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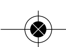

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November 2023

# M&A Transactions: Effect of Inflation Reduction Act

## IRS Penalty Assessments

## Name, Image, or Likeness Revenue: Tax Issues

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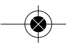

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As part of a larger effort to improve technology, the IRS announced an expansion of the Tax Pro Account capabilities, allowing tax professionals access to new services to help their clients. (IR 2023-182, 9/29/2023)

New additions to Tax Pro Account, available through IRS.gov, will help practitioners manage their active client authorizations on file with the Centralized Authorization File (CAF) database. Other enhancements will allow tax professionals to view their client's tax information, including balance due amounts. Tax Pro Account users can now also withdraw from their active authorizations online in real time.

With the recent enhancements, tax professionals can now use Tax Pro Account to send Power of Attorney (POA) and Tax Information Authorization (TIA) requests directly to a taxpayer's individual IRS Online Account. Upon the taxpayer's approval and validation of the information, the authorization records immediately to the CAF database, which avoids faxing, mailing, uploading, and long review and processing time by the CAF Unit.

Tax professionals must have a CAF number to use a Tax Pro Account; a CAF number cannot be requested through the Tax Pro Account. Currently, the digital authorization process is available only for individual taxpayers, not businesses or other entities.

For more information, see IRS Publication 5533-A, How to Submit Authorizations Using Tax Pro Account and Online Account.

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The IRS released regulations that reduce the user fees paid by tax preparers to obtain a preparer tax identification number (PTIN). (TD 9980, 10/2/2023) Under these new regulations, the cost for obtaining or renewing a PTIN will fall to $11 (plus $8.75 for a third-party contractor).

The IRS requires certain tax preparers to include a PTIN on a return, statement, or other document required to be filed with the IRS. A PTIN is used instead of the preparer's Social Security number to identify the preparer. The IRS charges practitioners a fee to obtain or renew a PTIN to cover its direct and indirect administrative costs for providing the PTIN.

In 2023 the IRS is using a new cost model to determine the costs that the government incurs for providing PTINs and administering the PTIN program. The IRS devised the new cost model after a court determined that the PTIN fee the IRS was charging preparers was too high.

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MAUREEN LINCH AND KATHY ZHANG

**This article considers some of the effects on M&A transactions of the changes made by the Inflation Reduction Act to the scope, availability, and monetization of clean energy tax credits.**

## I. Introduction

The Inflation Reduction Act (the "IRA"), passed in August 2022, is already making an impact on mergers and acquisitions ("M&A") in the United States.[1] Among the many provisions of the IRA, three major changes to U.S. tax law are particularly important for M&A: the new corporate alternative minimum tax, the excise tax on stock buybacks, and the extensive slate of green energy tax incentives. This article focuses on the green energy tax incentives in the IRA and their potential effects on M&A transactions.

Called the "most significant action Congress has taken on clean energy and climate change in the nation's history,"[2] the IRA is estimated to include up to $1.2 trillion in clean energy incentives[3] and to spur another $3 trillion in private-sector investment.[4] Even before the enactment of the IRA, renewable energy transactions were growing as a share of global M&A deals. In 2021, renewable energy transactions accounted for 20% of energy M&A deals with price tags of more than $1B.[5] The United States historically has been the leading market for renewable M&A, with a total of 710 publicly announced renewables deals between 2020 and 2022. Spain, the second largest market, had 253 renewable M&A deals in the same period.[6]

The IRA expanded the scope of activities and investments eligible to generate tax credits and deductions, introduced bonus credits for projects that meet domestic content and location-based requirements, lengthened the windows of time during which credit-eligible projects can begin construction, and introduced new monetization techniques to unlock the value of credits. Given these changes, M&A activity inside the renewable energy sector is expected to increase, and M&A activity outside of the renewable energy sector is likely to implicate the renewable energy provisions of the IRA.[7]

This article considers some of the effects on M&A transactions of the changes made by the IRA to the scope, availability, and monetization of clean energy tax credits. Part II provides a high-level overview of the IRA's clean energy tax incentives. Part III examines some of the general effects the IRA's green energy provisions may have on M&A transactions and analyzes certain issues that may arise in M&A involving targets who have taken advantage of IRA green energy incentives.

*MAUREEN LINCH is a partner, and KATHY ZHANG is an associate, at Cleary Gottlieb Steen & Hamilton LLP.* *The authors thank Cleary partner Jason Factor and practice development lawyer Michael Daly for their comments.*

## II. Overview of Clean Energy Incentives Under the IRA

### A. New Credit Types

Historically, two types of tax credits were available for renewable energy projects: the production tax credit ("PTC") and the investment tax credit ("ITC"), both of which were components of the general business credit under Section 38.[8] The PTC could be claimed annually for ten years and was calculated based on production from qualifying facilities. The ITC was a one-time tax credit calculated as a percentage of the cost basis of qualifying energy property. In general, PTCs and ITCs were available for only particular types of technology, including wind, solar, hydrokinetic, geothermal, biomass, and certain others. Most PTCs were set to expire for projects that began construction after 2021, and most ITCs were set to expire for projects that began construction after 2023.[9]

The IRA extended and expanded the availability of PTCs and ITCs, drastically increasing the types of activities and investments eligible for these tax credits. Under the IRA, PTCs are now available for manufacturing and selling components of clean-energy-related property, generating electricity from any zero-emissions energy source, creating clean fuels, producing clean hydrogen, and many other activities; and ITCs are available for energy storage, microgrid controllers, electrochromic dynamic glass, clean fuel production property, manufacturing facilities that produce components of renewable energy property, projects that use any type of zero-emission technology to generate electricity, and a variety of other renewable-related property.

### B. New Requirements

In addition to expanding the scope of available credits, the IRA also imposed new requirements for obtaining the full value of PTCs and ITCs. The IRA introduced a new base and bonus structure to the amount of credit available for both the ITC and the PTC. Before the IRA, the PTC was a flat amount per unit produced, and the ITC was a flat percentage of cost based on the technology type. Now, the new credit structure operates as a base amount with the addition of bonus amounts for meeting certain requirements. The base amount of the PTC is now 0.3 cents per kilowatt hour of electricity produced, and the base amount of the ITC is 6% of the cost basis of the property.[10]

From there, the PTC can be increased to 1.5 cents per kilowatt hour, and the ITC can be increased to 30% of cost basis by meeting the prevailing wage and apprenticeship requirements.[11] To meet the prevailing wage requirement, the taxpayer must pay all laborers employed in the construction or repair of a facility the prevailing wage for the geographic area and type of labor involved, as determined by the Secretary of Labor.[12] To meet the apprenticeship requirement, a certain percentage of total labor hours of constructing and repairing the facility must be completed by qualified apprentices participating in a registered apprenticeship program.[13]

Meeting two additional requirements – the domestic content requirement and the energy community requirement – can each increase the amount of the PTC and ITC by up to 10%. To satisfy the domestic content requirement, all components of a facility made primarily of steel or iron that are structural in nature must be made entirely in the United States, and at least 40% of the total costs of all manufactured product components must be produced in the United States.[14] To meet the energy community requirement, the facility must be located in an "energy community," which includes brownfield sites, census tracts where a coal mine or plant has recently closed, and areas where unemployment is high and employment is tied to fossil fuel production.[15]

### C. New Monetization Techniques

Prior to the enactment of the IRA, the tax benefits generated by renewable energy projects, which included ITCs, PTCs, and depreciation deductions, could be used only by

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1 Pub. L. No. 117-169, 136 Stat. 1818 (Aug. 16, 2022). The official name of the Act is "An Act to provide for reconciliation pursuant to title II of S. Con. Res. 14."

2 Building a Clean Economy: A Guidebook to the Inflation Reduction Act, The White House (Jan. 2023).

3 Martin A. Sullivan, *Revised EV Credit Estimate Further Raises Total Green Energy Costs*, 179 Tax Notes Federal 1621 (June 5, 2023). Josh Saul, *Goldman Sees Biden's Clean-Energy Law Costing U.S. $1.2 Trillion*, Bloomberg News (Mar. 23, 2023).

4 Josh Saul, *Goldman Sees Biden's Clean-Energy Law Costing US $1.2 Trillion*, Bloomberg News (Mar. 23, 2023).

5 Whit Keuer, Hyukin Lee, & Arnaud Leroi, *M&A Opportunities in the Energy Transition*, Bain & Company Energy & Natural Resources Report (June 14, 2022).

6 Nick Ferris, *Top Ten Renewables Dealmakers since 2020*, Energy Monitor, Renewables (Feb. 22, 2023).

7 Mason Vliet, *Expectations for Renewable Energy Finance: The Post-IRA Landscape*, American Council on Renewable Energy (June 21, 2023).

taxpayers who owned the property that generated the benefits. Developers of these projects typically did not have substantial tax liability, so reducing their tax liability through tax credits and deductions was not a valuable benefit to them. To unlock the value of these tax benefits, most developers partnered with banks and other institutional investors who had a consistent demand for tax benefits. Together, developers and institutional investors entered into complex "tax equity" structures that allowed the institutional investors to obtain the benefits of the tax credits and deductions generated by renewable energy projects and allowed the developers to obtain liquidity for the development of future projects.

Tax equity structures involved high transaction costs and relied on a limited universe of investors. To encourage broader investment and participation in the renewable energy market, the IRA introduced two new methods of monetizing tax credits, allowing for the first time renewable developers: (1) to elect to obtain a refund of unused tax credits for select credit types (called "direct pay")[16] or (2) to sell tax credits to other taxpayers (called "transferability").[17] Developers of renewable energy projects can still retain all or a portion of their tax credits to offset their own tax liability, but they now also have the opportunity to gain liquidity through tax refunds or credit sales.

### D. Increased Economic Certainty

One of the most significant changes brought to the renewable energy industry by the IRA is increased certainty about the long-term availability of credits. This is extremely helpful when making investment decisions and valuing a company or its assets. Historically, renewable energy producers in the United States have relied on tax credits that needed to be renewed by Congressional action every few years. This uncertainty resulted in boom-bust cycles that moved based on political whim. For example, in the month preceding the enactment of the IRA, the renewable energy industry had seen a 55% decline in projects from the same period in the prior year, with the industry citing "Congressional inaction and uncertainty on long-term tax policy" as one of the primary reasons for the decline in development.[18]

With the enactment of the IRA, renewable energy producers are able to make choices about longer-term projects with greater certainty about the economic consequences. The original PTC and ITC were each extended by the IRA for projects that begin construction by the end of 2024, after which a new technology-neutral PTC and ITC will replace the existing PTC and ITC. For example, the Clean Electricity Production Tax Credit under the newly introduced Section 45Y, which grants a tax credit for each kilowatt hour of electricity produced at a facility with no greenhouse gas emissions, is available to facilities for ten years. The credit will be available for facilities that begin construction after 2025 and on or before the later of 2032 or the year in which "annual greenhouse gas emissions from the production of electricity in the United States are equal to or less than 25 percent" of 2022 emissions levels.

Even with the enactment of the IRA, greenhouse gas emissions from electricity for 2030 are expected to be around a third of 2022 levels, giving renewable energy producers and potential buyers the ability to build models reflecting the availability of tax credits until 2032 at the earliest.[19] Although Congress could change the sunsetting provisions again through legislation, the industry may find relying on Congressional inaction more palatable than hoping for Congressional action.

## III. Effect of the IRA's Green Energy Incentives on M&A

The changes made by the IRA to green energy tax incentives will likely have a number of impacts on U.S. M&A transactions. Subsection A, below, discusses some of the general effects the IRA will

[8] Unless otherwise noted, all Section references are to the Internal Revenue Code of 1986 (the "Code") or the Treasury Regulations promulgated thereunder.

