



## What To Know About Like-Kind Exchange After Tax Reform

By John Charin, Associate at RSM US LLP

Like-kind exchange — long used as a valuable way to sell and buy property without taking a tax hit — changed significantly in recent tax legislation, commonly referred to as the Tax Cuts and Jobs Act (TCJA). While some of the impacts are well known, there are a number of important issues that anyone involved with like-kind exchanges should be aware of.

Like-kind exchange, generally contained within section 1031 of the Internal Revenue Code (IRC), enables a taxpayer to defer recognition of gain from the sale of property if it is exchanged for property of a like kind. The taxpayer applies the gain on the sale of the relinquished property to reduce its basis in the replacement property. This process can be repeated, and deferral can continue indefinitely. However, where the value of the relinquished property exceeds the value of the replacement property, or the taxpayer receives cash or other non-like-kind property in exchange, the taxpayer must recognize the excess gain or “taxable boot.”

The TCJA has reduced the number of possible like-kind exchange transactions, but deferring gain may be more valuable than ever for certain taxpayers under the new law. There are also several alternatives to like-kind exchange that may help taxpayers accomplish the same goals.

### Real estate only as of 2018

The biggest change introduced by the TCJA is that like-kind exchange is now restricted to real property.<sup>1</sup> Personal property and intangible property can no longer qualify.

It is important to note that the definition of “real property” as applied to like-kind exchange is fairly broad. There is no distinction between improved and unimproved land. Leasehold interests with terms of 30 years or more (counting renewals and options) count as real property interests that can be traded for any other real property.<sup>2</sup> Certain other interests in or appurtenant to land can potentially qualify (e.g., certain perpetual water rights),<sup>3</sup> although this is a more difficult determination.

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## Message from the Chair Anne R. Gordon



It’s hard to believe, but we are halfway through the year, and I want to update you on the spectacular year the Section has had thus far. This year continues to be one of the busiest yet, with the Section holding events across the country. Outside of Washington, D.C., the Section has held events in Dallas, Atlanta, New York, Miami, and Boston. In February, I had the pleasure of traveling to two of these events – Dallas and Atlanta. FBA Dallas Co-chairs Jeff Glassman & Josh Prywes coordinated an event at the City Club Dallas with Judge Kerrigan. Judge Kerrigan provided remarks and answered questions from the Dallas tax community. FBA Atlanta hosted an event with Commissioner Rettig, Commissioner of Internal Revenue, and Ken Corbett, Commissioner, Wage & Investment. The event was largely planned by FBA Atlanta Chair Chuck Hodges, along with the Atlanta Bar & Georgia Bar. Commissioner Rettig addressed a full house of private practitioners and government attorneys, urging everyone to work

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## FBA Section on Taxation News

### Boston Chapter Hosts Judge Nega

The Section's Boston Chapter hosted the Honorable Judge Joseph Nega of the Tax Court at an informal reception at the Boston Office of Ropes & Gray on April 1, 2019. Members of the Boston tax community had an opportunity to mingle and socialize with Judge Nega and each other. Judge Nega engaged in a wide-ranging conversation with attendees discussing recent Tax Court cases and providing insight on the inner workings of the Tax Court. ☞



### Atlanta Event with Commissioner Rettig

On February 26th, IRS Commissioner Rettig spoke at a joint event sponsored by FBA Tax, Georgia Bar Tax Section, and the Atlanta Bar Tax Section in Atlanta, Georgia. Over 100 members of the Atlanta tax community were in attendance, including members of IRS Wage & Investment, lawyers from IRS Chief Counsel, members of the Georgia Department of Revenue, including Commissioner Lynne Riley and her staff, in-house tax professionals, and private firm tax lawyers and CPAs. Anne Gordon, Chair of Section on Taxation, was also in attendance. Commissioner Rettig discussed his agenda as Commissioner and gave a memorable dedication to the members of our armed services. His entire presentation was well-received and appreciated by the entire Atlanta tax community. ☞



## FBA Section on Taxation News

### Young Tax Lawyer Event



On Thursday, January 24, 2019, the Young Tax Lawyer Group of the Section on Taxation held its first happy hour of the New Year for young practitioners and tax students in the Washington, D.C., metro area. The happy hour was held in Mount Vernon Triangle at the decommissioned firehouse, Sixth Engine. The event brought together approximately 30 tax lawyers from both the public and private sectors,

as well as many students from local law schools. The event included special guest Michael Desmond, since confirmed as Chief Counsel for the Internal Revenue Service and Assistant General Counsel in the Department of Treasury. Those who attended enjoyed happy hour drink specials and a variety of tasty appetizers. ☘

### Women in Tax Law Event



The Women in Tax Law Group held a luncheon on April 2, 2019 to discuss the basics of two key provisions of the Tax Cuts & Jobs Act. Jennifer Ray, a principal in the Washington National Tax Passthroughs Group of Deloitte Tax LLP, discussed IRC section 163(j), and Layla Asali, a member of Miller & Chevalier Chartered, discussed Global Intangible Low-Taxed Income (“GILTI”). The luncheon was hosted at the DC office of Alston & Bird and was attended by approximately 35 tax practitioners. ☘

## FBA Section on Taxation News

### FBA Dallas Event

The FBA's Section on Taxation, Dallas Chapter, hosted Judge Kathleen Kerrigan of the Tax Court to a welcome reception on February 25, 2019 at the City Club Dallas. Judge Kerrigan discussed a wide variety of topics and took questions from the nearly forty guests, comprising government and private tax practitioners as well as local law students. Members of the Dallas tax community also had an opportunity to socialize with Judge Kerrigan and each other. ☞



