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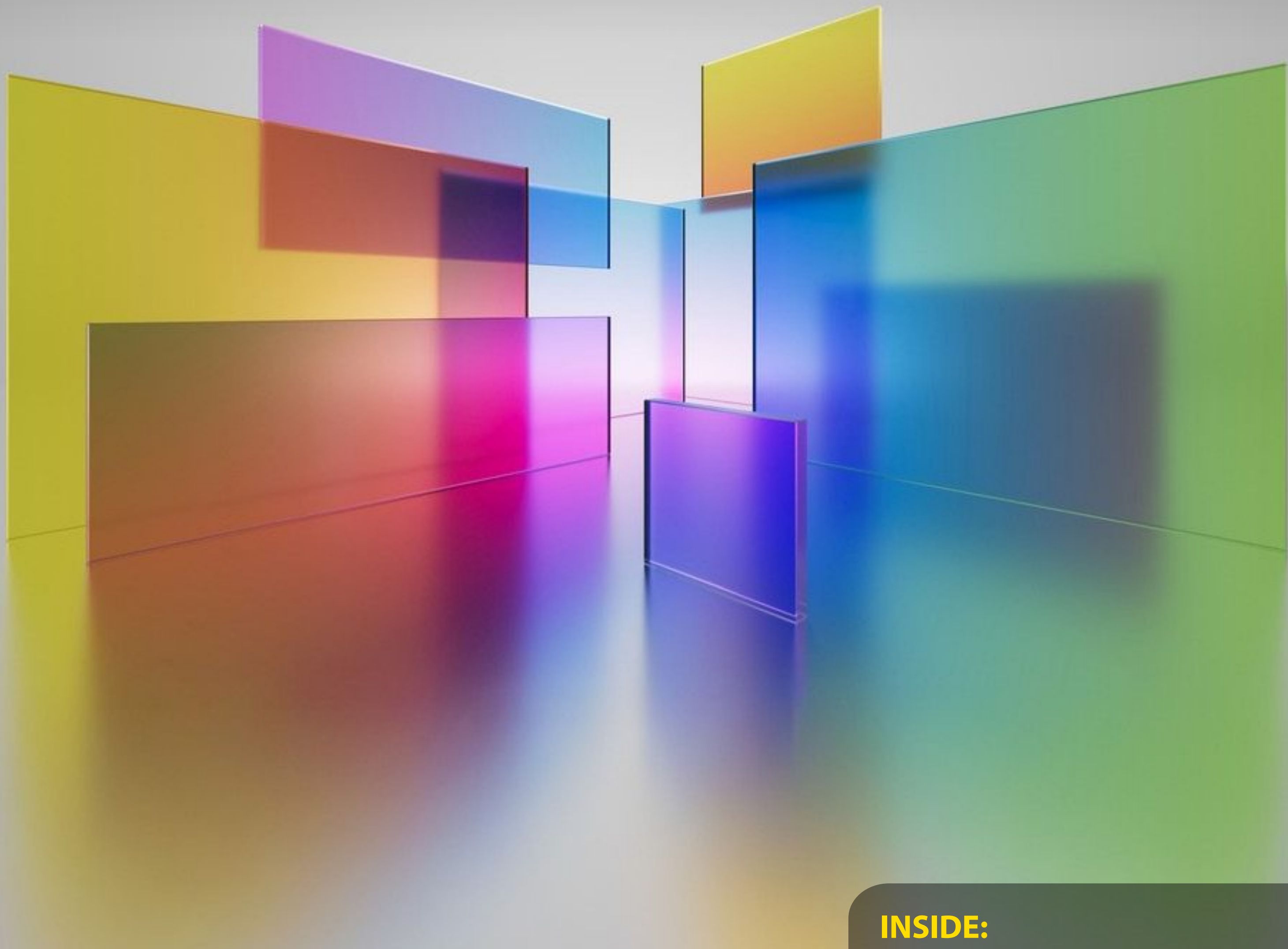
CPA firm M&A tax issues



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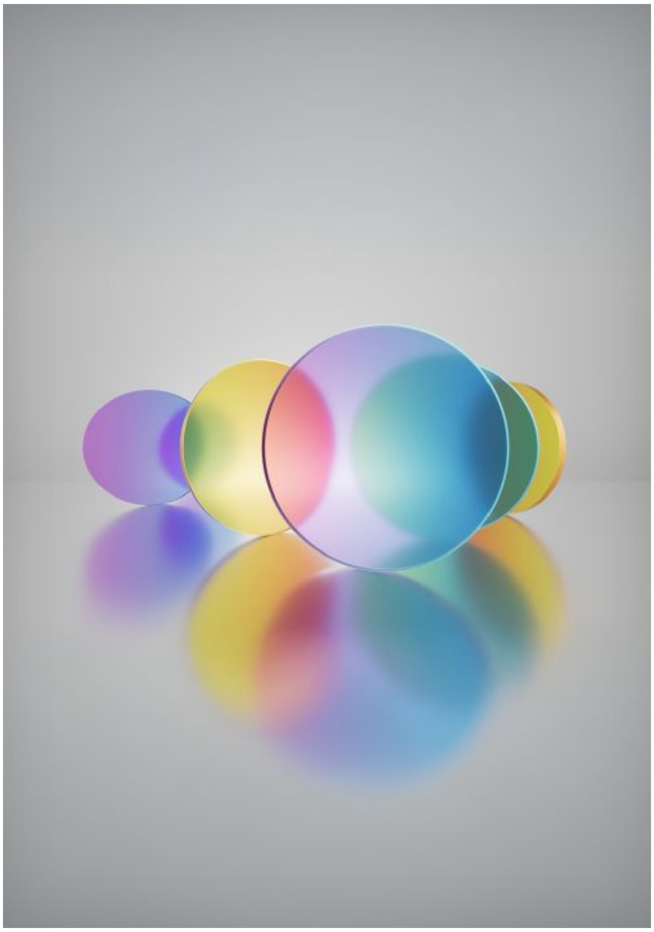

42 CPA firm M&A tax issues

By Paul N. Iannone and Danny A. Pannese

Just as for other businesses, tax considerations come to the fore when CPA practices combine. This article delves into some of the possible entity deal structures for CPA firm mergers and acquisitions and the potential tax issues they present.

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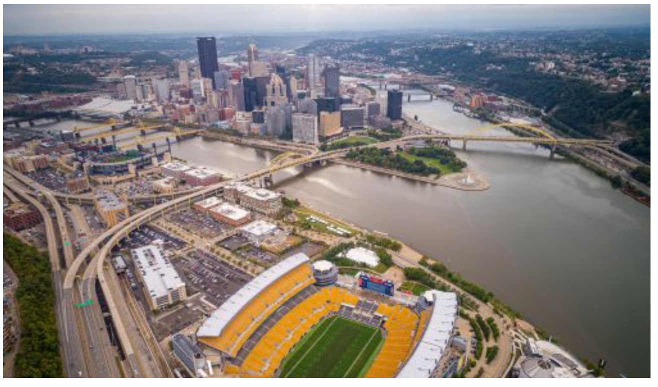

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TAX CLINIC

Practical advice on current issues.

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Deductibility of transaction costs incurred by an indirectly acquired entity

Expenses incurred by a buyer or target while pursuing a merger or acquisition (M&A) transaction are subject to various rules that limit the deductibility of such costs as incurred. These rules include Regs. Sec. 1.263(a)-5 and Sec. 195, which provide the framework for the treatment of expenses incurred in M&A transactions and help determine whether expenses may be deducted or must be capitalized as a result of the transaction for both buyers and sellers.

One important issue in determining the deductibility of transaction costs that is not thoroughly addressed by Regs. Sec. 1.263(a)-5 and subsequent IRS guidance is which is the proper party to account for expenses in transactions where multiple entities are involved in the transaction process. While case law such as *Square D Co.*, 121 T.C. 168 (2003), has addressed which is the proper party to take into account an expense that was incurred on behalf of such a party, guidance in the application of such rules to transaction expenses has been limited. In IRS Letter Rulings 202443001 and 202448003, the Service indirectly addressed a situation in which it is unclear under Regs. Sec. 1.263(a)-5 which taxpayer takes into account target-side transaction expenses. The letter rulings indicate that the target under Regs. Sec. 1.263(a)-5 may not always be the entity that was directly acquired in a transaction.

Rules

The general rule under Regs. Sec. 1.263(a)-5 requires taxpayers to capitalize amounts paid to facilitate certain transactions without regard to whether gain or loss is recognized in the transaction. Under Regs. Sec. 1.263(a)-5(e)(3), for "covered transactions," the IRS provides additional guidance as to what is considered a cost that facilitates the transaction. For it to qualify as a covered transaction, the taxpayer must be engaged in one of the following: (1) a taxable acquisition by the taxpayer of assets that constitute a trade or business; (2) a taxable acquisition of an ownership interest in a business entity, regardless of whether the taxpayer is the acquirer or the target if, immediately after the acquisition, the acquirer and the target are related within the meaning of Sec. 267(b) or 707(b); or (3) a reorganization described in Sec. 368(a)(1)(A), (B), or (C) or a reorganization described in Sec. 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under Sec. 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization). For covered transactions, the IRS has also issued a safe-harbor provision in Rev. Proc. 2011-29, under which electing taxpayers are permitted to treat 70% of any success-based fee (fees that were contingent upon the successful closing of the transaction) as an amount that does not facilitate the transaction (potentially leading to the amount being deducted by the taxpayer).

While Regs. Sec. 1.263(a)-5 addresses the treatment of transaction costs for the acquirer and target, Regs. Sec. 1.263(a)-5 fails to define "acquirer" and "target," which can be difficult to determine when multiple entities are involved in the transaction. In a simple transaction, it may be easy to identify buyer and target costs, as each party likely engages the service providers directly. However, in a transaction where multiple entities or a consolidated group is involved, a lower-tier entity that is not the buyer or target identified in the agreement may incur, engage, and pay service providers involved in pursuing and

The general rule under Regs. Sec. 1.263(a)-5 requires taxpayers to capitalize amounts paid to facilitate certain transactions without regard to whether gain or loss is recognized in the transaction.

investigating the transaction. Historically, there has been uncertainty surrounding the treatment of expenses incurred by these lower-tier entities and the proper party to take a deduction.

Prior case law has addressed the proper party to take a deduction more generally. In *Hood*, 115 T.C. 172 (2000), the Tax Court applied the "primary benefit" standard in deciding that a corporation was not entitled to deduct the legal fees incurred by its sole shareholder. In *Hood*, the court stated that the proper party to take a deduction is the one that receives the direct and proximate benefit; however, there is still uncertainty in how to apply this case law in the transaction-cost context.

Analysis

The IRS provided some guidance in Letter Ruling 202443001, where an indirectly acquired entity was permitted to take deductions for costs incurred related to the acquisition by Parent, a corporate owner of an affiliated group of corporations that filed a consolidated federal income tax return. While this letter ruling did not directly address the issue of which was the proper party to take into account expenses from a transaction, the IRS granted relief under Regs. Sec. 301.9100-3 to permit the taxpayer to make a safe-harbor election under Rev. Proc. 2011-29, which should be permitted only if the taxpayer was the proper party to take into account the transaction expenses.

In the letter ruling, the taxpayer, a limited liability company taxed as a partnership for federal income tax purposes, was owned directly by two corporate holding companies (Holdcos), which were owned by multiple shareholders (Sellers). The stock of the Holdcos was acquired by a disregarded entity of a corporation (Buyer) from the Sellers. In the letter ruling, the taxpayer (the partnership held by the Holdcos) represented that the Holdcos did not sell their interests in the taxpayer, but rather, Sellers sold their stock interests in Holdcos to Buyer.

In connection with the transaction, the taxpayer engaged a financial adviser to assist in investigating and pursuing the transaction. The financial adviser's fees were contingent upon the successful closing of the transaction, and the financial adviser was paid by a payment agent from the transaction closing payment funds flow.

After the consummation of the transaction, Parent engaged an accounting firm to prepare the tax returns for the taxpayer and Holdcos. On its tax return including the date of the transaction, the taxpayer failed to properly elect safe-harbor treatment under Rev. Proc. 2011-29 and capitalized the entire success-based fee. The taxpayer then sought relief from the IRS under Regs. Sec. 301.9100-3 to be permitted to make a late election under Rev. Proc. 2011-29. The IRS granted the taxpayer relief to elect success-based treatment for the contingent fees under Regs. Sec. 301.9100-3, finding that the taxpayer acted in good faith and relief would not prejudice the interests of the government. While the proper party to take into account the transaction expenses was not directly addressed by the IRS in its conclusion

— and the IRS even specifically stated that it expressed no opinion as to whether the taxpayer was the proper legal party to make the safe-harbor election and claim the deduction — the IRS has denied granting relief under Regs. Sec. 301.9100-3 when it believed the taxpayer was the incorrect party to account for such expense (see, e.g., Letter Ruling 202308010).

Additionally, in Letter Ruling 202448003, the IRS held that an indirectly acquired entity was the proper party to take into account transaction expenses when an interest in its holding company, which was a partnership, was sold, and the IRS permitted the expense to be taken at the level of the lower-tier corporation that the partnership held.

Commentary

As stated above, a covered transaction includes a taxable acquisition of an ownership interest in a business entity where the acquirer and target are related immediately afterward, under Sec. 267(b) or 707(b). In a transaction such as Letter Ruling 202443001, where two holding companies are directly acquired and own an operating entity, it is unclear under the regulations whether the directly acquired holding company should be treated as the "target" referenced in the regulations or whether the definition of "target" extends to the operating entity indirectly acquired as a result of the transaction.

While the IRS did not directly conclude whether the transaction in Letter Ruling 202443001 qualified as a covered transaction or whether the taxpayer was the proper party to take the deduction, the Service accepted a representation that the transaction constituted a covered transaction between the taxpayer and Buyer, which the Service would not likely have accepted if it took issue with the substantive legal conclusion that Target was the proper party to take into account the transaction expenses. Particularly considering that the proper party to take transaction expenses was recently indicated as the reason a letter ruling was denied (see Letter Ruling 202308010), the Service's granting of relief seems to indicate support for the position that the proper party to take expenses related to a transaction is not required to be the entity that was directly acquired by the buyer.

A question remains, then, whether the rationale applied in the aforementioned letter rulings is appropriate in other transaction-cost-analysis situations. For instance, which entity would be the proper taxpayer to deduct acquirer costs related to acquisitions of multinational groups where the acquired entities are ultimately acquired by different acquirers within the buyer group? In addition, questions still remain in other situations where the proper party to take into account transaction costs is uncertain, such as which is the proper party to take into account acquirer costs related to a partnership acquisition in which the legal acquirer is treated as a continuation of the target partnership. Additional guidance is needed to understand which is the proper party to take into account the transaction expenses in such variations. The letter rulings above provide an indication of the IRS's views for their specific fact patterns; however, many questions are unresolved for variations of their fact patterns.

From Nneamaka Oriala, J.D., Washington National Tax Office, Washington, D.C.

Foreign Income & Taxpayers

IRS issues guidance on treaty application to reverse foreign hybrids

The IRS Office of Chief Counsel issued a generic legal advice memorandum (GLAM), AM 2025-002, in September 2025 addressing whether relief is available under a U.S. federal income tax treaty from the branch profits tax (BPT) and, if so, to what extent, for a foreign entity that is fiscally transparent for foreign tax purposes but treated as a corporation for U.S. federal income tax purposes (known as a "reverse hybrid entity").

The IRS concluded that such a reverse hybrid entity may qualify for a reduced rate of BPT under the applicable U.S. federal income tax treaty on the portion of the entity's dividend equivalent amount (DEA) corresponding to interests held by the indirect owners who are resident in a treaty country and meet certain treaty requirements.

This is the first time the IRS has provided any meaningful guidance on this type of structure. A handful of treaties have previously addressed certain aspects of the hybrid rules, but those provisions were narrow and left several open questions. The new GLAM goes further, filling in many of those gaps and effectively confirming the approach that many taxpayers, particularly in the asset management space, have already been taking. This is a welcome development that brings additional comfort around the availability of treaty relief for reverse hybrids. Although the analysis centers on the 2016 U.S. Model Income Tax Convention (2016 Model), the IRS extends the logic to older treaties with more limited transparency language, making it broadly applicable to most modern treaties.

Background

Generally, under Sec. 882, a foreign corporation that is engaged in a trade or business within the United States (U.S. trade or business) during the tax year is taxed on its income that is effectively connected with that U.S. trade or business (effectively connected income, or ECI). Additionally, a foreign corporation is also generally subject to a BPT of 30% on its DEA under Sec. 884. The BPT is intended to provide parity

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between operating through a U.S. corporate subsidiary and through a U.S. branch by imposing withholding tax on amounts that are economically equivalent to dividends.

Under Sec. 884(b), a foreign corporation's DEA is determined based on its effectively connected earnings and profits for the tax year, adjusted to reflect changes in the corporation's investment in its U.S. business (i.e., the branch). If the foreign corporation increases its U.S. net equity (i.e., it leaves more capital invested in its U.S. branch), the DEA is reduced because those earnings are viewed as reinvested rather than distributed. Conversely, if the corporation decreases its U.S. net equity, the DEA is increased, since that reduction represents a deemed distribution of branch profits. The term "U.S. net equity" is defined under Sec. 884(c) as the excess of U.S. assets over U.S. liabilities.

Under Sec. 884(e), a corporation's BPT may be reduced or eliminated under certain U.S. federal income tax treaties. Specifically, Sec. 884(e)(1) provides that treaty benefits apply only if the relevant agreement is an income tax treaty and such foreign corporation is a "qualified resident" of that country. A "qualified resident" is a corporate resident of a treaty country that satisfies either the beneficial ownership test or the publicly traded test set out in Sec. 884(e)(4).

With respect to fiscally transparent entities, Sec. 894(c) disallows the application of a reduced treaty rate to any withholding tax imposed on certain income derived through a fiscally transparent entity (FTE). Regs. Sec. 1.894-1(d) further provides that the tax imposed by Secs. 871(a), 881(a), 1443, 1461, and 4948(a) on income received by an FTE is eligible for reduction under the terms of a U.S. income tax treaty only if such income is derived by a resident of the applicable treaty jurisdiction. However, neither Sec. 894(c) nor the regulations thereunder explicitly address the application of U.S. federal income tax treaties on BPT imposed under Sec. 884 on

Arthur J. Dixon Memorial and Jonathan Horn Distinguished Service awards

Arthur Auerbach, CPA, CGMA, recipient of the Arthur J. Dixon Memorial Award.

Arthur Auerbach, CPA, CGMA, received the 2025 Arthur J. Dixon Memorial Award, the highest honor given by the accounting profession for contributions to the field of taxation. The award by the AICPA's Tax Division was presented Nov. 18, 2025, at the AICPA Fall Tax Division Meeting in Washington, D.C.

At the same meeting, Cory Perry, CPA, received the 2025 Jonathan Horn Distinguished Service Award.

Auerbach's 23 years of volunteer service to the AICPA includes participation in a number of Tax Division committees and task forces. Currently, he chairs the Tax Practice & Procedures Committee and is a member of the State and Local Tax Deduction Pass-Through Entity Tax Task Force. He has worked 40 years as a tax practitioner and taught accounting at Pace University in New York City. He also has lectured and written articles on an array of tax topics, including in the *Journal of Accountancy* and *The Tax Adviser*, the latter of which he serves as editor of the Tax Practice & Procedures quarterly column.

"Art's volunteer experience with the AICPA touches many different areas of the Tax Division," said Cheri Hutchinson Freeh, CPA, CGMA, chair of the AICPA Tax Executive Committee (TEC). "His involvement has served as a true asset to the AICPA and the accounting profession."

The award was established in 1982 in memory of Arthur J. Dixon, who chaired

income received by a reverse hybrid entity. In addition, the preamble to T.D. 8889 expressly clarifies the limited scope of Regs. Sec. 1.894-1(d). Specifically, it provides that the regulations address "only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business" and notes that "the application of business profits provisions, with respect to the income of [FTEs], particularly where a conflict in entity classification exists" is outside the scope of the final regulations.

Proposed scenario

This GLAM proposes a scenario in which a reverse hybrid entity, *RFHX*, is formed the TEC from 1977 to 1980. It is given for distinguished service in the area of taxation in the spirit of Dixon's professionalism.

Jonathan Horn Distinguished Service Award

Perry, the recipient of the Jonathan Horn Distinguished Service Award, has provided input to eight AICPA comment letters and six international tax resources. He chairs the AICPA International Tax Technical Resource Panel and has served as chair of the AICPA's Organisation for Economic Co-operation and Development (OECD) Task Force. Perry has lectured on a variety of tax topics and written articles in a number of publications, including *The Tax Adviser*. He is a partner in Grant Thornton's National Tax Office, focusing on international tax and consulting.

The Jonathan Horn Distinguished Service Award is given for outstanding contributions to the Tax Division in the past year. It posthumously commemorates Jonathan Horn, CPA, CGMA, who was a longtime Tax Division volunteer, recipient of the Distinguished Service Award, and subsequently an AICPA staff member.

Cory Perry, CPA, left, receives the Jonathan Horn Distinguished Service Award from Cheri Hutchinson Freeh, CPA, CGMA, chair of the AICPA Tax Executive Committee.

under the laws of Country *X*, is taxable as a corporation under U.S. law, and is treated as fiscally transparent under the laws of Countries *X*, *Y*, and *Z*. *RFHX* has a single class of equity interests, with four equal owners:

- *A*, an individual resident in Country *Y*;
- *B*, a publicly traded Country *Y* corporation;
- *C*, a privately held Country *Y* corporation wholly owned by individuals resident in Country *Z*; and
- *D*, an individual resident in Country *Z*.