[9] Prior to the IRA, PTCs and ITCs were extended many times, usually only for a few years at a time. As discussed in more detail in Subsection D below, these unpredictable extensions inhibited long-term planning of projects that rely on the PTC or ITC.

[10] Section 45(a)(1); Section 48(a)(2). The base PTC amount is adjusted for inflation.

[11] Section 45(b)(6); Section 48(a)(9)(A)(i).

[12] Section 45(b)(7)(A); *see also* IRS Notice 2022-61 § 3.02.

[13] Section 45(b)(8).

[14] Section 45(b)(9); *see also* IRS Notice 2023-38.

[15] Section 45(b)(11)(B).

[16] This election is available under Section 6417.

[17] This election is available under Section 6418.

[18] *Clean Energy Deployment Slowed Substantially in Q2 as Policy Inaction and Economic Uncertainty Imperils Energy Transition*, American Clean Power, Press Release (July 26, 2022).

have on M&A transactions in the United States. Subsection B discusses some considerations relevant to an acquisition transaction in which the target has made a direct-pay election. And Subsection C considers certain issues that might arise in a transaction where the target has made an election to transfer credits.

### A. Generally

Given the increased scope of activities and investments for which credits are now available, more companies are likely to engage in investments and activities that can generate PTCs and ITCs. As a result, tax credits are more likely to be a subject of concern in M&A deals. The larger and more diverse pool of potential targets that have taken or could take PTCs and ITCs also means a larger and more diverse set of risks for M&A buyers. Likewise, the increased credit amounts mean greater emphasis will be placed by parties in ensuring that all requirements for achieving the tax benefits have been met.

The new requirements will impose additional diligence burdens on buyers and disclosure and indemnity provisions on sellers, and new types of representations and interim operating covenants may need to be developed. The many new requirements that must be met in order to obtain the full value of available tax credits, such as the prevailing wage and apprenticeship rules, the domestic content requirement, and the energy community requirement, will necessitate diligence conducted by experts as well as representations on the part of sellers.

The monetization techniques introduced by the IRA will also impact M&A. Buying a company that has made a direct-pay election or sold credits will require significant diligence to ensure that the buyer is not taking on liability for excessive payments or credit transfers. For targets that have sold credits, this may require diligencing both the credits and the contracts under which they were sold. The new credit transfer rules will mean that many non-renewable energy companies will require renewable-energy tax diligence. A buyer of a company that has purchased renewable energy tax credits will want to ensure that the purchased credits will be available and will want protection against any associated liabilities, including penalties. As discussed below, the *buyer* of tax credits is the one which, in the first instance, is subject to potential penalties if the purchased credits are not fully available.

Although some guidance, including notices and proposed regulations, has been issued on these rules, a number of important questions remain unaddressed. During the interim period when guidance remains unissued or still in proposed form, M&A contracts may need to take into account the lack of certainty in the applicable law and retain flexibility to deal with any changes.

Finally, the longer time horizons during which taxpayers can start projects that might be eligible for credits will increase the number of players in the market who are engaging in activities and investments that generate tax credits. Companies who desire to pivot from another industry to renewables manufacturing or energy generating will have time to get operations up to scale, and foreign renewables companies who would like to enter the U.S. market will similarly be afforded a sufficient timeline to establish U.S. operations. Both types of market entrants will likely involve some M&A activity.

### B. Target Company that Has Made a Direct-Pay Election

As discussed above, the IRA introduced a new direct-pay election for certain tax credits.[20] The direct-pay election, found in Section 6417, allows tax-exempt entities to participate in renewable projects and receive cash payments for tax refunds to the extent that the credits they generate exceed their tax liability. If a direct-pay election is made for a tax credit, then the relevant tax credits are treated as payments against Federal income tax equal to the amount of the credits.[21] Under proposed regulations to Section 6417, a direct-pay election applies to the entire amount

[19] *U.S. Greenhouse Gas Emissions Trends and Projections from the Inflation Reduction Act*, Congressional Research Service R47385 (Jan. 12, 2023), *https://crsreports.congress.gov/product/pdf/R/R47385#:~:text=The%20models%20estimate%20that%20with,2030%20compared%20with%202005%20levels*.

[20] Section 6417.

[21] Section 6417(a).

[22] Prop. Reg. 1.6417-2(b)(5).

[23] Section 6417(d)(1); *see also* Prop. Reg. 1.6417-3. The "placed in service" date is the date on which the property is ready and available for its intended use (*see Oglethorpe Power Corp.*, TCM 1990-505, 60 TCM (CCH) 850 (1990)).

[24] Prop. Reg. 1.6417-2(a)(2)(iv).

[25] Prop. Reg. 1.6417-2(a)(2)(vi).

[26] *See* Prop. Reg. 1.6417-4.

[27] Section 6417(d)(6); *see also* Prop. Reg. 1.6417-6.

[28] Prop. Reg. 1.6417-6(a)(2).

[29] 88 Fed. Reg. at 40544.

[30] Section 6418(d)(6)(A).

of credits determined with respect to each credit property that was properly registered for a taxable year.[22]

Although intended primarily for tax-exempt entities, the direct-pay election is also available in a limited manner to taxable entities. For three specific credits—the carbon oxide sequestration credit under Section 45Q, the clean hydrogen production credit under Section 45V, and the advanced manufacturing production credit under Section 45X—a taxable entity can make a direct-pay election (as an "electing taxpayer") for the amount of tax credits allowed under those sections. In the case of the carbon oxide sequestration credit and the clean hydrogen production credit, the election must be made in the year the relevant facility is "placed in service" and lasts for five years.[23] In the case of the advanced manufacturing tax credit, the election can be made for any consecutive five-year period within the twelve-year period for which credit is available from January 1, 2023, to December 31, 2032. The proposed regulations clarify that an electing taxpayer that holds the relevant credit facility directly or indirectly through a disregarded entity may make the direct-pay election for credits determined with respect to the credit facility held directly by the disregarded entity.[24] A member of a consolidated group may make a direct-pay election for credits determined with respect to the member.[25] Special rules apply to electing taxpayers that are partnerships or S corporations, the discussion of which is beyond the scope of this article.[26]

If the elective payment amount exceeds the amount of credits actually allowable with respect to the underlying credit property, an excessive payment is determined and the electing taxpayer must pay taxes in an amount equivalent to the excessive payment plus an additional 20% penalty.[27] The 20% penalty does not apply if the electing taxpayer can demonstrate to the satisfaction of the IRS that the excessive payment resulted from reasonable cause.[28] Treasury has provided examples of situations in which excessive payments may arise, such as improperly claimed bonus credit amounts, errors in calculating credits, failure to apply the Section 38(d) ordering rules, or misapplications of credit utilization rules.[29] The tax imposed for excessive payments is imposed in the year of the determination of an excessive payment.[30] Recapture under Section 45Q does not result in an excessive payment.[31]

Although the direct-pay election will be used primarily by tax-exempt entities, some taxable entities engaged in manufacturing renewable-related products, sequestering carbon, or producing clean hydrogen will make direct-pay elections. As a result, the direct-pay provisions can have implications for certain M&A transactions, particularly where the buyer or seller has engaged in manufacturing renewable energy components, carbon sequestration, or clean hydrogen production.

When negotiating the acquisition of a target company that has made a direct-pay election, a potential buyer may ask for protection against a determination of excessive payment with respect to any credits for which the target has made a direct-pay election. Risk protections may include extensive diligence into and representations with respect to base and bonus credit eligibility, correct credit calculations, and proper application of the Section 38(d) ordering rules and credit utilization rules. A buyer may also negotiate for the seller to indemnify or insure the buyer against the risk of any excessive payments caused by breach of the representations, including for the 20% penalty and other associated costs.

Buyers may ask for risk protection specific to the credit for which a direct-pay election has been made. For example, Section 45X provides a PTC for each "eligible component" that is produced in the U.S. and sold to an unrelated party after December 31, 2022, and before Jan-

[31] 88 Fed. Reg. at 40544. Taxpayers who have made the direct-pay election for any Section 45Q carbon oxide capture credits are subject to recapture in circumstances where the carbon oxide ceases to be captured consistent with the requirements of the section. Section 45Q(f)(4).

[32] Section 45X(a)(1).

[33] Section 45X(b)(4).

[34] Section 45Q(c)(1)(B), (d)(1)(B).

[35] Section 45Q(f)(2), (h)(3), (d)(2)(A).

[36] Section 45Q(f)(4).

[37] Section 45V(b)(2).

[38] Section 45V(c)(2).

[39] Section 45V(d)(2). By contrast, under Section 45Z(d)(4)(B)(i), the Section 45V and Section 45Z credits cannot be taken in the same year with respect to a given facility, but a taxpayer could toggle between the two across separate taxable years.

[40] Section 6418. The following eleven credits may be transferred under Section 6418(f)(1)(A): (1) the Section 30C Alternative Fuel Vehicle Refueling Property Credit, (2) the Section 45 Renewable Electricity Pro-

uary 1, 2033.[32] If a target company has made a direct-pay election for Section 45X PTCs with respect to certain eligible components, a potential buyer will need to do diligence on whether, and may ask for representations that, the target has in fact produced the components in the U.S. and sold the components to an unrelated party within the required time frame. Depending on the type of eligible component for which the direct-pay election has been made, the buyer may require additional representations about credit eligibility. In the case of an eligible component that is a battery cell or battery module, for instance, the buyer may require the seller to represent that the capacity-to-power ratio of the battery cell or module does not exceed 100:1, as required by the Code.[33]

If a target has elected direct pay for the Section 45Q carbon oxide sequestration credit, a potential buyer will need to diligence whether, or ask for representations that, the carbon oxide for which the credit is taken meets the credit requirements. These may include whether the carbon oxide was captured from an industrial source within the United States by carbon capture equipment that was placed in service on or after a certain date and for which the original planning and design included carbon capture equipment, that the carbon oxide would otherwise have been released into the atmosphere as industrial emission of greenhouse gases, and whether the carbon oxide was measured at the source of capture and verified to be used or disposed of as required.[34]

If the target company has elected direct pay with respect to any increased credit amounts under Section 45Q, a buyer may also look at whether the bonus credit requirements have been met. These may include inquiries into whether, and representations that, the carbon oxide has been properly sequestered in secure geological storage, that the project meets prevailing wage and apprenticeship requirements, or in the case of a direct air capture facility, that it captures no less than 1000 metric tons of qualified carbon oxide during the taxable year.[35] Additionally, a buyer may ask the target company to represent that the relevant carbon oxide remains captured, disposed of, or used, such that recapture has not been triggered with respect to any credits taken; to warrant that the target company will not engage in activities that may trigger recapture in the pre-closing period; and to indemnify the buyer for any recapture triggered by a breach of such representations and covenants.[36]

Finally, if the target has elected direct pay for the Section 45V clean hydrogen PTC, a potential buyer may conduct diligence into and ask the target to make representations about the lifecycle greenhouse gas emissions rate of the hydrogen production process, which determines the amount of the Section 45V PTC.[37] Buyers may also require representations that the hydrogen has been verified by an unrelated third party as produced in the United States for sale or use.[38] The Section 45V credit is not available for hydrogen produced at a facility once a Section 45Q carbon oxide sequestration credit has been taken with respect to the facility, so buyers may also ask for a representation that no Section 45Q credit has ever been taken with respect to the facility.[39]

### C. Target Company that has Elected to Transfer Credits

As discussed above, the IRA introduced a transfer election whereby a taxpayer who generates certain types of tax credits (the "transferor") through renewable energy projects can elect to sell those credits to another taxpayer (the "transferee").[40] The transfer election is available for PTCs for electricity generation, carbon sequestration, zero-emission nuclear power, clean hydrogen, clean fuel production, and advanced manufacturing of renewable property, including components used in generation and energy storage. It is available for ITCs for electricity generation under Section 48 as well as for qualifying advanced energy projects under Section

duction Credit, (3) the Section 45Q Carbon Oxide Sequestration Credit, (4) the Section 45U Zero-Emission Nuclear Power Production Credit, (5) the Section 45V Clean Hydrogen Production Credit, (6) the Section 45X Advanced Manufacturing Production Credit, (7) the Section 45Y Clean Electricity Production Credit, (8) the Section 45Z Clean Fuel Production Credit, (9) the Section 48 Energy Credit, (10) the Section 48C Qualifying Advanced Energy Project Credit, and (11) the Section 48E Clean Electricity Investment Credit.