### FBA Section on Taxation Hosts CLE Breakfast at Eversheds Sutherland

On April 4, 2019, the Federal Bar Association's Section on Taxation and Eversheds Sutherland hosted a round table discussion on the proposed Treasury Regulations under section 250 ("FDII Regulations"). This conversation featured two of the drafters of the FDII regulations, Gary Scanlon (Department of the Treasury) and Marissa

Rensen (IRS Office of Chief Counsel (International)), who were joined by Danielle Rolfes, Robert Russell, and Taylor Kiessig. The group discussed the basic FDII calculations and discussed several examples in the regulations, which were designed to highlight ambiguous aspects of the proposed regulations. ☞



## FBA Section on Taxation News

### Tax Section honors Mark Prater with Liles Award



After concluding the 43rd annual Tax Law Conference on March 8, the Section on Taxation presented Mark Prater with the Kenneth H. Liles Award for Distinguished Service. The Liles Award is the Section's highest honor and is presented annually to recognize practitioners for outstanding service and dedication to tax policy and administration.

Prater "is a person whose work in tax policy has impacted the lives of literally hundreds of millions of people. Since 1990, [he] has been involved in nearly all, if not completely all, tax legislation that has been enacted into law," said Shamik Trivedi, chair emeritus of the Section. The Liles Award ceremony attracted dozens of attendees and guests of Prater, who served as Chief Tax Counsel of the Republican Staff of the Senate Finance Committee for nearly 25 years. After his service to the Congress, Prater joined PricewaterhouseCoopers in its national tax office.

Mark's former government colleagues, Jonathan Talisman and Nick Giordano, gave tributes, and Prater concluded the ceremony with his own remarks that advised policymakers and practitioners to consider the "three C's": Communication, Consideration, and Completeness.

The Liles Award is determined through a nomination and voting process conducted by the former chairs of the Section on Taxation. ☘

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with the IRS for greater tax compliance. Lynne Riley, Georgia Commissioner of Revenue, also attended the event and mingled with the attendees. In both cities, it was great to see so many engaged tax practitioners. The Section continues to grow its influence outside of Washington, and I urge our members and future members beyond the Beltway to get involved.

I am happy to report that the Section drew more than 500 attendees to the 43rd annual Tax Law Conference on March 7-8 at the Ronald Reagan Building. Attendees heard from dozens of officials from the IRS, Treasury Department, Department of Justice, and Congress. Commissioner Rettig provided the luncheon remarks and newly sworn-in IRS Chief Counsel Mike Desmond attended as well. The conference concluded with the presentation of the Kenneth H. Liles award to Mark A. Prater in recognition of his nearly 25 years as a staff member on the Senate Finance Committee. As the tax bar grapples with the implementation of the Tax Cuts and Jobs Act, events like the Tax Law Conference, as well as the Insurance Tax Seminar in May, will be critical education opportunities. My personal thanks to our Chairs Matthew Hicks of Caplin & Drysdale and Robin Greenhouse of the IRS Office of Chief Counsel, LB&I for their efforts to organize the Tax Law Conference. I would also like to thank all of our Vice chairs for their efforts: David Berke, Kristina Novak, Kandyce Koroky, and Sophia Sidiqi.

With tax reform on everyone's mind, we've also hosted several informative events. For example, the Section has co-hosted a number of breakfasts with Eversheds Sutherland on proposed regulations. On April 4 the panel discussed the recently released Section 250 Foreign Derived Intangible Income proposed regulations. The lively discussion helped

clarify taxpayer questions and allowed for informal feedback to the government. We plan to continue the series, with an event discussing the Opportunity Zone Regulations next month. The Women in Tax Law chairs Teresa Abney, Carina Federico and Lisandra Ortiz arranged a primer on 163(j) and GILTI over lunch at Alston & Bird. Layla Asali (Miller & Chevalier) and Jen Reichert (Deloitte) expertly walked the attendees through the basics of the new rules, and answered questions.

Also on the horizon, the Section will hold the Insurance Tax Seminar on May 30-31 in Washington, DC, chaired by Jean Baxter of Deloitte, Surjya Mitra of PwC LLP, and Alexis MacIvor of the IRS Office of Chief Counsel. This is widely considered the premier event in Insurance Tax and is shaping up to be another successful year. We are thrilled that Commissioner Rettig will provide the keynote address. Thank you in advance to the entire planning committee and all of our generous sponsors.

Throughout the year, the Section has hosted numerous happy hours, networking events, and panel discussions benefiting students and young lawyers. This summer we look forward to our inaugural Diversity & Inclusion Committee event as well as continued programming from the Young Tax Lawyer Committee, Community Outreach Committee, and Women in Tax Law Committee.

I urge you to continue to attend events and to get involved in the Section. As always, if you have any ideas or suggestions, please reach out to me. ☘

Best regards,  
Anne R. Gordon  
Chair, Section on Taxation (2018-2019)

## LIKE-KIND continued from page 1

Depreciation rules do not determine whether property is real property that qualifies for like-kind exchange. The distinction between IRC § 1245 and IRC § 1250 property is not determinative. State law definitions of real property generally control,<sup>4</sup> which allows certain fixtures to qualify. For example, network cabling – considered personal property that is depreciable under IRC § 1245 – would likely be real property that is exchangeable under IRC § 1031.

Due to the broad definition of real property, there may be ways to structure transactions to qualify even when the property involved is not a fee interest in land. New interests in real estate can be created in order to use like-kind exchange rules as a way to construct improvements on land being newly acquired.

