Current Federal Tax Developments

Week of December 12, 2022

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SECOND DRAFT OF FORM 1065 SCHEDULES K-2 AND K-3 INSTRUCTIONS REVISE DOMESTIC FILING EXCEPTION

Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, 12/2/22

The IRS has now revised the draft Schedule K-2 and K-3 (Form 1065) instructions[1] issued on October 26, 2022, issuing a new draft Schedule K-2 and K-3 (Form 1065) instructions that make important changes to the domestic filing exception. While no revised S corporation instructions have been issued as of the time this is being written, it seems likely similar changes will be made to those instructions.

Key Changes

The following are the key changes made to the domestic filing exception in the new revised draft instructions.

- The notice to partners no longer must be issued by January 15, 2023. Rather, it can be issued as late as the date the Schedules K-1 are provided to the partners and even provided as an attachment to the Schedule K-1
- The 1-month date, for both the domestic filing exception and the Form 1116 exception, will now be one month before date the return is timely filed, which means it will move to as late as August 15, 2023, if the partnership files for an automatic extension of time to file a calendar year return.
- The list of US citizen/resident alien partners is now expanded to include S corporations with a single shareholder and single member LLCs owned whose owner is listed as an eligible US citizen/resident alien partner.

Domestic Filing Exception (as Revised in the December 2, 2022 Draft)

The sections that created the most problems for domestic partnerships involved items related to information that might be necessary for partners related to reporting foreign tax credit items. In the "What's New" section of the instructions, the IRS announces they have added a *domestic filing exception* this year.

This exception is a modification of the special relief offered for 2021 filings in Question 15 of the "Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S,

[1] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, https://www.irs.gov/pub/irs-dft/i1065s23--dft.pdf (retrieved December 4, 2022)

and 8865)" published on February 16, 2022, on the IRS website.[2] The instructions describe the new exception as follows:

> **New exception to completing Schedules K-2 and K-3.** These instructions add a new exception for filing and furnishing Schedules K-2 and K-3 for tax years beginning in 2022. See the domestic filing exception.[3]

The instructions do repeat the guidance from the prior year's instructions that warns that even some partnerships with no foreign activities may nevertheless need to complete the forms:

> **Note**. A partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner claims a credit for foreign taxes paid or accrued by the partner, the partner may need certain information from the partnership to complete Form 1116 or 1118. Also, a partnership that has only domestic partners may still be required to complete Part IX when the partnership makes certain deductible payments to foreign related parties of its domestic partners.
>
> The information reported in Part IX will assist any domestic corporate partner in determining the amount of base erosion payments made through the partnership, and in determining if the partners are subject to the base erosion and anti-abuse tax (BEAT).
>
> Further, if the domestic partnership with no foreign activity or foreign partners has direct or indirect domestic corporate partners, Part IV (concerning foreign-derived intangible income (FDII)) may need to be completed.
>
> A domestic or foreign publicly traded partnership as defined in section 7704(b) (PTP) with no foreign activity or foreign partners may need to complete Part XI. See each part for applicability.[4]

But following an example dealing with the base erosion and anti-abuse tax (BEAT), something most practitioners will not be dealing with, it does describe the new domestic filing exception, beginning by outlining the benefits of meeting this exception:

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[2] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), IRS Website, October 26, 2022

[3] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 1

[4] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

Domestic filing exception (exception to filing Schedules K-2 and K-3). A domestic partnership (as defined under section 7701(a)(2) and (4)) does not need to (a) complete and file with the IRS the Schedules K-2 and K-3, or (b) furnish to a partner the Schedule K-3 (except where requested by a partner after the 1-month date (defined in criteria number 4, below)) if each of the following four criteria are met with respect to the partnership's tax year 2022.[5]

Foreign Activity Test

The first criteria to meet relates to foreign activities:

1. **No or limited foreign activity**. During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity (as defined below), or, if it does have foreign activity, such foreign activity is limited to

(a) passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B)(iii));

(b) upon which not more than $300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the partnership; and

(c) such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the partnership.

Foreign activity. For purposes of the domestic filing exception, foreign activity means any of the following.