If a direct-pay election has been made for a credit under Sections 45Q, 45V, or 45X, a transfer election is not available for the tax years in which the direct-pay election is active. Sections 6417(d)(1)(D)(iii), 6417(d)(3)(C)(ii), and 6417(d)(3)(D)(ii).

[41] Section 48C(c)(1)(A). The Section 48C ITC is available only by application to the IRS, which may allocate a total of $10 billion worth of credits.

[42] Section 6418(b), *see also* Prop. Treas. Reg. § 1.6418-2(e)(2)-(3).

[43] Section 6418(e).

[44] Prop. Treas. Reg. § 1.6418-2(a)(2).

[45] Section 6418(a).

[46] Section 6418(g)(2)(A).

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48C. Section 48C provides a credit for certain projects, including carbon sequestration, refinement of renewable fuels, solar, hydro, wind, and geothermal energy facilities, and electrical grids supporting renewable energy.[41]

Credits can be transferred to an unrelated person for cash payment. The cash payment is not included in the income of the transferor and is not deductible to the transferee.[42] The transfer election is irrevocable and may be made only once.[43] A credit may be divided into specified credit portions and transferred to multiple transferee taxpayers.[44]

The transferee is "treated as the taxpayer" with respect to the transferred credit.[45] If the amount of credit transferred exceeds the amount actually allowable with respect to the underlying credit property, an excessive credit transfer is determined and the transferee must pay tax equivalent to the amount of credit transferred plus an additional 20% penalty.[46] The 20% penalty does not apply if the transferee can demonstrate that the excessive credit transfer resulted from "reasonable cause," but the transferee must still pay taxes in the amount of the excessive credit transfer.[47] In June 2023, Treasury and the IRS issued proposed regulations to the new transfer election provisions under Section 6418. These proposed regulations answered a number of open questions about the application of the credit transfer rules. For example, in the case of ITCs, if a recapture event under Section 50(a) occurs, recapture will apply under the proposed regulations to the transferee of the credits and not to the transferor.[48] The proposed regulations also contain special rules that apply when either the transferor or the transferee is a partnership or S corporation.[49] However, a number of important questions remain unaddressed by the proposed regulations.

As of the publication of this article, the transfer market for renewable tax credits is still in the early stages of development. Compared to the limited pool of tax equity investors, which are primarily large financial institutions, a broader group of taxpayers is expected to participate in the credit transfer market. Although there remains some ambiguity about the contours of the application of the Section 469 passive activity rules, under the proposed regulations, non-corporate transferees generally are required to treat the amount of transferred credit that exceeds their passive tax liability as passive activity credits.[50] This rule is likely to limit the demand for transferred tax credits among non-corporate taxpayers, with the result that many transferees will be corporations with substantial tax liability.

Sophisticated corporate transferees are expected to require risk protections similar in type and level to those historically sought by tax equity investors. With respect to excessive credit transfers, there is a risk of an additional 20% penalty that would not apply to a tax equity investor, so transferees may require even greater levels of protection against that possibility. Transferees will likely conduct extensive diligence to ensure that transferred credits are available. Additionally, transferees may require representations and warranties from the relevant transferors that requirements for credit eligibility, including bonus credit eligibility, have been met, and that the transferors have accurately completed the registration and transfer election processes. Transferees may ask that transferors covenant not to take any actions that would jeopardize the availability of the credits, such as triggering recapture through disposition. Transferees may negotiate risk protections such as indemnities and insurance, including tax gross-ups, to be borne by the applicable transferors.

When a buyer is considering acquiring a target company that has elected to transfer tax credits, the buyer will want to consider any potential liabilities it may be taking on with respect to credit transferees when it steps into the place of the target company. The buyer may consider asking for representations that the target has followed all property registration

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[47] Section 6418(g)(2)(B).
[48] Prop. Reg. 1.6418-5(d)(3).
[49] Prop. Reg. 1.6418-3.
[50] Prop. Reg. 1.6418-2(f)(4)(ii).
[51] Prop. Reg. 1.6418-5(a)(3).
[52] Section 50(a)(1).
[53] Section 50(a)(1)(B).
[54] Section 50(c)(3).
[55] Reg. 1.47-3(f)(1).
[56] Reg. 1.47-3(f)(2).
[57] Reg. 1.47-3(f)(6)(Ex. 1).
[58] The IRS has ruled that a partnership that transfers its assets to a newly formed corporation in a Section 351 transaction can avoid triggering recapture under the "mere change in form" exception. Ltr. Rul. 8224079 (1982).

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and transfer election procedures, and that the target has not transferred excessive credits (i.e., credits that the target was not eligible to take) to transferees. The buyer may also ask the seller to indemnify the buyer with respect to the risk that the buyer, who takes on the risks of the target, may need to indemnify the transferee of the tax credits with respect to any provisions breached in the tax credit transfer contract.

An additional consideration that arises in the context of excessive credit transfers is the tax treatment of the original cash amount the transferor received as consideration for the transferred credits. Although the proposed regulations to Section 6418 do not address the treatment of this amount to credit transferors, these amounts are not explicitly excluded from the income of the transferor.[51] If these amounts are includible in the income of the transferor, then a buyer of a target company that has transferred credits may ask the seller to indemnify the buyer with respect to the income inclusion, including tax gross-ups and interest.

When a target company has transferred ITCs, there is a risk of credit recapture to the transferee. Under Section 50(a), ITCs taken by a taxpayer can be recaptured, in whole or in part, if the underlying credit property ceases to be eligible credit property with respect to the taxpayer or if the taxpayer "disposes of" the underlying energy property within the recapture period. The recapture period lasts five years from the time the energy property is placed in service.[52]

For example, if an eligible credit property is disposed of within one full year of the property being placed in service, a tax equal to 100% of the ITC is imposed on the disposing taxpayer. If the property is disposed of after one full year, the recapture percentage decreases to 80% and decreases by 20% for each year of the recapture period. After five years, the recapture percentage is 0%.[53] If all or a portion of the ITC is recaptured with respect to an eligible energy property, the taxpayer's basis in the energy property will increase by an amount proportionate to the recaptured ITC. Because the ITC reduces basis by only 50% of the full ITC amount, basis is increased by 50% of the recaptured amount.[54]

As discussed above, if an ITC is transferred pursuant to an election under Section 6418, then recapture applies to the transferee rather than to the transferor. Transferees may require the transferor to covenant that the transferor will not enter into any transactions that could trigger recapture of the transferred ITC to the transferee. If the covenant is breached, transferees may require the transferor to indemnify the transferee for the cost of the breach, including costs and interest. If so, then it may be preferable to structure any M&A transaction involving a target company that has transferred ITCs so as not to trigger recapture to the transferee of the ITCs.

When structuring an M&A deal that involves a target who has transferred ITCs and agreed to a covenant against triggering recapture, the parties have two primary options for avoiding recapture: (1) structure the deal so as not to trigger recapture under Section 50(a); or (2) structure the deal so as not to trigger recapture *with respect to the transferee of ITCs* under the proposed regulations to Section 6418. With respect to the former option, a stock deal in which the target company continues to hold the relevant energy property is not likely to trigger recapture because the transferor has not disposed of the energy property. For other deal types, three main exceptions to Section 50(a) recapture apply in the corporate M&A context: (1) the "mere change in form" exception, (2) the Section 381(a) transaction exception, and (3) the consolidated group transfer exception. This section discusses each in turn. With respect to the latter option, there is one primary exception to the rule under the proposed regulations that recapture is triggered to the transferee: the transfer of interests in a partnership transferor triggers recapture to the transferring partner rather than to the transferee of the tax credits.

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59 Reg. 1.47-3(e)(1).

60 *Id.*

61 *Id.*

62 Reg. 1.1502-3(f)(2)(i).

63 Reg. 1.1502-3(f)(2)(iii) provides that recapture applies to a transfer or Section 38 property by a corporation during a consolidated return year if the corporation is liquidated in a transaction to which Section 334(b)(2) applies.

64 Revenue Ruling 74-101.

65 Prop. Reg. 1.6418-3(a)(6)(i)(A)-(B).

66 *See* 88 Fed. Reg. at 40501.

67 Prop. Reg. 1.6418-3(b)(4).

Section 50(a)(5) provides an exception to the general rule of recapture for transactions that effect a "mere change in the form of conducting the trade or business" in which the energy property is used, provided that the following conditions are satisfied: (1) the energy property is retained as energy property in the same trade or business; (2) the disposing taxpayer retains a substantial interest in the trade or business; (3) substantially all the assets (whether or not energy property) necessary to operate the trade or business are conveyed to the taxpayer to whom the energy property is conveyed (the "recipient"); and (4) the recipient gets carryover basis in the energy property.[55]

A disposing taxpayer retains a substantial interest in the trade or business only if, after the change in form, its interest in the trade or business is substantial in relation to the total interest of all persons or equal to or greater than his interest prior to the change in form.[56] Retaining 45% of the interest in the trade or business is considered substantial.[57] If the recipient disposes of the energy property after the mere change in form and before the end of the recapture period, then recapture applies. An example of a "mere change in form" transaction could be a shareholder or shareholder group contributing energy property to a corporation in a Section 351 transaction.[58]

Another exception for recapture exists for situations in which the underlying energy property is conveyed to a successor corporation in a transaction that qualifies for Section 381(a).[59] Section 381(a) applies a number of tax-free or tax-deferred corporate transactions, including: (1) complete liquidations under Section 332; (2) statutory mergers under Section 368(a)(1)(A) ("Type A Reorgs"); (3) asset acquisitions for stock under Section 368(a)(1)(C) ("Type C Reorgs"); (4) asset transfers to controlled corporations under Section 368(a)(1)(D) ("non-divisive Type D Reorgs"); (5) changes in corporate form under Section 368(a)(1)(F); and (6) transfers in bankruptcy under Section 368(a)(1)(G).

If a successor corporation disposes of energy property acquired in a Section 381 transaction before the end of the recapture period, then recapture applies.[60] The recapture period with respect to the successor corporation begins on the date on which the energy property is placed in service by the disposing corporation.[61]

Finally, ITCs are exempt from recapture when the underlying energy property is transferred to another member of a consolidated group.[62] If the recipient member subsequently disposes of the energy property, then recapture applies to the recipient member.