Although real estate transactions already made up the majority of like-kind exchanges, the new rule closes the door on a number of practical uses. For example, holders or dealers of expensive equipment, including automobiles and construction equipment, frequently used like-kind exchange to replenish their fleets. Like-kind exchange has been common in large fine art transactions. It has recently been a valuable tool to reinvest the proceeds from FCC spectrum auctions for television and radio broadcasters. Cryptocurrency traders used like-kind exchange to reinvest the proceeds of certain trades. For businesses in these industries, it is important to understand other options for minimizing the impact of losing like-kind exchange. Even when using like-kind exchange for real estate transactions, there are new considerations.

### Cost segregation studies now have more impact

Personal property is usually exchanged when transferring buildings, and it will generally create taxable gain in a sale. This was true before the TCJA. However, it was often possible to offset the types of personal property involved in a sale with personal property of like-kind in a real estate for real estate trade. As a practical matter, taxpayers often underestimate how much tangible property they have in a building without a cost segregation study.

Cost segregation studies are expected to become more prevalent as a result of the new rules on depreciation in the TCJA. As more property is revealed to be tangible personal property rather than real property, this means more taxable gain in the sale of a building. Cost segregation studies may become more conservative, as studies undertaken after an exchange frequently reveal a taxable gain that must be recognized in the current year.

Intangible property attached to a building can no longer be exchanged, and this may include leases, exclusivity agreements, or other types of property. However, a lease is considered an interest in real estate if it is 30 years or longer.<sup>5</sup> Renewal options count for this computation.<sup>6</sup>

When selling a building that has tenants with active leases, it can be difficult to determine whether the lease has value that must be recognized as gain as opposed to being inherently captured in the value of the real estate.

### Bonus depreciation – a worthy substitute

The TCJA introduced new bonus depreciation rules that will soften the impact of losing like-kind exchange for property like equipment and vehicles. One hundred percent bonus depreciation is available for property placed in service after September 27, 2017 until December 31, 2022.<sup>7</sup> Although taxpayers will have to recognize gain on the sale of property being replaced, the ability to fully expense the new property will often outweigh that gain. Importantly, TCJA now allows full expensing of used property, where before bonus depreciation was only available for new property.<sup>8</sup>

Bonus depreciation is not available for taxpayers with floorplan financing (generally automobile dealers).<sup>9</sup> Although floorplan interest is deductible under the TCJA, under the current proposed regulations bonus depreciation is not available on the assets of taxpayers with floorplan financing who do not qualify for the small business exception under IRC § 448(c).<sup>10</sup> Bonus depreciation is also not available for property that is required to be depreciated using ADS.<sup>11</sup>

### Installment sales – a partial solution

Where like-kind exchange is unavailable or impractical, installment sales can help avoid recognizing all the income from a sale in the first year. Under IRC § 453, a sale with payments spanning multiple tax years follows the installment method of accounting and defers some of the income into the later tax year(s). Structuring a transaction to pay over multiple tax years may not be as useful as like-kind exchange's indefinite deferral of gain, but it may help taxpayers who are eager to spread out their tax liability. Installment sales can be effectuated simply through the contract, or by using a deferred sales trust to spread a lump-sum payment over a number of years.

### Qualified Opportunity Zones

Much has been written about the potential to defer capital gains using Qualified Opportunity Funds (QOFs). In general, QOFs offer a way to defer gain on the sale of capital assets (including real property as well as personal property and intangibles) if the proceeds are invested in accordance with IRC §§ 1400Z-1 and 1400Z-2. Replacement property must be situated within a Qualified Opportunity Zone, but the relinquished property may be anywhere. While QOFs do not allow complete permanent deferral,<sup>12</sup> they offer other advantages including the potential for permanent forgiveness of the appreciation on

replacement property.<sup>13</sup>

### Bottom line

Like-kind exchange is still a very valuable tool for real estate transactions after the TCJA. However, real property is now the only property that qualifies, and even IRC § 1245 property exchanged in the sale of a building will create gain that cannot be deferred. Taxpayers using like-kind exchange for other types of property will need to pursue new strategies, which may include looking to installment sales or Qualified Opportunity Funds to defer gain into later tax years. ☞

### Endnotes:

<sup>1</sup>See H.R. Rep. No. 115-466, at 13303(a) (2017); see also IRC § 1031(a).

<sup>2</sup>Treas. Reg. § 1.1031(a)-1(c); see also PLR 201706009 (including renewal options).

<sup>3</sup>PLR 200404044.

<sup>4</sup>See CCA 201238027 (discussing how federal income tax law ultimately controls the classification of property

for purposes of like-kind exchange, but state law characterizations are generally the most persuasive).

<sup>5</sup>Treas. Reg. § 1.1031(a)-1(c).

<sup>6</sup>E.g. PLR 201706009 (including renewal options in less-than-fee interests including leaseholds and easements).

<sup>7</sup>IRC § 168(k)(1)(A).

<sup>8</sup>See generally Treas. Reg. § 1.168(k)-1(b) (establishing requirements for acquired property in addition to original use property).

<sup>9</sup>IRC § 168(k)(9)(B) (defining qualified property to exclude property used in a trade or business that has had floor plan financing indebtedness).

<sup>10</sup>Id.; see also IRC § 163(j)(3) (excluding from the limitation qualified small businesses that are not tax shelters); Prop. Treas. Reg. § 1.163(j)-2 (limiting taxpayers other than small businesses).

<sup>11</sup>IRC § 168(k)(2)(D).

<sup>12</sup> See generally IRC § 1400Z-2(b)(2)(B) (requiring partial recognition at certain milestones).