(a) foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder);

(b) foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder);

(c) ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5));

(d) ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5));

[5] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

(e) ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii));

(f) ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3). [6]

One key change from the 2021 FAQ is that there is a *de minimis* foreign activity provision if the partnership has a very minor amount of foreign taxes withheld on stocks, mutual funds, and the like.

US Citizen/Resident Alien Partner Test

The next criteria requires that all direct partners must meet certain criteria:

2. U.S. citizen/resident alien partners. During tax year 2022, all the direct partners in the domestic partnership are:

(a) individuals that are U.S. citizens;

(b) individuals that are resident aliens (as defined in section 7701(b)(1)(A) and the regulations thereunder);

(c) domestic decedent's estates (that is, decedent's estates that are not foreign estates as defined in section 7701(a)(31)(A)), with solely U.S. citizen and/or resident alien individual beneficiaries;

(d) domestic grantor trusts (that is, trusts described under sections 671 through 678) that are not foreign trusts as defined in section 7701(a)(31)(B)) and that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries;

(e) domestic non-grantor trusts (that is, trusts subject to tax under section 641 that are not foreign trusts as defined in section 7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries;

(f) S corporations with a sole shareholder; or

(g) single-member LLCs, where the LLC's sole member is one of the persons in subparagraphs (a) through (f), and the LLC

[6] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

> is disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3)..[7]

The last two categories were added in the December 2, 2022 draft version of the form.

Note that a partnership with partnership or corporate partners (other than S corporations with a sole shareholder) will be barred from using this exception. This is more restrictive than the 2021 FAQ Question 15 exception.

Partner Notification Requirement

The notification rules were made much more workable by the changes made in the December 2, 2022 draft of the instructions. No longer must this notice be sent to partners by January 15, 2022 for calendar year partnerships.

The instructions provide:

> **3. Partner notification**. With respect to a partnership that satisfies criteria 1 and 2, partners receive a notification from the partnership at the latest when the partnership furnishes the Schedule K-1 to the partner. The notice can be provided as an attachment to the Schedule K-1. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule. [8]

Partner Request Received by the "1-Month Date"

The final test looks to see if any partners return requests to have the form issued by what is referred to as the *1-month date*:

> **4. No 2022 Schedule K-3 requests by the 1-month date.** The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The "1-month date" is 1 month before the date the partnership files the Form 1065. For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension. [9]

The December 2, 2022 instructions were modified to tie this to one month before the partnership files Form 1065.

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[7] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

[8] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

[9] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3

The instructions go on to provide information on what the partnership still must do if it receives such a request after the 1-month date.

> **Note**. If a partnership receives a request from a partner for the Schedule K-3 information after the 1-month date and has not received a request from any other partner for Schedule K-3 information on or before the 1-month date, the domestic filing exception is met and the partnership is not required to file the tax year 2022 Schedules K-2 and K-3 with the IRS or furnish the tax year 2022 Schedule K-3 to the non-requesting partners. However, the partnership is required to provide tax year 2022 the Schedule K-3, completed with the requested information, to the requesting partner on the later of the date on which the partnership files the Form 1065 or 1 month from the date on which the partnership receives the request from the partner. See Example 4. The partnership must complete and file tax year 2023 Schedules K-2 and K-3 with respect to the requesting partner by the tax year 2023 Form 1065 filing deadline. [10]

Under the 2021 FAQ Question 15 exception, the key date was the date the return was filed by the partnership, so that any notice of a need for the information prior to the actual filing of the return meant the exception was not met.

