taxnotes federal

Volume 168, Number 12 ■ September 21, 2020

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Reprinted from *Tax Notes Federal*, September 21, 2020, p. 2193

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In this article, the authors explain why the *Microsoft* court was incorrect in characterizing a cost-sharing arrangement as a tax shelter, and they explore the potential implications of the court's decision.

Hold on a second. *Cost sharing is a tax shelter?* For over five decades, cost sharing has been a transfer pricing structure endorsed by Congress, regulated by Treasury and the OECD, agreed to by the IRS and foreign tax authorities alike, and widely embraced by taxpayers. How can it be a "tax shelter"? And yet that is precisely the headline from a recent district court decision in the Western District of Washington.

How did this happen? Is it right? And should we, as taxpayers, be worried about the reach of this holding somehow expanding to other tried-and-true vehicles similarly embraced by the tax law? This article explores those points.

I. The Taxpayer's Case

The case is *Microsoft*,[1] a summons enforcement action stemming from the IRS's audit of the taxpayer's tax returns for 2004-2006. The IRS sought files from both the taxpayer and its tax adviser, KPMG LLP, related to a cost-sharing arrangement (CSA) between the taxpayer's domestic and Puerto Rican subsidiaries. The taxpayer withheld 174 documents related to the CSA and claimed tax practitioner privilege under section 7525 on the majority of the withheld documents.

After an *in camera* review, the district court denied the taxpayer's tax practitioner privilege claims and compelled it to produce all but a few documents.[2] The court addressed several ancillary arguments, but most notable was its finding that the taxpayer's CSA fell within the tax shelter exception to the tax practitioner privilege under section 7525.

In reaching its decision, the court rejected the taxpayer's claim that it entered the CSA to replace annual disputes over its licensing arrangements. The court reasoned that tax savings appear to have driven the decision-making process, because the CSA would have no real "impact on how customers were served."[3] Thus, the court found that there was no business purpose for why the taxpayer needed or wanted this arrangement.

[1] *See* Order, *United States v. Microsoft Corp.*, No. 15-102, at ECF No. 187 (W.D. Wash. Jan. 17, 2020).

[2] *Id.* at 20.

[3] *Id.* at 16.

The court's premise that transactions must affect how customers are served in order to avoid being characterized as tax shelters is without support in the statute. Had the court applied the correct standard[4] instead of this misguided one, it likely would have reached a different result and protected the documents as privileged.

II. Tax Shelter Under Section 7525

Section 7525 extends the same protection of the attorney-client privilege to tax advice communicated between a taxpayer and any federally authorized tax practitioner.[5] But, like some exceptions to the attorney-client privilege, section 7525(b) provides that the tax practitioner privilege will not apply to any written communication in connection with the promotion of any tax shelter (as defined in section 6662(d)(2)(C)(ii)).[6] In turn, section 6662(d)(2)(C)(ii) defines a tax shelter as a transaction for which a significant purpose is the avoidance or evasion of federal income tax.[7] No regulation or IRS guidance under section 6662(d)(2)(C)(ii) or section 7525 further defines this standard. But reg. section 301.6111-2(b) does, and, for the reasons that follow, it is applicable to the meaning of tax shelter under these sections.

A. Sections 6111 and 6662

Congress enacted both section 6662(d)(2)(C)(ii) and the former section 6111(d)[8] in the Taxpayer Relief Act of 1997.[9] Sections 6111(d) and 6662 have the same definition of tax shelter: transactions for which "a significant purpose" is the avoidance or evasion of federal income tax. But more than just the mirrored language, all the relevant sources of legislative history and several canons of construction show that the term "tax shelter" must be interpreted the same under these sections.