<sup>13</sup>IRC § 1400Z-2(c).



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## Department of the Treasury's Policy Statement on the Tax Regulatory Process: Two Perspectives

### Department of the Treasury's Policy Statement on the Tax Regulatory Process: Explanation and Analysis

*By Shira Helstrom and Michael Kummer, both Associates at Morgan Lewis & Bockius LLP in Washington D.C.*

On March 5, the Department of the Treasury (Treasury) released a short "Policy Statement on the Tax Regulatory Process" reaffirming their commitment to a tax regulatory process that "encourages public participation, fosters transparency, affords fair notice, and ensures adherence to the rule of law." The two-page policy statement covered a wide range of issues of critical importance to anyone who relies on Internal Revenue Service (IRS) guidance, participates in the tax regulatory process, or wonders how or when Treasury and the IRS will issue additional interpretations of the recent Tax Cuts and Jobs Act (TCJA).

In short, the policy statement indicated that Treasury and the IRS issued the statement to clarify and affirm their commitment to sound regulatory practices through (1) committing to notice-and-comment regulatory rulemaking; (2) limiting the use of temporary regulations; (3) limiting notices announcing intent to propose regulations; and (4) confirming that the IRS will not take positions inconsistent with its subregulatory guidance in effect (i.e., Revenue Rulings, Revenue Procedures, Notices, and Announcements), but also will not seek judicial deference to subregulatory guidance under *Auer v. Robbins*<sup>1</sup> or *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*<sup>2</sup>

#### Important Historical Context

There has been a trend over the last several years of bringing tax law within the broader administrative law regimes that apply to other government agencies. In 2011, the Supreme Court announced in *Mayo Foundation for Medical Education and Research* that it was "not inclined to carve out" an approach to reviewing regulations that was "good for tax law only."<sup>3</sup> This was in response to a debate in the lower courts over whether the multi-factor test governing the Court's analysis of Treasury regulations as set forth in *National Muffler Dealers Association*<sup>4</sup> applied in the case at issue, or whether the more deferential two-step test in *Chevron* applied. The Court held that the principles underlying the decision in *Chevron* apply "with full force in the tax context."<sup>5</sup>

Shortly thereafter, the US Department of Justice's Tax Division announced that the Tax Division would no longer argue for *Chevron* deference to subregulatory guidance.<sup>6</sup>

Subregulatory guidance does not follow the same notice and comment procedures applied to regulations, which the Court stated in *Mayo* is a "significant sign that a rule merits *Chevron* deference."<sup>7</sup>

The trend accelerated following the enactment of the TCJA. In April 2018, several months after the TCJA was enacted, General Counsel McIntosh explained that "[s]wift and successful implementation" of the TCJA through guidance from Treasury and the IRS was critical, and that Treasury was also examining the tax regulatory process.<sup>8</sup> Also in April 2018, Treasury entered into a collaboration with the White House Office of Information and Regulatory Affairs (OIRA) that ended the longstanding practice of exempting tax rulemaking from OIRA review (the framework for other agencies' rulemaking).

Around the same time, OIRA hired Professor Kristin Hickman, one of the leading scholars on the interplay between administrative law and tax rulemaking, as a special advisor. Much of Professor Hickman's academic work covers the precise topics discussed in the policy statement.<sup>9</sup>

#### The Policy Statement

The Policy Statement on the Tax Regulatory Process clarified and affirmed the position of the Treasury and the IRS, but it also altered the existing tax regulatory landscape in a few meaningful ways and left some unanswered questions.

The policy statement, signed by David J. Kautter, assistant secretary for tax policy, and Brent J. McIntosh, general counsel for the Treasury, first confirmed that the "best practice for agency rulemaking is the notice-and-comment process established by the Administrative Procedure Act (APA)." The policy statement explained that the notice-and-comment process "enables the public to apprise the government of relevant information [or] alert the government to consequences that it may not foresee." The APA generally requires notice and comment for legislative rules—those that have the force and effect of law.<sup>10</sup> But the policy statement also committed "as a matter of sound regulatory policy" to continue to use the notice-and-comment process for interpretive rules—those that do not have the force and effect of law<sup>11</sup> and are published in the Code of Federal Regulations.

## Department of the Treasury's Policy Statement on the Tax Regulatory Process: Two Perspectives

Second, the policy statement acknowledged that Treasury and the IRS have long interpreted the Internal Revenue Code to “permit the issuance of immediately-effective temporary tax regulations without a statement of good cause.” This was a divergence from the APA, which requires an agency to include a statement explaining its finding of good cause when promulgating an interim final rule that becomes effective immediately without notice and comment.<sup>12</sup> The policy statement indicated a reversal of the Treasury and IRS interpretation, and it committed Treasury and the IRS to providing a statement of good cause when, in what it referred to as “exceptional circumstances,” sound tax administration requires temporary regulations to be without the notice-and-comment process. The policy statement also noted the requirement under the Internal Revenue Code that temporary regulations expire within three years of issuance, and stated that any final regulations will be subject to notice and comment.

Third, the policy statement confirmed that the Treasury and the IRS will not argue that subregulatory guidance has the force and effect of law, and will not ask the US Tax Court to apply *Auer* deference or *Chevron* deference to subregulatory guidance. The IRS also retained its commitment not to “take positions inconsistent with its subregulatory guidance when such guidance is in effect.” The policy statement acknowledged the need for taxpayers to have clarity and certainty concerning the IRS’s interpretation of the tax laws, but also noted that in applying subregulatory guidance, it is important to consider the effect of subsequent legislation, court decisions, rulings, and procedures.

