[Portland Business Journal: Tax reform could lead to a huge commercial real estate crash]

Steve Breitstone has partnered with local tax experts all over the nation to speak out about certain of the GOP Blueprint proposals which he believes could be particularly devastating to real estate investment throughout the country. Steve has authored a number of opinion pieces on the immediate expensing provision in the Blueprint and the loss of the tax deduction on interest paid on debt to acquire real estate. Steve warns that the implementation of immediate expensing would serve up a severe double blow to real estate investors once their expensing is used up – creating another dangerous real estate bubble.

[Crain's Cleveland Business: Learn from our past mistakes to avoid the next real estate bubble]

Stephen M. Breitstone and Richard Brown of Integrity Group co-authored this opinion piece which was published on June 6, 2017.

http://www.crainscleveland.com/article/20170606/BLOGS05/170609890/learn-from-our-past-mistakes-to-avoid-the-next-real-estate-bubble

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[Bloomberg BNA Tax Management Real Estate Journal: Something New in the Toolbox: The Installment Sale-Reacquisition Approach to Real Estate Development Projects]

In a fairly common fact pattern in the recent upward-trending real estate market, a taxpayer owns land or air rights that it wishes to develop into an income-producing asset. The taxpayer and a developer agree that the developer will acquire a portion of the taxpayer's land or air rights provided that the taxpayer winds up owning an income-producing real estate asset on the property that it retains. In effect, the developer will construct improvements for the taxpayer in exchange for part of the taxpayer's property.

[Bloomberg BNA Tax Management Memorandum Article: A Financial and Income Tax Analysis of Earnouts]

One objective of this article is to sensitize the reader to these income tax rules so that unintended and adverse income tax results will not occur.
The other objective of this article is to point out the myriad of objectives an earnout can accomplish so that one can design the earnout terms to compliment these objectives.

[Madoff Victims Who Paid Taxes on Scheme Seek Refunds]

Madoff Victims Who Paid Taxes On Scheme Seek Refunds
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The typical Madoff investor who was victimized by the alleged

Stephen M. Breitstone

Ponzi scheme has paid it now seems never existed. (1) The question now is whether these victims can get back taxes they paid on phony income from the Madoff Ponzi scheme or whether the taxing authorities can retain the windfall they derived from the taxes those victims paid. A refund of taxes actually paid on fictitious Madoff income, if available, could, in the end, be a major source of recovery for Madoff victims. Moreover, for victims that are subject to a clawback of prior distributions in the Madoff bankruptcy the ability to recover prior taxes paid on clawed-back amounts would be a major offset to this type of financial insult. (2)

The Victims

Madoff victims have been portrayed in the media as wealthy and privileged individuals who were unjustly enriched by fictitious profits paid on their Madoff accounts. For that reason, it may be tempting to many to characterize the payment of tax refunds to Madoff victims as yet another Wall Street-like government bailout for the wealthy and connected. However, such portrayals or characterizations would be inaccurate and unfair. Many Madoff victims were either elderly individuals or retirees who merely were responsibly saving for the future and had the misfortune to trust a scoundrel. Many have been left destitute and virtually penniless. Many other Madoff victims did not withdraw accumulations of "profits" from their accounts, and they paid their taxes out of other resources. They never benefited from the Ponzi scheme in any fashion.

More to the point, the Madoff victims are not seeking a government bailout. What they are seeking from the government is a repayment of funds these victims were duped by the Ponzi scheme into dutifully paying to the taxing authorities over many years. Since it has now become clear that Madoff's profits and statements were fictitious and that taxes should not have been paid on those fictitious profits, the question will be whether these taxing authorities who received those taxes, perhaps unwittingly, but certainly inappropriately, will retain the windfall they derived from the pockets of the Madoff victims.

It seems fair and equitable that victims should be able to obtain refunds of taxes paid on income that never existed. However, there is, in general, a three-year statute of limitations that could be a bar to obtaining refunds of such taxes for years that would be considered "closed" under this statute of limitations.