RFHX's income is ECI, and it distributes all ECI to its owners as earned and does not reinvest in its U.S. business. Under U.S. federal income tax law, such income is

Generally, under Sec. 882, a foreign corporation that is engaged in a trade or business within the United States (US trade or business) during the tax year is taxed on its income that is effectively connected with that US trade or business (effectively connected income, or ECI).

subject to 21% U.S. federal corporate income tax and BPT, with the DEA generally taxed at 30% under Sec. 884 in the absence of any treaty relief.

Treaty analysis under 2016 Model

The United States has a U.S. income tax treaty with Country *Y* but not with Country *X* or *Z*. The U.S.–Country *Y* treaty is worded consistently with the 2016 U.S. Model Income Tax Convention (2016 Model).

The 2016 Model contains two provisions particularly relevant to this analysis: the FTE provision under Paragraph 6 of Article 1 and the BPT provision under Paragraph 10 of Article 10. The relevant text of these provisions are as follows:

> [A]n item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident. [2016 Model, Article 1, Paragraph 6]

> a) A company that is a resident of one of the Contracting States and that has a permanent establishment in the other Contracting State … may be subject in that other Contracting State to a tax in addition to the tax allowable under the other provisions of this Convention.
> b) Such tax, however, may be imposed:
>   i) on only the portion of the business profits of the company … that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, …
>   ii) at a rate not in excess of the rate specified in subparagraph (a) of paragraph 2 or paragraph 6 of this Article, but only if for the twelve-month period ending on the date on which the entitlement to the dividend equivalent amount is determined, the company has been a resident of the other Contracting State or of a qualifying third state [2016 Model, Article 10, Paragraph 10]

The BPT provision allows a contracting state to impose a BPT on the portion of business profits comprising a DEA of a "company" (resident in the other contracting state) that has a permanent establishment (PE) in the taxing contracting state to which the profits are attributable, with the applicable BPT rate subject to reduction if the company meets the 12-month residence requirement. To align with the object and purpose of this provision, the IRS interprets

the term “company” by reference to U.S. law, under which *RFHX* is treated as a corporation subject to BPT.

In addition, the FTE provision treats an item of income, profit, or gain derived by or through an entity treated as fiscally transparent under the laws of either the source state or residence state as derived by a resident of a contracting state to the extent the item is subject to tax in such contracting state as income of a resident. The IRS, in the GLAM, applies a modified lookthrough approach in interpreting the FTE provision in the context of a DEA. In its analysis, profits derived through an FTE take into account such entity's tax attributes and characteristics under the source state's law. Thus, *RFHX*'s U.S. business is treated under the U.S.–Country *Y* treaty as an enterprise of a resident of Country *Y* to the extent *RFHX*'s owners are residents of Country *Y*.

Conclusions

This memorandum concludes that *RFHX* is entitled to a reduction in the rate of BPT to the extent that the DEA corresponds to the percentage interest of an owner in the profits or income of *RFHX* as of the close of *RFHX*'s tax year, provided that such owner meets the following conditions that it:

- Is taxable on profits or income earned through *RFHX* under the laws of Country *Y* as a resident;
- Has been a resident of Country *Y* for more than 12 continuous months (as required by the U.S.–Country *Y* treaty); and
- Satisfies the applicable limitation on benefits (LOB) provision under the U.S.–Country *Y* treaty.

A, a Country *Y* individual, and *B*, a publicly traded Country *Y* entity, are qualified persons under the LOB provision, while *C*, wholly owned by a Country *Z* individual, and *D*, a Country *Z* individual, are not qualified. *A* and *B* also meet the 12-month residency requirement and are subject to Country *Y* tax on their share of *RFHX* income. Accordingly, *RFHX* is entitled to a reduced rate of BPT on the portion of the DEA corresponding to interests held by *A* and *B* but must pay a 30% rate of BPT on the portion of the DEA corresponding to the interests held by *C* and *D*.

Other implications and observations

The IRS specifically noted that the same results would occur under treaties containing the FTE provisions in the 1996 and the 2006 U.S. Model Income Tax Convention, notwithstanding slight differences in wording from the 2016 Model, as the IRS does not view those differences as substantive. Additionally, the IRS indicated that similar conclusions would apply under treaties containing the FTE provisions of the draft 1981 U.S. Model Income and Capital Tax Convention.

Without citation, the memorandum also confirms that where a reverse foreign hybrid earns business profits not attributable to a U.S. PE, those profits may qualify for exemption under the treaty's business profits article. This conclusion aligns with positions commonly adopted in inbound lending and investment structures and provides additional support for applying treaty benefits even under certain treaties that do not explicitly address this treatment.

Taken together, the memorandum offers meaningful insight into the IRS's current interpretation of treaty relief for reverse foreign hybrids subject to the BPT. It validates the practical market approach reflected in many existing structures, extends the FTE analysis beyond withholding taxes, aligns with Organisation for Economic Co-operation and Development commentary, and confirms that this interpretation applies broadly across multiple U.S. model treaties. While not precedential, it provides welcome clarity on an issue that had long remained uncertain.

From Cory Perry, CPA, Washington, D.C.; Wei Fan, CPA, J.D., San Diego; and Abigail Hartnett, J.D., Washington, D.C.

Interest Income & Expense

IRS removes associated-property rule from interest capitalization regulations

The IRS issued final regulations (T.D. 10034) that remove the associated-property rule from the interest capitalization requirements for improvements to designated property. These final regulations apply to tax years beginning after Oct. 2, 2025, (i.e., 2026 tax years for calendar-year filers) and generally align with the Federal Circuit's decision in *Dominion Resources, Inc.*, 681 F.3d 1313 (Fed. Cir. 2012). As a result, taxpayers now have less flexibility in tax planning for interest capitalization.

PHOTO BY BILLIONPHOTOS.COM/ADOBE STOCK

Interest capitalization and the associated-property rule

Sec. 263A(f) and the regulations thereunder contain rules for capitalizing interest with respect to certain property produced by the taxpayer, generally limiting capitalization to designated property. Regs. Sec. 1.263A-8(b)(1) defines designated property as property that is produced that is either (1) real property or (2) tangible personal property that is long-lived (i.e., with a class life of 20 years or more under Sec. 168), has an estimated production period greater than two years, or has an estimated production period greater than one year and an estimated cost of production exceeding $1 million. Regs. Sec. 1.263A-8(d)(3) also provides that any improvement to designated property constitutes the production of designated property.

In accordance with Regs. Sec. 1.263A-8(a), taxpayers are generally required to capitalize interest to designated property using the avoided-cost method. Under this method, interest that a taxpayer theoretically would have avoided if those production expenditures had been used to repay or reduce the taxpayer's outstanding debt must be capitalized. Under Regs. Sec. 1.263A-11(e)(1), before it was removed by T.D. 10034, production expenditures for improvements to designated property included:

- All direct and indirect costs required to be capitalized with respect to the improvement,
- In the case of real property:
  - An allocable portion of the cost of land, and
  - The adjusted basis of any existing structure, common feature, or other property that is not placed in service or

must be temporarily withdrawn from service to complete the improvement (associated property), and

- In the case of tangible personal property, the adjusted basis of the asset being improved if the asset either is not placed in service or must be temporarily withdrawn from service to complete the improvement.

Including the basis of associated property in production expenditures results in the capitalization of more interest to improvements to designated property under Sec. 263A(f), as the adjusted basis increases the base of production expenditures for calculating the amount of interest that must be capitalized.

Overview of the final regulations

Under the final regulations, taxpayers making improvements to real or tangible personal property that constitute the production of designated property are required to include only the direct and indirect costs of the improvements as production expenditures for purposes of determining interest capitalization associated with improvements. Adopting the previously issued proposed regulations with slight changes, the final regulations:

- Remove the adjusted basis of any associated property (e.g., property not placed in service or temporarily withdrawn from service) from production expenditures;
- Remove an allocable portion of the cost of land from production expenditures; and
- Clarify the scope of improvements that constitute the production of property for purposes of determining whether such an improvement is designated property.

The final regulations amend Regs. Sec. 1.263A-8(d)(3) to update the definition of an improvement to be consistent with the definition in Regs. Sec. 1.263(a)-3. Therefore, any improvement to real or tangible personal property does not include repairs as described in Regs. Sec. 1.162-4(a). A change in the treatment of interest to implement the final regulations is a change in method of accounting subject to Secs. 446 and 481.

Dominion Resources decision

In *Dominion Resources*, the Federal Circuit invalidated the associated-property rule, finding that it was not a reasonable interpretation of the avoided-cost method because the rule unreasonably linked the interest capitalized when making an improvement to the adjusted basis of the property temporarily withdrawn from service to complete the improvement.

The taxpayer in *Dominion Resources* was a public utility that replaced coal burners in two of its electricity-generating plants. During the improvement, the taxpayer temporarily removed the two electricity-generating plants from service and deducted a portion of interest expense that it incurred. The IRS disagreed with the taxpayer's computations and challenged the amount of interest that the taxpayer deducted, citing the associated-property rule under Regs. Sec. 1.263A-11(e)(1)(ii)(B). The IRS argued that the associated-property rule required the taxpayer to include the adjusted basis of the electricity-generating plants temporarily withdrawn from service as production expenditures.

The Court of Federal Claims denied the taxpayer's subsequent claim for refund and granted summary judgment in favor of the government (*Dominion Resources, Inc.*, 97 Fed. Cl. 239 (Fed. Cl. 2011)). However, on appeal, the Federal Circuit overturned the lower court's ruling. The Federal Circuit analyzed the validity of the associated-property regulation and found that the regulation directly contradicted the avoided-cost rule that Congress intended the statute to implement, reasoning that an amount equal to the adjusted basis of property temporarily drawn from service would not have been available to pay down the debt had the improvement not been made, as those funds were expended prior to the decision to make the improvement.

Additionally, the Federal Circuit stated that the associated-property rule violated the requirement that Treasury provide a reasoned explanation for adopting a regulation, as established by the Supreme Court ruling in *Motor Vehicles Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983). The Federal Circuit examined prior IRS guidance interpreting the interest-capitalization requirements, including Notice 88-99 and proposed regulations, finding no explanation for the way that use of an adjusted basis implements the avoided-cost rule.

Takeaways

The final regulations are a significant development for taxpayers making improvements to designated property. Under prior law and the ruling in *Dominion Resources* that invalidated the associated-property rule, taxpayers had flexibility in applying the regulatory or judicial interpretation to calculate the amount of interest required to be capitalized to improvements to designated property. While many taxpayers relied on *Dominion Resources* to reduce the amount of interest required to be capitalized, taxpayers wanting to capitalize additional interest as part of a broader tax planning strategy may have applied the associated-property rule in prior regulations.

Taxpayers have less flexibility in tax planning under the final regulations, which now align with the ruling in *Dominion Resources*. As taxpayers begin planning for their 2026 tax years, they will need to evaluate how these regulations fit into their broader tax strategy. This includes considering the impact that the change in method of accounting may have on interest capitalization strategies that have been implemented in prior years and strategies that will be implemented in future years.

From John Suttora, CPA, Washington, D.C.; Dennis St. Martin, CPA, Raleigh, N.C.; and Kenzie Huff, Kansas City, Mo.

Miscellaneous

Practical tax issues related to qualified reopenings

A company that needs capital to fund operations or an acquisition, expand its business, or pay off existing debt will often look to issue new debt. Different types of borrowing arrangements can have particular tax implications. One common borrowing arrangement is a credit agreement that provides for an immediate "initial term loan" but also provides for one or more additional tranches of a "delayed draw term loan" (DDTL) that can be drawn as needed over a specified period.

Without applying the relevant tax rules covered below, a borrower may treat all loans issued under the initial term loan and the DDTL as a single loan or treat each borrowing as a separate loan. Either treatment can be an incorrect tax treatment, depending on the circumstances. Specifically, the rules under Regs. Sec. 1.1275-2(k) provide that debt issued subsequent to an original debt (an additional debt) that has identical terms as the original debt is treated as part of the same issue as the original debt if the additional debt is a "qualified reopening" of the original debt.

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If the additional debt is a qualified reopening of the original debt, the original debt and the additional debt are regarded as fungible and treated as a single debt for tax purposes. If the additional debt is not a qualified reopening of the original debt, the original debt and the additional debt are treated separately for tax purposes.

Whether the original debt and the additional debt are fungible can have substantial ramifications for tax purposes, but this analysis is often overlooked. This item summarizes the rules governing whether debt is treated as a qualified reopening and some of the ramifications.

'Issue' of debt instruments

Two or more debt instruments that are part of the same issue will have the same issue price (as defined in Sec. 1273) and generally are accounted for as a single loan for tax purposes. The regulations under Regs. Sec. 1.1275-1(f)(1) define two or more debt instruments that have been issued on or after March 13, 2001, as part of the same issue if: (1) they have the same credit and payment terms; (2) they are issued pursuant to a common plan or as part of a single transaction or a series of related transactions; and (3) they are issued within a period of 13 days, beginning with the issue date of the first debt instrument that would be part of the issue.

Thus, if these criteria are met, debt issued within 13 days from an initial borrowing is automatically treated as part of the same issue.

Qualified reopening

An additional debt may also be treated as part of the same issue as the original debt if it meets one of three tests to constitute

a "qualified reopening" as defined in Regs. Sec. 1.1275-2(k). If the additional debt is determined to be a qualified reopening, the additional debt is treated as having the same issue date, same issue price, and same adjusted issue price as the original debt with respect to the holders.

To potentially be treated as a qualified reopening, the following requirements must be met regarding the additional debt under Regs. Sec. 1.1275-2(k)(2)(ii): (1) The additional debt would be part of a single issue of debt as defined in Regs. Sec. 1.1275-1(f), without the application of Regs. Sec. 1.1275-2(k); (2) the additional debt is not part of the same issue as the initial debt issuance as defined in Regs. Sec. 1.1275-1(f); and (3) the additional debt has terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.

To constitute a qualified reopening, an additional debt must meet the requirements in Regs. Sec. 1.1275-2(k)(2)(ii) and *also* meet the requirements of one of the tests under Regs. Sec. 1.1275-2(k)(3)(ii), (iii), (iv), or (v), which are discussed below.

For the reopening-within-six-months test (Regs. Sec. 1.1275-2(k)(3)(ii)), the requirements are:

- The original debt is publicly traded (within the meaning of Regs. Sec. 1.1273-2(f)) as of the date on which the price of the additional debt is established (or, if earlier, the announcement date of the additional debt) (Regs. Sec. 1.1275-2(k)(3)(ii)(A));
- The reopening date of the additional debt instruments is not more than six months after the issue date of the original debt instruments (Regs. Sec. 1.1275-2(k)(3)(ii)(B)); and
- On the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the original debt instruments (based on their fair market value (FMV)) is not more than 110% of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of original issue discount (OID), the coupon rate) (Regs. Sec. 1.1275-2(k)(3)(ii)(C)).

For the reopening-with-*de-minimis*-OID test (Regs. Sec. 1.1275-2(k)(3)(iii)), the requirements are:

- The original debt is publicly traded (within the meaning of Regs. Sec. 1.1273-2(f)) as of the date on which the price of the additional debt is established (or, if earlier, the announcement date) (Regs. Sec. 1.1275-2(k)(3)(iii)(A)); and
- The additional debt instrument is issued with no more than a *de minimis* amount of OID. *De minimis* OID is defined under Regs. Sec. 1.1273-1(d) as an amount equal to 0.0025 (or 0.25%, or 25 basis points) multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date.

For the nonpublicly-traded-debt-issued-for-cash test (Regs. Sec. 1.1275-2(k)(3)(iv)), the requirements are that the additional debt is issued to persons unrelated to the issuer for cash for an arm's-length price, and either:

1. The Regs. Secs. 1.275-2(k)(3)(ii)(B) and (C) requirements for a reopening within six months are satisfied, with the yield test (Regs. Sec. 1.275(k)(3)(ii)(C)) being satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments (based on their cash purchase price) is not more than 110% of the yield of the original debt instruments on their issue date (or, if the original debt

instruments were issued with no more than a *de minimis* amount of OID, the coupon rate); or

2. The additional debt instruments are issued with no more than a *de minimis* amount of OID.

For the 100%-yield test for reopening after six months (Regs. Sec. 1.1275-2(k)(3)(v)), the requirements are that the additional debt instrument is issued more than six months after the issue date of the original debt instruments, and:

1. The requirements in Regs. Secs. 1.1275-2(k)(3)(ii)(A) and (C) are satisfied, with the yield test in Regs. Sec. 1.1275-2(k)(3)(ii)(C) being satisfied if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date), the yield of the additional debt instruments (based on their FMV or cash purchase price, whichever is applicable) is not more than 100% of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a *de minimis* amount of OID, the coupon rate); or
2. The additional debt instrument is issued for cash to persons unrelated to the issuer for an arm's-length price and with no more than a *de minimis* amount of OID.

The following example illustrates the tax treatment of the rules described above:

Example: The taxpayer borrows an initial term loan on Feb. 1, 2024, which matures on Feb. 1, 2029. Also on Feb. 1, 2024, the taxpayer enters into a DDTL that can be drawn in the next two years. The terms of the DDTL are identical to the initial term loan. The taxpayer borrows under the DDTL on the following dates:

- DDTL No. 1 — Feb. 10, 2024;
- DDTL No. 2 — April 21, 2024; and
- DDTL No. 3 – Aug. 15, 2024.

After testing, the taxpayer's issuer determines that:

1. DDTL No. 1 was drawn within 13 days of the initial term loan and is part of the same issue as the initial term loan under Regs. Sec. 1.1275-1(f).
2. DDTL No. 2 was determined to be a qualified reopening of the initial term loan under Regs. Sec. 1.1275-2(k) and thus treated as having the same issue date, same issue price, and same adjusted issue price as the initial term loan and DDTL No. 1 on April 21, 2024.
3. DDTL No. 3 was determined to be not a qualified reopening of the initial term loan under Regs. Sec. 1.1275-2(k) and is treated as a separate debt from the initial term loan, DDTL No. 1, and DDTL No. 2.

Tax considerations

The tax effects of a qualified reopening can seem inconsequential but can be important.

First, once it is determined that an additional debt was issued in a qualified reopening, the issuer must redetermine the yield of the aggregated original debt and additional debt (the aggregate debt) as of the reopening date under Regs. Sec. 1.163-7(e) to determine the accrual of interest expense, OID, and debt-issuance costs over the remaining term of the aggregate debt. In comparison, if the additional debt is determined to be not a qualified reopening, the issuer would create a separate schedule for the additional debt to accrue interest expense, OID, and debt-issuance costs.

Second, whether there is an aggregate debt or the original debt and additional debt are treated as separate tranches can have other meaningful differences for tax purposes. For example, when the terms of a debt are modified, taxpayers must analyze whether the modification is a "significant modification" under Regs. Sec. 1.1001-3. The most common tests that can result in a significant modification are a change in yield under Regs. Sec. 1.1001-3(e)(2) or a material deferral of payments under Regs. Sec. 1.1001-3(e)(3). The test under Regs. Sec. 1.1001-3(e)(2) could be affected by a qualified reopening because there could be different results under a single change-in-yield test treating the original debt and additional debt as an aggregate and more than one change-in-yield test treating the original debt and additional debts as separate loans. Similarly, the determination of a material deferral under Regs. Sec. 1.1001-3(e)(3) could be affected because that test is based on the timing of payments relative to a debt's unmodified payment schedule. Thus, if the additional debt is a qualified reopening, it would have the same issue date and maturity term as the original debt; however, if the additional debt is not a qualified reopening, its issue date and maturity term would be determined separately based on its actual issue date. Therefore, the determination of whether there was a material deferral of a payment with respect to the additional debt could be different depending on whether it was a qualified reopening due to the different maturity terms.

Another aspect that can be important to consider is whether tranches of debt are aggregated appropriately to determine whether the small-debt issuance exception applies under Regs. Sec. 1.1273-2(f)(6). For background, when a debt is significantly modified under Regs. Sec. 1.1001-3, the modified debt is treated as a new debt for tax purposes, and the issue price of the new debt is determined under Sec. 1273 and the regulations thereunder. If a debt is publicly traded, as defined in Regs. Sec. 1.1273-2(f), the issue price of the new debt may be the fair market value of the publicly traded debt, which can be different than the stated principal of the new debt. However, Regs. Sec. 1.1273-2(f)(6) provides that a debt instrument is not publicly traded if at the time of the determination the outstanding stated principal amount of the issue does not exceed $100 million. Thus, if an original debt and the additional debt are treated as the same issue, the determination of issue price may be different if they exceed $100 million combined than if they are treated as separate loans and respectively do not exceed $100 million.

Whether an additional debt is a qualified reopening or a separate debt can also affect the timing of income inclusion for the holder. For example, when an additional debt is a qualified reopening of the original debt, a discount on the additional debt may be converted into market discount subject to Sec. 1276 to the extent the discount exceeds any discount reflected in the adjusted issue price of the original debt. In comparison, if the additional debt is treated as a separate loan from the original debt, the discount related to the additional debt may be OID subject to Sec. 1272.

Best practices

Performing a qualified reopening analysis under Regs. Sec. 1.1275-2(k) on every additional debt under a DDTL can be a tedious and time-consuming process if a taxpayer makes numerous draws. An issuer may be able to limit testing if a draw falls squarely within the definition of an issue, i.e., a draw within 13 days from the original debt; however, it is often the case that the issuance of an additional debt falls outside the 13-day period.

Before analyzing each additional debt, taxpayers must determine if the requisite criteria are met to treat an additional debt as part of the same issue or as a potential qualified reopening. In practice, the additional debt commonly does not have identical terms as the original debt because the regulations strictly provide that the additional debt must have terms that are "in all respects identical."