If a partnership does receive notification by the 1-month date, the instructions provide:

> **Note for partnerships that satisfy criteria 1 through 3, but do not satisfy criterion 4.** If the partnership received a request from a partner for Schedule K-3 information on or before the 1-month date and therefore the partnership does not satisfy criterion 4, the partnership is required to file the Schedules K-2 and K-3 with the IRS and furnish the Schedule K-3 to the requesting partner. The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting partner.
>
> For example, if a partner requests the information reported on Part III, Section 2 (Interest Expense Apportionment Factors), the partnership is required to complete and file Schedule K-2, Part III, Section 2 with respect to the partnership's total assets and Schedule K-3, Part III, Section 2 with respect to the requesting partner's distributive share of the assets. On the date that the partnership files Schedules K-2 and K-3 with the IRS, the partnership must provide a copy of the filed Schedule K-3 to the requesting partner. The partnership does not need to complete, attach, file, or furnish any other parts or sections of the Schedules K-2 and K-3 to the IRS, the requesting partner, or any other

[10] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 3-4

> partner. The partnership should keep records of the information requested by the partner. See Example 3.[11]

If this partnership later receives requests from other partners after the 1-month date, the instructions state:

> If a partnership receives requests from partners for Schedule K-3 information both on or before the 1-month date and after the 1-month date, the partnership is required to file Schedules K-2 and K-3 as described in the prior paragraph only with respect to the partner requests received on or before the 1-month date. With respect to requests received after the 1-month date, the partnership is required to provide the Schedule K-3, completed with that partner's requested information, on the later of the date on which partnership files the Form 1065 or 1 month from the date on which the partnership receives the request from the partner. See Examples 3 and 4.[12]

Examples for the Domestic Filing Exception

The instructions provide a series of examples of applying this rule. The first example looks at a partner who receives only a minor amount of foreign taxes reported to it on a Form 1099DIV from a mutual fund:

> **Example 2.** Husband and wife, U.S. citizens, each own a 50% interest in USP, a domestic partnership. USP and husband and wife each have a tax year end of December 31. USP invests in a regulated investment company (RIC). With respect to tax year 2022, USP receives a Form 1099 from the RIC reporting $100 of creditable foreign taxes paid or accrued on passive category foreign source income. USP does not have any foreign activity other than that from the RIC. Husband and wife receive notification from USP on an attachment to Schedule K-1 that they will not receive the Schedule K-3 unless they so request. Husband and wife do not request Schedule K-3 from USP for tax year 2022. USP qualifies for the domestic filing exception, and, as such, USP need not complete Schedules K-2 and K-3.[13]

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[11] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

[12] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

[13] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

The next example adds a case where there is another partner who does require certain information on Schedule K-3 and gives noticed by the 1-month date:

> **Example 3.** The facts are the same as in Example 2 except that husband and wife each own a 40% interest in USP, and A, a U.S. citizen, owns a 20% interest in USP. A requests Schedule K-3 from USP for tax year 2022 and USP receives this request on February 1, 2023. After requesting an extension, USP files Form 1065 on August 31, 2023. USP does not qualify for the domestic filing exception because A requested the Schedule K-3 by the 1-month date (July 31, 2023). As such, USP must complete and file with the IRS the parts and sections of the Schedules K-2 and K-3 that are relevant to A. With respect to the Schedules K-2 and K-3 filed with the IRS, USP does not need to complete, attach, or file any parts or sections relevant to husband and wife. USP must provide a copy of the filed Schedule K-3 to A on the date that USP files its Form 1065. USP does not need to furnish a Schedule K-3 to husband and wife.[14]

The next example uses the same facts, except the request is received after the 1-month date:

> **Example 4.** The facts are the same as in Example 3 except that USP receives the request from A on August 20, 2023. USP qualifies for the domestic filing exception because A requested the Schedule K-3 after the 1-month date. USP is not required to file the tax year 2022 Schedules K-2 and K-3 with the IRS or furnish the Schedule K-3 to husband and wife. However, USP is required to provide the Schedule K-3, completed with the requested information, to A on September 20, 2023, the later of the date on which USP files the Form 1065 or 1 month from August 20, 2023. Because A requested a Schedule K-3 for tax year 2022, USP must file tax year 2023 Schedules K-2 and K-3 with the IRS with respect to the information requested by A.[15]

[14] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

[15] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

The Form 1116 Exemption

The instructions provide for a second exception to completing the forms related to foreign tax credit issues in the Form 1116 exemption. The draft notes at the end of the instructions for the domestic filing exception that:

> **Note**. If a partnership does not meet the domestic filing exception, it may meet the Form 1116 Exemption to filing the Schedules K-2 and K-3. See below.[16]