Courts commonly refer to conference reports as the most persuasive evidence of congressional intent besides the statute itself.[10] In this case, the 1997 act's conference report explains that a previous version of the bill defined a tax shelter under section 6662 as an entity whose *principal purpose* is the avoidance or evasion of tax,[11] but that in a late amendment, Congress changed "principal purpose" to "significant purpose" to conform the definition of tax shelter in sections 6111 and 6662.[12]

Moreover, basic canons of construction support that "tax shelter" must be interpreted the same under these sections. First, the Supreme Court has repeatedly held that "identical words used in different parts of the same act are intended to have the same meaning."[13] And Treasury and the IRS are obligated to interpret section 6662 as they interpreted this language under reg. section 301.6111-2(b). Courts have held that only when two or more statutory provisions in the same statute do not stand *in pari materia* (that is, relate to the same subject or object) may an agency interpret a common term differently in each provision.[14] But sections 6111 and 6662 clearly are *in pari materia* because Congress explicitly conformed the definition of tax shelter in one section to that in the other. Thus, the U.S. District Court for the Western District of Washington should have used the definitions in this regulation to interpret the meaning of tax shelter as it applies to the tax practitioner privilege.

B. Reg. Section 301.6111-2(b)

Reg. section 301.6111-2(b) determines which transactions are tax shelters by defining those that

[4] The taxpayer pointed to the correct standard to apply. Microsoft's Reply Brief Regarding Privileged Documents Still in Dispute at 5-6, *Microsoft*, No. 15-102, ECF No. 170. An amicus brief submitted in the case, which the court declined to admit, identified this standard as well. *See* Brief of Amici Curiae Silicon Valley Tax Directors Group et al., *Microsoft*, No. 15-102, ECF No. 165 (attachment to order).

[5] Section 7525(a).

[6] Section 7525(b).

[7] Section 6662(d)(2)(C)(ii).

[8] The American Jobs Creation Act of 2004 removed section 6111(d).

[9] Section 1028 of the Taxpayer Relief Act of 1997.

[10] *See Davis v. Lukhard*, 788 F.2d 973, 981 (4th Cir. 1986); and *Demby v. Schweiker*, 671 F.2d 507, 510 (D.C. Cir. 1981); *see also* 2A Sutherland Statutory Construction section 48:8 (2019).

[11] H.R. Rep. No. 105-220, at 542 (1997) (Conf. Rep.).

[12] *Id.*

[13] *Atlantic Cleaners & Dyers Inc. v. United States*, 286 U.S. 427, 433 (1932); *see also Sorenson v. Secretary of Treasury*,475 U.S. 851, 860 (1986); and *Ortiz-Santiago v. Barr*, 924 F.3d 956, 962 (7th Cir. 2019).

[14] *See, e.g., Common Cause v. Federal Election Commission*, 842 F.2d 436, 441-442 (D.C. Cir. 1998); and *National Association of Casualty & Surety Agents v. Board of Governors*, 856 F.2d 282, 287 (D.C. Cir. 1988).

have the avoidance or evasion of federal income tax as a significant purpose. It describes two types of transactions that meet this standard: Reg. section 301.6111-2(b)(2) refers to listed transactions that the IRS has identified in published guidance, and reg. section 301.6111-2(b)(3) refers to "other tax-structured transactions." A transaction falls into the latter category if (1) it has been structured to produce federal income tax benefits that constitute an important part of the intended results, and (2) the tax shelter promoter reasonably expects the transaction to be presented in the same or substantially similar form to more than one participant.

Clearly, CSAs are not listed transactions under published IRS guidance. Whether CSAs are the type of transactions that may be structured to produce impermissible tax benefits to multiple participants, the regulations provide further clarification. Namely, reg. section 301.6111-2(b)(3) excludes from the definition of tax shelter any transaction for which the promoter reasonably determines (1) that the potential participant is expected to enter into the transaction in the ordinary course of its business in a form consistent with customary commercial practice and (2) that there is a generally accepted understanding that the expected federal income tax benefits from the transaction are properly allowable under the code for substantially similar transactions. As discussed in the next section, CSAs are not tax shelters under this definition because they are a way to account for a fundamental aspect of ordinary multinational business, and they are congressionally approved and regulatorily mandated quasi-safe harbors that have existed for more half a century.

III. 'Ordinary Course,' Long Accepted

A. Ordinary Course of Business

Most businesses develop some form of intangible property, whether it is legally registered intangibles — like patents, copyrights, or trademarks — or the more amorphous intangibles — like manufacturing know-how, marketing intangibles, workforce-in-place, goodwill, and going concern value.[15] Intangibles can have a profound financial effect on a business at both the front-end (development) and back-end (exploitation) stages. These impacts can be particularly complex for a multinational organized as a group of commonly controlled companies operating in multiple countries.