A common difference between the terms of an original debt and the terms of an additional debt is the required principal payment schedules. For example, a DDTL may not require a principal payment upon the first accrual period after the borrowing date of the additional debt when the original debt requires such a payment upon the end of that accrual period. While the terms of an initial-term loan and DDTL may otherwise be identical, a slight difference in the required principal payment schedule may be sufficient to disqualify an additional debt from being a qualified reopening. Some debt agreements have precise terms that avoid this issue but may require that the required principal payments for the original debt be adjusted going forward.

Taxpayers and their advisers should be aware that even slight variations of terms between the original debt and the additional debt can disqualify the additional debt from being a qualified reopening; therefore, a granular review of the debt terms is warranted before any testing.

From Amanda Stidham, CPA, Oklahoma City

Partners & Partnerships

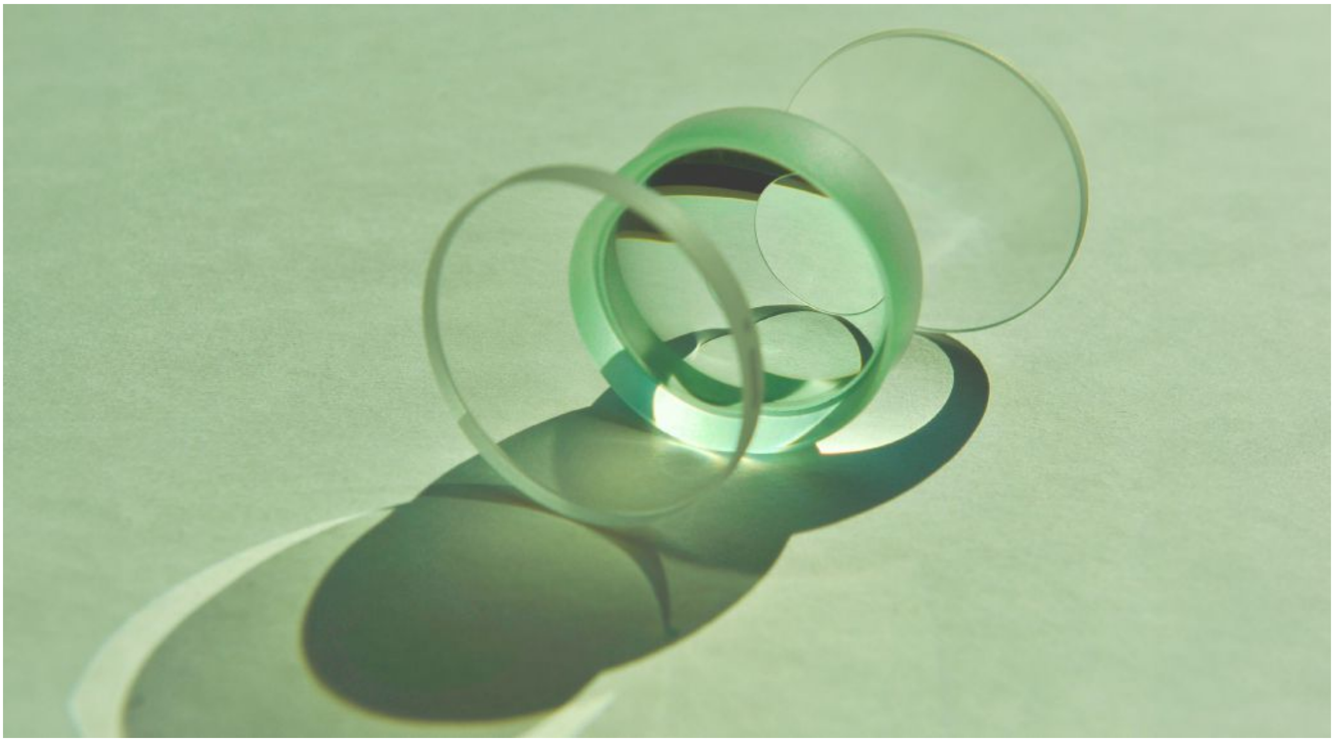
Partner redemptions from 'dry' partnerships

Taxpayers frequently choose to hold investments in corporate entities through a so-called "dry partnership," where, rather than directly holding the corporation's stock, the investors hold interests in an entity classified as a partnership. The dry partnership then holds 100% of the corporation's stock as its sole asset. The dry partnership structure offers several tax-structuring advantages over direct stock ownership, including facilitating tax-free rollovers as part of subsequent bolt-on acquisitions and the ability to offer partnership profits interests to incentivize the corporation's employees.

For purposes of this item, we consider a dry partnership that has as its sole asset 100% of the stock of a single corporation and with no partnership-level liabilities or other activity. However, even this basic dry partnership can present far more complex tax issues than might be suggested by the absence of entity-level operations. This focuses on certain structuring considerations that arise when a dry partnership seeks to fully redeem one of its partners prior to a liquidity event.

Partner redemptions generally

Partnership redemptions of partners' interests are generally not taxable to either the distributee partner or the partnership, except to the extent that the amount of any money distributed exceeds the partner's basis in its partnership interest prior to the redemption. To the extent the partnership distributes money in excess of the partner's basis, the partner recognizes gain under Sec. 731(a), which is generally capital gain under Regs. Sec. 1.731-1(a)(3). For partnerships that hold certain unrealized receivables and appreciated inventory items ("hot assets"), a portion of the gain recognized as a result of a redemption may be characterized as ordinary income under Sec. 751(b). However, Sec. 751(b) recharacterization generally does not arise in the context of redemptions from dry partnerships. Property distributions in redemption of the partner's interest are also generally tax-free, and Sec. 732 and its regulations provide rules for determining a partner's basis in the distributed property.



A partner whose interest in a partnership is liquidated solely for cash and hot assets, as described under Regs. Secs. 1.751-1(c) and 1.751-1(d), may recognize a loss if the sum of the amount of cash and the adjusted basis in the hot assets in the partner's hands is less than the partner's basis in the pre-distribution partnership interest.

Partner exits from dry partnerships

In many cases, investors in dry partnerships expect that the source of liquidity to exit their investment will be the partnership's ultimate sale of its corporate stock. However, certain partners may need or be required to exit a dry partnership prior to a liquidity event. Because a dry partnership generally holds only corporate stock, the partnership and the remaining partners will need to consider the source of funds needed to facilitate a partner's exit. In some cases, the exiting partner may simply sell its interest to a new partner. However, this item discusses certain tax considerations for structuring alternatives for partnerships that choose to redeem an exiting partner.

The manner in which a dry partnership sources the funds necessary to redeem a partner can have significant tax implications, not only to the redeemed partner but also to the partnership and its remaining partners. We first discuss three methods in which the corporation's cash is ultimately used to redeem the dry partnership's partner. We then discuss the possibility that an existing or incoming partner provides the necessary cash. The methods discussed below are certainly not an exhaustive list of potential options to structure a partner redemption. Further, the optimal choice of redemption structure will depend on all of a partnership's particular facts.

Cash distribution funded by the corporation

The first and perhaps simplest method of funding the redemption of a partner from

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a dry partnership is for the corporation to distribute funds to the partnership, which in turn uses the cash to redeem its partner.

The redeemed partner will recognize gain under Sec. 731(a) to the extent the distributed cash exceeds the partner's basis in its partnership interest prior to the redemption. If the partnership has a Sec. 754 election in effect (or makes one in connection with the redemption), the basis of the partnership's remaining stock is increased under Sec. 734(b) by the amount of gain recognized by the redeemed partner. Although making the Sec. 754 election and computing a Sec. 734(b) adjustment impose some degree of administrative burden on the partnership, this adjustment might be necessary to avoid distortions in the amount, character, or timing of subsequent gain or loss in connection with partnership-level dispositions of its corporate stock. Additionally, since the basis adjustment is on nonamortizable and nondepreciable property, i.e., corporate stock, this reduces some of the administrative burden of making a Sec. 754 election.

Because the cash is not transferred directly to the redeemed partner, the consequences of the corporate distribution are first analyzed at the partnership level. Rules under Sec. 301(c) generally provide that a corporate distribution is treated as a dividend to the extent of the corporation's earnings and profits (E&P), as determined under Regs. Sec. 1.316-1. Distributions in excess of the corporation's earnings reduce the shareholder's basis in its stock, and to the extent the distribution exceeds such basis, the excess generally results in capital gain. If the corporate distribution resulted in dividend or capital gain income at the partnership level, the partnership's allocation of the income and gain could affect all of the partners of the partnership.

Specifically, when a partnership recognizes income and gains, the partnership has to determine how it is required to allocate such income and gains among its partners. The allocation of the partnership's income, gains, deductions, and losses is guided by Sec. 704(b) and the allocation provisions within the partnership agreement. Some partnership agreements seek to "stuff" the partnership-level income to the redeemed partners and away from the remaining partners that do not receive cash in the transaction. Such allocations should be evaluated in light of Sec. 704(b) and the regulations thereunder. Alternatively, other partnership agreements might contain allocation provisions that simply allocate any dividend or capital gain among all partners like any other income.

Once Sec. 704(b) is applied to the allocation, any capital gain could be subject to the Sec. 704(c) allocation rules, which would require that tax items be allocated to specific Sec. 704(c) partners. As a result, although the redeemed partner is the ultimate recipient of the distributed cash, other partners in the partnership could be allocated dividend income and capital gain. Accordingly, corporate distributions to the partnership can affect the tax liability of the remaining partners in addition to the partner that is being redeemed. If this is the case, the corporation may need to distribute additional cash to allow the partnership to make tax distributions to the partners that are recognizing income and gain.

An additional technical analysis may be required to the extent a corporate distribution exceeds its E&P and will offset the partnership's basis in its stock under Sec. 301(c)(2). Where the partnership has received contributions of corporate stock from multiple partners or has made contributions to the corporation at varying times (perhaps

The manner in which a dry partnership sources the funds necessary to redeem a partner can have significant tax implications, not only to the redeemed partner but also to the partnership and its remaining partners.

in connection with the addition of new partners over time), the partnership may have multiple blocks of stock with varying basis in each. A detailed discussion of whether a corporate shareholder must track its basis separately for each of its blocks of stock (potentially treating a distribution as a return of basis for one block while recognizing capital gain with respect to another) or whether it may aggregate the basis of all its blocks into a "unitary" stock basis is beyond the scope of this item. However, the issue highlights the complexity that can present itself in even the simplest partner redemption transactions involving dry partnerships.

Partnership distribution followed by corporate redemption

The second method is a two-step approach in which the dry partnership first distributes a portion of its corporate stock out to the to-be-redeemed partner in complete liquidation of its partnership interest. The corporation then redeems its stock directly from the former partner.

In ideal situations, neither the partnership nor any of the other partners will recognize gain on the partnership's distribution of stock in redemption of the exiting partner. The complete redemption of the former partner, assuming it qualifies for redemption treatment under Sec. 302, results in the recognition of gain by the redeemed partner. The distribution of cash from the corporation in redemption of the former partner's stock does not affect the taxable income of the partnership or any of its remaining partners.

While the distribution of property to a partner is generally a nonrecognition event, care should be taken in several circumstances. First, if the redeemed partner previously contributed cash to the partnership, the disguised-sale rules under Sec. 707(a)(2)(B) and Regs. Sec. 1.707-6 may treat the initial transfer of cash and subsequent distribution of stock as a sale of such stock to the redeemed partner, particularly if the redemption occurs within two years of the prior cash contribution. In that case, what was otherwise anticipated to be a tax-free distribution may result in recognized gain at the partnership level to be allocated among the partnership's remaining partners (none of which received cash or property in connection with the redemption).

The two-step redemption method may also present complications if any of the partners previously contributed property to the partnership. Distributions of stock to a redeemed partner within seven years of any such contributions should be evaluated under the so-called mixing-bowl rules in Secs. 704(c)(1)(B) and 737.

Sec. 704(c)(1)(B) generally requires a partner that contributes property to a partnership to recognize any remaining built-in gain or loss if the contributed property is subsequently distributed to another partner within seven years. If any of

the remaining partners previously contributed the corporation's stock or, perhaps, contributed other property to the corporation in exchange for stock, consideration should be given to whether Sec. 704(c)(1)(B) and Regs. Sec. 1.704-4 require that contributing partner to recognize any remaining pre-contribution built-in gain or loss upon the distribution of stock to the redeemed partner.

Likewise, if the exiting partner previously contributed any property to the partnership other than shares of the distributed corporation, Sec. 737 may require the redeemed partner to recognize gain in connection with the distribution as determined under Regs. Sec. 1.737-1. However, any gain recognized under the mixing-bowl rules to the redeemed partner ought to offset gain that would otherwise be recognized upon the corporation's subsequent redemption of its stock.

Taxpayers should also evaluate whether the transfer of cash to the redeemed partner can be respected as a redemption of corporate stock directly from the former partner. Given that the partner holds only transitory ownership of the stock, there could be a risk the transaction is instead characterized as a transfer of cash from the corporation to the partnership, followed by the partnership's redemption of the partner. A deemed distribution of cash by the corporation to the partnership would present the same issues discussed with the first method above.

In summary, the two-step redemption method provides the potential to use the corporation's cash to redeem a partner while isolating the potential gain associated with that distribution to the redeemed partner. However, the method also requires additional substantive scrutiny, and the path to ensure the redemption is tax-free to the partnership's remaining partners is lined with traps for the unwary.

Loan from corporation to the partnership

Where the distribution of cash from the corporation would be expected to result in taxable income at the partnership level, the parties might consider having the partnership borrow the funds necessary to redeem a partner from the corporation or another entity under the corporate structure. The principal tax issue presented by this approach is the potential recharacterization of the loan to the partnership as a distribution. It may be difficult to sustain the parties' intended loan treatment where the "borrower" partnership lacks any operating income or other assets to repay the loan. Tax consequences similar to those discussed above (including potential partnership-level taxable income) could arise if an advance papered as a loan were recharacterized as a corporate distribution.

Cash contribution from other partners

The final method discussed in this item looks to either existing or incoming partners to provide the cash to be used by the partnership to redeem its partner. That is, the redemption transaction is structured so that one or more partners first contribute cash to the partnership for a new or increased partnership interest. Then the partnership uses the cash to redeem out the exiting partner. As with the corporate-loan method discussed above, the key consideration with this approach is whether the tax characterization of the transaction will follow its form.

A detailed discussion of situations in which related contributions and distributions in redemptions of a partner may be recharacterized as a sale of a partnership interest is well beyond the scope of this item. While the simple interrelatedness of the contribution and redemption might suggest a sale, several factual circumstances may increase the likelihood that the redemption is recast. These circumstances could include direct negotiations between the contributing and exiting partners and the receipt by the contributor of a partnership interest that is identical to the interest that is relinquished by the exiting partner. Although most practitioners have long acknowledged the possibility that related contributions to and distributions from a partnership could be treated as sales of partnership interests in appropriate circumstances, the tax law known as the One Big Beautiful Bill Act, H.R. 1, P.L. 119-21, modified Sec. 707(a)(2)(B) to clarify this possibility, notwithstanding the absence of specific implementing regulations.

The tax consequences of a recasting from a cash contribution and subsequent redemption to a sale of a partnership interest are perhaps not as dire a result compared to a recasting in the corporate loan or two-step redemption methods discussed above, particularly in a situation in which the exiting partner is fully redeemed (and thus applies its full basis against the sale price in determining gain or loss realized). However, it is worth noting that in the sale scenario, the exiting partner's capital account will transfer to the buyer under Regs. Sec. 1.704-1(b)(2)(iv)(l) and that the adjustment to the basis of the partnership's asset (if the partnership has a Sec. 754 election in place) is made pursuant to Sec. 743(b) and is personal to the purchasing partner(s), as compared to the adjustment made to the partnership's common basis pursuant to Sec. 734(b) in the case of redemption.

Analysis and planning required

The approaches above represent some of the common approaches taken by dry partnerships seeking to redeem a partner. As we have highlighted, even the apparently simple task of redeeming a partner from a partnership with no operating assets or liabilities can entail detailed technical analysis. Proper planning for partner redemption transactions can help ensure a redemption does not unexpectedly result in allocation or recognition of taxable income to the remaining partners.

From Nancy Langdon, CPA, Washington, D.C.; Whit Cocanower, J.D., LL.M., Washington, D.C.; and Mike Howard, CPA, Chicago

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S Corporations

When is a QSub election considered timely filed?

Planning a reorganization of any entity is a complex endeavor requiring consulting with tax professionals and lawyers. There are many traps for the unwary requiring professional expertise to guide a corporation through a potentially once-in-a-lifetime event. However, even for experienced professionals, there are lots of unknowns in the law requiring a thoughtful plan to mitigate the risks while still achieving the client's goals. One such risk is ensuring that the transaction steps are performed in the proper order and given effect so they are able to withstand an IRS audit that may occur years after the fact.

Background

An F reorganization under Sec. 368(a)(1)(F) is a tax-free corporate structuring that involves a mere change in identity, form, or place of organization of a single corporation. It is often used to facilitate changes such as converting a corporation to a limited liability company (LLC) or restructuring for private-equity transactions — without triggering immediate tax consequences.

In a typical F reorganization of an S corporation, a new corporation is formed, and the shareholders contribute the stock of the legacy S corporation into the newly


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formed corporation in exchange for all the stock of the newly formed corporation. The newly formed corporation then files a Form 8869, *Qualified Subchapter S Subsidiary Election*, (commonly referred to as a QSub election) on the legacy S corporation, effective as of the contribution date, to complete the F reorganization. See Situation 1 of Rev. Rul. 2008-18 as an example. It is common for the legacy S corporation to then convert to an LLC under state law to get rid of the corporate taint on the entity so that the legacy S corporation can be a partnership instead of a C corporation upon the addition of new unit holders or after being purchased by a new owner.

As long as the contribution and conversion of the legacy S corporation to an LLC occurs within a short period after the contribution, even without the QSub election, the steps generally should qualify as an F reorganization. However, in this scenario there is little guidance from the IRS on how long is too long between the contribution and conversion before it does not qualify as an F reorganization, and it is unclear if the legacy S corporation will retain its employer identification number (EIN) (see the ABA's Comment letter, "Comments on Guidance on S Corporation F Reorganizations With a State Law Conversion to a Limited Liability Company," (July 2, 2024) for additional information).

Rev. Rul. 2008-18 provides that if a QSub election is filed as part of an F reorganization, then the EIN of the legacy S corporation will remain with the legacy S corporation. While many argue the QSub election is not necessary for there to be an F reorganization, most practitioners recommend the QSub election step in order to ensure the EIN of the legacy S corporation does not transfer to the newly formed corporation. This is also a matter of administrative ease in reporting the transaction to the IRS so that the IRS updates its system with the proper records. The question then becomes how to make a proper QSub election, knowing the legacy S corporation will be converting to an LLC.

Several errors can occur in the filing of a QSub election, including using the wrong name, EIN, address, or even effective date. Each of these errors is potentially curable on its own through Rev. Proc. 2022-19. However, Rev. Proc. 2022-19 still likely requires certain items to be correct on the original filing, including that it is signed by a duly authorized officer of the new parent corporation and that it is timely filed.

The most common error in the transaction steps may be the timely filing of the QSub election. Regs. Sec. 1.1361-3(a) requires the legacy S corporation to meet all the requirements of Sec. 1361(b)(3)(B) at the time the election is made. Sec. 1361(b)(3)(B) requires (1) 100% of the stock of the legacy S corporation to be held by an S corporation and (2) that the S corporation elects to treat such corporation as a QSub. The requirement in Regs. Sec. 1.1361-3(a) that the corporation meet the requirements at the time the election is made is different from most elections that only require the entity to qualify as of the effective date of the election rather than the filing date of the election. In addition, while the Form 8869 can be filed at any time during the tax year, it cannot be effective more than two months and 15 days prior to the date of filing and cannot be effective more than 12 months after the date of filing (Regs. Secs. 1.1361-3(a)(3) and (4)). Thus, there is a narrow window after the contribution has occurred and before the state-law conversion is effective in which the QSub election must be filed.

The Code does not define the term “file” or “filed”; however, the courts have long held that in order to be considered “filed” the document must be delivered in the appropriate form to the specific individual or individuals identified in the Code or regulations (*Helvering v. Campbell*, 139 F.2d 865 (4th Cir. 1944); *W.H. Hill Co.*, 64 F.2d 506 (6th Cir. 1933)). The burden is on the taxpayer to substantiate when the document is filed. The general rule for when a document is considered filed is when it is received by the IRS at the place where it is required to be filed (i.e., the received date) (see also *Allnutt*, 523 F.3d 406 (4th Cir. 2008), aff’g T.C. Memo. 2002-311; *Miller*, 784 F.2d 728 (6th Cir. 1986); *Hotel Equities Corp.*, 546 F.2d 725 (7th Cir. 1976), aff’g 65 T.C. 528 (1975)).

The mailbox rule is an exception to the received date to allow for certain documents to be deemed filed on the mailing date under certain facts and circumstances. Sec. 7502, more commonly referred to as the mailbox rule, provides the rules on when an election that is required to be filed is considered made. (Note that a common-law mailbox rule differs from the codified mailbox rule in Sec. 7502. The codified mailbox rule applies to federal returns and elections that are required to be filed, such as the QSub election.) Sec. 7502 provides that if certain requirements are met, then the date on which a return, claim, statement, or other document is mailed is the date it is deemed to be filed for federal income tax purposes.

Generally, for Sec. 7502 to apply, the document must be:

- Required to be filed within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws;
- Properly addressed;
- Timely deposited in the mail in the United States (special requirements if mailing from outside the United States are not covered here); and
- Received after the prescribed period or prescribed date.