There are two exceptions to the general rule of no recapture on intergroup transfers: (1) recapture applies if the transfer of energy property is made by a member that is liquidated in a completed liquidation under Section 332;[63] and (2) recapture applies if the energy property is transferred in a divisive reorganization to a subsidiary that is distributed under Section 355.[64]

In addition to the aforementioned exceptions to recapture on disposition, there is an additional way to avoid recapture being triggered as to the *transferee* of transferred credits. Under the proposed regulations to Section 6418, if a partner in a partnership that holds and continues to hold the underlying energy property disposes of its partnership interest, the recapture rules under Section 50 apply to the disposing partner and not to the partnership or the transferee.[65]

Tax credits may be transferred only once under Section 6418(e)(2). The statute and the proposed regulations, however, do not state exactly when a credit transfer is deemed to occur. The preamble to the regulations suggests that general Federal income tax principles relating to the benefits and burdens of ownership apply in making this determination.[66] The proposed regulations contain a safe harbor for pass-through entities clarifying that a pass-through transferee taxpayer that allocates purchased tax credits to its direct or indirect owners is not considered a transfer and does not violate the rule prohibiting second transfers.[67]

In the corporate context, it is unclear whether certain corporate transactions will constitute a transfer of tax credits. For example, it is currently unclear whether, if a target corporation has purchased tax credits for its use but has not yet applied them to its tax liability for the year, an acquisition of the target company constitutes a second transfer

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of the purchased tax credits. Similar issues arise if the target corporation transfers its assets in a taxable or tax-free transaction to an acquiror or is deemed to do so as a result of an election under Section 338 or Section 336. For a target that has acquired significant amounts of tax credits, this may be relevant in structuring the acquisition.

## IV. Conclusion

The IRA has made sweeping changes to the tax benefits available for renewable energy activities and investments and will leave a deep impression on the U.S. M&A market. While the IRA provides a substantial economic boost to actors inside and outside traditional renewable energy markets, the new requirements and increased credit amounts embedded in the new law generate larger risks with more contingencies than parties previously faced. As a result, it is important to consider structural and contract points when negotiating an M&A transaction where credits are at stake.

In addition, there is still significant uncertainty with respect to a number of aspects of the new regime. The IRS has been issuing guidance in this area fairly regularly since the enactment of the IRA, but there is quite a long way to go before parties are able to fully understand all of the requirements. Given the rapid recent and future growth in the renewable energy market and the ongoing development of IRS guidance, we expect the market to evolve in the coming years.

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ANTHONY DIOSDI

Recently, the United States Tax Court held in *Alon Farhy*[1] that the IRS lacked the authority to assess certain penalties against taxpayers under Code Section 6038(b). In *Farhy,* the petitioner was required to file Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, but he did not. The penalty for failure to file, or for delinquent, incomplete, or materially incorrect filing is a reduction of foreign tax credits by 10% and a penalty of $10,000. An additional $10,000 continuation penalty may be assessed for each 30-day period that noncompliance continues up to $50,000 per return.[2]

The IRS assessed penalties against the petitioner under Section 6038(b). The Tax Court determined that there is no law giving the IRS authority to assess penalties under Section 6038(b). For reasons discussed in this article, the IRS also lacks the authority to assess Section 6039F penalties associated with the failure to timely file a Form 3520.

## IRS's Authority to Assess Penalties

Section 6201(a) authorizes and requires the Secretary of the Treasury to make assessments of all taxes, interest, additions to taxes, and assessable penalties imposed by the Internal Revenue Code. The Secretary of the Treasury has delegated these duties to the IRS Commissioner, who has delegated them in turn to other IRS officials. When a tax, interest, or assessable penalty is assessed, the IRS may take certain actions to collect the tax administratively through means such as liens and levies.

If there is no law giving the IRS the authority to assess a penalty, the IRS's only recourse to collect the penalty would be to ask the Department of Justice to sue the individual or entity assessed the penalty. This would involve bringing suit in a United States district court with proper venue and asking the court to liquidate the penalty assessment into a judgment.[3]

## The Section 6039F Penalty and the IRS's Position Regarding Its Authority to Assess and Collect the Penalty

Code Section 6039F applies to U.S. persons (other than certain exempt organizations) that receive large gifts (including bequests) from foreign persons. The Section 6039F reporting pro-

**In this article the author concludes that the IRS lacks the authority to assess Section 6039F penalties associated with the failure to timely file a Form 3520.**

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visions require U.S. donees to provide information concerning the receipt of large amounts that the donees treat as foreign gifts, giving the IRS an opportunity to review the characterization of these payments and determine whether they are properly treated as gifts. Donees are currently required to report certain information about foreign gifts on Part IV of Form 3520.

Section 6039F(b) generally defines the term "foreign gift" as any amount received from a person other than a U.S. person that the recipient treats as a gift or bequest. However, a foreign gift does not include a qualified transfer (within the meaning of Section 2503(e)(2)) or any distribution from a foreign trust. A distribution from a foreign trust must be reported as a distribution under Section 6048(c) and not as a gift under Section 6039F.

Section 6039F(c) provides that if a U.S. person fails, without reasonable cause, to report a foreign gift as required by Section 6039F, then (1) the tax consequences of the receipt of the gift will be determined by the Secretary and (2) the U.S. person will be subject to a penalty equal to 5% of the amount for the gift for each month the failure to report the foreign gift continues, with the total penalty not to exceed 25% of such amount.

Under Sections 6039F(a) and (b), reporting is required for aggregate foreign gifts in excess of $100,000 during a taxable year. Once the $100,000 threshold has been met, the U.S. donee is required to file Form 3520 with the IRS.

The IRS treats Section 6039F penalties as summarily assessable, as they are not subject to the deficiency procedures, wherein taxpayers receive a notice of deficiency alerting them of the potential assessment and explaining the taxpayer's options for contesting or complying with the penalty assessment. The notice of deficiency also informs taxpayers of the last day to petition the Tax Court for pre-assessment and prepayment judicial review.

Many penalties related to income tax filings are not summarily assessable (that is, they are generally subject to deficiency procedures). For example, deficiency procedures typically apply when the IRS determines noncompliance of a taxpayer resulting in an underpayment of some type of tax. Common penalties associated with the issuance of a notice of deficiency include an accuracy or negligence penalty under Section 6662.

Summarily assessable penalties are primarily found in Sections 6671 through 6720C. Chapter 68, Subchapter B, titled "Assessable Penalties," authorizes the IRS to assess and collect penalties "in the same manner as taxes" without first sending a notice of deficiency. Summary assessments are made without the issuance of a notice of deficiency and "shall be paid upon notice and demand and collected in the same manner as taxes." Most of these "penalties" are included in Chapter 68 of the Internal Revenue Code. Chapter 68, Subchapter A, titled "Additions to the Tax and Additional Amounts," allows the IRS to impose penalties for failure to file or pay taxes, understatements or underpayments of tax, and penalties for fraud. However, Chapter 61 penalties are not located in Chapter 68 of the Internal Revenue Code and are not therefore assessable penalties.

The IRS believes it has a grant of authority to assess Section 6039F penalties under Section 6201(a) as a result of a Supreme Court decision in *NFIB v. Sebelius*.[4] As discussed above, this provision of the Internal Revenue Code permits the IRS to assess tax as well as interest and penalties. In *NFIB v. Sebelius*, the U.S. Supreme Court agreed that the plain language of Section 6201(a) places within the definition of tax for the purpose of granting the IRS the authority to assess Affordable Care Act (ACA) penalties.

To reach this result, the Supreme Court had to clear the hurdle of the prohibition against injunctive relief in tax cases contained in the Anti-Injunction Act.[5] The Supreme Court stated that unlike penalties contained in Chapters 68A and 68B of the Internal Revenue Code, the ACA individual mandate penalty was not designated a tax, even though it was to be assessed and collected like a tax. Since the Anti-Injunction Act only applies to a "tax," the Anti-Injunction Act was not a bar to litigation involving the Affordable Care Act penalty.

The Declaratory Judgment Act prohibits suits for declaratory relief concerning "federal taxes."[6] Since the Declaratory Judgment Act is almost identical to the Anti-Injunction Act, the Declaratory Judgment Act does not bar a court from granting declaratory relief with respect to a penalty that is not deemed a "tax" under the Internal Revenue Code. Like the individual mandate penalty of the Affordable Care Act, no provision of the Internal Revenue Code states that the foreign information reporting penalties contained in Part III of Chapter 61A of the Internal Revenue Code are deemed a tax. Moreover, unlike the ACA individual mandate penalty, there is no provision in the Internal Revenue Code stating that the penalties contained in Part III A

of Chapter 61A are assessed and collected like a tax.[7]

In *NFIB v. Sebelius*, the Government argued that the Anti-Injunction Act barred any challenge to the penalty provisions, since they were contained in the Internal Revenue Code and, thus, a tax. A group of legal scholars filed an amicus brief arguing that the Anti-Injunction Act barred the Supreme Court from hearing the case. The Supreme Court disagreed. In reaching its conclusion, the Supreme Court stated as follows:

> "We think the Government has the better reading. As it observes, "Assessment" and "Collection" are chapters of the Internal Revenue Code providing the Secretary authority to assess and collect, and generally specifying the means by which he shall do so.[8] Section 5000A(g)(1)'s command that the penalty be "assessed and collected in the same manner" as taxes is best read as referring to those chapters and giving the Secretary the same authority and guidance with respect to the penalty. That interpretation is consistent with the remainder of Section 5000A(g), which instructs the Secretary on the tools he may use to collect the penalty.[9] The Anti-Injunction Act, by contrast, says nothing about the procedures to be used in assessing and collecting taxes. Amicus argues in the alternative that a different section of the Internal Revenue Code requires courts to treat the penalty as a tax under the Anti-Injunction Act. Internal Revenue Code Section 6201(a) authorizes the Secretary to make "assessments of all taxes (including interest, additional amounts, additions to the tax, and assessable penalties)."
>
> "Amicus contends that the penalty must be a tax, because it is an assessable penalty and Section 6201(a) says that taxes include assessable penalties. That argument has force only if Section 6201(a) is read in isolation. The Internal Revenue Code contains many provisions treating taxes and assessable penalties as distinct terms.[10] There would, for example, be no need for Section 6671(a) to deem "tax" to refer to certain assessable penalties if the Internal Revenue Code already included all such penalties in the term "tax." Indeed, amicus's earlier observation that the Internal Revenue Code requires assessable penalties to be assessed and collected "in the same manner as taxes" makes little sense if assessable penalties are themselves taxes. In light of the Internal Revenue Code's consistent distinction between the terms "a tax" and "assessable penalty," we must accept the Government's interpretation: Section 6201(a) instructs the Secretary that his authority to assess taxes includes the authority to assess penalties, but it does not equate assessable penalties to taxes for other purposes."
>
> "The Affordable Care Act does not require that the penalty for failing to comply with the individual mandate be treated as a tax for purposes of the Anti-Injunction Act. The Anti-Injunction Act therefore does not apply to this suit, and we proceed to the merits."

Based on the Supreme Court's rationale, none of the penalties contained in Part A III of Chapter 61A can be classified as a "tax." Consequently, the Anti-Injunction Act or the Declaratory Judgment Act would not prevent a taxpayer from filing suit for injunctive or declaratory relief in connection with a penalty contained in Part A III of Chapter 61A. The Supreme Court ultimately determined in *NFIB v Sebelius* that a penalty found in Section 5000A(g)(1) was to be paid upon notice and demand and was assessed and collected in the same way as assessable penalties under Chapter 68B, and as a result, the Affordable Care Act penalty was to be assessed and collected in the same manner as a tax.

## The Tax Court's Farhy Reasoning and the Farhy Court's Application to Section 6039F Penalties

Based on the Supreme Court's reasoning in *NFIB v. Sebelius,* a number of the Internal Revenue Code provisions that apply the term "tax" to foreign information reporting penalties are susceptible to challenge. As noted above, in *Farhy*,[11] the Tax Court recognized that certain Internal Revenue Code sections contain their own express provisions authorizing assessment of penalties provided therein, and that such penalties are encompassed within the "assessable penalty" reference in Code Section 6201(a).

