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# UPDATE FOR ACCOUNTANTS AND FINANCIAL PLANNERS



**STEIN SPERLING**

BENNETT • DE JONG • DRISCOLL PC

ATTORNEYS AT LAW

October 22, 2019

# AGENDA

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- Cryptocurrency and the IRS
- Tax Issues on LLC Formation
- “Hidden” Taxes in the DMV

# CRYPTOCURRENCY AND THE IRS

Eric J. Rollinger, JD, CPA & Michael Y. Goldberg, JD, CPA

# OUTLINE

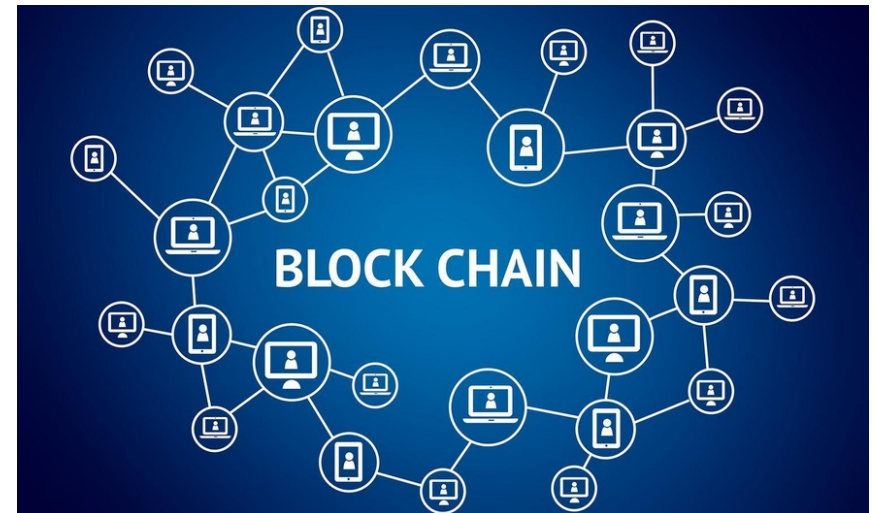
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- What is Cryptocurrency?
- How is it taxed?
- Recent IRS Enforcement Action and “Education” Program
- Non-tax legal issues

# WHAT IS VIRTUAL CURRENCY AND/OR CRYPTOCURRENCY?

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- ❑ Digital asset
- ❑ Medium of Exchange
- ❑ Trustless
- ❑ Cryptocurrency uses cryptography
- ❑ No central authority
- ❑ Blockchain
- ❑ Not legal tender
- ❑ Anonymity
  - ▣ KYC issues
- ❑ #buzzwords



# BITCOIN

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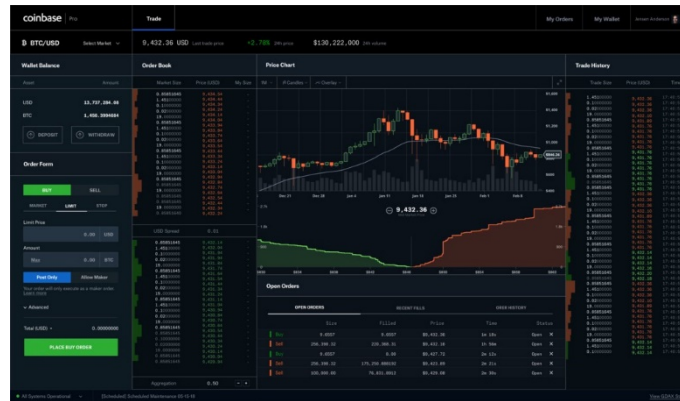
- ❑ Started in 2009 by Satoshi Nakamoto
- ❑ Decentralized Digital Currency
- ❑ No Central Bank
- ❑ Peer to Peer network
- ❑ In 2010, someone bought two Papa John's pizzas for 10,000 Bitcoin
- ❑ First users were black markets such as Silk Road
- ❑ In 2017, reached almost \$20,000 per Bitcoin
- ❑ Criticism includes high energy consumption



# HOW IT WORKS











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- ❑ Coins “held” in a wallet or on an exchange but are still on blockchain ledger
- ❑ Can purchase on an exchange such as Coinbase or Gemini



# COMMON VIRTUAL CURRENCIES

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#	Name	Market Cap	Price
1	 <b>Bitcoin</b>	\$151,562,254,597	\$8,424.68
2	 <b>Ethereum</b>	\$19,947,384,808	\$184.47
3	 <b>XRP</b>	\$12,056,620,052	\$0.279303
4	 <b>Tether</b>	\$4,127,464,737	\$1.00
5	 <b>Bitcoin Cash</b>	\$4,105,645,480	\$227.40
6	 <b>Litecoin</b>	\$3,641,834,247	\$57.39
7	 <b>EOS</b>	\$2,912,300,121	\$3.11
8	 <b>Binance Coin</b>	\$2,831,898,330	\$18.21
9	 <b>Bitcoin SV</b>	\$1,580,873,341	\$88.54
10	 <b>Stellar</b>	\$1,235,945,562	\$0.061724