The taxing authorities, often motivated by the administrative expedience resulting from closure of past years, attempt to cast the statute of limitations on refunds as sacrosanct. (3) In the case of the Madoff victims, the statute of limitations on refunds can add further insult to the financially devastating injuries recently suffered. While there are mechanisms in the Internal Revenue Code (IRC) that can, in appropriate instances, permit equitable principles to override the statute of limitations on tax refunds, it is unclear whether the Internal Revenue Service (IRS) will permit that to happen.

This article identifies the principal tax refund opportunities for victims of the Madoff fraud and explores statute of limitation mitigation provisions for tax periods otherwise closed by the statute of limitations. The reader should be cognizant that a number of the issues raised by the Madoff fraud break new ground and have not yet been resolved.

The ability of the Madoff victims to obtain otherwise-barred tax refunds depends upon the resolution of a number of procedural and factual issues. It also depends, in large part, upon whether the taxing authorities decide to allow these refunds, which they seem to have the authority to do-at least in many cases.

IRS' Precedential Stances

In other Ponzi-scheme-type cases the IRS has in informal unpublished guidance adopted certain legal positions that seem designed to limit to the maximum extent possible the refund potential for aggrieved taxpayers who made overpayments in reliance upon the fraud perpetrated upon them. (4) It is questionable whether positions taken internally by the IRS in these prior instances would hold up if challenged in court based on case law (the discussion of which is beyond the scope of this article). Nonetheless, it remains unclear whether the IRS will adopt a similar stance in the case of Madoff victims and whether the IRS will uniformly apply the principles in the field.

At least to date, there is no formal ruling position on many of these issues. Unless and until the IRS publishes more uniform guidance, each taxpayer may be required to develop its own unique strategy to maximize tax recoveries. In some instances it may become necessary to challenge the administrative determinations by the IRS in the courts.

Although on a factual level there are many variations, in analyzing the tax issues raised by the Madoff fraud it is useful to focus on two broad categories of Madoff victims. The first category consists of victims who drew out what they thought was income or principal from their Madoff accounts. In many instances, the withdrawals from Madoff accounts were one of the primary sources of funds that these victims used to pay living expenses. In other instances, withdrawals from the Madoff accounts were used to purchase homes and other large-ticket assets.

Victim Categories

This first category of victims paid tax on what was purported to be income, but which in hindsight seems to have been a return of their own capital or the capital of other victims. The principal issue for these victims is whether and to what extent they can get back the taxes they paid on the basis of fraudulent information, on amounts distributed to them, especially if they are required to repay some or all of the distributed amounts.

The second category of victims are those who invested funds with Madoff but did not make any withdrawals, or only withdrew some relatively small portion of the purported earnings. These victims also paid taxes on the purported earnings, but to the extent funds were not withdrawn, there obviously is nothing to claw back. Accordingly, the principal issue for these victims is whether they can get a refund of the taxes they paid on income that apparently never existed and never was actually received.

As will be discussed below, there appears to be authority for the IRS to grant refund relief to both categories of Madoff victims. However, as the Madoff fraud appears to raise certain novel issues, it is unclear whether the IRS will choose to grant such relief without a fight. As noted above, in prior similar cases the IRS has opted to minimize the refunds that could have been granted to the aggrieved taxpayers. (5)

Irrespective of whether they fall into the first category or the second category, Madoff victims in many instances should attempt to claim a theft loss deduction on their timely filed 2008 tax returns absent unusual circumstances. IRC §165(e). (6) Generally, the amount of the theft loss will equal the amount by which the victim's tax basis in his investment exceeds the portion of the loss, if any, for which there is a reasonable prospect of recovery.