On the front end, for some businesses intangible property development is simple and discreet: An idea begets a commercially viable invention, and nothing further is required. In most cases, however, development is more involved, requiring months or years of trial and error and massive outlays of cash.[16] What's more, once development is successful, many businesses are required to continue to improve their products through post-commercialization research and development efforts that may extend in perpetuity.[17] In all cases, the company needs to make business decisions about whether to conduct specific R&D activities and how to pay for them.

R&D funding decisions include deciding whether the company wants to self-fund intangible property development or seek funding from outside capital sources or its affiliates — and these decisions have an undeniable business impact. For example, the OECD has noted that purely centralized research labs may generate intangible property that at times is difficult for companies to capitalize on, and, of course, it can be costly.[18] So companies have consequential business decisions to make, including whether to (1) source funding from product and geographical divisions to receive input linked closer with customers or (2) enter joint ventures or broader corporate venture capital funds with unrelated parties.[19] The OECD has also noted that co-development options with unrelated parties may reduce internal resource commitment, but it also entails a transfer of R&D to performers outside the company, which may affect how ideas

[15] *See* former section 936(h)(3)(B).

[16] *See* OECD and European Commission, "World Corporate Top R&D Investors: Shaping the Future of Technologies and of AI," at 8 (2019) (stating that in 2016 the top 2,000 R&D investors spent a total of €742 billion); and Gary P. Pisano and Steven C. Wheelwright, "The New Logic of High-Tech R&D," 73 *Harv. Bus. Rev.* 93 (Sept.-Oct. 1995).

[17] Pisano and Wheelwright, *supra* note 16.

[18] OECD, "Changing Strategies for R&D and their Implications for Science and Technology Policy," at paras. 9 and 10 (2001).

[19] *Id*. at paras. 9, 10, 16, and 17.

flow through a business.[20] Thus, many companies opt to seek funding from foreign affiliates, which can reduce the use of internal domestic resources, create more links and input from customers in relevant geographical markets, and keep all R&D within an affiliated group.

At the back end, once the development of intangible property has been fruitful, the company needs to decide how it wants to exploit that property using related or unrelated enterprises. And because intangible property is the main source of many companies' enterprise value, the stakes can be extremely high. To the extent a multinational opts to use affiliated companies to exploit its intangibles globally, it may enter into one of only a few types of transactions that allow other entities to gain access to its intangible property. For example, it may enter into an outright transfer of the intangible property across jurisdictions or license it to an affiliate.[21] But these transactions can trigger large amounts of gain or income to the intangible property developer as that property is transferred or exploited. Moreover, disputes with tax authorities over the right compensation for the intangible property developer are common, as shown by numerous Tax Court cases, such as *Seagate* and *Medtronic*.[22]

Cost sharing, on the other hand, presents an alternative by which two or more affiliates may be deemed co-owners of intangibles with non-overlapping subdivided rights, such as separate rights to exploit the intangible property in different geographic markets,[23] as long as they share in the expenses of the intangible property development on the front end. Cost sharing over a long period can be particularly attractive in certain instances, such as in the software industry, in which the intangible property must be continuously developed in order to retain value.[24] Finally, cost sharing is regularly considered less contentious and leads to less costly disputes than licenses and royalties.[25]

Simply put, conducting and funding R&D are fundamental activities that take place in the ordinary course of business across industries. And a CSA is one of just a few vehicles for companies to carry out these essential activities.

B. 50-Year-Old Quasi-Safe Harbor

The Western District of Washington seems to have viewed CSAs as some sort of clever gimmick devised by sneaky tax advisers to exploit unforeseen loopholes to the great surprise and dismay of the government. But in fact, CSAs have been expressly sanctioned and even encouraged by the government as legitimate transactions under the statutory framework of section 482.