# IS CRYPTOCURRENCY TAXABLE?

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- IRS Notice 2014-21 (issued March 25, 2014)
  - Treated as “property” NOT currency
  - Must be included in gross income if received in exchange for goods or services
  - Must track basis – IRC 1001, 1011, 1012
  - Is a capital asset
  - Determine fair market value through exchange or other reasonable manner
    - Difficult with coin to coin trades or hard forks
      - Dominion and Control – Rev Rul 63-225
  - No Like-Kind Exchanges under TCJA



# TAX REPORTING ISSUES

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## □ Charitable Contributions

- ▣ Report on Form 8283? Is a qualified appraisal required if FMV > \$5,000
- ▣ AICPA proposes treating like publicly traded stock

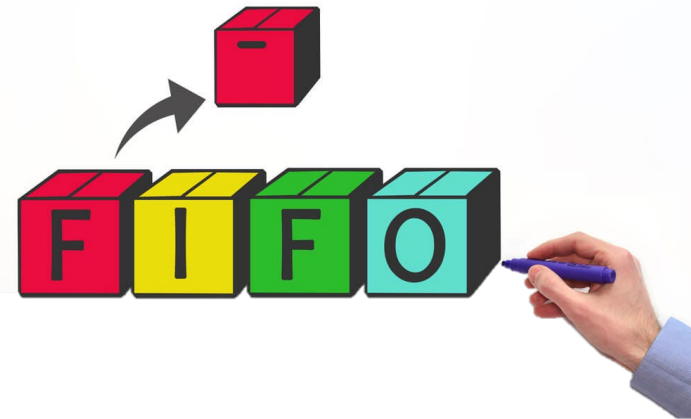
## □ *De minimus* Exception

- ▣ IRC 988 foreign currency transactions under \$200

## □ Sales of property are generally handled through specific identification

- ▣ FIFO if unable to identify specific property per IRS FAQs

## □ Transfers between exchanges



# SECURITIES TRADING/ TRADING AS A BUSINESS

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- Mark to Market Election (IRC 475(f))
- Weigh Business Deductions vs. SE Tax
  - ▣ No IRC 67 deduction for investment expenses (2018 through 2026)
- Inventory Subject to 263A?
- No Wash Sale Application – IRC 1091
- ICOs may be securities offerings per SEC



# IS “MINING” VIRTUAL CURRENCY TAXABLE?

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- What does mining mean?
  - ▣ For example, use computer resources to validate Bitcoin transactions and maintain the public Bitcoin transaction ledger
- Subject to self-employment income?
  - ▣ If done as a trade or business



# FBAR/FACTA REPORTING

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- AICPA Virtual Currency Task Force reached out to Treasury's Financial Crimes Enforcement Network (FinCEN)
  - ▣ Virtual currency is not reportable **for now**
- “[I]n consultation with the IRS, [FinCEN] continue[s] to evaluate the value of incorporating virtual currency held offshore into the FBAR regulatory reporting requirements.”

Report of Foreign Bank and Financial Accounts

Home | Filer Information | Financial Account Owned Separately/Jointly | No Financial Interest Account Information | Consolidated Report | Signature Information

**Part IV Information on Financial Account(s) Where Filer has Signature or Other Authority but No financial Interest in the Account(s)** 1 of 1

**Account Information**

15 Maximum account value  15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City  21 State

22 Foreign postal code  23 Country

**Owner Information**

34 Last name or organization name

35 Taxpayer Identification Number (TIN)  35 a TIN type

36 First name

37 Middle name

37a Suffix

38 Address

Part III		Yes	No
You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.			
<b>Foreign Accounts and Trusts</b>  (See instructions.)	<b>7a</b> At any time during 2018, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions . . . . .		
	If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements . . . . .		
	<b>b</b> If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ►		
<b>8</b>	During 2018, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions . . . . .		

# NEW IRS CRYPTOCURRENCY FAQs (RELEASED OCTOBER 9, 2019)

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- Expanded from 16 FAQs to 43 FAQs
  - How to calculate gain and loss
    - You may choose to specifically identify units
    - Otherwise use first in, first out (FIFO)
  - How to calculate income from receiving cryptocurrency
    - Through performing services, in exchange for goods, etc.
  - How to calculate a charitable deduction
  - Must maintain records that are sufficient to establish the positions taken on your return – IRC 6001

# I.R.S. REVENUE RULING 2019-24

## (RELEASED OCTOBER 9, 2019)

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First guidance since 2014



A hard fork does not result in income until the taxpayer is able to exercise dominion and control of the new cryptocurrency



A Revenue Ruling is the IRS's litigating position but not necessarily represent a legally accurate position

# CRYPTOCURRENCY ENFORCEMENT

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- *United States v. Coinbase*
  - ▣ John Doe Summons on 13,000 customers
  - ▣ Coinbase turned over information in March 2018
- 2018 IRS Virtual Compliance Campaign
  - ▣ IRS teamed up with tax authorities in four other countries to launch the Joint Chiefs of Global Tax Enforcement
- Per IRS Chief Counsel there will be no voluntary disclosure program like OVDP





