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Legal and Tax Update

February 22, 2022

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Overview

- Jason B. Freeman IRS Enforcement
- Matthew Roberts Tax Court Update
- Cory Halliburton UBIT for Tax-Exempt Orgs



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IRS Enforcement

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IRS Enforcement Priorities

- Chief Counsel hiring 200 “experienced attorneys to focus on abusive tax deals”
- Promoter Investigations
- Abusive Tax Schemes
- High-Income Taxation
- Tax Professionals

IRS Office of Promoter Investigations

- "By establishing the Office of Promoter Investigations, we are continuing our increased focus on promoters of abusive tax avoidance transactions, which we have demonstrated over the last year," said IRS Commissioner Chuck Rettig. "This office will coordinate efforts across multiple business divisions to address abusive syndicated conservation easements and abusive micro-captive insurance arrangements, as well as other transactions."
- "These groups are exclusively dedicated to investigating those who peddle abusive tax schemes. Bringing these agents together, in combination with the creation of the service-wide Office of Promoter Investigations, will help strengthen our compliance work and is yet another opportunity to increase our capacity to conduct these investigations," said De Lon Harris, commissioner, SB/SE Exam. "Our promoter office will strategically focus resources to help expand detection and deterrence efforts of promoter work across the IRS."

National Fraud Counsel

- IRS Press Release:
 - As Assistant Division Counsel (International), the new National Fraud Counsel has been responsible for coordination and management of all international and offshore tax and Report of Foreign Bank and Financial Accounts (FBAR) matters under the jurisdiction of SB/SE Division Counsel. She helped to ensure the government consistently applies law and policy in international and offshore tax and FBAR matters, including in non-docketed cases and cases docketed in the U.S. Tax Court, U.S. district courts, the Court of Federal Claims and the U.S. Courts of Appeals. Schenck also provides guidance to and serves as the principal legal advisor and contact point on international and offshore tax and FBAR matters to the SB/SE Division and the Withholding and International Individual Compliance function of the IRS Large Business and International Division. Her international work also involves John Doe summons actions, the Offshore Voluntary Disclosure programs and Streamlined Filing Compliance Procedures, working with Treaty partners on cross-border issues and cases, and conducting nationwide trainings for attorneys and agents on investigative techniques, evidence and substantive tax issues.

Promoter Investigations

- Penalties
- IDRs for client lists
- IRC 6700 permits assertion of penalties against any person who:
 - Organizes or assists in the organization of a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement; or
 - Participates (directly or indirectly) in the sale of any interest in an entity or plan or arrangement; and
 - Makes or furnishes or causes another person to make or furnish a false or fraudulent statement about any material matter or a gross valuation overstatement.

Chief Counsel hiring 200 “experienced attorneys to focus on abusive tax deals”

- "Combating abusive tax transactions that threaten to undermine our tax system remains a top priority for our enforcement efforts," said IRS Commissioner Chuck Rettig. "It's critical we work to ensure a fair tax system and adding these new attorneys will help us in on our ongoing efforts in this arena."
- “Promoters have been particularly active developing and marketing tax shelter schemes that purportedly enable taxpayers to avoid paying what they legally owe. These new hires will help the IRS manage the increasing caseload in its multi-year effort to stamp out these abusive schemes and ensure that those participating in them pay the tax they owe plus penalties.”

Chief Counsel hiring 200 “experienced attorneys to focus on abusive tax deals”

- Abusive syndicated conservation easement deals remain a major focus for the IRS. These transactions generally use inflated appraisals of undeveloped land and partnerships devoid of legitimate business purpose designed to generate inflated and unwarranted tax deductions.
- "Bogus syndicated conservation easement transactions undermine the public's trust in private land conservation and defraud the government," Rettig said. "Putting an end to these schemes is imperative."
- Abusive micro-captive insurance arrangements also remain a key focus of IRS enforcement. These deals are generally sold to owners of closely held entities. The deals commonly lack many of the necessary attributes of insurance, have excessive premiums, insure highly improbable risks and have no connection to genuine business and insurance needs.
- These are just some of the abusive schemes that the new hires will be working on.

Congressional Testimony

- Tax Gap
- Intention to focus on “partnerships and high-wealth returns”
- “Cross Border and Treaty and Transfer Pricing Operations”
- Cryptocurrency-related tax violations
- Tax-Exempt violations

Criminal Investigation Division FY 2021 Annual Report

- High-Income Taxpayers who Fail to File Returns and Pay Tax Owed
- Abusive Tax Schemes
- Offshore Tax Schemes
- Employment Tax Fraud
- Covid-19-Related Fraud
- Cryptocurrency

Compliance Options?