That exception is described at page 10 of the instructions:

> **Form 1116 exemption exception.** Under section 904(j), certain partners are not required to file a Form 1116 ("Form 1116 exemption"). Also see Foreign Tax Credit—How To Figure the Credit.[17]

IRC §904(j) reads, in part:

> (j) Certain individuals exempt
>
> (1) In general
>
> In the case of an individual to whom this subsection applies for any taxable year—
>
> (A) the limitation of subsection (a) shall not apply,
>
> (B) no taxes paid or accrued by the individual during such taxable year may be deemed paid or accrued under subsection (c) in any other taxable year, and
>
> (C) no taxes paid or accrued by the individual during any other taxable year may be deemed paid or accrued under subsection (c) in such taxable year.

[16] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 4

[17] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 10

> (2) Individuals to whom subsection applies
>
> This subsection shall apply to an individual for any taxable year if—
>
> (A) the entire amount of such individual's gross income for the taxable year from sources without the United States consists of qualified passive income,
>
> (B) the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year does not exceed $300 ($600 in the case of a joint return), and
>
> (C) such individual elects to have this subsection apply for the taxable year.

This is the exemption available to individuals who receive their entire amounts of creditable foreign tax and income as foreign tax credit passive income (generally interest and dividends) reported to them on Forms 1099, trust and estate K-1s, partnership K-3s and S corporation K-3s that allows them to claim the entire amount of tax as a credit without computing the detailed limitations on the credit on Form 1116. The amount of tax is simply reported as a tax credit on Schedule 3, Form 1040.

The instructions continue:

> A domestic partnership is not required to complete Schedules K-2 and K-3 if all partners are eligible for the Form 1116 exemption and the partnership receives notification of the partners' eligibility for such exemption by the 1-month date (as defined above).[18]

Note that the 1-month date again becomes relevant, though this time the partnership must receive the notification from the partner by the 1-month date in order to take advantage of this exception—otherwise the partnership is going to be required to treat the information as needed by all partners for which the notification is not received.

> If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 with respect to the other partners to the extent that the partnership does not qualify for the domestic filing exception.[19]

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[18] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 10

[19] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 10

The instructions make this point clear later, noting:

> A partnership that does not have or receive sufficient information or notice regarding a direct or indirect partner must presume such partner is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118 to claim a credit. As such, the partnership must complete the Schedules K-2 and K-3, including Parts II and III, accordingly.[20]

One interesting item to note about this additional instruction is that it mentions the partnership having or receiving "sufficient information" related to the lack of need for this data in addition to the previously described notice. It's not clear if this means that a partnership could avoid the 1-month date notification problem by receiving other information confirming that the partner will not have to file a Form 1116 or Form 1118, and thus avoid preparing the Schedules K-2 and K-3 parts II and III.

The IRS does provide an example of applying the Form 1116 exemption exception:

> **Example 6.** Husband and wife, U.S. citizens, each own a 50% interest in USP, a domestic partnership. Husband and wife and USP each have a calendar tax year. USP invests in a RIC. USP receives a Form 1099 from the RIC reporting $400 of creditable foreign taxes paid or accrued on passive category foreign source income. USP's only foreign activity is that from the RIC.
>
> Husband and wife do not pay or accrue any foreign taxes other than their distributive share of USP's foreign taxes. Husband and wife also do not have any other foreign source income.
>
> Husband and wife qualify for the Form 1116 exemption and notify USP by the 1-month date that they do not need the Schedule K-3. Even though USP does not qualify for the domestic filing exception because the creditable foreign taxes treated as paid or accrued by USP are greater than $300, because husband and wife notify USP by the 1-month date that they do not need the Schedule K-3 under the Form 1116 exemption, USP need not complete Schedules K-2 and K-3.[21]

IRS ANNOUNCES PLAN TO RELEASE PROPOSED REGULATIONS TO ADD LISTED TRANSACTIONS WHOSE

[20] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 10

[21] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of December 2, 2022, December 2, 2022, p. 10

STATUS HAS BEEN BROUGHT INTO QUESTION BY RECENT COURT DECISIONS

Announcement 2022-28, 12/6/22

The IRS in Announcement 2022-28[22] explained the reasons why it issued proposed regulations[23] involving certain syndicated conservation easement cases.