# NEW IRS “EDUCATION” PROGRAM

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- July 26, 2019 IRS began sending “education letters”
  - ▣ Letter 6173 – MUST
    - File delinquent returns
    - Amended returns to report virtual currency transactions
    - Provide a statement that explains why taxpayer is full compliance under penalties of perjury
  - ▣ Letter 6174 – May have misreported
  - ▣ Letter 6174-A
- IRS has multiple data sources and better analytics

## Reporting Virtual Currency Transactions

Dear [Name]:

### Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency and may not have met your U.S. tax filing and reporting requirements for transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

### Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency but may not know the requirements for reporting transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

# CRYPTOCURRENCY ENFORCEMENT

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## □ Forms 1099-K

FILER'S name, street address, city or town, state or province, country, ZIP or town or postal code, and telephone no. <b>COINBASE INC.</b> <b>545 MARKET ST #23008</b> <b>SAN FRANCISCO, CA 94104</b> <b>555.908.7830</b>		FILER'S TIN [REDACTED]		OMB No. 1545-2205 <b>2018</b> Form 1099-K		<b>Payment Card and Third Party Network Transactions</b>	
Check to indicate if FILER is a (an): Payment settlement entity (PSE) <input checked="" type="checkbox"/> Electronic Payment Facilitator <input type="checkbox"/> Other third party <input type="checkbox"/>		Check to indicate transactions reported are: Payment card <input type="checkbox"/> Third party network <input checked="" type="checkbox"/>		<b>1a</b> Gross amount of payment card/third party network transactions <b>\$9,325,750.47</b>		<b>2</b> Merchant category code	
PAYEE'S name, street address, city or town, state or province, country, and ZIP or foreign postal code [REDACTED]		<b>1b</b> Card Not Present transactions		<b>3</b> Number of payment transactions <b>383</b>		<b>4</b> Federal income tax withheld	
PSE'S name and telephone number [REDACTED]		<b>5a</b> January <b>\$3,338,810.94</b>		<b>5b</b> February <b>\$2,946,224.58</b>		<b>Copy B For Payee</b> This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.	
		<b>5c</b> March <b>\$947,239.25</b>		<b>5d</b> April <b>\$139,549.00</b>			
		<b>5e</b> May <b>\$281,696.17</b>		<b>5f</b> June <b>\$169,733.68</b>			
		<b>5g</b> July <b>\$630,455.69</b>		<b>5h</b> August <b>\$839,349.95</b>			
		<b>5i</b> September <b>\$32,691.21</b>		<b>5j</b> October			
		<b>5k</b> November		<b>5l</b> December			
Account number (see instructions) [REDACTED]		<b>6</b> State <b>VA</b>		<b>7</b> State identification no.		<b>8</b> State income tax withheld	
Form 1099-K (keep for your records)		<a href="http://www.irs.gov/Form1099K">www.irs.gov/Form1099K</a>		Department of the Treasury - Internal Revenue Service			

# NEW CRYPTOCURRENCY QUESTION ON THE SCHEDULE 1 (DRAFT RELEASED OCTOBER 11, 2019)

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## SCHEDULE 1 (Form 1040 or 1040-SR)

Department of the Treasury  
Internal Revenue Service

## Additional Income and Adjustments to Income

► Attach to Form 1040 or 1040-SR.  
► Go to [www.irs.gov/Form1040](http://www.irs.gov/Form1040) for instructions and the latest information.

OMB No. 1545-0074

**2019**

Attachment  
Sequence No. **01**

Name(s) shown on Form 1040 or 1040-SR

Your social security number

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? . . . . .

☐ Yes ☐ No

### Part I Additional Income

# INCOME TAX COLLECTION

20

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	190,226.
8a	Taxable interest. Attach Schedule B if required	8a	1,018.
b	Tax-exempt interest. Do not include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	13	4,752,774.



## □ Price

■ 1/1/2017 - \$960

■ 12/17/2017 - \$19,891

■ 12/31/2018 - \$3,800

■ 9/10/2019 - \$10,500

■ 10/13/2019 - \$8,500

63 Add lines 56 through 62. This is your <b>total tax</b>		63	1,202,162.
Payments	64 Federal income tax withheld from Forms W-2 and 1099	64	25,608.
	65 2017 estimated tax payments and amount applied from 2016 return	65	
	66a <b>Earned income credit (EIC)</b> NO.	66a	
	b Nontaxable combat pay election 66b	66b	
	67 Additional child tax credit. Attach Schedule 8812	67	
	68 American opportunity credit from Form 8863, line 8	68	
	69 Net premium tax credit. Attach Form 8962	69	
	70 Amount paid with request for extension to file	70	
	71 Excess social security and tier 1 RRTA tax withheld	71	
	72 Credit for federal tax on fuels. Attach Form 4136	72	
73 Credits from Form: a <input type="checkbox"/> 2439 b <input type="checkbox"/> Reserved c <input type="checkbox"/> 8885 d <input type="checkbox"/>	73		
74 Add lines 64, 65, 66a, and 67 through 73. These are your <b>total payments</b>	74	25,608.	
Refund	75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you <b>overpaid</b>	75	
76a Amount of line 75 you want <b>refunded to you</b> . If Form 8888 is attached, check here <input type="checkbox"/>	76a		
Direct deposit? See instructions.	b Routing number	c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings	
d Account number			
Amount You Owe	77 Amount of line 75 you want applied to your 2016 estimated tax	77	
78 <b>Amount you owe.</b> Subtract line 74 from line 63. For details on how to pay, see instructions	78	1,176,554.	
79 Estimated tax penalty (see instructions)	79		