In general, losses from thefts that exceed the current year's taxable income can be carried back three years pursuant to IRC Section 172(b)(1)(F), and thereby offset income reported in each of the preceding three taxable years, in this case 2005, 2006 and 2007. Net operating losses also can be carried forward 20 years pursuant to IRC Section 172(b)(1)(A)(ii), but it is obviously more valuable to obtain an immediate cash refund through a carryback than to reduce future tax liabilities (leaving aside the possibility of significant increases in tax rates in the next few years).

For victims who lost virtually everything in this scheme, the ability to carryforward losses into the future may be of little value since they may not have any significant future income. For those seeking carrybacks, it should be noted that there are certain procedures in the IRC for obtaining expedited refunds resulting from net operating loss carrybacks. Particularly those Madoff victims who otherwise may be left without any resources should explore whether these procedures will provide some relatively quick relief.

In claiming a theft loss, issues may arise as to the determination at the end of 2008 of the amount of the theft loss for which there is no reasonable prospect of recovery. If the IRS were to conclude that there was insufficient information available to make that determination, the IRS might use that as a basis to disallow a theft loss deduction for 2008. However, based on currently available information, a sufficiently accurate determination to support a material loss may well be possible for many victims. Furthermore, if a claim is not filed until 2009, the earliest possible year to which the theft loss may be carried back will be 2006 instead of 2005; so generally speaking, it is worth it for taxpayers to try to claim at least some theft loss for 2008.

There is a question as to whether, if the taxpayer has potential remedies in the bankruptcy proceeding or otherwise, the IRS could take the position that there is a reasonable prospect of recovery until those claims are resolved. Some value judgment must be made as to whether there is a significant likelihood of recovery and to what extent.

Informal IRS Memoranda

In two informal internal IRS memoranda the IRS expressed the view that no such claims should be allowed until the bankruptcy or other recovery litigation has run its course. However, it could be a serious mistake to rely upon that position in this case. It will likely take years for the entire bankruptcy proceeding to run its course. Given that there is a three-year carryback, and that going forward many Madoff victims will have limited income earning potential, the only opportunity to claim the carryback to years that actually have income may be if the loss is claimed 2008.

In addition to obtaining the benefit of a three-year net operating loss carryback for a theft loss, depending on their particular facts, it should also be possible for some victims to file amended returns going back up to three taxable years to seek a refund of taxes paid on what apparently was fictitious Madoff income reported during those periods. Based upon the informal IRS memoranda in other Ponzi scheme type cases, the IRS does not appear likely to accept amended returns except for victims who can show that they did not receive distributions up to their original investment. The outcome is less clear for victims who may have actually benefitted from the scheme even though in the past three years they might have reported and paid tax on phony income. Thus, appropriate victims should consider filing amended returns for 2005, 2006 and 2007. (They should also not report on their 2008 returns any income reflected on 2008 statements from Madoff.) However, in filing those amended returns, care should be exercised to maximize the potential for refunds for earlier periods under the statute of limitations mitigation provisions discussed below.

Prior to 2005

The more difficult question is whether it is possible to obtain refunds of taxes paid on phony Madoff income from periods earlier than 2005. The analysis differs depending upon whether the Madoff victim received funds that it might have to repay (category one, above); or whether they paid taxes on purported income that they never received (category two, above).

For category one victims, it appears relief may be found under IRC Section 1341. If and to the extent a victim is required to forfeit funds pursuant to a clawback, it would appear the victim should be entitled to essentially recoup the tax he or she paid on the income that gave rise to the clawback pursuant to IRC Section 1341. IRC Section 1341(a)(5)(B) allows an investor to receive a refund of the taxes paid in respect of income that is subsequently clawed back even if the clawed-back income was included in income in a year otherwise barred by the statute of limitations. See Treas. Reg. Section 1.1341-1(d)(4)(iii), Examples 4 and 5.