In determining the term "assessable penalties" and holding that the Section 6038(b) penalty was not subject to the IRS's assessment authority under Section 6201(a), the Tax Court in *Farhy* com-

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[1] *Farhy*, 160 T.C. No. 6 (2023)
[2] *See* IRC Section 6038(b) and (c).
[3] *See* IRC Section 2461(a).
[4] *National Federation of Independent Business v. Sebelius,* 567 U.S. 519. (2012).
[5] *See* IRC Section 7421.
[6] *See* 28 USC section 2201.
[7] *See* California Lawyers Association Taxation Section 2019 Washington D.C. Delegation, *Clarifying Provisions on the Assessment and Collection of Foreign Information Reporting Penalties (IRC Sections 6038, 6038A, 6038C, 6038D, 6039F, 6046, 6046A, 6048)*, Robert S. Horwitz and Jonathan Kalinski.
[8] *See* IRC Section 6201 (assessment authority); IRC Section 6301 (collection authority).
[9] *See* Section 5000A(g)(2)(A)(barring criminal prosecutions); Section 5000A(g)(2)(B)(prohibiting the Secretary from using notices of lien or levies).
[10] *See, e.g.,* Sections 860(h)(1), 6324A(a), 6601(e)(1)-(2), 6602, 7122(b).
[11] *See Farhy*, 160 T.C. No. 6, 5 n.8 (2023).
[12] *See Smith*, 133 T.C. 424, 428 (2009).

pared Section 6038(b) to penalty Code sections outside Chapter 68, Subtitle F. The Tax Court in *Farhy* noted that Code sections outside Chapter 68 of Subtitle F whose violations the Internal Revenue Code specifically penalizes, commonly contained a reference to the treatment of the assessable penalty in one of three ways:

- The statute contains its own express provision specifying the treatment of penalties as a tax or an assessable penalty for purposes of assessment and collection (e.g., *see* IRC Section 527(j); IRC Section 5684(b); IRC Section 5751).
- The statute contains a cross reference to a provision within Chapter 68 of Subtitle F providing a penalty for their violation (e.g., *see* IRC Section 1275(c)(4); IRC Section 6033(o)).
- The statute is expressly covered by a penalty provision within Chapter 68 of Subtitle F (e.g., *see* IRC Section 6652(c) (Failure to file certain information returns, registration statements); IRC Section 6674 (Fraudulent statement or failure to furnish statement to employee); IRC Section 6677 (Failure to file information with respect to certain foreign trusts)).

Code Section 6039F is distinguishable from Code Section 6038(b), in that it contains language providing that the penalty must be paid upon notice and demand, in the same manner as taxes. Similar language is not present in Code Section 6038(b). Although Section 6039F provides that the penalty must be paid upon notice and demand, this language is not clearly indicative of the penalty being considered an "assessable penalty" for purposes of the general grant of the IRS's authority to assess "assessable penalties" in Code Section 6201(a).

In order for the IRS to have the authority to assess and collect a Section 6039F penalty, the penalty must be paid upon notice and demand and assessed and collected in the same manner as taxes.[12] While the express language of Code Section 6039F(c)(1)(B) states that the penalty is payable "upon notice and demand by the Secretary and in the same nature as tax," this express language is missing the key phrase "assessed and collected." The absence of this key phrase "assessed and collected" from the language of Code Section 6039F(c)(1)(B) is fatal to the IRS's argument that it has the authority under Section 6201 to assess and collect a Section 6039F penalty. The express language is insufficient to transform the penalty into an "assessable penalty"— i.e., the Code Section 6039F(c)(1)(B) penalty is not a penalty as to which the IRS (as the Treasury Secretary's delegate) is authorized by statute to use its administrative powers to levy (i.e., execute, enforce, and collect) on the extent of the penalty that has been determined by the IRS.

## Conclusion

Since the IRS cannot assess and administratively collect the tax, a Section 6039F penalty can only be collected by authorizing the Department of Justice to file a lawsuit to collect the penalty.

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It has been said that the only constant in life is change. NIL (Name, Image, or Likeness) Revenue has been altered dramatically since an August 2022 *Practical Tax Strategies* (PTS) article.[1] Major shifts covered in this piece include exploding growth, an expanding pool of NIL revenue-generating organizations, and extra scrutiny by third parties. What has not changed is the amount of a scholarship in excess of tuition that is considered taxable. In most cases, the room and board element of a scholarship is included in gross income.

The NCAA Student Assistance Fund (SAF), which was covered in the PTS article cited above, assists student athletes in meeting certain needs that arise in conjunction with participation in intercollegiate athletics. Typically, the SAF is used to handle the federal, state, and local income taxes tied to room and board and other financial help. The SAF amount is included in the student/athlete's gross income.

## Exploding Growth

In a little over two years, NIL Revenue has become an important and arguably the key element in a student/athlete's choice of colleges. Some student/athletes are generating six and seven figure NIL revenue. The income tax implications are important at most levels of income. However, when a student/athlete finds himself/herself on the receiving end of this amount of revenue, he/she must be prepared to set aside enough funds to handle federal, state, and local income taxes.

## Expanding Pool of NIL Revenue-Generating Organizations

Not only has the amount of NIL revenue changed dramatically, but the sources of NIL revenue reflect the creativity from both NIL Revenue recipients and providers. For example, Josh Lugg (a member of the Notre Dame football team) created a real estate company that is owned by and created for athletes. The company is purchasing properties, signing leases, and operating with a specific focus on connecting former student-athletes with current student athletes.[2]

Collectives providing NIL revenue have been formed by interested alumni and other supporters of collegiate athletic programs. Exhibit 1 is a partial list of collectives and the college or university with which they are unofficially affiliated. Later in this article, the IRS response to collec-

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**This article is an update on developments concerning NIL (Name, Image, or Likeness) Revenue since the publication of an earlier article in Practical Tax Strategies.**

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tives and their current or proposed not-for-profit classification will be covered in detail. Suffice to say, the IRS has taken a very tough stance on Section 501(c)(3) treatment that allows donors to the collective a charitable contribution deduction.

Collectives are perhaps the most visible type of organization that has entered the NIL Revenue "arena" during the past two years. For example, the Matador Club will provide $25,000 to over 100 Texas Tech football players.[3]

Other revenue-generating organizations are identified in Exhibit 2. Major corporations, regional companies, and local entities have intensified their NIL Revenue presence. Opendorse, a company that connects corporations with student-athlete competitors, estimates that about "90,000 college athletes have made money on its platform. It expects athletes to have earned more than $100 million in NIL revenue by the end of 2023."[4]

Another source of income that surely will grow moving forward is revenue generated via social media (e.g., Instagram, TikTok, and Twitter). For example, Sam Hurley (a high jumper at the University of Texas-Austin) has 5 million followers on TikTok. This makes Hurley a "social-media influencer." His earnings through TikTok for 2022 were close to a million dollars.[5]

**EXHIBIT 1**
Partial List of NIL Collectives (as of 6/30/2023)

| College or University | Title or Name of the Collective |
|---|---|
| Alabama | High Tide Traditions |
| Baylor | Startup Waco |
| Clemson | Tiger Impact |
| Drake | DU Great Collective |
| East Carolina | Team Boneyard |
| Florida State | Rising Spear |
| Georgia | Classic City Collective |
| HBCUs | Rise HBCU |
| Indiana | Hoosier Hysterics NIL Collective |
| Jacksonville | DOLPHINS NIL |
| Kansas State | Wildcat NIL |
| Louisiana State | Bayou Traditions |
| Michigan | Valiant Management Group |
| Notre Dame | FUND—Friends of the University of Notre Dame |
| Ohio State | THE Foundation |
| Penn State | Success with Honor |
| Quinnipiac | SEAAV Athletics |
| Rutgers | Knights of the Raritan |
| Southern California | House of Victory |
| Tennessee | Spyre Sports Group |
| Utah | Who Rocks the House |
| Virginia Tech | Triumph NIL |
| Washington | Montlake Futures |
| Xavier | MarkeyPryce Musketeers |
| Youngstown State | The Penguin Collective |

Source: Google and businessofcollegesports.com

## Extra Scrutiny by Third Parties

As NIL revenue numbers skyrocketed, so did the scrutiny by third parties. The IRS has made it very clear that NIL revenue is taxable. Just about all NIL revenue is reported by a taxpayer on Schedule C and is subject to both federal income taxes and self-employment tax. Both taxes were covered in depth in the PTS article cited above as was the Qualified Business Income deduction.

State and local governments which have been taxing professional athletes on their earnings generated in a particular state or locale are now turning their attention to NIL Revenue. For example, an athlete at Ohio State will be subject to state or local income taxes when the Buckeyes play games at schools located in Illinois (i.e., University of lllinois and Northwestern), Indiana (Indiana University and Purdue), and other states.

Example 1 illustrates the state and local income tax implications when a student/athlete from Illinois plays two games in Indiana. Example 2 reports the state and local income tax implications when an athlete receiving NIL revenue at Indiana University has two games in Illinois. Reciprocal agreements between states will protect some student/athletes from being taxed by another state in specific situations. For example, the states of Indiana and Michigan have a reciprocal agreement that allows Indiana/Michigan residents to avoid or reduce double taxation. Thus, a Purdue football player who travels to Michigan for a pair of games (i.e., Michigan State University and the University of

Michigan) will pay no or limited state income tax to Michigan.

Example 1. Brad Leigh is an Illinois resident who plays football at the University of Illinois. His 2023 NIL Revenue is $72,000, while his room and board and SAF payments add another $9,000 to total income. During 2023, the University of Illinois plays two games in Indiana.

Leigh's income tax liabilities in 2023 add up to $20,002

**Form 1040**

| | | |
|---|---|---|
| Federal income tax on taxable income of | $49,470 | $ 6,191 |
| Self-employment tax | | 10, 173 |
| | | **$16,364** |

**State of lllinois**

| | | |
|---|---|---|
| Based on a Federal AGI of $75,913 reduced by $2,425 exemption= | $73,488 | |
| @4.95% $3,638 | | |
| Less: Allowed Indiana state income taxes | -(347) | **$3,291** |

**State of Indiana**

Leigh played two games in Indiana during 2023. He reports:

1/6 of $72,000 on a Form IT-40PNR.

Indiana state income tax on an Indiana Adjusted Gross

| | | | |
|---|---|---|---|
| Income of | $11,004 | @3.15% | **$347** |
| **TOTAL** | | | **$20,002** |
| Total income | $72,000 + $9,000 | | $81,000 |
| Minus: 50% of self-employment tax. | | | (5,087) |
| ADJUSTED GROSS INCOME | | | $75,913 |
| Less: Standard deduction | | | (13,850) |
| Qualified Business Income deduction | | | (12,593) |
| TAXABLE INCOME | | | $49,470 |

An assumption made is the state of lndiana will contend the NIL revenue of $72,000 is tied to Brad Leigh's participation as a football player. Since the regular season is 12 games, Indiana will use 2/12 or 1/6 in determining the income to be taxed by the Hoosier state.

Example 2. Gary Hammond is an Indiana resident who plays football at Indiana University. His 2023 NIL Revenue amounts to $72,000, while his room and board and SAP payments add another $9,000 to total income. During 2023, Indiana University plays two games in Illinois. Hammond's income tax liabilities add up to $19,861.