# VALUATION ISSUES

21

- Income Approach
  - ▣ No underlying cash flows
- Asset Approach
  - ▣ High transaction fees
- Market Approach
  - ▣ Exchanges may differ in value
  - ▣ Large transactions can move the market

# OTHER NON TAX LEGAL RISKS

22

- FinCEN – Anti-Money Laundering and Bank Secrecy Act
- Securities laws
- State and International Regulation
- Treasury Secretary Steven Mnuchin said that U.S. regulators are likely to soon issue new regulations on cryptocurrencies so they don't negatively affect the financial system
- Price manipulation
- Lack of stability
- Huge energy consumption

# TAX ISSUES ON LLC FORMATION

Mark W. Schweighofer, LL.M.



Issues on Contribution to a Partnership



# CONTRIBUTION OF PROPERTY - IRC 721

# CONTRIBUTION OF PROPERTY - IRC 721

- General Rule:

- ▣ “No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership”

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - Transfers to Investment Company
    - Intended to prevent a taxpayer from achieving diversification with respect to liquid investments by contributing an investment portfolio to a partnership
    - Defined by reference to investment company definition in Section 351(e)
      - An entity in which more than 80% of the value is made up of: stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - ▣ Transfers of Encumbered Property
    - If a partner contributes property subject to a liability, the contributing partner may recognize gain to the extent considered relieved of such liability (using the principles of Section 752).
      - I.E. contributing property with debt in excess of basis

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - ▣ Transfers of Encumbered Property
    - When is a partner considered relieved of a liability on contribution?
      - Recourse Debt—generally the contributing partner will continue to bear the economic risk of loss and, assuming no change following contribution, no gain should be triggered on contribution
      - Non-Recourse Debt—will be allocated among all partners using the three tier allocation regime under 752 (PMG, then 704(c) minimum gain, then based on partner's interest in the partnership)
        - Debt allocated away from the contributing partner can trigger gain

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - ▣ Transfers of Encumbered Property
    - Non-recourse Debt
      - Consider use of partner level guarantees to avoid liability shift
        - But—guarantee cannot exceed fair market value of property at time of contribution

# CONTRIBUTION OF PROPERTY - IRC 721

- Related Issue with Respect to Non-Recourse Debt
  - Admission of a new partner will cause reallocation of partnership liabilities.
    - Existing partners share of partnership non-recourse debt may decrease as a result, triggering unintended gain.
    - Again, consider limited guarantees to avoid triggering immediate gain
  - Less likely with respect to recourse debt but—
    - Watch for situations where a lender (or an affiliate of a lender) is admitted as a partner
      - In such cases, who bears the ultimate economic risk of loss?

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - Disguised Sales
    - Disguised Sales of Property (possible gain to contributing partner)
    - Disguised Sale of Partnership Interests (possible gain to existing partners)





# CONTRIBUTION OF PROPERTY - IRC 721

## □ Exceptions to the general rule

### ■ Disguised Sales

#### ■ Disguised Sales of Property (possible gain to contributing partner)

- Typical fact pattern—transfer of property to partnership by contributing partner followed by purported distribution to the contributing partner

#### ■ Reg. 1.707-3

- The transfer of money or other consideration would not have been made but for the transfer of property; and
- In cases of nonsimultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - ▣ Disguised Sales
    - Disguised Sales of Property (possible gain to contributing partner)
      - Facts and circumstances analysis
        - Timing and amount of subsequent transfer
        - Partners legally enforceable right to receive the subsequent transfer

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule

- Disguised Sales

- Disguised Sales of Property (possible gain to contributing partner)

- Presumption

- Transfers of property within two years following a contribution to a partnership will be presumed to be a sale of property to the partnership unless facts and circumstances *clearly establish* the transfer does not constitute a sale
        - The presumption (and burden) flips on transfers outside of the two-year contribution window

# CONTRIBUTION OF PROPERTY - IRC 721

## □ Exceptions to the general rule

### ■ Disguised Sales

#### ■ Disguised Sales of Partnership Interest

- Generally involves a contribution of money/property to a partnership followed by a distribution of money/property to one or more of the non-contributing partners
- Identical presumptions

# CONTRIBUTION OF PROPERTY - IRC 721

- Exceptions to the general rule
  - ▣ Disguised Sales
    - Pay special attention to recent debt
      - Unless debt is a “qualified liability” under the 1.707-5 regulations, possible disguised sale
        - When did the debt arise?

