissioner*

On May 3, 2021 the U.S. Tax Court issued its opinion in the highly anticipated valuation case of *Estate of Jackson v. Commissioner*, T.C. Memo 2021-48, valuing three of the estate's assets: (1) Michael Jackson's image and likeness, (2) a partial ownership interest through a trust in Sony/ATV Music Publishing, LLC (Sony/ATV), and (3) a full ownership interest through a trust in Mijac Music (“Mijac”), a music-publishing catalog. In a lengthy 271 page opinion by Judge Mark Holmes, the Tax Court found the value of the assets in question to be approximately $111.5 million collectively, much less than the approximately $481.9 million valuation determined by the IRS, for purposes of the estate tax under Internal Revenue Code Section 2001.

Michael Jackson was, and still is, one of the most well known celebrities in the world. Although at the time of his death his albums had set world-record sales, the King of Pop's reputation and finances were in dire straits due to prior criminal accusations and prosecution. While Jackson could still sell out concerts, sponsors would not attach themselves to his name, and his assets were subject to major debts.

Jackson started his career singing with his brothers as part of the Jackson 5, and he later launched a solo career. Jackson's fame continued to rise with the release of *Thriller*, which is still the top-selling album of all time. Jackson's musical feats led to financial success and on the advice of his team he started buying copyrights in other artists' musical compositions. Most notably in 1985 he bought the ATV Music publishing catalog which included 175 Beatles songs. Jackson also formed Mijac, a music catalog that held the publishing rights for the compositions of various composers including Jackson himself.

Jackson thereafter continued to release albums and tour, but by 1993, his personal behavior would eventually lead to a tort lawsuit that included accusations of sexual battery of a minor followed by a criminal investigation. Although Jackson was not criminally charged, by 1995, his financial troubles began, following declining corporate sponsorships. On the advice of his advisors, he merged his ATV Music catalog with Sony's music publishing business, forming Sony/ATV. While his 50% interest in Sony/ATV provided Jackson with steady income, it was not enough to keep up with his spending. He thus started borrowing against his interests in Sony/ATV and, eventually, Mijac.

Jackson’s financial situation continued to deteriorate following an additional criminal investigation, a trial, and subsequent acquittal in the mid-2000s. In early 2009, Jackson made a deal with AEG Live to perform in the "This Is It" concert tour and giving AEG Live the right to develop three feature films. Tickets for concerts sold out almost instantly, but organizers could not find any sponsors or merchandising deals for the tour due to Jackson's personal reputation. Jackson was killed just three weeks before the tour was set to begin. At the time of his death, Jackson's interest in Sony/ATV was subject to $303 million in loans and his interest in Mijac was subject to $72 million in debt.

Widely Disparate Valuations of the Estate's Assets

By the time of the Tax Court trial, the Jackson Estate and the IRS had resolved many of their arguments but continued to disagree on the value of three of Jackson's assets: (1) his image and likeness, (2) his interest in Sony/ATV and (3) his interest in Mijac. The parties' valuations on all three assets were miles apart.

The Estate initially reported that Jackson's image and likeness was worth only $2,105, "the price of a heavily used 20-year old Honda Civic." This was based on an appraisal by a large accounting and consulting firm, which found that Jackson had earned almost nothing from his image and likeness during the last years of his life. At the time of trial, the estate had increased their valuation to just over $3 million. The IRS, on the other hand, valued Jackson's image and likeness at just over $161.3 million. The court found the Jackson Estate valuation more credible and valued his image and likeness at just under $4.2 million.

The Tax Court's valuation finding of Jackson's interest in Sony/ATV was another blow to the IRS. There the IRS has argued for a valuation of just under $206.3 million, but the court agreed with the Estate and found that due to the associated debt, the interest was worthless.

The IRS's sole victory came in the valuation of the third asset – Jackson's interest in Mijac. The Estate argued it was worth just under $2.3 million, while the IRS argued it was worth just under $114.3 million. The court found the IRS's valuation more accurate and valued it at just over $107.3 million.

In a "Battle of the Experts," Credibility Matters

While this case most directly addresses the valuation of large estates, and the associated technical inputs that go into various economic analyses, it also reaffirms the lesson of the importance of expert credibility for any taxpayer litigation. As the court explained, valuation disputes are questions of fact, which means they are often "battles of the experts." While courts are not bound by an expert's opinion and are free to accept or reject them in whole or in part, credible experts and reasonable valuations are key to persuading the court that one's valuation is the most accurate. This is especially true when the court is valuing a novel and potentially high value asset.

For trial, the Jackson Estate retained four experts: two to value Jackson's image and likeness, one to value Jackson's interest in Sony/ATV and one to value Jackson's interest in Mijac. In contrast, the IRS relied on only one expert, the chairman of an intellectual-property consulting firm, to value all three assets at issue.

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Because the IRS had only one expert, it was especially important that he be credible. Unfortunately for the IRS, the court was so unimpressed by the IRS's expert that it dedicated a section of the opinion to his credibility. The Tax Court details multiple false statements by the expert, including lying about not having worked with the IRS on another valuation and testifying that his firm never advertised his participation in the case to promote the business when it actually had. The court noted that while there is nothing wrong with either activity, his testimony undermined his credibility. As a result the court discounted "the credibility and weight" given to the expert's opinions which affected the court's "factfinding throughout" the case.