**Form 1040 (see detail in Example 1)**

| | |
|---|---|
| Federal income tax on taxable Income of $49,470 | $ 6,191 |
| Self-employment tax | 10,173 |
| | **$16,364** |

**State of Indiana**

| | |
|---|---|
| Indiana state income tax on an Indiana Adjusted Gross Income of $74,913 @3.15% | $3,497 |
| Reduced by tax paid to Illinois (534) | $2,963 |

**State of Illinois**

Hammond played two games in Illinois. Illinois state income tax is based on 16.7% of Hammond's Federal AGI reduced by 16.7% of the Illinois exemption allowance or $11,152 minus $356 or

| | |
|---|---|
| $10,796 x 4.95% | **$_534** |
| TOTAL | **$19,861** |

Similar to Example 1, the assumption made is the state of Indiana will contend the NIL Revenue of $72,000 is tied to Gary Hammond's participation as a football player. Since the regular season is 12 games, Illinois will use 2/12 or 1/6 in determining the income taxed by Illinois.

As mentioned earlier, the IRS issued a memo in May 2023 that indicates money provided to some collectives will not qualify as a deductible charitable contribution. "The memo is a sign that the IRS will deny many collective applications for charitable status and begin revoking some prior rulings through audits ... Going forward, a collective that loses its charity status would have to pay corporate taxes on its annual earnings."[6]

Adding to this apparent "piling on" activity, lawmakers in California passed a bill in June 2023 that would "require universities in the state to use

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1 Milani, "NIL (Name, Image or Likeness) Revenue and Its Income Tax Implications," 109 Practical Tax Strategies, No. 2, pp. 4-13 (August 2022).

2 Interview with University of Notre Dame athletic administrator.

3 "Texas Tech collective to offer $25,000 NIL deals to I 00-plus football players," theathletic.com, 7/19/2022.

4 Opendorse website.

5 "How a Texas High Jumper Used His TikTok Savvy to Score Nearly $1 Million in Deals." Time, 6/6/2023, page 18.

6 "IRS Curbs College Athletics Tax Break," Wall Street Journal, 6/14/2023, page 1.

7 "California Kicks Off Uproar Over Paying College Athletes," Wall Street Journal, 6/3-4/2023, page l.

8 Time, supra, n. 5.

9 "College Sports are a Treasure. Don't Turn Them Into the Minor Leagues." Opinion Guest Essay by Fr. John Jenkins and Jack Swarbrick. New York Times website, 3/23/2023.

**EXHIBIT 2**

Other NIL Revenue-Generating Organizations as of 6/30/2023

**Local NIL Exchange/Market Places**

Over 30 colleges and universities partner with INFLCR or Opendorse or Icon Source per businessofcollegesports.com.

**NFT Communities**

Five universities have established a Community per businessofcollegesports.com.

**Season Pass Model**

Over 30 colleges and universities use this configuration per businessofcollegesports.com.

**Student Athletic Empowerment**

Five colleges and universities use this configuration per businessofcollegesports.com.

**University-Specific Marketing and Talent Agencies**

Ten colleges and universities use this configuration per businessofcollegesports.com.

all new athletic revenue generated by sports...to pay players. It could give athletes a slice of tens of millions of dollars each year."[7] Looking back at NIL Revenue treatment, athletes were provided the opportunity to monetize their NIL based on legislation that originated in California.

## Repercussions

NIL Revenue has and will continue to be a controversial issue. Several possible outcomes have been explored by both proponents and opponents of the current situation. People in favor of NIL Revenue point to equitable treatment issues involved when one considers the gigantic salaries paid to many college coaches. This group also argues for fairness and cites a statement from Supreme Court Justice Brett Kavanaugh. "Nowhere else in America can businesses get away with agreeing not to pay their workers a fair market rate.... The NCAA is not above the law."[8]

Those opposed to the current state of NIL revenue include a group concerned about the "pay-for-play" signal conveyed. Another set of opponents feel the next step in the revenue-sharing scenario will find the IRS stepping in and mandating that student/athletes be treated as employees of the college or university. Their contention is the school has more control of the student/athlete's time than it does over a faculty member's time. One college administrator estimated that the typical student/athlete is "locked in" for between 30 and 35 hours per week when practice sessions, strength work, training table, team meetings, and travel time are taken into consideration. A faculty member's required time could add up to as much as 25 hours per week when class time, preparation, grading, office hours, and other responsibilities are tallied.

Example #3 explores the possible income tax and other implications that could

surface if employee status for student/athletes is mandated by the IRS. The example illustrates the student/athlete's preference for employee status due to a lower amount of total taxes paid and receiving fringe benefits (e.g., health insurance, life insurance) estimated at 15% of wages.

**Example** 3. Una Simon is a gymnast. She is single. Her estimated NIL, room and board, and SAF income are detailed below:

| | |
|---|---|
| NIL | $36,000 |
| Room and board | 12,000 |
| SAP | 1,500 |
| Total | $49,500 |

Assuming the NIL revenue will be reported on a Form W-2, the below analysis shows Simon's Federal income tax (using the 2023 rates) and her university's out-of-pocket costs generated since Simon will be treated as an employee of the university.

**Una Simon**

| | |
|---|---|
| Wages (per W-2) | $36,000 |
| Other income (12,000 + 1,500) | 13,500 |
| ADJUSTED GROSS INCOME | $49,500 |
| Less: Standard deduction | (13,850) |
| TAXABLE INCOME | $35,650 |

**University**

| | |
|---|---|
| Wages paid to UNA | $36,000 |
| FICA match (7.65% x $36,000) | 2,754 |
| Federal Unemployment tax | 420 |
| Fringe benefits(*) | 5,400 |
| TAXABLE INCOME | $41,574 |

(*) 15% of wages

| | |
|---|---|
| Federal tax on $35,650 | $4,058 |
| FICA tax deducted | 2,754 |
| **Total taxes paid by Una Simon** | **$6,812** |

If Una Simon was *not* an employee of the university, the following Federal income and self-employment tax would be Simon's responsibility, while the university's out-of-pocket costs for income and other taxes is $0.

| | |
|---|---|
| NIL Revenue | $36,000 |
| Other income | 13,500 |
| | $49,500 |
| Less: 50% of self-employment tax | (2,544) |
| ADJUSTED GROSS INCOME | $46,956 |
| Less: Standard Deduction | (13,850) |
| Qualified Business Income Deduction | (6,801) |
| TAXABLE INCOME | $26,305 |

| | |
|---|---|
| Federal income tax | $2,937 |
| Self-employment tax | 5,088 |
| **Total taxes paid by Una Simon** | **$8,025** |

## Recommendations

The current state of NIL Revenue has been compared to the "Wild West" by many.

College administrators are calling for some type of regulatory body to be formed.[9] Several options to explore include:

- A regulatory body composed of current and former athletic directors, college administrators, and college graduates who participated in intercollegiate athletics.
- A regulatory body composed of current and former league commissioners, college faculty, current athletic directors, and coaches.
- A regulatory body created by the U.S. Government composed of individuals appointed by members of the House of Representatives and the Senate.

The author feels that some type of deferred compensation plan should be established for the student/athletes. One possibility would be to have 30% of NIL revenue paid to the competitor as he/she participates in his/her sport. The remaining 70% would be disbursed to the student/athlete when he or she graduates or reaches the age of 25, whichever occurs first.

## Conclusion

As NIL moves into its third year, this article continues to examine the income tax ramifications of the revenue generated for student/athletes. State income taxes are the primary focus of the effort. Controversy and consequences concerning NIL are also examined. Many facets of NIL are still at the work-in-process stage. Not addressing some of the issues mentioned in the article will lead to distortions that may have a negative impact on intercollegiate sports in general, and colleges/universities in particular.

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In *Organic Cannabis Foundation, LLC*, 161 TC No. 4 (2023), the Tax Court held that the 30-day period under Section 6320(a)(3)(B) is subject to equitable tolling where the circumstances warrant it. It further held that *Kennedy*, 116 T.C. 255 (2001), is overruled to the extent that it holds that the IRS Independent Office of Appeals (Appeals) is not authorized to waive the 30-day period under Section 6320(a)(3)(B) and is not obliged to provide a collection due process (CDP) hearing where the circumstances warrant equitable tolling of the 30-day period.

Organic Cannabis had unpaid tax for 2010, 2011, and 2018. The IRS issued notices of federal tax lien filings to Organic Cannabis for all three years. Organic Cannabis timely requested a hearing with Appeals during the 30-day period for requesting a CDP hearing under Section 6320(a)(3)(B) (30-day period) for 2010 and 2011 but requested a hearing for 2018 after the 30-day period.

Appeals provided a CDP hearing for 2010 and 2011. Appeals determined that Organic Cannabis' hearing request for 2018 was untimely and provided an equivalent hearing under Reg. 301.6320-1(i)(1). Appeals issued a Notice of Determination for 2010 and 2011 that did not contain a determination for 2018. Organic Cannabis filed a petition seeking review for all three years. After the petition was filed, Appeals issued a Decision Letter for 2018.

The IRS moved to dismiss as to 2018 for lack of jurisdiction on the ground that Appeals did not make a determination for the Tax Court to review under Section 6330(d)(1). Organic Cannabis argued that the 30-day period for requesting a CDP hearing under Section 6320(a)(3)(B) should be equitably tolled. Organic Cannabis further argued that Appeals should have made a determination for 2018 for the Tax Court to review. The IRS argued that the 30-day period is a fixed deadline that is not amenable to equitable tolling.

The Tax Court explained that its precedent had construed the 30-day period for requesting a CDP hearing as a fixed deadline. In *Kennedy*, the Tax Court held that Appeals was not authorized to waive the 30-day period for requesting a CDP hearing and that Appeals was not required to provide a CDP hearing requested after the 30-day period.

However, in *Boechler, P.C.*, 129 AFTR 2d 2022-1489 (S Ct 2022), the Supreme Court held that a different 30-day period in Section 6330(d)(1) for a taxpayer to file a petition with the Tax Court for review of Appeals' determination following a CDP hearing is a non-jurisdictional deadline that is subject to equitable tolling. Thereafter, in *Hallmark Research Collective*, 159 TC No. 6 (2022), the Tax Court distinguished *Boechler* in holding that the 90-day deadline for filing a deficiency petition under Section 6213(a) is jurisdictional.

The Tax Court held in the instant case that, in the light of the Supreme Court's decision in *Boechler* and the Tax Court's opinion in *Hallmark*, it should reexamine its precedent as to the 30-day deadline in Section 6320(a)(3)(B) for requesting a CDP hearing. After a reexamination, the Tax Court overruled *Kennedy* to the extent that it holds that the 30-day period for requesting a CDP hearing is a fixed deadline that is not amenable to equitable tolling. The Tax Court held that the 30-day period in Section 6320(a)(3)(B) is subject to equitable tolling.

Capitalizing on Inflation Reduction Act funding and "following a top-to-bottom review of enforcement efforts," the IRS has announced "a sweeping, historic effort to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, large corporations, and promoters abusing the nation's tax laws." (IR 2023-166, 9/8/2023) The IRS stated that these changes will be driven with the help of improved technology, including Artificial Intelligence. (See also Rappeport, "IRS Deploys Artificial Intelligence to Catch Tax Evasion," New York Times, 9/8/2023)

The IRS promised that audit rates will not increase for those earning less than $400,000 a year and that the IRS will add new fairness safeguards for those claiming the Earned Income Tax Credit.