Administrative Procedures Act

The IRS took this action due to two recent losses in Court cases regarding the method the IRS used to add listed transactions under §6707A(c)(2) that would incur the penalties found in IRC §6707A(b) if such transactions were not properly disclosed on a taxpayer's tax return. IRC §6707A(c)(2) provides the following:

> **(2) Listed transaction.** The term "listed transaction" means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

The penalty in this case, 75% of the reduction in tax claimed due to the transaction, subject to a maximum penalty of $200,000 (or $100,000 for a natural person) per return, is strictly based on the failure to disclose such a transaction properly, Thus, even if the taxpayer later prevails in an IRS challenge to obtain the tax benefit, the penalty would still need to be paid.

In the cases of *Mann Construction Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022)[24] and *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022)[25] the courts ruled that the IRS had not properly added two transactions to the list of listed transactions, thus holding that the penalty under §6707A(c) did not apply in those two cases even though the taxpayers had failed to disclose the transactions.

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[22] Announcement 2022-28, December 6, 2022, https://www.taxnotes.com/research/federal/irs-guidance/announcements/irs-explains-need-for-proposed-regs-listing-easement-transactions/7ffp7 (retrieved December 7, 2022)

[23] REG-106134-22, Proposed Reg. §1.6011-9, December 6, 2022, https://www.taxnotes.com/research/federal/proposed-regulations/proposed-regs-require-reporting-of-conservation-easement-deals/7ffp5 (retrieved December 7, 2022)

[24] *Mann Construction Inc. v. United States,* 27 F.4th 1138 (6th Cir. 2022), March 3, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/sixth-circuit-holds-irs-didn%e2%80%99t-comply-with-apa-in-issuing/7d7r1 (retrieved December 7, 2022)

[25] *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022), November 9, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/tax-court-holds-notice-in-conservation-easement-cases-is-invalid/7fcg2 (retrieved December 7, 2022)

The Courts each found that the IRS had violated 5 USC §553, part of the Administrative Procedures Act. That provision provides:

> **5 USC §553 Rule making**
>
> (a) This section applies, according to the provisions thereof, except to the extent that there is involved—
>
> > (1) a military or foreign affairs function of the United States; or
> >
> > (2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.
>
> (b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—
>
> > (1) a statement of the time, place, and nature of public rule making proceedings;
> >
> > (2) reference to the legal authority under which the rule is proposed; and
> >
> > (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> Except when notice or hearing is required by statute, this subsection does not apply—
>
> > (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
> >
> > (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.
>
> (c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

> (d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—
>
> > (1) a substantive rule which grants or recognizes an exemption or relieves a restriction;
> >
> > (2) interpretative rules and statements of policy; or
> >
> > (3) as otherwise provided by the agency for good cause found and published with the rule.
>
> (e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

In both cases the courts found that identifying a transaction as a listed transaction was a rule covered by this section, rejecting the IRS's view that either Congress had specifically exempted IRC §6707A(c)(2) actions from the APA by the language of the statute or this was a mere interpretative rule.

Notice 2017-10, dealing with syndicated conservation easements, was the topic of the Tax Court's *Green Valley Investors* decision. The IRS, despite still disputing the holdings of both courts, made the decision to go through a formal notice and comment process to add back the syndicated conservation easement transactions to the listed transaction list even if IRS in unable to convince other courts that Notice 2017-10 did add properly these transactions to the listed transaction list.

IRS Notice Procedures for Listed Transactions

The Announcement begins by noting that more than 30 listed transactions have been added since 2000 under Reg. §1.6011-4.