# CONTRIBUTION OF SERVICES

- What type of interest?

- ▣ Capital Interest

- Gives the recipient a current right to existing partnership capital

- Generally taxable and governed by Section 83 (see 1.721-1(b)(1))

- Profits Interest—anything other than a capital interest (See Rev. Proc. 93-27)

# CONTRIBUTION OF SERVICES

## □ Profits Interests

### ■ Rev. Proc. 93-27—deals with vested profits interests

- No income to recipient on grant (and no corresponding deduction to entity)
- Requirements:
  - Received in connection with the provision of services to the partnership in a partner capacity (or in anticipation of becoming a partner)
  - Interest cannot relate to a substantially certain and predictable stream of income
  - Recipient cannot dispose of interest within two years of receipt;
  - Cannot be a publicly traded partnership

# CONTRIBUTION OF SERVICES

## □ Profits Interests

■ Rev. Proc. 2001-43 addresses substantially non-vested profits interests

■ In order to achieve non-recognition treatment:

- All of the requirements of Rev. Pro. 93-27 apply; plus
- Both partnership and recipient must treat the recipient as a true partner for tax purposes from the date of grant
  - Recipient must receive allocations of income and loss; must get K-1, etc.
  - Neither partnership nor recipient takes any compensation deduction



# CONTRIBUTION OF SERVICES

## □ Profits Interests

### ▣ Is an 83(b) election required?

- No, not if the Rev. Proc. is followed.
- Consider making a protective 83(b) election

### ▣ Notice 2005-43

- Published with proposed regulations that have not been finalized
- Authorizes the use of liquidation method in determining value

# CONTRIBUTION OF SERVICES

- Profits Interests
  - ▣ Use of hurdles becoming increasingly more common
  - ▣ Must book-up capital accounts
    - Failure to do so may change character of interest granted
    - In addition, will alter the economic deal between the parties
    - Consider use of “catch-up” special allocations

# CONTRIBUTION OF DEBT

- When a creditor contributes its debt to the partnership in exchange for a partnership interest, the partnership is considered to have satisfied the obligation with an amount of money equal to the fair market value of the interest transferred.
- If FMV is less than the amount of the debt, will trigger gain and be included in the distributive shares of the partners immediately prior to the contribution
  - IRC 108

# CONTRIBUTION OF DEBT



- If contribution of debt results in income from discharge of indebtedness, insolvency is tested at the partner (not the partnership) level.
  - ▣ Compare with S corporation, which is tested at the entity level.

## 704(C) PROPERTY

# 704(C) PROPERTY

- Deals with contribution of property where the adjusted basis of the property contributed differs from the property's fair market value
- Intent to limit the ability to shift tax pre-contribution tax attributes to other partners
- General Rule:
  - ▣ income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution

# 704(C) PROPERTY

- Tax follows book
- Three approaches
  - ▣ Traditional Method
    - Generally most favorable to the contributing partner
  - ▣ Traditional Method with Curative Allocations
    - Method helps correct “ceiling rule” distortions
  - ▣ Remedial Method

# 704(C) PROPERTY:

## TRADITIONAL METHOD: TREAS. REG. §1.704-3(B)

- Overview:

- Steps:

- Determine tax depreciation amount
- Determine and allocate book depreciation amount under §704(b)
- Allocate tax depreciation to non-contributing partner up to the amount of the allocated book depreciation (if excess, allocate to contributing partner)

Note: under the ceiling rule, the total amount of income, loss, gain or deduction allocated to the partners may not exceed the partnership's income, loss, gain or deductions - this could lead to discrepancy between the non-contributing partner's tax and book allocations, causing the non-contributing partner to incur an economic loss with no corresponding tax loss



# 704(C) PROPERTY: TRADITIONAL METHOD WITH CURATIVE ALLOCATIONS: TREAS. REG. §1.704-3(C)

- Overview:
- The steps are the same as the tradition method, but the partnership is permitted to make curative allocations of other items of income, loss, gain and deduction in order to mitigate the non-contributing partner's tax and book allocation distortions caused by the ceiling rule



# 704(C) PROPERTY:

## REMEDIAL METHOD: TREAS. REG. §1.704-3(D)

### □ Overview:

Under this method, if the ceiling rule creates a disparity between the non-contributing partner's tax and book capital accounts, but there is no other item of income, gain, loss or deduction, the partnership makes a remedial allocation of **phantom, non-existent** items of income, gain, loss or deduction to the non-contributing partner in the amount of the disparity, PLUS an offsetting allocation of income, gain, loss or deduction to the contributing partner, which net to zero at the partnership level.