Each of the requirements of Sec. 7502 provides a unique set of issues and risks in filing Form 8869 under the given facts.

What is the prescribed period for filing Form 8869?

Sec. 7502 requires that the document, Form 8869 under our facts, be filed within the prescribed period. The "prescribed period" is not defined within the Code or regulations but rather relates back to the Code or regulations requiring the particular form to be filed. Defining the prescribed period to file a return is easier. For example, Regs. Sec. 1.6037-1(b) specifies that Form 1120-S, *U.S. Income Tax Return for an S Corporation*, is due on or before the "15th day of the third month following the close of the taxable year." Sec. 7701(a)(23) defines "taxable year" as the calendar year, or the fiscal year ending during such calendar year. Therefore, the prescribed date for filing Form 1120-S for a calendar-year taxpayer is generally March 15. Applying Sec. 7502 means that if Form 1120-S is mailed on or before March 15 but arrives at the proper IRS address after March 15, the mailing date will be the filing date, assuming the other requirements of Sec. 7502 are met.

For Form 8869, Regs. Sec. 1.1361-3(a)(3) provides the time for making the QSub election is "any time during the taxable year." As Sec. 7701(a)(23) defines "taxable year" as the calendar year or the fiscal year ending during such calendar year, does this mean that if the contribution occurs on Dec. 30 for a calendar-year-end taxpayer that the form must be filed by Dec. 31? This interpretation is supported by Section 4.01(2) of Rev. Proc. 2013-30, which states that the due date of the election is specified in Regs. Sec. 1.1361-3(a)(3).

The IRS campus applies the "prescribed period" in relation to the effective date and ignores the "taxable year" language included in the regulations (see Internal Revenue Manual (IRM) §3.13.2.24.3 (effective Jan. 1, 2025)). Just be warned there is at least some level of risk in the effectiveness of a QSub election if Form 8869 is filed after the end of the corporation's tax year in which the election is to be effective. It may be prudent to request late election relief under Rev. Proc. 2013-30 on Form 8869 if it is filed after the S corporation's tax year end.

Where is it required to be delivered?

One of the requirements of Sec. 7502 is that the envelope be properly addressed. If the envelope is not properly addressed, then Sec. 7502 does not apply and it will not be deemed filed until the election is transferred to the proper location by the IRS (*Allnutt*, 523 F.3d at 412–13 *Seaview Trading, LLC*, 62 F.4th 1131 (9th Cir. 2023) (*en banc*), aff'g T.C. Memo. 2019-122). In most instances, this means even an election timely placed in the mail but addressed to the incorrect IRS location for processing will not be "filed" until after the "prescribed period" is over, as it can take months for the IRS to transfer the election to the proper IRS location for processing.

Regs. Sec. 1.1361-3 and the Form 8869 instructions provide the election is to be filed at the service center where the most recent return of the subsidiary was filed, and if the S corporation forms a new subsidiary, then the election should be filed in the service center where the parent S corporation last filed a return. There are two items of note in the regulations and form instructions. The first is that Form 8869 could be sent to one of several service centers across the country, depending upon the facts (typically, Ogden, Utah, or Kansas City, Mo., based on the current form instructions). The second item of note is that the regulations and form instructions specify it must be sent to a "service center."

There are no instructions if the prior return was electronically filed. As Form 8869 cannot be electronically filed, practitioners commonly take the position that it should be filed with the service center where the most recent return would have been filed if it had been paper-filed.

Another quirk is where to deliver if mailing using the U.S. Postal Service (USPS) versus a private delivery service such as United Parcel Service or FedEx. The USPS will deliver to the service center, and there are no instructions providing a delivery address using USPS other than the service centers.

However, for using a private delivery service to file a tax return, the tax return is supposed to be delivered to a different address than the service center. The return form instructions provide a link to a web address to which a return is to be delivered using private delivery services. The web address provides an address that is not the service centers' (it even names them "submission processing centers" rather than the regulatory language of "service center"), but the form instructions provide it does meet the "timely mailing as timely filing" rule for tax returns. It is unclear if this address can also be used for a Form 8869 filing, since it is not a tax return or a service center. As the regulations and form instructions require delivery to a service center, it is unclear where to mail Form 8869 using a private delivery service. It may be best practice to mail Form 8869 to the service center and the private delivery service addresses.

Under IRM Section 3.13.2.24(3) (effective Jan. 1, 2025), the IRS will process a Form 8869 if it is faxed. However, the Form 8869 instructions do not provide fax instructions or a fax number to which it can be submitted. The Form 1120-S instructions also do not provide a fax number to which the tax return can be filed. Form 2553, *Election by a Small Business Corporation*, does provide instructions on how to file Form 2553 via fax. As Regs. Sec. 1.1361-3 and the Form 8869 instructions do not provide faxing as an appropriate method of filing, it is not recommended to rely upon a fax to meet the requirements of Regs. Sec. 1.1361-3. In addition, there have been issues with the IRS accepting a fax receipt as proof of filing, since the Service does not confirm receipt. This author has found faxing the form to be very effective if I already have proof of timely filing and the Form 8869 was never actually processed or was processed incorrectly by the IRS.

What is proof of depositing in the mail?

The third requirement of Sec. 7502 is proof of mailing. There is case law of taxpayers filing their returns and the IRS never receiving the filing or of the IRS losing the envelope from which the proof of mailing could be obtained. The taxpayer has the burden to prove that the form was mailed, and the courts have had mixed reactions on what proof is required. It is not uncommon for a court to consider a self-serving affidavit as not having much weight without other credible support.

If the taxpayer is filing using USPS, certified mail with a domestic return receipt is the best mailing method. The certified mail item should be stamped by the Postal Service when it is accepted. This is the proof of timely mailing that is required for Sec. 7502 purposes. A taxpayer or practitioner cannot self-certify by adding the postage to the letter. The Postal Service also allows senders to track the progress of the letter using the certified mail number on the USPS website.

For a private delivery service, the IRS issued Notice 2016-30, which provides the exclusive list of private delivery services that are acceptable for Sec. 7502 purposes. The list is very specific; for example, FedEx 2 Day is acceptable, but FedEx Ground is not. Thus, verifying the acceptable mailing type is necessary prior to shipping. In order to prove the form was timely placed in the mail, a copy of the mail receipt and, likely, a printout of the tracking record is required. There is little guidance on what evidence a court may require as proof of filing by a private delivery service, but an affidavit from the private delivery service on receipt of the package may be necessary. Note that a private delivery service is required to maintain the records for only six months.

Does the state-law conversion change the prescribed period for filing Form 8869?

In order for Sec. 7502 to apply, Form 8869 must be received after the prescribed period or prescribed date. In the case of Form 8869, there is not a simple answer to what is the prescribed period, providing for probably the single greatest risk to a timely filed Form 8869 in an F reorganization transaction. There is a risk that the state-law conversion will take place before Form 8869 is "filed," resulting in an ineffective QSub election. Without the application of Sec. 7502, many of the QSub elections filed today as part of an F reorganization would not be proper elections. While it is clear if the conversion under state law occurs before Form 8869 is "filed" that it is not a good QSub election, it is not clear whether the state-law conversion shortens the period for filing under Sec. 7502 so that Sec. 7502 applies.

In order for Sec. 7502 to apply, the election must be received after the prescribed period or prescribed date. Just because an entity no longer qualifies to be a QSub does not mean that the period in which to file the election is also shortened when the regulations provide clear guidance that the election must be filed within the two-month-and-15-day period. The additional requirement to also qualify at the time of filing may not be sufficient to change the two-month-and-15-day period requirement for Sec. 7502 purposes.

If using USPS, it is highly recommended to also use a domestic return receipt, which requires the IRS to sign the receipt upon delivery. This offers undeniable, direct proof of the IRS's actual receipt. The downside of this method of mailing is that it frequently takes a month or more to receive the domestic return receipt. Keep in mind that courts have not litigated whether a scan of a certified mail receipt is acceptable (instead of the actual original).

For private delivery services, the same issues with providing proof of depositing the form in the mail also apply to proof of delivery. A printout record of the tracking information should be maintained by the taxpayer.

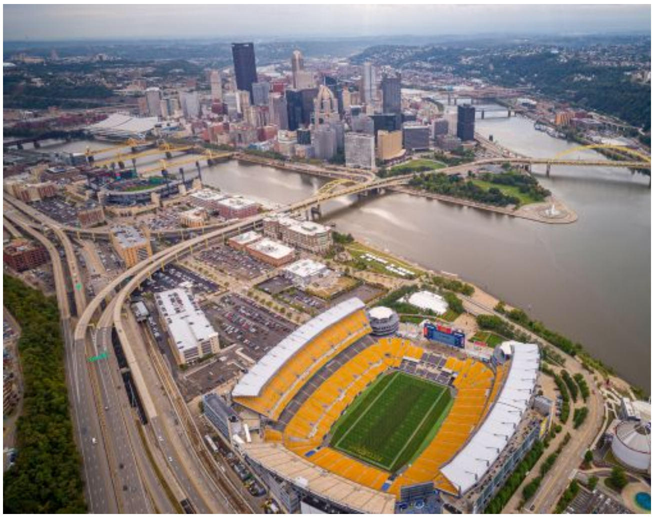
In conclusion, in planning an F reorganization with a legacy S corporation followed by a QSub election, there are a number of factors to consider to ensure the QSub election is effective. Depending upon the facts, there may be a substantial risk that Sec. 7502 does not apply to the QSub election, but with proper planning, the risk of an ineffective QSub election can be minimized.

From Jeff Alberty, CPA, J.D., Denver

State & Local Taxes

Pennsylvania Supreme Court invalidates Pittsburgh 'jock tax'

In September 2025, the Pennsylvania Supreme Court struck down a Pittsburgh tax imposed on nonresident athletes and entertainers, finding that the tax violates the Uniformity Clause of the Pennsylvania Constitution. In *National Hockey League Players' Association et al. v. City of Pittsburgh*, 343 A.3d 1165 (Pa. 2025), the court unanimously affirmed a lower court finding that the city's 3% public facility usage fee (facility fee) unconstitutionally



discriminated against nonresident athletes and entertainers who perform in the city's publicly funded sports venues. The decision is consistent with the Pennsylvania courts' historically strict interpretation of the Uniformity Clause of the Pennsylvania state constitution (Article VIII, §1).

Background and procedural history

Since 2005, Pittsburgh has levied a 3% nonresident public facility usage fee on nonresident athletes and entertainers who compete in athletic events or engage in other performances at a publicly funded sports stadium or arena in Pittsburgh. The city derives the taxing authority to impose the facility fee from the Local Tax Enabling Act of 1965, a state law that provides Pennsylvania localities other than Philadelphia with specific taxing powers. In contrast, Pittsburgh residents are not subject to the facility fee but instead are subject to the city's 1% earned income tax (EIT) and a 2% school district tax. In the aggregate, city resident and nonresident athletes and entertainers are taxed at the same rates but under two different taxing regimes.

In November 2019, several active and retired professional athletes and players' associations for the National Hockey League (NHL), Major League Baseball, and the National Football League filed a complaint with a state trial court, arguing that the facility fee treats nonresident athletes and performers less favorably than similarly situated resident athletes and performers, in violation of state uniformity principles. Pennsylvania's Uniformity Clause requires that "[a]ll taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under the general laws." The city argued that both residents and nonresidents pay the same total effective tax rate of 3%, since residents are also subject to a 2% school district tax that does not apply to nonresidents.

In September 2022, the Allegheny County Court of Common Pleas agreed with the taxpayers that the fee qualifies as a tax that violates state uniformity principles. In doing so, the court compared the 3% facility fee against the 1% resident EIT and found them not to be uniform. The court found "no permissible or rational basis for an unequal application of tax rates across residents and nonresidents." Accordingly, the court ruled the fee unconstitutional in violation of state uniformity principles.

Pittsburgh appealed the trial court decision to the Pennsylvania Commonwealth Court, arguing that resident athletes and entertainers are subject to the same tax rate as nonresidents when the 2% school earnings tax is taken into account. The Commonwealth Court disagreed with the city and affirmed the trial court, finding that the 2% school district tax paid by Pittsburgh residents is not relevant to the uniformity analysis. Finding that the city failed to provide a reasonable justification for treating residents and nonresidents as distinguishable classes that may be subject to different tax burdens, the

PHOTO BY MINDAUGAS DULINSKAS/ADOBE STOCK court affirmed the trial court and likewise concluded that the fee was unconstitutional. Pittsburgh petitioned the Pennsylvania Supreme Court for an allowance of appeal, which the court granted.

Supreme Court decision

In affirming both lower courts, the court found that Pittsburgh failed to provide a "concrete justification" for taxing nonresident athletes and entertainers at a higher rate than resident athletes and entertainers. The court rejected Pittsburgh's argument that the facility fee does not impose an unequal tax burden on nonresidents because it equalizes the tax burdens of residents and nonresidents. In doing so, the court disagreed with the city that its decision in *Minich v. City of Sharon*, 77 A.2d 347 (Pa. 1951), controlled the outcome of this case. In *Minich*, the court upheld a 5-mill EIT imposed on residents plus a 5-mill school tax, and a 10-mill EIT with no school tax imposed on nonresidents. The city argued that *Minich* employed a "functional," "rough uniformity" standard to uphold a local income tax scheme that was analogous to the facility fee. The court disagreed, finding that *Minich* applied no such functional analysis permitting taxing authorities to "manufacture uniformity" by aggregating distinct taxes into an overall tax that is roughly equal. Further, the court found that *Minich* did not employ the broad uniformity principles that the city attempted to read into the decision.

Turning to the taxpayers' arguments, the court agreed with the taxpayers that its decision in *Danyluk v. Bethlehem Steel Co.*, 178 A.2d 609 (Pa. 1962), was dispositive in the case at bar. *Danyluk* involved a $10 local occupational tax imposed upon nonresidents engaged in an occupation in the city of Johnstown. Residents were not subject to the occupational tax but instead paid a $10 per capita tax. The court held that a per capita tax only imposed upon residents could not be used to justify a nonuniform occupational tax on nonresidents.

The court relied on the *Danyluk* decision for the proposition that a locality "cannot use a tax which, of necessity, only applies to residents to cover up the discriminatory effect of a separate, disuniform tax on nonresidents." In the court's view, Pittsburgh's 2% school district tax cannot be used to justify the imposition of the facility fee under the court's Uniformity Clause jurisprudence. Concluding that Pittsburgh failed to provide a concrete justification for treating resident athletes and entertainers differently from nonresident athletes and entertainers, the court ruled the fee is unconstitutional.

Concurrences

In separate concurring opinions, two justices agreed with the majority that the facility fee violates the state Uniformity Clause, but for different reasons. The concurrences analyzed the overall burden of the city and school district taxes together to determine whether they resulted in discrimination between resident and nonresident performers. However, the justices concluded that Pittsburgh's denial of a credit to nonresident athletes (in contrast to residents) was sufficient to render the fee unconstitutional under the court's uniformity jurisprudence.

Implications

The court's invalidation of the facility fee is the latest decision in a long line of uniformity cases recently considered by Pennsylvania courts, which historically have applied a rigid interpretation of the state's Uniformity Clause. Most recently, in *Alcatel-Lucent USA Inc. v. Commonwealth*, 326 A.3d 816 (Pa. 2024), the state Supreme Court ruled that a taxpayer was not entitled to a refund of

Pennsylvania corporate net income tax paid in the 2014 tax year when the taxpayer's use of net operating loss (NOL) carryovers was limited by the state's percentage limitation for NOL deductions. The case represented the third Pennsylvania Supreme Court decision ruling on the application of the Commonwealth's complex and controversial NOL deduction provision, which began with the court striking down the fixed-dollar limitation on uniformity grounds in *Nextel Communications of the Mid-Atlantic v. Pennsylvania Department of Revenue*, 171 A.3d 682 (Pa. 2017). With respect to Pennsylvania property taxes, the court ruled in *Valley Forge Towers Apartments, LP v. Upper Merion Area School District*, 163 A.3d 962 (Pa. 2017), that the Uniformity Clause prohibited a school district from selectively appealing the tax assessments of commercial properties while passing over the assessment appeals of residential properties.

The court's decision in *National Hockey League Players' Association* likewise represents the latest case of professional athletes challenging the application of state and local "jock taxes" in nonuniform ways and at dissimilar tax rates for nonresident athletes compared to resident athletes. For example, the Ohio Supreme Court ruled in *Hillenmeyer v. Cleveland Board of Review*, 41 N.E.3d 1164 (Ohio 2015), that the games-played method for calculating Cleveland's nonresident tax on professional athletes violated the Due Process Clause of the U.S. Constitution because the calculation of the tax included days in which athletes were not present in the city. In 2014, Tennessee repealed its $2,500-per-game professional privilege tax imposed on certain professional athletes after the NHL and National Basketball Association players' associations challenged the tax on the basis that it did not apply to all professional sports played in the state (Tenn. H.B. 1134, Laws 2014).

The income tax treatment of sports enterprises and their players is distinctive due to the mobile nature of the business and the desire of states and localities to collect revenue on high-earning athletes and entertainers. Players have long been aware of the disparities in state and local tax burdens that exist in deciding where to live and what team to play for, often leading players to choose Florida or Texas franchises because these states do not impose a personal income tax. As discussed above, the local taxes imposed on nonresident athletes may be significant when aggregated with state taxes, even affecting those athletes establishing residency in non-income-tax states.

In the near term, Pittsburgh will be required to pay out refunds to athletes and entertainers who have paid a tax that is now invalid. The city will also be pressed to look for ways to replace the lost revenue previously collected from nonresident athletes and entertainers. Pittsburgh may also consider restructuring its EIT system such that similar taxes and rates are imposed on residents and nonresidents alike, as a means to ensure that they do not run afoul of the state's strict uniformity requirements. On a broader scale, the *National Hockey League Players' Association* case serves as a reminder that state and local taxes singling out nonresidents may be at risk for discriminatory treatment challenges in states with strictly interpreted uniformity clauses similar to Pennsylvania's.

From Jamie C. Yesnowitz, J.D., LL.M., Washington, D.C., and Patrick K. Skeehan, J.D., Philadelphia

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IMAGE BY WACOMKA/ADOBE STOCK

CPA firm M&A tax issues

By: Paul N. Iannone, CPA, J.D., and Danny A. Pannese, CPA/ABV/CFF

Consolidation of CPA firms continues to advance at a steady pace. Advisers and consultants often play a key role in locating acquisition or merger targets, facilitating discussions and negotiations, and designing deal terms and conditions. In many CPA firm consolidations, the legal entity and tax issue complexities rest with the CPA firm parties to handle. Further, legal counsel may not have in-house tax personnel to assist with the tax structure and may assume that because the parties to the transaction are CPA firms, they have the tax issues under control. In many cases, the deal progresses, and the terms are negotiated absent proper attention to any tax pitfalls or tax efficiencies in the legal entity structure.

Many CPA acquisitions involve purchasing a practice for cash from a retiring partner. Typically, the retiring partner would remain employed for a year or two to aid in the transition and to secure the existing client base. In other cases where the partners (or sole owner) may be younger and want to continue working in a larger practice environment or where finding talent is problematic, the acquisition consideration may be equity in the acquirer where the target partners (or sole owner) become owners of the acquirer.

This article discusses some of the possible entity deal structures for CPA mergers and acquisitions (M&As) and their potential tax issues (and, to a large extent, those more broadly applicable to M&As of other types of businesses). The recent trend of private-equity investments in public accounting firms creates the need for alternative legal entity structures to comply with state-law requirements. Due to the differences in state-law requirements and their consequential legal entity structure requirements, structuring for private-equity investment is beyond the scope of this article, which discusses only federal tax law.

For consistency, this article uses the following nomenclature, word construction, and assumptions:

- "Combination" can broadly refer to either an asset acquisition or a merger.
- A limited liability company (LLC) will be identified as a multimember LLC (MMLLC) or a single-member LLC (SMLLC), depending upon the structure discussed.
- In this article, MMLLCs and limited liability partnerships (LLPs) are classified as partnerships for tax purposes. This article assumes that no entity-classification election was made to treat these entities as corporations.
- An SMLLC is classified as a disregarded entity for tax purposes. This article assumes that no entity-classification election was made to treat an SMLLC as a corporation.
- Corporations will be specifically referred to as either S corporations or C corporations as the structure requires.
- A merger of firms is not necessarily a "merger of equals." A merger may also connote an acquisition of a target firm.

Contingent asset acquisitions

Many CPA firm acquisitions are promoted as "mergers" rather than "acquisitions" to quell client concerns over continuity of the practice. Many CPA firm acquisitions are true asset acquisitions of a going concern where the existing owner or owners are retirement-minded and lack internal succession. The assets acquired typically are both tangible and intangible, with intangible assets comprising the bulk of the assets acquired. Intangible assets principally include the client base and goodwill. In addition, the parties typically enter into some form of a covenant-not-to-compete agreement, either a standard geographic/time covenant or an anti-solicitation covenant, or both. In an asset acquisition, the selling entity would remain in the hands of the target owners and would likely be liquidated at some future date.

The terms of each deal are unique to each situation. Nevertheless, in many asset acquisitions where the owners are retirement-minded, the assets (essentially, the intangible client base or goodwill) are purchased with a minimal down payment on a contingent basis for a price that is dependent upon future collected billings. For example, the purchase price may be structured to require 20% of collected billings for five years to be paid to the target seller. This would equate to 100% of one year's gross receipts or "1 × revenue." In a contingent installment sale, there is symmetrical risk for both the acquirer and the acquired. An exodus of clients post-acquisition could be detrimental to both sides.