- Voluntary Disclosure Program
- Streamlined Filing Compliance Procedures
- Maintaining the Privilege



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Tax Court Update

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Tax Court Update

- *Long Branch Land, LLC v. Comm'r*, T.C. Memo. 2022-2
- *Soni v. Comm'r*, T.C. Memo. 2021-137
- *Huff v. Comm'r*, T.C. Memo. 2021-140

Long Branch Land

- Facts: TP claimed a conservation easement deduction, which was disallowed by the IRS. The IRS also imposed valuation penalties against TP. The IRS moved for partial summary judgment on the issue of whether it complied with section 6751(b).
- Refresher on Section 6751(b).
 - Requires “initial determination” of a penalty assessment to be personally approved in writing by the immediate supervisor of the person making the penalty determination.
 - Tax Court has concluded that each word means what it says, *i.e.*, IRS must have it in writing and it must be the immediate supervisor of the IRS exam agent.
 - If IRS fails to comply, penalty is invalid.

Long Branch Land

- When is section 6751(b) required for TEFRA cases?
 - In TEFRA cases, supervisory approval must generally be obtained before the FPAA is issued to the partnership. If approval was obtained by that date, the partnership must establish that the approval was untimely—*i.e.*, that there was a formal communication of the penalty to the TP before the proffered approval was secured.
- So what happened here?
 - In this case, the IRS was able to show that a manager had made the penalty approval on 7/31/18, which was months *prior* to the issuance of the FPAA. Moreover, the partnership failed to show that a formal communication of the penalty was made prior to 7/31.18.

Long Branch Land

- What was issue then?
 - TP contended that manager who purportedly made the approval was not the “immediate supervisor.”
 - Tax Court disagreed, noting that under the “presumption of regularity,” it is presumed that government agencies—including the IRS—act in accordance with law. Without more evidence, presumed that person was immediate supervisor.

Soni

- Facts: The Sonis were married in India in 1978 in an arranged marriage traditional to their culture. Anjali, On's wife, left all financial matters to her husband, including tax matters. She never signed tax returns even though the couple filed joint income tax returns. The IRS issued a NOD to the Sonis.
- Issue: Whether the IRS can assess a tax against Anjali, even though she did not sign the tax return at issue?

Soni

- The Tacit Consent Doctrine

- To determine whether the TPs filed a joint income tax return, Tax Court must look to both spouses' intent—*i.e.*, did they intend to file a joint income tax return.
- The failure of one spouse to actually sign does not necessarily negate the intent to file a joint return.
- Intent may be shown through tacit consent; indeed, the “tacit consent rule” holds that the intent to file jointly may be inferred from the acquiescence or tacit approval from the nonsigning spouse.

Soni

- The Tacit Consent Doctrine
 - What does Tax Court look at under tacit consent rule?
 - Did the nonsigning spouse file a separate income tax return?
 - Did the nonsigning spouse object to filing jointly?
 - Does prior history indicate the intent to file jointly?
 - Note: A pattern of relying on one' spouse to handle the family's financial matters, including preparation of tax returns, suggests that the spouse consented to the other spouse's filing of the return.
- Tax Court Holding: Tacit consent rule applies because: (1) Sonis had always filed joint income tax returns since they were married; (2) Anjali indicated that she trusted her husband to make decisions for her; (3) Anjali did not object to her husband filing the return; and (4) she did not file any separate tax returns.

Huff

- Facts: TP was a wealthy financier, engaged in the miniature donkey breeding business. TP engaged in extensive research regarding the miniature donkey business and acquired multiple donkeys with the intent to breed newer ones under 25 inches tall. He kept this business segregated on farm land that he owned and kept separate books and records. TP did not enjoy the business as it was “a lot of work”. TP’s miniature donkey activities resulted in losses, which TP reported on his tax return.
- Issue: Whether the miniature donkey activities constitute a trade or business and are outside the hobby loss rules of section 183?

Huff

- Hobby Loss Rules

- Activity is engaged in profit if the activity was entered with the dominant hope and intent of realizing a profit. To determine whether the activity is engaged in for profit, the Tax Court looks at all the surrounding facts and circumstances.
- Factors:
 - Manner in which the TP conducts the activity.
 - Expertise of the TP/his advisers.
 - Time and effort spent by TP in carrying on the activity.
 - Expectation that assets used in the activity may appreciate in value.
 - Success of TP in carrying on other similar activities.
 - TP's history of income/losses with respect to the activity.
 - Amount of occasional profits, if any.
 - Financial status of the TP.
 - Elements of personal pleasure or recreation.

Huff

- Factors here:
 - TP had a business plan (very important!) and kept books and records.
 - TP undertook deep research into all factors related to raising miniature donkeys and hired experts to help.
 - TP was involved in other businesses where he turned unsuccessful businesses into profitable ones.
 - Donkey business was within startup phase.
 - No personal pleasure from activity.
- Result: TP engaged in trade/business with expectation of profit



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Tax-Exempt Organizations & Unrelated Business Income *-What is it and is it Taxable?*

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Overview of UBI Presentation

- This portion of the presentation will provide an overview of unrelated business income tax matters for organizations who enjoy taxation under section 501(a) of the IRC, with an emphasis on organizations that are exempt pursuant to section 501(c)(3) of the IRC.
- Statutes in Focus: IRC §§ 501, 511, 512, 513, and 514, and related Treasury Regulations.