# 704(C) PROPERTY: REMEDIAL METHOD

- Overview, cont'd:
- The remedial tax item must have the same tax attributes as the tax item that is being limited by the ceiling rule:
  - ▣ If the limited tax item is loss from sale of property, the remedial tax item must be gain from the sale of that property, and vice versa;
  - ▣ If the limited tax item is depreciation or other cost recovery allowance, the remedial tax item must be income of the type produced by that property

# PROFITS, LOSSES, AND CAPITAL ACCOUNTS

# PROFITS AND LOSSES

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- Can range in complexity
- Complications arise when capital contributions do not tie to allocations/distributions
- May lack substantial economic effect
- Worse – may not reflect the intended economic deal between the members

# PROFITS AND LOSSES

## □ Partnership Allocations

### ▣ Two tests

#### ■ Traditional

- LLC/Partnership agreement complies with the capital account maintenance rules
- Liquidating distributions are made in accordance with positive capital account balances
- LLC/Partnership agreement contains a deficit restoration obligation

#### ■ Alternate Test for Economic Effect

- First two rules above are the same
- Agreement contains a qualified income offset

# MAINTENANCE OF CAPITAL ACCOUNTS

- Capital account rules are important because a partner's capital account is the mechanism that dictates what a partner is to receive upon a dissolution of the company
- For this reason, book capital accounts focus on the fair market value of property rather than the tax basis of such property

# LOSS LIMITATION

- ❑ Losses should go to partners who can use them, but be careful of economic consequences
- ❑ A member's capital account can go negative in some situations, within limits
- ❑ If a member is allocated losses or deductions causing a deficit capital account balance beyond that which the member is actually, or is deemed to be, obligated to restore under the regulations, the loss must be reallocated to the other members with positive capital account balances



# IMPACT LOSS LIMITATION ON ECONOMICS

## □ Example:

- A and B form AB, LLC
- A contributes \$10k
- B contributes \$90k
- Profits, losses and distributions are allocated 50-50
- Year 1, there is an \$40k loss. Loss must be allocated \$10k to A and \$30k to B
- In year two partnership has \$20k of income, allocated \$10k to each
- If AB, LLC liquidated at end of year 2, A would get \$10k (no overall loss) and B would get \$70k (\$20k overall loss)
  - Allocations have economic effect, but is this what the parties intended?

# IMPERMISSIBLE DEFICITS AND QUALIFIED INCOME OFFSET

- Designed to remedy impermissible capital account deficits as quickly as possible
- Allocation of gross income to a member
- Reduces gain or increases loss to other members

# IMPERMISSIBLE DEFICITS AND QUALIFIED INCOME OFFSET

## □ Example:

- Partners A & B each have a capital account of \$25k (\$50k aggregate)
- The partnership has income of \$25k and losses of \$25k for the year
- Partnership agreement contains a QIO
- During the year, the partnership made a distribution to A of property in the amount of \$30k
- The distribution to A causes A to have a negative \$5k capital account balance - to rectify this, A must be allocated \$5k of gross income
- This off the top allocation to A causes the partnership to incur a \$5k loss for the year
- Because A's capital account after the distribution and after the allocation of gross income is \$0, the \$5k loss must be allocated entirely to B

# MINIMUM GAIN CHARGEBACKS

- Deductions that are attributable to non-recourse debt cannot have substantial economic effect
- Basic idea is that members/partners who receive the benefit of nonrecourse deductions must also be allocated a corresponding amount of income
- Partnership minimum gain is the amount of gain the partnership would realize if the partnership transferred the property to the creditor in full satisfaction of the debt

# MINIMUM GAIN CHARGEBACKS

## □ Example:

- A and B each contribute \$100k to a partnership
- Partnership borrows \$400k on a nonrecourse basis to purchase an asset worth \$600k
- Assume that partnership breaks even except for \$200k of depreciation deduction each year
- At the end of year 1, both A and B have capital account balances of \$0 and there is no partnership minimum gain because the adjusted basis of the property (now \$400k) equals the amount of the outstanding debt (\$400k)
- At the end of year 2, A and B would each have a deficit in their capital account of \$100k, which would cause a problem, but for the minimum gain chargeback rules

# MINIMUM GAIN CHARGEBACKS

## □ Example (cont.)

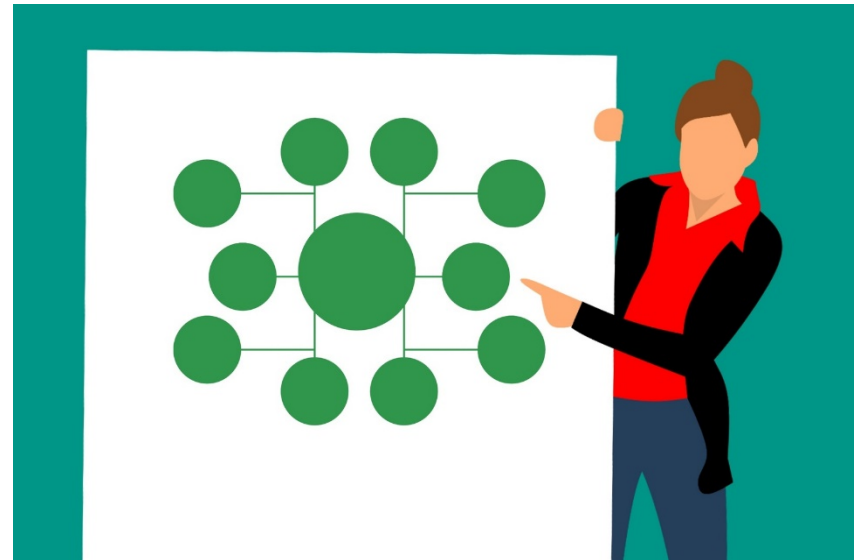
- If the partnership disposed of the asset at the end of year 2 it would recognize \$200k of gain (\$400k debt less \$200k AB of the asset)
- If the property was disposed of, A and B would each be allocated \$100k, thereby eliminated the deficit – this is sometimes referred to as a “deemed DRO”