For category two victims, depending upon how the IRS chooses to react to the situation, there may be relief from the three-year statute of limitations pursuant to statute of limitation mitigation provisions contained in IRC Section 1311, et seq. For example, if a victim claims a theft loss deduction attributable to all of the phony income he paid taxes on over the years, and purportedly accumulated, the IRS may be inclined to deny a portion of that deduction on the grounds that the prior reported income was not "real" and therefore did not give rise to an increase in the victims tax basis in his "investment." If the IRS were to make a "determination" to that effect, the victim may be entitled to relief pursuant to the statute of limitations mitigation provision contained in IRC Section 1311 et seq, and more specifically IRC Section 1312(7). See Treas. Reg. Section 1.1312-7, Example 4.

It should be noted that in prior Ponzi scheme cases the IRS has not opted to take this position. Instead, it has taken the position that the phony income previously reported gives rise only to a current theft loss deduction. The theoretical basis for this position is dubious. It is unclear whether the IRS will adopt a similar stance in the case of Madoff victims. It is also unclear whether the IRS will adopt this position uniformly and in actual practice in the field.

From a tax policy perspective, if the government refunds taxes paid in tax years closed by the statute of limitations to category one victims who received distributions that they must now repay under Section 1341, it would seem that as a matter of consistency the government also should refund the taxes paid in tax years closed by the statute of limitations to category two victims on undistributed income that is now lost. Both sets of victims are in a similar economic position.

The IRS has a certain amount of discretion as a practical matter in deciding to make it easy or hard for taxpayers to obtain relief under these provisions. Accordingly, careful planning may be required to obtain the benefits of those provisions.

In determining how to proceed, victims should be cognizant that the manner in which they invested can affect their options. A victim who has invested through a feeder fund may need its own representation and may need to take certain tax positions that are inconsistent with the positions on the K-1 issued by the fund.

Conclusion

As the repercussions from Madoff's Ponzi scheme become clearer, it is certainly possible that the IRS will issue guidance for those affected by the fraud. Hopefully, the guidance, if issued, will be on a basis that provides meaningful relief to Madoff victims. Meaningful relief does not mean merely allowing theft loss deductions at the end of the bankruptcy for phony income that was previously taxed. That type of relief would be of little benefit since many Madoff victims have limited ability to benefit from such losses. Instead, the IRS should devise some method of returning the tax windfall it has unwittingly received on the backs of the defrauded Madoff victims. Although it might be administratively expedient for the IRS to retain those revenues, it certainly would be extremely unfair.

Similarly, one would hope that state or local tax relief may also be granted in some jurisdictions. In the meantime, investors should be mindful that each individual's avenue to potential recovery is different. Careful planning will be required to put an individual victim in the best posture to obtain the maximum tax refunds and net operating loss deductions.

1. Funds invested by charities and other tax exempts generally would not have been subject to income taxation.

2. Although the bankruptcy laws and fraudulent conveyance rules are beyond the scope of this article, it should be noted that victims who withdrew funds from their Madoff accounts may be required to repay all or a portion of those funds to the Madoff bankruptcy estate. The victims who withdrew the purported income on their accounts (as opposed to principal) are at the greatest risk of being subject to a clawback, which in many instances can reach back six years.

3. See, e.g., Non Docketed Service Advice Review, 2003 IRS NSAR 20419 (2003); and Chief Counsel Advisory, IRS CCA 200451030 (2004).

4. Id.

5. Id.

6. All references to the Code or the IRC are to the Internal Revenue Code of 1986, as amended.
Stephen M. Breitstone heads the tax and trusts and estates departments at Meltzer, Lippe, Goldstein & Breitstone in Mineola. Co-author José L. Berra is counsel to Meltzer, Lippe and formerly served in the U.S. Department of the Treasury's Office of Tax Policy.

Many Madoff victims were either elderly individuals or retirees who merely were saving for the future and had the misfortune to trust an alleged scoundrel. Many have been left virtually penniless.