> Since 2000, the Internal Revenue Service (IRS) has identified over 30 "listed transactions" — transactions that the IRS has determined to be abusive tax avoidance transactions within the meaning of § 1.6011-4(b)(2) of the Income Tax Regulations — by publishing a notice or other subregulatory guidance as provided in § 1.6011-4.[26]

The Announcement makes clear that the IRS disagrees with the courts' rulings:

> The Department of the Treasury (Treasury Department) and the IRS disagree with the Tax Court's decision in *Green Valley* and the Sixth Circuit's decision in *Mann Construction*, and are continuing to defend the validity of existing listing notices in circuits other than the Sixth Circuit.[27]

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[26] Announcement 2022-28, December 6, 2022
[27] Announcement 2022-28, December 6, 2022

But the IRS has decided, while still contesting the view that the APA must be followed in this case, to start adding the listed transactions back into the law via the formal regulatory path:

> At the same time, however, to eliminate any confusion and to ensure that these decisions do not disrupt the IRS's ongoing efforts to combat abusive tax shelters throughout the nation, the Treasury Department and the IRS are today issuing proposed regulations to identify certain syndicated conservation easement transactions as listed transactions. The Treasury Department and the IRS intend to finalize these regulations, after due consideration of public comments, in 2023 and intend to issue proposed regulations identifying additional listed transactions in the near future.[28]

Congress Enacted IRC §6707A After Reg. §1.6011-4 Had Been Adopted

The Announcement notes that after the IRS had adopted Reg. §1.6011-4, Congress added IRC §6707A to the Code via the *American Jobs Creation Act*:

> Following the promulgation of § 1.6011-4, Congress passed the American Jobs Creation Act (AJCA), which included section 6707A of the Code. Section 6707A imposes penalties on any person who fails to disclose participation in a reportable transaction, including a listed transaction. Consistent with the regulation, that statute defines a "reportable transaction" as "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion;" and a "listed transaction" as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."[29]

IRS Position: These Remain Listed Transactions

The Announcement notes that while the IRS still takes the position that their actions were proper (and thus these remain listed transactions), they note that the Sixth Circuit decision can't be ignored by the IRS for taxpayers subject to that Circuit's jurisdiction:

> The Treasury Department and the IRS continue to take the position that listed transactions can be identified by notice or other

[28] Announcement 2022-28, December 6, 2022
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> subregulatory guidance and that the APA's notice-and-comment procedure does not apply to identification of such transactions. The Treasury Department and the IRS disagree with the Tax Court's decision in *Green Valley* and the Sixth Circuit's decision in *Mann Construction* and continue to defend the validity of existing listing notices in litigation. The Treasury Department and the IRS recognize, however, that Mann Construction is controlling law in the Sixth Circuit, and the IRS has ceased enforcing disclosure and list maintenance requirements with respect to Notice 2017-10 in the Sixth Circuit.[30]

Not stated, but implied by the paragraph, is that the IRS is likely going to continue to assert the penalties outside the Sixth Circuit. While the published Tax Court decision means the IRS will not prevail should the taxpayer take the case to that venue (which seems likely to happen), the IRS likely will be looking to find a case to take to another Court of Appeals to look to create a split in the decisions of the Circuits.

Thus, those who reside outside the Sixth Circuit are taking more than zero level of risk by failing to report these transactions should the IRS prevail in their Circuit. For this particular penalty there's additional jeopardy, since the law provides that a listed transaction penalty is not subject to being rescinded by the IRS[31] and would not be subject to judicial appeal.[32] Thus, should the IRS ultimately prevail (not likely given two rulings against them, but still possible), the agency may argue it's required to collect the penalty from any taxpayers outside the Sixth Circuit who failed to file disclosures following these cases.

The current cases succeeded because the taxpayers were able to persuade the Court that these weren't listed transactions, thus working around the bar on judicial appeal of a penalty imposed on an actual listed transaction.

Problems Even in the Sixth Circuit if Valid Regulation Makes This a Listed Transaction

The IRS decided to add some saber rattling language to the announcement, noting that even if the Notice procedure is found to be an improper way to add a listed transaction, if the transaction is validly added after a notice and comment period the law will require reporting of the transaction within 90 days of it becoming listed with regard to any return for which the statute is open at the date it becomes listed:

> Taxpayers should take note that, if a transaction becomes a listed transaction after a taxpayer files a return reflecting the tax effects of the transaction, § 1.6011-4(e)(2)(i) requires the participant to file a

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[31] IRC §6707A(d)(1)(A)
[32] IRC §6707A(d)(2)