In the example above, for tax purposes, this type of transaction is considered a contingent installment sale. It is contingent because the ultimate selling price is not known until the five-year term has elapsed. Contingent installment sales have special reporting requirements for both the acquired entity (target) and the acquiring entity (acquirer). The target must determine the tax year of any gain recognition.[1] The acquirer must determine the tax year of acquisition for the assets acquired as well as the amount and timing of depreciation and amortization deductions. Both the target and the acquirer have information-reporting requirements to report the allocation of the assets acquired on either Form 8594, *Asset Acquisition Statement Under Section 1060*, or Form 8883, *Asset Acquisition Statement Under Section 338*. Inconsistencies in reporting between the target and acquirer could result in IRS scrutiny.

Assets acquired in an "applicable asset acquisition," i.e., assets that constitute a trade or business for which the basis is determined

1. Installment sales are reported on Form 6252, *Installment Sale Income*.

EXECUTIVE SUMMARY

- CPA firm acquisitions are often asset acquisitions, with intangible assets, such as a client base and goodwill, predominating.
- Many firm mergers and acquisitions take the form for tax purposes of a contingent installment sale, with special reporting requirements for gain recognition and the amount and timing of depreciation and amortization deductions.
- In a merger or consolidation of partnerships, the continuing partnership is generally that of which its members own more than half of the capital and profits of the resulting partnership. The transaction can take one of the two forms — the assets-over form or the assets-up form. The assets-over form is the default.
- Combinations of two corporations can generally result in nonrecognition of gain, provided the Code and regulations are followed. However, combinations of corporations with limited liability companies can pose issues reconciling Subchapters C and K of the Code.

by reference to the consideration paid for the assets, are subject to the special allocation rules of Sec. 1060.[2] Acquired assets in an applicable asset acquisition are allocated using the residual method as prescribed in the regulations governing deemed asset acquisitions under Sec. 338 and, in particular, Sec. 338(b)(5) and the regulations thereunder.[3] Under the residual method, assets are allocated pursuant to their fair market value (FMV) among seven classes of assets (Classes I through VI, with any residual allocated to goodwill, Class VII).[4]

Whether or not a written promissory note has been executed in a contingent installment sale,[5] the contingent consideration is considered an installment obligation. The target must report the sale transaction using the installment-sale method or elect out of installment-sale reporting.[6] General principles of taxation apply to determine whether the assets sold result in capital gain or ordinary income, including any imputed interest.[7] Nevertheless, the target must report any ordinary recapture income in the year of disposition.[8] Recapture income includes any ordinary income under Secs. 1245, 1250, and 751 (as it relates to Sec. 1245 or 1250).[9]

The contingent-payment regulations provide detailed rules "to be applied in allocating the taxpayer's basis (including selling expenses except for selling expenses of dealers in real estate) to payments received and to be received in a contingent payment sale."[10] The regulations set forth guidance for contingent-payment sales in which a maximum selling price is determinable, for sales in which a maximum selling price is not determinable but the payment term is defined, and sales in which neither a maximum selling price nor a payment term is defined.[11] In addition, the regulations permit taxpayers in appropriate situations to recover basis under an income-forecast computation.[12]

In transactions where the maximum selling price is determinable (for example, the purchase-and-sale agreement provides for payment of 20% of collected billings over five years with a maximum cap on the contingent consideration), the regulations provide that in calculating the gross profit[13] for installment sale reporting, the specified maximum selling price is used, assuming all contingencies in the agreement are satisfied.[14] The initial maximum selling price

2. Sec. 1060(c).
3. Sec. 1060(a); Regs. Sec. 1.1060-1(c)(2), citing Regs. Secs. 1.338-6 and 1.338-7.
4. Regs. Sec. 1.338-6(b). A complete discussion of Sec. 1060 and allocation is beyond the scope of this article.
5. The regulations under Regs. Sec. 15a.453-1(c) refer to contingent installment sales as "contingent payment sales."
6. Regs. Sec. 15a.453-1(c)(1). See Sec. 453(d) for electing out of installment-sale reporting. For electing out of contingent-payment sales, see Regs. Sec. 15a.453-1(d)(2)(iii) for valuing the contingent-payment obligation. "The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale)" (Regs. Sec. 15a.453-1(d)(2)(iii)).
7. Generally, capital gain or loss treatment results from the sale of goodwill or client base. Ordinary income results from a payment for a covenant not to compete. In addition, in the absence of stated interest, the rules for reporting imputed interest under Secs. 483, 1274, and 1275 should generally apply. See Regs. Sec. 1.1274-2(c) for rules pertaining to whether a debt instrument provides for adequate stated interest.
8. Sec. 453(i)(1)(A).
9. Sec. 453(i)(2).
10. Regs. Sec. 15a.453-1(c)(1). A complete discussion of the installment contingent payment regulations are beyond the scope of this article. Only general principles will be presented. See Regs. Sec. 15.a453-1(c) for further details and examples.
11. Id.
12. Id.
13. Gross profit equals selling price less the adjusted basis as defined in Sec. 1011 (including its regulations) (Regs. Sec. 15a.453-1(b)(2)(v)).
14. Regs. Sec. 15a.453-1(c)(2)(i).

will be used to determine the gross profit ratio (gross profit divided by the contract price[15]) in all years unless the maximum selling price is reduced by the terms of the agreement, amendment to the agreement, application of a payment recharacterization rule (dealing with recomputed interest where there is a contractual arrangement that treats part of the selling price as an interest payment),[16] or by a subsequent event such as the obligor's bankruptcy.[17] In such a reduction situation, the gross profit ratio is reduced in the tax year of the event causing the reduction and in subsequent years.

In transactions where the maximum selling price is not determinable but the term is fixed (which would likely be the case in many CPA firm asset acquisitions), the target's tax basis (including any selling expenses) is allocated in equal annual amounts over the term of the payments to be received under the agreement.[18] If no payments are received in any tax year, or if the payment received (not including any interest) is less than the tax basis, no loss is allowed, unless it is the last payment year or the obligation is deemed to be worthless.[19] In a tax year when no loss is allowed, "the unrecovered portion of basis allocated to the taxable year shall be carried forward to the next succeeding taxable year."[20]

In transactions where there is neither a maximum selling price nor a fixed term for payments, the regulations question whether there was actually a sale or whether the payments resemble some other economic arrangement, such as rent or royalty income.[21] If a sale does realistically exist, the regulations provide that basis is recovered ratably over 15 years beginning with the year of sale.[22] If no payments are received in any tax year, or if the payment received (not including any interest) is less than the tax basis, no loss is allowed unless the obligation is deemed to be worthless.[23] "[I]nstead the excess basis shall be reallocated in level amounts over the balance of the 15 year term. Any basis not recovered at the end of the 15th year shall be carried forward to the next succeeding year, and to the extent unrecovered thereafter shall be carried forward from year to year until all basis has been recovered or the future payment obligation is determined to be worthless."[24]

The target can choose to hold the unrecovered contingent installment obligation to full term or distribute the contingent installment obligation to its owners. A distribution of an installment obligation is considered a disposition of the installment obligation subject to potential accelerated gain recognition, depending upon the type

15. Regs. Sec. 15a.453-1(b)(2)(i). Contract price "means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in [Regs. Sec. 15a.453-1(b)(2)(iv)]), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property" (Regs. Sec. 15a.453-1(b)(2)(iii). "The term 'selling price' means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price" (Regs. Sec. 15a.453-1(b)(2)(ii)).
16. See Regs. Sec. 15a.453-1(c)(2)(ii) for further details concerning the payment-recharacterization rule.
17. Regs. Sec. 15a.453-1(c)(2)(i).
18. Regs. Sec. 15a.453-1(c)(3)(i).
19. Id.
20. Id.
21. Regs. Sec. 15a.453-1(c)(4).
22. Id.
23. Id.
24. Id.

of distributor entity. In the case of a C corporation liquidating distribution of an installment obligation, the distribution of the installment obligation is a disposition resulting in corporate-level gain recognition to the extent of the difference between the amount realized and the basis of the installment obligation.[25] With respect to the shareholders of the corporation, in general,[26] the shareholder may treat the receipt of payments under the installment obligation as payment for its stock (rather than the installment obligation) provided that (1) the distribution of the installment obligation is pursuant to Sec. 331;[27] (2) the liquidating corporation acquired the installment obligation in respect of a sale or exchange during the 12-month period beginning on the date a plan of complete liquidation is adopted; and (3) the liquidation is completed during such 12-month period. Essentially, the shareholder may use the installment method with respect to the Sec. 331 gain for the payments received under the installment obligation (unless the shareholder elects out of the installment-sale method).[28]

There is a special exception to corporate-level gain for S corporations upon a liquidating distribution of an installment obligation. Provided that the requirements discussed above under Sec. 453(h)(1) are satisfied, there is no gain recognition at the S corporation level upon the liquidating distribution of the installment obligation to the shareholders.[29] This exception does not apply to any built-in gains tax under Sec. 1374 or to the passive investment income tax under Sec. 1375.[30] Further, provided the requirements of Sec. 453(h)(1) are satisfied, the S shareholders may avail themselves of the installment method of reporting their Sec. 331 gain with respect to the installment obligation.

With respect to partnerships, a distribution of the installment obligation to a partner under Sec. 731 should not result in recognition of gain at the partnership level.[31] This general rule for nonrecognition does not apply to distributions pursuant to Secs. 704(c)(1)(B), 736, 737, and 751(b).[32]

In a contingent installment sale, the acquirer is faced with determining the timing of capitalizing and depreciating or amortizing contingent payments made to the target. In general, the cost of property acquired in exchange for a debt instrument is equal to the issue price of the debt instrument as determined under Secs. 1273 and 1274 and the regulations thereunder, whichever applies.[33] The regulations under Sec. 1274[34] provide that if a debt instrument provides for one or more contingent payments, the issue price is the lesser of (1) the noncontingent principal payments and (2) the sum of the

25. Sec. 453B(a). This section also applies to a nonliquidating distribution.
26. There are other detailed rules in Sec. 453(h) that are not discussed in this article, e.g., related-party rules, liquidating subsidiaries, etc.
27. Sec. 331, *Gain or Loss to Shareholder in Corporate Liquidations*, provides rules for a distribution received by a shareholder in exchange for stock in a complete liquidation. Further, for Sec. 453(h) to apply, the shareholders' stock must not be publicly traded. See Sec. 453(k)(2).
28. Sec. 453(h)(1)(A).
29. Sec. 453B(h).
30. Id.
31. Prop. Regs. Sec. 1.453B-1(c)(1)(i)(C). Presumably, this exception agrees with the aggregate approach to partnership taxation. Sec. 731 provides rules regarding gains or losses on partnership distributions.
32. Id. These sections override nonrecognition for certain types of "mixing bowl" transactions, payments to a retiring or deceased partner's successor's interest, and disproportionate distributions of "hot assets" (ordinary-income assets).
33. Regs. Sec. 1.1012-1(g).
34. *Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property*.

present values of the noncontingent principal payments.[35] This means that only the noncontingent payments create tax basis; contingent payments create basis only in the tax year when they are actually paid or become fixed.[36]

In many cases, contingent payments will be allocated to the acquired intangible assets, i.e., goodwill and client base. These intangibles are Sec. 197 intangibles amortizable ratably over a 15-year period beginning with the month of acquisition.[37] With respect to the treatment of contingent amounts, amounts that are included in tax basis during the 15-year period are amortized ratably over the remainder of the 15-year period.[38] Contingent amounts that are included in tax basis after the expiration of the 15-year period are immediately amortized in full.[39]

Partnership combinations

Regulations provide guidance where partnerships[40] consolidate or merge into one partnership.[41] For simplicity, this article and the following example assume that the partnership merger transaction only includes two partnerships. In addition, consideration for the target owners will only include equity of the acquirer and will not include any cash.

In the case of a merger or consolidation of two or more partnerships, the continuing partnership is the partnership whose members own more than 50% of the capital and profits of the resulting partnership.[42] In the case where partners own interests in both partnerships (pre-merger) and both partnerships can be considered the continuing partnership under the 50% threshold discussed above, the partnership credited with the greatest FMV of assets (net of liabilities) in the resulting partnership is considered the continuing partnership.[43] The tax year of the terminated partnership will close under the provisions of Sec. 706(c), and it will file its final return for a tax year ending on the date of termination.[44] The regulations provide for two alternate structures or forms, "assets-over" and "assets-up."[45]

Assets-over

Unless the form of the transaction specifically comports to the assets-up form, the transaction will be governed by the assets-over form.[46] In other words, assets-over is the default form. For example, under this default rule, a contribution of all the partners' interests in Partnership *A* to Partnership *B* in exchange for interests in Partnership *B*, with Partnership *A* being immediately liquidated into Partnership *B*, is treated as an assets-over form.[47]

> ***Example:*** The acquirer CPA firm, Firm *A*, is an MMLLC that will acquire another CPA firm, Firm *B*, that is also an MMLLC. Both are classified as partnerships for tax purposes. Firm *A* will acquire all of Firm

35. Regs. Sec. 1.1274-2(g). See also Regs. Sec. 1.1275-4(c)(4) for characterization of principal and interest for contingent-payment debt instruments.
36. For purposes of determining the adjusted grossed-up basis under Sec. 338(b) and Regs. Sec. 1.338-5, this rule should equally apply to a deemed asset acquisition under Sec. 338, including an acquisition election under Sec. 338(h)(10). Sec. 338 applies to elections to treat stock transactions as deemed asset acquisitions.
37. Secs. 197(a) and (c).
38. Regs. Sec. 1.197-2(f)(2)(i).
39. Regs. Sec. 1.197-2(f)(2)(ii).
40. Partnerships include general partnerships, MMLLCs, and LLPs.
41. Regs. Sec. 1.708-1(c).
42. Sec. 708(b)(2)(A); Regs. Sec. 1.708-1(c)(1).
43. Regs. Sec. 1.708-1(c).
44. Regs. Sec. 1.708-1(c)(2).
45. Regs. Sec. 1.708-1(c)(3).
46. Regs. Sec. 1.708-1(c)(3)(i).
47. Regs. Sec. 1.708-1(c)(5), Example (4).

Many CPA firm acquisitions are promoted as 'mergers' rather than 'acquisitions' to quell client concerns over continuity of the practice.

B's assets, both tangible and intangible, and assume all liabilities. The consideration for the acquisition will be LLC membership interests in Firm *A*. Firm *B* will merge into Firm *A* under state law. Firm *A* will be the surviving partnership; Firm *B*'s legal existence will be terminated.

Under the assets-over form, the partnership that is considered terminated contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership.[48] This exchange should not result in any gain or loss.[49] The terminated partnership is considered to distribute the interests in the resulting partnership to its partners in liquidation of the terminated partnership.[50] Assuming no cash is distributed, the distribution of the partnership (membership) interest in liquidation should also not result in any gain or loss to the distributee partners or the liquidating partnership.[51] Tax basis in the distributed resulting partnership interests to the distributee partners should be equal to their adjusted tax basis in the liquidating partnership.[52] The tax basis in the assets contributed by the terminating partnership should also carry over to the resulting partnership.[53]

Assets-up

Partnerships could also be combined using an assets-up form, where partnership assets are distributed "up" to the partners with a subsequent contribution of those assets to the acquiring or resulting partnership. Provided that the partnership that is considered terminated distributes all of its assets to its partners, the transitory or momentary ownership of the assets by the partners will be disregarded, and therefore, the concept of partnership continuation will be respected.[54] Specifically, under this assets-up form, the partnership that is to be terminated must actually distribute all of its assets to its partners (in a manner that the partners are treated as the owners of the assets under state law) in liquidation of the partners' interests.[55] Immediately thereafter, the partners must contribute the distributed assets to the resulting partnership.[56] To qualify as an assets-up transaction, the transaction must follow the form described

48. Regs. Sec. 1.708-1(c)(3)(i).
49. See Sec. 721(a). See also Sec. 722 for the tax basis of the interest acquired by the terminating partnership.
50. Regs. Sec. 1.708-1(c)(3)(i).
51. See Sec. 731. Whether the mixing-bowl statutes under Secs. 704(c)(1)(B) and 737 apply is beyond the scope of this article.
52. See Sec. 732(b).
53. See Sec. 723.
54. Regs. Sec. 1.708-1(c)(3)(ii).
55. Id.
56. Id.

above. Otherwise, it will be governed by the assets-over form.

There are certain disadvantages to the assets-up form that make it less advantageous than the assets-over form. Using the assets-up form, there is the added legal cost and complexity of effecting actual distributions of assets and assumption of liabilities, including retitling of certain assets such as automobiles and real estate; paying transfer taxes such as real estate conveyance taxes; obtaining any consents pursuant to existing contracts; and dealing with creditors regarding assumption of debt, which could result in accelerating the balance due. In addition, distributions of partnership assets in the assets-up form could trigger partner-level gain where cash distributed may exceed a partner's tax basis in their interest, including a reduction in liabilities treated as a cash distribution.[57] Further, tax basis of the distributed partnership assets may change when in the hands of the partner under the assets-up form. A change in basis may occur because the tax basis of assets distributed to partners in liquidation of a partner's interest is equal to the adjusted basis of the partner's interest in the partnership, reduced by any cash distributed in the same transaction.[58]

Corporate and SMLLC/MMLLC combinations

CPA firm acquisitions involving only equity consideration can present some difficult tax issues where (1) the acquirer is a corporation, either a C or S corporation, and the target is an SMLLC (or sole proprietorship) or an MMLLC (or general partnership); or (2) the acquirer is an SMLLC (or sole proprietorship) or an MMLLC (or general partnership) and the target is a corporation, either a C or S corporation. Some of the difficulty lies in the need to cross-reference Subchapter C (corporations) and Subchapter K (partnerships), unlike pure partnership combinations that are only affected by Subchapter K. Each of these acquisition types is examined next.

Corporate acquirer, SMLLC or MMLLC target

A corporation (C or S) may acquire the sole membership interest of an SMLLC or the membership interests of an MMLLC (no check-the-box election to be classified as a corporation) or may directly acquire the assets of the SMLLC or MMLLC. With respect to an SMLLC, for federal tax purposes, the transaction is treated as acquiring the assets of the SMLLC because the SMLLC is a disregarded entity.[59] A merger under state law of an MMLLC into a corporation, with the corporation as the survivor, is treated as a transfer of assets by the MMLLC to the corporation for tax purposes. The corporate nontaxable reorganization provisions of Subchapter C do not apply to a corporate/partnership merger under state law. Further, with respect to an MMLLC, the form of the transaction (including the merger of an MMLLC into a corporation) will be respected whether it is an exchange of the entity's assets or an exchange of the members' membership interest for equity in the corporation because the MMLLC is not disregarded for tax purposes.[60] The danger in the corporate acquisition of an SMLLC (or sole proprietorship) or MMLLC (or LLP, or

57. See Secs. 731(a)(1) and 752(b). Gain may also be recognized under the mixing-bowl provisions of Secs. 704(c)(1)(B) and 737.
58. Sec. 732(b). For an excellent in-depth discussion of the assets-up form, see Bloomberg Tax Research, Portfolio 718, *Disposition of Partnership Interests or Partnership Business; Partnership Termination*, Section IV.C., "Structural Changes."
59. Regs. Sec. 301.7701-3(b)(1)(ii).
60. Regs. Sec. 301.7701-3(b)(1)(i).

partnership) is that the exchange transaction, i.e., assets for stock, must satisfy Sec. 351[61] to receive nonrecognition treatment for the target or target owners.

No gain or loss is recognized to the transferor if property is transferred to a corporation solely in exchange for stock, provided that the transferor or transferors are in control of the corporation immediately after the exchange.[62] Control is defined as ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of the corporation's stock.[63]

Consequently, unless the target transferor(s) acquires control of the acquirer (the "minnow swallowing the whale"), the gain or loss will be recognized to the transferors. The transfer of assets by the target (including a transfer of the sole membership of an SMLLC) or the transfer of MMLLC membership interests by the members can result in gain (or loss) to the transferor(s) measured by the difference between the FMV of the property transferred and the adjusted tax basis. With respect to the transfer of goodwill or client base, these assets generally have zero tax basis unless these intangibles were previously purchased in a taxable transaction (any amortization previously deducted could result in ordinary income[64]). Consequently, the exchange of intangibles can result in potentially significant gain recognition to the transferor(s) without the receipt of cash to pay the resulting tax. In a gain recognition situation, the acquirer will receive FMV as tax basis for the acquired assets. In this case, it may be advisable to negotiate a tax-sharing agreement with respect to the tax benefit of the amortization deductions inuring to the acquirer.

SMLLC or MMLLC acquirer, corporate target

Structuring an acquisition of corporate assets by an SMLLC or MMLLC in exchange for LLC equity can create its own set of difficulties. The good news is that no gain or loss is recognized to any partner or partnership for a contribution of property in exchange for an interest in the partnership.[65] Therefore, a corporate target that contributes assets in exchange for a partnership interest (including a membership interest) to a partnership (or an SMLLC that becomes a partnership upon the contribution and exchange) should not recognize gain or loss. The acquiring partnership would succeed to the corporation's tax basis in the assets, i.e., carryover basis.[66] With one caveat, this nonrecognition rule should also apply to the contribution of a shareholder's stock in the corporation to the partnership in exchange for a partnership interest, resulting in the creation of a corporate subsidiary of the partnership. The caveat is that the contribution of stock of an S corporation would terminate the S election because a partnership is not an eligible shareholder of an S corporation.[67]

A transfer of assets by a corporation to a partnership in exchange for an interest in the partnership would result in the corporation's becoming a partner in the partnership. Under

61. *Transfer to Corporation Controlled by Transferor*.
62. Sec. 351(a).
63. Sec. 368(c).
64. See Sec. 197(f)(7), treating them as depreciable property.
65. Sec. 721(a). This general rule does not apply in the case of a partnership treated as an investment company (defined in Sec. 351) (Sec. 721(b)).
66. Sec. 723.
67. See Sec. 1361(b)(1).

state law in many jurisdictions, only licensed CPAs (or a limited number of non-CPAs) can be partners in a CPA firm. As a result, the corporation would need to divest itself of the partnership interest by either making a current distribution of the interest or a liquidating distribution. State law should be consulted on whether a momentary corporate ownership of a CPA firm partnership interest is permissible.