General Rule for Tax-Exemption under IRC 501(c)(3)

- ORG must be **both organized and operated** exclusively for a purpose specified in IRC § 501(c)(3). *See* 26 U.S.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3)-1(a)(1).
- ORG will be regarded as operated exclusively for one or more exempt purposes **only if ORG engages primarily** in activities that accomplish a purpose in 501(c)(3). *See* 26 C.F.R. § 1.501(c)(3)-1(c).

Organizational Test Under IRC 501(c)(3)

An organization is **organized** exclusively for one or more exempt purposes **only if its articles of organization:**

- (A) Limit the purposes of such ORG to exempt purposes; and
- (B) Do not expressly empower the ORG to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of an exempt purpose.

Id. at § 1.501(c)(3)-1(b)(1)-(b)(1)(i)(B).

Operational Test Under IRC 501(c)(3)

“An organization **may** meet the requirements of section 501(c)(3) **although it operates a trade or business** as a substantial part of its activities, **if** the operation of such trade or business is in furtherance of the organization’s exempt purpose or purposes **and** if the organization is not organized or operated for the **primary purpose** of carrying on an **unrelated trade or business**, as defined in section 513.”

26 C.F.R. § 1.501(c)(3)-1(e).

A Substantial Trade or Business Destroys Exemption

“The presence of a single nonexempt purpose, if **substantial** in nature, **will destroy** the exemption regardless of the number or importance of truly [exempt] purposes.””

Am. Ass'n of Christian Schools Voluntary Employees Beneficiary Ass'n Welfare Plan Trust v. United States, 850 F.2d 1510, 1513 (11th Cir. 1988) (quoting *Better Business Bureau v. United States*, 326 U.S. 279, 283, 66 S.Ct. 112, 114, 90 L.Ed. 67 (1945)).

Overview of Unrelated Business Income

- Tax-exempt ORG must pay income tax on UBI. IRC § 511.
- An unrelated trade or business is any trade or business the conduct of which is not substantially related to ORG's exempt purpose. IRC § 513.
- Modifications, exclusions, and exceptions exist. IRC §§ 513-514.

Definition of Unrelated Trade or Business

- Any trade or business the conduct of which is not substantially related (aside from the need of such organization for income) to the performance by ORG of its charitable, educational, or other purpose constituting the basis for its exemption under section 501[.]” *See* IRC § 513(a).
- UBTI (T for taxable) = gross income derived by ORG from any “unrelated trade or business” **regularly carried on**, less applicable deductions connected with the carrying on of such business, computed with the modifications in subsection 512(b). *See* IRC § 512(a)(1).

Definition of Unrelated Trade or Business- *Type of Relationship Required*

“Trade or business is *related* to exempt purposes . . . only where the conduct of the business . . . has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is *substantially related* . . . only if the causal relationship is a substantial one. Thus, . . . the production or distribution of the goods or the performance of the services from which the gross income is derived **must contribute importantly to the accomplishment of those purposes.** . . .”

26 C.F.R. § 1.513-1(d)(2).

Judicial Review of “Unrelated Trade or Business”

A trade or business is “**substantially related**” only if the production or distribution of the goods or the performance of the services from which the gross income is derived **contributes importantly to the accomplishment of the purposes for which exemption was granted.** “A ‘substantially related’ trade or business ‘has **causal relationship to the achievement of exempt purposes**’ and ‘**must contribute importantly to the accomplishment of those purposes.**””

Ocean Pines Ass’n v. Comm’r, 672 F.3d 284, 287-289 (4th Cir. 2012) (quoting 26 C.F.R. § 1.513-1(d)(2)).

Modifications – IRC 512(b)

- **Dividends & Interest.** Dividends and interest income are excluded.
- **Rents from to Real Property.** Rents attributable to real property are excluded from UBTI, provided that an exception to the exclusion does not apply.
- **Rents from Personal Property.** rents from personal property leased with real property are excluded from UBTI, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease (and provided an exception to the exclusion does not apply).
 - Mixed use rules apply.
 - Rental income excludable from UBTI if rent attributable to the personal property are not more than 10% of total rents received. *See* 26 C.F.R. § 1.512(b)-1(C)(2)(ii)(b).

UBI Exceptions to the Modifications or Exclusions

26 U.S.C. § 512(b)(3)(B)(i), (b)(4)

The exclusions from UBTI for rents **shall not apply**:

- if more than 50% of the total rent is attributable to personal property, or
- if the determination of the amount of such rent depends in whole or in part on the income or profits.

Notwithstanding modifications in ¶ (1) (investment income), (2) (royalties), (3) (rent of property), or (5) (stock sales) **in the case of debt-financed property** (§514) “there shall be included, as an item of gross income derived from an unrelated trade or business,” the amount ascertained under §514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under §514(a)(2).

UBI in Summation

- Unrelated trade or business: **(1)** it is a trade or business, **(2)** it is regularly carried on, and **(3)** it is not substantially related to furthering the exempt purposes of ORG.
- Modifications and Exclusions exist but may be inapplicable by statutory exceptions to the modification or exclusion.
- **Issue Identification – any income-producing activity should be carefully evaluated for UBI purposes.**
- **Common UBI** – Be wary of rental income for leasing property that is debt-financed, or where the lease also includes personal property associated with the real property.



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