Treasury and the IRS have recognized and embraced CSAs for over 50 years in order to provide certainty to the government and taxpayers on how to treat the complex set of economic transactions necessary to develop multinational intangible property. In the past, Treasury has gone so far as to call CSAs a "safe harbor,"[26] but more recently it has retreated from that moniker. Yet it has never abandoned one safe-harbor-like aspect of CSAs: If taxpayers enter a bona fide or qualified CSA and share front-end development expenses as required by the regulations, the IRS must respect the existence of the CSA and may only adjust specific allocations used in the agreement while treating the cost-sharing participants as owners of the intangible property on the back end.

In 1966 Treasury first proposed regulations that allowed related parties to enter bona fide CSAs for the development of intangible property.[27] The first sentence of this new standard stated, "The district director shall not make allocations with respect to [the acquisition of intangible property under a CSA] except as may be appropriate to reflect a full share of the costs and risks of developing the property."[28] So from

[20] *Id.* at paras. 13 and 17.

[21] Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 386 n.1766 (Dec. 20, 2018).

[22] *See, e.g.*, *Seagate Technology Inc. v. Commissioner*, 102 T.C. 149 (1994); and *Medtronic v. Commissioner*, T.C. Memo. 2016-112, *vacated*, 900 F.3d 610 (8th Cir. 2018).

[23] *See* reg. section 1.482-4(f)(3)(i).

[24] *See* Order, *supra* note 1, at 16.

[25] American Electronics Association, "Comments on the Proposed Regulations on the Treatment of Employee Stock Options for Qualified Cost Sharing Arrangements," at 2 (Oct. 28, 2002).

[26] Preamble to T.D. 8632, 60 F.R. 65553, 65555 (Dec. 20, 1995).

[27] *See* former prop. reg. section 1.482-2(d)(4), 31 F.R. 10394, 10399 (Aug. 2, 1966).

the start, the IRS has been bound to respect the form of CSAs once a taxpayer has elected to enter one. In 1968 Treasury finalized those regulations.[29] Ultimately, the final regulations were much shorter than those originally proposed, but even those final regulations contained the edict that the IRS must respect the form of CSAs once elected.[30]

The 1968 final regulations remained unchanged for over 25 years.[31] During that span, both the United States and foreign governments approved of CSAs. In 1979 the OECD recognized the internationally accepted nature of the U.S. CSA regulations. It stated in its first transfer pricing report that experiences with CSAs were positive and that "no greater danger of tax avoidance is seen through cost sharing arrangements than through any other type of intra-group transaction."[32] In 1984 Congress endorsed the use of CSAs and explained that it purposefully excluded them from the newly enacted section 367(d) tax on outbound transfers of intangibles.[33] Congress also stated in the conference report to the Tax Reform Act of 1986 that CSAs satisfy the commensurate with income standard and that it did "not intend to preclude [their] use."[34]

In its ubiquitous 1988 white paper, "A Study of Intercompany Pricing," the IRS cited Congress's approval of CSAs and also noted that the agency was bound to respect the form of the agreements.[35] Similarly, the 1992 proposed regulations provided that the IRS could make only three specific adjustments within qualified CSAs.[36] In 1995 Treasury finalized those CSA regulations, and in the preamble it specifically called qualified CSAs a "safe harbor."[37] Treasury stated that it promulgated parts of reg. section 1.482-7(b) "to ensure that [CSAs] will not be disregarded by the IRS as long as the factors upon which an estimate of benefits was based were reasonable, *even if the estimate proved to be inaccurate*."[38] (Emphasis added.)

In 2005 Treasury proposed new regulations that arguably reigned in CSAs' safe harbor status.[39] The preamble stated that CSA transactions must produce results consistent with the arm's-length standard to "dispel the misconception that cost sharing is a safe harbor."[40] But in reality this was not a change because since at least the white paper, Treasury and the IRS had repeated that if a CSA is not bona fide or qualified, the IRS may make any adjustments to the transactions under other transfer pricing regulations.[41] Most importantly, the proposed regulations did not abandon the safe-harbor-like aspect of qualified CSAs and repeated that the commissioner *must* treat the arrangement as a CSA if the taxpayer reasonably concluded the arrangement to be one.[42]

The 2008 temporary regulations, the 2011 final regulations, and all later revisions have not expanded or repeated the claim that CSAs are not safe harbors or that they are products of disfavored regulations.[43] The history of CSAs shows that Treasury, the IRS, and even Congress do not consider them to be a tax shelter, abusive, or evasive. So even if the estimates on which thetaxpayer based its CSA were inaccurate, under the explicit terms of the regulations, the

[28] *Id.* at 10399.