Fourth, the policy statement described the practice of publishing notice of Treasury’s and the IRS’s intent to issue proposed regulations in the *Internal Revenue Bulletin*. The policy statement explained that if no proposed regulations or other guidance is released within 18 months after the date a notice is published, taxpayers may continue to rely on the notice but are not required to do so—Treasury and the IRS will not assert a position adverse to taxpayers “based in whole or in part on the notice.”

### Where Does This Leave Us and Where Do We Go from Here?

Taxpayers should take comfort in many of the Treasury and IRS positions included in the policy statement, particularly that Treasury and the IRS will continue to not take positions that are inconsistent with applicable subregulatory guidance<sup>13</sup> or adverse to taxpayers based on notices of intent to issue regulations until additional guidance is issued.

There are also, however, some open questions raised by the policy statement in light of the issues it did not

address. For example, it did not indicate the level of deference courts should apply to regulations (as opposed to subregulatory guidance), which is an increasingly debated topic and one that Justice Neil Gorsuch raised in a recent tax case when questioning whether *Chevron* deference “retains any force” with respect to regulations.<sup>14</sup>

With respect to deference to subregulatory guidance, the policy statement did not mention *Skidmore* deference.<sup>15</sup> Although *Skidmore* deference is generally the lowest level of deference—a case-by-case inquiry that depends on a piece of guidance’s “power to persuade” even if it lacks “power to control”—the IRS and the Department of Justice’s Tax Division often requests and receives *Skidmore* deference for subregulatory guidance.<sup>16</sup> *Skidmore* deference has been criticized as being hard to apply and, thus, the analytical framework for applying and relying on guidance might become murkier than under *Chevron* deference or *Auer* deference.<sup>17</sup> The policy statement also left open the question of the extent to which subregulatory guidance taxpayers use to support a position should be accorded less weight, despite the fact that Treasury and the IRS will not take positions inconsistent with the subregulatory guidance in effect.

The policy statement also left open the question of subregulatory guidance that is not published in the *Internal Revenue Bulletin*. These forms of guidance, such as “frequently asked questions” and “issue snapshots,” provide taxpayers with guidance on new and emerging issues.<sup>18</sup> How, if at all, these other important types of subregulatory guidance should be viewed is not entirely clear.

### Conclusion

The Policy Statement on the Tax Regulatory Process made many welcome and meaningful pronouncements that taxpayers should appreciate. A number of important questions remain, however, only a handful of which are raised above. It will be important for taxpayers and practitioners alike to consider those unanswered questions and their effects going forward—especially as we continue to grapple with the uncertainty and ambiguity created by the TCJA. ❧

### Endnotes:

<sup>1</sup>519 U.S. 452 (1997). Under *Auer*, a Court will defer to an agency’s interpretation of its own regulation unless “plainly erroneous or inconsistent with the regulation.

<sup>2</sup>467 U.S. 837 (1984). Under *Chevron*, a court will defer to an agency’s interpretation of a statute if Congress has not “directly spoken to the precise question at issue. If the statute is silent or ambiguous with respect to the specific issue and there was an express delegation of authority to

## Department of the Treasury's Policy Statement on the Tax Regulatory Process: Two Perspectives

an agency to elucidate a specific provision of the statute by regulation, the resulting regulations would be given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. If there is only an implicit rather than explicit delegation to an agency on a particular question, the court will defer to the agency's reasonable interpretation of the statutory provision.

<sup>3</sup>*Mayo Found. For Med. Educ. & Research*, 562 U.S. 44 (2011).

<sup>4</sup>440 U.S. 472 (1979).

<sup>5</sup>*Mayo*, 562 U.S. at 57-58.

<sup>6</sup>See Marie Sapirie, "ABA Section of Taxation Meeting: DOJ Won't Push Chevron Deference for Revenue Rulings," *Tax Notes Today* (May 16, 2011) (quoting Acting Deputy Assistant Attorney General (Review and Appellate) Gil Rothenberg).

<sup>7</sup>*Mayo*, 562 U.S. at 55-56.

<sup>8</sup>Statement of Brent J. McIntosh, General Counsel, US Department of the Treasury, Before the Senate Subcommittee on Regulatory Affairs and Federal Management (Apr. 12, 2018).

<sup>9</sup>See, e.g., Kristin E. Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements," 82 *Notre Dame L. Rev.* 1727 (2007); Kristin E. Hickman, "IRB Guidance: The No Man's Land of Tax Code Interpretation," 2009 *Mich. St. L. Rev.* 239 (2009).

<sup>10</sup>*Chrysler Corp. v. Brown*, 441 U.S. 281, 302-03 (1979).

<sup>11</sup>*Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 99 (1995).

<sup>12</sup>See 5 U.S.C. § 553(b)(B) (providing for "good cause" finding and "a brief statement of reasons therefor" when

an agency issues regulations after finding that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest").

<sup>13</sup>See Internal Revenue Manual § 32.2.2.10(4) (Aug. 11, 2004) ("Chief Counsel attorneys must follow legal positions established by publications in papers filed in Tax Court or in defense letters or suit letters sent to DOJ. Chief Counsel attorneys may not rely on case law to take a position that is less favorable to a taxpayer in a particular case than the position set forth in a publication.").

<sup>14</sup>*BNSF Ry. Co. v. Loos*, 586 U.S. \_\_\_\_ (2019) (slip op.) (Gorsuch, J., dissenting).

<sup>15</sup>See *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944).

<sup>16</sup>See, e.g., *Webber v. Commissioner*, 144 T.C. 324, 357-60 (2015); *W.E. Partners II, LLC v. United States*, 119 Fed. Cl. 684 (Ct. Cl. 2015) (granting *Skidmore* deference to subregulatory guidance and holding for the United States).