In either a corporate current distribution or a liquidating distribution, a distribution of appreciated property to a shareholder results in gain recognition at the corporate level as if the property were sold to the shareholder(s).[68] Therefore, the distribution of the partnership interest (membership interest) to the shareholders of the corporation would result in corporate-level gain recognition. For S corporation distributions of appreciated property, the gain passes through to the shareholders and increases their stock basis. The S corporation could also be subject to the built-in gains tax if the distribution was made during the five-year recognition period.[69] For C corporations, the distribution would constitute a taxable dividend or taxable liquidating distribution to the shareholders, creating a potential double-taxation situation.[70]

If the corporate target merges into an SMLLC or an MMLLC under state law, the merger is not governed by the nontaxable reorganization provisions of Sec. 368 located in Subchapter C.[71] For Subchapter C to be invoked, both the acquirer and the target must be corporations (either a C or S corporation). In such a corporation merger into an LLC, the corporation transfers all assets and liabilities to the acquirer and is terminated under state law. The LLC acquirer is the survivor. In exchange for corporate net assets, the corporate shareholders receive membership interests in the LLC. In the case of a merger of a corporation into an SMLLC, the SMLLC would then convert to an MMLLC.

For federal tax purposes, a state-law merger of a corporation (either a C or an S corporation) into an LLC resembles the assets-over form discussed above. The merger is treated as a transfer of corporate assets to the LLC (and an assumption of liabilities by the LLC) in exchange for membership interests in the LLC. The membership interests are then deemed distributed to the corporate shareholders in complete liquidation of the corporation.[72] No gain or loss should be recognized to the corporation upon the transfer of assets to the LLC.[73] Tax basis of the assets in the hands of the LLC is carryover basis.[74] Gain or loss will be recognized to the corporation upon the deemed distribution of membership LLC interests as though the corporation sold the membership interests at FMV to the shareholders.[75] The shareholders will recognize gain or loss upon receipt of the deemed liquidating distribution in exchange for their stock.[76] Note that the assets-over approach for a merger of a corporation into an LLC that is not owned prior to the merger by the corporation is in contrast to the assets-up form for a corporation

68. See Sec. 311(b) for current distributions and Sec. 336(a) for liquidating distributions.
69. Sec. 1374.
70. Sec. 301 for current distributions; Sec. 331 for liquidating distributions.
71. Regs. Sec. 1.368-2(b)(1)(iii), Example (5).
72. IRS Letter Ruling 200214016.
73. Sec. 721(a).
74. Sec. 723.
75. Sec. 336. For S corporations, the gain or loss passes through to the shareholders. Further, for S corporations, the built-in gains tax of Sec. 1374 may also apply.
76. Sec. 331.

that changes its classification to an LLC under the entity-classification regulations. Under the entity-classification regulations, if a corporation elects to be classified as a partnership (or MMLLC), the corporation is treated as distributing all of its assets and liabilities to its shareholders in liquidation of the corporation, and immediately thereafter, the shareholders are treated as if they contributed all of the distributed assets and liabilities to a newly formed partnership.[77] Under the entity-classification regulations, if a corporation elects to be classified as a disregarded entity (SMLLC), the corporation is treated as distributing all of its assets and liabilities to its single owner in liquidation of the corporation.[78]

Corporate combinations

An acquisition transaction that involves both a corporate acquirer and corporate target where the consideration is substantially stock in the acquirer can result in nonrecognition of gain or loss under the corporate reorganization provisions in Subchapter C of the Code. The reorganization provisions apply to S corporations as well as C corporations.[79] Nonrecognition is not guaranteed. A failure to meet the technical requirements of Sec. 368 and the regulations thereunder will result in a taxable sale to the target and/or the target shareholders.

The transaction must meet the requirements of one of the nontaxable reorganizations permitted in Sec. 368. Three common structures are: an "A" reorganization (statutory merger under state law);[80] a "B" reorganization (stock exchange);[81] and a "C" reorganization (exchange of the acquirer's voting stocks for the target's assets).[82] Each of these reorganizations has its own requirements, including the percentage of stock required as consideration, the amount of cash or other property given as consideration, whether voting stock is required to be used as consideration, the amount of assets that must be transferred to the acquiring corporation, and others. A complete discussion of the reorganization provisions is beyond the scope of this article.

Under state law in many jurisdictions, only licensed CPAs (or a limited number of non-CPAs) can be partners in a CPA firm.

The F reorganization

A structure for the acquisition of an S corporation that has become popular in recent years is the so-called "F reorganization" acquisition structure.[83] It is worth a mention in this article, even though it may be a difficult structure for CPA firm acquisitions due to state-law restrictions of non-CPA owners discussed below.

The F reorganization acquisition is useful to preserve S corporation status for the target when there could potentially be an ineligible shareholder of the S corporation. Under the

77. Regs. Sec. 301.7701-3(g)(1)(ii).
78. Regs. Sec. 301.7701-3(g)(1)(iii).
79. "Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders" (Sec. 1371(a)).
80. Sec. 368(a)(1)(A).
81. Sec. 368(a)(1)(B).
82. Sec. 368(a)(1)(C).
83. An F reorganization is described in Sec. 368(a)(1)(F) as "a mere change in identity, form, or place of organization." It is discussed in Rev. Rul. 2008-18. See also Joshi, "Private Equity and F Reorganizations Involving S Corporations," 51 *The Tax Adviser* 566 (September 2020).

F reorganization (as described in Situation 1 of Rev. Rul. 2008-18), the shareholders of the S corporation contribute their stock to a new corporation so that the new corporation owns all the stock of the S corporation. This contribution of stock is followed by a qualified Subchapter S subsidiary (QSub) election[84] for the old S corporation, resulting in the old S corporation becoming a disregarded entity. The old S corporation's S election does not terminate but continues for the new parent corporation.[85]

The QSub then converts to an LLC under state law, which should be a nontaxable transaction (i.e., disregarded to disregarded). The acquirer then makes a nontaxable cash contribution to the LLC, converting the SMLLC to an MMLLC. The MMLLC would have two partners, the S corporation, owned by the original S corporation owners, and the acquirer entity. This structure would create a partially owned subsidiary (now a partnership) of the acquirer. The clients remain in the original entity, now in the form of an MMLLC.

Unfortunately, this structure could violate state restrictions of nonlicensed CPAs (in this case, the S corporation and the acquirer entity) having an ownership interest in a CPA firm. Some states allow some percentage of ownership by nonlicensed CPAs.

Planning for tax issues

This article is meant to highlight a few of the common structures and tax complexities encountered in a typical CPA acquisition; there certainly may be others. Consolidation of CPA firms does not appear to be slowing down. Structuring the transaction from a tax perspective should not be left to the end of the negotiation process. The tax issues could be as complex, and possibly as contentious, as the nontax deal terms. Too often, the parties assume the other has considered all the tax ramifications. ■

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MEMBER RESOURCES

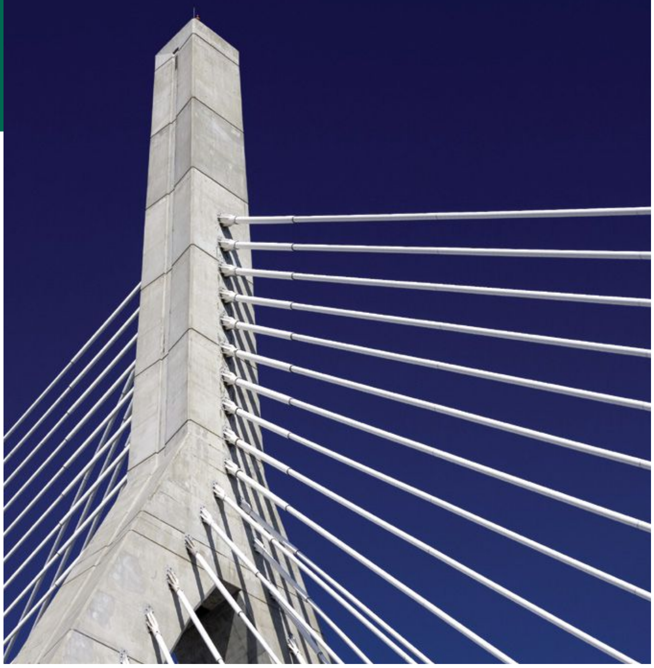
Article

- Peterson, "Understanding the Current M&A Market," AICPA Professional Insights, Sept. 4, 2024

Webpages

- Mergers & Acquisitions
- Key Considerations When Buying a CPA Practice

84. See Sec. 1361(b)(3).
85. Rev. Rul. 64-250 and Rev. Rul. 2008-18. See also Form 8869, *Qualified Subchapter S Subsidiary Election*, Part II, Question 14.



TAX PRACTICE RESPONSIBILITIES

Return preparer reliance on third-party tax advice

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Advisers must be competent, reliable, and free from conflicts of interest for signing preparers to use their advice on a return or claim for refund.

Tax return preparers are often asked to prepare tax returns that are consistent with tax positions or strategies that originate with third-party advice. Clients frequently receive services from attorneys, financial advisers, and other tax professionals in addition to their primary tax return preparer. Such advice can take the form of a formal written tax opinion, informal written or verbal advice, computational schedules, or even suggested reporting positions that lead to an entry on the client's tax return.

Most tax return positions must be supported by substantial authority or reasonable basis with adequate disclosure to avoid accuracy-related penalties under Sec. 6662 if challenged. Sec. 6664(d)(3) provides that tax return positions involving reportable transactions must be adequately disclosed, identify substantial authority for the position, and have a good-faith belief that the position is more likely than not correct, to avoid accuracy-related penalties under Sec. 6662A (Sec. 6694(a)(2)(C)). The safeguards that protect taxpayers from accuracy-related penalties are the same safeguards that protect tax return preparers from preparer penalties under Sec. 6694. The potential for third-party advisers to reach different conclusions than

> **The potential for third-party advisers to reach different conclusions than the primary tax return preparer can create difficult professional practice dilemmas for the preparer tasked with signing the return.**

the primary tax return preparer can create difficult professional practice dilemmas for the preparer tasked with signing the return.

Tax return preparers

Understanding who qualifies as a tax return preparer is the foundation for analyzing reliance issues. There are incongruities in the procedural requirements associated with the preparation of tax returns as a paid preparer. Sec. 6109(a)(4) and Regs. Sec. 1.6109-2(d) provide that after Dec. 31, 2010, all tax return preparers must have a preparer tax identification number (PTIN) in order to prepare tax returns for compensation. All federal tax-compliance forms for individuals, trusts, and business entities contain a field for the paid preparer's PTIN next to the signature line.

A "tax return preparer" is defined in Regs. Sec. 301.7701-15(a) as any person who prepares for compensation all or a substantial portion of any return of tax or any claim for refund under the Internal Revenue Code (see also Regs. Sec. 1.6694-1(b)(5)). An individual or a firm that employs an individual is held to the same standards for assessing preparer penalties. For the purposes of this discussion, both are referred to as "tax return preparers." A "signing tax return preparer" is the individual who has primary responsibility for the overall substantive accuracy of the preparation of such return or claim for refund (Regs. Sec. 301.7701-15(b)(1)). A "nonsigning tax return preparer" is any third-party adviser or tax return preparer who is not a signing tax return preparer who prepares all or a substantial portion of a tax return (Regs. Sec. 301.7701-15(b)(2)(i)). Examples of nonsigning preparers are third-party advisers who provide advice (written or oral) to a taxpayer (or to another tax return preparer) when that advice leads to a position or entry that constitutes a substantial portion of the tax return (see Regs. Sec. 301.7701-15(b)(2)(ii)).

The regulations list factors to consider in determining whether an item constitutes a substantial portion of the tax return, including the size and complexity of the item relative to the taxpayer's gross income and the size of the understatement attributable to the item compared to the taxpayer's reported tax liability (Regs. Sec. 301.7701-15(b)(3)(i)). A *de minimis* rule provides that amounts under $10,000, or less than $400,000 and also less than 20% of the gross income shown on the return (or, for an individual, the individual's adjusted gross income), are not substantial (Regs. Sec. 301.7701-15(b)(3)(ii)(A)). This means that in practice, relatively modest planning work can constitute a substantial portion of a tax return.

Thus, there is ample opportunity for third-party advisers to rise to the level of nonsigning preparers with respect to the line item or entry they advanced on

This puts the signing tax return preparer in a precarious position when a third-party adviser advances a position to be reported on the tax return that the signing tax return preparer has not evaluated, especially if the position may result in penalties.

the tax return. However, there is no field on any federal tax form that requires the identification of the nonsigning tax return preparer through a PTIN or other reference. Instead, it remains the signing tax return preparer whose identity is disclosed and who retains responsibility for the overall substantive accuracy of a tax return or claim for refund. This puts the signing tax return preparer in a precarious position when a third-party adviser advances a position to be reported on the tax return that the signing tax return preparer has not evaluated, especially if the position may result in penalties.

Accuracy-related penalties under Sec. 6662 and practitioner penalties under Sec. 6694 both require substantial authority or a reasonable basis with adequate disclosure of any uncertain tax return position to avoid penalties. Adequate disclosure is achieved through the filing of Form 8275, *Disclosure Statement*; Form 8275-R, *Regulation Disclosure Statement*; or equivalent. Form 8275 is used to disclose positions that may be contrary to existing tax authorities that are not otherwise adequately disclosed on a tax return. Form 8275-R is used to disclose positions that are contrary to Treasury regulations. Circumstances under which the disclosure on a taxpayer's income tax return with respect to an item or position is adequate for the purpose of reducing the understatement of income tax under Sec. 6662(d) and for the purpose of avoiding the tax return preparer penalty under Sec. 6694(a) with respect to income tax returns are outlined in a revenue procedure that is periodically updated, Rev. Proc. 2024-44 at the time of this publication.

A client may not give the signing tax return preparer a sufficient budget to fully vet third-party positions because it is unlikely that a client will pay two advisers for the same advice. How, then, can a signing tax return preparer be comfortable with third-party conclusions or determine if adequate disclosure is required to avoid penalties if the preparer does not have an opportunity to independently research and analyze the position?

Third-party reliance

Fortunately, Regs. Sec. 1.6694-1(e) and Section 10.37(b) of Treasury Circular 230, *Regulations Governing Practice Before the Internal Revenue Service* (31 C.F.R. Part 10), permit tax return preparers to rely on third-party advice *if* the advice is reasonable and the reliance is in good faith, considering all the facts and circumstances. Reliance is not reasonable if:

- The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;
- The practitioner knows or reasonably should know that the other person is

not competent or lacks the necessary qualifications to provide the advice; or

- The practitioner knows or reasonably should know that the other person has a conflict of interest with respect to the advice given to the client.

In determining whether the above criteria are satisfied, Circular 230 provides that the IRS will apply a "reasonable practitioner" standard to evaluate whether reliance is reasonable (Circular 230, §10.37(c)(1)). The tax return preparer may not ignore the implications of information furnished to, or actually known by, the tax return preparer. The tax return preparer must make reasonable inquiries if the information furnished to the tax return preparer appears to be incorrect or incomplete. Some positions may require third parties to produce certain documents for reliance on a position to be reasonable (e.g., an appraisal may be required to support a charitable contribution deduction for certain types of property) (Regs. Sec. 1.6694-1(e)(1)). If reliance on third-party advice is reasonable and made in good faith, the signing tax return preparer can sign the return and assert a reasonable-cause defense against any preparer penalties if proposed (Sec. 6694(a)(3)).

Thus, it is important for signing tax return preparers to understand when reliance on third-party advice is unreasonable and the actions a preparer can take to avoid such outcomes.

The enforceability of Circular 230 was drawn into question by *Ridgely v. Lew*, 55 F. Supp. 3d 89 (D.D.C. 2014), which enjoined the IRS from imposing penalties on a preparer of "ordinary refund claims," which may extend to all return preparation activities. However, the IRS has not revised or rescinded Circular 230, and preparer penalties for inappropriate reliance on third-party advice are still enforceable under Regs. Sec. 1.6694-1(e). Thus, the Circular 230 standards still inform signing tax return preparers on how to avoid preparer penalties.

Contingent-fee arrangements may incentivize third-party advisers to take aggressive positions to maximize their fees.

Opinion of another person should not be relied on

A signing tax return preparer must gauge whether third-party advice has obvious defects for which it should not be relied upon. Such defects might include unreasonable assumptions, omission of material facts or analysis of negative authority, reliance on authority that is superseded or outdated, or inconsistencies with other positions included in the taxpayer's filing history (see, e.g., *Stobie Creek Investments, LLC*, 82 Fed. Cl. 636 (2008), aff'd 608 F.3d 1366 (Fed. Cir. 2010) (reliance on law firm opinion for tax shelter rejected because opinion was based on misrepresented facts); see also *Canal Corp.*, 135 T.C. 199 (2010) (Tax Court rejected reliance on a tax opinion "riddled with questionable conclusions and unreasonable assumptions" in reaching a "should" confidence level)). The signing tax return preparer should conduct reasonable diligence with respect to the facts and technical merits of the positions asserted. Following are some actions that preparers may wish to take in performing that diligence:

- Ask the client to confirm that facts described in the third-party advice are accurate and complete.
- Check all sources cited in third-party analyses to confirm that sources are real, on point, and are not "hallucinations" generated by artificial intelligence.
- Look for negative authority that might have been omitted from the analysis supporting the third party's position.

It is common for attorney advisers to refuse access to their work product to preserve attorney-client privilege. In that case, a signing tax return preparer should request an acknowledgment from the authoring attorney that an opinion, memorandum, or other advice exists. The letter should describe the resulting position and indicate whether the preparer can sign the return with or without adequate disclosure to secure penalty protection. Be wary of any communication that attempts to disclaim responsibility as a nonsigning preparer. Preparer status is determined by the definitions in Treasury regulations, not by agreement between the parties. If the acknowledgment raises additional questions, the signing tax return preparer should interview the author of the advice to vet the author's analysis supporting the position.

Less-than-satisfactory responses to any of the above inquiries should be discussed with the client and may serve as grounds for the tax return preparer to refuse to sign a tax return or claim for refund if the client insists on taking the reporting position.

Other person is not competent or lacks qualifications

A signing tax return preparer may not rely on advice given by third parties who lack appropriate credentials to provide such advice or from third parties who have been disciplined for providing improper tax advice. Many third-party tax advisers are CPAs, attorneys, or enrolled agents. Credentials for these professionals can be verified through state boards of accountancy, state bar associations, the National Association of State Boards of Accountancy, or the IRS Directory of Federal Tax Return Preparers. The IRS Office of Professional Responsibility maintains a list of sanctioned tax professionals that should also be searched.

The realm of adviser credentials that may be relevant to third-party advice is not confined to tax professionals. Certified financial planners, engineers, appraisers, and other professionals are often involved in providing third-party tax advice. Boutique advisory firms employing CPAs, attorneys, and enrolled agents but not necessarily practicing in those capacities also contribute to the development or marketing of tax positions. Subject matter expertise in almost any field can be relevant to certain tax questions. Irrespective of the individual's discipline, a signing tax return preparer should always confirm that the third party advancing a tax return position has the appropriate credential or experience required to give advice and has not been discredited by disciplinary actions taken by any relevant oversight body.

Positions advanced by persons who lack the competency or qualifications to provide advice may be valid, but a signing preparer will have to independently research the position and arrive at his or her own level of confidence regarding the position if the preparer hopes to secure penalty protection.

Other person has a conflict of interest

A signing tax return preparer may not rely on the advice of a third party who has a conflict of interest with the underlying client. The most common conflict scenario

It is much better to discuss the roles and responsibilities of all advisers at the front end of the tax-reporting process than to point fingers at each other if a controversy arises.

involves third-party advisers who are paid a percentage of the tax benefits secured for the client. Contingent-fee arrangements may incentivize third-party advisers to take aggressive positions to maximize their fees. The IRS's ability to police contingent-fee arrangements was also enjoined by *Ridgely*, but preparer penalties for inappropriate reliance on third-party advice are still permissible. The signing tax return preparer provides an important check on potentially abusive positions that could result in penalties assessed against the client.

Other conflicts may result from relationships between the client and the third-party adviser, such as the promoter of an investment opportunity that promises tax benefits to investors (see, e.g., *Gustashaw*, 696 F.3d 1124 (11th Cir. 2012) (taxpayer's reliance on tax opinion found unreasonable in part because of conflicts of interest)).

Again, positions advanced by self-interested third parties may be valid, but signing preparers will have to conduct their own diligence with respect to the position if they hope to secure penalty protection.

Define roles and responsibilities of third-party advisers

Sophisticated clients often seek advice from a variety of professionals with respect to tax matters. It is inevitable that advisers will form different opinions with respect to the merits of certain tax return positions and the level of confidence assigned to such positions.

Signing tax return preparers have a unique responsibility in this crowded field of advisers. They are the only advisers ultimately responsible for the overall substantive accuracy of a tax return or claim for refund. When the signing preparer is asked to rely on third-party advice, clients need to be educated about the role of third-party advisers who become nonsigning tax return preparers and the conditions required for reliance on such advice to be deemed reasonable and made in good faith.