Key elements of the IRS's new enforcement efforts include:

- *Prioritization of high-income cases.* In the High Wealth, High Balance Due Taxpayer Field Initiative, the IRS will intensify work on taxpayers with total positive income above $1 million that have more than $250,000 in recognized tax debt.
- *Expansion of pilot program focused on largest partnerships, leveraging Artificial Intelligence (AI).* The IRS stated that the complex structures and tax issues present in large partnerships require a focused approach to best identify the highest risk issues and apply resources accordingly. In 2021, the IRS launched the first stage of its Large Partnership Compliance (LPC) program with examinations of some of the largest and most complex partnership returns in the filing population. With the help of AI, the IRS is expanding the LPC program to additional large partnerships. The IRS stated that will open examinations of 75 of the largest partnerships in the U.S. that represent a cross section of industries, including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms, and other industries. On average, these partnerships each have more than $10 billion in assets.
- *Greater focus on partnership issues through compliance letters.* The IRS has identified ongoing discrepancies on balance sheets involving partnerships with over $10 million in assets, which is an indicator of potential non-compliance. This effort will focus on high-risk large partnerships to quickly address the balance sheet discrepancy.
- *Expanded work on digital assets.* The IRS continues to expand efforts involving digital assets, including work through the John Doe summons effort and release of proposed regulations on broker reporting. The IRS Virtual Currency Compliance Campaign will continue.
- *More scrutiny on FBAR violations.* The IRS noted that high-income taxpayers continue to utilize foreign bank accounts to avoid disclosure and related taxes. A U.S. person with a financial interest over a foreign financial account is required to file a Report of Foreign Bank and Financial Accounts (FBAR) if the aggregate value of all foreign financial accounts is more than $10,000 at any time. The IRS plans to audit the most egregious potential non-filer FBAR cases in Fiscal Year 2024.
- *Labor brokers.* The IRS stated that it has seen instances where construction contractors are making Form 1099MISC/1099NEC payments to an apparent subcontractor, but the subcontractor is a "shell" company that has no legitimate business relationship with the contractor. Monies paid to shell companies are exchanged at money service businesses or flowed through accounts in the name of the shell company and returned to the original contractor. The IRS will be expanding attention in this area with both civil audits and criminal investigations.
- *Emerging scam issues.* The IRS will continue its aggressive work warning consumers about emerging scams and schemes.
- *Protection against identity theft.* The IRS will continue the efforts of the Security Summit initiative, a joint effort between the federal government, state tax agencies, and the nation's software and tax professional communities to protect against identity theft.

The Treasury Inspector General for Tax Administration (TIGTA) has released an audit initiated in response to a congressional request to evaluate employees moving between large accounting firms and the IRS, often referred to as a "revolving door." (TIGTA Audit Report No. 2023-40-047, 8/24/23) According to TIGTA, the overall objective of the audit was to assess the IRS's processes and procedures to identify and address potential conflicts of interest regarding tax administration matters involving large corporations.

TIGTA found that the IRS's processes and procedures to address potential conflicts of interest regarding tax administration matters involving large corporations primarily rely on individual self-reporting. This self-reporting includes disclosures of potential conflicts of interest in work assignments either through an employee's annual reporting or elevating a concern to their manager or the IRS General Legal Services.

TIGTA's analysis identified 496 employees (executives and non-executive employees from the IRS Large Business and International Division, Office of Chief Counsel, and Independent Office of Appeals) who received income from a large accounting firm or a large corporation either prior to joining, during their time at, or after leaving the IRS. Of these 496 employees: 241 employees had income from a large accounting firm, and 255 employees had income from a large corporation.

TIGTA's review found no direct correlation between the employees' work assignments and the company or firm from which they came or left for in the private sector. However, the review identified four Office of Chief Counsel non-executive employees who charged time to a private letter ruling in which the taxpayer's representative was the same large accounting firm that the employee recently worked for before joining the IRS or left the IRS to join. TIGTA stated that while not a direct correlation, this can raise impartiality concerns.

TIGTA also found that IRS General Legal Services assists IRS managers and employees with advice regarding interpretation or application of ethics rules, related statutes, or other ethical questions. They also maintain the IRS Ethics Hotline. The General Legal Services worked 735 cases from Calendar Years 2017 through 2021 on issues related to financial conflicts of interest, impartiality, outside employment, and post-employment issues. However, according to TIGTA, the advice given to employees for these issues/questions is not maintained in its case management system. Therefore, the extent that these cases required some type of mitigation or action is not readily available.

TIGTA made two recommendations to the IRS to ensure that employees who work on private letter rulings are aware of the disclosure requirements for conflicts of interest, and that the General Legal Services develops a process and procedure to track and aggregate data based on the types of advice given in response to concerns raised. The IRS agreed with both recommendations. IRS management noted that the IRS has reinforced the impartiality rule, revised the 2023 ethics briefing, and plan to revise the annual ethics training for financial disclosure filers. The IRS will also review current reporting capabilities and case processing procedures to identify a means to track and aggregate data.

The IRS announced the availability of expanded chatbot technology to help quickly answer basic questions for taxpayers receiving notices about possibly underreporting their taxes. (IR 2023-178, 9/26/2023)

The new chatbot feature will assist taxpayers who receive notices CP2000, CP2501, and CP3219A. These mailings inform taxpayers if the tax information the IRS received from third parties does not match the information they provided themselves to the IRS. The IRS noted that this technology expansion is supported through the Inflation Reduction Act funding to transform the IRS and improve services to help taxpayers.

According to the IRS, rollout of this chatbot builds on prior IRS successes using the technology to help improve taxpayer service. Since January 2022, IRS voice and chatbots, both in English and Spanish, have helped more than 13 million taxpayers avoid wait times by resolving their tax issues, including setting up roughly $151 million in payment agreements.

The chatbot simulates human interaction with taxpayers through a web or mobile app on a computer or mobile screen by responding to questions or requests in a chat feature. At the end of the conversation, taxpayers can press the "representative" button to speak to a live assistor.

The new IRS chatbot is available to help taxpayers with questions such as:

- What to do if they received a notice.
- What to do if they need more time to respond to a notice.
- How to find out if the IRS received their response.

The IRS stated that it plans to continue additional bot technology features in the future to assist taxpayers with more complex issues.

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The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has issued additional guidance on the Beneficial Ownership Information (BOI) reporting requirements.

The Corporate Transparency Act (CTA) established uniform BOI reporting requirements for certain corporations, limited liability companies, and other similar entities created, or registered to do business, in the United States. The CTA authorizes FinCEN to collect BOI information from reporting entities and disclose it to authorized government authorities and financial institutions, subject to certain safeguards and controls.

BOI is the identifying information of the individuals who directly or indirectly own or control a reporting entity. Beneficial ownership information that must be reported by an entity includes: the full legal names, dates of birth, and addresses for all individuals who have "substantial control" or who own at least 25% of the entity.

FinCEN has updated its BOI frequently asked questions (FAQs) to include new questions about beneficial owners, initial reports, FinCEN identifiers, and third-party service providers. These FAQs are available on the FinCEN website (www.fincen.gov).

FinCEN has also published a Small Entity Compliance Guide to assist the small business community in complying with the BOI reporting rule. (FinCEN News Release, 9/18/2023) The Guide is now available on FinCEN's Beneficial Ownership Information reporting webpage. Among other things, the Guide:

- Describes each of the BOI reporting rule's provisions in simple, easy-to-read language.
- Answers key questions.
- Provides interactive checklists, infographics, and other tools to assist businesses in complying with the BOI reporting rule.

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he IRS has issued a Notice containing a preview of forthcoming proposed regulations that will provide guidance on the amortization of specified research or experimental expenditures under Section 174, as amended by the Tax Cuts and Jobs Act. (Notice 2023-63, 2023-39 IRB 919)

According to Notice 2023-63, the IRS intends to propose rules addressing:

- The capitalization and amortization of specified research or experimental (SRE) expenses under Section 174.
- The treatment of SRE expenses under Section 460.
- The application of Section 482 to cost sharing arrangements involving SRE expenditures.

According to the IRS, the guidance in Notice 2023-63 does not apply when determining whether an expenditure paid or incurred for tax years beginning before 1/1/2022 is an SRE under former Section 174. In addition, the guidance in Notice 2023-63 does not change the rules for determining eligibility for, or computation of, the research credit under Section 41, including rules for "research with respect to computer software," and the definitions of "qualified research" and "qualified research expenses."

Taxpayers may rely on the guidance provided in Notice 2023-63 until the proposed regulations are published in the Federal Register. In addition, the IRS is seeking comments on specific issues and issues not addressed in this Notice.

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The IRS has issued a new procedure covering the wash sale rules for money market funds. The new procedure describes the circumstances in which the IRS will not treat a redemption of shares in a money market fund (MMF) as part of a wash sale for purposes of Section 1091. (Rev. Proc. 2023-35, 2023-42 IRB 1079)

An investment company registered under the Investment Company Act of 1940 that meets the requirements of SEC Rule 2a-7 may hold itself out as an MMF. Historically, MMFs have sought to keep stable the prices at which their shares are distributed, redeemed, and repurchased.

Originally, Rule 2a-7 allowed MMFs to compute their price per share by using either or both (1) the amortized cost method of valuation, and (2) the penny-rounding method of pricing. These pricing methods were intended to enable MMFs to maintain stable share prices under most circumstances.

In 2014, the SEC amended Rule 2a-7 to bar most MMFs from using the amortized cost method of valuation and the use of the penny-rounding method of pricing. Under the amended rules, an MMF that is neither a government MMF nor a retail MMF must value its portfolio securities using market-based factors and compute its price per share by rounding the fund's net asset value per share to a minimum of the fourth decimal place.

The 2014 amendments also allowed MMFs to institute a liquidity fee if certain liquid assets of the MMF fall below a specified percentage of the MMF's total assets. If those liquid assets fall below a specified percentage, the 2014 amendments generally require the MMF to institute a liquidity fee, unless the MMF's board of directors (including a majority of the directors who are not interested persons of the fund) determines that imposing such a fee is not in the best interests of the

MMF. When an MMF has a liquidity fee in effect, the fee reduces the proceeds received by all redeeming shareholders.

Rev. Proc. 2023-35 expands the scope of Rev. Proc. 2014-45 to reduce undue tax compliance burdens resulting from the new SEC rules. In Rev. Proc. 2014-45, the IRS provided an exemption from the wash sale rules only for certain MMFs. Under Rev. Proc. 2023-35, the IRS will not treat as part of a wash sale a redemption of a share in any MMF. This means that the wash sale rules will not disallow the deduction for the resulting loss in the year realized and will not cause the basis of any property to be determined by reference to the basis of the redeemed shares.

Rev. Proc. 2023-35 amplifies and supersedes Rev. Proc. 2014-45 for redemptions of shares in MMFs after 10/2/2023.

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The IRS has provided additional interim guidance on the new corporate alternative minimum tax (CAMT). The IRS anticipates that forthcoming proposed regulations will be consistent with this interim guidance. (Notice 2023-64, 2023-40 IRB 974; IR 2023-167, 9/12/2023) This new guidance clarifies and supplements the guidance in Notice 2023-7 and Notice 2023-20.

The Inflation Reduction Act of 2022 created the CAMT, which imposes a 15% minimum tax on the adjusted financial statement income (AFSI) of large corporations for tax years beginning after 12/31/2022. Generally, the CAMT applies to large corporations with average annual financial statement income exceeding $1 billion.

Generally, AFSI is the net income (or loss) that a corporation reports on its applicable financial statement. AFSI is reduced by the amount of tax depreciation deductions that the taxpayer claims when calculating taxable income for the year.

According to the IRS, the guidance in Notice 2023-64 will help corporations to determine whether the CAMT applies to them and to compute the tax. The guidance in Notice 2023-64 describes how to determine:

- A taxpayer's applicable financial statement and AFSI (including when the taxpayer's financial results are reported on a consolidated financial statement).
- A taxpayer's applicable corporation status.
- The CAMT foreign tax credit.
- Financial statement net operating losses.