<sup>17</sup>See, e.g., *Aeroquip-Vickers, Inc. v. Commissioner*, 347 F.3d 173, 184 (6th Cir. 2003) (Clay, J., dissenting) (criticizing the majority for nominally applying *Skidmore* deference despite the IRS's request for Chevron deference on the basis that the majority "overstate[d] the level of deference revenue rulings receive").

<sup>18</sup>See, e.g., Opportunity Zones Frequently Asked Questions (last updated Jan. 11, 2019); FATCA Frequently Asked Questions (last updated Nov. 29, 2018).

### Publication Opportunity: Inside Basis

The FBA's Section on Taxation is searching for submissions for the next edition of Inside Basis. Anyone who wants to submit an article to the newsletter should contact [brandon.king@bakermckenzie.com](mailto:brandon.king@bakermckenzie.com).

## Department of the Treasury's Policy Statement on the Tax Regulatory Process: Two Perspectives

### Department of Treasury and IRS's March 5, 2019 Policy Statement: New Policy or More of the Same

By Benjamin Tompkins, Attorney at KennyHertz Perry

On March 5, 2019, the Department of Treasury and the IRS issued a "Policy Statement on the Tax Regulatory Process." Despite recent taxpayer challenges to regulations, notices and other policy guidance, the Statement "reaffirm[s] their commitment to a tax regulatory process that encourages public participation, fosters transparency, affords fair notice, and ensures adherence to the rule of law." This Statement is consistent with Executive Order 13789 which provided that "tax regulations provide clarity and useful guidance" to ensure tax regulations do not increase tax burdens or impede economic growth. *See also* Steven T. Mnuchin, SECOND REPORT TO THE PRESIDENT ON IDENTIFYING AND REDUCING TAX REGULATORY BURDENS (Oct. 2, 2017). Time will tell whether this goal rings true or rings hollow. However, this does appear to be a clarification of the government's position concerning the regulatory process and is consistent with the overall approach of the current administration to ease regulations. Given the delays and difficulties associated with implementing P.L. 115-97 (tax reform), tax practitioners should welcome this commitment. However, tax practitioners must encourage participation in the notice and comment process and also hold the government accountable in order to ensure the implementation of procedurally sound regulatory policy.

#### Taxpayers continue to challenge regulatory actions

Under the IRC, the Secretary "shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." 26 U.S.C. § 7805(a). In *Mayo Foundation for Med. Educ. And Research v. United States*, the Supreme Court found that *Chevron* deference – as opposed to a greater form of deference – applied to Treasury Department and IRS regulations. *See*, 562 U.S. 44, 56-58 (2011) (Supreme Court stated that it's "not inclined to carve out an approach to administrative review good for tax law only"). In issuing regulations, taxpayers have challenged IRS's actions that did not provide for notice and comment, and whether the Service complied with the APA, including whether the actions were arbitrary and capricious. Notice and comment generally applies to substantive or legislative rules that "affect individual rights and obligations" and are "issued by an agency pursuant to statutory authority." *Chrysler Corp. v. Brown*, 441 U.S. 281, 302 (1979). Interpretive rules are generally

permitted to be issued without subjecting them to notice and comment. *Perez v. Mort. Bankers Ass'n*, 135 S. Ct. 1199, 1203 (2015); *see also* 5 U.S.C. § 553(b).

In challenging an IRS regulation, traditionally taxpayers either (1) waited to be audited, received a statutory notice of deficiency and then petitioned the United States Tax Court or (2) paid the tax due, filed a claim for refund and then filed suit after waiting the requisite time period. In response, the government moved to dismiss pre-enforcement challenges as lacking standing or being barred by the Anti-Injunction or Declaratory Judgment Acts. *See* 26 U.S.C. § 7421 & 28 U.S.C. § 2201. However, recent courts have expressed a willingness to allow challenges under the APA if the plaintiff has suffered an injury in fact.

#### Summary of the Policy Statement

The Statement has four main sections. First, the Statement reiterated the commitment to the notice and comment rulemaking process provided in the APA. The administrative process provides the public with the opportunity to participate "before any final rule becomes effective and ensures that all views are adequately considered." The process also allows the public to provide information that the government may not have and "alert the government" to possible consequences of the proposed action.

Second, the government might change how it uses temporary regulations. The government promises to include a statement of good cause if it uses temporary tax regulations. Previously, the position of the government was that the Internal Revenue Code permitted Treasury and the IRS to issue "immediately-effective temporary tax regulations without a statement of good cause." This Statement implicitly recognizes that sound regulatory policy suggests that the government allow for notice and comment and only issue temporary regulations when there is good cause. The government made this commitment while also recognizing that there are other IRC limitations that "mandate that temporary regulations must expire within three years of issuance and that proposed regulations must be issued simultaneously with any temporary regulations." *See also* 26 U.S.C. § 7805(e) (IRS authority for issuing temporary regulations). Thus, even when temporary regulations are used, the government contends any final regulations will still "be

## Department of the Treasury's Policy Statement on the Tax Regulatory Process: Two Perspectives

subject to notice and comment.” However, Courts will continue to decide cases in which taxpayers challenge temporary non-interpretative regulations issued prior to notice and comment.