[29] *See* 33 F.R. 5848 (Apr. 16, 1968).

[30] *Id.*

[31] Treasury replaced the 1968 regulations with proposed regulations in January 1992 (INTL-0372-88 and INTL-0401-88, 57 F.R. 3571 (Jan. 30, 1992)) that it finalized in December 1995 (T.D. 8632).

[32] OECD, "Transfer Pricing and Multinational Enterprises," at para. 109 (1979).

[33] *See* JCT, "General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984," JCS-41-84, at 433 (Dec. 31, 1984). In 1982 Congress also added a statutory cost-sharing provision into section 936. *See* section 213 of the 1982 Tax Equity and Fiscal Responsibility Act.

[34] H.R. Rep. No. 99-841, at II-638 (1986) (Conf. Rep.).

[35] Notice 88-123, 1988-2 C.B. 458, at 495 (white paper).

[36] *See* preamble to INTL-0372-88 and INTL-0401-8857, 57 F.R. at 3576; *see also id.* at 3597 and 3600; and former prop. reg. section 1.482-2(g)(4)(ii)(C) and (g)(5) (1992).

[37] 60 F.R. at 65555.

[38] *Id.*

[39] REG-144615-02, 70 F.R. 51116 (Aug. 29, 2005).

[40] *Id.* at 51128.

[41] The white paper, *supra* note 35, and the 1992 proposed regulations contain statements similar to those in the 1995 final CSA regulations, which provide that if the IRS determines a CSA is "materially greater or lesser than its share of reasonably anticipated benefits," the IRS may disregard the terms of a CSA and make adjustments under the general transfer pricing regulations in reg. section 1.482-1 and -4 through -6. 60 F.R. at 65564.

[42] *Id.* at 51121.

[43] T.D. 9441 (2008 temporary regulations); T.D. 9568 (2011 final regulations, as amended by 77 F.R. 3606 (Jan. 25, 2012) and 77 F.R. 8144 (Feb. 12, 2012)); T.D. 9569 (2011 temporary regulations); and T.D. 9630 (2013 final regulations, as corrected by 78 F.R. 62426 (Oct. 22, 2013)).

arrangement must be respected by the IRS, and the IRS may only make adjustments to the terms of the CSA.

IV. True Tax Shelter Transactions

Beginning with the Taxpayer Relief Act of 1997, Congress, Treasury, and the IRS focused on corporate tax shelters at the turn of the millennium in several ways.[44] In part, this initiative was driven by a desire to provide more uniformity to the ad hoc approach courts had taken.[45] Over the years, courts had developed several overlapping judicial doctrines to deny tax shelters their intended tax benefits: the business purpose doctrine, the economic substance doctrine, the sham transaction doctrine, the substance-over-form doctrine, and the step transaction doctrine.[46] The doctrines have many similarities, but most defining is that once a court deems a doctrine to apply, the form of a transaction is not respected, and it is either recast or disregarded entirely.

For example, courts frequently have applied the traditional business purpose doctrine — which is not to be confused with the version from the Western District Court of Washington — as part of the following two-prong test for determining whether a transaction should be disregarded for tax purposes: whether (1) the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering the transaction, and (2) the transaction lacks economic substance. In essence, a transaction will be respected for tax purposes only if it has economic substance that is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features with meaningless labels attached.[47] Clearly, as discussed earlier, a CSA meets this standard because decisions on how to conduct and fund R&D have economic substance and are not shaped solely by tax avoidance features.

But authorities became impatient waiting for cases to make their way through the courts, so they pushed for a more proactive approach. To this end, the IRS established the Office of Tax Shelter Analysis to quickly and effectively identify and respond to tax shelter transactions used by taxpayers to claim benefits not properly allowable under the code.[48] To date, that office has identified 36 listed types of tax shelter transactions. Of course, CSAs are not a listed transaction, even though their use far predates the list's publication. And when compared with the transactions on that list, it is clear why CSAs are not included.