If a signing tax return preparer intends to rely on third-party advice, they should ask the third-party adviser to acknowledge that they are nonsigning preparers once the appropriate diligence is complete. It is much better to discuss the roles and responsibilities of all advisers at the front end of the tax-reporting process than to point fingers at each other if a controversy arises. ■

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CAMPUS TO CLIENTS

Multistate corporate income taxes: An exercise in nexus and apportionment

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This case study can provide practical instruction to students and entry-level accounting staff in key issues of state corporate income tax.

Advances in technology have helped companies dramatically expand their customer base beyond their physical location. Digital platforms such as e-commerce websites and mobile apps allow businesses to connect to customers everywhere. With the help of these platforms, even the smallest businesses can now sell their products to customers in all 50 states. While an increase in customers and sales is beneficial, increased sales across state lines may also lead to an increase in a company's state income tax exposure. Forty-four states impose a corporate income tax. In addition, five states without a corporate income tax impose a gross-receipts tax on businesses: Delaware, Nevada, Ohio, Texas, and Washington. With each of these states having its own laws and regulations regarding the imposition and calculation of the tax, businesses have a challenging time keeping in compliance without the assistance of professional tax advisers.

In addition, the laws regarding when states other than a commercial domicile have the right to impose an income tax on a business are constantly evolving. A state has the right to impose tax on an out-of-state business if that business has nexus with the state. Traditionally, the concept of nexus was thought to exist when a company had a physical presence, either property or employees based in or operating within the state. However, technology-led changes in business models have resulted in businesses moving away from the traditional model of manufacturing plants and traveling salespeople that the original concept of physical presence was based upon.

The evolution of economic nexus

To maintain their share of state income taxes from out-of-state business and to keep up with new business models, states have looked to redefine nexus. In *South Dakota v. Wayfair, Inc.*, 585 U.S. 162 (2018), the Supreme Court overturned the traditional physical-presence definition of nexus for sales tax purposes. Instead, the court allowed a more encompassing definition of nexus based on economic presence, specifically, the dollar amount of sales or number of sales transactions the company entered into within that state. Following this case, many states have begun adopting the concept of nexus based on economic presence for income tax purposes as well. Some states have adopted bright-line economic-presence threshold tests, such as California's and New York's sales dollar thresholds, while other states have enacted more subjective standards, such as having "substantial" economic activity within the state. As more states implement economic-presence standards for income taxes, the lack of consistent standards creates even more complexity for businesses to navigate (see Jensen, Wilps, Hogroian, and Gillespie, "*South Dakota v. Wayfair* — Five Years Later," 54-6 *The Tax Adviser* 48 (June 2023)).

This ever-changing nexus environment and the increasing complexity of state income tax laws provide significant advising opportunities for tax professionals. While multinational accounting firms have had dedicated lines of service specializing in multistate tax issues for decades, increases in the interstate activities of smaller businesses means smaller accounting firms need to be able to advise clients in this area as well. Developing a thorough understanding of nexus and state apportionment can help accountants focus on minimizing their clients' state income tax exposure, turning state income taxes into a tax planning engagement, not just a compliance engagement.

The need for instruction

The accompanying Microsoft Excel–based case is designed to give accounting students and entry-level accounting staff experience working with state income taxes and exposure to the concepts of nexus and apportionment. While textbook examples and problems typically require students to compute one apportionment factor, this case study provides students with a comprehensive state apportionment problem. Users must calculate all three apportionment factors (payroll, property, and sales). They must also research income tax nexus rules and research and apply specific state apportionment formulas to calculate income apportioned to specific states. Students must also research and apply the income tax rates of specific states to calculate the company's state income tax liability.

At the university level, undergraduate accounting programs typically have only one tax course that focuses on federal income taxes, with little, if any, discussion of state income taxes. State income taxes are typically not discussed until graduate-level tax classes, and even then, coverage of the topic may still be light. Therefore, it is important that any state income tax case offers sufficient substance for professors to effectively address the topic without requiring extended classroom time. A review of accounting education journals shows one case study related to multistate taxes for individuals. There are no multistate corporate tax case studies. As technology and tax law changes make multistate income taxes an issue for an increasing number of companies, it is essential for accounting students to grasp key concepts such as nexus and state apportionment.

Using Excel for this case provides several benefits. First, incorporating Excel into the class is consistent with the AICPA's Model Tax Curriculum and the CPA Evolution Model Curriculum of the AICPA and the National Association of State Boards of Accountancy, both of which note the need for students to develop the technological skills necessary to be successful in the tax profession. Second, students gain experience working with a program (Excel) that practitioners indicate is an essential tax planning and compliance tool. Third, embedded checks throughout the Excel file allow students to monitor their performance and gain confidence with each correct step in the assignment. Lastly, faculty can tailor the requirements for student worksheets to contain Excel skills they want students to demonstrate, such as using "IF" functions.

Case overview

The case requires students to assume the role of an entry-level tax professional in a public accounting firm. Students are given the task of calculating the state income tax liability for a hypothetical multistate C corporation ("Techie Paradise"). Students are provided background client information as well as the client's payroll, property, and sales data by state. Payroll, property, and sales information for the hypothetical company is provided in Excel, and users are asked to prepare their state apportionment calculations and income tax liability using Excel, which allows students to further develop their skills and confidence with this software tool and to see its value in practice.

State income taxes are typically not discussed until graduate-level tax classes, and even then, coverage of the topic may still be light.

The exercise is designed for use in an undergraduate-level tax course. Students at this level will most likely not have been exposed to state apportionment and nexus concepts. As this case allows faculty to introduce these concepts at an introductory level, an overview of nexus and state apportionment is included in the case. The case is also well suited for public accounting firms to use during new staff training since many of those individuals will be responsible for calculating state taxable income and preparing state income tax returns. The case can be adjusted (discussed below) for use with individuals who are more experienced with state income taxes, such as students in a graduate tax course or experienced public accounting staff.

To successfully complete the case, users must first correctly determine which states the company has nexus with for income tax purposes. Then they must research how the states apportion federal taxable income. For purposes of this case study, no state adjustments to federal taxpayer income are provided. If the instructor desires, the case can be made more complex with the addition of a few state adjustments, such as for depreciation. Users then compute

the applicable apportionment factors and apportioned state taxable income, using the necessary payroll, property, and sales information provided. Lastly, users research the applicable states' income tax rates to correctly calculate the company's state income tax liability.

The case study

The case study packet includes the assignment with relevant company information in Microsoft Word and a Microsoft Excel file, which contains the company's payroll by state, property by state, and sales by state. The Excel file also serves as a template for students to complete the case. All calculations and answers to the case study are required to be entered into designated cells within the template. The template also contains correction checks after each input to provide students with feedback as they progress through the assignment. The solution file is an Excel file containing separate tabs for (1) property by state; (2) sales by state; (3) payroll by state; and (4) apportioned income calculation and state income tax. To minimize the possibility that students can search for terms and find online solutions, instructors may want to change the company name throughout the case.

The case focuses on the concepts of nexus and state apportionment, as well as the calculations of apportioned state taxable income and state income tax liabilities. Students are provided with background client information, including details about the company's operations. The company is an electronics retailer with its headquarters in New Jersey that has retail stores in New Jersey and six additional states. The company has employees and property in these seven states only. Company employees may use company vehicles to deliver to customers within these states. Deliveries to customers outside these states, if any, are made via common carrier.

Students are notified that the company, wanting to expand its sales reach, began selling products through a third-party e-commerce website starting Dec. 29, 2025. While most of the online sales made in December were to customers within the states where Techie Paradise already has retail locations, a small number of sales (three) were made to customers in Rhode Island. Students are also informed that the company has no employees or property in Rhode Island and has no other connection to Rhode Island besides these sales.

The case also informs users that they prepared the company's 2025 federal Form 1120, *U.S. Corporation Income Tax Return*, which showed taxable income of $24,850,000, all of which is business income, and they are now tasked with calculating the company's expected state income taxes. As this is typically undergraduate students' first exposure to these concepts, an overview of the concepts of nexus and state apportionment is provided. The facts and materials provided in the case study are intended to give instructors a starting point for discussing nexus and apportionment concepts, including physical presence, economic presence, remote selling, and apportionment and allocation. Instructors can cover these topics in more depth if desired. The requisite tasks of the case study are as follows:

Task 1: Use the information provided in the "Property by State," "Sales by State," and "Payroll by State" tabs in the Excel template file to calculate the company's apportionment factors for property, sales, and payroll. For the property-by-state factor, use the provided beginning and ending inventory, beginning and ending property at cost, and beginning and ending accumulated depreciation to calculate the average property owned in each state. Then use the calculated average property owned by state to calculate the property apportionment factor. For the sales and payroll factors, use the sales by state and payroll by state provided to calculate the appropriate apportionment factor. Calculated answers should be entered into the purple highlighted fields.

Task 2: For each state in which the company reports sales, research the income tax nexus requirements. On the "Apportioned Income & State Tax" tab of the Excel template, note "Yes" or "No" for each state in the green highlighted column for nexus, indicating whether the company's activities create nexus with each state for income tax purposes.

Task 3: For each state the company has nexus with, research the required state apportionment formula. On the "Apportioned Income & State Tax" tab of the Excel template, enter the appropriate apportionment formula for each state within the green highlighted fields for "Apportionment Formula." Enter the formula as one of the following four options: "3 Factor," "Double wtd Sales," "Sales," or "No Nexus." Then compute the required apportionment formula using the applicable property, sales, and payroll factors computed earlier. The calculated formula (answer) should be entered into the purple highlighted field "Apportionment Factor."

Task 4: On the "Apportioned Income & State Tax" tab, use the required apportionment formula to calculate apportioned taxable income for each state based upon the provided federal taxable income of $24,850,000. The formula (answer) should be entered into the purple-highlighted "Taxable Income per State" fields.

Task 5: For each state with taxable income, research the applicable corporate income tax rate for that state. Enter the tax rate on the "Apportioned Income & State Tax" tab in the green-highlighted field "Tax Rate." Use the applicable tax rate and taxable income per state previously calculated to calculate the state income taxes. The formula (answer) should be entered into the purple-highlighted "State Taxes" field.

Case variations

Several modifications can be made to the case study, allowing it to be used in different courses/settings and at varying levels of difficulty. For instructors wanting to limit the amount of required research for students, students can be provided the answers to one or all of the required research activities in the case: (1) whether the company's activities create nexus with a state; (2) each state's required apportionment formula; and (3) each state's tax rates. Alternatively, professors can provide students with links to the applicable websites to find this information while still requiring students to find the actual answers.

The case study assumes that all of the company's taxable income is business income and as such is apportionable to each state. However, if professors want to cover the difference between allocating income and apportioning income, they can add a nonbusiness income element to the case. The case also does not include any information about rental property by state. Instructors may want to add this element for a more thorough discussion of the definition of property used in the business for calculation of the property factor. On the other hand, instructors may want to provide students with the average property by state to reduce the complexity surrounding coverage of the property factor calculation.

For students who already have a solid understanding of nexus and state apportionment, the state taxes overview provided can be removed from the case. Instructors who want to add more writing content to their course can add a writing element to the case. Students could be required to write a memo to the client explaining the concept of nexus and how state apportionment works in general. They could also provide a specific explanation of the client's state tax situation and its expected state tax liability. Inclusion in the case of a limited number of sales to Rhode Island through an e-commerce website allows instructors to discuss the concept of economic presence. Students' memos to the client should include an explanation of the nexus issues of remote sellers and how the company's continued use of e-commerce websites may affect its state income tax exposure.

For professors looking for a more challenging case, the case can be implemented without an Excel template file. For Task 1, students can be provided with three Excel files: one containing the company's actual sales transactions for the year; one containing the company's actual payroll records for the year; and one containing the company's property owned at the beginning and end of the year, including information on rented property. Students would then be required to create pivot tables in the sales and payroll files to determine the company's sales by state and payroll by state. The property by state would also need to be calculated separately, based on the information provided. The remainder of the case can then be completed by requiring students to create their own spreadsheet for tasks 2–5 above.

Finally, this case provides an excellent opportunity for instructors to invite tax professionals into the classroom. Instructors can invite tax professionals who specialize in multistate tax to introduce the concepts of nexus and state apportionment and discuss their own experiences with these concepts. Alternatively, tax professionals can participate in a debriefing session, discussing the importance of multistate taxation and the relevance of the case to practice.

Gaining confidence and knowledge

As the number of businesses engaging in interstate sales increases, companies will be looking to tax professionals for advice on multistate taxation. Tax professionals with a knowledge of nexus and state apportionment rules can provide a valuable service to clients, identifying how their clients can work within the nexus and state apportionment rules to save tax dollars. This case study provides the opportunity to learn about state corporate income taxes and the concepts of nexus and apportionment.

This case provides students with valuable experience using client information to calculate state apportionment factors and researching tax laws to calculate state-apportioned income and state income tax liabilities. It also allows students to see how Excel is used in practice. Successful completion of the case study should allow students and new staff to gain confidence working with state income taxes and researching nexus and state apportionment laws. ■

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CASE STUDY

Death of an LLC member: Basic tax considerations

Editor:
Shaun M. Hunley, J.D., LL.M.

A member's death will likely require apportioning LLC income and may entail treatment of the interest as a sale or disposition or even terminate the LLC.

This case study has been adapted from *Checkpoint Tax Planning and Advisory Guide*'s Limited Liability Companies topic. Published by Thomson Reuters, Frisco, Texas, 2025 (800-431-9025; tax.thomsonreuters.com).

An LLC taxed as a partnership will likely face one or more tax issues upon the death of a member. These will include determining the best method of allocating the deceased member's share of LLC income for the portion of the LLC's tax year before the date of death. In some cases, the tax year or even the continuity of the LLC itself may be affected.

Closing the LLC's tax year with respect to a deceased member

The LLC's tax year closes with respect to a deceased member on the date of death. Deceased members are allocated their ratable share of the LLC's income for the portion of the tax year occurring before that date. Either the annual proration or the interim closing-of-the-books method can be used to determine the amount of income required to be reported on the decedent's final Form 1040, *U.S. Individual Income Tax Return*. The member's estate (or successor member) receives a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, reporting its share of LLC income or loss earned from the date of death through the end of the LLC's tax year.

When an estate distributes an interest in an LLC that is classified as a partnership to a beneficiary to satisfy a specific bequest, the transfer from the estate to the beneficiary is not considered a sale or exchange.

Allocating income when an LLC interest is distributed from the decedent member's estate

An LLC's tax year closes if the decedent's estate or other successor sells or exchanges the entire interest in the LLC or if the entire interest is liquidated. However, when an estate distributes an interest in an LLC that is classified as a partnership to a beneficiary to satisfy a specific bequest, the transfer from the estate to the beneficiary is not considered a sale or exchange (Regs. Sec. 1.706-1(c)(2)(i)). So, in that instance, the LLC's tax year does not close. Instead, the beneficiary includes the LLC's income or loss for the part of the year the estate held the LLC interest as well as the part of the year the beneficiary held the interest. However, if the estate distributes the LLC interest to the beneficiary to satisfy a specific bequest in the same year that the member dies, the LLC's income or loss for that year is allocated between the decedent (through the date of death) and the beneficiary (for the rest of the year).

Caution: When an estate distributes an LLC interest to a beneficiary to satisfy a pecuniary (monetary) bequest, the transaction is considered a sale or exchange that closes the LLC's tax year with respect to the estate (Regs. Sec. 1.706-1(c)(1)). As a result, the LLC must allocate the year's taxable income or loss between the estate and the beneficiary.

Example 1. Allocating income when an LLC interest is distributed by an estate to a beneficiary: *L* was a 50% member of *P* LLC (which is classified as a partnership for federal income tax purposes) when she died on Feb. 15 of Year 1. *P* uses the calendar year for tax purposes. At her death, *L*'s interest in *P* was transferred to her estate. *P*'s tax year closes with respect to *L* on Feb. 15, Year 1. *L* will report her share of *P*'s Year 1 income through Feb. 15 on her final Form 1040, and her estate will report its share of *P*'s Year 1 income from Feb. 16–Dec. 31.

L's estate held its interest in *P* until March 31 of Year 2, when it was transferred to *W* to satisfy a specific bequest. None of the LLC's income for Year 2 is reported by the estate. Instead, *W* reports the income for the entire year. Both the estate and *W* should receive a Schedule K-1 for Year 2. The estate's Schedule K-1 will not reflect any income or loss for the year, and its capital account should be zeroed out.

Variation 1: If, instead, the estate's transfer to *W* satisfies a pecuniary (monetary) bequest, the transfer from the estate to *W* is treated as a sale or exchange. Then, the LLC's tax year closes with respect to the estate on March 31 of Year 2. So, the estate reports its share of LLC income or loss allocable to the period from Jan. 1 through March 31 of Year 2, and *W* reports his share of income or loss

A two-person LLC that is classified as a partnership generally terminates for tax purposes under Sec. 708(b)(1) at either of the members' deaths (since a partnership requires at least two partners).

allocable to the period from April 1 through the end of the year.

Variation 2: Assuming the same facts as the original example, with the exception that on July 31 of Year 1, the estate of *L* transferred the partnership interest to *W*. In this scenario, no income is allocated to the estate of *L*. Like the original example, *L* will report her share of partnership income through Feb. 15 on her final Form 1040. *W* will report his share of partnership income from Feb. 16 through Dec. 31 (Regs. Sec. 1.706-1(c)(2)(ii)).

Buy/sell agreement

Service LLCs, such as law firms and accounting firms, often prohibit the interests of deceased members from being transferred to anyone except an existing LLC member. To ensure this result, the remaining members (as opposed to the LLC itself) may be required to acquire the interest from the decedent's estate immediately after the member's death. Similar buy/sell agreements may be entered into by members in LLCs engaged in other types of businesses to provide a market for a deceased member's interest or ensure the remaining members can purchase a deceased member's interest for a price agreed upon at some earlier point in time (see Owen, ed., "Case Study: Using a Buy/Sell Agreement to Establish the Value of a Business Interest," 51 *The Tax Adviser* 136 (February 2020)).

Note: Because the value of the LLC interest must be included in the decedent's gross estate at FMV for federal estate tax purposes, a buy/sell agreement that results in the sale of the LLC interest for less than FMV may cause the deceased member's successor-in-interest (e.g., the deceased member's estate) to pay estate tax on LLC interest value that is never received.

Death of a member in a two-person LLC

A two-person LLC that is classified as a partnership generally terminates for tax purposes under Sec. 708(b)(1) at either of the members' deaths (since a partnership requires at least two partners). Although terminated for tax purposes, the LLC may continue in legal existence as a single-member LLC (SMLLC). However, there are two exceptions to the rule that an LLC immediately terminates for tax purposes upon the death of a member in a two-person LLC.

Estate or beneficiary continues as member: A two-member LLC does not terminate as a partnership for tax purposes upon the death of a member if the deceased member's successor-in-interest (i.e., the estate or a beneficiary) continues to share in the LLC's profits or losses (Regs. Sec. 1.708-1(b)(1)(i)). However, if the estate is not closed in a timely fashion, the IRS might question the reason for its remaining open.

> ***Example 2. Estate has a continuing interest in LLC profits and losses:*** *S*, M.D., and *R*, M.D., are 50/50 members in a medical practice professional LLC that is classified as a partnership for federal tax

purposes. The LLC operating agreement provides that, upon the death of one of the members, the surviving member has the first right of refusal to buy the deceased member's interest at a price calculated pursuant to a specified formula. Accordingly, the LLC will not terminate for federal income tax purposes upon the death of one of the members, since the deceased member's estate (or other successor-in-interest) will have a continuing interest in the LLC's profits and losses unless and until a purchase price is agreed upon and paid, thus resulting in only one owner.

Liquidating payments made under Sec. 736: A second exception to the general rule governing the termination of a two-member LLC classified as a partnership applies when an LLC continues to make payments to a retiring member or a deceased member's successor-in-interest under the provisions of Sec. 736 (Regs. Sec. 1.708-1(b)(1)(ii)). The retired member or deceased member's successor-in-interest will be treated as a member until the interest in the LLC has been completely liquidated (Regs. Sec. 1.736-1(a)(1)(ii)). Accordingly, the LLC does not terminate as a partnership for tax purposes until such time. Under this provision, if the LLC buys out a member through a series of liquidating payments made under Sec. 736, the LLC will not terminate as a partnership for tax purposes until the final payment is made.

Planning tip: Some state LLC statutes prohibit a nonlicensed person from holding an interest in a professional LLC. A professional LLC may want to enter into a buy/sell agreement to avoid a situation in which liquidating payments are made to a nonlicensed successor-in-interest.

It is possible that a member's death could cause business activities of an LLC to cease, thereby causing the LLC's termination for tax purposes.

LLC ceases to do business on date of death

An LLC is terminated for tax purposes if all of its business activities are discontinued (Sec. 708(b)(1)). It is possible that a member's death could cause business activities of an LLC to cease, thereby causing the LLC's termination for tax purposes. For example, assume an LLC is in the business of providing a service and has one member who provides the service and a number of members who do not participate in providing services but are investors. If the service provider dies, the business activities of the LLC could cease on the date of the service provider's death. In that case, the LLC's tax year would close for all members, and the decedent's distributive share of LLC income or loss through the date of death (which would also be the date the LLC terminates) would be reported on the decedent's final Form 1040. ■

Contributor

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TAX TRENDS

Analysis of and reflections on recent cases and rulings

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Relevancy determination required for codified economic substance doctrine; debts discharged in bankruptcy not fully paid for purposes of the *Flora* full-payment rule.

Procedure & Administration

Penalties under codified economic substance doctrine upheld

The Tax Court held that a Sec. 6662(b)(6) penalty and the increased rate for the penalty under Sec. 6662(i) applied to underpayments attributable to the disallowance of the taxpayers' deductions from microcaptive insurance transactions that lacked economic substance under the Sec. 7701(o) codified economic substance doctrine.