Third, with regards to what it refers to as “subregulatory guidance” the government recognizes that this guidance cannot be used to “affect taxpayer rights or obligations independent from underlying statutes or regulations.” The government provided that if there is clear subregulatory guidance, including “revenue rulings, revenue procedures, notices and announcement,” the IRS “will not take positions inconsistent with its subregulatory guidance when such guidance is in effect.” Furthermore, for purposes of Tax Court litigation, the IRS will not argue that this guidance is entitled to deference. *See Auer v. Robbins*, 519 U.S. 452 (1997) or *Chevron v. U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). However, this Statement does not and cannot preclude the Department of Justice from arguing for any such deference. Furthermore, the Statement noted that it does not apply to regulations issued jointly with HHS and the Department of Labor.

Finally, the Statement describes the position of the IRS on notices of intent to issue proposed regulations. Generally, the notices describe the scope and content of possible regulations and can include statements that taxpayers can rely upon in taking tax positions, and may also invite comments. In this Statement, the government recognizes that sometimes the regulations are not promulgated, which “can cause confusion or uncertainty for taxpayers.” In order to limit this possibility, the government agreed to “include a statement in each future notice . . . that if no proposed regulations or other guidance is released within 18 months after the date the notice is published, taxpayers may continue to rely on the notice. . . .” The Statement also provides that neither the Treasury Department nor the IRS will assert a position adverse to the taxpayer based in whole or in part on the notice. Once again, this would not preclude DOJ from using the notice, especially where the taxpayer had notice and elected to take a contrary position.

The Statement concludes that it “is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity by any party against the United States, its departments, agencies or entities, its officers, employees, or agents, or any other person.” This general language is standard and a recognition that neither the Treasury Department nor the IRS has such authority.

### Implications for practitioners

Practitioners will have to wait and see what the

Statement’s full impact will be. Initially, this Statement is not intended to include taxpayer specific actions, such as the issuance of a notice of deficiency. *See Qinetiq US Holdings, Inc. & Subs. V. Comm’r*, 845 F.3d 555 (2017) (notice of deficiency was not subject to the APA), cert. denied 138 S. Ct. 299 (2017). Second, this statement will presumably be used taxpayers seeking to rebut attempts by the government to dismiss suits under the AIA or the Declaratory Judgment Act. *See Florida Bankers Ass’n v. United States Dept. of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015); *CIC Services, LLC v. IRS*, 2017 WL 5015510 (following Florida Bankers Ass’n to dismiss a similar challenge to IRS Notice 2016-66), on appeal, Case No. 18-5019 (6th Cir.). *But see Chamber of Comm. of U.S. v. Int. Rev. Serv.*, Case No. 2017 WL 4682050, at \*4-\*6 (W.D. Tex. Oct. 6, 2017) (found that temporary regulation issued without notice and comment violated the APA and the challenge was not precluded under the AIA or for lack of standing), appeal dismissed, 2018 WL 3946143 (5th Cir. July 26, 2018). Indeed, in *CIC*, the taxpayer recently filed a notice of supplemental authority referencing this Statement and asserting the government failed to comply with it. In response, the government asserted the Statement does not provide any substantive rights. *Cf.* Chief Counsel Notice CC-2003-014 (May 8, 2003) (policy of the IRS (as opposed to DOJ who is litigating the appeal) not to take positions contrary to IRS guidance). Even if the Court considers the Statement, and assuming the AIA does not preclude the pre-enforcement challenge, it remains to be seen whether Section four will help since Notice 2016-66 does not refer to proposed regulations and instead requires the disclosure of certain micro-captive transactions and warns of possible penalties for failures to disclose.

What is clear is that taxpayers and other organizations will continue to challenge the actions of the government, the government needs to be prepared to defend those actions in a consistent manner. Given the overall budgetary constrains and other resource challenges, the government; should ensure compliance with the applicable regulatory requirements and implement regulations, policies, and other guidance that are consistent with the Statement. ☞

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## Safe Harbor for Pass-Through Deduction for Real Estate: Landlords Should Take Action Now

*By Katie Lepore, Associate at Miller, Monson, Peshel, Polacek & Hoshaw*

Landlords should be aware of new recordkeeping requirements if they want to qualify for tax breaks.

Internal Revenue Code (“IRC”) Section 199A was instituted in December 2017 under the Tax Cuts and Jobs Act. It allows a deduction of up to 20% of “qualified business income.” The Section is effective for tax years 2018 through 2025. Proposed Regulations were released August 8, 2018, which stated that only “trades or businesses” would qualify for the deduction, as defined under IRC Section 162. This requirement leaves much uncertainty since the IRC Section 162 “trade or business” qualification is largely a facts-based test and is not actually defined in IRC Section 162. Taxpayers and tax advisors alike submitted comments to the IRS about this uncertainty, especially with regard to rental real estate.

Final Regulations were released on January 18, 2019 along with Revenue Procedure 2019-11 (guidance to calculate W-2 wages). In conjunction with the final Regulations and Revenue Procedure, the IRS also released a proposed Revenue Procedure in Notice 2019-07, which provides a safe harbor for rental real estate to qualify as a trade or business for purposes of Section 199A. Section 199A is rather complex and multi-faceted; the safe harbor and its application to rental real estate will be the sole focus of this article. Taxpayers may rely on the safe harbor provided in the Notice until it is published as a final Revenue Procedure.

### General Background

Section 199A is applicable to non-corporate taxpayers only, including some trusts and estates. The Section allows a deduction for “qualified business income,” which is a defined term in Section 199A. Sole proprietorships are included as a source of pass-through income in addition to partnerships, S-corporations, limited liability companies, and some trusts and estates. The Section is complex and has different calculations depending on the type of business and the income levels of the taxpayer, and has further possible restrictions based on the wages paid or depreciable assets of the business. Only qualified trades or businesses are eligible for the deduction. Provided next is analysis of the safe harbor distinguishing whether the rental real estate qualifies as a trade or business eligible for the deduction. If it does qualify, taxpayers will need to analyze their income levels and, if required, the further restrictions based on wages paid and depreciable assets, in order to calculate the allowable deduction.