Consider a classic listed transaction tax shelter like the son-of-BOSS shelter. There are several variations, but the essential elements include a series of prearranged transactions that create an artificially high basis in a partnership interest.[49] For example, a tax shelter participant might short U.S. treasury notes and contribute both the proceeds and the obligation to eventually close the short sales to a partnership, which results in a net zero economic result for the contributor. The tax shelter participant and the partnership then assert that the proceed contribution increased the partner's outside liability but that, because of the obligation's uncertainty, it is not a liability for purposes of section 752, and that the future obligation does not correspondingly decrease the partner's outside basis. This results in a large artificial increase in outside basis that will ultimately allow the partner to claim large — but not out-of-pocket — losses on the partner's individual tax returns.[50]

Unlike the son-of-BOSS transaction, a CSA has at least two very real and undeniable economic consequences. First, an entity receives non-overlapping rights to exploit specified intangible property. Next, the entity pays for those rights through a platform contribution

[44] *See, e.g.*, Treasury, "The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals" (July 1999); and JCT, "Study of Present-Law Penalty and Interest as Required by Section 3801 of the IRS Restructuring and Reform Act of 1998 (Including Provisions Relating to Corporate Tax Shelters)," JCS-3-99 (July 22, 1999).

[45] *Cf.* JCS-3-99, *supra* note 44, at 186.

[46] *Id.* at 195.

[47] *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *cf. Esmark Inc. v. Commissioner*, 90 T.C. 171, 198 (1988), *aff'd without published opinion*, 886 F.2d 1318 (7th Cir. 1989).

[48] Announcement 2000-12, 2000-1 C.B. 835, at 836.

[49] *See Endeavor Partners Fund LLC. v. Commissioner*, T.C. Memo. 2018-96, at *6 n.3.

[50] *See American Milling LP v. Commissioner*, T.C. Memo. 2015-192, at *2 n.2.

payment and through further development costs proportionate with its reasonably anticipated benefits. Finally, as with all tax shelters, courts entirely disregard son-of-BOSS transactions.[51] But, as discussed, the IRS is required to respect the form of CSAs. Therefore, CSAs do not pass a common-sense test of whether they are tax shelters.

V. Taxpayer Take-Aways

Given the historical backdrop of CSAs and tax shelters, and the common use of CSAs as a solution for making important R&D funding business decisions within a multinational enterprise, the outcome of the *Microsoft* decision is bizarre to transfer pricing practitioners. The court's odd conclusion that transactions that do not affect the way "customers are served" are shelters has seemingly endless applications, because so many tax and financing transactions do not affect customers. Check-the-box elections; tax-free reorganizations; spinoffs; debt or equity decisions; like-kind exchanges; and partnership formations, contributions, and withdrawals — to name a few — have nothing at all to do with how customers are served. But surely no one views these as on par with son-of-BOSS transactions.

The court's analysis and conclusion are not supported by any applicable authority. First, they conflict with the relevant definition of tax shelter under reg. section 301.6111-2(b), because CSAs are entered into in the ordinary course of business, and there has been a generally accepted understanding of their benefits for over half a century. Further, the court's analysis is inconsistent with all existing judicial doctrines applicable to tax shelters, and CSAs clearly have real economic substance. Finally, CSAs cannot just be disregarded because of their quasi-safe-harbor status, so they are simply incompatible with tax shelters.

VI. Conclusion

It is often said that bad facts make bad law. That may have been the case here. The judge reviewed the documents *in camera*, and we can only speculate that he saw something unfortunate that colored his analysis of the issues. Or perhaps he lacked a proper foundation in the commonplace nature of transfer pricing and the long history of cost sharing as a government-recommended tool to accomplish a legitimate business objective. Either way, for reasons discussed earlier, the decision should not prevent other taxpayers from making tax practitioner privilege claims in connection with advice received related to structuring and defending CSAs or their related buy-in payments. ■

[51] *See, e.g.*, *CNT Investors LLC v. Commissioner*, 144 T.C. 161 (2015); *Endeavor Partners Fund*, T.C. Memo. 2018-96; and *Greenberg v. Commissioner*, T.C. Memo. 2018-74.