Background

Sunil Patel is a medical doctor, the co-founder of an eye surgery center, and the founder of two medical research centers in West Texas. Beginning in 2011, Patel's businesses supplemented their commercial insurance coverage by purchasing assorted policies from purported microcaptive insurance companies — Magellan Insurance Co. (Magellan) and Plymouth Insurance Co. (Plymouth) — that Patel controlled. Patel and his wife, Laurie McAnally-Patel, deducted the premiums paid to the microcaptives, which were substantially more than the premiums paid to the commercial insurers, creating substantial tax benefits for the Patels.

The IRS examined the Patels' returns for 2013 through 2016 (the tax years at issue) and determined that the insurance premiums paid to Magellan and Plymouth were not deductible. Thus, it issued notices of deficiency (NODs) to the Patels that disallowed their deductions for the premiums. The NOD for 2013 disallowed the deductions for insurance expenses because of a lack of economic substance, while the NODs for 2014 through 2016 determined a disallowance of the deductions for reasons other than the economic substance doctrine.

The IRS also determined that the Patels were liable for Sec. 6662(a) accuracy-related penalties on the underpayments related to the disallowed deductions for the tax years at issue in the NODs. In the NOD for tax year 2013, the accuracy-related penalty was determined pursuant to Secs. 6662(a), (b)(6), and (i) and, in the alternative, pursuant to Secs. 6662(b)(1) and (b)(2). For tax years 2014 through 2016, accuracy-related penalties were determined pursuant to Secs. 6662(a), (b)(1), (b)(2), and (b)(6).

The Patels challenged the IRS's determination in Tax Court. In its answers to the Patels' petitions, the IRS asserted that the deductions for 2014 through 2016 were also disallowed because of the economic substance doctrine and, under Sec. 6662(i), increased the penalties for those years.

In *Patel*, T.C. Memo. 2020-133 (*Patel I*), the Tax Court granted in part the Patels' motion for partial summary judgment related to the penalties. In relevant part, the court held that the IRS failed to satisfy the Sec. 6751(b)(1) supervisory-approval requirement with respect to the penalties under Secs. 6662(b)(2) and (b)(6), as well as the increased rate under Sec. 6662(i), for tax year 2013. In addition, the IRS conceded that the increased rate under Sec. 6662(i) did not apply in tax year 2016.

In *Patel*, T.C. Memo. 2024-34 (*Patel II*), the Tax Court held that for the tax years at issue, Magellan's and Plymouth's purported microcaptive transactions did not constitute insurance for federal income tax purposes because the microcaptives failed to distribute risk and did not operate as insurance companies in the commonly accepted sense. Accordingly, the court sustained the IRS's disallowance of the deductions for the premiums paid as part of the transactions for the tax years at issue. The court, however, reserved on the issue of the penalties asserted by the IRS on the underpayments related to the disallowance of the deductions.

The NODs for the tax years at issue listed several alternative grounds for the IRS's imposing the penalties, including that the transactions lacked economic substance within the meaning of Sec. 6662(b)(6). Thus, the Tax Court, in a third opinion in the Patels' case, addressed the IRS's determination that the transactions lacked economic substance and its assertion of accuracy-related penalties (as limited by *Patel I*) against the Patels on that ground.

In addressing whether the Patels were liable for the accuracy-related penalties, the Tax Court first addressed whether there is a threshold relevancy determination for the codified economic substance doctrine in Sec. 7701(o) and whether the economic substance doctrine was relevant in the Patels' case.

Secs. 7701(o), 6662(b)(6), and 6662(i)

After years-long development in case law, Congress codified the economic substance doctrine in 2010 as Sec. 7701(o) in the Health Care and Education Reconciliation Act of 2010, P.L. 111-152. As relevant to the Patels' case, Sec. 7701(o) provides:

Sec. 7701(o). Clarification of economic substance doctrine.

(1) Application of doctrine. In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if —

(A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and

(B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction....

(5) Definitions and special rules. For purposes of this subsection —

(A) Economic substance doctrine. — The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose.

(B) Exception for personal transactions of individuals. — In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) Determination of application of doctrine not affected. — The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted.

(D) Transaction. — The term "transaction" includes a series of transactions.

The act also added Sec. 6662(b)(6), which imposes a 20% penalty on the portion of an underpayment of tax required to be shown on a return that is attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of Sec. 7701(o).

Sec. 6662(i) increases the Sec. 6662(a) penalty from 20% to 40% for any portion of an underpayment that is attributable to one or more nondisclosed noneconomic substance transactions under Sec. 6662(b)(6).

The Tax Court's decision

The Tax Court held that the codified economic substance doctrine requires a relevancy determination within the meaning of Sec. 7701(o) and that the codified economic substance doctrine was relevant in the Patels' case. It further held that the Patels were liable for penalties under the codified economic substance doctrine pursuant to Secs. 6662(a) and (b)(6) and the increased rate of tax for nondisclosed transactions under Sec. 6662(i). Finally, it determined that the Patels were liable for the Sec. 6662(b)(1) and (b)(2) accuracy-related penalties asserted by the IRS.

Relevancy determination

The Tax Court first addressed whether Sec. 7701(o) requires a determination that the economic substance doctrine is relevant to the transactions at issue. Sec. 6662(b)(6) applies the accuracy-related penalty to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance within the meaning of Sec. 7701(o). Sec. 7701(o)(1) requires application of the economic substance doctrine "[i]n the case of any transaction to which the economic substance doctrine is relevant." In deciding whether a relevancy determination was required, the court considered the statutory text of Sec. 7701 and its legislative history.

Statutory text: The Tax Court began by analyzing the text of Sec. 7701(o). As noted above, the text of Sec. 7701(o)(1) states that

Sec. 6662(i) increases the Sec. 6662(a) penalty from 20% to 40% for any portion of an underpayment that is attributable to one or more nondisclosed noneconomic substance transactions under Sec. 6662(b)(6).

it applies to "transaction[s] to which the economic substance doctrine is relevant." Sec. 7705(o)(5) further states, "The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted."

The Tax Court stated, "Faced with these provisions, we easily conclude that the statute requires a relevancy determination. To put it plainly — the statute says so, right there, on its face." The court explained that Sec. 7701(o)(1) signals that a relevancy determination is required by conditioning application of the doctrine on certain circumstances, i.e., if there is a transaction to which the doctrine is relevant. Also, Sec. 7701(o)(5) expressly requires a court to determine whether the doctrine is relevant and directs the court to make the determination as if the statute had never been enacted.

The Tax Court also concluded that the text of Sec. 7701 indicated the relevancy determination is not coextensive with the two-part economic substance test set forth in Secs. 7701(o)(1)(A) and (B). The introductory sentence of Sec. 7701(o)(1) states that the two-part test applies only in the case of any transaction to which the economic substance doctrine is relevant. In the court's view, "Conflating the relevancy determination with the two-part test would ignore that direction and deprive the statute's reference to relevance of independent meaning."

Legislative history: Because Sec. 7701(o) was enacted in the Reconciliation Act of 2010, for the legislative history of the provision, the Tax Court looked to the House report for the act (H.R. Rep't No. 111-443(I), 111th Cong., 2d Sess. (2010)). Based on the report, the court found that the legislative history of the codified economic substance doctrine is fully consistent with its interpretation that Sec. 7701(o)(1) requires a relevancy determination. According to the court, the explanation of Sec. 7701 in the House report made clear that the economic substance doctrine does not apply to every transaction and may be applied only when it is relevant.

Economic substance doctrine in the insurance context

To determine whether the economic substance doctrine was relevant in the Patels' case, the court looked at how it had been applied in insurance cases decided before codification of the doctrine and, in particular, captive insurance transactions. Reviewing those cases, it found that *Malone & Hyde, Inc.*, 62 F.3d 835 (6th Cir. 1995), rev'g and remanding T.C. Memo. 1993-585, was the closest to the Patels' case.

In *Malone & Hyde*, a corporate taxpayer created a thinly capitalized Bermuda insurance subsidiary to reinsure certain risks. It then entered into primary insurance contracts with a third-party insurer (Northwestern National Insurance Co.). The taxpayer had Northwestern enter into reinsurance contracts with the Bermuda subsidiary. The taxpayer paid insurance premiums to Northwestern, which in turn paid a portion of the premiums to the Bermuda subsidiary. The taxpayer deducted the full amount of the premiums it paid to Northwestern, resulting in the taxpayer's claiming deductions for amounts ultimately received by the Bermuda subsidiary as reinsurance premiums.

The IRS disallowed the taxpayer's deductions for the portion of the insurance premiums Northwestern received and paid to the Bermuda subsidiary. The Sixth Circuit upheld the IRS's determination, concluding that the arrangement lacked economic substance or a business purpose, and consequently, under the economic substance doctrine, the premiums paid to the subsidiary were not bona fide business expenses that entitled the taxpayer to a Sec. 162(a) deduction.

The Tax Court found that parallels between *Malone & Hyde* and the Patels' case were "easy to draw" and that there were no mitigating factors in the Patels' case that would "argue for a different approach" from that which it and the appeals courts had previously taken. The court stated that in the Patels' case, "heeding Congress's direction that we proceed in the same manner as if section 7701(o) had never been enacted — to determine whether the economic substance doctrine is relevant to a transaction — we conclude that the doctrine is relevant."

Application of the Sec. 7701(o) economic substance test

Having held that the economic substance doctrine was relevant to the Patels' microcaptive transactions, the Tax Court applied the two-part test for economic substance in Sec. 7701(o) to them. Under Sec. 7701(o)(1)(A), the court examined whether the microcaptive transactions changed the Patels' economic position in a meaningful way other than federal income tax effects (the objective test) and, under Sec. 7701(o)(1)(B), whether the Patels had a substantial purpose, apart from federal income tax effects (i.e., tax avoidance), for entering into the transactions (the subjective test). The court found that the Patels did not meet either the objective or the subjective test, so it held that their purported insurance transactions carried out through their two microcaptive insurance companies lacked economic substance.

Objective test: With regard to the objective test, the Tax Court held that the Patels' transactions did not result in a meaningful change in economic position with respect to insurance, aside from the federal tax effects. As the court had more fully described in *Patel II*, the Patels' microcaptive transactions involved a circular flow of funds among Magellan, Plymouth, and a related reinsurance company. The court also noted that the Patels paid unreasonable and excessive premiums to Magellan and Plymouth up to the deductible amount allowed under Sec. 831(b), while maintaining insurance coverage with third-party commercial insurers.

Subjective test: With regard to the subjective test, the Tax Court also held that the evidence before it, as it had discussed at length in *Patel II*, demonstrated that the Patels entered into their microcaptive transactions to reduce their federal income tax bill, not for any business purpose. This evidence included, but was not limited to, the Patels and their entities paying excessively high premiums designed to maximize deductions; demonstrating through overwhelming contemporaneous emails and documents that the microcaptives served no legitimate business purpose; and maintaining commercial insurance during the tax years

The court found that Patel had failed to make reasonable attempts to comply with the tax law and failed to make reasonable attempts to determine the correctness of deductions that should have seemed to him too good to be true.

at issue for significantly lower premiums, which often covered the same risks as the microcaptives.

Application of Sec. 6662(b)(6)

The Tax Court next addressed whether the Sec. 6662(b)(6) penalty applied. After analyzing the text of the provision, the court determined that its natural reading is that a lack of economic substance must be the cause of the disallowance of the claimed tax benefit, which in the Patels' case was the deductions for purported insurance premiums paid in the microcaptive transactions.

As discussed above, the Tax Court held that the Patels' microcaptive transactions lacked economic substance. Thus, the court found the disallowance of the Patels' claimed tax benefits were by reason of a transaction lacking economic substance within the meaning of Sec. 7701(o), and, accordingly, Sec. 6662(b)(6) applied. Therefore, the court sustained the IRS's assertion of Sec. 6662(b)(6) penalties for tax years 2014 through 2016 on the ground that the transactions lacked economic substance.

Increased penalty under Sec. 6662(i)

Having determined that the Patels' disallowed deductions were subject to the Sec. 6662(b)(6) penalty, the Tax Court then considered whether the increased penalty rate under Sec. 6662(i) applied. Sec. 6662(i) increases the Sec. 6662(a) penalty from 20% to 40% for any portion of an underpayment that is attributable to one or more nondisclosed noneconomic substance transactions under Sec. 6662(b)(6).

Under Sec. 6662(i)(2), "the term 'nondisclosed noneconomic substance transaction' means any portion of a transaction [lacking economic substance] with respect to which the relevant facts affecting the tax treatment are not adequately disclosed in the return nor in a statement attached to the return." The Tax Court found that the Patels did not adequately disclose the relevant facts about the microcaptive transactions on their returns or in a statement attached to them. Therefore, it sustained the IRS's imposition of the Sec. 6662(i) increased penalty rate in 2014 and 2015.

Negligence and substantial understatement of income tax

The IRS, after the Tax Court's decision in *Patel I*, continued to assert that the Patels were liable for the accuracy-related penalty under Sec. 6662(b)(1) for negligence or disregard of the rules or regulations as the primary penalty for 2013. For 2014–2016, the IRS asserted that the Sec. 6662(b)(1) penalty or the Sec. 6662(b)(2) penalty for any substantial understatement of tax served as alternative grounds to sustain its penalty determinations.

Negligence or disregard of rules or regulations: Under Sec. 6662(c), for purposes of the accuracy-related penalties in Sec. 6662, "negligence" includes any failure to make a reasonable attempt to comply with the tax law, and the term "disregard" includes any careless, reckless, or intentional disregard. Regs. Sec. 1.6662-3(b)(1)(ii) provides that negligence is strongly indicated where a taxpayer fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion on a return that would seem "too good to be true" under the circumstances.

The court observed that while Patel was a highly educated man and described himself as a "savvy financial person," the record did not show that he questioned or investigated the propriety of a microcaptive transaction, which the court described as "the type of 'too good to be true' transaction that should cause taxpayers to seek out competent advice from independent advisers." Thus, the court found that Patel had failed to make reasonable attempts to comply with the tax law or to determine the correctness of deductions that should have seemed to him too good to be true. Accordingly, it held that the Patels were liable for the Sec. 6662(b)(1) penalty in the tax years at issue.

Substantial understatement of income tax: Under Sec. 6662(d)(1)(A), an understatement of income tax is "substantial" if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. In 2014, 2015, and 2016, the Patels' understatements on their returns were over $5,000 and well in excess of 10% of the tax they were required to show on their return, so the Tax Court held that the Sec. 6662(b)(2) substantial understatement of income tax penalty applied to those years.

Reflections

In 2023, in *Liberty Global, Inc.*, No. 20-cv-63501 (D. Colo. 10/31/23), the District Court for the District of Colorado came to the opposite conclusion of the Tax Court, finding that the prefatory clause of Sec. 7701(o) did not require a threshold relevancy determination before the application of the statute's two-prong test for economic substance in Sec. 7701(o)(1). In a footnote to its opinion, the Tax Court stated, "In the light of the text [of Section 7701(o)], we respectfully disagree with other courts that have held that the relevancy requirement is coextensive with the requirements of section 7701(o)(1)(A) and (B)."

Patel, 165 T.C. No. 10 (2025)

Refund suit dismissed because *Flora* full-payment rule not met

A district court concluded that a taxpayer's tax debts were not discharged in bankruptcy and therefore were not fully paid for purposes of the "full-payment rule" set out in *Flora*, 357 U.S. 63 (1958). Accordingly, the district court held that it did not have subject-matter jurisdiction over the taxpayer's refund claims and dismissed his refund suit.

Background

Michael Dicks filed a refund suit in district court for tax years 2013, 2014, and 2015, asserting that the IRS improperly withheld $1,839,176 in tax refunds for those years. The IRS conceded that Dicks had paid the taxes for 2013 but not for 2014 and 2015. The IRS moved to dismiss the claims for tax years 2014 and 2015, asserting that the district court did not have jurisdiction because Dicks had failed to pay taxes for those years and did not meet the full-payment rule set out in *Flora*.

Dicks argued that his tax liabilities for 2014 and 2015 had been discharged in bankruptcy court; consequently, because no tax deficiency remained after the discharge, the *Flora* full-payment rule did not apply. The district court dismissed Dicks's refund suit, finding it lacked subject-matter jurisdiction over Dicks's claims because he failed to show that his taxes for 2014 and 2015 were discharged.

Dicks then filed an amended complaint, which included an amended Form 1040, *U.S. Individual Income Tax Return*, a bankruptcy petition, and an order of discharge. The IRS again moved to dismiss the claims for tax years 2014 and 2015, arguing that the district court did not have subject-matter jurisdiction because, despite the amended complaint, Dicks still failed to show that his taxes for 2014 and 2015 were discharged.

The district court then issued an order directing Dicks to submit evidence that his tax obligations in 2014 and 2015 were discharged and to submit a supplemental briefing explaining how that evidence showed the debts were discharged. Dicks provided additional evidence and briefing in response to the order. The IRS once again moved to dismiss Dicks's 2014 and 2015 tax refund claim because the district court lacked subject-matter jurisdiction pursuant to the *Flora* full-payment rule.

Flora and the full-payment rule

In *Flora*, the IRS assessed a deficiency against a taxpayer who paid only part of the assessment before suing in district court for a refund (*Flora*, 357 U.S. at 63–64). The Supreme Court held that the district court lacked subject-matter jurisdiction because, under 28 U.S.C. Section 1346(a)(1), a taxpayer must pay the full amount of the assessed tax before filing a suit for refund (id. at 75–76). The Court explained that Congress's waiver of sovereign immunity for refund claims was limited and did not alter the established principle that a taxpayer must "pay first and litigate later" (id.).

The district court's decision

The district court held that Dicks could not recover his 2014 and 2015 taxes under the *Flora* full-payment rule since he did not fully pay them. Furthermore, the court held that because full payment is a prerequisite for a district court to maintain jurisdiction over refund claims, it lacked subject-matter jurisdiction over Dicks's refund claims and granted the IRS's motion to dismiss his case.

Proof of discharge: As proof of discharge, Dicks submitted to the district court, among other things, a bankruptcy order of discharge. He argued that the order of discharge eliminated his tax liability, and therefore there was no tax deficiency.

The district court found that the bankruptcy discharge order did not prove that Dicks's 2014 and 2015 tax debts had been discharged. The court explained that, as the IRS contended, the bankruptcy discharge order did not explicitly state that Dicks's 2014 and 2015 tax obligations were discharged. Although the order confirmed that some debt was discharged, it contained no specification regarding the 2014 and 2015 tax years. Furthermore, the court found that a general order of discharge does not identify which debts are discharged, citing United States Courts, Discharge in Bankruptcy — Bankruptcy Basics.

Recovery of discharged taxes: The district court held that even if Dicks's tax obligations were discharged, taxes discharged in bankruptcy do not satisfy the *Flora* full-payment rule because the taxes are still not paid, only rendered uncollectable. As the court observed, the bankruptcy court stated in *In re Berry*, 85 B.R. 367, 369 (Bankr. W.D. Pa. 1988):

> The cases are clear in construing … that the effect of a discharge [is] simply to release a Bankrupt's personal liability for repayment of the debt. The discharge is not a payment or extinguishment of the debt itself. It simply bars future legal proceedings

Although the order confirmed that some debt was discharged, it contained no specification regarding the 2014 and 2015 tax years.

to enforce the discharged debt against the Bankrupts.

Similarly, in *Wagner*, 573 F.2d 447, 453 (7th Cir. 1978), the Seventh Circuit found "that a discharge does not cancel the obligation; the obligation still exists."

Dicks did not dispute that he failed to pay his 2014 and 2015 tax obligations. Instead, he argued that because those debts were discharged in a 2023 bankruptcy proceeding, no tax deficiency remained, and the *Flora* full-payment rule was satisfied. However, he offered no authority or evidence showing that a bankruptcy discharge constitutes full payment under *Flora*.

The district court determined that even if it considered Dicks's argument that he fulfilled the *Flora* full-payment rule, case law precedent showed that this argument failed. The primary exception to *Flora*'s full-payment rule is the divisible tax exception, which the court found did not apply in Dicks's case because his taxes were not divisible, as they arose from single events.

According to the district court, a debt discharged in bankruptcy court is analogous to a debt rendered uncollectable by the running of the statute of limitation. Where a debt is uncollectable due to the statute of limitation, although the IRS may no longer pursue collection, the underlying debt remains unpaid. Under Sec. 6502(a)(1), the IRS has 10 years to collect an assessed tax, yet a taxpayer seeking a refund on such taxes cannot recover because the tax was never fully paid (see, e.g., *Wolfing*, 144 Fed. Cl. 626, 640–41 (2019)). In *Wolfing*, the IRS wrote off taxes the taxpayer owed that were never collected and rendered them "uncollectable" because the 10-year statute of limitation on collection had expired (id. at 633). While the taxpayer thus did not owe anything to the IRS, the Court of Federal Claims found this did not qualify as full payment under *Flora* (id. at 640–41). Likewise, the district court held that although Dicks did not owe anything to the IRS due to the bankruptcy discharge, the *Flora* full-payment rule was not met.

Reflections

Despite having amended his complaint several times, Dicks again asked the district court for leave to amend his complaint, but the court dismissed his case without leave to amend his claims. The district court noted that courts have broad discretion to grant leave to amend a complaint. However, according to the court, "Mr. Dicks's allegations do not permit a reasonable inference that an absence of liability satisfies *Flora*'s requirement of full-payment. As Mr. Dicks has not shown that he can recover under *Flora* for the claims arising from his 2014 and 2015 taxes, those claims fail as a matter of law. Therefore, leave to amend is not warranted."

Dicks, No. 3:25-CV-0192 (S.D. Cal. 11/13/25) (order granting motion to dismiss) ■

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