# ALLOCATION TO TRANSFERRED INTEREST

- Allocation of income/distributive share in year of transfer
  - ▣ Per diem
  - ▣ Closing of the Books
- Comparison to S corporation

# MANDATORY TAX DISTRIBUTION

- ❑ Important provision to protect minority owners
- ❑ What rate?
- ❑ Who decides?
- ❑ Annual or cumulative?





# GUARANTEED PAYMENTS

- Made to a partner/member pursuant to Section 707(c) of the Code; payments are made *without regard* to partnership profits.
  - ▣ Salary equivalent in a partnership context
  - ▣ Per IRS, one cannot be both a partner and an employee
- Consider 199A implications

# CENTRALIZED PARTNERSHIP AUDIT RULES

- Bipartisan Budget Act of 2015 (“BBA”)
  - Repealed the TEFRA audit rules and replaced them with the Centralized Partnership Audit Process
  - Tax Matters Partner eliminated for all tax years after 2017; replaced by Partnership Representative with significantly expanded powers

# “HIDDEN” TAXES IN THE DMV

David S. De Jong, LL.M., CPA & Eric J. Rollinger, JD, CPA

# MD – SALES TAX ON ASSET SALES OF BUSINESSES

68

Md. Code – Tax General Section 11-209 and Regulation 03.06.01.12 state that the Maryland sales and use tax does not apply to a casual and isolated sale by a person who regularly does not sell tangible personal property or a taxable service if the sales price is less than \$1,000. Conversely, the tax applies to one-time sales of \$1,000 or more.

# MD – SALES TAX ON ASSET SALES OF BUSINESSES (CTD)

69

- In ACF Industries, Inc. v. Comptroller, 257 Md. 543 (1970), the Maryland Court of Appeals ruled that the sale of an entire business was not exempt from the casual sales and use tax rule when the seller had sold multiple businesses in the past.
- An Opinion of the Attorney General dated March 10, 1972 clarified that a casual sale requires that the seller no longer be engaged in the sale of tangible personal property, that the sale not be one of several similar transactions, that the sale is outside the normal course of business **AND** the price paid for the tangible personal property is less than \$1,000.

# MD – SALES TAX ON ASSET SALES OF BUSINESSES (CTD)

70

The Comptroller's website states its longtime policy that the sales and use tax applies on the purchase of a business to charges for “furniture and fixtures, computer software, business records, customer lists and non-capitalized goods and supplies.”

- A fixture is a piece of equipment or furniture which is fixed in position.

# MD – SALES TAX ON ASSET SALES OF BUSINESSES (CTD)

71

QUERY – The policy was developed decades ago when a customer list and other business records were transmitted on paper. Is a different result obtained in the case of electronic transmission? What if the buyer writes down needed information from the seller's records?

TIP – The tax is apparently avoided in the case of an allocation to goodwill even if defined to include a customer list, etc.

# MD – SALES TAX ON ASSET SALES OF BUSINESSES (CTD)

72

OBSERVATION – A buyer seeking to maximize the allocation to fixed assets as opposed to goodwill to obtain quick writeoffs must offset the benefit by the added sales tax to be paid.

OBSERVATION – The sales tax does not apply under similar circumstances in Virginia and the District of Columbia.



# MD – SALES TAX ON ASSET SALES OF BUSINESSES (CTD)

73

The Maryland sales tax is imposed on the buyer but the seller is secondarily liable. Accordingly, the seller's attorney should insist on collection of the full tax at closing with counsel remitting to the Comptroller.

# MD – ADMISSION AND AMUSEMENT TAX

74

- ❑ Imposed on gross receipts from admissions and/or services at places where entertainment is provided
- ❑ No deductions for cost of goods sold or prizes
- ❑ Tax owed even if no net income
- ❑ Rates set by local officials at county and/or city level
- ❑ Tax Rate ranges from .5% to 10% of gross receipts
- ❑ If activity is subject to S & U tax then A & A tax is limited to 5%
- ❑ Tax due in the subsequent month for one-time events, and assigned by the State for ongoing businesses
- ❑ Remittance issues may arise between owner and operator
- ❑ Increased audit risk for companies running illegal gaming operations
- ❑ Form COD/RAD 099
- ❑ Md. Code – Tax General Section 4-102

# DC – UNINCORPORATED BUSINESS TAX

75

The District of Columbia does not have an income tax on nonresidents per se but its 8.25 percent unincorporated business franchise tax may be applicable to nonresidents as well as residents.