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DIEBOLD and the Not So Beautiful: Transferee Liability Trumps Tax Shelter

By Jeffrey A. Galant

The Second Circuit, in Diebold v. Commissioner, describes the requirements for finding transferee liability under Section 6901, here specifically under New York law, as state law predominates the determination of whether a person will be liable for federal taxes as a transferee. This case involved a so-called "Midco"transaction, whereby the goal was to avoid the corporate level taxes on the disposition of the assets of a C-corporation.

A sale by the shareholders of their C corporation stock and a sale by the C corporation of its assets were recharacterized as a sale by the C corporation of its assets and then a liquidating distribution of the sale proceeds to the shareholders of the C corporation. This recharacterization allowed the Second Circuit to hold that the C corporation's shareholders had transferee liability under New York law with respect to the tax liability recognized by the C corporation on the sale of its assets. A remand to the Tax Court concerns whether such recharacterization satisfies federal law.

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On Historic Boardwalk: Substance is Key Regarding Partner Status

By Jeffrey A. Galant

"The core issue in Historic Boardwalk was whether an investor in a partnership would be considered to be a partner and as such would be eligible to receive an allocation of historic rehabilitation credits. More specifically, the question was whether the parties, a New Jersey state agency and a subsidiary of Pitney Bowes Corporation, acting with a business purpose, intended to join together as partners in a profit-making activity and share the gains and losses.

In reaching its decision, the Court was not unmindful of Congress' goal of encouraging rehabilitation of historic structures, pointing out, however, that such statute was not in question here. The issue for the Court was whether the transaction as a whole involved the prohibited sale of tax credits.

The recurrent theme throughout the Court's decision is its reliance on the principle that for income tax purposes a transaction must be judged by its substance rather than its form, and to be a bona fide partner for tax purposes, a party must have a meaningful stake in the success or failure of the enterprise."

View PDF Here: "On Historic Boardwalk: Substance is Key Regarding Partner Status."

Deducting or Capitalizing Expenditures Related to Tangible Property

At the end of December 2011, the Treasury and the IRS promulgated temporary regulations (Temp. Regs.) principally dealing with the application of the expensing rules of Section 162 and the capitalization rules of Section 263 with respect to tangible personal property. The Temp. Regs. are generally effective for amounts paid or accrued after 1/1/12.

A change to conform to the Temp. Regs. will be a change in method of accounting under Section 446(c). In general, a taxpayer seeking a change in method of accounting to comply with the Temp. Regs. has to take into account an adjustment under Section 481(a). On 3/8/12, the Service published Rev. Procs. 2012-19′ and 2012-20, which provide procedures whereby a taxpayer may obtain automatic consent to change its method of accounting to that provided in the Temp. Regs. for a tax year beginning on or after 1/1/12. Taxpayers will undoubtedly be comparing the principles in the Temp. Regs. with prior rules, including the manner in which the prior rules, including the manner in which the prior rules were applied to them on audit, to determine the impact of any such change….

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Partnership Characteristics - Confusion Reigns

By Jeffrey A. Galant

Recent litigation has put into question the tests for determining the validity of a partnership and one's status as a partner. The seemingly simple questions of whether, for tax purposes, a partnership exists and whether one is a partner require thoughtful, and sometimes complex, analysis to answer. There are two recognized tests for determining whether a partnership exists or whether one is a partner, but what remains uncertain is how these tests relate to each other.

Whether applying the subjective test under Culbertson, or the objective test under Section 704(e), the Castle Harbour cases have thus far made clear that where a purported partner's upside and downside are deminimus, such "partner" will not be respected as such for tax purposes."

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IRS Looks Closely at Tax Issues of Closely Held Businesses

By Jeffrey A. Galant

The recent decisions in *Menard*, *Inc*. and *Muskat* drive home the importance of a proper record to support the desired tax results. Involving settled law, each case was fact driven. At issue in *Menard* was the deductibility for income tax purposes of compensation paid to a chief executive officers. *Muskat* concerned the taxability of consideration received in connection with the sale of a business (i.e. whether such consideration is taxable as ordinary income or capital gain)…

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