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Court of Appeals Holds Offsetting Foreign Currency Option Transaction Lacked Economic Substance

The U.S. Court of Appeals for the Fifth Circuit, affirming the Tax Court, has held, in *Tucker v. Comm'r* (5th Cir. 2019) (<http://www.ca5.uscourts.gov/opinions/unpub/17/17-60833.0.pdf>), that a complex offsetting foreign currency option transaction did not have economic substance and thus did not justify the losses taken by the taxpayer. The economic substance doctrine allows the government to look beyond technical compliance with the Internal Revenue Code of 1986, as amended (the Code) to ascertain the real nature of the transaction at issue. The Fifth Circuit held that (1) it was appropriate for the Tax Court to apply the economic substance doctrine to the transaction and (2) the Tax Court applied the economic substance doctrine correctly. To determine whether a transaction has economic substance, courts usually make a two-pronged factual inquiry to determine whether (1) the taxpayer motivated by a business purpose (i.e., that the taxpayer had a purpose other than obtaining tax benefits) in entering into the transaction (the “subjective test”) and (2) the transaction had objective economic substance (i.e., whether there was a reasonable possibility of a profit) (the “objective test”) (*Frank Lyon Co. v. U.S.*, 435 US 561 (1978)). The Fifth Circuit stated that in order to have economic substance, both prongs of the economic substance test have to be met, and the foreign currency transaction at issue in the case failed the objective prong. The taxpayer argued that the economic substance doctrine was inapplicable because the transaction complied with the literal reading of the Code. The Court of Appeals noted that it and the Supreme Court have applied the economic substance doctrine to transactions that technically complied with tax laws. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Supreme Court said that it is appropriate for a court to apply the economic substance doctrine to a transaction to determine whether what was done, apart from the tax motive, was the thing which the statute intended. The Fifth Circuit found that the taxpayer’s “manipulation of the rules” was contrary to Congress’ intent with respect to the various Code provisions involved in the case, and looked to the legislative history of the Code in making that determination.

U.S. Tax Court Rules Economic Development Grants Are Nontaxable Capital Contributions

The U.S. Tax Court, in *Brokertec Holdings, Inc. v. Commissioner*, T.C. Memo. 2019-32 (<https://www.ustaxcourt.gov/ustcinop/OpinionViewer.aspx?ID=11921>), held that cash grants received by the affiliates of a financial services company under a state economic development program were nontaxable contributions to capital under Section 118. (Section references are to the Code.) The Tax Court found that the grants were made to induce the affiliates to establish offices in targeted areas to develop and revitalize the state’s economy.

IRS Issues Final Regulations on Exempt Organization Excise Taxes

The IRS issued final regulations (T.D. 9855) (<https://www.govinfo.gov/content/pkg/FR-2019-04-09/pdf/2019-07010.pdf>) that specify which return to use to pay certain excise taxes, including two new excise taxes enacted as part of the 2017 Tax Cuts and Jobs Act (TCJA), and the time for filing the return. The Pension Protection Act of 2006, Pub. L. 109-280, 120 Stat. 780, 1094, added Sections 4966 and 4967 to the Code. These sections impose excise taxes related to certain distributions from donor-advised funds maintained by organizations that are defined as sponsoring organizations in Section 4966(d)(1). The TCJA added Sections 4960 and 4968 to the Code. Section 4960(a) imposes an excise tax equal to the product of the rate of tax under Section 11 and the sum of (1) so much of the remuneration paid (other than any excess

parachute payment) by an applicable tax-exempt organization for the taxable year with respect to employment of any covered employee in excess of \$1 million, plus (2) any excess parachute payment paid by such an organization to any covered employee. Section 4960(c)(4)(A) provides that remuneration of a covered employee by an applicable tax-exempt organization includes any remuneration paid with respect to employment of such employee by any related person or governmental entity. Section 4960(c)(4)(C) provides that when remuneration from more than one employer is taken into account in determining the tax imposed by subsection (a), each such employer is liable for a pro rata share of the tax imposed by subsection (a) based on the ratio of the amount of remuneration paid by such employer with respect to such employee to the amount of remuneration paid by all such employers to all such employees. Separately, Section 4968 imposes an excise tax on each applicable educational institution based on the net investment income of such institution (including certain income of related organizations) for the taxable year.

In November 2018, the IRS issued proposed regulations specifying which return to use to pay certain excise taxes, including the two new excise taxes under the TCJA. (See our prior coverage at <https://www.stradley.com/insights/publications/2018/11/tax-insights-november-14-2018>.) The final regulations adopt the proposed regulations without change. They provide that persons (including governmental entities) who are liable for excise taxes under Sections 4960, 4966, 4967 or 4968 are required to file a return on Form 4720. The final regulations also provide that a person required to file a Form 4720 to report an excise tax described above must do so by the 15th day of the fifth month after the end of that person's tax year during which the excise tax liability was incurred. Additionally, the final regulations, consistent with the Code, reflect the statutory addition of the Section 4966 and Section 4967 taxes to the first-tier taxes subject to the IRS' abatement authority under Section 4962, by adding such taxes to the definitions of "first-tier tax" in Treasury Regulation Section 53.4963-1.

IRS Issues Final Regulations Excepting Certain Capital Projects From Arbitrage Restrictions

The IRS issued final regulations (T.D. 9854) (<https://www.federalregister.gov/documents/2019/04/09/2019-06937/arbitrage-investment-restrictions-on-tax-exempt-bonds>) clarifying the definition of "investment-type property" covered by the Section 148 arbitrage restrictions. Treasury Regulation Section 1.148-1(e)(4) states that investment-type property does not include real property or tangible personal property (for example, land, buildings and equipment) that is used in furtherance of the public purposes for which the tax-exempt bonds are issued. For example, investment-type property does



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not include a courthouse financed with governmental bonds or an eligible exempt facility under Section 142, such as a public road, financed with private activity bonds.

IRS Issues Foreign Financial Account Reminders – April 15 FBAR Due Date

The IRS issued a news release (IR 2019-63) (<https://www.irs.gov/newsroom/irs-reminds-those-with-foreign-assets-of-annual-april-15-fbar-deadline>) and fact sheet (Fact Sheet 2019-7) (<https://www.irs.gov/newsroom/understand-how-to-report-foreign-bank-and-financial-accounts>) that contain numerous reminders for taxpayers with foreign bank or financial accounts, including that the annual Report of Foreign Bank and Financial Accounts (FBAR) is due on April 15.

IRS Issues Fact Sheet Outlining Qualified Business Income Deduction

The IRS has released a fact sheet (FS-2019-8) (<https://www.irs.gov/newsroom/facts-about-the-qualified-business-income-deduction>) outlining the Section 199A deduction, which allows varying deduction amounts for qualified business income, qualified real estate investment trust dividends and qualified publicly traded partnership income.

NYSBA Tax Section Comments on Qualified Business Income Guidance

The New York State Bar Association (NYSBA) Tax Section has submitted a report (http://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1415_Report.html) on final Section 199A regulations (T.D. 9847), proposed regulations (REG-134652-18) on the treatment of regulated investment companies (including the rationale for extending (or not extending) conduit treatment to qualified publicly traded partnership income), and a proposed Revenue Procedure (Notice 2019-7) that provides a real estate qualified trade or business safe harbor.