Even setting aside these issues, the Tax Court found the IRS expert's valuation deficient as unreliable and unpersuasive. The court rejected his valuation of Jackson's image and likeness, partly because he valued the wrong asset. The court found that his valuation included not only Jackson's image and likeness, but also non-image and likeness rights, such as copyrights, and completely failed to distinguish between them. According to the Tax Court, the IRS expert's overbroad description of the asset subject to valuation was made consciously to reach a higher valuation. In particular, he had authored an earlier draft report that included only image and likeness rights, the items that were protected under California law and that were in dispute. Not only was the IRS's valuation of the asset overbroad, but the valuation methodology also incorporated unforeseeable events. The court found that four of the five revenue streams traceable to Jackson's image and likeness included in the IRS's valuation were unforeseeable at the time of his death, and therefore could not be included in the Jackson Estate's value. Moreover, the IRS expert generally miscalculated the valuation of such rights through faulty math. As a result the court described the IRS expert's valuation of Jackson's image and likeness as "pure fantasy."

Next, the IRS expert valued the Sony/ATV interest based on two general valuation approaches - the income (in particular, the discounted cash flow) method and the market approach. Importantly, with respect to the market approach, the court took issue with the valuation of Sony/ATV as a music catalog instead of the music-publishing company it is. Although the court eventually dismissed the market approach as being inapplicable, the court concluded that if it had been applied, the interest would have been required to be valued based on Sony/ATV being an operating business. Again, categorizing an asset properly for valuation purposes is a basic, key initial step.

Finally, with respect to the valuation of Mijac, although the Tax Court recognized it was a complex factual and economic issue, the Tax Court was left "with a mess" by both the IRS and the taxpayer. The IRS expert's credibility was "shaky at best." But the court was also unconvinced by the Jackson Estate's expert because he did not provide explanations for some of his projections used in the valuation, and there were inconsistencies between his report's verbal descriptions and his actual calculations. At one point, the court said that the Jackson Estate expert's "lack of clarity makes it difficult to believe his projections." Given the state of the record with respect to the Mijac asset valuation, the court in the end relied on the IRS and its expert's inputs over the Jackson Estate's assertions multiple times. That is not to say that the IRS had a free pass on the valuation of this last asset – quite the contrary– the court also found various deficiencies in the IRS's valuation approach.

Overall, a general lesson to be learned from this opinion is that an overly aggressive valuation weakens its credibility. Here, the IRS overreached, especially in its valuation of Jackson's image and likeness. On the other hand, making certain strategic concessions that are not favorable to one's case adds credibility. For example, the court acknowledged that by using a value in the higher range for the valuation of the Sony/ATV interest, the Jackson Estate's expert opinion was "rhetorically stronger by being a bit unfavorable to the Estate."

In short, when it comes to valuation disputes, as well as other issues, it is critical to pick, support and oversee one's experts carefully.

By: Ivan Morales, Palo Alto and Katie Scull, (Summer Associate), San Francisco

Maryland Amends its Digital Advertising Gross Revenues Tax, Creating Additional Constitutional Infirmities

Maryland legislators passed Senate Bill 787, which proposed several significant amendments to Maryland's digital ad tax. If enacted, this tax would raise serious constitutional concerns involving the Dormant Commerce Clause, First Amendment, Contract Clause, Equal Protection Clause, and Due Process Clause. Additional changes were made to Maryland's sales and use tax provisions to clarify the recently enacted definition of "digital products."

For more information, please see "*Maryland Amends its Digital Advertising Gross Revenues Tax, Creating Additional Constitutional Infirmities*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Kelsey Muraoka, New York

Connecticut's Digital Advertising Tax Continues to Move Forward

Connecticut legislative leaders recently announced support for a digital advertising tax ("Connecticut Digital Advertising Tax") proposed by the Connecticut Joint Committee on Finance, Revenue and Bonding (the "Finance Committee"). Connecticut joins Maryland, Massachusetts, New York, and Texas, among others, as states with concrete digital advertising tax proposals on the table (and in Maryland's case, an enacted law). The Connecticut Digital Advertising Tax proposals are similar to Maryland's enacted digital ad tax. Namely, "digital advertising services" is defined as "advertisement services on a digital interface, including banner advertising, search engine advertising, interstitial advertising and other comparable advertising services." This definition is nearly identical to Maryland's definition. The "assessable base" is defined as

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"annual gross revenues derived from digital advertising services in the state." The tax rate schedules are also identical to those in Maryland: the tax rates range from 2.5% to 10% of the assessable base and the rate increases according to *global* annual gross revenues. If passed, the Connecticut Digital Advertising Tax would become effective January 1, 2022.

For more information, please see "*Connecticut's Digital Advertising Tax Continues to Move Forward*" on the SALT Savvy blog, available at www.saltsavvy.com.

By: Joshua Lin, Los Angeles

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