> disclosure statement with OTSA within 90 days of the transaction becoming a listed transaction if the assessment limitations period remains open for any taxable year in which the taxpayer participated in the listed transaction. Accordingly, any taxpayer, including taxpayers who reside in the Sixth Circuit, who has participated in a transaction in any year for which the assessment limitation period remains open when the regulation identifying the transaction as a listed transaction is finalized will have an obligation to disclose the transaction. Failure to disclose will subject the taxpayer to the penalty under section 6707A. Participants required to disclose listed transactions who fail to do so are also subject to an extended period of limitations under section 6501(c)(10). That section provides that the time for assessment of any tax with respect to the transaction will not expire before the date that is one year after the earlier of the date the participant discloses the transaction or the date a material advisor discloses the participation pursuant to a written request under section 6112(b)(1)(A).[33]

There will also be impacts on material advisers of the finalization of the regulation:

> Likewise, if a regulation identifying a transaction as a listed transaction is finalized after the occurrence of the events described in § 301.6111-3(b)(4)(i) of the Procedure and Administration Regulations, a material advisor will be treated as becoming a material advisor on the date the regulation is finalized pursuant to § 301.6111-3(b)(4)(iii) (if not deemed a material advisor earlier pursuant to a valid listing notice). A material advisor is required to file a Form 8918 by the last day of the month following the quarter in which the advisor became a material advisor with respect to the listed transaction. See § 301.6111-3(d) and (e).
>
> In addition, a material advisor must maintain a list identifying each person with respect to whom the advisor acted as a material advisor with respect to a listed transaction, if the person advised by the material advisor entered into the listed transaction within six years before the transaction was identified as a listed transaction. See § 301.6112-1(b)(2).[34]

Quirky Nature of IRC §6707A and Impact of the Rulings

Advisers should note that the rulings only find that the transactions were not ones that had to be reported under IRC §6707A because the IRS had not properly adopted these rules per the requirements of the Administrative Procedure Act.

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It is important to note what was not decided:

- Neither Court ruled that these transactions are not ones of a type that could be added to the listed transaction list. Only after the IRS went through a proper notice and comment period and adopted the same rule would there be consideration of whether that resulting regulation is or isn't valid. The IRS clearly is betting that even if the court opinions are not overturned, the regulatory process will eventually put the list right back where it was before *Mann Construction* and *Green Valley*.

- Neither Court dealt with the merits (or lack of merits) of the underlying transactions, as that issue is not relevant with regard to the disclosure penalty under IRC §6707A. An absolutely meritless transaction would nevertheless fail to be a listed transaction under the rulings in question should they have been added to the list by the use of subregulatory Notices.

Both are important to note, since there is existing caselaw on the merits of similar transactions that advisers will need to consider before advising a client that such a transaction is one for which the adviser would be able to sign the tax return.

As well, some advisers are using these losses to bring into question every piece of IRS guidance issued via a subregulatory process, implying that such tax positions at odds with such guidance would gain the tax advantage claimed by the taxpayer. That likely is overreaching for a couple of reasons.

First, the APA clearly allows the IRS to skip the comment period if the guidance is merely interpretative. The decisions in these cases take care to show why selecting specific transactions to add to the list goes beyond mere interpretation.

Second, this particular statute is one that gives each transaction a binary state—it either is on the list or it isn't. In other cases, even if the IRS guidance was found to be invalid, the taxpayer would still need to show that the tax benefits weren't denied by the language of the statute. In this case, an invalid addition to the list would automatically mean the penalty would not apply.

Few statutes only apply to situations that the IRS has added to something like the listed transaction list. Rather, most often the IRS is looking to outline the positions that are and aren't acceptable based on statute that does not itself require any such IRS action before it could be applied against taxpayers.

It is true that the courts have become more likely to look at compliance with the Administrative Procedures Act and that it's very possible more IRS guidance will be struck down for failure to comply with it. But it does not flow from such a result that a court would have to find a transaction at odds with that not validly issued guidance would automatically gain the claimed tax benefits—at that point the taxpayer must be able to justify the result based on the law enacted by Congress.