### Notice 2019-07

Notice 2019-07 solely applies to Section 199A trade

or business analysis. Therefore, whether a real estate enterprise qualifies as a trade or business for Section 199A will not extend automatically to make the same real estate enterprise qualify as a trade or business under Section 162 or any other section. If a taxpayer’s rental real estate does not qualify as a trade or business under the safe harbor, it may still qualify for Section 199A if it can be considered a “trade or business” under Section 162; therefore, the two Sections are not mutually exclusive. The Notice also applies to taxpayers and pass-through entities that hold real estate through a disregarded entity. Rental real estate is defined in the Notice as “an interest in real property held for the production of rents.”

### Separate Books and Records

The first requirement to qualify as a trade or business under the Notice is to keep separate books and records. The taxpayer must either treat each real property held for the production of rents as a separate “enterprise,” or treat all similar properties as a single enterprise. Therefore, for example, several single-family homes used to collect rents may be grouped together as the same “enterprise.” However, commercial properties must be separated from residential properties and cannot be part of the same enterprise. Triple net lease properties unequivocally do not qualify as a real estate enterprise under the safe harbor. Once the taxpayer chooses the grouping to define the enterprise, the grouping cannot be changed unless there is a significant change in facts and circumstances. The taxpayer must maintain separate books and records to reflect income and expenses for each enterprise.

### 250 Hours

The second requirement to qualify for the safe harbor is that the taxpayer must perform 250 hours or more of “rental services” with respect to the enterprise, for taxable years prior to 2023. For tax years 2023 and beyond, taxpayers must have 250 hours or more of rental services for 3 of the past 5 consecutive years (or in each year if the enterprise has been held less than 5 years).

Rental services include: advertising to rent or lease the real estate; negotiating and executing leases; verifying information contained in prospective tenant applications; collection of rent; daily operation, maintenance, and repair of property; management of real estate; purchasing materials; and, supervising employees and independent contractors.

Rental services do not include: arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing or

contracting long term capital improvements; or travelling to/from the real estate enterprise.

The rental activities can be performed by the owner and/or employees, agents, or independent contractors of the owner.

#### *Contemporaneous Records*

The final requirement under the Notice to qualify for the safe harbor is to maintain contemporaneous records, including time reports, logs, and similar documents with regard to hours of services performed; description of services performed; dates the services were performed; and, who performed the services. The contemporaneous records requirement must be maintained for tax years 2019 and forward to meet the safe harbor, since the Notice was not published until January 2019. For tax year 2018, contemporaneous records are not required but taxpayers must still meet the 250-hour requirement and sign a statement under penalty of perjury on the tax return that the taxpayer met such standards.

This seems to imply that unless the taxpayer can meet the 250-hour requirement solely by his own efforts, landlords should be requesting detailed invoices from all contractors and employees showing the hours worked, description of the services, dates performed, etc. The Notice does not restrict the definition of an agent or independent contractor, so that would presumably include everyone from the property manager, to the weekly gardener, to the plumber who fixes a leaky pipe. Taxpayers who think they may qualify for the deduction should begin this detailed recordkeeping immediately since the recordkeeping requirement is contemporaneous and 2019 is already underway.

#### **Exclusions**

As mentioned previously, triple net leases do not qualify as a trade or business for purposes of the safe harbor; they may still qualify as a trade or business under IRC Section 162. Also, any property used by the taxpayer as a residence for any part of the year under IRC Section 280A is ineligible under the safe harbor.

#### **Claiming the Safe Harbor**

In order to claim the safe harbor, the taxpayer must include a statement attached to the return specifying that the requirements have been met. This statement must say, "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete." The individual(s) signing the statement must have personal knowledge of the facts and circumstances related to the statement.

#### **Losses**

Previously disallowed losses including suspended

passive activity losses are taken into account in calculating qualified business income so long as the losses were incurred in tax year 2018 or after. Disallowed or suspended losses are deducted on a first in, first out basis. Therefore, if the taxpayer wishes to deduct a loss in 2018 or after that was generated in a year before Section 199A was instituted (2017 and prior), the loss will not offset qualified business income for the Section 199A calculation. However, if the taxpayer wishes to deduct a loss that was generated in a year in which Section 199A was in effect (2018 through 2025), such loss will offset qualified business income for the Section 199A calculation in the year the taxpayer is actually deducting the loss. See Regulation 1.199A-3(b)(1)(iv) and Proposed Regulation REG-134652-18.

#### **Entities**

Entities that hold rental properties must undergo the same analysis as outlined above and then report to the ultimate taxpayer (individual, trust, or estate) on a Schedule K-1 whether it was engaged in a qualified trade or business. The K-1 must also report each owner's allocable share of any qualified business income, wages, and unadjusted basis of depreciable assets to compute the deduction. The test for whether an entity which holds real estate meets the safe harbor is at the entity level. See Regulation 1.199A-6. It would follow, therefore, that the combined efforts of partners/members, agents, employees, and contractors of the entity need to meet the 250-hour requirement, rather than each partner/ member individually.

#### **Conclusion**

Section 199A is complex and has many moving pieces. Although the safe harbor relating to rental real estate is cumbersome, it provides helpful guidance in an otherwise gray area. Taxpayers who own rental real estate should immediately make sure their recordkeeping meets the safe harbor requirement if they think they may qualify for the deduction. ☘

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