The UBT applies to businesses or commercial activities carried on in DC with **gross** income of more than \$12,000 from DC sources and is reported on Form D-30.

# DC – UNINCORPORATED BUSINESS TAX (CTD)

76

The UBT includes the renting/leasing of real or tangible personal property.

The UBT excludes businesses and professional organizations where capital is not a material income producing factor and more than 80 percent of gross income is derived from personal services “actually rendered by owners or members of the business.”

TIP – Consider having non-owners receive a small percentage of interest in profits if the 80 percent test would not otherwise be met.

# DC – UNINCORPORATED BUSINESS TAX (CTD)

77

DC residents not having to file and pay the UBT because of sufficient owner-rendered personal services or insufficient gross receipts will report their income on a partnership or individual return.

Maryland gives residents credit for the UBT tax paid but Virginia does not.

# DC – BALLPARK TAX

78

The DC corporate and UBT tax returns ask if the taxpayer filed the annual ballpark tax return. A business filing either return must also pay the ballpark fee on Form FR1500 if it has DC gross receipts of \$5 million or more. A tax exempt organization is also liable if its DC gross receipts constituting unrelated business taxable income exceed the threshold.

The tax commenced in 2005 and raises in excess of \$21 million per year to help curtail the debt service on two issuances of bonds to fund the construction of Nationals Park. DC expects the bonds to be paid off by 2026 – ten years early.

# DC – BALLPARK TAX (CTD)

79

The gross receipts test is based on the most recent calendar or fiscal year ending prior to June 15. Filing and payment is due on June 15 and an electronic submission is required.

The tax is \$5,500 for gross receipts of \$5-\$8 million, \$10,800 for \$8-\$12 million, \$14,000 for \$12-\$16 million and \$16,500 for businesses with greater DC gross receipts.

# VA – INDIVIDUAL TANGIBLE PERSONAL PROPERTY (TPP) TAX

80

- ❑ Tax on value of TPP owned as of January 1<sup>st</sup>
- ❑ TPP includes: Motor Vehicles, Mobile Campers/Trailers, Mobile Homes, Boats/Watercraft, Aircraft, etc.
- ❑ Tax Rates vary depending on type of TPP and county/city
  - City of Fairfax is 4.13% of assessed value of taxable TPP
  - County of Prince George is 4.25% of assessed value of taxable TPP
- ❑ Due Date Varies by City/County
- ❑ VA § 58.1-3500 pursuant to Article X, § 4 of the Constitution of Virginia
- ❑ Maryland and DC do not have Individual TPP Taxes



# VA – SOFT DRINK EXCISE TAX

81

- ❑ Tax on every wholesaler or distributor of carbonated soft drinks
- ❑ Tax Based on Receipts
- ❑ Tax Ranges from \$50 if receipts are under \$100,000 to a tax of \$33,000 if receipts are over \$50,000,001
- ❑ Due 15<sup>th</sup> Day for fourth month following year end
- ❑ Form 404
- ❑ VA § 58.1-1700

# VA – LITTER TAX

82

- Every manufacturer, wholesaler, distributor and retailer of certain products (i.e. groceries, wine, motor vehicles parts, cleaning agents, toiletries, and newspapers, etc.) must pay
- Exempt Businesses include: Laundromats, Antique shops, Repair garages, etc.
- Rate is \$10 per locations plus \$15 dollars additional per location if location manufactures or distributes groceries, soft drinks or beer
- Due May 1<sup>st</sup>
- Form 200
- VA § 58.1-1707

# VA – BPOL TAX

The Business, Professional and Occupational License (BPOL) tax is a local option gross receipts tax on the privilege of doing business within a locality. Most counties and independent cities have a BPOL tax. Since 1996 localities have been forced to follow certain uniform guidelines in their tax. The guidelines were revised in 2000 and set maximum rates by types of business and required exemptions. Professionals, consultants and real estate brokers have the highest maximums.

# VA – BPOL TAX (CTD)

84

A taxpayer must obtain a license in each jurisdiction in which it has a “definite” place of business and in the jurisdiction in which the applicant resides if there is no definite place of business. There is no “throwback” to the locale of the principal office if a jurisdiction in which business is conducted has no tax.

Exempt businesses by law include farm products, most publications, manufacturers and landlords among others.

# VA – BPOL TAX (CTD)

85

An affected business must seek a license prior to the commencement of business.

The due date for renewal of a license is May 1.

The statute of limitations for failure to file is limited to the current year and three preceding years.

THANK YOU!

# ABOUT STEIN SPERLING

87

Stein Sperling, founded in 1978, provides a broad range of services to meet the business and personal needs of a broad range of clients. Our focus is on a team approach and our flexible and dynamic organizational structure offers our clients the benefit of our full range of legal resources in the following practice areas:

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Family Law

Construction Law

Injury Law

Criminal Law

Real Estate Law

Employment Law

Tax Law

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