Notice 2023-64 provides a list of financial statements that meet the definition of an applicable financial statement (AFS) as well as priority rules for identifying a taxpayer's AFS. In addition, the Notice provides guidance on how to make adjustments for:

- Depreciation of Section 168 property.
- Amortization of qualified wireless spectrum.
- The treatment of certain taxes.

Notice 2023-42 waives the estimated tax penalty for a corporation's CAMT shortfall for a tax year that begins after 12/31/2022 and before 1/1/2024.

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# IRS STOPS PROCESSING NEW EMPLOYEE RETENTION CREDIT CLAIMS AMID SURGE OF QUESTIONABLE CLAIMS

Amid rising concerns about a flood of improper Employee Retention Credit (ERC) claims, the IRS announced an immediate moratorium through at least the end of 2023 on processing new claims for the pandemic-era relief program "to protect honest small business owners from scams." (IR 2023-169, 9/15/2023) IRS Commissioner Werfel ordered the immediate moratorium, beginning 9/15/2023, to run through at least 12/31/2023, following growing concerns inside the IRS, and from tax professionals and media reports, that a substantial share of new claims from the ERC program are ineligible and increasingly putting businesses at financial risk by being pressured and scammed by aggressive promoters and marketing.

The IRS continues to work on previously filed ERC claims received prior to the moratorium, but cautioned that increased fraud concerns means processing times will be longer. The IRS emphasized that payouts for these claims will continue during the moratorium period but at a slower pace due to the detailed compliance reviews. The IRS noted that with the stricter compliance reviews in place during this period, existing ERC claims will go from a standard processing goal of 90 days to 180 days — and much longer if the claim faces further review or audit. The IRS may also seek additional documentation from the taxpayer to ensure it is a legitimate claim.

According to the IRS, this enhanced compliance review of existing claims submitted before the moratorium is critical not only to protect against fraud but also to protect the businesses from facing penalties or interest payments stemming from bad claims pushed by promoters.

The IRS is developing new initiatives to help businesses who were victims of aggressive promoters. This includes a settlement program for repayments for those who received an improper ERC payment. In addition, the IRS is finalizing details for a special withdrawal option for those who have filed an ERC claim where the claim has not been processed. This option will allow the taxpayers, many of them small businesses who were misled by promoters, to avoid possible repayment issues and paying promoters contingency fees. Filers of these more than 600,000 claims awaiting processing will have this option available.

However, the IRS noted that withdrawing a fraudulent claim will not exempt taxpayers from potential criminal investigation and prosecution. ■

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As the IRS continues to focus more attention onto high-income compliance issues, it announced plans to establish a special area to focus on large or complex pass-through entities. (IR 2023-176, 9/20/2023)

The new work unit will be housed in the IRS Large Business and International (LB&I) division. The new pass-through area will include people who are joining the IRS under the new IRS hiring initiative. IRS Commissioner Werfel stated that "this is another part of our effort to ensure the IRS holds the nation's wealthiest filers accountable to pay the full amount of what they owe."

The IRS noted that pass-through organizations, which will be the focus of the new group, include entities such as partnerships and S corporations. According to the IRS, pass-through entities are frequently used by higher-income groups and can be complex tax arrangements.

The IRS added that the larger compliance effort, building off work following the Inflation Reduction Act funding, will center on adding more attention on high-income and high-wealth individuals, partnerships, and large corporations that have seen sharp drops in audit rates during the past decade. The changes will be driven with the help of improved technology as well as Artificial Intelligence that will help IRS compliance teams better detect tax cheating, identify emerging compliance threats, and improve case selection tools to avoid burdening taxpayers with needless "no-change" audits..

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he IRS reminded eligible farmers and ranchers forced to sell livestock due to drought that they may have an extended period of time in which to replace the livestock and defer tax on any gains from the forced sales. (IR 2023-179, 9/27/2023) Notice 2023-67, 2023-42 IRB 1074, lists the applicable areas designated as eligible for federal assistance. This includes 49 states, the District of Columbia, and two U.S. Territories.

The relief generally applies to capital gains realized by eligible farmers and ranchers on sales of livestock held for draft, dairy, or breeding purposes. Sales of other livestock, such as those raised for slaughter or held for sporting purposes, or poultry, are not eligible.

The sales must be solely due to drought, causing an area to be designated as eligible for federal assistance. Livestock generally must be replaced within a four-year period, instead of the usual two-year period. The IRS is authorized to further extend this replacement period if the drought continues.

The one-year extension, announced in Notice 2023-67, gives eligible farmers and ranchers until the end of their first tax year after the first drought-free year to replace the sold livestock. Details, including an example of how this provision works, can be found in Notice 2006-82.

The IRS provides this extension to eligible farmers and ranchers that qualified for the four-year replacement period, if the applicable region is listed as suffering exceptional, extreme, or severe drought conditions during any week between 9/1/2022 and 8/31/2023. This determination is made by the National Drought Mitigation Center.

As a result, eligible farmers and ranchers whose drought-sale replacement period was scheduled to expire on 12/31/2023, in most cases now have until the end of their next tax year to replace the sold livestock. Because the normal drought-sale replacement period is four years, this extension impacts drought sales that occurred during 2019. The replacement periods for some drought sales before 2019 are also affected due to previous drought-related extensions affecting some of these localities.

More information on reporting drought sales and other farm-related tax issues can be found in IRS Publication 225, Farmer's Tax Guide.

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ISRAEL BLUMENFRUCHT

## Casualty losses

In September 2022, two months after Jim and Betty finished constructing a barn, it was completely destroyed by a hurricane. Their adjusted basis in the barn was its cost, $40,000. It was not covered by insurance. The entire community has been declared a federal disaster area. Jim and Betty may elect to do which of the following (before considering any limitations)?

a. Deduct $40,000 in either 2021 or 2022
b. Deduct $40,000 in either 2020 or 2021
c. Deduct $40,000 in 2020, 2021, or 2022
d. No deduction in any year because the loss is personal

**Solution**: The correct choice is "a."

The Tax Cuts and Jobs Act temporarily suspended, through 2025, the itemized deduction for personal casualty losses except for losses attributable to a federally declared disaster. An exception is provided where a taxpayer has more than one personal casualty during the year and one results in a gain; then the personal casualty loss can be used to offset the personal casualty gain (but cannot result in a net loss).

In general, if a taxpayer incurs a personal casualty loss in a federally declared disaster area, the personal casualty loss rules are used for determining the amount of the deduction. Specifically, the amount of the deduction is equal to the lesser of (1) the sustained loss, i.e., the difference between the fair market value (FMV) of the property immediately before the casualty and its FMV immediately after the casualty, or (2) the adjusted basis of the property, which generally is its cost price. This amount is reduced by any salvage value, insurance, or other proceeds received by the taxpayer. Moreover, the deduction is limited in that the first $100 per casualty is nondeductible and the total casualty loss for the year must be reduced by 10% of adjusted gross income (AGI).

Moreover, special and separate rules apply to losses incurred in Presidentially or federally declared disaster areas. In general, if a taxpayer incurs a casualty loss in a disaster area the taxpayer can either (1) deduct the loss in the current year or (2) elect to deduct the loss in the year immediately preceding the tax year in which the disaster occurred (Section 165(i)). Claiming the casualty loss deduction in the preceding year allows the taxpayer to have access to new funds by either receiving an immediate tax refund of the prior year's tax or, if the taxpayer did not yet file the prior year's tax return, such as when the disaster occurs in January or February, by reducing the tax liability for that prior year. Note that if the taxpayer filed the prior year's tax return, a refund may be obtained by filing an amended tax return.

A taxpayer who lives in a Presidentially declared disaster area can also benefit from special rules applicable to disaster area losses if his personal residence is determined to be unsafe to live in by the state or local government as a result of the disaster even if it was not actually damaged during the disaster. The state or local government must issue the order to tear down the residence within 120 days after the area is declared a disaster area by the President. In such a situation the loss is computed in the same manner as is any personal casualty loss (i.e., the loss is equal to the lesser of the adjusted basis of the residence or the difference between the FMV immediately before and after the disaster).

The election to deduct the casualty loss in the preceding year must generally be made by the due date, without extensions, for filing the taxpayer's income tax return for the year in which the disaster actually occurred. Once the election is made, the Regulations provide that the election can be revoked within 90 days of the election by returning to the IRS any refund received as a result of the election (Reg. 1.165-11). However, if the taxpayer revokes the election before receiving a refund, the refund must be returned within 30 days after receiving it for the revocation to be effective. Note that the Tax Court in *Matheson*, 74 TC 836 (1980), held that the taxpayer can revoke the election even after 90 days as long as it is done prior to the due date for filing the tax return for

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the year in which the disaster occurred. The IRS, however, to date has not acquiesced.

Accordingly, since Jim and Betty's barn was destroyed by a hurricane and their entire community was subsequently declared a federal disaster area, they may elect to deduct the $40,000 disaster loss either on their 2021 or 2022 income tax returns. If they want to elect to claim the deduction for 2021 and have already filed their 2021 income tax return, they would claim the $40,000 deduction by filing an amended return by 4/15/2023. Note that the $40,000 amount must be reduced by the $100 floor and 10% of AGI.

## Determining holding period for stock

Rudy purchased 100 shares of publicly traded stock on 1/2/2022 for $1,000. He sold all his shares on 12/31/2022 for $1,500. On 1/4/2023, the settlement date, the stocks were actually delivered and payment received in Rudy's account. How and when should Rudy report this sale?

a. $500 long-term capital gain on 2022 return
b. $500 short-term capital gain on 2022 return
c. $500 long-term capital gain on 2023 return
d. $500 short-term capital gain on 2023 return

**Solution**: The correct choice is "b."

The holding period of property is critical for determining whether the gain or loss on the sale of the property is considered short-term or long-term. Under current law, transactions on property held for more than one year are considered long-term, while transactions for property held one year or less are considered short-term.

In general, the holding period for property begins on the day *after* the property was acquired and includes the date of disposition. However, certain acquisitions have special holding period rules (Section 1223).

The holding period for securities purchased on an established securities market begins on the day after the securities are acquired. The settlement date, by which the taxpayer must actually pay for the securities, or the date the securities are delivered to the taxpayer, are irrelevant in determining the holding period. The holding period ends on the date the securities are sold, commonly referred to as the "trading date," and not on the settlement date or the date the proceeds are received by the stockholder. Thus, in determining the year in which to report the gain or loss on the sale of securities traded on an established securities market, the key date is the trading date (Rev. Rul. 93-84).

The holding period for property received in nontaxable exchanges such as a like-kind exchange of real estate generally includes the holding period of the former asset.

The holding period for property received as a gift generally includes the holding period of the donor. However, there is a special rule for losses. If the property is sold at a loss and the donee must use fair market value at the date of the gift as his basis for determining the loss, then the holding period begins on the date of the gift.

The holding period for inherited property is treated as long-term no matter how long the property is actually held by the beneficiary.

Accordingly, since Rudy purchased the 100 shares of publicly traded stock on 1/2/2022 and sold all his shares on 12/31/2022, he is deemed to have held the stock for less than one year, even though the settlement date was on 1/4/2023. Thus, Rudy must report a $500 ($1,500 - 1,000) short-term capital gain on his 2022 return as a result of the sale of these shares of stock.

**The problems presented in this column are adapted from the official, verbatim texts of IRS Special Enrollment Examination questions. The answers were prepared by Prof. Blumenfrucht. The examination covers tax topics about which the IRS expects tax practitioners to be extremely knowledgeable.**

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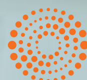

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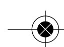


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